BALANCE SHEET SOLUTIONS
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WEEK OF MARCH 4, 2019

Weekly Relative Value

The Stock Market is Not the Economy

"In economics, things take longer to happen than you think they will, and then they happen faster than you thought they could." – Kenneth Rogoff, Professor of Public Policy and Economics at Harvard University

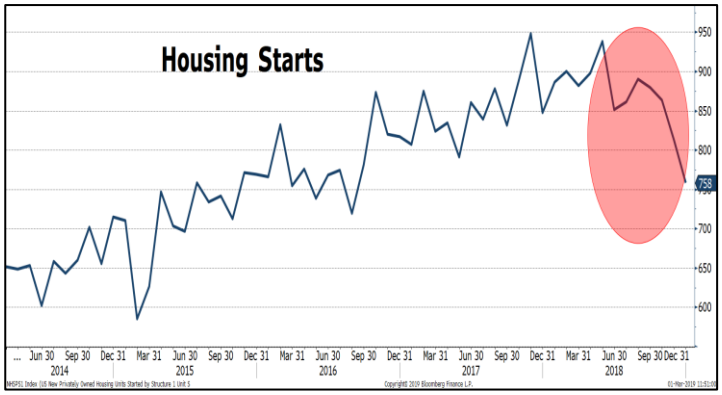
"Remember, everything is right until it's wrong. You'll know when it's wrong."
— "You think so?"
— "I'm quite sure. If you don't it doesn't matter. Nothing will matter then."
– Ernest Hemingway

If we were to objectively look at the list of key macroeconomic data published in recent weeks, I cannot use a better adjective to describe them than "disappointing."

Let's assess how this "solid" U.S. economy performed in the fourth quarter:

Housing Starts: Starts were down 11.2% in December compared to the previous month, marking three consecutive quarters of decline – and the biggest decline in four years.

Housing Starts Plunge



Source: Bloomberg

Home Resales: Existing home sales were down 8.5% year-over-year. That was the third month in a row that we have seen a decline of at least 8%. And resales have been negative for five straight quarters. Remember that existing home sales account for 90% of housing

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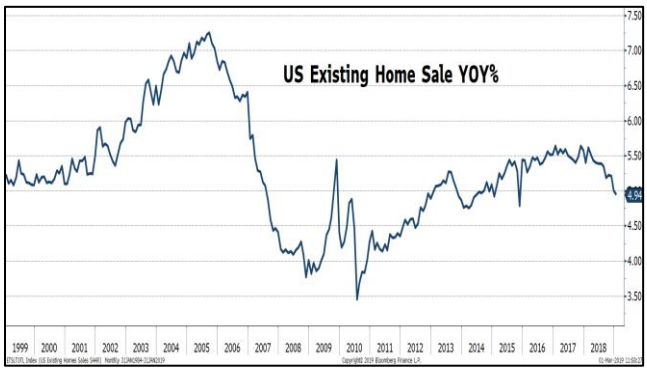
THIS WEEK…

activity in this country. And the trend does not appear to be turning around near-term. Demand for mortgage credit is weakening and the banks also are becoming more cautious on their lending guidelines.

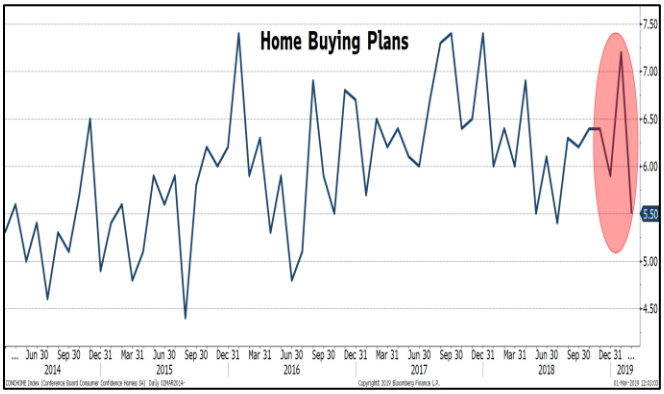
Existing Home Sales at Five-Year Lows



Source: Bloomberg

And according to the latest Conference Board, homebuying plans slumped from 7.2% to 5.5%, a seven-month low. Not good news for a sector already under relentless downward pressure.

