BALANCE SHEET SOLUTIONS
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WEEK OF MAY 6, 2019

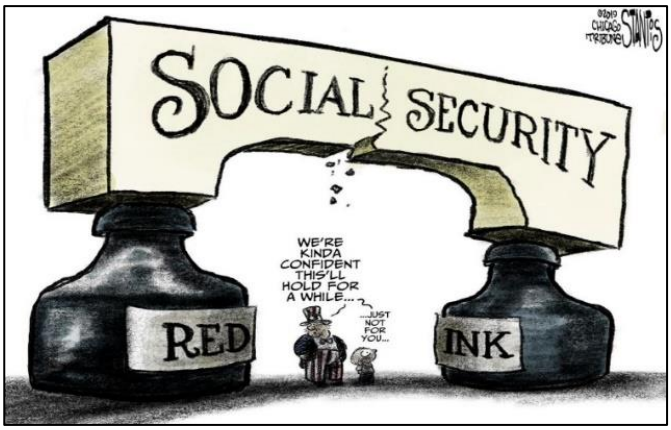
Weekly Relative Value

Social Security or Bust

"Social Security will be insolvent and unable to pay the full value of promised benefits by 2035—that's one full year later than previously expected—and Social Security's costs will exceed its income by 2020." – Board of Trustees Social Security Administration

Last week, the Board of Trustees for the Social Security and Medicare programs released their annual report. Check it out here.

The gist of the report is quite disturbing. Both of these programs are massively underfunded. Social Security's long-term shortfall is now estimated to be a mind-boggling $43+ trillion. That, my friends, is a lot of money!



Source: Cagle Cartoons

Starting in 2020, Social Security's cost will exceed the money it earns from interest and taxes. That's next year! And every year after that. And by 2034, just 15 years from now, Social Security's primary trust fund will be fully depleted. And one of Medicare's trust funds will run out of money in 2026.

If there is a national emergency, this is it. Yet, hardly a word is spoken about it. And the reason is so obvious. Politicians have a two to four-year cycle to get elected and they simply do not have the political courage to do what is best for the country over the long run. They kick the can down the road and wait for someone else to deal with the crisis.

Social Security was NOT designed to be a long-term retirement plan. When President Franklin Delano Roosevelt created the Social Security Program in 1939, you could not

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THIS WEEK…

collect benefits until you were 65. Back in those days, the average American lived to 62 years of age. In other words, you were dead before you could collect Social Security.

Because of the many advances in medicine and technology, humans are living longer than ever. Every 10 years median life expectancy increases by two years. In fact, if you were born in 2007 your life expectancy is now 103 years old. And that is the median estimate. Many will live beyond 103. Our social safety net was not built on these longer life expectancies. If we were to adjust Social Security to our longer life expectancies, you would have to be 82 before you would be eligible to receive any benefits.

Here's the rub. Over the years, unfortunately, Social Security has morphed into a retirement plan. There are literally millions of Americans who rely strictly on Social Security to pay their bills. At the end of 2018, Social Security was providing income to about 67 million Americans. About 47 million of them were over age 65, and the majority of the rest were disabled.

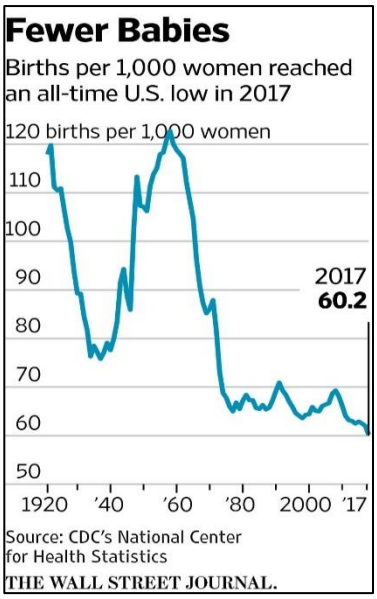
"43% of adults between the ages of 50 and 64 are expected to retire on Social Security during retirement." – Gallup

The country's 401(k)s and individual retirement accounts? The old-fashioned company pension plans? Most of these assets are owned by the wealthiest 25% of the country. Approximately 85% of the total balance is in the hands of the highest-earning one-fourth. For everyone else? It's down to Social Security or bust. And that's especially so for the bottom half of the income distribution.

