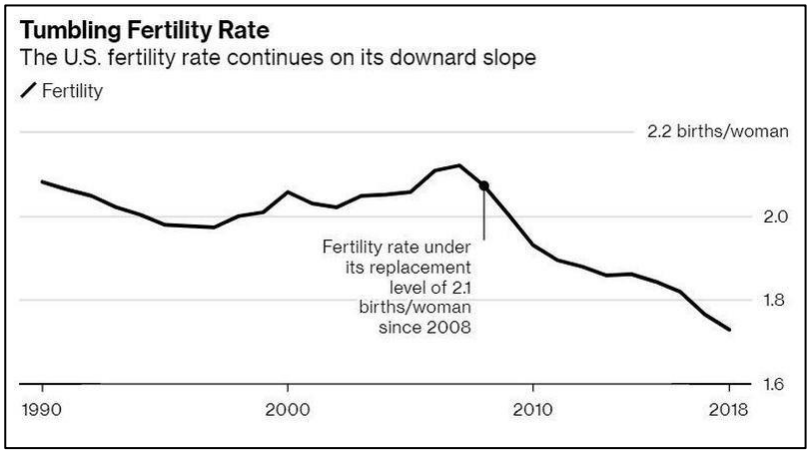
Weekly Relative Value

Baby Bust

"It's really remarkable, not something that we've seen over the last century."
– Professor Stephen Buckles of Vanderbilt University, on the changing fertility patterns

All Americans – but particularly those who are younger and with college degrees – are having fewer kids. Overall, the number of births in America dropped to 3.8 million in 2018, the lowest level since the 1980s. And the birth rate declined to 1.7, the lowest rate "ever" and well below the so-called "rate of replacement" of 2.1.



Source: Bloomberg

Consider the following facts:

- The number of births for the U.S. in 2018 was 3,788,235, down 2% from 2017 and the **lowest number of births in 32 years**.
- The **fertility rate was 59.0 births per 1,000 women** aged 15-44, down 2% from 2017 and another **record low for the U.S.**
- **Birth rates declined for nearly all age groups of women under 35** but rose for women in their late 30s and early 40s.
- **The birth rate for teenagers aged 15-19 was down 7% in 2018** to 17.4 births per 1,000 women; rates declined for both younger (aged 15-17) and older (aged 18-19) teenagers.

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

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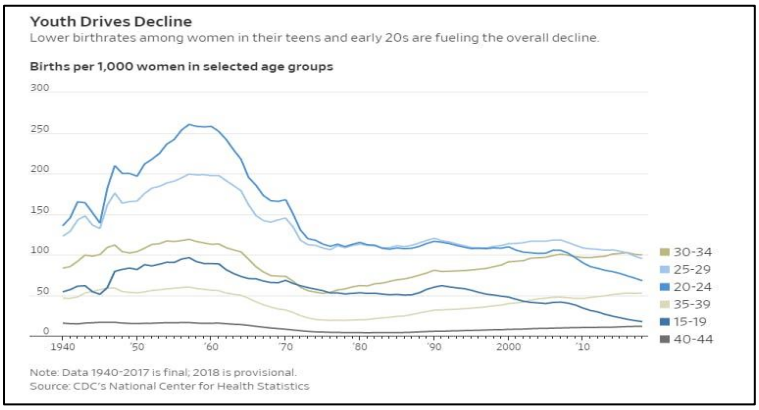
- WHY IT MATTERS
- KEEP AN EYE ON AUTOS
- FARM CRISIS

PORTFOLIO STRATEGY

Abortion is not responsible for the birth decline. The total number of abortions have fallen to their lowest levels since around the time that Roe v. Wade legalized the procedure in 1973.

Rather, the decline in fertility rates is rooted in birth control, education and waiting longer.

As noted, birth rate declines have been dramatic among teens (15-19), falling to 17.4 births per 1,000 women. That represents a 72% decline from a peak of 61.8 in 1991. And that trend shows no sign of reversing.



