Weekly Relative Value

Crazy Talk

"That is some crazy talk." – Bill Gates

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PORTFOLIO STRATEGY

If you follow the debates over U.S. economic policy, you have probably heard of Modern Monetary Theory or MMT. The school of thought has received backing on the left from politicians such as Representative Alexandria Ocasio-Cortez and self-proclaimed socialist Senator Bernie Sanders.

But it's not just the left. President Donald Trump has expressed views that align with it, too. *"First of all, you never have to default because you print the money. I hate to tell you. So, there's never a default,"* Trump said while campaigning in 2016.

"Please, do go on about modern financial theory —but with someone else."

CartoonStock.com

In essence, MMT dismisses concerns about sovereign debt since countries that print their own currency can't really run out of money. In other words, Uncle Sam has a printing press and Uncle Sam can run that printing press whenever he wants… and, therefore, Uncle Sam can always pay off debts issued in his own legal tender.

This is not the sleight-of-hand that quantitative easing was. This is direct monetization in lieu of borrowing. It sounds like printing money, that's because it is. Upfront and in-your-face.

MMT devotees think debt and deficit concerns are bunk. In fact, they don't see much reason to worry at all! MMT essentially believes the government spending can be funded by printing money. Currently, government spending is funded by debt and not the Fed's printing press. MMT disciples tell us that when the shackles of debt and deficits are removed, government spending can promote economic growth, full employment and public handouts galore. The MMT crowd has deluded themselves into thinking that they've found a new "free lunch."

If you think the whole idea sounds like lunacy, you are right. The problem is, what seems like a joke is actually gainin traction. Politicians are increasingly talking about "free stuff" – universal jobs guarantee and "Medicare for All," free college, guaranteed basic income, basic housing and more. At least, that is how the theory is being sold. And an increasingly large group of voters, especially younger voters, feel a natural affinity with this idealism. Why shouldn't a rich nation help those who are less advantaged? After all, it's good for society.

This theory is crucially important for investors and citizens to understand as its popularity is spreading like wildfire. The theory promises to be a strong force in the coming election. Will the most successful politician at the ballot box in 2020 be the one who promises the most freebies?

"Modern monetary theory is seductive in its promises. But if enacted it could cause great harm to the U.S. economy. Like Medusa, it may seem beautiful. But if you look it in the eye you will turn to stone."
– Michael R. Strain, Director of economic policy studies at the American Enterprise Institute (AEI)

Consider the following scenario: The U.S. is attempting to run trillion-dollar deficits on a continuing basis. Sooner or later, potential bond-buyers will question whether they were going to get repaid. Or a foreign lender could decide for political reasons not to roll over the debt. For whatever reason, the bondholders stop buying U.S. bonds. Deficits don't have to matter for extended periods of time. But then, all of the sudden, they can start mattering a great deal.

The MMT cultists claim that this would be no problem whatsoever, because the Fed could directly finance the government deficit, either directly or by buying Treasury bonds. In other words, moving bookkeeping entries from one side of the ledger to the other.

"Well, nobody knows how much of this money printing we can do. *And of course, we have politicians who are in both parties, who like to believe that it doesn't matter how much you do. That we can ignore the whole subject and just print money as convenient.* ***Well, that's the way the Roman Empire behaved, then it was ruined.*** *And that's the way the Weimar Republic was ruined. And* ***there is a point where it's dangerous.*** *You know, and of course, my attitude when something is big and dangerous is to stay a long way away from it."*
– Charlie Munger, Warren Buffet's lifetime business partner

Such a move would have enormous consequences. Money supply would expand rapidly. And because inflation is a monetary phenomenon, inflation would start climbing and could quickly run out of control. Anyone holding dollar-denominated assets would do their best to unload them, meaning that the demand for dollars would collapse just as the supply of dollars is accelerating without limit. Zimbabwean hyperinflation, here we come!

Furthermore, one thing the Modern Monetary Theorists forgot to tell everyone — the term "crowding out." Government budget deficits crowd out private investment by competing away the limited pool of private savings available. And, sorry to say it, but we will have a recession. Unemployment will rise and deficits increase until we are on our way to a $30 trillion debt in just a few years. Today there is a record $50 trillion of debt, at all levels of society, at rates that are 100-200 basis points higher than they were at the time of origination. Rolling this debt will be no easy task when debtors are competing with the more than $2 trillion of annual borrowing needs by the Treasury.

