Best Ideas – Catalysts (for a Major Shift in Credit Quality)

March 2019

While recent economic results have been fairly robust (i.e., 2.9% GDP growth for the 4th quarter of 2018 and record low unemployment), there are incipient risks which have the potential for causing harm. The focus of this report are those areas which are unsustainable from the perspective of traditional economics and have the potential to derail economies. While the concerns are real and in many cases growing, the vigilance of the central banks provide a salve.

Challenges/ Concerns:

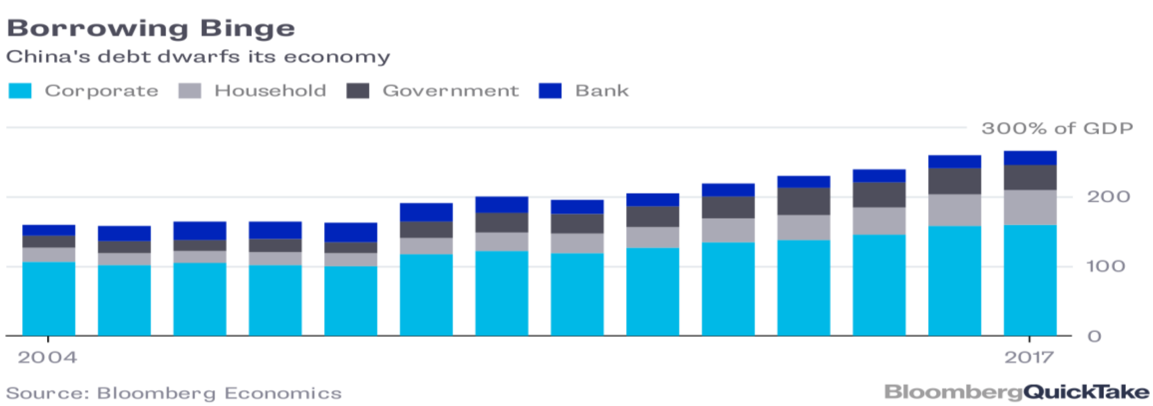
United States Governance – probably the largest risk is the growing divide between the two major political parties. In the case of the Democrats, it appears that most legitimate presidential candidates need socialistic policies to be considered serious candidates (the entrance of Mr. Biden as a candidate might change the narrative) while in the Republican circles, Mr. Trump continues to be beset by attacks from a variety of sources. The upshot of the friction is increased difficulty in making any real progress, which based on historical results might not be terrible. Nonetheless, if the policies of Alexandria Ocasio-Cortez and other similar representatives become the accepted platform of the Democratic party, growth is likely to be curtailed. The 2020 presidential elections are dominating Washington as candidates and parties attempt to assume optimal stances to win the nomination and the election. A major test is whether the maxim "it's the economy stupid" still applies or whether the plethora of negative news on Mr. Trump trumps progress on the economy.

EJR Comment – despite the turmoil, the economy is continuing to grow.

European Union – despite negative interest rates, the EU is not growing much and is probably shrinking. Adding to the problems are tariffs, the weak operating results for Deutsche Bank, the Italian banks, and concerns about some of the other major banks. Over the past decade via quantitative easing and depressed interest rates, the ECB has been the savior by providing capital to those areas which need support. Probably the most pressing concerns are Brexit, addressing the budget shortfalls in Italy and Spain, and recapitalizing the major banks

EJR Comment – despite the turmoil, the EU has massive staying power.

China – the country is struggling to adjust to changing conditions and increasing the debt:



Trade negotiations garner the headlines but our major concern is the increased leverage, increased corporate defaults, and the challenge in shifting away from an export-led economy. Mr. Trump's rapid exit from the North Korean talks might force China to recalibrate its posture. Additionally, the slowdown in GDP is likely to result in a re-examination of the levels of indebtedness.

EJR Comment – historically a centrally planned economy has resulted in major mistakes in capital allocation. In China's case, the government appears to be more vigilant than most governments in providing support.