Source: CDC

Demographers hope that as more millennials age into their 30s, the birth rate will begin rising again but that seems to be wishful thinking. Since women who wait to have kids typically have fewer of them, the odds are stacked against them. Contrary to expectations, the stronger economic security and independence of women have prompted them to have fewer children, not more, since fewer women want to interrupt their careers to have kids. Debt and, more specifically, attitudes about debt, are the number one reason that faith in millennials having more kids is misplaced.

Source: Cagle

Millennials were told to get an education at any cost, and it would work out. It didn't and won't. Kids saddled with student debt have delayed home purchases, marriage and family formation.

On top of that, the Fed's inflationary tactics helped boomers with assets but severely punished millennials who cannot afford homes. Even attitudes towards car ownership have changed. Once again, it's the cost of ownership.

An attitude change coupled with economic reality is the true driver. The economic reality of having children is that it now requires two incomes instead of one like it did 30+ years ago.

Children can be wonderful but are a lot of work and frequently are inconsistent with millennials' personal and professional goals (particularly for women who need marriage less), inflation (which makes all but supporting yourself difficult) and half of whom have seen their parents go through recessions and divorce (which deters household formation).

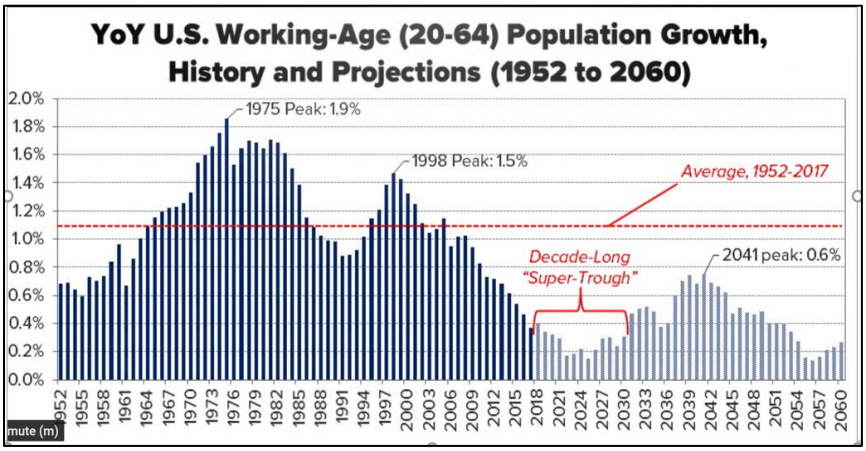
WHY IT MATTERS

While U.S. birthrates are higher than Europe and Japan, we are heading in the same direction. One way to change this trajectory is to make most immigration legal. Studies have found that immigrants are often willing to take the lower paying jobs that no one seems to want, which boosts growth automatically. Employers make more, and workers make money to spend. This would be good for the economy. Unfortunately, some say immigrants cost more than they contribute. That is absolutely untrue. The U.S. Treasury collects billions each year from illegal immigrants using phony social security cards yet pays out no benefits.

The decline in birth rates has important implications for the U.S. economy and workforce. As shown below, growth in the labor force hit a post-war high in excess of 3% during the 1970s. It has slowed down to today's 10-year forecasted growth rate of 0.5%. Growth will slow even further into the early 2020's as more baby boomers retire. A low fertility rate means that, without enough immigrants, the U.S. could see population declines and a workforce too small to support a growing segment of retirees.

Looking at the annual growth in the working-age population, the U.S. is headed for a slowdown unlike anything ever seen.

Less growth in the labor force explains why growth in the economy is slower.



