Risk Commentary – Good, Bad, and Ugly

February 2020

The world is changing and as fiduciaries and risk managers, it is helpful to understand these changes and how it is likely to impact clients.

The Good –

A cursory glance at the daily newspapers would suggest that the world is in miserable shape and that relying on the future, which is the essence of investing, is a fool's game. Our view is different; with each passing year conditions for the average denizen on earth becomes a bit more attractive in terms of quality of life, living standards, accessibility to medical care, knowledge, and variety of other measures. The negative news sells newspapers and gets clicks but does not present a balance view of conditions.

The Bad -

Despite the first paragraph, there are some significant problems which will impact conditions. Close to the top of our list is the increased indebtedness of a variety of market participants including sovereignties, municipalities, students, and major state enterprises. The low to negative interest rates are masking some of these problems for the time being, but with increased dependency rates and increased off-balance sheet obligations, the problem is growing. The fear is that defaults will rise as time passes and/or rates increase. Negative interest rates disenfranchise savers and are ultimately harmful to normal economies since they interfere with the normal balance between savings and consumption.

A few comments on Negative Interest Rates (NIR) and Quantitative Easing (QE). Regarding QE, most said it would lead to massive inflation, which of course it has not. While for NIR, economists said would never happen. Again, they were wrong. Our view is that QE did not result in inflation because the demand levels have been weak perhaps because birth rates are low, baby boomers are down-sizing, student debt has delayed the starting of new families, and a variety of other factors. Regarding negative rates, in the past the nation which issued currency at a faster rate than the growth of the economy would be punished by the markets. However, over the past decade, the major developed economies have engaged in QE simultaneously, thereby leaving major investors with no alternative. Since nearly all currencies have abandoned links to precious metals (such as gold) no longer is there an anchor on currency creation.

The Ugly –

The coronavirus appears to be a particularly pernicious disease because (i) apparently a person can be asymptomatic and spread the disease and (ii) it is similar to AIDs in the sense it might be suppressed but not cured, (iii) developing a vaccine appears to be challenging because of its HIV-like shell, and (iv) the major infected country, China, appears to have difficulty addressing and suppressing its spread. Perhaps with the advance of modern medicine, the world has become numb to the threat caused by disease, but this one appears to be particularly pernicious.

Regarding macro-economic expectations, 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	+.5%	+.1%	+1.5%	+1.0%	+1.0%
Currency Values	Decline	Decline	Slight Rise	Decline	Mixed
Stimulus Change	Slight Deceleration	Some Growth	Some Growth	Some Growth	Little change
Earnings Trend	Slight Growth	Down	Slight Growth	Slight Growth	Growth
Interest Rates	Low	Little Change	Little Change	Little Change	Varied
Asset Valuations	Slight Growth	Flat	Varied	Varied	Slight Rise

Regarding interest rates, they appear to be bouncing around on a quarterly basis with little long-term direction. The EU countries and credits cannot afford significant increases in rates. The periphery EU countries are likely to see continued 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	1.47	1.6	1.62	1.85	2.08	2.4
Germany	-0.77	-.70	-0.55	-.40	-0.03	.20
Italy	0.26	0.2	0.88	0.8	1.98	1.8
United Kingdom	0.28	.80	0.50	0.44	0.97	1.0
Japan	-0.33	0.03	-0.17	0.20	0.39	0.55

Below are our expectations for major currencies:

Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.09	1.05
Yuan to Dollars	7.15 $/RMB	7.2 $/RMB
USD-JPY	107.41	110
GBP-USD	1.23	1.20