BALANCE SHEET SOLUTIONS
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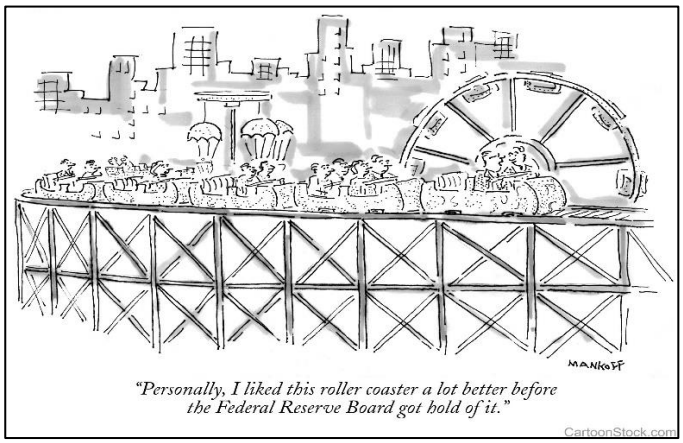
WEEK OF APRIL 8, 2019

Weekly Relative Value

The Fed's Roller Coaster

Who would have thought that barely more than three months ago after the stock market plunged 20% into bear market territory, we would then go on to see the best quarter for the S&P 500 since 1998? Likewise, commodities have surged with oil prices up 32% and posting its best start to any year since 2002.



Source: Cartoon Stock

What the heck happened? This dramatic sentiment reversal and rally in risk assets can easily be traced to the dovish and sharp 180-degree reversal by the Federal Reserve. Despite proclaiming that the economy is strong, Fed Chairman Jerome Powell flipped from a posture of 2-3 rate hikes in 2019 to zero. Anticipated rate hikes have been replaced by bets on cuts by the end of 2019. The question I ask when trying to understand the difference between actions and words is, "What do they know that we do not?"

And it's not just the Fed. Every central bank on the planet has turned from hawk to dove, from the European Central Bank to the Bank of Japan to Australia, New Zealand and Canada. As such, liquidity (the oxygen for markets) has dramatically improved. In fact, financial conditions, as measured by the Chicago Fed, are now the easiest since 1994. This explains why the financial markets have been in risk-on mode even with the global economy back on its heels.

Meanwhile, in bond markets, rates have plummeted, and yield curves have flattened in tandem. Unlike the stock market, the bond market has taken its cue from the downward revisions to global growth and inflationary pressures that are subsiding everywhere.

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

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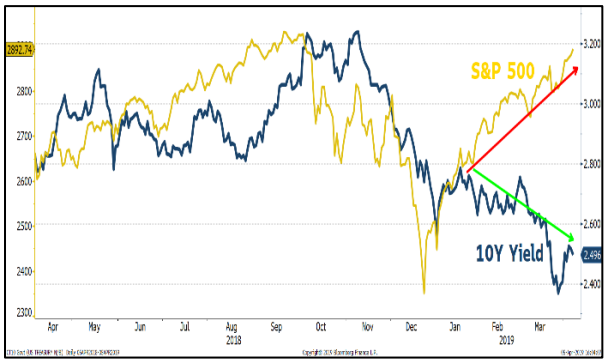
THIS WEEK…

In other words, both stocks and bonds are reacting to a different set of conditions. Stocks are reacting to dovish central banks. Bonds are responding to sluggish economic growth and inflationary pressures, which are now fading globally.

This risk-on rally has also been predicated on the view that the U.S. or global economy is set for a durable reacceleration. If so, we could be in for a bit of a letdown in the months ahead. The vast majority of the incoming data at home and abroad and the cascading downward growth forecasts from the likes of the World Bank, Organisation for Economic Co-operation and Development and International Monetary Fund (IMF) dovetail with my view that even if we avert outright recession, risks to the economic outlook are still squarely to the downside.