MAKE AMERICA MATE AGAIN (MAMA)

It takes a certain number of workers paying into the system to support each retiree receiving benefits. Every generation has to be large enough to support the previous generation. And the Social Security Administration has said that they need a minimum of 2.8 workers paying into the system for every one retiree collecting benefits ("worker-to-retiree ratio").

If population growth trends get too far out of whack, it means there will either be too few workers, or too many retirees. And that's exactly what's happening now: people are simply having fewer children. Birth rates are the lowest levels EVER since they started keeping records decades ago. The birth rate reached an all-time low in 2017. At just over 60 births per every 1,000 women (between the ages of 15 and 44), this is the lowest birth rate the country has ever recorded. And there is no sign of a new baby boom on the horizon. To prevent the U.S. from becoming more like Japan, with fewer young people supporting a massive older population, the nation needs more babies and more immigrants.



WHY ARE BIRTH RATES DECLINING?

So why are Americans having fewer babies? There are many reasons.

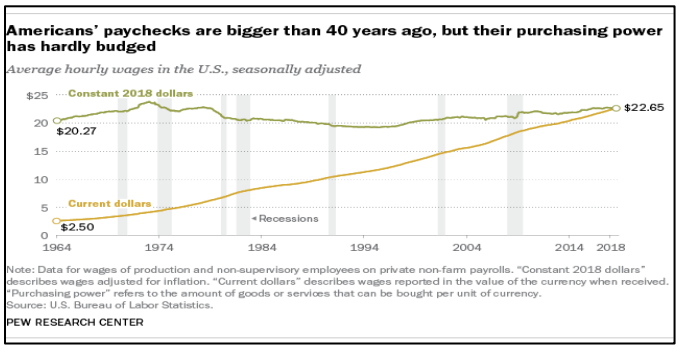
One reason is: kids are expensive. And they aren't getting any cheaper.

Years ago, one earner could raise a family on a single income. Today, the average household can afford one, maybe two kids. And that's with both parents working. But the problem isn't just the cost of living due to inflation, but the "real" cost of raising a family in the U.S. has grown incredibly more expensive with surging food, energy, health, education and housing costs.

Researchers at Purdue University recently studied data culled from across the globe and found that in the U.S., $132,000 was found to be the optimal income for "feeling happy" raising a family of four.

Gallup also surveyed to find out what the "average" family required to support a family of four in the U.S. (Forget about being happy, we are talking about "just getting by.") That number turned out to be $58,000.

A Dollar is Not What It Used to Be



Source: Pew Research

In addition, more women are delaying marriage and children for work and education. Economists have also found a correlation between low fertility and higher incomes. Full-time professional women tend to give birth to no more than two children. Education and government policies, meanwhile, have sharply reduced births among teenage girls.

So, as the fertility rate has fallen over the years, so has Social Security's worker-to-retiree ratio. And next year there will be just 2.7 workers paying into Social Security for each retiree – below the minimum necessary to sustain the program. After that it will keep falling.

In 2034, when Social Security estimates its trust funds will run out of money, there will only be 2.3 workers per retiree. The Trustees say that after the fund is fully depleted in 2034, balancing the Social Security account would need extra

taxes of about 1% of GDP (balancing Medicare would need another 0.4%). These will not be politically trivial sums. Current taxes are only about 16.5% of GDP, so we're looking at a hike of nearly 10%.

This is the bottom line: If nothing changes, the Social Security Trust Fund will be fully depleted by 2035 and the program would impose across-the-board cuts of 20% to all beneficiaries.

But don't expect cuts anytime soon. And this is why: According to the U.S. Census, by 2030 those over age 65 will account for 26% of the voting age population, and those aged 45 to 59 and nearing retirement another 29%.

According to Fed data, approximately 25% currently nearing retirement are going to be able to shrug off any cuts at all in Social Security. Actually, it's probably considerably less than one quarter. And everyone else will be in serious trouble. Half of those nearing retirement will end up in dire straits. That's because most of them have little or nothing in private retirement plans. Almost 60% of those 54-60 have no retirement plan. Eek!

And according to the U.S. Elections Project, in the last presidential election just 43% of those in their 20s bothered to vote. The figure for the over 60 was 71%.