Source: HedgeEye

KEEP AN EYE ON AUTOS

Auto loan delinquencies (90 days or more past due) jumped to 4.69% of outstanding auto loans and leases in the first quarter of 2019. This is just a smidge below the peak of delinquencies during the Great Recession (5.27%). And dollars are big. In the first quarter, total outstanding balances of auto loans and leases were $1.28 trillion. Much of the increase

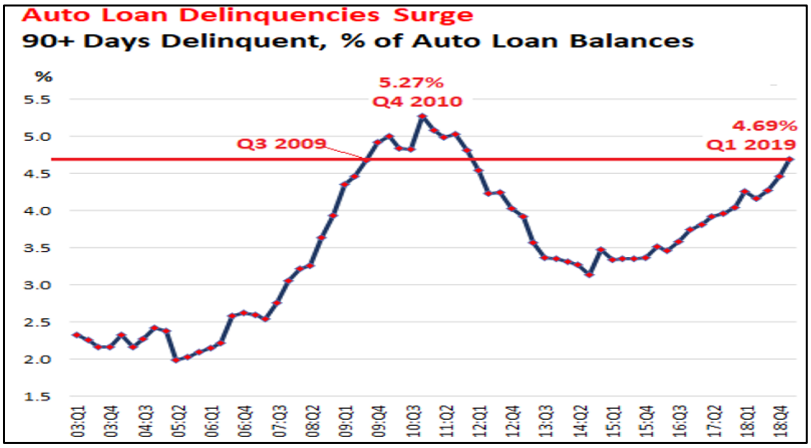
in the auto loan balances is due to the ballooning amount financed with each new loan and longer loan terms that cause those loans to stay on the books longer.

For lenders, these delinquent loans don't represent total losses. This debt is collateralized by vehicles, which can be repossessed without much of a delay.

Today's repo man:

1. Locates vehicle on GPS.
2. Disables vehicle ignition remotely.
3. Picks up vehicle.
4. Puts it through the car wash.
5. And backs into the car lot.

These losses are spread over thousands of banks, credit unions and non-bank lenders, and over asset-backed securities holders, such as pensions funds, other institutional investors, and bonds funds. Most will get through this by just licking their wounds. But some smaller subprime-focused non-bank lenders will collapse, and a few have already collapsed. So, these defaulted auto loans are going to hurt, and they're going to take down some smaller lenders, but they're not going to take down the U.S. banking system. They're just not big enough.



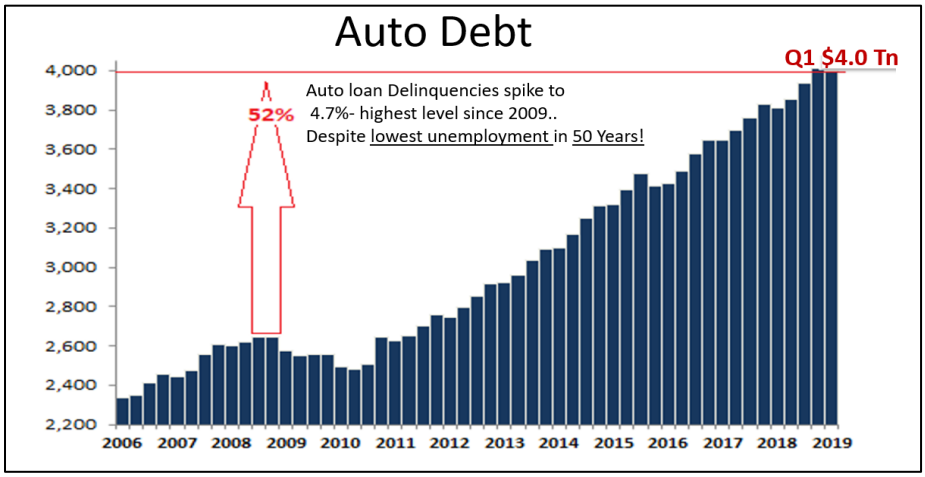
Source: New York Fed

But here's the key point: This is happening in good times with one of the strongest labor markets in many years. Yet, people with jobs are defaulting. I saw a report a few weeks back that said that 83% of those employed live paycheck to paycheck. Doesn't take much under that kind of employment to cause missed payments. And we know what happens when the cycle turns. Layoffs and unemployment surge and millions of people lose their jobs and cannot make their car payments. And we know all too well what happens to the auto industry when the economy dives into a recession. We know what this will look like because we've seen it before.

