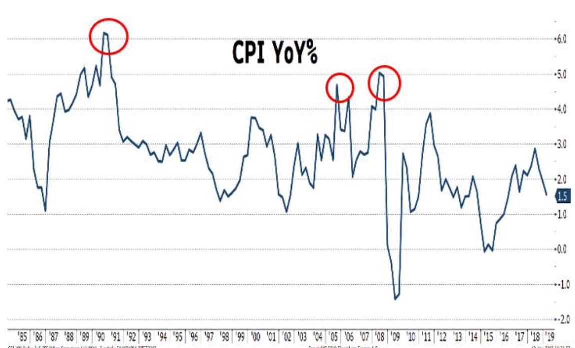
Weekly Relative Value

Have Consumers Thrown in the Towel?

A central banker walks into a pizzeria to order a pizza. When the pizza is done, he goes up to the counter to get it. There a clerk asks him: "Should I cut it into six pieces or eight pieces?" The central banker replies: "I'm feeling rather hungry right now. You'd better cut it into eight pieces."

We are fast approaching the longest economic recovery of all time. Could it be that inflation, like growth, has peaked for this cycle? Even with the surge this year in oil prices, headline inflation was very tame, with the Consumer Price Index (CPI) up 0.2% in February (+0.174% to be exact) following three months in a row of fractional decline. The year-over-year trend recently peaked last July at +2.9% — compared with 5%+ in the last two economic expansions — and is now running at half that pace at +1.5%, the slowest since September 2016.

Has Inflation Peaked?



Source: Bloomberg

The "core" CPI (excluding food and energy) inched up 0.1%, the smallest increase since August of last year, and this trimmed the year-over-year path to +2.1% from +2.2% in each of the previous three months. The cycle peak was 2.4%, the lowest "high" ever posted.

Look at the year-over-year inflation trend: Third Quarter 2017: +2.5%; Fourth Quarter 2017: +2.2%; First Quarter 2018: +2.0%; Second Quarter 2018: +1.4%; Third Quarter 2018: +1.1%; and Fourth Quarter 2018: +1.0%. Put simply, this is not at all consistent with consumer prices heading higher.

Tom Slefinger is Senior Vice President, Director of Institutional Fixed Income Sales at Balance Sheet Solutions.

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THIS WEEK...

- Peak Growth
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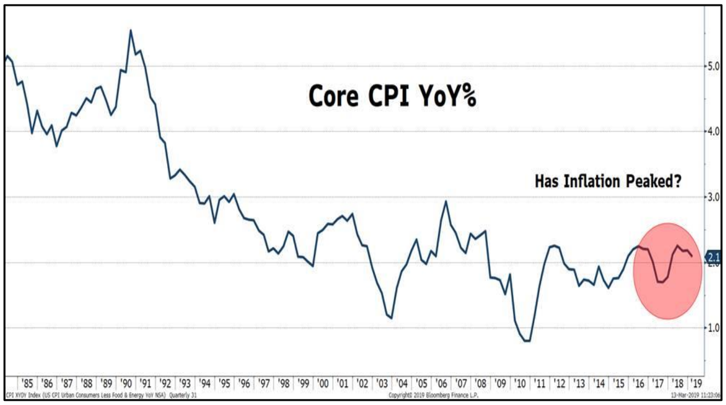
- U.S. vs. the World
- Who Has it Right: Stocks or Bonds?

PORTFOLIO STRATEGY

The core "goods" CPI category declined 0.2% — the first falloff since last September. The year-over-year trend is flat as a pancake. This is a very cyclical index and wouldn't be under downward pressure if the economy were strong. Excluding rent, service sector pricing was non-existent for the second month in a row.

The CPI for transportation services, arguably the most economic sensitive sector, saw prices recede 0.1%, extending the deflation here to three months. The year-over-year trajectory has done this since last September: 4.0%, 3.8%, 3.3%, 2.8%, 2.0% and now... 1.1%. You have to go back to September 2007 to find the last time inflation was so negligible in this space — two months before the last recession started.

