Best Ideas – Method to the Madness, or Just Madness

The year 2018 was marked by wild swings in the markets with few of the "experts" being able to understand, let alone call the market trends and turns. Our view is that few understand that the old rules have changed as a result of the efforts of the current administration and that a new understanding is needed for proactive investors. Listed below are some of the major shifts:

Washington Shutdown – Even after the government re-opens, it is likely to remain paralyzed as the House of Representatives is unlikely to pass any substantial legislation the White House wants, and the White House is unlikely to sign anything the House of Representatives passes. The Mueller investigation will continue but the report is unlikely to change much. Likewise, while some presidential hopefuls will talk of impeachment, given the disaster the Republicans faced post President Clinton's impeachment, Nancy Pelosi is unlikely to allow it to happen. Hence, by default, the current administration is likely to focus on those areas where congressional support is not needed and gearing up for the 2020 campaign. The major item in 2019 and 2020 will be the extent to which the Democratic party will move to the left and like the Tea Party movement of the Republicans a few years ago, whether it will undermine mainstream support.
EJR's Commentary – Inaction in Washington is not necessarily a bad thing. However, the power of Washington is immense and needs to be monitored. The fight between Mr. Trump and the Washington status quo is likely to continue for the foreseeable future. Democrats are searching for a lever to make Trump ineffective and Mr. Trump is continuing his pugilistic approach.

China Reset – unlike prior administrations, Mr. Trump is attempting to reset the US's relationship with China and in the process is triggering major angst. The current administration is challenging China-based technology firms such as Huawei, questioning the security of the tech sector's supply chain, objecting to the technology transfers, rejecting unequal tariffs and challenging the newly-created islands in the South China Sea. President Xi is hoping to wait out the current administration, but a strong Democratic challenger has yet to emerge.
EJR's Commentary – This multi-faceted fight is likely to have a massive impact on global markets, particularly if it spins out of control. Our view is the Mr. Trump will garner a few victories which he can tout on the campaign trail but that overall, little will change.

Maturity of the Recovery/ Pending Recession – an issue on most sophisticated investors' mind is whether we are due for a recession, and if so, when it will occur and how deep it will be. The indications of concern are the flat and at times, inverted yield curve, the duration of the recovery, the rising indebtedness, and the impact of a withdrawal/ unwinding of the monetary easing. Additionally, the weakness in the capital markets might be an indication that a reversal is already upon us.

EJR's Commentary – There is little doubt that the current recovery is mature and that we are due for a correction. The difficult part has been and remains predicting the timing. We were bearish prior to the 2007 recession because of the lack of capital at the monoline insurance firms, Lehman and Bear. (The troubles in the housing market were related.) While the markets are becoming attenuated currently, we are far from the 2007 conditions. However, 2007 was unique and would have been a Depression if not for the massive money creation of the central banks. Controls are now in place limiting some of the central banks' flexibility. Hence, some vigilance is needed.

EU Ennui – the divorce between the UK and the EU is progressing and the upshot is likely to be some restructuring struggles. Meanwhile, Italy is questioning its continuation in the Union and Turkey is seeking compensation for the refuges. While the Greece problems have been announced as solved, we have our doubts. Perhaps the most relevant item for financial watchers is he supposed exit of the ECB from quantitative easing.
EJR's Commentary – The EU will continue its troubled ways for the foreseeable future and Germany will provide just enough support to keep the confederation going. Germany will become stronger and France will become a concern over time.

The New Economic Miracles – while focus is on old, hackneyed problems, the more interesting and probably profitable development is the emergence of new economic powers (we will develop this theme more completely in future monthly reports). Suffice to say, many regions are anxious to garner the success realized by the developed countries and will make major strides over the next decade.

The Middle East Miasma – The murder of Khashoggi has hamstrung relations with Saudi Arabia in the short run but the reality is that the US is less dependent on the Middle East for energy.
EJR's Commentary – The area will remain problematic but will muddle through.

Pension Pandemonium – with the continued growth in selected municipality and state budget deficits and pension shortfalls, it is only a matter of time before restructuring is needed.
EJR's Commentary – While the above is true, several municipalities have restructured, and the markets have taken it in stride.