What we haven't seen before is this kind of credit stress among car buyers during good times – with the bad times still ahead. So, when credit stress gets this bad during good times, imagine what it might look like during bad times.

So, why is this happening? It comes down to years of aggressive and reckless auto lending, aided and abetted by yield-chasing investors piling into subprime auto-loan-backed securities because they offer more yield in an era of central-bank-engineered financial repression. It's a sign like so many others in this economy, that the whole credit spectrum has

been grossly distorted and has gone haywire over the years. Thank you, Fed, for having engineered this whole thing with your ingenious policies. So now there's a price to pay – even during good times.

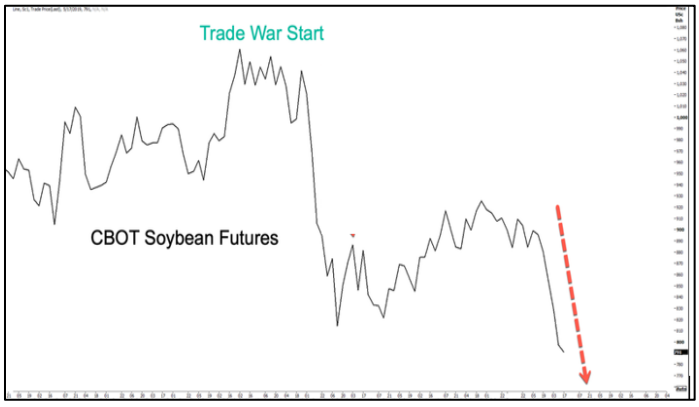


Source: New York Fed

FARM CRISIS

"The markets are so low; we cannot even break even to pay our bills. Farmers are losing their farms every day. The suicide rate among farmers is at an all-time high… It took us 40 years to build these markets… and while no trade deal is perfect, for the most part the agriculture trade with China was on the up and up, or mutually beneficial."
– Bill Gordan, Vice President of the American Soybean Association

The deepening trade war between the U.S. and China has roiled America's Heartland. Soybean exports to China have crashed, and huge stockpiles are building. Farmers right now are losing $50 to $100 on corn and soybeans per acre. As shown below, the Chicago Board of Trade (CBOT) soybean futures plunged 25% in 50 weeks since the inception of President Trump's trade war early last summer. Today, soybean prices are the lowest level in a decade.



Source: CBOT

As such, many farmers are teetering on bankruptcy, unable to pay their debts and losing their land to creditors. Sadly, this has triggered the suicide rate among farmers to jump in the last several years.

It is widely expected that the Trump administration will hand out checks to farmers.

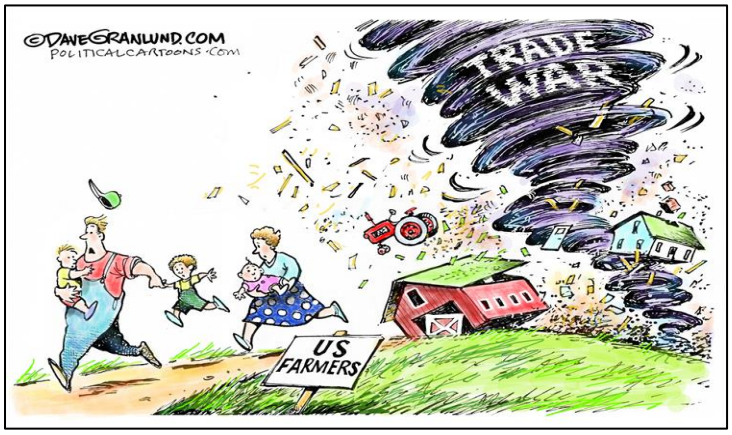
"Every developed country in the world subsidizes its agricultural sector… We have an over 80-year history of doing that here in the U.S. If it is socialism, it is not new socialism." – Agricultural Economist Scott Irwin, professor at the University of Illinois Urbana-Champaign

Gordon emphasized that farmers are looking to compete on a fair and level playing field, and don't want government bailouts during a time when spot prices drop.

