Best Ideas – Be Careful What You Wish For

July 2017

The central banks have succeeded beyond normal expectations and are now faced with the consequences of their "success."

A major goal of most adults is to save enough for retirement. Unfortunately, with global risk-free interest rates near zero (or less in some countries), realizing that goal is becoming increasingly elusive. Assuming a risk-free 10 year treasury rate of 2.2%, yielding $50K pretax through 10 years of retirement requires $444K upon retirement. Given the fact that most adults aim to enjoy more than 10 years in retirement, required savings upon retirement may be closer to $1M. Unfortunately, the median savings for families headed by someone aged 56 to 61 is merely $17,000 according to the Economic Policy Institute. Hence, there is a major problem which is the flip side of central banks manipulating interest rates in an effort to pull their economies out of the 2007-2008 credit crisis. ***In short, while the lower interest rates boost asset prices, the amount of savings need to generate reasonable returns has substantially increased.***

Some of the manifestations of this disparity are the decline in consumer spending, a rise in savings, and a collapse in some of the pension funds which are having difficulty meeting their liabilities. Illinois, Puerto Rico, and Chicago's problems are likely to be followed by numerous others although the timing is often attenuated.

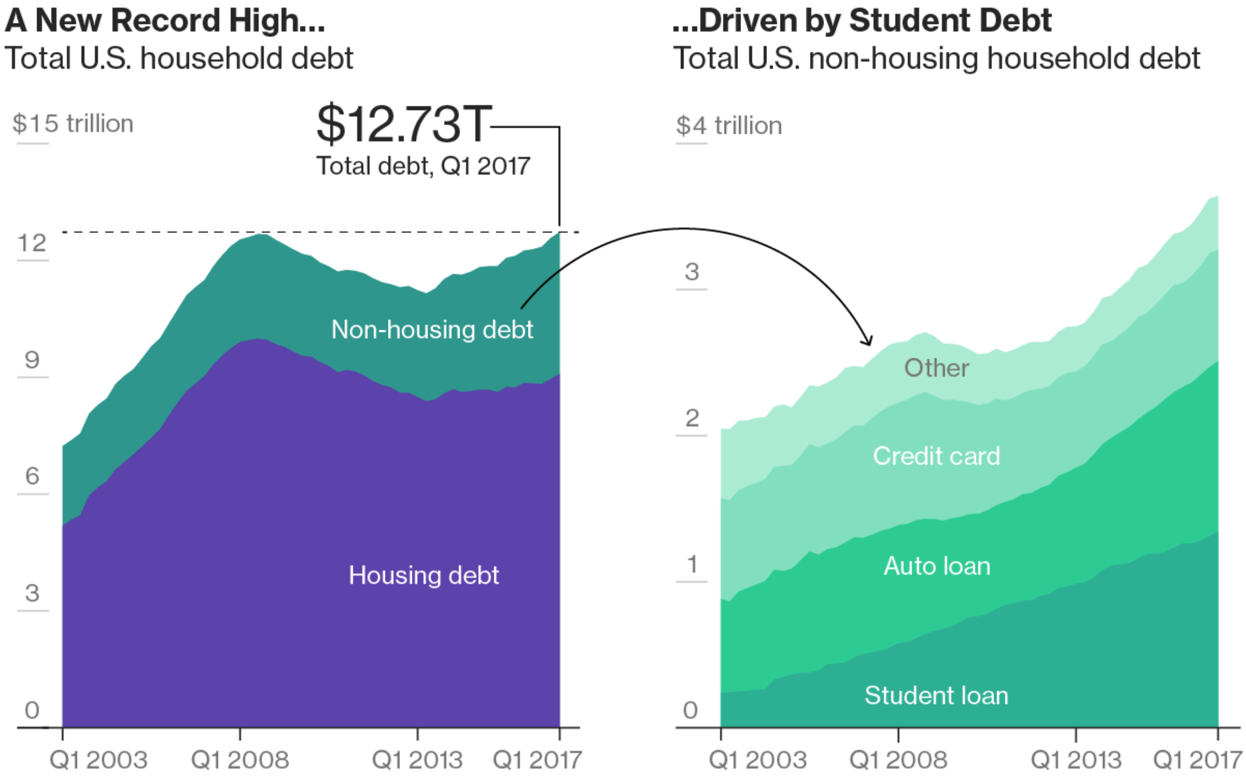
From an economic perspective, what are the implications? Before answering that question, perhaps it is useful to broaden our view from the individual and state level to the global level to include those who are often making decisions on interest rates, and that is the sovereignties themselves. Given the fact that sovereign indebtedness has risen dramatically, most major developed economies simply cannot afford a substantial rise in interest rates. If they cannot afford a rise, and they control overall interest rates via the treasuries (with the central banks buying those securities they want to suppress yields), our thesis is that the major developed countries will continue to attempt to depress interest rates. With the low rates, of course consumer spending will remain suppressed and potential retirees will remain potential retirees.