So, when will stocks and bonds converge? By early June, when we start getting the second-quarter data flow from the high frequency economic data, we'll get a better handle on the economy's health.

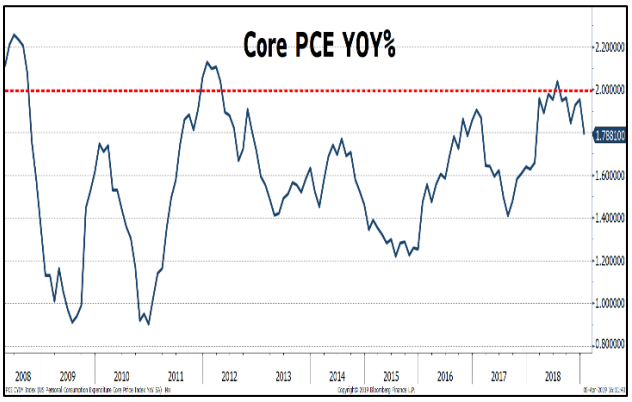
Stocks and Bonds Diverge



Source: Bloomberg

But let's stick to what we know today. We know that central banks will no longer be tightening, and inflation has peaked and rolled over for the cycle. As such, interest rates will likely continue to be benign. To wit: we are back to over $10 trillion (yes that is with a T) of global bonds trading at a negative yield. That volume of negative-yielding bonds just six months ago was sitting closer to $7.5 trillion, so this is a huge 30% increase.

Inflation Has Peaked



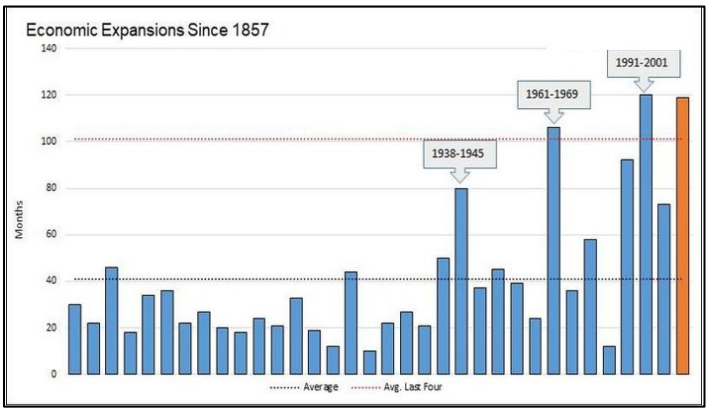
THE AGING EXPANSION

"It is remarkable how much long-term advantage people like us have gotten by trying to be consistently not stupid, instead of trying to be very intelligent." – Charlie Munger, Vice Chair of Berkshire Hathaway

It's quite interesting that Mr. Munger does not encourage people to seek brilliance. Rather, Munger focuses on not making big mistakes. And that is the key to winning the investment game in the long run.

Since exiting the financial crisis in June 2009, the economy has managed to maintain a growth trajectory for 10 years. In May 2019, the current economic expansion will tie the expansion of 1991-2001 as the longest since at least 1857, as shown below. At the same time, despite record low rates for over 10 years, massive liquidity injections and fiscal stimulus, this has been the weakest recovery in the modern era.

The Cyclical Clock Is Ticking Into Record Old Age



Source: Real Investment Advice

What we know is that we are late in the economic cycle and a downturn in the economy, a recession, is out there. Recession is coming. We can debate the timing, but the economy will turn decisively downward at some point. In addition to when it will happen, there's also the question of how deep the next recession will be. A shallow downturn wouldn't be fun but compared to the last one, might feel relatively refreshing.

Alas, I don't think we will be that lucky. I think the opposite. The next recession will be deeper, longer and far more painful to many more people than your average recession and could persist as long as the last one. That is because the next recession in all likelihood will be truly global and will be even worse simply due to the fact that we have an additional $100 trillion worth of debt to deal with now.