Plans to Buy a Home at Seven-Month Low



Source: Bloomberg

For an economic expansion that is just months away from the longest on record, this has been one incredibly weak housing rebound. Population-adjusted numbers are far worse. We are at levels seen in the 1950s!

Home price growth has slowed for nine straight months – up just 4.18% year-over-year – the weakest since September 2012, according to S&P Case-Shiller"s 20-City Composite Index.

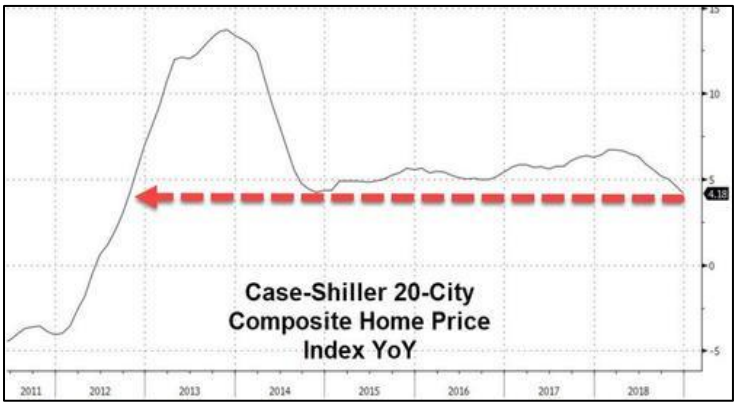
This slump adds to signs of weakness in housing despite a pullback in mortgage rates.

The problem now isn't one of liquidity or iffy mortgages; it's the generation that would like to buy homes yet finds they don't earn enough, and their incomes are not secure enough, to gamble everything on an overpriced house that chains them to a local economy they might want to leave if opportunities arise elsewhere.

In other words, the economy has changed, and the sacrifices required to buy a house in hot markets at today's prices make no sense.

Unless the Fed is going to start buying millions of homes outright, prices are going to fall to what buyers can afford.

Home Price Gains Have Peaked

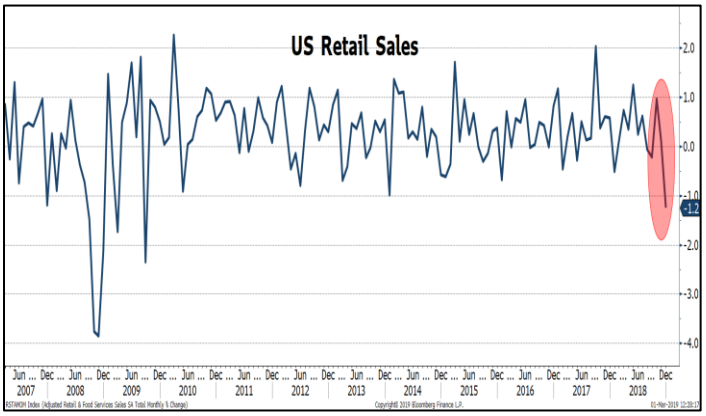


Source: Bloomberg

Moving on to the consumer:

Retail Sales: Retail sales were down 1.2% in December, sharpest decline since 2009. We also know that auto sales collapsed 5% in January too, which means the consumer has started the first quarter off in a bit of a hole.

