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WEEK OF MAY 13, 2019

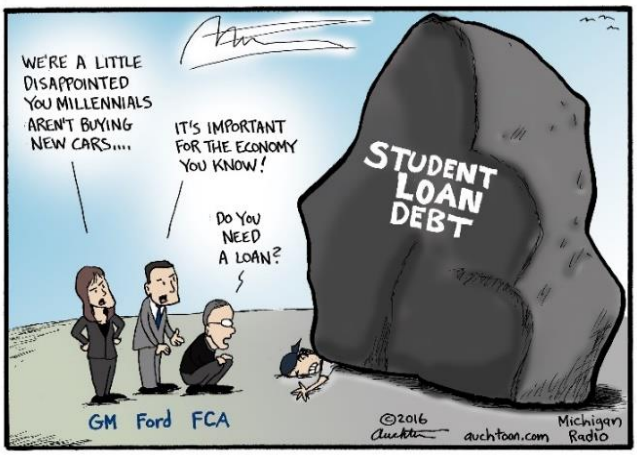
Weekly Relative Value

Thinking Outside the Box

"If you look at student loan lending, which the U.S. government effectively nationalized during the great financial crisis, you're now looking at the consequences of this 11 years later – the cost of college education exploding since the government has been involved, creating a generation of students, who are now graduates, who are completely disillusioned with their economic prospects." – Ken Griffin, CEO, Citadel

I expect to hear from some of you on this article. First, let me say this upfront, I am an **Independent** and not a proponent of the left-wing policies espoused by Elizabeth Warren, Bernie Sanders and many others. However, there is one policy that deserves to be explored. Warren is proposing a student loan forgiveness plan, which would cancel up to $50,000 in student debt for anyone from households earning less than $100,000 a year. She would fund the program with a wealth tax on all families with net worths above $50 million. (Robin Hood would surely approve.) This, in turn, would provide much needed relief for over 40 million people and boost the economy.

Is this utter nonsense?



Source: Cagle

Let's start with a general picture of the student loan landscape. The most recent reports indicate there is:

- $1.56 trillion in total U.S. student loan debt
- 44.7 million Americans with student loan debt

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

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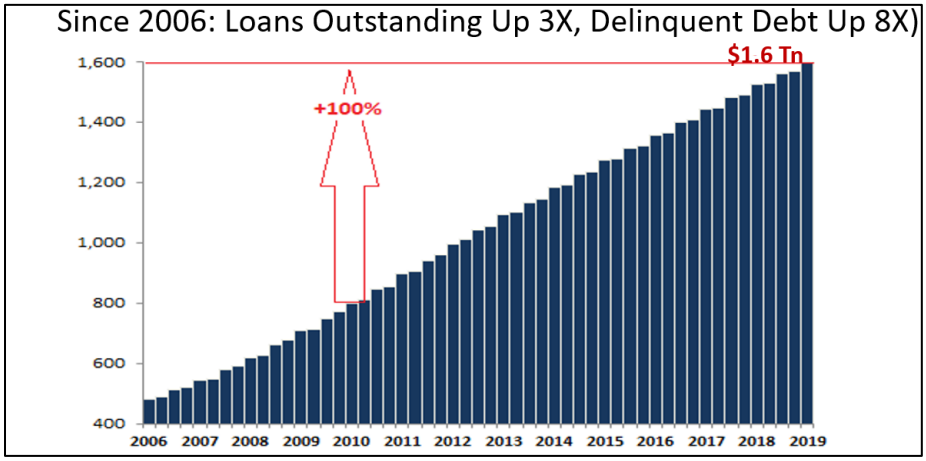
THIS WEEK…