North Korea Knockabout – it is easy to forget but North Korea is no longer on the front-page item and the latest is a summit with Kim and Trump.
EJR's View – Mr. Kim is trying to find the right path forward. We expect some low-level agreement and a moderate level of tension soon.

Back to the macro view, we do not see a material threat to the current conditions for the next 12 to 18 months. Below is a summary of our expectations for the various economies:

Figure I: Summary of EJR Economic Expectations

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	+1.0%	+1.5%	+3.0%	+3.5%	3.5%
Currency Values	Decline	Mixed	Rise	Mixed	Mixed
Stimulus Change	Slight Deceleration	Slight Deceleration	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Slight Growth	Growth	Growth	Growth
Interest Rates	Low	Slight Rise	Slight Rise	Little Change	Varied
Asset Valuations	Improving	Varied	Varied	Varied	Slight Rise

Regarding interest rates, U.S. is raising interest rates. Hence, rates in the U.S. are likely to be higher because of the FED's action and increased demand, and on the other hand, most major non-U.S. economies are trying to maintain low interest rates. The periphery EU countries are likely to see continued pressure because of increased credit quality concerns.

Figure IV: Rising U.S. rates, Japan and Europe emerging periphery credit concerns

	5 year		10 year		30 year	
	Current (%)	Year End (%)	Current (%)	Year End (%)	Current (%)	Year End (%)
United States	2.50	2.6	2.67	2.8	2.99	3.20
Germany	-0.37	0.05	0.17	0.50	0.8	1.10
Italy	1.75	1.60	2.69	3.2	3.5	3.52
United Kingdom	0.83	1.23	1.21	1.65	1.77	2.05
Japan	-0.15	0.03	-0.01	0.20	0.71	0.88

Below are our expectations for major currencies:

Figure III: Currency

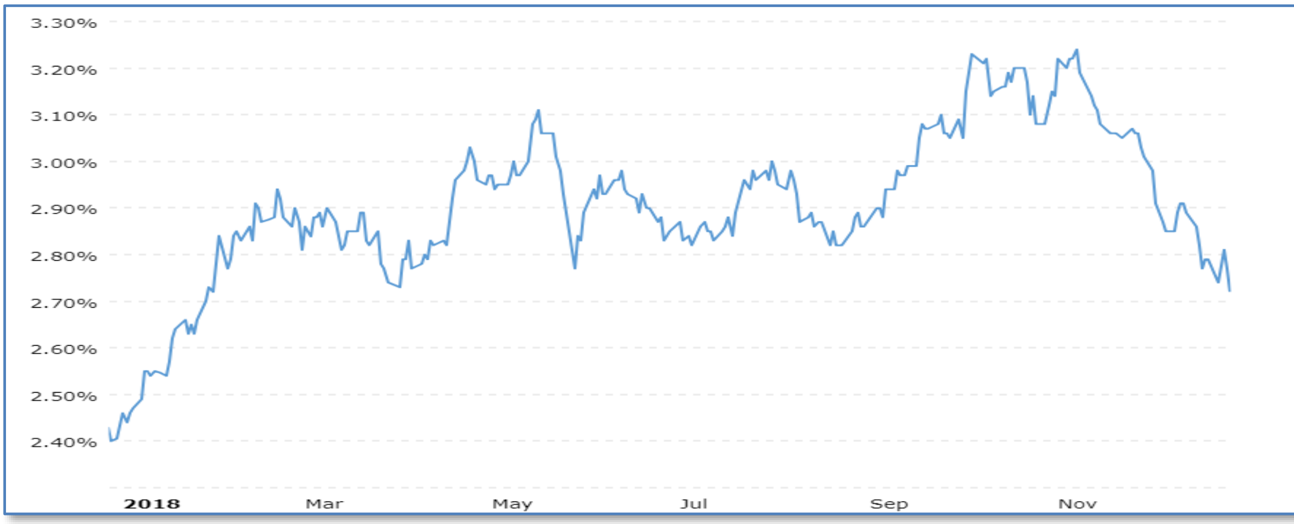
	Current	EJR Est. Year End
EUR-USD	1.1356	1.20
Yuan to Dollars	6.86 $/RMB	6.8 $/RMB
USD-JPY	109.29	110
GBP-USD	1.428	1.35

Some of the major drivers of the economy and our expectations for those drivers are:

- **Interest Rates –** the 10 year is near 2.7% with many calling for an end to the 30-year bull market in rates.