Median retirement account savings of families by age, 1989–2013 (2013 dollars)

	32–37	38–43	44–49	50–55	56–61
1989	$0	$542	$0	$1,808	$1,808
1992	$0	$812	$812	$2,275	$1,024
1995	$379	$2,429	$3,795	$7,589	$4,857
1998	$2,144	$7,148	$9,006	$8,291	$12,866
2001	$1,313	$6,566	$12,607	$14,445	$15,759
2004	$1,233	$3,699	$9,372	$12,331	$21,580
2007	$1,123	$5,951	$15,158	$26,386	$35,929
2010	$289	$1,929	$10,181	$13,932	$7,609
2013	$480	$4,200	$6,200	$8,000	$17,000

Source: http://www.epi.org/publication/retirement-in-america/#charts

Another problem is the debt overhang which can be seen by the below charts; the high debt levels are likely to suppress growth rates.



The economy is beginning to feel the insidious effects of unnaturally low interest rates (i.e., ZIRP or zero interest rate policy) which is being manifested via suppressed growth and serial restructurings in some sectors of the economy. (The adage that there is no free lunch applies.) ***Hence, even though the FED is no longer engaged in Quantitative Easing (i.e., purchasing securities) and raised short term rates several times, the 10 year Treasury has reached a recent low of 2.135% approximately a week ago. In our opinion, this is the result of low inflation and low growth expectations, and to a lesser extent, the continued quantitative easing of other central banks.***

Before moving on, there are a few additional developments worth covering

Trump's Troubles – although President Trump has hobbled himself via unorthodox communications, the sting of the investigations is fading and some progress on his initiatives is possible.

Dismal Energy Prices – fracking, horizontal drilling, and possibly peaking demand are weighing on petroleum prices, thereby pushing down expected trading ranges to $35 to $50 per barrel for WTI. Expect pain for the major offshore producers and others which are reliant on high prices such as the Middle East countries, Russia, and Venezuela.

Low-quality Employment – while the stated unemployment rate is low, many people are unsettled because of the dearth of solid (i.e., high-paying) employment opportunities and rising costs, particularly from health insurance. President Trump was able to connect with the disgruntled middle class and now is attempting the hard part, which is delivering on campaign promises.

Amazon Juggernaut – Amazon has a tendency of disrupting any business it enters and the grocery store industry is now in its sights. Our view is that its ambitions will continue and it is likely to enter other retail spaces including automotive retail over time.

Russia, Syria and North Korea – conditions in these areas appear to change on a daily basis. The hope is that the risks remain manageable.

Fannie/ Freddie – it is clear to most that Fannie and Freddie need to be restructured; the major problem is finding a workable structure. We expect a framework will emerge shortly and the two will be eased from most government support with the result being a substantial rise in funding costs. (The activities of the two could be curtailed to focus on the direst problems in the housing market).

Waffling UK – financial services are critical for the UK and if Brexit occurs (note, the likelihood of a full exit has declined with May's poor election results), the UK's position in financial services is likely to decline.

The Italian Job – the rules for bank bailouts in the Southern European countries are becoming increasingly clear: there are no rules. An alternative interpretation is that the real rules are whatever works from a political perspective, which is yet again, protecting the retail investors and senior bondholders and let the taxpayers fund the bailout. The market's surprise was the wipeout of the Coco bonds which were good until they were not good.

Restructuring Japan – Japan's 250% debt to GDP will have to be addressed at some point; issue is when and how. We expect that as Japan's current account and balance of payments turns negative, some adjustments will be required.

Greece Yo-yo – Greece and the EU apparently have become experts at serial negotiations swinging between depressive and manic stages with no real solution being reached. The fundamental problem is simple: Greece cannot pay its debts and the EU does not want to recognize losses. However, just as with a company stuck in restructuring limbo, there is a cost to Greece and its creditors in the form of higher administrative costs and increased uncertainty.