- Famous Last Words
- Tariff Talk
- Trial Balloon
- Hints of Deflation

PORTFOLIO STRATEGY

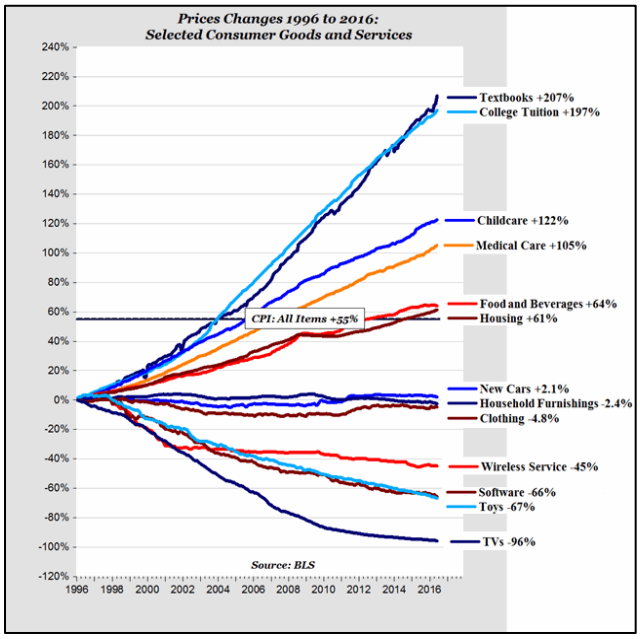
- 11.5% of student loans are 90 days or more delinquent or are in default



Source: Wolf Street

As shown in the graph below, education and health care are the two categories that have risen the most in price for many years now. Frankly, it is sad, if not criminal, that healthcare and education costs – the things we need the most – have been allowed to spin out of control. If the government had not backstopped the student loan market, colleges would not have been given the green light to raise college tuition without limits and consequences. This is yet another example of where the government gets involved and bad things happen.

Healthcare and Education Costs are Off the Charts



Source: BLS

Today, the delinquency rate for student debt approaches 12%. And, there is no way to restructure the debt. If you are in arrears, you are shut out of the credit markets for years after missing a payment. Think about how this impacts consumption (i.e., housing , autos, etc.) which drives the U.S. economy. This is one reason the recent housing market

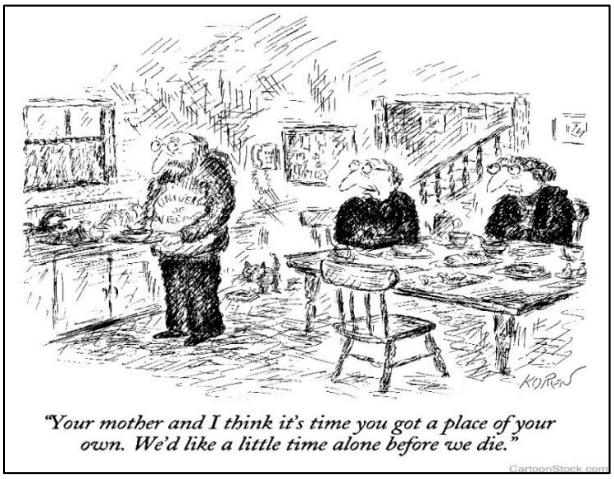
cycle was not normal. First-time home buyer sales rarely got above 30%, whereas a typical bull market in residential real estate the share of this cohort is hovering between 40% and 50%.

"There is a sense that the ability to get ahead has been diminished." – Ken Griffin

The situation is without precedence, and has posed some serious socioeconomic challenges. And, most importantly, it is acting as a serious constraint to economic growth. Imagine how strong the economy would be if 40 million Americans were freed up from the student debt albatros?

Second, the cost of education and the burden of taking on so much debt has coincided with a precipitous decline in post-secondary school enrollment — which has shrunk in five of the past six years to near-decade-lows and that occurred in the face of all the fiscal and monetary stimulus.

The lack of opportunity has, in turn, led to the share of "kids" between the ages of 25 and 34 that are living at home rising to 17% from 12% a decade ago. For males in that age cohort, for the first time since the Great Depression, there is more than one-in-five living at home right now. That is incredible as it is sad, though on the bright side these boomerangs get to go back to a life of mom and dad doing the cooking and laundry.