Core Inflation Heading Lower



Source: Bloomberg

The price declines were widespread and breathtaking in February:

- Jewelry and watches: -3.4% (the third steepest slide on record)
- Movie/sports admissions: -2.2% (on top of a 0.3% retreat in January)
- Sporting goods: -1.9% (second largest decline ever) on top of a 0.2% dip in January
- Prescription drugs: -1.0% (sharpest drop ever)
- Toys: -1.0% (down for back-to-back months)
- Appliances: -0.9% (flat or down in three of the past four months)
- Women's apparel: -0.9% (down in four of the past months five months)
- Computers: -0.9% (declining in four of the past five months)
- Used cars: -0.7% (down in two of the past three months)
- Hospital services: -0.6% (after dropping 0.2% in January)
- New cars: -0.2% (flat or down in six of the past seven months)

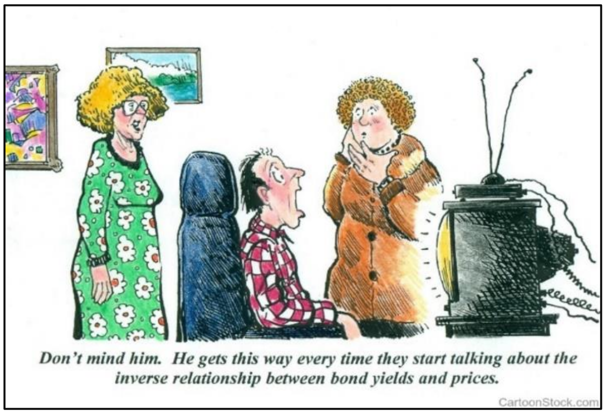
Does anyone see inflation above? If I had told you that we would have experienced…

1. Seven years of zero interest rates
2. A five-fold surge in the Fed balance sheet
3. Central banks globally taking 20% of the bond market into a negative yield
4. Massive fiscal reflation efforts in China and the U.S.
5. A return to tariffs and trade barriers

...and inflation would be below the Fed's target of 2% and heading lower, you would have said it is "crazy talk."

Yes indeed, it is incredible to think that nearly 10 years into the expansion, at a time of full employment, there is a strong deflationary undertow in the economy. That may seem hard to believe, but the data do bear it out.

The Treasury market absolutely has this story right.

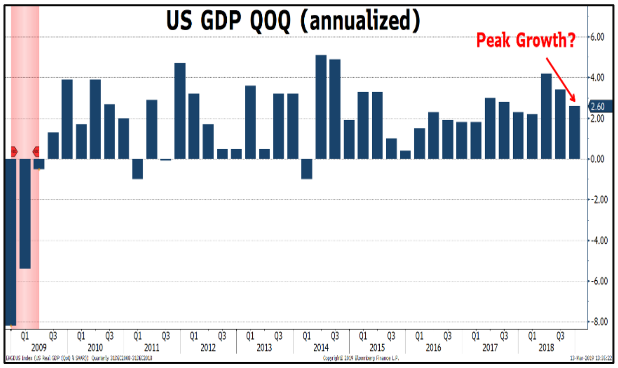


Source: Cartoon Stock

PEAK GROWTH

The "peak" inflation story ties in nicely with "peak" growth. As one can glean from the table below, growth spiked after the stimulus plan was implemented. However, that "sugar high" is fading …and fast. After peaking at 4.2% in the second quarter of 2018, growth has steadily declined. In the third quarter, growth was 3.4%, and 2.6% in the fourth quarter (I expect a downward revision).

Post-Tax-Cut Sugar High Peaked Early Last Fall



Source: Bloomberg

At this point, even mainstream economists are openly admitting what is coming. Mark Zandi, the chief economist at Moody's Analytics, sounded downright gloomy.

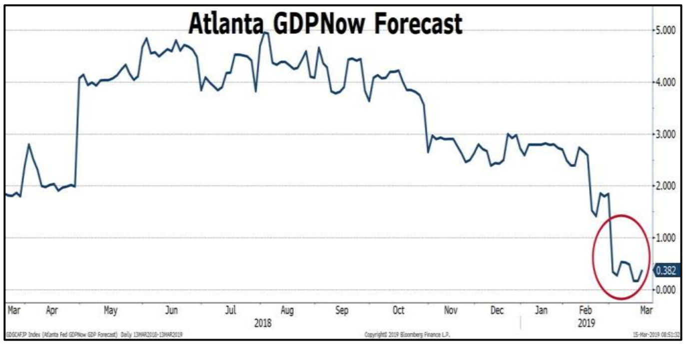
> ***"The economy is throttling back. Way back.*** *That's the message in the near stall out of job growth last month. Job creation probably isn't as bad as February's disappointing numbers suggest — unusually poor weather played a role in limiting job growth to just 20,000 — but it is weaker than just a few months ago. Businesses are nervous, and sentiment is at risk of breaking if anything goes wrong." – Mark Zandi*

And plenty could go wrong.