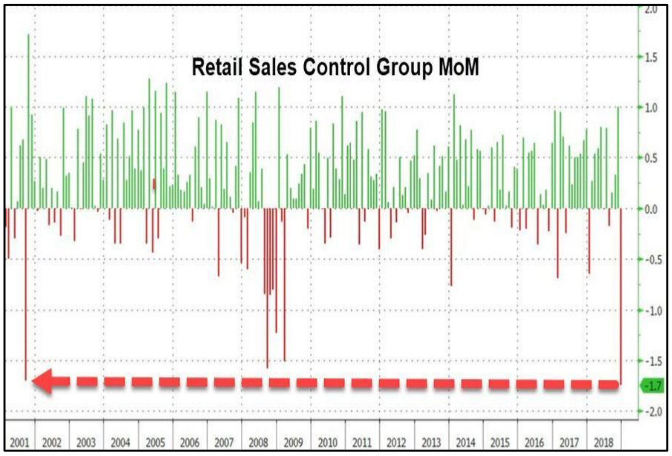
Proponents of MMT, who claim the sky is the limit when it comes to deficit-finance, point to Japan. In Japan, debt-to-GDP is the highest in the developed world at 253%. And the Bank of Japan has purchased essentially every bond available and now holds around 43% of all JGBs. In other words, 43% of Japan's debt has been monetized.

The Japanese economy has remained in an extended period of economic stagnation, punctuated with occasional "false dawns." This is what Japanification looks like! Is this the path the U.S. wants to take?

AS CONSUMERS GO, SO GOES THE ECONOMY…

Retail sales for December were released last week and showed the biggest decline since 2009! Headline retail sales plunged -1.2% month-over-month and, most importantly, to the bean counters measuring GDP, the control group retail sales were dramatically lower at -1.7% versus a consensus forecast of +0.04%. This is the largest month-over-month drop in retail sales since 2009 for the headline and the biggest drop in the control group since the 9/11 attacks in 2001!

Nah, Probably Nothin'!



Source: Bloomberg

Trump's Chief Economic Advisor Larry Kudlow explained the disastrous, worst-in-nine-years retail sales number, and claimed it was due to, drumroll please, a "glitch." Some pundits claim that the weak retail sales data reflected the government shutdown or that somehow the numbers were released in a big rush and therefore cannot be trusted.

I cannot comment on the latter. We shall wait to see. As for the former, the government shutdown started on December 22 and by then most if not all of the holiday shopping season was in the books. Find a different excuse.

Unquestionably, the monthly retail sales release is perhaps the most revised report to come out of the government's statistics mill. However, when digging below the headlines, it was interesting that grocery sales slumped 0.5% in December and have been flat or down in four of the past five months. Likewise, pharmacies have seen their sales decline or stagnate in five of the past six months after the 2% fall-off in December. What does it mean when families are cutting the budget on essentials? Did government workers, if that is the story, suddenly stop eating and using soap just because of the shutdown? Come on.

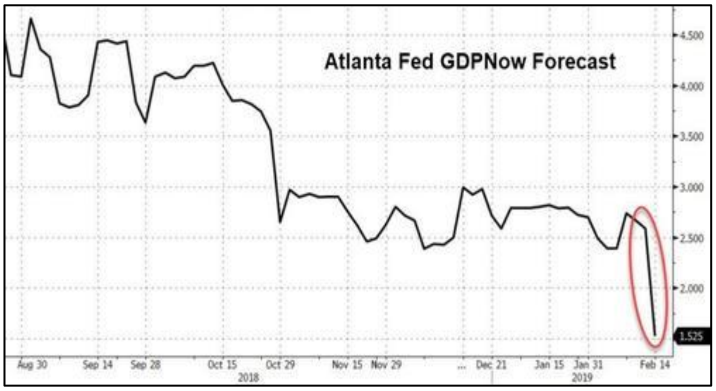
Last week everyone said retail sales numbers had to be wrong because Redbook survey hadn't declined.

Well… this private survey of retail sales showed a 50% slowdown in year-over-year growth in the early weeks of 2019. The Redbook Index isn't as large or as closely watched as the Commerce Department's survey, but it isn't providing optimism in the wake of the government's weak December report.

Confirmation?

Regardless, after the retail sales shock report, the economic downgrades started, with virtually every analyst slashing its estimates for fourth quarter GDP. The most scathing revision came from the Atlanta Fed's GDPNow with economic growth being slashed to just 1.5%, down nearly 50% from 2.7% as recently as February 6. That would be a major slowdown from the third and second quarters' respective growth rates of 3.4% and 4.2%.