Student Debt – news about 60-year-old carrying $200K of student debt is cause for real concern. Watch for the leading Democratic candidates to propose some relief to solidify support among millennials and other indebted former students.

Negative Interest Rates – as of 15 years ago, economists claimed there would never be negative interest rates beyond the minuscule amounts needed to maintain an account at one of the major banks. Well, negative rates have existed among strong EU sovereigns and corporates for approximately 10 years and do not appear to be g0ing away anytime soon.

Wrap-up – so what does all this mean, do we expect a collapse anytime in the near future. Well, to paraphrase John Maynard Keynes, the market can stay irrational longer than you can stay solvent. While the risks have increased, the growth in the US economy is real and provides policymakers with flexibility. If some of the major policies of the Democratic candidates are not softened, we expect a continuation of the same over the next couple of years.

While we traditionally focus on risks, there are a few items worth mentioning which are positives:

Reduced Threat from North Korea– although a deal was not reached last week, the threat from N. Korean nuclear missiles has abated. We expect an agreement over the next 6 to 12 months.

Terrorist Attacks – in Europe and to a lesser extent, the US, the terrorist attacks have waned.

Back to the macro view, 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%	+.5%	+2.5%	+3.0%	+3.%
Currency Values	Decline	Decline	Slight Rise	Mixed	Mixed

Stimulus Change	Slight Deceleration	Little change	Decelerating	Some Growth	Little change
Earnings Trend	Slight Growth	Flat	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	2.53	2.6	2.72	2.8	3.09	3.05
Germany	-0.29	0.05	0.16	0.50	0.80	1.10
Italy	1.66	1.60	2.73	3.2	3.65	3.52
United Kingdom	0.92	1.23	1.27	1.65	1.78	2.05
Japan	-0.15	0.03	0.00	0.20	0.64	0.88

Below are our expectations for major currencies:

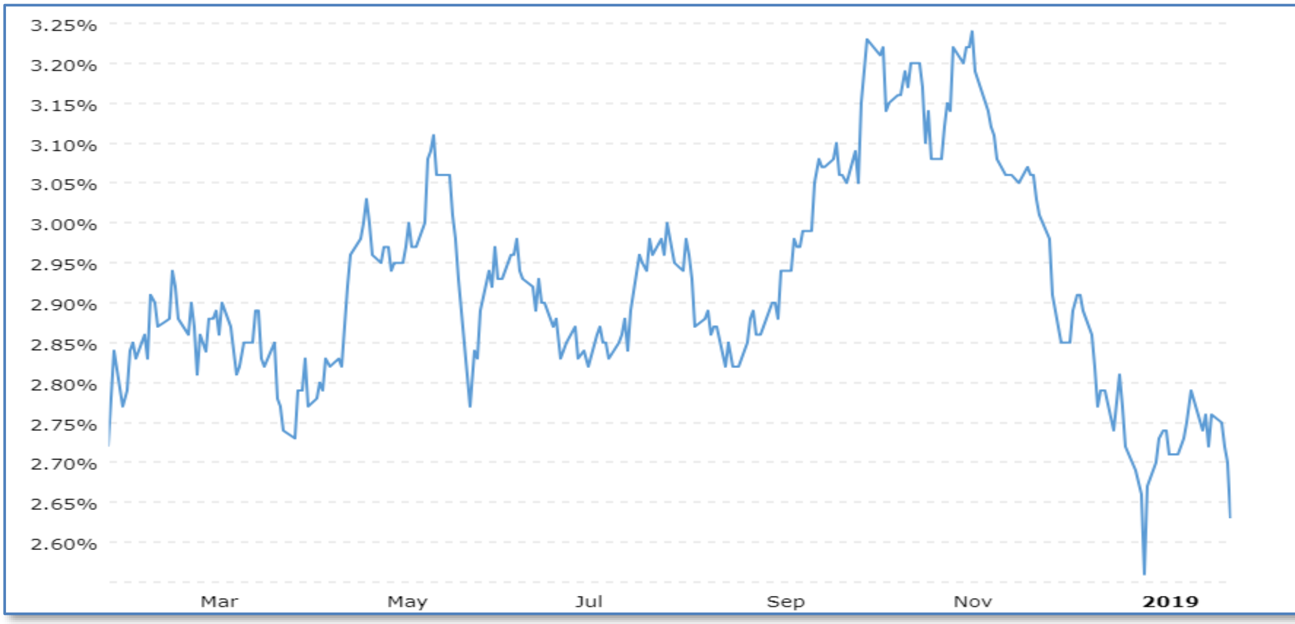
Figure III: Currency

	Current	EJR Est. Year End
EUR-USD	1.13	1.20
Yuan to Dollars	6.71 $/RMB	6.8 $/RMB
USD-JPY	111.73	110
GBP-USD	1.32	1.35

Some of the major drivers of the economy and our expectations for those drivers are:

- **Interest Rates –** the 10 year is near 2.7% with many calling for an end to the 30-year bull market in rates.
  Prognosis – while interest rates edged up earlier this year, the underlying driver is inflation which to date, has been manageable. The treasuries of the major developed countries (except for Germany) are concerned about fiscal deficits and therefore are likely to discourage a substantial rise in interest rates and sovereign funding costs.

Figure IV: 10 Year US Treasury Yield



Source: macrotrends.net

Petroleum Prices – as can be seen in the chart below, petroleum prices have partially recovered. While it is always difficult to divine the underlying causes of petroleum prices, it appears that the supply is outrunning demand.

Prognosis – trade tensions and technology are conspiring to depress prices with the result being major angst among the totalitarian regimes.

Figure V: WTI – Recent Crude Oil Prices

Source: macrotrends.net

- **Central Banks' Money Creation –** the central banks of the developed countries have approximately $21 trillion in assets which have been used to suppress interest rates and support asset 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.
  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.

Figure VI: Five Year Forward Inflation Expectation %

Source: macrotrends.net

- **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.

- **Growth/ Stock Market Valuations –** the stock market has had an eight-year run with the normal concern that we are overdue for a downturn. However, from an earnings perspective, valuations do not appear to be too attenuated (see below).
  Prognosis – conditions have improved in most countries for economic expansion and perhaps we will see at least a couple more years of growth.

Figure VII: S&P 500 Price to earnings ratio

Source: macrotrends.net

- **Inflation –** most economic commentators have predicted over the past ten years that inflation would rise dramatically although to date, it has not. However, the tightening labor force is resulting in wage pressures.
  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.

Regarding various industries, below is a summary of some of the major developments:

Below is our summary of the major industries:

Deteriorating:

Agriculture Prices/Ag Chemicals – Agri market participants have adjusted to the 'new normal' of a persistent US-China trade war talks. Volatile agricultural commodity prices are likely to be tied to: i) low farmer income; ii) commodity oversupply; iii) low fertilizer cost; and iv) industry consolidation. Any improvement in the US-China trade relationship is a materially bullish risk factor for agri markets.

Health Insurance – AOC is proposing to eliminate private health insurance.

Retail – Amazon (and other internet giants) will destroy margins for any industries involved in selling goods, and over time, services. U.S. retail sales recorded their biggest drop in more than nine years in December as receipts fell across the board, suggesting a sharp slowdown in economic activity at the end of 2018. The Commerce Department said retail sales in Dec. fell 1.2% - the largest decline since September 2009, when the economy was emerging from recession. The December retail sales report was delayed by a 35-day partial shutdown of the federal government that ended on Jan. 25. Retailers have been more focused on internal investments into their businesses vs. growing/competing via acquisitions. EJR expects the majority of issuance next year to be refinancing, as well as debt raised to fund share repurchase programs (Starbucks and McDonald's).

Media – Netflix, other internet distributors, and non-traditional media outlets continue to dis-intermediate traditional media providers and cable firms. Rising competition and increasing programming costs are key factors to watch out for. Note, print media continues to suffer. EJR expects M&A activity will continue in the media sector, though note potential deals will likely be smaller in size with limited debt financing.