Source: Cartoon Stock

Is it shocking that living in the parents' basement and playing Fortnite all day long hinders the development of romantic relationships?

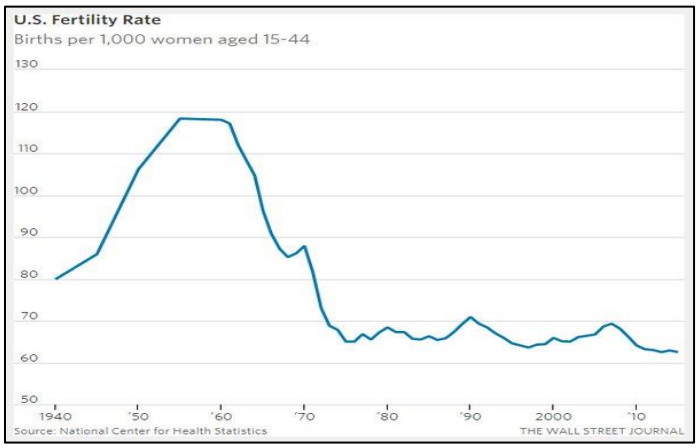
The median age of first marriage by a male is now 30 years. For women, it is 28 years. This is unprecedented.

The U.S. birth rate has dropped to the lowest level in recorded history. In 2010, the fertility rate was as high as 64% and is now down to a record low of 60%. But this makes sense. Who wants to start a family when you're either saddled with debt at a young age or can't get a loan because you're not current on your existing student debt?

The average family size is now down to just three people.

This was achieved without a Chinese mandated "one child" policy. Demographically, combined with a restrictive immigration policy stance, the fact that American parents are not "replacing themselves" comes at the cost of lost future potential economic growth.

U.S. Fertility Rate at All-Time Low



Source: Wall Street Journal

I realize some readers will totally disagree with this. They think that this policy is unfair. I agree, it is. It sends the wrong message and creates a dangerous precedent. After all, if you paid off their student debt why should others be let off the hook? Or, if you, as a parent, paid for your kids, why should others get a free ride? I hear you loud and clear. (I, too, paid college costs for three kids). Some may wonder if this creates a moral hazard or unintended consequences. Maybe. Unquestionably, for these reasons, this is a bitter pill to swallow. Frankly, it goes against every principle I have believed in.

On the other hand, this is the future of America. If you look at the bigger picture over the long-term, this program could help the next generation get back on track. If we want the next generation to thrive (not just survive) and if we want a stronger overall economy, something needs to be done. This may not be the solution. Maybe there's a better way out. But we need to think outside the box.

But forgiving debt solves only half the problem. In addition to student loan relief, the quality of education in America needs to be improved and made more relevant for the modern economy. To wit: The LendEDU College Pulse Survey, conducted between December and mid-March, asked 69 schools and 7,749 college students the following question:

"Do you think that college is sufficiently preparing you for your future career?"

36% of Seniors Don't Feel Prepared For Their Career, Compared to 20% of Freshmen

Graduating Year	Yes	No	Not Sure
2019 (Seniors)	47%	36%	17%
2020 (Juniors)	47%	32%	21%
2021 (Sophomores)	50%	25%	25%
2022 (Freshmen)	54%	20%	27%
OVERALL STATISTICS	49%	29%	22%

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Do you think that college is sufficiently preparing you for your future career? (Asked to current college students)

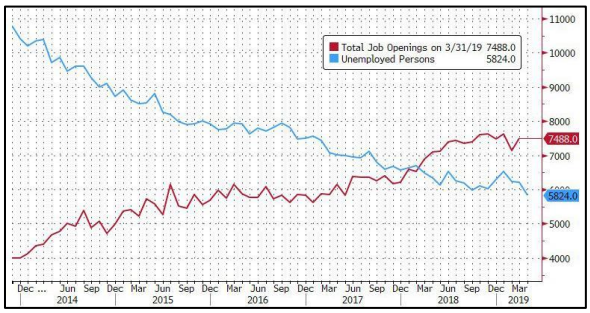
Almost 40% of seniors said they don't feel prepared for their career.

