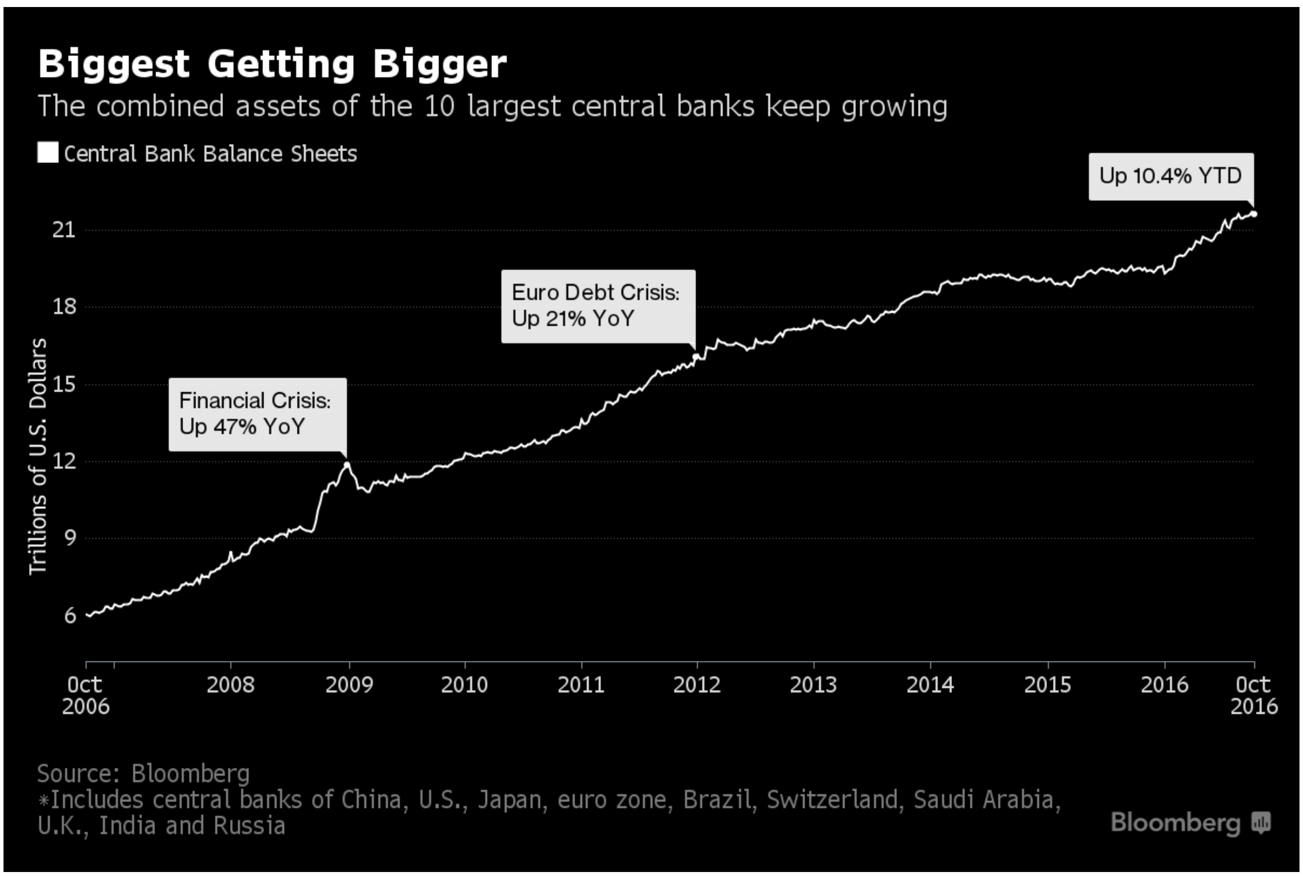
Best Ideas – Emerging Themes

May 2017

Some Inflation - Central banks have been dominant forces in the markets since the 2007-2008 credit crisis and are in the process of scaling back additional investments; the FED's balance sheet has not grown over the past couple of years, and the ECB and BOE are now making noise about becoming less active. Given the fact that the central banks now own $21 trillion of assets, and there is pressure for tapering, what might this tapering result in? Our view is that we might be on the verge of a major reset as a result of the normalization of the markets. The first item to examine might be inflation, which was nonexistent for years in most of the developed economies until recently. If inflation is real, then why is the yield curve flatter than normal? The short answer is that we are not sure, but if inflation is now an issue, the longer yields should start showing some increases.