Fourth Quarter GDP Plummets



Source: Bloomberg

More importantly, as we look forward, inquiring minds are wondering how the tax law changes are affecting tax refunds which may have a substantial effect on consumer spending in the months ahead.

Here's the math: It is estimated that 30 million people or families that got a return this year will be paying taxes instead. (I'm in that group.) **The average refund was $1,865** as of February 1 — down 8.4% (about $170 per tax filer) from $2,035 a year ago.

Further, according to IRS data, there are 140 million tax filers. That means that the total decline in the amount of tax refunds is approximately $24 billion. And when the average person on the street figures this out will they cut back on their purchases. Thus, the economic impact of decreased tax refunds is likely to be significant.

The bottom line: Most of Trump's tax cut went to corporations rather than individuals, and many families, especially in coastal blue states (and Illinois), will see or have already seen their total tax bill rise.

RECESSION RISK IS REAL

"There can be few fields of human endeavor in which history counts for so little as in the world of finance. Past experience, to the extent that it is part of the memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present." – John Kenneth Galbraith

Despite the Fed narrative that "*recession risk*" is non-existent, it is important to remember that the Fed has NEVER predicted a recession. NEVER! And we have had at least one recession every decade since 1950. Their record speaks for itself. To drive home the point, in January 2008, former Fed Chairman Ben Bernanke stated, "*The Federal Reserve is not currently forecasting a recession.*" And shortly thereafter, the National Bureau of Economic Research called an official recession that began in December of 2007.

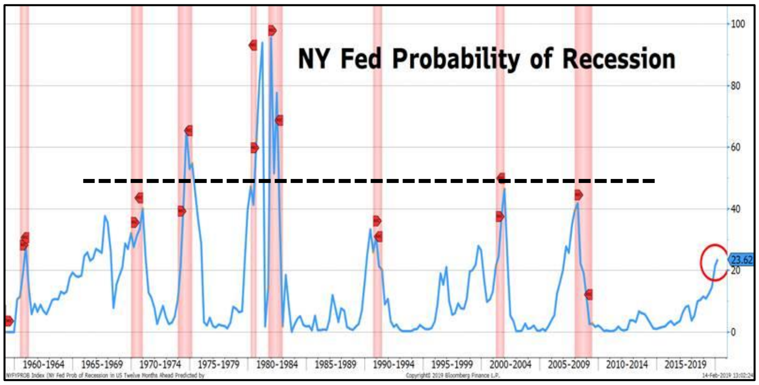
The reality is no one wants to discuss the "R" word ("recession"). Why spoil the party and be a Debbie Downer? I get it. Bull markets are more fun. But recessions are part of a normal and healthy economy that purges the excesses built up during the first half of the cycle.

Furthermore, by ignoring the risk of a recession, investors have historically been repeatedly crushed by the inevitable completion of the full market and economic cycle. While we all hope that a recession does not occur "hope" is NOT a good investment or risk management strategy.

Below I list various indications which suggest that risk of recession is much higher than currently appreciated.

Two years ago, the New York Fed model was pegging recession probabilities at 4.1%. A year ago, even with the tax relief, those odds rose to 10.4%. In December, the odds were 21.4%. And today, the third increase in as many months, the odds sit at 23.6%.

Recessions Probability Rises



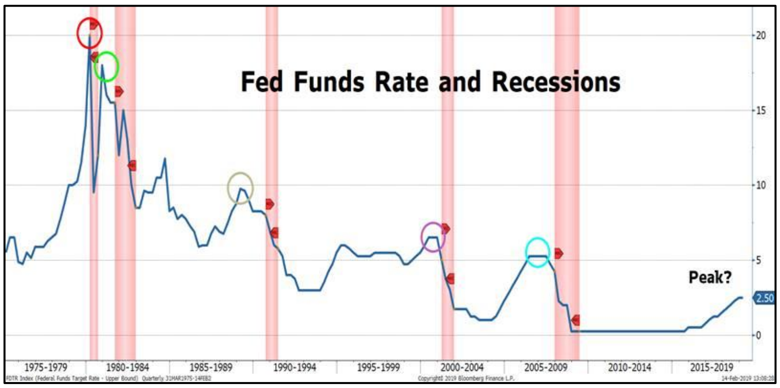
Source: Bloomberg

Currently, the probability is now at the highest level in 11 years during the depths of the Great Recession. This metric never goes as high as 100%. Quite often, recessions hit once this measure breaks into a 30%-40% range. Over the past 50 years, this level has never been above 28 before a recession occurred. So, whether or not a recession is your base case scenario, it is safe to say that the chance of an economic contraction is on the rise. This is a red flag.