The world, along with China (which is now fiscally pump-priming its economy) and the U.S. (which has blown a hole through its fiscal finances), have a situation today where total debt is $240 trillion. That is debt at all levels of society — household, corporate and government. And it is only what is officially counted on the balance sheet. At the peak of the 2007 credit bubble, outstanding world debt was $100 trillion. Yet again, for the third cycle of the past three decades, global policymakers have chosen to fight the bursting of a debt bubble by creating a new debt bubble.

At the cycle peak of economic activity in 2007, global GDP stood at $60 trillion. Today it is $80 trillion. Think about that for a second in terms of growth sustainability and having a situation where interest rates can be totally or even remotely

"normalized." In the past 12 years, from peak to peak, global GDP has risen $20 trillion while global debt has ballooned $140 trillion. Debt has expanded three times faster than the world economy's income capacity to ever repay this debt. Is that a stable data-point to you?

Global debt has continued to explode after the global financial crisis because central banks cut interest rates to 5,000-year lows, which has made it much cheaper to borrow. So, governments, corporations and households have been throwing a giant debt party for the past decade, which is creating artificial economic activity, and voilà – GDPs continue to grow.

We are doing exactly that by continuing to lever up the global economy and expecting sustainable economic growth without 2008-style crises. With global debt up an incredible $100 trillion since the global financial crisis, anyone who thinks that another crisis is far-fetched is incredibly naive.

Further with rates close to all-time lows and virtually every country in the world overextended, what will or can the policy makers do in the next downturn?

Regardless, a recession is coming sooner or later, and risk management comes down to trying to make as few mistakes as possible. Now is NOT the time to be adding more risk in the loan or investment portfolios. Using common sense and avoiding the emotion of markets dramatically raises one's ability "to be consistently not stupid." A lofty goal for all of us.

Grow Your Way Out of Debt, My Eye!

	2007	2019	% Change
Total Debt	$100Trillion	$ 240 Trillion	+140%
GDP	$60 Trillion	$ 80 Trillion	+33%

SO, WHY ARE ECONOMISTS SO BAD AT FORECASTING RECESSIONS?

The answer in a Bloomberg Business week article is precious — *"Professional forecasters feel safer in a crowd. There's not much incentive to stick one's neck out."*

Since 1988, there have been 469 economic downturns globally and the IMF predicted just four of them the spring of the preceding year (what forecasting is supposed to be). In the spring of the year the recession happens, the IMF still only predicted 111 of them, or less than one-in-four. The article cites an IMF study that looked at private forecasters and found that out of 153 recessions in 63 countries from 1992 to 2014, only five were accurately called by a mere five economists in April of the year the downturn occurred.

THE BIG FOUR

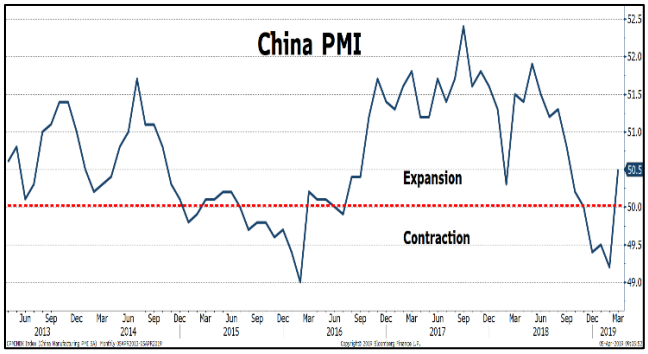
Last week the headlines, focused on the improvement in the manufacturing data out of China. After being in contraction mode since November, the Caixin Manufacturing Purchasing Managers' Index (PMI) and the Official Manufacturing PMI, both returned to a very feeble growth mode.

First the basics. PMIs are based on surveys of industry executives. Executives rate various aspects of their business – new orders, new export orders, employment, backlog, inventories, supply chain delays, input costs, etc. — by whether each

of these aspects is increasing or decreasing. Their responses form the sub-indices, which are then combined into the overall headline index. PMIs are a boots-on-the-ground view by executives about how their company is being impacted by economic developments. For PMI measures, a value below 50 means "contraction," and a value above 50 means "expansion."