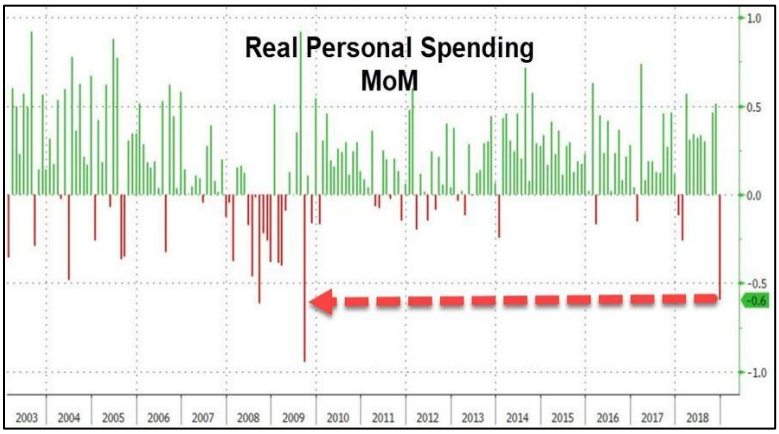
What's Wrong with the Consumer?



Source: Bloomberg

Confirming the collapse in retail sales that was called an outlier, December personal income fell 0.1% month-over-month (against expectations of a 0.3% rise) – the worst drop since January 2013. Meanwhile, personal spending plunged 0.5% month-over-month in January – the worst drop since September 2009!

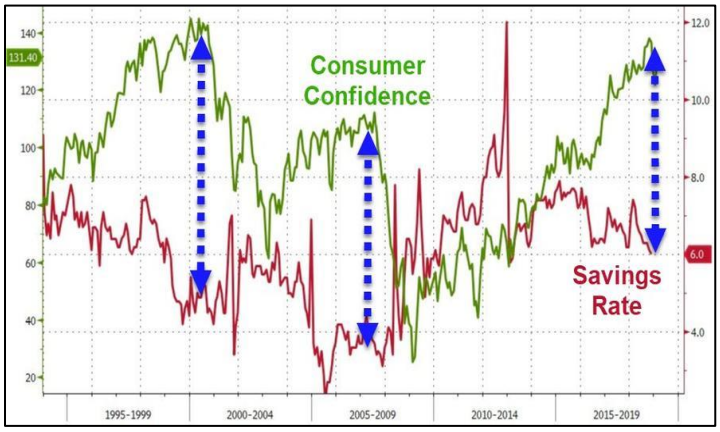
Additionally, real personal spending crashed 0.6% month-over-month. Is terrible news on America's consumer great news for the market? We shall see.



Source: Bloomberg

And the bulls have to be disappointed that the average income tax refund is DOWN 17% year-over-year through mid-February. Almost every single rose-colored-glass-wearing economist pointed to stuffed refunds bolstering consumer spending as the most important reason to be bullish on first quarter growth. Back to the drawing board.

Meanwhile, the savings rate showed by the biggest monthly increase in five years, and the second biggest since the financial crisis. One thing is for sure – the collapse in the savings rate to placate the exuberance in spending confidence may have just hit a wall.



Source: Bloomberg

And according to the Conference Board, the most fascinating (and disturbing) development was the sharp pullback in spending plans:

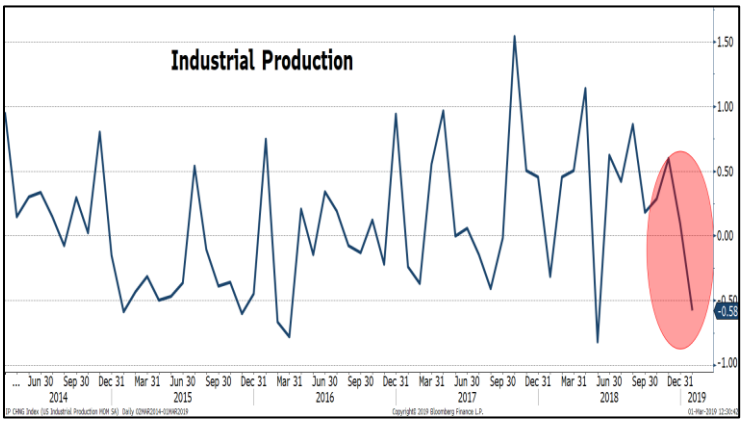
- Plans to take a vacation sagged to 52.2% of respondents in February from 62.3% in December. This is the lowest since June 2018. This explains why airline stocks have been so weak because plans to travel by air tanked to 24.3% from 29.0% and is at its weakest level since June 2017. For a nation of drivers, it was striking to see travel intentions by car drop from 32% in October, to 28.2% in December and now down to 24.8% in February.
- Auto spending intentions have declined for four straight months — from 14.0% in October, to 13.8% in November, to 13.1% in December, to 12.9% in January to 12.0% currently — a notable pattern of weakness to

the lowest level since July. Then again, this makes perfect sense if people aren't going to be driving around, as the vacation component highlighted.