Put those two things together, and by 2030 around 60% of likely voters will be over 45 and half of those will already be over 60.

Good luck passing a 20% Social Security cut!

Politicians can defer making the tough decisions, but eventually they will need to address this problem. The longer they wait the bigger the problem. And they basically have three options: cut benefits, raise taxes or both.

These are facts: The future of Social Security is uncertain, and the program definitely needs to be reformed. With that said, it's important to start planning with these basic truths in mind… The longer you have until retirement, the less likely you are to ever see a penny in benefit. If politicians change the program, you will likely wait longer to be eligible and benefits will be significantly less. The message is clear: Save as much as you can and start today!

WORK IS GOOD

"I'm a capitalist, and I believe that universal basic income is necessary for capitalism to continue."
– Andrew Yang, 2020 U.S. Democratic Presidential Candidate

Democratic presidential candidate Andrew Yang says we should all get universal basic income (UBI) of $1,000 a month. That will pay individuals who lose jobs to automation and free us up to **pursue our dreams**. He's not alone. Former President Barack Obama has recently expressed interest in the idea. So have Bill Gates, Richard Branson, Mark Zuckerberg, Elon Musk, Marc Benioff and others in Silicon Valley.

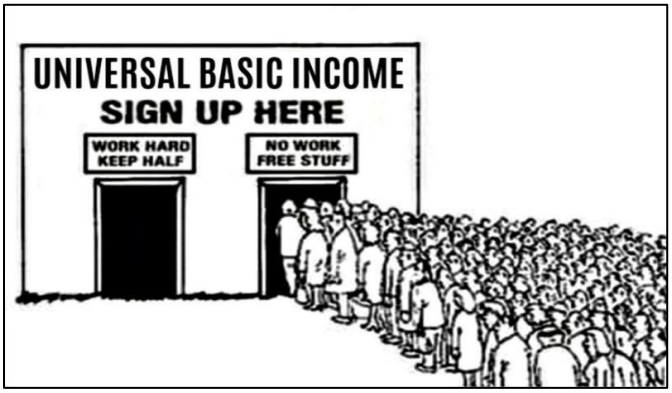
This is a very bad idea!

First, UBI is like granting open-ended unemployment benefits with no requirement to look for work or financing (aka an indefinite "gap year") to anyone who wants it. It would be nice. We just don't have the money.

Second, UBI would send exactly that wrong-headed message, reducing people's incentive to work. And it would get worse. Third, idleness is bad for individuals (and society as a whole). Spend some time at home playing video games, and within a few months, you will be utterly convinced of the meaninglessness and pointlessness of life. Multiply that by 100 million people, and you have a big problem. Idleness isn't just bad for 20-somethings, it's also bad for 70-somethings.

Fourth, individuals gain not only income, but meaning, status, skills, networks and friendships through work. Delinking income and work, while rewarding people for staying at home, is what lies behind social decay.

Finally, we all know stories about individuals who had exciting, rewarding and meaningful careers. Then they retire and they're dead within a few years. If you don't have structure and a purpose, there aren't just psychological effects, there are physical effects, too. When people don't have a plan, they end up spending a lot of time at home with Jeopardy and cable news on at top volume.



Even if you have a plan, can you chase a white ball around for 10 hours a day? Or travel every day? Or go out with friends for three meals a day? Even if you had the financial resources to do that, would you want to?

So, if Social Security is reduced or disappears entirely, Americans will need to work longer. But that's not bad.

Because work is good!

LOWEST SINCE 1969

Speaking of working… the U.S. job market continued to accelerate in April as the U.S. economy added another 263 thousand, smashing expectations of a 190 thousand print, and well above both the March (189 thousand) and February (56 thousand) prints. After revisions to prior months, job gains have averaged 169,000 per month over the last three months.

But there are numerous caveats and non-confirmations worth taking note of.

First, as good as the headline was, it does not at all detract from the view that payroll growth is cooling off. The average gain in employment in the past three months is +169 thousand versus the average of +245 thousand in the previous three months. Still a decent trend, don't get me wrong, but it is moderating, nonetheless.