The Fed funds chart illustrates that the last three recessions began shortly after the peak of the tightening cycle.

Just as everyone breathes a sigh of relief that the Fed has stopped in the nick of time and engineered a soft landing, the lags begin to kick in. There is no reason, after a de facto monster tightening cycle of over 300 basis points (with the effects of the balance sheet unwinding together with the nine rate hikes), to think it will be different this time.

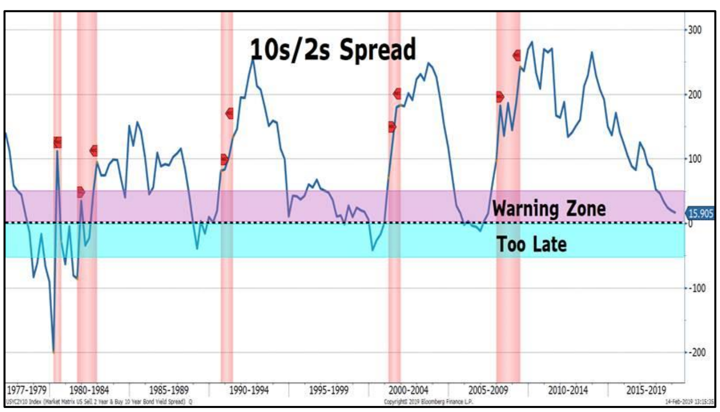
Has the Fed Tightened too Much?



Source: Bloomberg

The yield spread between the 10-year and the two-year Treasury yields is also suggesting there is a rising risk of a recession in the economy. As I have noted numerous times in this space, the yield curve is the single best predictor for recessions. In fact, every time the curve has inverted a recession has followed. While Wall Street argues "it's different this time" do you want to bet against those odds? As shown below, the 10s/2s spread is now 15 basis points away from inversion.

Yield Curve in Warning Zone



Source: Bloomberg

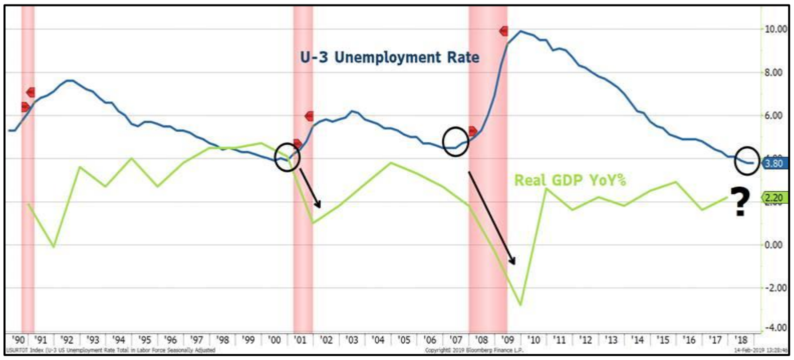
Historically, the lag between the inversion of the yield curve and the recession is on average 22 months. If history repeats itself – which is not certain – the likelihood that a recession happens in 2020 is very high.

Why it matters? An inverted yield curve negatively impacts the real economy through the banking sector by hurting banks' profitability, which leads to more restrictive credit conditions. It may also signal that the monetary policy is too tight, implying that the neutral rate is lower than what the Federal Reserve believes.

The unemployment rate may also be warning of a recession. There is significant correlation between the unemployment rate and economy and stock returns… but not the way you might expect. For what is considered to be a lagging indicator of the economy, the unemployment rate provides surprisingly good signals for the beginning and end of recessions. This model, back tested to 1948, reliably provided recession signals.