"What a college student does with their career really does play an impact on their student loan debt… They go to college and they graduate with the average of $30,000 in student loan debt and they can't land a job, or a good-paying job, then they are going to be stuck with that student loan debt and it's only going to get worse and it's going to impact how they handle their life after graduation." – Mike Brown, a spokesman for LendEDU

As shown below, we have a near-record level of job openings not getting filled, month after month. The reason for the void is a chronic lack of skilled labor. And the problem with that is skills, and perhaps the education, that young people are getting aren't worth the cost or the debt they took on. This may be one key reason why school enrollment, in Wall Street parlance, is in a bear market.

Think of this as a "human infrastructure" project. Real wage growth moves in relation to productivity. The more productive you are to a company, the more you get paid. Education and training are key. These people are the future. Get this dynamic moving in the right direction, and the economic benefits will flow much more freely than building a "bridge to nowhere" or the types of fiscal and monetary policy measures we have seen this cycle.

Record 1.7 Million More Job Openings Than Unemployed Workers



Source: Bloomberg

FAMOUS LAST WORDS

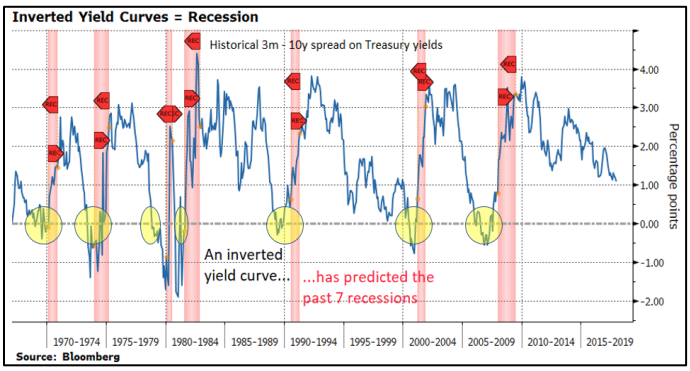
"I would not interpret the currently very flat yield curve as indicating a significant economic slowdown to come, for several reasons… This time, both short- and long-term interest rates – in nominal and real terms – are relatively low by historical standards. Second, as I have already discussed, to the extent that the flattening or inversion of the yield curve is the result of a smaller-term premium, the implications for future economic activity are positive rather than negative." – Former Federal Reserve Chair Ben Bernanke on March 20, 2006

The above quote was taken from a speech by Ben Bernanke in March 2006. He cited reasons as to why the yield curve was signaling a head fake. Now how great of a call did that turn out to be? A year and a half later, it was quite a different story.

Last week, the closely watched spread between three-months and 10-years turned negative for the second time this year. We are told that it does not matter, even though when this spread turned negative seven times since 1974 it predicted seven recessions. It amazes me how the central bankers and Wall Street economists tell us this time is different. To the typical economist, yield curves are only relevant when they are steep at the beginning of the market

and economic cycle, and lose their allure when they flatten, or invert, late in the game. This is otherwise known as human nature and the innate need to spin a bullish tale at all times — only when it flattens, or inverts, late in the cycle.

Is This Time Different?



TARIFF TALK

As promised by President Donald Trump, the latest round of U.S. tariffs on $200 billion of Chinese exports has just come into place, taking the rate from 10% to 25%.