Most of the Wall Street focus seems to be on expectations that a new trade deal with China is going to send the economy soaring again. Then again, maybe not.

Meanwhile, what we do know is the Atlanta Fed slashed its first quarter GDP Nowcast... and is now at the lowest recorded level, and just **0.4%** away from economic contraction. Assuming first quarter GDP comes in with a 1% handle, that would be the third consecutive decline in GDP (+2.56% in Q418 and +3.4% in Q318). That trend is not your friend.

From a longer-term perspective, economic growth is projected to slow to 1.5-2% over the next several years. An economy that is growing at 2%, inflation near zero, and central banks globally required to continue dumping trillions of dollars into the financial system just to keep it afloat is not an economy we should be aspiring to.

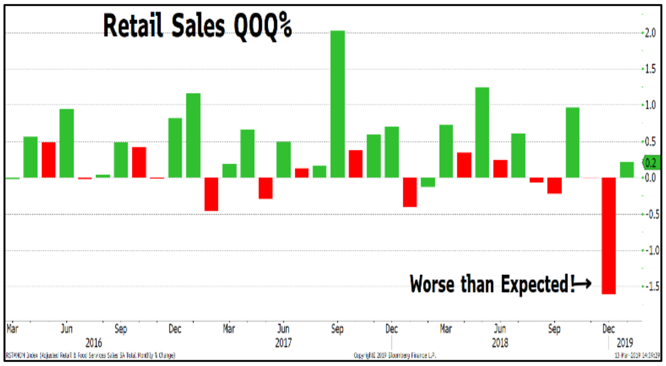


Source: Bloomberg

HAVE CONSUMERS THROWN IN THE TOWEL?

While retail sales did tick up 0.2% in January, versus the consensus view of a flat number, December's tally was revised sharply lower to -1.6% from -1.2%. As shown below, sales have declined now in five of the past six months and have sagged at a 1.5% annual rate through this time frame.

Retail Sales Decline in 4 of Last 6 months



Source: Bloomberg

Econoday attempted to spin this as positive news.

“For the first-quarter GDP outlook, today's report is positive as it shows acceleration.”

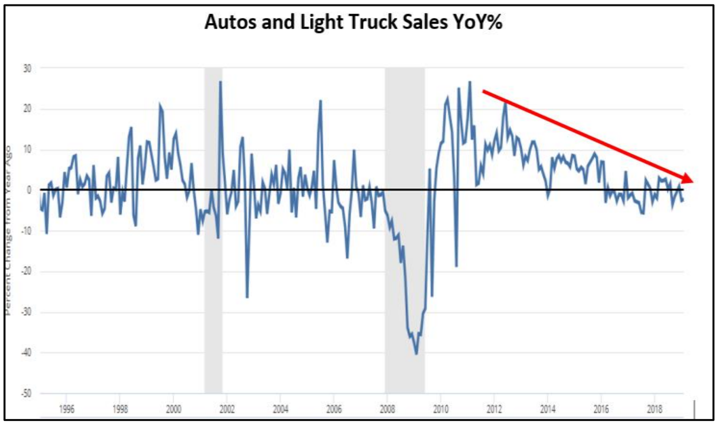
Puleeze. Year-over year core retail sales are up less than 2%. On an inflation-adjusted basis, real retail sales are flirting with zero.

Core Retail Sales Remain Weak

Source: Bloomberg

It would appear that the all-powerful and important American consumers have thrown in the towel on both housing and autos. Auto purchases collapsed 5% in January and then auto sales fell 0.8% in February. They are now down in three of the past four months, to a 16.57million unit annual rate — the lowest they have been since 2014. So much for the excuses surrounding the shutdown and lousy weather.