The official China Manufacturing PMI squeaked into expansion mode (50.5), after having been in contraction mode since November. Companies signaled "slightly quicker rises in output and overall new work," and employment increased for the first time since October 2013. Production rose for the second month in a row, "supported by a stronger, albeit still relatively muted, rise in total new work." But purchasing activities continued to contract.

China Manufacturing Rebounds



Source: Bloomberg

Despite the improvement in China, the other PMIs that were released, including those of Germany and Japan, put China's upticks into a different light.

First let's look at Germany – which happens to be the fourth largest economy in the world. In March, the Manufacturing PMI for Germany plunged to 44.1, down from 47.6 in February, the lowest level since July 2012.

Germany Manufacturing Tanks

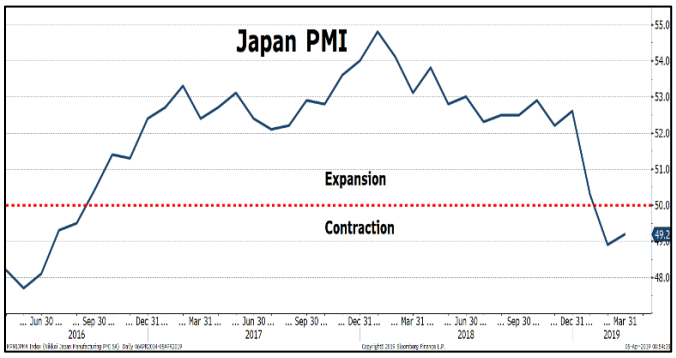
Source: Bloomberg

There was a sharp and accelerated decrease in new orders, with total orders and export orders falling at the fastest rate since April 2009.

To be sure, as recently as February was nothing short of abysmal economic data out of Germany... Last week, Germany's leading economic institutes slashed their growth forecast for Germany by 60% to 0.8% from a previous estimate of 1.9%. Most of all, Germany – which is an export machine – is facing continued pain from the ongoing trade deterioration with its most important trading partner, China. Thus, ultimately, Germany's fate will depend entirely on whether China's economy has indeed troughed or if the recent PMI rebound ends up being a transitory spike.

Now let's talk about Japan. Japan's manufacturing economy ended the first quarter in poor shape. At 49.2 in March – slightly up from February, which had been the lowest in 32 months – the index remains in contraction mode, thus signaling a further slowdown. New domestic orders and new export orders fell further. The decline in export orders was blamed on weaker foreign sales to Chinese and Taiwanese clients. The outlook remained underwhelming in March bogged down by global trade fears, the impact of the incoming sales tax hike, and weaker growth in China.

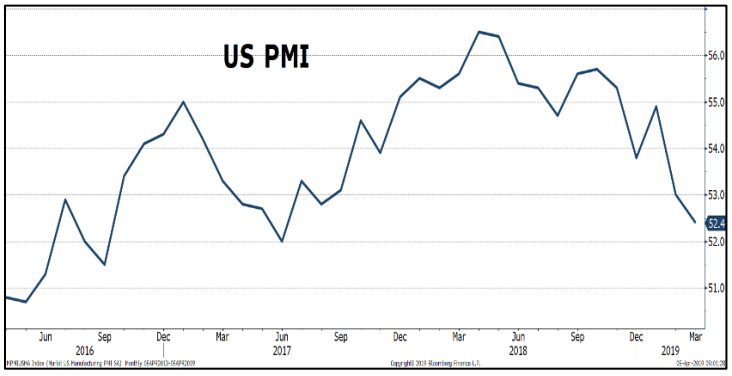
Japan Stagnates



Source: Bloomberg

In the U.S., the IHS Markit Manufacturing PMI dipped to 52.4 in March, the lowest reading since June 2017, and notably softer than the trend seen for 2018. New order growth has fallen close to the lows seen in the 2016 slowdown. Export orders rose only marginally. Firms noted that global trade tensions and the ongoing impact of tariffs had dampened foreign demand.