Make no mistake — the consumer is increasingly on a soft footing despite the popular narrative to the contrary.

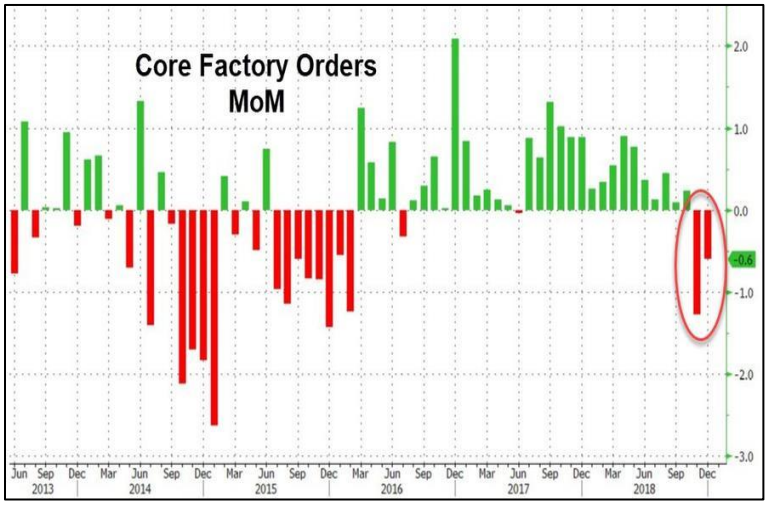
On the manufacturing front:

- **Industrial Production:** The January industrial production report was well below consensus forecasts at -0.6% vs. -0.01%



Source: Bloomberg

- **U.S. core factory orders** (excluding transports) are the best leading indicator for business capital spending. They have now fallen for the second month in a row in December and have contracted in four of the past five months at roughly a 5% annual rate. This is the worst slump for core U.S. factory orders in three years. Remember when we were told that the tax cuts would lead to an acceleration of capital spending?



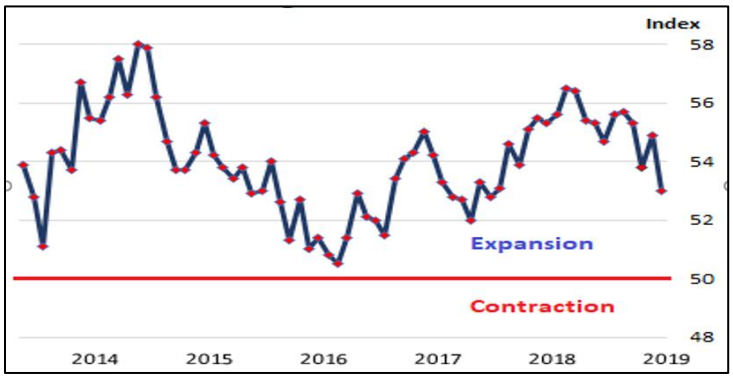
Source: Bloomberg

- Markit's U.S. Manufacturing Purchasing Managers' Index (PMI) plummeted to 53.0 in February – its lowest since August 2017.

"Worries regarding the impact of tariffs and trade wars, alongside wider political uncertainty, undermined business confidence, with expectations of future growth running at one of the most subdued levels seen for over two years and suggesting downside risks prevail for coming months."

The survey suggests that "factory production and orders growth rates are close to stalling mid-way through the first quarter," the report said. "Export markets remained the principal drag on order books."