Automakers, already burning through $3 billion a month in incentive spending, will need to cut deeper into profit to buoy sales and reduce bloated truck inventory. Federal tax refunds averaging an 8.4% decline threaten to further mute new-vehicle sales, right as U.S. automakers have built a record truck supply on the expectation of elevated demand through the summer. And sure enough, last week both Ford and VW announced major job cuts. VW announced cuts of 7,000 but Ford won't disclose how many until the deed is done.



Source: Bloomberg

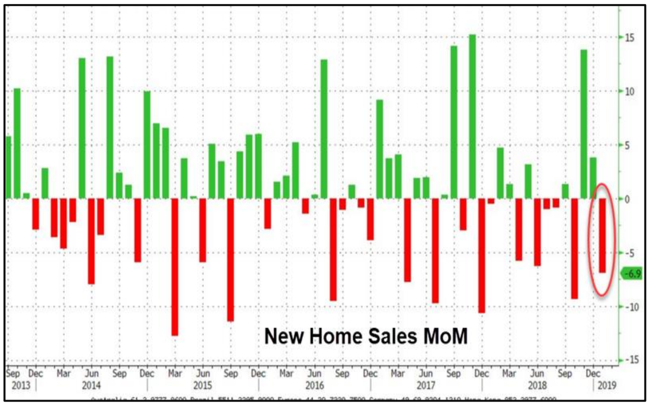
And on the all-important home front, following a rebound in November and December, January's (delayed due to the government shutdown) new home sales plunged 6.9% below the revised December rate of 652,000 and is 4.1% below the January 2018 estimate of 633,000.

The new home sales drop occurred despite a drop in the median sales price, down 3.8% from a year earlier to $317,200. As seen below, there were huge regional percentage variances, suggesting more revisions are on the way.

- Northeast: 31,000 Units, -11.4%
- **Midwest: 50,000 Units, -28.6%**
- South: 342,000 Units, -15.1%
- West: 184,000 Units, +27.8%

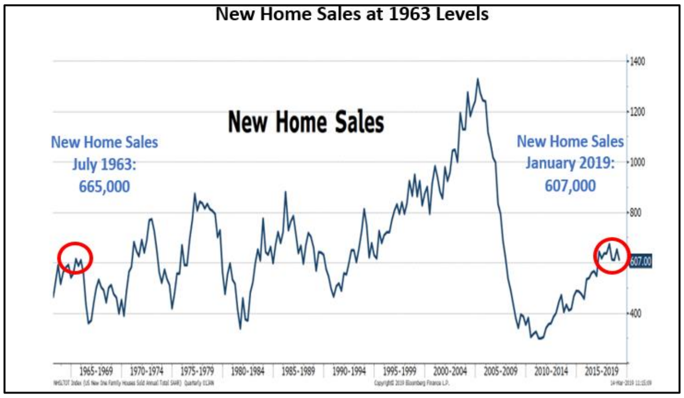
Clearly the Midwest suffered the most. It should be noted that smaller markets are much more volatile, and weather also plays a big role.

Home Sick



Source: Bloomberg

From a longer-term perspective, new home sales are running 10% below 1963 levels. The population in 1963 was 190 million. Today the population is 328 million. Let's just say, on a "population-adjusted basis," home sales are quite unimpressive.



Source: Bloomberg

ATTOM Data Solutions noticed that 60 of the 220 major U.S. metropolitan areas posted a year-over-year increase in foreclosure activity in January 2019, an ominous sign of deceleration in the housing market. The hardest hit areas in January include Orlando, Florida (up 72% year-over-year); Austin, Texas (up 60% year-over-year); Miami, Florida (up 41% year-over-year); San Diego, California (up 12% year-over-year); and Seattle, Washington (up 10% year-over-year).

Across the U.S., a total of 29,382 U.S. properties started foreclosure proceedings in January, up more than 4% from the previous month and 2% from January 2018**.** January marked the second consecutive month with a year-over-year increase in foreclosure starts.

Bottom line — if housing, one of the quintessential leading indicators, is still reeling even after the move lower in mortgage rates, then you know just how soft the economic backdrop is at the current time.