While the afore-mentioned issues are causes for concern, they are all manageable provided the central banks continue providing liquidity. The central banks' expansion of their balance sheets has been a driver of the markets for the past 7+ year and is likely to continue to provide support albeit at a lower level.

Positives – the major positive which has propelled the market since last Nov. and appear to be partially in place are the expected tax reforms, growth via the emerging markets, and a reduction in some regulatory costs.

Resulting Outlook – Despite all of the problems in the domestic and global economies, assuming the central banks remain vigilant, the domestic and global economy should be in decent shape. Both the U.S. and the emerging markets appear to be safe havens and despite uncertainty, Europe is bolstered by the high productivity of most areas other than Southern Europe. Japan is hobbled by massive debt and little growth, and China is in the midst of a redirection. Below is a summary:

Figure II: U.S. and Emerging Markets Expectation

	Japan	Europe	U.S.	China	Emerg Mrkt
Population Change	Decline	Decline	Slight Growth	Slight Growth	High
Productivity Growth	Low	Moderate	Moderate	Moderate	High
Govt Regulation	High	High	Material Reduction	Moderate	Low
GDP Growth	1.0%	+1.8%	+1.5%	+5.0%	+3.0%
Currency Values	Decline	Decline	Rise	Decline	Mixed
Stimulus Change	Same	Same	Decelerating	Some Growth	Little
Earnings Trend	Declining	Varied	Slight Growth	Varied	Varied
Perceived Safe Haven	Yes	Yes	Yes	No	No
Interest Rates	Low	Low	Slight Growth	Falling	Varied
Asset Valuations	Varied	Varied	Improving	Varied	Improving

From a credit quality perspective, we expect the environment to be fairly propitious for most U.S. credit.

Regarding interest rates, Europe and Japan are stuck with low growth and high debt levels and therefore have significant difficulty in raising interest rates. Meanwhile, the U.S. is raising interest rates. Hence, ST 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 under increasing pressure because of increased credit quality concerns.

Figure III: 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	1.92	1.95	2.35	2.38	2.86	2.90
Germany	-0.23	-0.10	0.47	0.55	1.27	1.33
Italy	0.84	0.9	2.15	2.19	3.30	3.33
United Kingdom	0.69	0.75	1.26	1.32	1.87	1.95
Japan	-0.069	-0.10	0.083	0.12	0.86	0.89

Below are our expectations for major currencies: the dollar is likely to be slightly stronger relative to other currencies because of the slight rise in interest rates and the possibility of additional increases.

Figure IV: U.S. dollar

	Current	EJR Est. Year End
Dollars to Euros	0.879 $/€	0.85 $/€
Dollars to Yuan	6.80 $/RMB	6.80 $/RMB
Dollars to Yen	112.21 $/¥	112.25 $/¥
Dollars to Pound	0.77 $/£	0.76 $/£

Deteriorating:

Retail Disaster – Amazon will destroy margins for any industries involved in selling goods, grocers, and over time, services. Nearly all the major retailers will be trading sideways at best for the next couple of years. A filing by Sears and JC Penney would not be a surprise and Macy's might slip from investment grade over the next couple of years. As expected, Walmart is having difficulty being competitive in the web market.

Media – Netflix, other internet distributors, and non-traditional media outlets continue to dis-intermediate traditional media providers and cable firms. Note, print media continues to suffer.

Improving:

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.

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, effective capacity management, and moderate fuel prices have helped. However, in the U.S., the rate of improvement is likely to slow down as margins and load factors slip from record levels. President Trump's immigration ban will likely affect major airlines in the short term.

<u>Autos and Auto Suppliers</u> – With the exception of Volkswagen and FIAT, most of the auto industry prospered over the last couple of years. The European producers are probably in the best shape because of the recent rise in the dollar and yen. Watch for new car sales, used car prices, and weaker profitability as used car inventory is at all-time high.

<u>Banking</u> – Reduced regulations should improve cost structures. The smaller banks are aided by the improved margins and the M&A upside. The flattening yield curve is concerning.

<u>US Manufacturing Exporters</u> – The softening U.S. Dollar against Yen, Euro, and Pound will level the playing field for domestic exporters. Watch for the economic growth prospect in U.S.