Best Ideas – Dysfunctional Administration or a Nascent Reset March 2017

Never in the history of the U.S. or any other major Western nation has the chief executive been at war with the media. The usual course is for the administration to take its lumps privately and attempt to build a better prospective working relationship. The current administration is taking a completely different tack: attacking the major media, calling it "fake news", excluding the major media from briefings, and bowing out of the annual press dinner. Adding to the discord are reports of contacts between the Administration and Russian officials. The controversy is noted on a daily basis in the major media, and as a result, to the casual observer, the administration appears to be dysfunctional. Mr. Trump appears to be continuing his attack on the major media initiated during his presidential campaign.

Regarding the alternative view, Mr. Trump campaigned (successfully it should be noted) as an outsider trying to reset conditions in the country. Mr. Trump is suggesting massive changes in nearly every area of the federal government and is incurring the wrath of those affected. The hope is that the structural changes the new administration is pursuing will enhance growth. Judging from the stock market over the past couple of months, investors are comforted by the early actions.

While the "noise" created by the conflict between the Administration and the major media is a distraction, from an investor perspective, it might help to focus on the likely outcomes. The themes which are driving the administration's actions are growth and assisting in wage growth for the middle class. A major manifestation of those themes is likely to be a reduction in the tax and regulatory burdens and a normalization of central bank/ FED policies. If successful, growth above 2+% per annum might be realized; both the equity and credit markets would welcome such growth. In general, the U.S. should fare better than other major economies. Below is a summary

Figure I: U.S. and Emerging Markets Growing

	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%	+0.5%	+2.0%	+2.5%	+3%
Currency Values	Decline	Decline	Rise	Decline	Mixed
Stimulus Change	Same: High	Same	Decelerating	Some Growth	Little

Earnings Trend	Declining	Varied	Slight Rise	Varied	Varied
Perceived Safe Harbor	Yes	Yes	Yes	No	No
Interest Rates	Low	Low	Slight Rise	Falling	Varied
Asset Valuations	Varied	Varied	Some Improvement	Varied	Improving

From a credit quality perspective, we expect the environment to be fairly propitious for most US credits:

Figure II: Reduced Regulatory Burden and Normalized Interest Rates Help

Theme	Winners	Losers
Reduced Energy Regulation	Petroleum fracking, coal, natural gas, airlines	Alternative Energy, Shipping, major energy cos. (reduced prices)
Increased Infrastructure Spending	Major construction and material firms	Pressure on debt levels and interest rates
Obamacare Cuts	Most healthcare	Hospitals (increased bad accounts receivable)
Easing of Financial Regulations	Most financial service firms	Legal and compliance professionals
Increased Defense Spending	Defense Cos.	Minor pressure on debt levels and interest rates
Normalized interest rates	Banks, dollar (also benefits as a safe haven)	Exporters, the euro, the yen
"Populist" Actions/ Restrictions on Foreign Manufact.	Some rises in domestic employment	Increased production costs accelerating a shift to robotics

Turning to where the overall economy is heading and what might be surprises, below are a few givens:

<u>Stronger Earnings</u> – President-elect Trump is focused on growth and is likely to establish policies to foster growth.

<u>Energy Prices</u> – petroleum prices have whipsawed in their movement over the past 24 months. The most likely outcome is a trading range between $45 and $65.

<u>Dollar Strength</u> – is likely to be strong because of the growth of the US economy, rate increase, and the safe-haven aspect of the US. While Japan is not growing, its currency has been aided by the flight to safety.

<u>Industry Consolidation</u> – as the market is awash with funds, the big players are seeking to take advantage by consolidating their businesses, and in turn, bargaining power. Mergers

such as that between AT&T and Time Warner will see an erosion of consumer value in the long run.

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, 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.

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

	5 year		10 year		30 year	
	Current	Year End	Current	Year End	Current	Year End
United States	1.99	2.03	2.46	2.73	3.07	3.53
Germany	-0.51	-0.1	0.28	0.7	1.08	1.55
Italy	0.84	1.18	2.13	2.60	3.22	4.00
United Kingdom	0.35	0.65	1.42	1.86	2.05	2.53
Japan	-0.13	-0.92	0.06	0.15	0.84	0.96

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: Rising U.S. dollar

	Current	EJR Est. Year End
Dollars to Euros	0.95	0.98
Dollars to Yuan	6.88	6.96
Dollars to Yen	113.5	114.2
Dollars to Pound	0.81	0.84

Regarding the major domestic winners and losers:

Deteriorating:

Retail Disaster – Amazon will destroy margins for any industry involved in selling goods, and over time, services. Nearly all the major retailers will be trading sideways at best for the next couple of years.

US Manufacturing Exporters – the stronger dollar and yen will hurt major exporters. The winners in general are the EU firms. The losers are the major exporters such as CAT and CUM. Boeing is protected by the low level of competition.

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:

Banking – a higher and more normal yield curve should aid net interest margins. Reduced regulations should improve cost structures.

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.

"Sin" Industries – alcohol and tobacco will benefit from the laissez faire approach.

Technology – while at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels and recently announced weak earnings.