So why have consumers pulled back?

In the household sector, there are more than seven million Americans who are behind on their car payments and the delinquency rate has risen to seven-year highs (sub-620 FICO score late-payment rates already have spiked to 8%). No, this isn't a repeat of 2008-09, but these financial stresses will flow through to reduce consumer spending this year. And this is happening when capex, housing, exports and commercial construction are under their own strains.

It's important to remember that the economy benefitted from the tax cuts in the first half of 2018 combined with pre-buying activity to get ahead of potentially higher tariffs in the second half. This pulled growth from 2019 into 2018. Now the fiscal stimulus has faded and they don't expect another stimulus program. Further, it is becoming apparent that the personal tax refunds will not provide any tailwind for the consumer this quarter, as many had expected.

U.S. VS. THE WORLD

The global economy remains weak. Italy is already in a recession while data from even Germany are on a recessionary cusp. Japan is seemingly always flirting with a recession while China's economy shows significantly decelerating growth. Given these countries' significance to the U.S. economy, we are now seeing these trends wash up on American shores.

Yes, I hear constantly that the Fed isn't talking about a recession. Right. It never does and never will. If you wait for the Fed to declare a recession is coming, it is too late. Remember: The Fed has NEVER predicted a recession. We have had 10 recessions since 1950.

You might remember this:

> *"The Fed's official forecast, an average of forecasts by Fed governors and the Fed's district banks, essentially portrays a 'Goldilocks' economy that is neither too hot, with inflation, nor too cold, with rising unemployment."*
> *– Wall Street Journal, February 15, 2007*

Of course, it was just 10-months later that the U.S. entered into a recession followed by the worst financial crisis since the Great Depression.

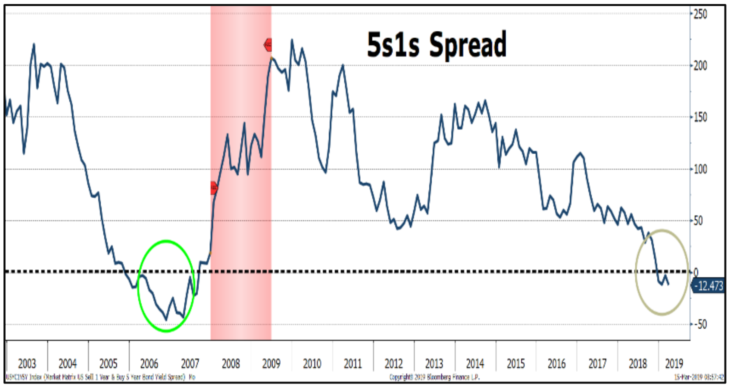
The CEO of Goldman Sachs recently said that there is no recession. Famous last words.

And here's another nifty stat. A mere 7% of the economics community actually saw a recession coming as late as June 2001, when the downturn was already four months old. Best to ignore the consensus.

Rather than listen to the Fed or Wall Street pundits, I would prefer to take my signals from the bond market. While there is no guarantee the past results will prevail in the future, it is important to recognize that the yield curve has been the most accurate indicator in forecasting a recession. And the message from the bond market is a downturn is coming.

For instance, the one- to five-year spread in Treasuries inverted at the end of December and, despite the Fed making a big policy U-turn, has remained inverted ever since. The spread is currently minus 12 basis points.

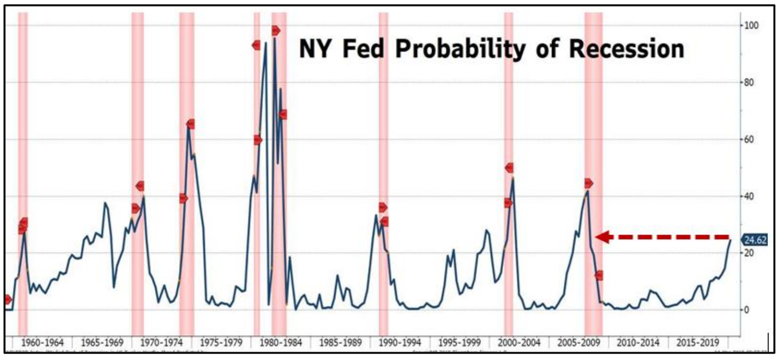
Yield Curve Points to a Slow-Down



Source: Bloomberg

Whether one wishes to believe it or not, it is safe to say that recession risks are high and rising. To wit, the New York Fed recession-odds model is now at a decade high. Even the consensus isn't fooled any longer, with over half of the economists polled by the Wall Street Journal predicting a downturn by next year.