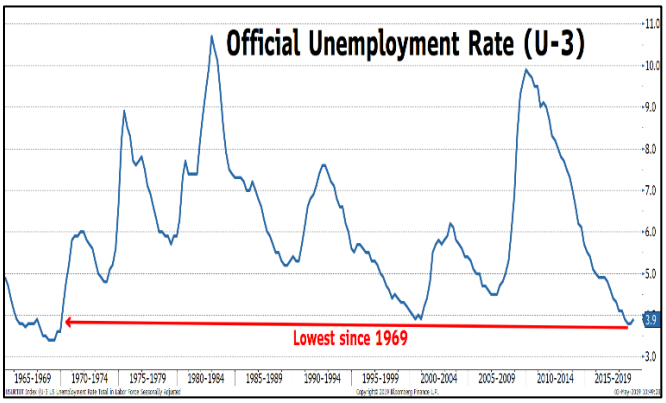
Another point worth making is that 93 thousand of that +263 thousand non-farm payroll print came from the Bureau of Labor Statistics birth death model. This is a guestimate of how many jobs come from net new business creation. Without

that number, which basically comes from government statisticians sticking their finger in the air, the headline payrolls would have been a tad below the consensus at 170 thousand. But we'll keep that our little secret.

The workweek contracted 0.3% in April (to 34.4 hours) and has declined or stagnated in three of the past four months. This is also important because hours tend to lead bodies. As an aside, that decline in hours worked was the equivalent of a 373 thousand slump in payrolls. So, netting this against the number of jobs that were added to payrolls, the net effect was actually the equivalent of a 110 thousand reduction in employment in April. See if you end up reading that anywhere else.

The official unemployment rate declined to 3.6%, which is the lowest in 49 years! But it is the way this happened that needs to be addressed.

Lowest in 50 Years!

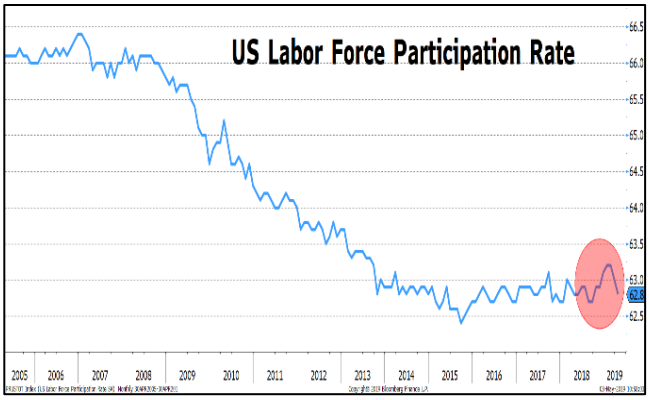


Source: Bloomberg

The participation rate declined to 62.8% from 63.0% in March, the lowest since September of last year. Some of those dropping out of the labor force retired because they wanted to retire. The rest is disability fraud, forced retirement, discouraged workers, and kids moving back home because they cannot find a job.

This renewed disengagement from the labor force is not a good thing because without declines in the participation rate in March and April, the unemployment rate would be 4.0% right now, not 3.6%.

Labor Force Declines

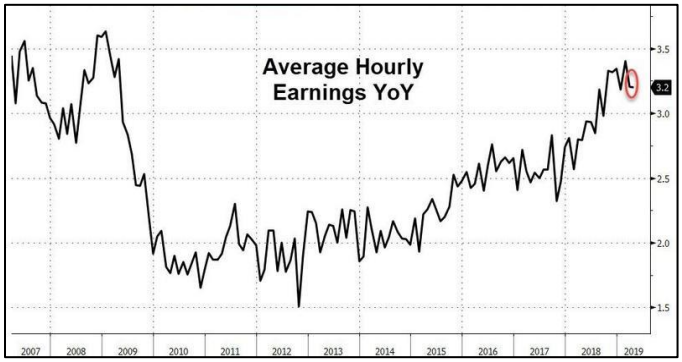


Source: Bloomberg

Also of note, if you start counting all the people who want a job but gave up, all the people with part-time jobs that want a full-time job, all the people who dropped off the unemployment rolls because their unemployment benefits ran out, etc., you get a closer picture of what the unemployment rate is. That number is much higher at 7.3%.