Prognosis – while interest rates edged up earlier this year, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (except for Germany) are concerned about fiscal deficits and therefore are likely to discourage a substantial rise in interest rates and sovereign funding costs.

Figure I: 10 Year US Treasury Yield



Source: macrotrends.net

Petroleum Prices – as can be seen in the chart below, petroleum prices have collapsed. While it is always difficult to divine the underlying causes of the petroleum prices, it appears that the supply is outrunning demand.

Prognosis – trade tensions and technology are conspiring to depress prices with the result being major angst among the totalitarian regimes.

Figure II: WTI – Recent Crude Oil Prices

Source: macrotrends.net

- **Central Banks' Money Creation –** the central banks of the developed countries have approximately $20 trillion in assets which have been used to suppress interest rates and support equity values. While the FED is no longer growing its balance sheet, other central banks are growing by approximately $300M per month. Such central bank support is historically rare and in our opinion is a major reason for the buoyant market.
  Prognosis – while numerous factions have argued against any quantitative easing, the central banks are now committed and unlikely to pull back any time soon especially with the high levels of debt to GDP for many sovereignties. Our view is that if there were a major setback in the markets, the central banks would re-engage.

Figure III: Five Year Forward Inflation Expectation %

Source: macrotrends.net

- **The Tax Act –** the corporate tax rate has been reduced from approximately 40% to 21% while depreciation allowances have been increased substantially. The net effect is approximately a 30% rise in a corporation's after-tax earnings.
  Prognosis – a 30% rise in earnings is massive (although not all corporations were taxed near 40%) and provides a huge stimulus to the economy.

- **Growth/ Stock Market Valuations –** the stock market has had an eight-year run with the normal concern that we are overdue for a downturn. However, from an earnings perspective, valuations do not appear to be too attenuated (see below).
  Prognosis – conditions have improved in most countries for economic expansion and perhaps we will see at least a couple more years of growth.

Figure IV: S&P 500 Price to earnings ratio

Source: macrotrends.net

- **Inflation –** most economic commentators have predicted that inflation would rise dramatically although to date, it has not. However, the tightening labor force is resulting in wage pressures.
  Prognosis – Our view is that inflation remains tepid and because of the use of technology and the ease of "transportation" via the internet and transit services.

Regarding various industries, below is a summary of some of the major developments:

Deteriorating:

Retail Reshuffling – Amazon (and other internet giants) has hastened the demise of many retailers but the internet model has its limitations. However, with the emergence of G5 wireless technologies, rapid manufacturing, and improve logistics, we can expect another round of reshuffling. With Sears and Toys R Us gone, watch for JC Penny to struggle and Wal-Mart to be pushed off its perch. Over time, we are likely to view retailing as solely a physical activity and that multi-channel will become essential.

Media – Netflix, other internet distributors, and non-traditional media outlets continue to dis-intermediate traditional media providers and cable firms. Watch Amazon's war with Netflix.

Note, print media continues to suffer.

Improving:

Banking – Higher interest rate and a normal yield curve should aid net interest margins. Reduced regulations should improve cost structures. The smaller banks are aided by the improved margins and the M&A upside.
Defensive Industries – Alcohol, tobacco, and defense are traditional defensive credits and continue to be so.

Healthcare – Hospitals will be hurt, but nearly every other area should see improvement.

Infrastructure – Watch for massive improvements for firms connected to building; an infrastructure act will enhance the gains.

Metals and Mining – Some have been given a reprieve as a result of increased demand, rising prices, and expectations of a more amenable regulatory environment.

Technology – While at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels.

Neutral

Airlines – The economic recovery, low fuel prices, effective capacity management have helped. However, the increased competition is likely to depress margins especially as load factors slip from record levels.

Autos and Auto Suppliers – With the exception of Volkswagen, most of the auto industry has prospered over the last couple of years. Watch for new car sales, used car prices, and weaker profitability as used car inventories are at all-time high. Electric autos will threaten revenues and margins for traditional internal combustion engine vehicles,