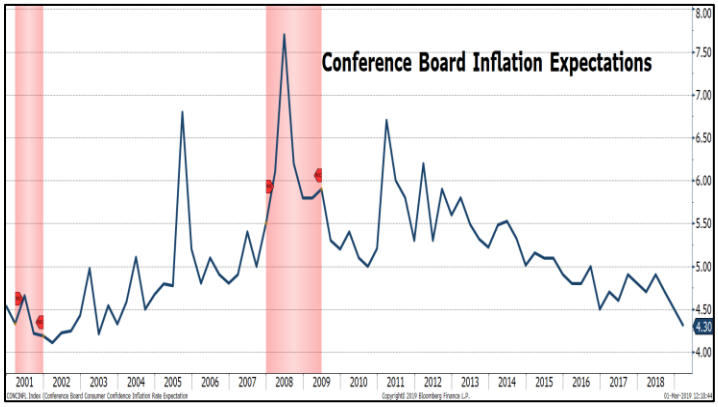
Manufacturing Sentiment Continues to Decline



Source: Bloomberg

Finally, the bond bulls will like the fact that inflation expectations fell for the fourth month in a row to stand at a 15-year low.

Inflation Expectations Tumble

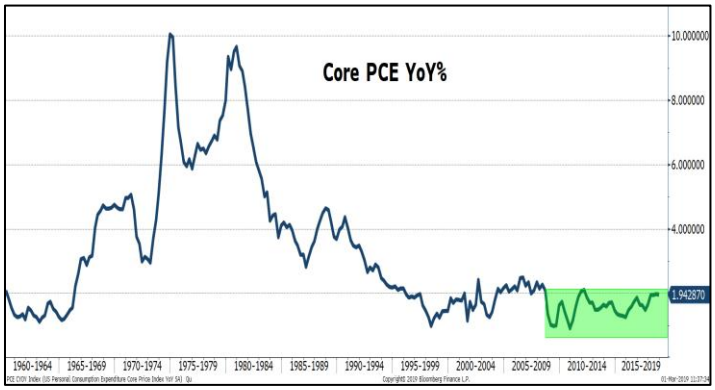


Source: Bloomberg

Isn't it amazing that despite every central bank in the world printing trillions of dollars, euros and yen combined with massive fiscal spending, inflation has never reached the desired levels of the "central planners?" This lack of pricing expectations is not exactly commensurate with a booming economy.

As shown below, the Fed's favorite inflation metric – core personal consumption expenditures (PCE) – has remained below the Fed's target of 2% since 2009.

Inflation Remains Below Fed's Target of 2%



Source: Bloomberg

THE STOCK MARKET IS NOT THE ECONOMY

"As you all know, I couldn't disagree more with the notion of an efficient market nor that price is truth. Emotion, liquidity, sentiment, positioning and the machines and algos are some of the many factors that create an artificiality in stock prices and run counter to natural price discovery." – Doug Kass

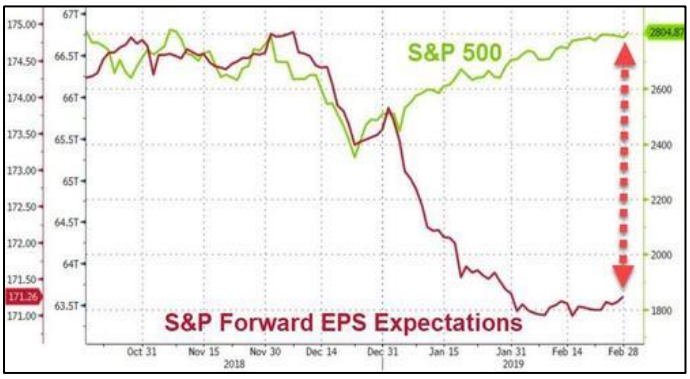
Virtually every piece of hard economic data is telling us that the U.S. economy is slowing down. But the stock market has been surging over the last two months, and at this point stocks are off to their best start to a year since 1987, and as long as stock prices are rising a lot of people are simply not going to pay much attention to the economic alarm bells that are ringing.