Probability of Recession at 10-Year High



Source: Bloomberg

The bond market has correctly adjusted its view that growth is going to be slower in developed markets next year. Central banks are adjusting, too. The Federal Reserve has put rate hikes on hold and signaled it may phase out the run-off of its bond portfolio by year-end. The European Central Bank has put off plans for its first rate increase since that region's debt crisis. The Reserve Bank of Australia has abandoned guidance that the next move is definitely a rate rise.

Now let's take a look at where 10-year yields are around the world. Japan's is back in negative territory and German yields are 0.05% away from turning negative. In Canada, yields are 1.75%. Even in Australia, which hasn't seen a recession since the 1990s, 10-year yields are now below 2%. The U.K. gilt is down below 1.2%. Even Italy manages to still trade at a modest yield discount to Treasuries while Spain is also below 1.2%.

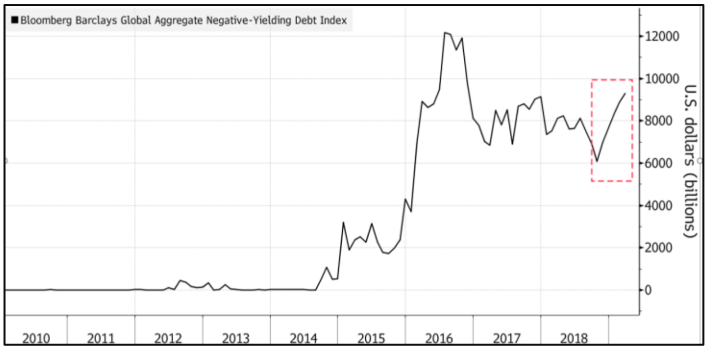
And back home, 10-year Treasury yields are 2.58%; the lowest in almost a year.

Yields Have Plunged since November 2018

Source: Bloomberg

And of note, the Bloomberg Barclays Global Aggregate Negative-Yielding Debt Index has increased in value by well over $3 trillion since its low five months back, to approximately $10 trillion. Does this look like a robust economic backdrop?

Almost $10 Trillion in "Negative" Yielding Debt



Source: Bloomberg

So, given the recent sharp downward move in yields, is it too late to buy bonds? My short answer is no.

It is safe to say that rates will gyrate higher and lower over the near-term. Any sell-off provides an attractive entry point for credit unions looking to invest excess cash reserves.

More importantly, yields could decline significantly from today's levels if economic weakness becomes more widespread and pronounced. As I have noted previously, in the event of a recession, the Fed would likely slash rates to zero bound. In doing so, yields on the front-intermediate sector of the yield curve could plummet! And despite the recent downward shift in rates over the past three months, U.S. yields remain the highest in the world.

As such, I believe in that U.S. yields could converge with the rest of the world. Remember who won the race between the tortoise and the hare?

U.S: Highest Yielding G-7 Country

Source: Bloomberg

That said, I realize that a recession may not be everyone's base-case forecast. Frankly, we may somehow avoid a recession. No one has a crystal ball. However, risk management means adjusting your risk levels around changing probabilities. Even the uber-bullish would have to recognize that the chance of recession is now almost three times as high as it was a year ago and up six-fold from where it was two years ago. If you're sitting on the same level of risk in your loan and investment portfolio as you were two years ago, it means you may not be paying attention. Risk management is not about "my" or "your" view; it is about the shifting risks around changing probabilities.

WHO HAS IT RIGHT: STOCKS OR BONDS?

Something very strange has been taking place in the market over the past days. While stocks are once again soaring, led by the old faithful tech sector bonds are not only not "buying it" quite literally, but are telegraphing further economic weakness ahead. Nowhere is this more visible than in the latest divergence between stocks and bonds shown below.

Who's Right?

