Best Ideas – Walls of Worry - March 2018

The equity markets experience a setback in early February leading many investors to question whether the long bull run is coming to an end. While the questioning is appropriate, since early February, the markets have recovered some of their losses and investor sentiment appears to remain generally intact. Despite the recovery of the equities markets, the domestic fixed income markets have had a bit of a reset with the ten year treasury nearing the 3.0% mark, perhaps indicating that some inflation is kicking up. While market performance and sentiment remain fickle, it is worthwhile reviewing some of the major drivers of the economy and our expectations for those drivers:

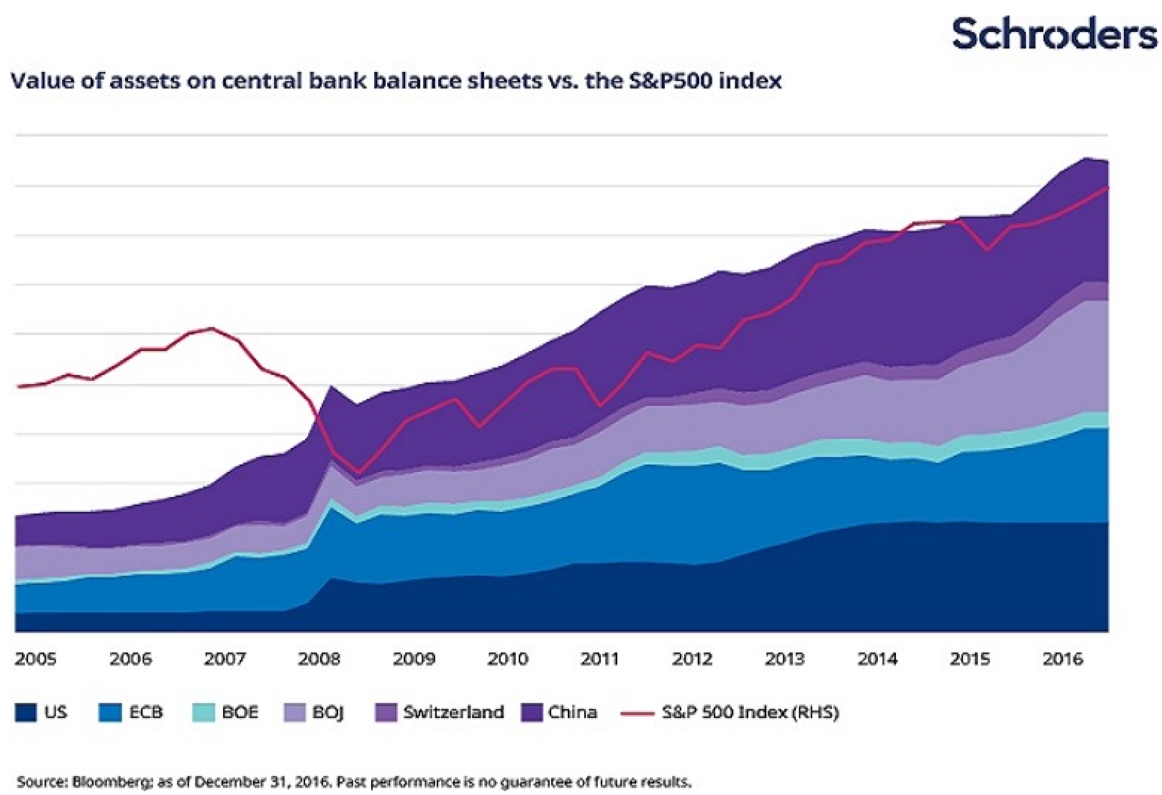
- **Interest Rates –** the 10 year has hit 2.95% with many calling for an end to the 30 year bull market in rates.
  Prognosis – while interest rates are edging up, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (with the exception of Germany) are concerned about fiscal deficits and therefore are likely to discourage a substantial rise in interest rates and sovereign funding costs.

Figure I: U.S. 10 year Interest Rates

source: macrotrends.net

- **Central Banks' Money Creation –** the central banks of the developed countries have \$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.

Figure II: Central Bank Assets



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.

- **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.

- **Global Growth –** it is not only the U.S. which is growing, but every major country as evidenced by the rise in most major stock indices.
  Prognosis – conditions have improved in most countries for economic expansion; the cycles for such improvement are generally five to ten years.

- **Inflation –** most economic commentators have predicted that inflation would rise dramatically although to date, it has not.

  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.

- **Unpopular Leaders –** the apparent irony currently is that the leaders of the U.S. (Trump), the U.K. (May), Spain (Raju), Italy (Mattarella), and to a lesser extent Germany (Merkel) have been unpopular and yet the economies have strengthened. It begs the question of whether popular leaders are deleterious for the economy.
  Prognosis – we expect Trump will continue his attempts to improve the economy and the major infrastructure spending plans are likely to further stimulate the economy.

- **North Korea –** President Kim increasingly has the ability to start a nuclear war.
  Prognosis – the news that North and South Korea are cooperating on the Olympics is positive although Trump recently announced a new round of sanctions against North Korea. We believe Kim wants to remain in power and is angling for a partial removal of sanctions and additional subsidies.

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 III: U.S. and Emerging Markets Expectation

	Japan	Europe	U.S.	China	Emerg Mrkt
GDP Growth	+1.0%	+1.8%	+2.8%	+5.0%	+4.0%
Currency Values	Decline	Mixed	Decrease	Mixed	Rise
Stimulus Change	Decelerating	Decelerating	Decelerating	Some Growth	Little
Earnings Trend	Slight Growth	Growth	Growth	Growth	Growth
Interest Rates	Low	Flat to Rise	Slight Rise	Little Change	Varied
Asset Valuations	Improving	Improving	Improving	Improving	Improving

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	2.58	2.8	2.85	3.05	3.09	3.20
Germany	0.01	0.05	0.64	0.76	1.29	1.45
Italy	0.68	0.65	1.94	1.92	3.04	3.10
United Kingdom	1.13	1.23	1.47	1.65	1.87	2.05
Japan	-0.012	0.03	0.003	0.20	0.75	0.88

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.23	1.30
Yuan to Dollars	6.36 $/RMB	6.50 $/RMB
USD-JPY	106.25	110
GBP-USD	1.38	1.45

The major gainer in the currency markets has been the pound as the market believes the UK will be able to negotiate Brexit gracefully and growth will resume. (We are not so sure.) From a credit quality perspective, we expect the environment to be fairly propitious for most U.S. obligors. Regarding various industries, below is a summary of some of the major developments:

Deteriorating:

Retail Disaster – Amazon (and other internet giants) will destroy margins for any industries involved in selling goods, and over time, services. (Watch for the next major wave with virtual reality technologies.) 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; we question the long-term effectiveness of its attempt to go up-market online. Watch Amazon's war with Netflix.

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 – 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.

US Manufacturing Exporters – The weaker U.S. Dollar helped, but the major driver is the health of the global economy.

Neutral

Airlines – The economic recovery and effective capacity management have helped. However, the increased fuel prices and increased competition are 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.