Stocks Have Decoupled from Macro Data

Source: Bloomberg

In addition, earnings estimates for 2019 have sharply collapsed, as I previously stated they would, and still have more to go. So far, 431 of S&P 500 companies have reported aggregate year-over-year earnings-per-share growth of +10.9%. That's down big time from the third quarter 2018 growth rate of +26.2% year-over-year. As a reminder, earnings recessions have always led to broader recessions.

Stocks Decoupled from Earnings Expectations...



Source: Bloomberg

So, with the economy slowing and earnings forecasts declining, why have stocks risen so much in the first two months of the year?

Easy! Stocks have been rescued by a $3 trillion global liquidity injection after the Christmas Eve slaughter. As shown below, stocks are perfectly coupled with global money supply (and global central bank balance sheets). And between December 26 and February 15, we have seen the largest injection of liquidity in the markets of the last two years, bringing the global money supply to record levels. So, who cares about fundamentals when global money supply (and bank balance sheets) have suddenly reversed course and exploded higher?

Hand in Hand Together

Source: Bloomberg

The message here, and from other central banks, is that the Fed has your back as an investor. The admission of *mea culpa* in the aftermath of the December meltdown has been fast and furious. The European Central Bank is set to unleash a fresh targeted longer-term refinancing operation (TLTRO). The People's Bank of China is back into credit stimulus. Even the Bank of Japan feels it has more to do, which is why the 10-year JGB yield is back below zero. The Reserve Bank of Australia has turned dovish and the Bank of China has headed to the sidelines. More and more

adherents are coming to the fore in support of the Modern Monetary Theory, which basically stipulates that money does indeed grow on trees.

Here we are, 10 years past the worst point of the global financial crisis, and economies everywhere are so fragile that central banks are still being called up to prop up equities. The level of policy infiltration has created a background where price discovery is next to impossible to achieve. Pricing is divorced from fundamentals across most risk asset classes.

The central planners have created artificial "Potemkin-like" financial market conditions. Conditions that generate an environment of artificial pricing where economic laws are turned on their head, and where "bad news is good news" because of the perception that central banks will act before a bear market or investor panic can ever be allowed to reappear. If we get a correction, central banks will step in.

It's tough to make recommendations into such a "fake" market. There is just too much of a divide between prices and fundamentals.

QUOTES OF THE WEEK

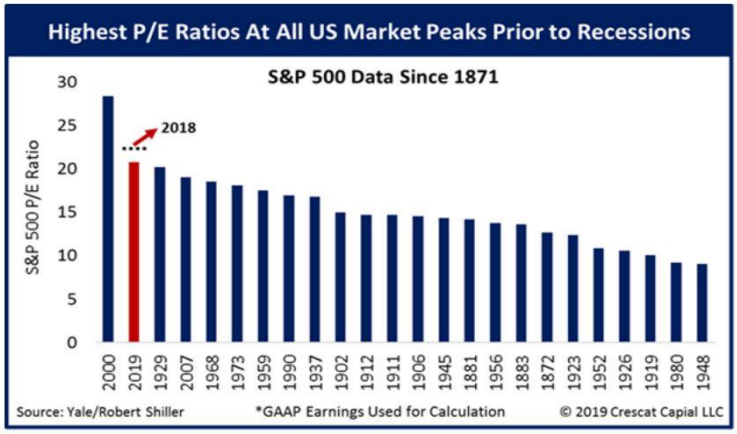
"We are prepared for a recession. We're not predicting a recession. We're simply pointing out that we are very conscious about the risks we bear." – Jamie Dimon, CEO of JPMorgan Chase

"In the years ahead, we hope to move much of our excess liquidity into businesses that Berkshire will permanently own. The immediate prospects for that, however, are not good: Prices are sky high for businesses possessing decent long-term prospects." – Warren Buffett, CEO of Berkshire Hathaway

To sum it up: Rising recession risks combined with elevated equity price. What could go wrong?