And let's face it, if the labor market were truly as strong as the headlines suggest, wages would be rising at a faster clip. But average hourly earnings only eked out a 0.2% month-over-month gain for the second month in a row and the year-over-year trend has stopped accelerating and is now running at +3.2%. Here's another tidbit: The combination of the meagre wage gain and shrinkage in the workweek means that average weekly earnings — the mother's milk for personal income — receded in April in the biggest retreat since November 2016, and this dragged the year-over-year trend down to 2.9% from 3.2% in March and the 3.5% nearby peak.

Wages Stall



Source: Bloomberg

PAYROLL REPORT VS. HOUSEHOLD SURVEY

The Household Survey is a phone survey conducted by the BLS. It measures unemployment and many other factors. The payroll survey is based on employer reporting.

1. In the household survey, if you work as little as one hour a week, even selling trinkets on eBay, you are considered employed.
2. In the household survey, if you work three part-time jobs, 12 hours each, the BLS considers you a full-time employee.
3. In the payroll survey, three part-time jobs count as three jobs. The BLS attempts to factor this in, but they do not weed out duplicate Social Security numbers. The potential for double-counting jobs in the payroll survey is large.

These distortions artificially lower the unemployment rate, artificially boost full-time employment, and artificially increase the payroll jobs report every month.

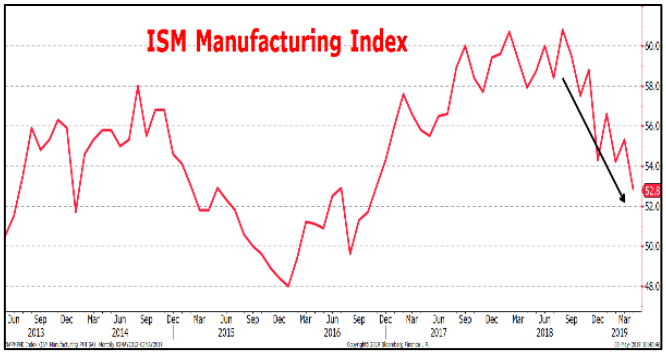
So, in April, the household survey showed a decline in employment of 103 thousand in April. Can you imagine if this was the headline in the payroll report? Then again, there is no "birth death" (the "plug factor") in the household survey and it contains a completely different methodology. But it has been around just about as long (since 1948) and tends to do a much better job at depicting turning points in the economic cycle (in both directions).

In fact, household employment has declined in three of the past four months, by a cumulative 300 thousand, and the last time we saw such a string of weakness in this metric was in October 2013 (when the Fed was still easing). Prior to that, it was in January 2010 (when the Fed was still easing) and prior to that in the Great Recession.

It's important to put the jobs numbers into proper perspective.

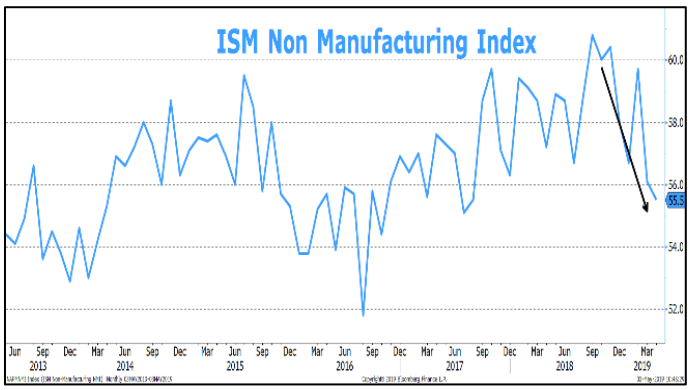
TAKING THE OPT OUT OF ISM

The April Institute for Supply Management (ISM) Manufacturing Index came in well below expectations at 52.8 and represented a drop of 2.5 points from March. It was also the lowest reading since October 2016, and it means that the current level is now eight points below the August 2018 peak. The breakdown was also soft with the employment component dropping over five points to 52.4, new orders also down over five points to 51.7 and, most notably, the prices paid component falling over four points to 50.0. This is a very big move in the context of an index that typically moves about a point in any given direction in any given month.



So, this was no ordinary slippage. With the S&P 500 at a new high, maybe what we can blame is just a moribund economy, both here and abroad. The lagged impact of the Fed rate hikes, quantitative tightening and the firm U.S. dollar are coming home to roost, and there is no fiscal stimulus this year to serve as an antidote.