Power Generators – This industry faces a triple threat: 1) tighter margins (revenues are often tied to the price of natural gas), 2) more burdensome regulations (i.e. the new federal carbon limits), and 3) reduced demand as a result of solar and wind generation as well as LED lighting and efficient appliances. Pres. Trump's pledge to revive the U.S. coal industry and roll back Obama-era restrictions on emissions – is too late for many companies. Since 2010, nearly 40% of the capacity of U.S's fleet of coal-fired power plants has either been shut down or designated for closure, according to the American Coalition for Clean Coal Electricity. According to EEI, capex in 2019 will be ~$117B, which is a reduction from the peak of $127B in 2018 – something to watch out for. The recent cold freeze in Midwest is expected to see significantly high heating bills. The overall composition of FERC also remains in focus, with one current vacant seat and the announcement that Commissioner LaFleur will not be nominated for a third term.

Restaurant Industry - We see an elevated discounting / promotional environment which coupled with rising food inflation will weigh on the margins. We do expect momentum to improve across the casual dining category in terms of footfall. Supply/demand imbalance, potentially waning pricing power, labor challenges at the store level are the primary issues facing the group in 2019. Unit supply growth and YOY change in nonfarm payrolls (employment) examined together are a good indicator of traffic trends in casual dining + fast casual. While this metric suggests flattish traffic, the overall consensus is suggesting negative traffic.

Poland/Hungary - European Union's regulatory arm proposed a new method for distributing regional aid under its first post-Brexit budget, shifting part of the funds from eastern Europe to countries in the south of the continent that face unemployment and migration challenges. Funds for Poland would shrink to €64.4 billion compared with almost €84 billion in the 2014-2020 fiscal plan, while Hungary would see a decrease of around 24% to €17.9 billion.

Argentina/Turkey - Erdogan has made Turkey the sick man of Europe again. Confidence in Turkey's economy has managed to inch up in February, up 1.2% MoM, up from 78.5 in January. Argentina's economy suffered its worst shrinkage during the tenure of President Mauricio Macri. Argentina's GDP fell 2.6% in 2018, underscoring the turmoil that dragged the South American country into recession last year. In December, monthly economic activity was 7.0% lower than the same month the prior year, following a 7.5% dip in November. Further with Argentina's Macri throwing $2.6 billion lifelines to cash-strapped firms, is something the country can ill-afford at this stage.

Venezuela/Possibly Greece – The countries' debt is not sustainable and it is merely a matter of time before there is another restructuring. Greece's economy is showing signs of a long-awaited rebound. Output grew by 2.3% in annual terms between January and March, marking a fifth straight quarter of expansion - sustainability is what we need to confirm here.

Telecom – Regardless of whether or not the Sprint + TMUS deal goes through, EJR expects wireless competition to remain. If approved, S+TMUS, the industry will focus on transition and building scale. And if the TMUS, S merger falls through, the focus will shift towards profitability to fund network needs**.** Significant historical over-investment in cable have pressured industry margins. Wireless industry net adds have come in better than expected in 2018 due to economic growth and the move from prepaid to postpaid; market expects net add growth to decline in 2019.

Traditional Retailing – Tax refund dollars issued through the third week of the tax refund season (second week of February ending 2/15) are down 39% YOY (while returns processed are down ~7% YOY). Analysts expect this to have an adverse impact on retail spending. For 2019, EJR expects to see a lower likelihood for accelerating growth across the P&L. Most of the companies are lapping elevated top-line gains from a strong consumer and increased marketing investments (thanks to tax cuts) as well as a less inflationary cost environment.

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.

Beverage – This slow-growth industry is in reasonably good shape. Higher global economic growth expectation and ongoing consolidation should help.

Chemicals – The chemical industry is riding an upturn in the world economy and continued strength across major end-use markets such as construction, automotive and electronics. Another positive for the industry is a recovery in demand in the energy space – a key chemical end-market that had been out of favor for a spell. The recovery has been driven by the rebound in crude oil prices from their historic lows.