U.S. Manufacturing Falling



Source: Bloomberg

So, in this snapshot of the four biggest manufacturing powerhouses in the world, German manufacturers are as gloomy as during the euro debt crisis and very nervous. Japanese manufacturers are worried by the ongoing slowdown; Chinese manufacturers are counting on the government to provide a more relaxed financing environment and bail out the private sector; and U.S. manufacturers are in weakening growth mode – the slowest growth since 2016 – and for now, the cleanest dirty shirt that's getting dirtier.

The bull case is that China and the U.S. are nearing some sort of amazing trade agreement and the recovery in the Chinese economy will act as a spring board for the remainder of the global economy. Time will tell if this is correct but so far, the two sides are still at odds over enforcement mechanisms, intellectual property protection and the rollback of tariffs. Call me a cynic, but if those important issues are still outstanding, I'm not sure how "close" a deal really is. The damage may already be done to this later-cycle economy.

U.S. PAYROLLS

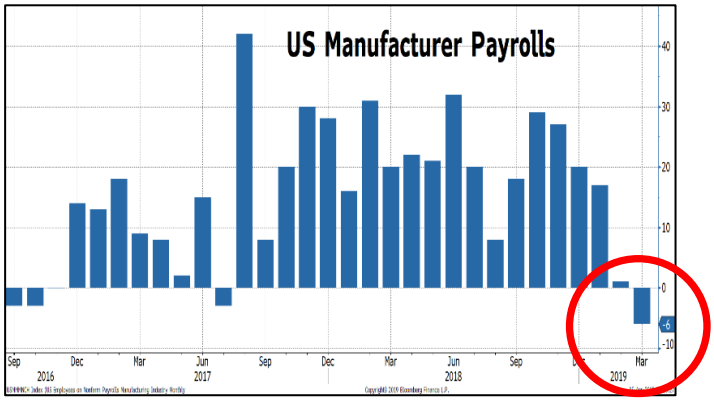
After seeing the headline jobs number and then the details, you wonder if the Bureau of Labor Statistics was playing a belated April Fool's joke on everybody. Yes, non-farm payrolls topped consensus views with a +196 thousand tally for March (consensus was +170 thousand) and there were net upward revisions to the prior two months of 14 thousand (February was taken up to a still-dismal +33 thousand from +20 thousand). On the surface, the number looked strong. The stock market loved the number and the bond market seems to hate it, but that only tells me that investors have been slow drill down into the details, which were less than robust.

- For the months of February and March, payrolls gained +115 thousand, which is less than half the November-January average of +245 thousand. It's obvious the pace of new hiring has cooled down.
- Temp agency employment, a leading indicator, dropped 5,000 and is now down in two of the past three months (by -28 thousand in total).
- The biggest decline in manufacturing employment in nearly three years is a blemish on this report. Likewise, retail jobs followed suit with a 12 thousand slide and are down 32 thousand in the past two months. There has been no growth since last November. What does this say about the state of the American consumer?
- The household survey showed a net employment decline of 201 thousand and is down in two of the past three months. While this is the best start to any year for the stock market since 1998, for household employment, the 197 thousand decline in the first quarter was the worst start to any year since 2009 (ahem). Not just that, but full-time positions (the key generator for income) plunged 190 thousand last month. And of the folks who got part-time jobs, the ones saying that they were actually looking for full-time work but had to settle for a temporary position jumped 189 thousand.
- The participation rate fell to a four-month low of 63.0% from 63.2% in each of the prior two months. The employment-to-population ratio edged down to a three-month low of 60.6% from 60.7%.

- The voluntary "quit" rate, a bellwether measure of worker confidence, fell to 12.5% from 13.5%, which may help explain why wage trends are decelerating. And we see from the household survey that employment for multiple job holders spiked 212 thousand last month — this is a bellwether contra-cyclical economic indicator.