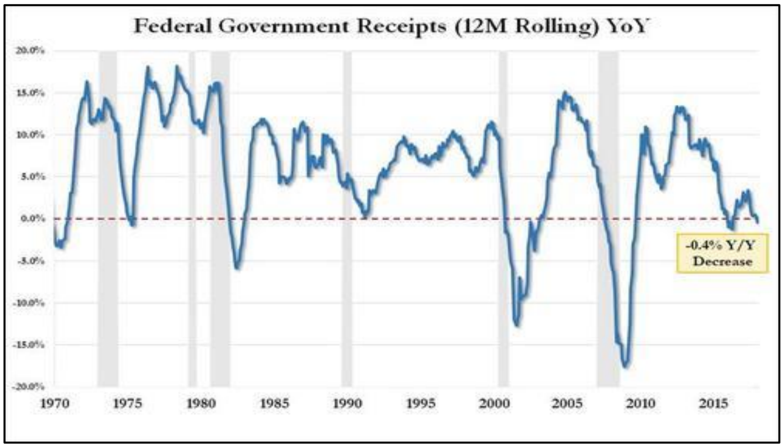
Intuitively, you would think low unemployment means a strong economy and thus a strong stock market. The opposite is true. Going back to 1948, the U.S. unemployment rate was below 4.3% for 20.5% of the time. In those years, the S&P 500 gained an annualized 1.7%. And as shown below, when unemployment troughs, it often coincides with the end of the economic cycle. Recessions follow shortly thereafter.

Peak Employment?



Source: Bloomberg

Finally, government receipts have turned negative. Since 1970, every time (two exceptions) 12-month governmental receipts dipped into the red, the U.S. economy suffered a recession. Lower corporate tax rates – due to the new tax law – are a big reason for declining tax revenue as corporate tax receipts have declined 19%. However, it is just as concerning that Individual Income Taxes also posted a decline, dropping 3% for the current fiscal year.



Meanwhile, as receipts are now declining, government outlays are rampaging higher as the national debt just surpassed the $22 trillion milestone for the first time; that's an increase of over 10% from when President Trump took office. Imagine what happens to the Fed's balance sheet if a recession hits home.

And as the U.S. debt continues to grow with reckless abandon, both parties turn their collective heads. Medicare and Medicaid and Social Security are at the root of the issue. But few politicians on the left or right will run on a platform of cutting these programs. However, if politicians don't have the nerve to reduce the size of government spending, they should not cut taxes until they are at least willing to pay for what they're spending. This is ridiculous.

Both parties claim to care about the deficit, but once in power they often act as if they care more about putting their preferred policies in place, whether these are tax cuts in the case of conservatives or new spending programs in the case of liberals. No matter who is in power, invariably takes the form of… adding to debt.

Dick Cheney was famous for saying Ronald Reagan proved that deficits don't matter. But the national debt is now over $22 trillion dollars and it's growing at over a trillion dollars a year during a "growing" economy. During recessions, it's fine and appropriate if debt and deficits rise. But after nearly 10 years of economic growth, debt and deficits should be declining nor rising. Has any politician ever heard of "saving for a rainy day?" We have decided that debt doesn't matter one bit.

Thinking ahead to the next recession, we should de deeply concerned about our nation's tenuous fiscal position. To see deficits approaching 5% of GDP – with unemployment and interest rates at such historically low levels – should have us all fearful. **Debt and deficits don't matter. Until they do.**

Source: Cagle Cartoons

POLITICAL EMERGENCY

"The moment the wall goes up, there will be drones flying drugs over the wall to the other side"
– David Stockman, Former Direct of the Office of Management and Budget under President Ronald Reagan

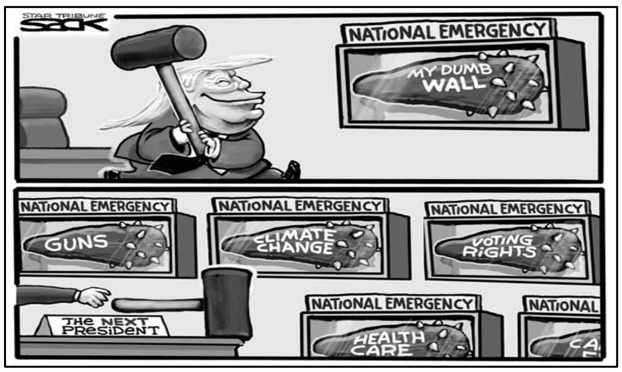
Last week, President Trump declared a national emergency over border security, bypassing Congress in an effort to divert money from elsewhere in the government to pay for the construction of additional barriers along the southern U.S. border. Mr. Trump defended the actions as critical to national security. *"We're talking about an invasion of our country."* At another point, however, he suggested an emergency declaration wasn't necessary. "*I didn't need to do this, but I'd rather do it much faster.*"

Question: Did the Prez declare upfront that it wasn't really an emergency? This should be interesting.