Following manufacturing's collapse, ISM reports that the services sector slumped to its weakest since August 2017. The Non-Manufacturing Index declined to 55.5 in April from 56.1. Under the hood, it's just as ugly with new orders and employment both tumbling (the latter to two-year lows).



Source: Bloomberg

The weakness in employment contrasts with Friday's U.S. jobs report, which showed payrolls climbed in April by a robust 263,000 that topped all projections. Surely, we aren't going to be hearing economists blame the weather again (will we?).

THE STOCK MARKET IS NOT THE ECONOMY

"Buybacks were illegal throughout most of the 20th century because they were considered a form of stock market manipulation. But in 1982, the Securities and Exchange Commission passed rule 10b-18, which created a legal process for buybacks and opened the floodgates for companies to start repurchasing their stock en masse." – Vox

Over the recovery since 2009, we experienced the weakest recovery of all time despite massive and unprecedented monetary and fiscal stimulus. Yet the stock market had one of the strongest rallies ever.

Beyond low interest rates and central bank intervention, declining supply is also the reason behind the massive surge in equity prices.

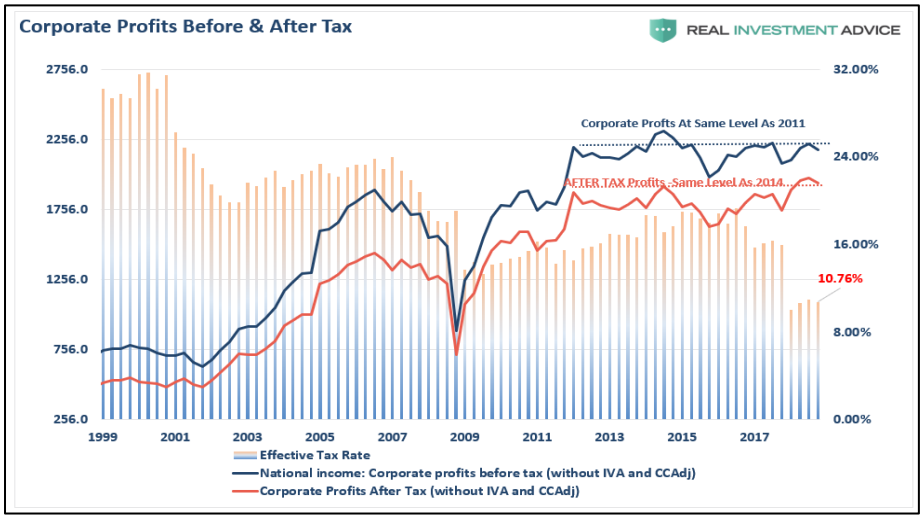
Just last year alone, stock repurchases soared more than 20% from year-ago levels. With the help of the tax cuts (that's where they went!) share buybacks culminated in a record $800 billion in 2018. In the first quarter of this year, share buybacks had soared 22% above year-ago.

Since the bull market commenced in mid-2009, 25% of the buybacks have been funded with new debt, which has surged from $5 trillion to $9 trillion. By creating scarcity in the market for safe securities this cycle, investors were forced to up the risk curve. This meant tremendous opportunity for CEOs and CIOs to issue gobs of debt to receptive yield-starved investors. And this debt, or at least 25% of the new issuance, went to fund an unprecedented wave of share buybacks. In effect about $5 trillion of S&P 500 stock has been taken out of the public market since the bull market began.

The equity market run has nothing to do with so-called "fundamentals." The stock market is beholden to the $4 trillion expansion of the Fed's balance sheet, a $4 trillion surge in corporate debt, and $4 trillion in share buybacks.

What most people don't know is that pre-tax economy-wide profits, in actual dollar terms, are actually lower today than they were four years ago. Blessed by the buyback craze, the scrubbed-down "operating" earnings per share for the S&P 500 universe has swelled more than 30% over this time. Creating a Potemkin-type environment for profits via rampant share buybacks can certainly skew "earnings per share" data.

Corporate Profits at the Same Level as 2011



Source: Real Investment Advice

If the "fundamentals" were strong and the macro outlook sunny, then Apple and many other companies would be investing they're cash flow into new capital expenditures rather than diverting resources towards share buybacks. This really says a whole lot about how bizarre this cycle has been. CEOs see a very murky economic outlook and they have curbed expenditure growth.