- Average hourly earnings came in at a microscopic +0.1% month-over-month. The three-month wage trend is now running at a 2.5% annual rate, the six-month pace is 3.0% and the year-over-year trend is 3.2%. A visible slowing, in other words.

Manufacturing Loses Jobs

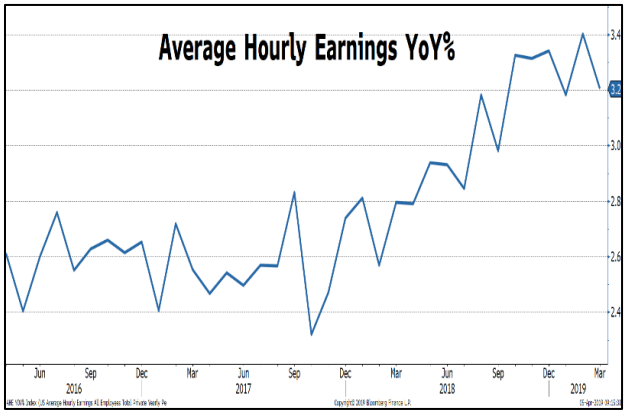


Source: Bloomberg

Yet, everyone seems to believe that the overall economic fundamentals are strong because of the ultra-low jobless rate. Remember that the unemployment rate is a lagging indicator. Look no further than Japan. Over the past three decades, the unemployment rate in Japan has averaged 3.8%. It never rose above 5.5%. And yet, the "land of the rising sun" has experienced seven recessions, endless corrections and bear markets along the way, and a Nikkei that is still lower today than it was in 1989.

From my lens, employment growth is slowing. And it would appear that the business cycle is fatigued. And while the unemployment rate measures remain drum-tight, it seems obvious me that we are seeing labor market slack re-emerging, based on the quit rate, the shift to part-time from full-time work and the deceleration on the wage front.

Wages Fall



Source: Bloomberg

QE4?

"I personally think the Fed should drop rates, I think they really slowed us down, there's no inflation, in terms of quantitative tightening, it should really be quantitative easing... you would see a rocket ship. Despite that, we're doing very well." – President Trump

Before any Fed officials get the idea that Friday's stronger-than-expected headline jobs might justify raising interest rates again in the not-too-distant future, President Trump slammed the central bank (again).

Trump said the central bank should instead "drop" interest rates, something that markets have already priced in, adding that the central bank has "really slowed" the American economy.

Setting aside the cognitive dissonance between these comments and Trump's repeated claims that the U.S. economy is doing "really, really well" and that companies are preparing to announce that they're "coming back" to the U.S., Trump's comments show that he won't let up the pressure on Powell after reportedly trying to replace him with Kevin Warsh and declaring Powell one of the worst hires of his administration.

Trump's rate cut comments were echoed by Director of the National Economic Council Larry Kudlow, who said that the U.S. economy "could do with a rate cut."

While pressuring the independent Fed is never helpful, the President was right that monetary policy was too tight last year. But the central bank has shifted, and the Dow ended the week just 1.5% shy of their record close of last October. Bashing the Fed now makes no sense.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

As for the U.S. economy, let's look at the three months to February: housing starts -13.8% (at an annual rate), building permits -9.1%, real retail sales -4.9%, industrial production -0.8%. In the three months to December (the latest data available), exports have collapsed at a 14% annual rate (and the Institute for Supply Management export orders data for March were scary in this respect). Does this look like a recessionary picture to you?

As challenging as that list of issues is for the domestic economy, things are even more troubling on a global basis.

From a portfolio strategy perspective, we continue to advocate a fully invested portfolio. A well-diversified, high quality ladder strategy is the most prudent and risk adverse risk-management approach in the current environment.

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– Darin Higgins, President of Western Illinois Credit Union

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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.