Furthermore, can the President legally do what he is proposing? Whether or not this is Constitutional is to be decided by the courts. It could take months or years for a final ruling.

Last week, the Wall Street Journal editorial board weighed in: *Trump's Political Emergency*.

"The emergency declaration will please his most ardent supporters, but Mr. Trump is setting an unfortunate precedent – and judges could tie up his wall in court for years… He boxed himself in by saying in December that he'd gladly take ownership of a shutdown."



Source: Cagle Cartoons

And, of course, there was dissent from both sides. Obviously, the Democrats pushed back.

But it wasn't just the Dems. Many Republicans spoke up as well.

"I don't think that this is a matter that should be declared a national emergency."
– Republican Senator Lisa Murkowski (Alaska)

"Declaring a national emergency is a mistake." – Republican Senator Susan Collins

Meanwhile, as expected... Tweets on what our next President should declare as a #NationalEmergency were coming out of the woodwork. Will the next "national emergency" be the existential threat to all life on the planet posed by climate change, gun control, health care, etc.?

No matter what side of the wall you fall on, this is a bad precedent for our country.

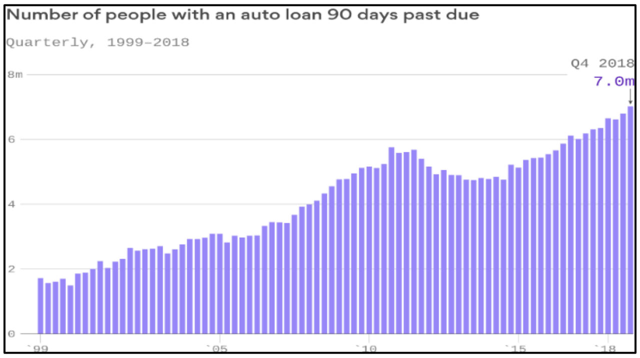
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"It seems like there has to be an elevated probability of a recession this year or next year… There are these signs that show people are worried. It's also the longest bull market in the stock market… There's a spirit of thinking –- it ought to come to an end soon." – Yale Professor and Nobel Laureate Robert Shiller

The incoming economic data are poor. Housing remains in a downtrend. Investment and inventory plans are declining. And exports are predictably in decline with overseas demand softening across a broad front. Auto loan delinquencies have surged. This is a picture of distress. Car loans are the last debt that Americans generally default on, since a car is in most cases necessary to get to work.

This degree of woe is happening despite a growing economy and record-low unemployment. If and when a recession hits, expect these numbers to get a lot worse.

Delinquent Car Loans Hit Record Highs



In addition, U.S. corporate guidance and earnings estimates are coming down in tandem and rather significantly. U.S. small business optimism tumbled last month to its lowest level since President Trump's election amid growing uncertainty over the economic outlook. As discussed last week, the latest Fed Senior Loan Officer Survey already contained the early signs of a contraction in household and business credit. Both on the supply side and the demand side.

The Organisation of Economic Co-operation and Development's Composite of Leading Indicators (CLI) fell for a thirteenth straight month in December, a stretch of weakness we haven't seen in over two years. On a year-over-year basis, the index is running at -1.3%, the most negative it has been since July 2009. This is yet another metric that points to elevated recession risks.

The weakness is widespread — 95% of countries are now contracting relative to year-ago levels. In other words, we have moved away from synchronized global upswing to a synchronized global slowdown. Of note, China's economic malaise is expected to continue. And make no mistake, Europe is in a recession, right here, right now. Last week eurozone industrial production fell more than expected in December which took the year-over-year trend to a horrible -4.2% from -3.0% in November. This is the largest contraction in industrial activity for the 19-member region since the financial crisis and is another vivid sign that economic momentum continues to wane.

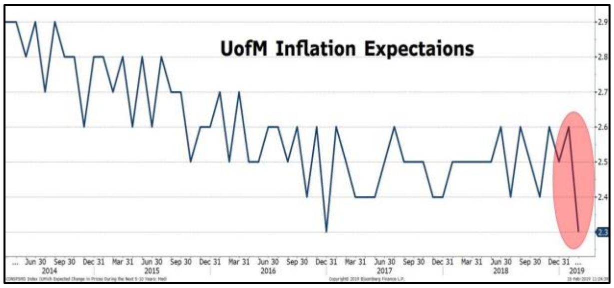
The U.S. is NOT an island. There is no such thing as global decoupling given how interconnected supply chains have become. Remember how well this argument worked out last cycle as the global economy followed the U.S. into recession.