Source: Bloomberg

The major averages are up now in 10 of the past 12 weeks and are back to October 9, 2018 levels. At the same time, the yield on the 10-year Treasury note has slipped below 2.6% again.

Both asset classes are responding to the same force, which is this pivot by the Fed. For bonds, the cost of carry and the latest CPI and Producer Price Index (PPI) inflation data have been quite cooperative. For stock markets, the Fed has managed to suppress the equity risk premium.

But over time, who has it wrong here? Bonds or equities?

Only time will tell but the historical track record has shown time and again that it is bonds that virtually always end up being correct in the long- or even medium-run.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

A lot has changed since the last set of Federal Open Market Committee (FOMC) forecasts released after the December meeting, when the Fed raised the funds target by 25 basis points, and the dot plot indicated a median forecast of three more hikes. However, in early January, Fed Chairman Jerome Powell pivoted sharply to indicate that the monetary authorities would be "patient" in raising rates further and would be flexible in reducing its holdings of Treasury and agency mortgage-backed securities. After the 180-degree shift, equity and other risky assets rallied sharply erasing much of those markets' fourth-quarter swoon.

33% Chance of a Fed Rate Cut in December

Meeting	Hike Prob	Cut Prob
03/20/2019	0.0%	2.3%
05/01/2019	0.0%	4.3%
06/19/2019	0.0%	13.3%
07/31/2019	0.0%	15.5%
09/18/2019	0.0%	21.8%
10/30/2019	0.0%	25.4%
12/11/2019	0.0%	33.1%
01/29/2020	0.0%	40.9%

Source: Bloomberg

The FOMC is all but certain to leave its federal funds target range unchanged at 2.25%-2.50% at the conclusion of its two-day meeting. It may disclose plans to wind down its program of reducing the size of its balance sheet. At the same time, the FOMC will also release its latest Summary of Economic Projections ("dot plot"), which will include the members' guesses on where the fed funds rate will end.

And as shown above, the futures market is showing a 25% probability that the Fed **CUTS** in October and is pricing in a one-in-three chance that the Fed will lower rates in December. The odds increase to 40% for January. And whatever odds that there were regarding a hike have completely vanished. Equity investors are excited that the Fed will be poised to ease policy, but it is the reason for this tilt that is disturbing: a weaker-than-expected economic backdrop.

In terms of portfolio strategy, we continue to emphasize that credit unions remain fully invested in a well-diversified, high-quality, and duration-appropriate ladder strategy.

In terms of sectors, traditional agency debt spreads have collapsed to comparable duration Treasury securities. Going forward, these tight spreads are likely to persist due to shrinking new issuance. As such, we recommend that credit unions consider investment alternatives that offer better value. Of note, we continue to advocate well-structured CMBS products (FNMA DUS and Freddie K's) that provide bullet-like characteristics of agency debt while offering higher yields and income.

We also favor well-structured CMOs that limit prepayment and extension risk. In addition to the added yield, credit unions benefit from monthly cash flows and broader diversification.

Finally, in the credit arena, high-quality bank notes are recommended as a means of diversifying and adding income.

Please do not hesitate to contact your Fixed Income Representative for additional information.

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Join us for our fifth annual Credit Union Executive Leadership Symposium from September 4-6, 2019 in Chicago, Illinois!

Highlights of this year's event include:

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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
- 9.5 CPE Credits Available

Register now for early bird pricing and a chance to win free symposium registration with hotel accommodations included – a value of more than $1,500! Runner-up prize will be a $500 Visa gift card.

Visit **www.alloyacorp.org/symposium2019** to view the agenda and register today!

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Since its launch in September 2018, Balance Sheet Solutions' online trading platform – Premier Portfolio – has been making a positive impact at credit unions across the corporate's membership.

"Premier Portfolio's online services allows me to access statements and overall market analyses, review a list of available security offerings, as well as purchase SimpliCD's and Alloya's certificates. Premier Portfolio is convenient, easy, secure, and has become my go-to place for investing!"
– Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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– Shawn Nikkel, Finance Director of Denver Fire Department FCU

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– Darin Higgins, President of Western Illinois Credit Union

Visit **www.alloyacorp.org/premierportfolio** to learn more about Premier Portfolio and how it can benefit your credit union!

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.

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