Defensive Industries – Alcohol, defense are traditional defensive credits and continue to be so.

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. Global capex has fallen by appx 50% since the peak spending in 2012, watch for risk that volumes consistently disappoint over the next few years. But in the meantime, bulk and base volumes have risen by ~35% and ~10%, respectively between 2011-18e.

Packaging – The paper and food packaging industry was and will continue to benefit from e-commerce. However, Amazon could squeeze their margin.

Technology – While at a slower pace than normal, tech industry spending remains robust. However, Apple will have difficulty maintaining prior growth levels. FX swings too might dent earnings in the medium term.

Neutral

Airlines – Economic recovery and effective capacity management have helped. Earnings season largely assuaged concerns related to the government shutdown as well as potential capacity creep and near-term demand trends. Jet prices are highly correlated to diesel. Like diesel, the market expects jet cracks to hit +$30/bbl over H2'19-2020 period, which is above the futures curve, and up from ~$15/bbl from current levels today. Jet fuel prices are crucial for airlines, accounting for some 20-25% of airlines' cost structure. Airlines will need to consider tactical hedging of diesel outright or cracks, rather than crude oil alone, given IMO 2020 impacts.

Autos and Auto Suppliers – The seasonally adjusted annualized rate (SAAR) of U.S. light-vehicle sales in January, reported by OEMs on Friday, tracked to an estimated ~16.7mm rate. In January, which typically tends to be the slowest sales month of the year, saw industry sales volumes decreased 1.9% YOY. EJR expect domestic auto sales to remain resilient in 2019 given the relative age of the car park and a still healthy economic backdrop.

Insurance – M&A and Weak core P&C underwriting margins, lackluster overall trends in the life & retirement business are medium-term negatives. Though from a long-term perspective, the industry continues to improve with reasonable returns and continued consolidation. For life insurance companies, despite maintaining strong balance sheets and reserve levels, the prospect of higher interest rates has not come to fruition. As a result, life insurers have continued investing in riskier asset classes such as private placements, mortgage loans and mezzanine debt.

Railroads – Though Rail's good growth seems to be running out - and the overall rate of growth in 2018 which had decelerated – continues into 2019. For the first seven weeks of 2019, U.S. railroads reported the cumulative volume of 1,730,989 carloads, up 0.1 percent from the same point last year; and 1,867,360 intermodal units, up 0.5 percent from last year. Total combined U.S. traffic for the first seven weeks of 2019 was 3,598,349 carloads and intermodal units, an increase of 0.3 percent compared to last year.

REIT – General consensus is bullish on residential and industrial REITs, a relatively improved outlook for health care and net lease, and more bearish views on malls and office REITs. Vacancy ratios and leverage ratios are at cyclical lows but several REIT subsectors have begun to show signs of peaking. Notably, the retail segment has faced same-store net operating income declines and occupancy rates has fallen modestly. Offsetting the decline in retail has been an improvement in industrial REIT, partially due to e-commerce. Apartment prices have risen substantially in many cities including San Francisco and New York. Multi-family is likely to improve due to slow family formation. Suburban offices will likely continue to slide as occupancy rates decline.

Utility Distribution – Distribution firms face long-term issues associated with local power generation from solar. Nonetheless, currently firms are in decent shape. Moreover, highly leveraged utilities will probably have troubles raising equity, as the dividend yield will not be as competitive in a rising rate environment.

Need to watch:

Big Technology – Media sources say Samsung plans to lower its memory chip output next year to tighten supplies for an expected slowdown. The supply restriction would help maintain or push semi prices up. The company expects a bit growth of less than 20% DRAM and a 30% rise for NAND flash. Overall semiconductor industry revenue growth is on pace to achieve 14% Y/Y growth in 2018 or ~8% ex. memory on positive demand trends during the year such as data center, automotive and industrial. The US-China trade-related slowdown combined with poor iPhone sales and auto production volatility kicked off a demand-driven correction reflected in the recent weaker October earnings season. Hopefully, things recover in 2019.