"I still remember back in 1998, during the Asian financial crisis, Alan Greenspan argued for an interest rate cut in spite of the fact that the U.S. economy was doing very well. ***And, in justifying it, he said 'it's just not credible that the United States can remain an oasis of prosperity unaffected by a world that is experiencing greatly increased stress****…' And I think that remains as true today as it was then."*
– Former Fed Chair Janet Yellen

Don't say you weren't warned.

On the inflation front, prices appear to have peaked and are now heading lower. Thanks to falling energy prices, the Consumer Prices Index (CPI) is once again steady, with year-over-year rates down a third month. The CPI index was unchanged in January. On a year-over-year basis, CPI slowed to +1.6% from +1.9%, the weakest run-rate since September 2016. Last week, price inflation numbers on imports and exports both came in well below consensus estimates. And inflationary expectations have plummeted.

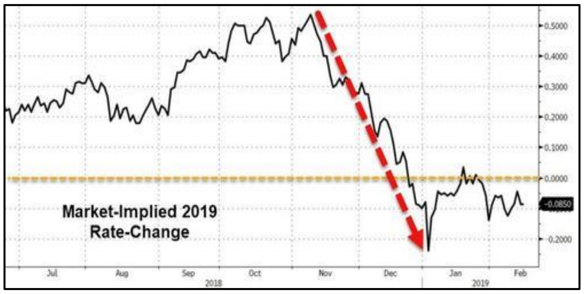
Inflation Expectations Plunge!



Source: Bloomberg

So, with economic momentum waning and inflation pressures subsiding, is it any wonder the "normalization" of both interest rates and the Fed's balance sheet have stopped cold. But what happens if the economic cycle – at home and abroad – continues to slow? If so, look for the Fed to "walk the walk" and commence with rate cuts. And that is exactly what the market is now pricing in.

Fed Cuts in 2019?



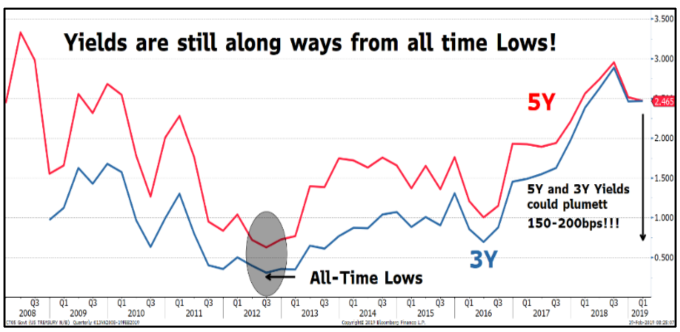
Source: Bloomberg

And the bond market has begun to discount economic weakness and a reversal in the Fed rate hike cycle. So, from a short-term strategic perspective, it would be hardly surprising to see yields retrace given the sharp decline over the past three months.

Yields Have Declined Significantly...

That said, any market dip in the bond market should be viewed as an opportunity to invest excess cash. Should the U.S. fall into recession and the Fed cut rates aggressively, the entire yield curve could plunge 100-200 basis points from current levels. Should a recession occur, look for the Fed to completely unwind its tightening program as rates head back to zero-bound.

But Yields Could Decline Much More…



Thus, from a long-term structural risk-management perspective, we continue to advocate that credit unions maintain a risk-appropriate, high-quality ladder investment portfolio. Avoid the short-term noise, stop forecasting (aka guessing) and maintain the ladder discipline. The medium-/long-term risk is that not if, but when the Fed reverses policy, credit unions will have missed an opportunity to lock in higher yields and returns.

Also, by remaining fully invested, credit unions will minimize the reinvestment rate risk. In other words, while staying in cash may seem like a risk averse strategy, it may in fact be adding risk to the balance sheet and reducing income from a longer-term horizon.

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- Dinner at Smith & Wollensky Restaurant
- Leadership & Motivational Speakers
- Football Night with Alloya – NFL Opener
- Economic Outlook
- Dueling Market Views featuring Tom Slefinger and Steven Rick
- Multiple Networking Opportunities
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MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@balancesheetsolutions.org or (800) 782-2431, ext. 2753.

Tom Slefinger, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI, has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Balance Sheet Solutions, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.