As February comes to an end, we wonder, when does reality break back into the market's perception?

GAAP PE Ratio at Highest Eve

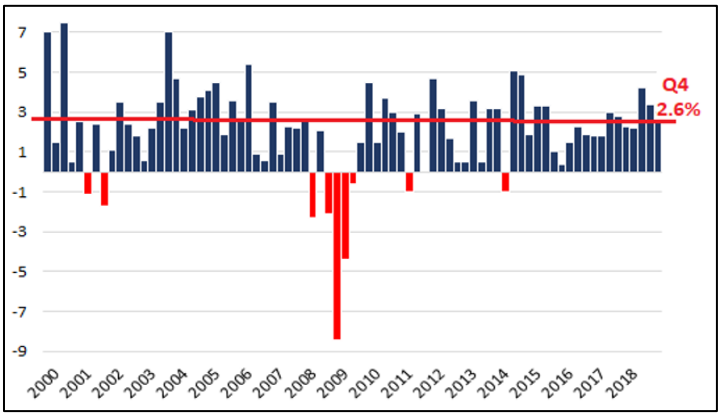


PRINT AND SPEND

The dream of 3%-plus economic growth in 2018 was fulfilled, after tax cuts and ballooning federal deficit spending, which acted as a huge stimulus. In the fourth quarter, the economy as measured by GDP grew by 0.55% from the third quarter. This brought GDP growth for the entire year 2018 to 3.1%.

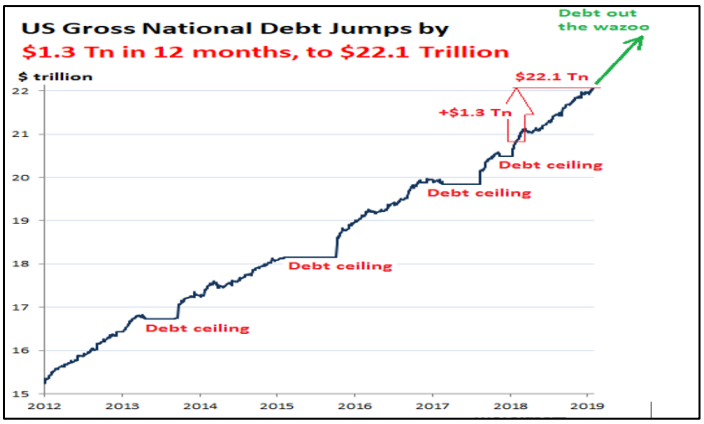
This fourth quarter growth rate of 0.55% would mean for the whole year if the economy had grown for an entire year at the same growth rate of 2.6%. As shown below, this annualized fourth quarter growth rate was decent but nothing to write home about. It was somewhere in the middle of the range since the financial crisis. The two fastest-growth quarters by this measure since the financial crisis were both in 2014 with 5.1% and 4.9%. Before the financial crisis, annualized growth rates were as high as 7%.

U.S. Real GDP Quarter-Over-Quarter Annualized



Nominal GDP, increased in 2018 by $1.0 trillion to reach $20.5 trillion in today's dollars while the government's debt grew by $1.3 trillion, to end the year at $21.97 trillion. Most of the $1.3 trillion was added to GDP and therefore to GDP growth. Without that additional federal borrow-and-spend, GDP growth would have been negative.

In essence, debt has been the primary driver behind GDP growth.



Thus, the slight GDP growth we've been seeing is a mirage. Stock prices are being propped up by GDP growth, and related corporate earnings, that are clearly unsustainable. Current fiscal policy is not "borrow and spend," it's "print and

spend." Today, no one genuinely believes the federal debt will ever be paid down, just rolled over. So, today's deficit spending is just loose credit driving monetary inflation.

As long as debt grows faster than GDP, we are making the bubble bigger.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Now I've got that feeling once again,
I can't explain; you would not understand.
This is now who I am.
I, I, I've become comfortably numb."
– Pink Floyd, "Comfortably Numb"

As discussed above, the building blocks for a downturn are in place.