The Donald rushed off to tweet the following utter nonsense:

"Talks with China continue in a very congenial manner - there is absolutely no need to rush - as Tariffs are NOW being paid to the United States by China of 25% on 250 Billion Dollars' worth of goods & products. ***These massive payments go directly to the Treasury of the U.S....***

... The process has begun to place additional Tariffs at 25% on the remaining 325 Billion Dollars. The U.S. only sells China approximately 100 Billion Dollars of goods & products, a very big imbalance. ***With the over 100 Billion Dollars in Tariffs that we take in, we will buy...***

... agricultural products from our Great Farmers, in larger amounts than China ever did, and ship it to poor & starving countries in the form of humanitarian assistance. *In the meantime, we will continue to negotiate with China in the hopes that they do not again try to redo deal!*

Tariffs will make our Country MUCH STRONGER, not weaker. Just sit back and watch! In the meantime, China should not renegotiate deals with the U.S. at the last minute. This is not the Obama Administration, or the Administration of Sleepy Joe, who let China get away with "murder!"

Tariffs will bring in FAR MORE wealth to our Country than even a phenomenal deal of the traditional kind. *Also, much easier & quicker to do.* ***Our Farmers will do better, faster, and starving nations can now be helped****. Waivers on some products will be granted, or go to new source."*

Meanwhile, Beijing has defied President Trump's demands that it not resort to retaliatory tariffs and announced plans to slap new levies on $60 billion in U.S. goods. In bad news for American farmers, China might stop purchasing agricultural products from the U.S., reduce its orders for Boeing planes and restrict service trade. There has also been talk that the People's Bank of China could start dumping Treasuries.

No new talks have been scheduled, as far as we know, and nobody wrote any more "beautiful" letters. Nothing is likely to happen now until the G-20 summit in June... so investors are best to batten down the hatches at least for the next month.

Tariffs 101: The contention that tariffs are filling the U.S. Treasury coffers and set to dramatically reduce the debt/deficit is a mischaracterization, at best. The U.S. imposes tariffs on imports of Chinese goods. The tax is levied at the time of import and is paid by the American importer of record, and then usually passed onto consumers.

U.S. importers and consumers overwhelming absorb those higher costs in the form of lower margins (business) and/or higher retail prices (consumers). See last year's +12% year-over-year increase in washing machines/dryer prices as a case study for prospective impact as the tariff list increasingly broadens out to consumer products.

Goldman Sachs says the same thing:

- Goldman Sachs said the cost of tariffs imposed by President Donald Trump last year against Chinese goods has fallen "entirely" on American businesses and households, with a greater impact on consumer prices than previously expected.
- The bank said in a note that the trade war's impact on U.S. consumer prices is now higher than previously expected, partly because Chinese exporters have not lowered their prices to better compete in the U.S. market

Directly contradicting Trump, White House economic adviser Larry Kudlow admitted the U.S. will pay for China tariffs.

1. White House economic adviser Larry Kudlow on Sunday acknowledged that the Chinese do not directly pay tariffs on goods coming into the U.S., contradicting President Donald Trump's claims that China will pay for tariffs imposed by the U.S.
2. Kudlow said that "both sides will suffer on this," but argued that China will suffer significant GDP losses as export markets are hit.

Source: Gulf Times

Oxford Economics estimates that a tariff on all imports from China would cost the economy about $100 billion by 2020, which translates to an equivalent loss of $800 per household. And if it's bad for the consumer, it's bad for the U.S.

Finally, Kip Eideberg, Vice President of Government Affairs for the Association of Equipment Manufacturers, which represents more than 1,000 U.S. makers of farm, construction and mining machinery, is warning that the higher tariffs could cost 400,000 jobs.

Let us all remember and revel in the incontrovertible decree: "Trade wars are good and easy to win!"

TRIAL BALOON

"Under this policy, the Federal Reserve would stand ready to use its balance sheet to hit the targeted interest rates… Once the short-term interest rates we traditionally target have hit zero, we might turn to targeting slightly longer-term interest rates—initially one-year interest rates, for example, and if more stimulus is needed, perhaps moving out the curve to two-year rates." – Federal Reserve Board Governor Lael Brainard

Simply put, it's an "interest rate peg."