"It is not up to us to tell the President how to negotiate, but a handout from the government is not how I want to run my business… What we want people to understand is that we don't want people to think we are complaining because we are not becoming super profitable… Today, if I plant soybeans, I'm guaranteed to lose $65,000 on this planting. I have to find somewhere else [to replenish] that money just to get me back to zero."

The 2019/2020 farm crisis is a repeat of the 1980s crisis; farmers back then had heavy debt loads with high stockpiles. Once the U.S. slapped the Soviet Union with trade embargos, crop exports to the country collapsed and triggered an agriculture recession in the Midwest.

Very similar to today, the Trump administration's trade war forced China to respond with retaliatory tariffs on American soybeans, thus collapsing soybean exports to China by 80%. With the trade war deepening, financial stress in America's Heartland will only increase.

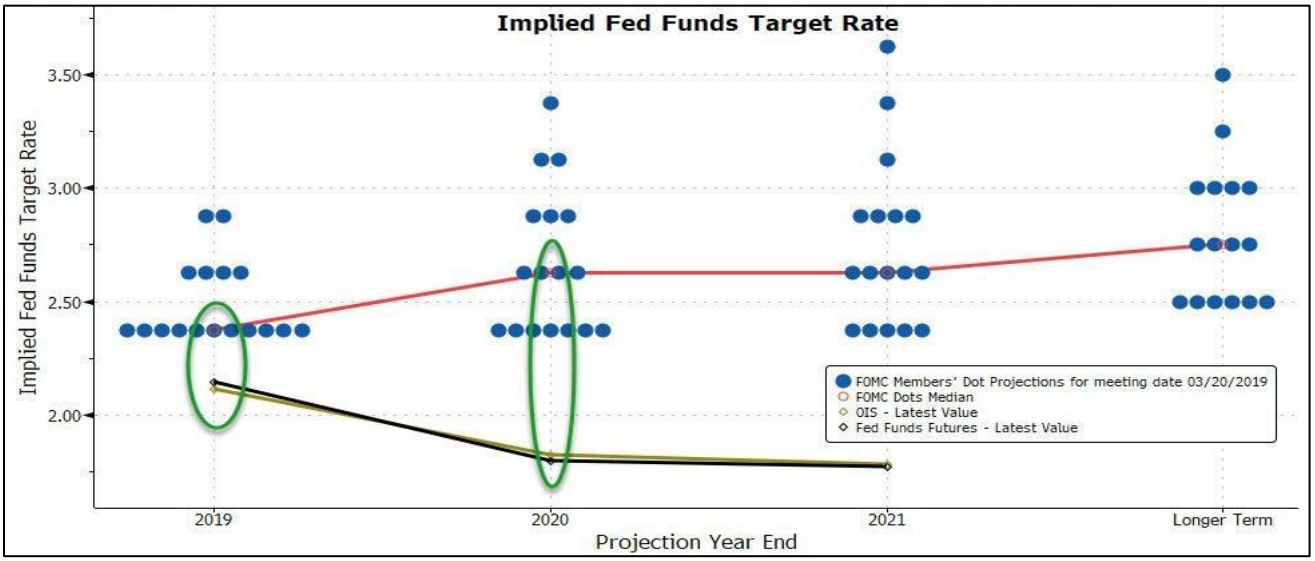


Source: Cagle

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Stocks plunged at the beginning of the week on news of China's retaliation to the ratcheting up of tariffs by the Trump administration, but they clawed back most of their losses to end just a bit below historic highs. Bonds, meanwhile, rallied on perceptions that trade frictions would slow the economy and force the Fed to lower interest rates to stave off a recession. Clearly, there was a divide between the glass-half-full equity types and their chronically depressive debt counterparts. Rarely has the future been less certain, which is reflected in the divergence between the stock and bond markets.