Yes, I can hear it now from the talking heads, the fourth quarter GDP print of 2.6% came in well above the expected 2.2% consensus. In other words, where's the recession? But then again, I know of no one who was forecasting a recession in 2018. How could there be a recession given the epic fiscal stimulus percolating through most of the year. The "R call" was saved for 2019/2020 and nothing in the fourth quarter GDP report gave anybody any clue about how the coming year is going to unfold. Please do not extrapolate!

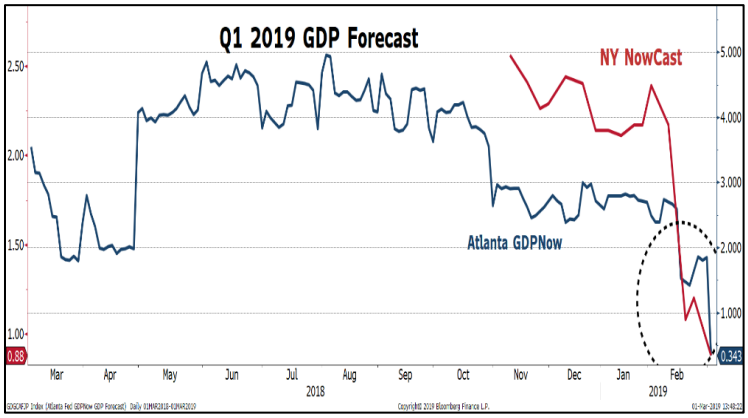
Let's review a bit of history. In the fourth quarter of 2000, real GDP growth came in at a 2.5% annualized. The question then was "where's this recession?" Guess what? The very next quarter!

In the fourth quarter of 2007, real GDP growth was yet again +2.5% annualized. And the question arose, "where is that recession?"

And like clockwork... it began the next quarter.

And in 1990, GDP was 4.5%. And guess what? The recession basically began four months later.

Today's GDP number tells you nothing about what the numbers are going to be looking like in the spring and summer.



Source: Bloomberg

So, with that said how's first quarter shaping up?

Goldman launched its first quarter GDP tracking estimate at a paltry +0.9**%.** This forecast "reflects an expected drag from inventories, sequentially slower consumption growth, a decline in residential investment, and a four-tenths drag from the government shutdown."

It wasn't just Goldman, because at roughly the same time, the New York Fed's GDP Nowcast, which was launched to counter the Atlanta Fed's famous GDP tracker, crumbled from 1.22% last week (and 2.17% as recently as a month ago), to a stunning 0.88%, as a result of big declines in personal consumption, housing starts, wholesale inventories, and others.

And speaking of the Atlanta Fed, its latest GDP Now forecast was a doozy, with the initial estimate coming just barely positive at only 0.3%.

It appears that now the broader U.S. economy is on the verge of contracting, if only for just one quarter. The question then becomes whether China's massive reflation attempts are successful, and lead to a rebound in U.S. growth in the second quarter. If not, what was expected to become the longest U.S. expansion in history in June 2019, will be prematurely terminated by a technical recession.

Yet no one sees a recession.

And when you hear "no recession in sight" from economics intelligentsia, it's generally time to head for the hills.

The euphoric behavior in risk-on assets, and some reappraisal as to whether the Fed is indeed on hold for the remainder of the year, have caused a partial reversal in the U.S. Treasury market rally of late. In terms of portfolio strategy, the yield back-up we have seen of late will likely prove temporary and is yet another buying opportunity. Every survey is flashing a retreat in inflation views. The National Federation of Independent Business (NFIB) poll is showing a mere 2% of small businesses see inflation as their top problem. Maybe it really shouldn't be much of a worry for investors, either. Thus, whether a recession occurs or not, the theme of the three "L's" (low growth, low rates, low inflation) remain entrenched.

Given this backdrop, we continue to advocate a fully invested ladder strategy of high-quality debt instruments.

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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
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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.