To illustrate how a peg could work, suppose that the overnight interest rate was at zero and the two-year Treasury rate was at 2%. The Fed could announce that it intends to hold the two-year rate at 1% or less and enforce this ceiling by standing ready to buy any Treasury security maturing up to two years at a price that corresponds to a return of 1%.

A rate peg of this type is designed to make borrowing cheaper along certain parts of the yield curve.

Rest assured the target will not stop at one-year. Think five-year, then 10-year.

Think Japan.

It's so frustrating to watch the central bankers, with their God complex and infinite knowledge, come up with new experiments.

Why is there an itch to control when free markets can reach equilibrium on their own?

By the way, this talk is indicative of a Fed that is far more concerned about a recession than they want you to believe.

HINTS OF DEFLATION

The headline Consumer Price Index (CPI) came in below expected at +0.3% in April — the consensus was looking for a 0.4% gain. That still took the headline inflation rate up to 2.0% from 1.9% in March, but that pales next to the 2.5% trend last October, which is rather incredible when you consider what oil prices have done of late.

The key as always is the core. For the third month in a row, core inflation came in at +0.1%. The year-over-year trend has been stubbornly holding at just over 2.0% now (+2.07%) for three months running, but it is destined to melt as the CPI has decelerated to just a 1.6% annual rate on a three-month basis. This definitely does not look "transitory."

The key in the data is the renewed deflation in core goods prices, a reflection of the strong dollar and the weak real private final demand. This metric declined 0.3% in April, down for three consecutive months. Year-over-year, the trend

has gone from +0.3% in January to +0.1% in February to flat in March to -0.2% in April. A pattern here of going from lowflation, to noflation to deflation.

There were price declines at the grocery stores (-0.5%), household appliances and furniture (-0.3%), clothing (-0.8%), autos (-0.4%) and parts (-0.2%), airlines (-0.1%), professional services (-0.1%), hospital services (-0.4%), video/audio services (-0.2%), sporting goods (-0.9%), photography (-0.1%), other recreational goods (-1.6%), communication services (-0.03%), "other" (i.e. personal) goods and services (-0.03%) and utilities (flat).

In fact, 45% of the items that make up the CPI were either flat or negative last month. Take out that spurious shelter component, and fully two-thirds of the index last month was either in deflation mode or a basis point away.

This is reality. The Fed is terrified of deflation. And they are disappointed that they have been unable to maintain a 2% inflation rate over the past decade.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The announced tariffs have come at a rather inopportune time, economically speaking.

Back in 2018, when the U.S. was slapping tariffs on washing machines and solar panels (January 2018), steel and aluminum (March 2018) and Chinese goods broadly (July 2018) the economy looked to be strong and was getting an added boost from tax cuts and the deregulation push.

This time around, economic growth is weakening, and the U.S. faces added headwinds from monetary policy tightening and actual fiscal drag in 2020.

The first quarter GDP data in the U.S., which the pundits fawn over, seem to ignore the impact that a 45% surge in soybean exports exerted on the number. Strip out trade, inventories and government spending, and the U.S. economy is barely growing better than at a 1% annual rate.

Abroad, the European Commission cut its real GDP growth estimate for this year for the euro area to 1.2% from 1.3%, and to 1.5% for 2020 from 1.6%. At these low levels of growth, even a handful of basis points matter. Japan remains in a slow growth morass and China's economy is slowing.

Treasury Yields Continue their Descent

Source: Bloomberg

In light of this macro back drop, you don't need the uncertainty from a trade war to be bullish on the high-quality fixed income securities. The downward pressures on growth and inflation are enough for me. All told, I am keen to reiterate my bullish bias across the curve.

In terms of value, the intermediate (five-year) securities appear attractive on a risk/return basis. To wit, the five-year note yields 2.18%, versus 2.40% for the benchmark 10-year Treasury. That means the five-year maturity provides 91% of the yield of the 10-year, with half the risk.

From a portfolio perspective, we encourage credit unions to maintain a disciplined ladder strategy. Any sell-off in the markets provides an attractive entry point to put excess cash reserves to work.

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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.