Credit Card Network/Processors – Acceptance of Bitcoin and other cryptocurrencies would be a significant negative to the credit card network like Visa and MasterCard and credit card processor like First Data.

Exploration and Production and Servicing Firms (Energy) – As oil prices moved higher, despite natural gas prices continuing to fall, E&P index has rebounded in the YTD period. Oil prices were lifted early in the week after Saudi Arabia signaled it would reduce output in February to levels "well below" the OPEC production agreement and as the U.S. issued sanctions on Venezuela's state-owned oil company. Watch for nat gas price volatility, with the recent natural gas prices decline to reflect the possibility of the market looking beyond the polar vortex that engulfed much of the Midwest with near-term weather forecasts now calling for warmer-than-average temperatures across much of the East Coast.

Healthcare – According to Axios, a new analysis from U.S. federal government actuaries say that Americans spent $3.65 trillion on health care in 2018. This represents $11,212 per person, with 59% of the spending going to hospitals, doctors, and clinical services. Prescription drug spending was up 3.3% year over year. Most of the increase was due to higher prices, not the increased use of services. Under private health insurance, spending per person rose 4.5% between 2017 and 2018, even though the same number of people were enrolled. Members of the Senate Finance Committee grilled pharma executives during a public hearing in last month about their role in rising drug costs, and while the executives noted that they want to do something about the costs, they would not commit to dropping list prices. Expect some long term pricing pressure to emerge in this area.

Tobacco – The rising U.S. teen e-cigarette use threatens the tobacco market. Over the past year, the number of high school students who have used e-cigarettes in the past 30 days has skyrocketed by about 75%, as per CDC's annual National Youth Tobacco Survey. That means roughly 3M, or about 20% of high school kids, are using e-cigarettes, up from 1.73M, or 11.7% in last year's National Youth Tobacco Survey. The Food and Drug Administration move to ban menthol cigarettes, amid its ongoing crackdown on e-cigarettes would prove a particularly big blow to BAT, whose Reynolds American subsidiary paid $25B in 2015 to acquire Lorillard Inc. and Newport, the top menthol brand in the U.S. Menthols last year represented 55% of BAT's U.S. cigarette sales by volume and ~20% of sales for Altria's cigarette sales. Competition from Marijuana is a very real threat, with legal sales of marijuana in the U.S. catching up to beer and wine, potentially reaching $47B in ten years, implying a 17% CAGR. Thirty-two states have now legalized medical weed in some capacity, with the residents of Missouri and Utah also joining in. Meanwhile, residents in Michigan voted overwhelmingly to become the 10th state to legalize adult-use cannabis during midterms. California, which is already the fifth-largest economy in the world by GDP, is forecast to generate between $6B and $7B in annual cannabis sales.

Wireless Providers – Competition in wireless is heating up. We expect the change in data plans to be essentially neutral to ARPU, but watch for SG&A spend.

Major debt levels

Country	Last		Previous
Japan	253.00	Dec/17	250
Italy	132.10	Dec/18	131
Singapore	110.60	Dec/17	112
Spain	98.30	Dec/17	99
France	97.00	Dec/17	96.6
Canada	89.60	Dec/17	92.4
Euro Area	86.70	Dec/17	89
United Kingdom	85.30	Dec/17	82.6
Brazil	74.04	Dec/17	69.95
India	68.70	Dec/17	69.6
Germany	63.90	Dec/17	67.9
Argentina	57.10	Dec/17	53.3
Netherlands	56.70	Dec/17	61.8
South Africa	53.10	Dec/17	51.6
China	47.60	Dec/17	44.3
Mexico	46.40	Dec/17	48.2
Australia	41.90	Dec/17	41
South Korea	38.00	Dec/17	38.3
Switzerland	29.70	Dec/17	29.1
Indonesia	28.70	Dec/17	27.9
Turkey	28.30	Dec/17	28.3
Saudi Arabia	17.20	Dec/17	13.1
Russia	13.50	Dec/17	12.9

https://tradingeconomics.com/country-list/government-debt-to-gdp