Ironically, the last thing Wall Street wants is a capex boom, which would eliminate or greatly reduce the sugar-high from the buyback craze. Think of it this way. Weak capex means weak GDP, which means low inflation, which means sustained low interest rates. This helps perpetuate this unprecedented debt-financed buyback cycle. In fact, the weaker the economy is, the better that will be for the stock market because the lack of capital spending will just continue to free up funds for the share buybacks – the prime reason why earnings look so well dressed-up, and the principal factor behind this bull market.

And if the economy was fundamentally so strong, the Fed would have gone ahead as planned last December and stuck with the strategy of raising rates two more times this year and kept the balance sheet reduction on "auto pilot." But with the now famous "Powell Pivot," the Fed has yet again signaled to the markets that it "has your back." In other words, "Buy, Mortimer, buy!"

Source: The Acting Man

Basically, the market for pubic equities is trading more and more like a commodity. And the greater the buybacks, the greater the scarcity of stock outstanding, which in turn drives prices higher. But the reality is that nothing about what the stock market has done is rooted in the economic backdrop. In fact, I will argue that weak economic growth is actually bullish for equities.

It's not about fundamentals, it's about scarcity.

End of story. Anyone who tells you that the stock market is telling you that the economic fundamentals are "solid" show him or her this piece and buy them a drink. Make it a double!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The U.S. economic expansion is about to mark its 10th anniversary next month and become the longest on record in July. Reaching this milestone would seem to be an occasion for triumphalism, but both the lack of inflation and slow growth would appear to be symptoms of persistent slow growth in what has been called "secular stagnation."

While the current expansion is likely to go into the books as the longest, it has also been the weakest, averaging only 2.3% growth a year. That contrasts with the boom at the end of the 20th century, when economic expansion averaged 3.8% from April 1991 through December 2000.

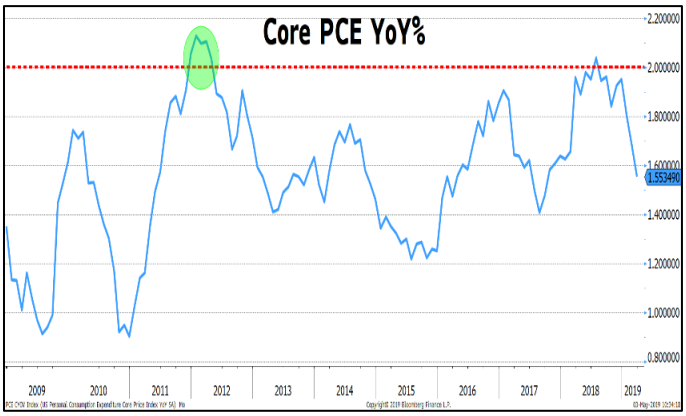
I believe the slow growth is a function of central banks, which have intervened to prevent the business cycle from running its course. In doing so, they have short-circuited recessions, which are actually regenerative and useful. Think of

how fast forests grow after a major fire. However, with central banks forestalling the business cycle, the U.S. and global economy are consigned to low single-digit growth.

And despite warnings that expansionary monetary policies would lead to surging inflation, the opposite is actually evident. The working hypothesis is that aging populations tamp down wage demands and spending. Bloomberg Businessweek declared in a recent article that inflation is dead, extinct and deflated like the dinosaur.

Last week at his press conference following the Federal Open Market Committee meeting, Fed Chair Jerome Powell stated the decline in core inflation was "transitory." I'll take the other side of that bet — after all, core personal consumption expenditures (PCE) inflation has managed to be at, or above, the Fed's 2% target for the grand total of six months out of this 118-month-ong economic expansion. What is that? Five percent of the time?

Inflation Heading in Wrong Direction



Source: Bloomberg

The Fed Chairman talked about GDP rising at "a solid rate" but full well knows how weak demand was in the first quarter, with slow growth of household spending and business fixed investment in the first quarter. The message from falling core inflation rates is that the demand-side of the economy is running below the growth of the supply-side. As such, you don't need a recession to see that the Fed will be cutting rates before too long. Unless the Fed wants to change its target, getting to 2% on core is going to require that it uses one of its policy levers to get there — as in rate cuts.

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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.