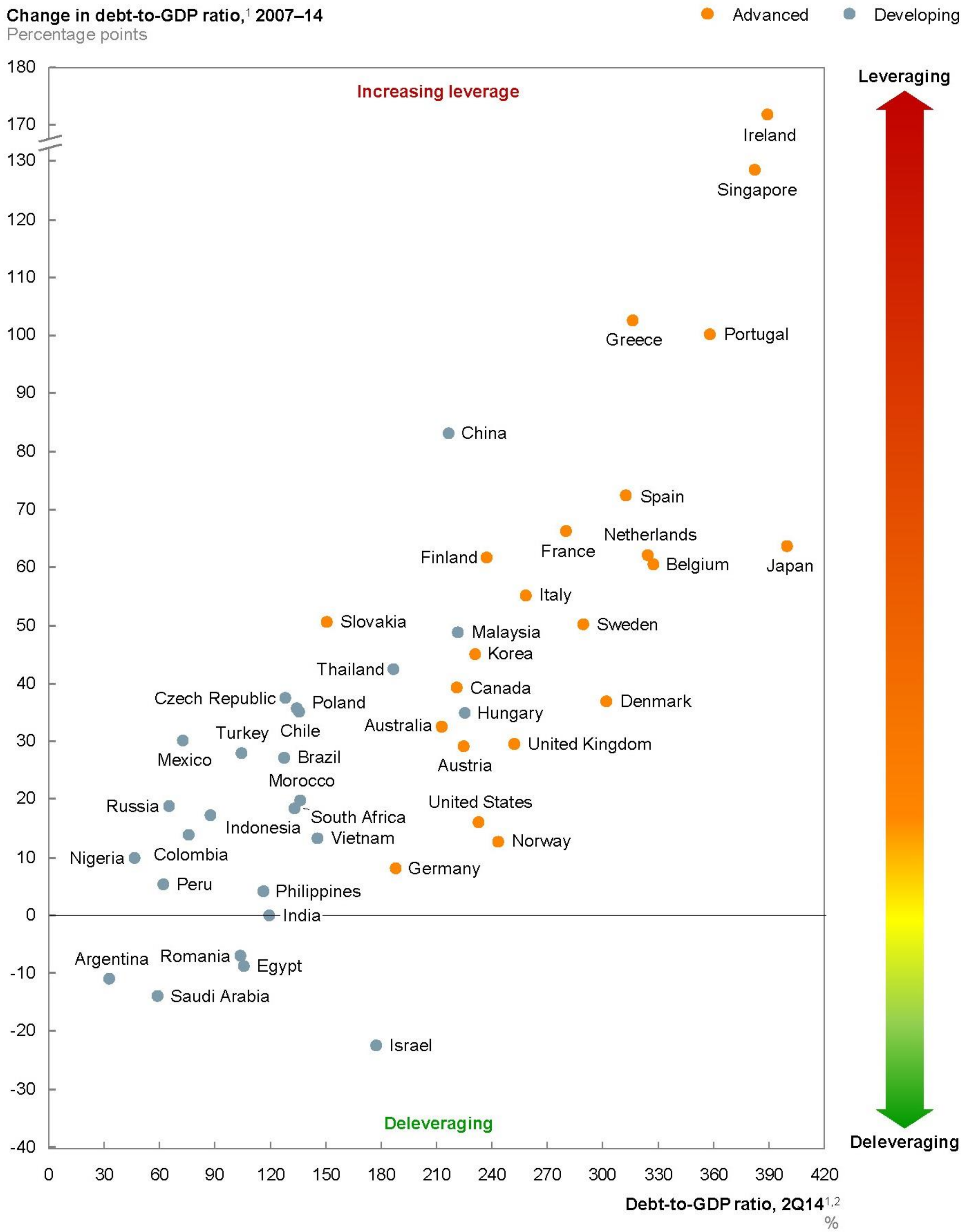
Neutral

Airlines – the economic recovery and moderate fuel prices have helped. However, in the U.S., the rate of improvement is likely to slow as margins and load factors fall from record levels. President Trump's immigration ban will likely affect major airlines in the short term.

Autos and Auto Suppliers – with the exception of Volkswagen and FIAT, most of the auto industry is prospering. The European producers are probably in the best shape because of the recent rise in the dollar and yen. However, watch for inventory levels.

An item which has been ignored by most market participants over the past couple of years has been the rise in sovereign indebtedness. Our view is that this will garner increasing attention as the European Union becomes less united and Japan becomes more geriatric. See the below chart:

Figure IV


Change in debt-to-GDP ratio,1 2007–14
Percentage points
Advanced
Developing
Increasing leverage
Deleveraging
Leveraging
Deleveraging
Ireland
Singapore
Greece
Portugal
China
Spain
Netherlands
France
Finland
Belgium
Japan
Italy
Slovakia
Malaysia
Sweden
Korea
Thailand
Canada
Czech Republic
Poland
Denmark
Hungary
Australia
Turkey
Chile
United Kingdom
Mexico
Brazil
Austria
Morocco
Russia
United States
South Africa
Indonesia
Vietnam
Norway
Nigeria
Colombia
Germany
Peru
Philippines
India
Argentina
Romania
Egypt
Saudi Arabia
Israel
180
170
130
120
110
100
90
80
70
60
50
40
30
20
10
0
-10
-20
-30
-40
0
30
60
90
120
150
180
210
240
270
300
330
360
390
420
Debt-to-GDP ratio, 2Q14 1,2
%

Source: McKinsey & Co, February 2015.