Trump's Move to the Middle - Despite the worries about France's exit from the European Union, and Trump going on a Twitter rampage, conditions are settling down such that investors can expect more or less normal conditions for the next several quarters. (An indication of Trump's becoming more mainstream is the removal of Steve Bannon from the National Security Council.) The result has been seen in the markets whereby equity indexes are reaching all-time highs and borrowing rates are remaining manageable. Granted there remain major risks, but at this time they appear to be manageable.

One of the largest uncertainties as of the beginning of the year was how the new president was going to "fit" into the job. Early indications were cause for concern as no other president regularly tweeted out thoughts to the world at the wee hours of the morning, and accused major media sources of generating "fake news". While those concerns remain, they have been tempered by President Trump's appointments, which have been comprised of numerous time-tested experts. In the next several quarters we are likely to see the following:

- A reform of the Affordable Care Act
- A reduction in corporate taxes
- A reform of Dodd-Frank

Europe: No French Fiasco; Watching the Italian Job - The equity markets are up over the past couple of weeks because of the likely victory if Macron in the French election and affirmation of the administration's plan to reduce corporate taxes. The Italian banks continue to be a concern but the most likely outcome is support from the European taxpayers after the conclusion of the French and German elections and possibly some injections from the French banks.

North Korea – looking for a solution today to tomorrow's problem. While there is little doubt that Kim Jong-un is threatening neighbors, there is a real cost to his actions with a cut in coal exports. The conundrum remains Kim's perception that he has to maintain threats to maintain power and a flow of support, and a concern about N. Korea's nuclear developments.

Benign Global Outlook - Regarding the global economy, both the U.S. and the emerging markets appear to be safe havens currently as Europe is still struggling through its multitude of festering structural issues, Japan is hobbled by massive debt and little growth, and China is in the midst of a redirection. Below is a summary

Figure I: 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%	+0.5%	+2.0%	+3.0%	+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 Harbor	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, 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 II: 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	1.85	2.03	2.33	2.50	3.01	3.40
Germany	-0.39	-0.10	0.32	0.70	1.10	1.55
Italy	1.04	1.18	2.28	2.60	3.35	4.00
United Kingdom	0.51	0.65	1.09	1.56	1.71	2.13
Japan	-0.17	-0.15	0.01	0.10	0.79	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 III: Rising U.S. dollar

	Current	**EJR Est. Year End**
Dollars to Euros	0.92 $/€	0.98 $/€
Dollars to Yuan	6.90 $/RMB	6.96 $/RMB
Dollars to Yen	111.8 $/¥	114.2 $/¥
Dollars to Pound	0.77 $/£	0.83 $/£

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Regarding domestic affairs, while the major media remains aghast at the improprieties of our new president, the equity markets are rejoicing at the prospect of lower tax rate, eased regulations, an overall reduction in the cost of doing business, and higher growth prospect. We expect the new president to adjust his behaviors as unsubstantiated accusations cost him political support which will be needed to institute his programs. On balance, we expect that the new environment will be propitious for most industries:

Deteriorating:

<u>Retail Disaster</u> – Amazon will destroy margins for any industries 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. 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. The next major target for Amazon appears to be grocers.

<u>US Manufacturing Exporters</u> – The stronger U.S. Dollar against Yen, Euro, and Pound will continue to hurt major exporters. The winners in general are the EU and Japanese firms. The losers are the major exporters such as CAT and CUM, although both are helped by the rise in the growth prospect. Boeing is protected by the low level of competition, although Airbus has a more robust backlog than Boeing.

<u>Media</u> – 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:

<u>Banking</u> – 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.

<u>Defensive Industries</u> – Alcohol, tobacco, and defense are traditional defensive credits and continue to be so.

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

<u>Infrastructure</u> – Watch for massive improvements for firms connected to building.

<u>Metals and Mining</u> – 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.

Autos and Auto Suppliers – 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.