Last week, yields on Treasuries fell to the lowest levels in over a year, while the federal funds futures market placed the odds of a Fed interest rate cut as soon as September at nearly even odds.



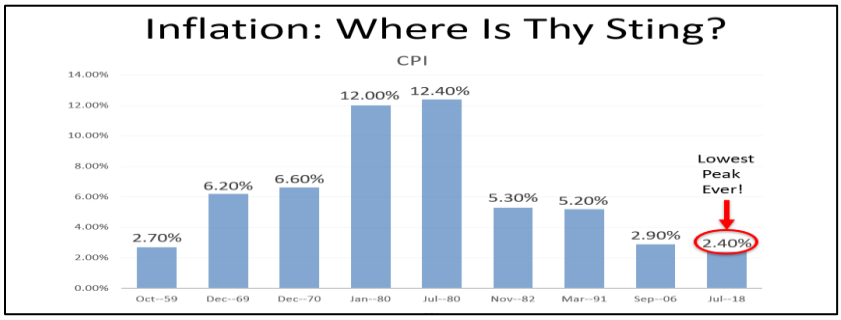
Source: Bloomberg

Meanwhile, declaring that too-low inflation was "one of the major challenges of our time,'' Fed Chair Jay Powell left open the possibility last week that the Fed's next interest rate move might be a cut after four increases last year.

> *"If inflation expectations are below 2%, they're always going to be pulling inflation down and we're going to be paddling upstream [to keep prices up]… I don't feel we have kind of convincingly achieved our 2% mandate in a symmetric way."* – Fed Chair Jay Powell

Powell confessed that there is "no easy answer'' to explain why price rises have been so subdued. Two possible reasons he cited were that the labor market might not be as tight as policy makers believe or inflation expectations might have slipped lower.

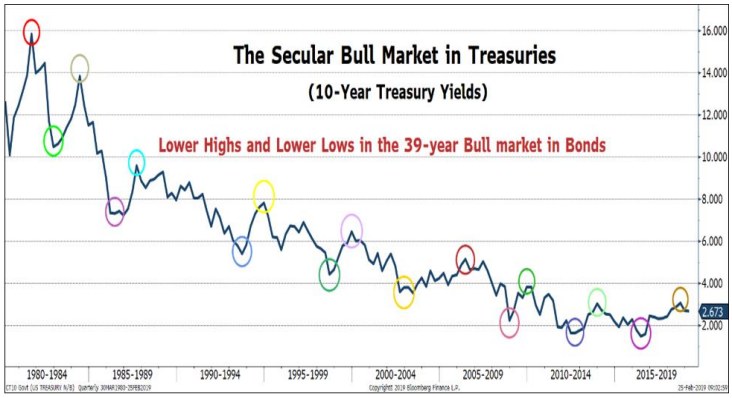
Take a look at the graph below. Core inflation did rise this cycle as one would expect, with the output gap vanishing. The year-over-year trend went from +0.6% at the lows to +2.4% at last year's peak. But it appears that this may be the lowest peak for inflation ever recorded. This is despite eight years of free money, repeated rounds of quantitative easing, two huge fiscal stimulus packages and trade frictions, if not an outright trade war.



Source: Bloomberg

In addition, the industry capacity utilization rate is declining, and the output gap is starting to widen. With aggregate demand growth already weakening to around a 1% pace, and aggregate supply ("potential") closer to 2%, look for the resource gap to widen further in the coming quarters, exerting more downward pressure on core inflation... and long-term bond yields in this process. Last week, the key 10-year Treasury benchmark yield declined to 2.38%. Based on the graph below, the long-term bull market remains in place.

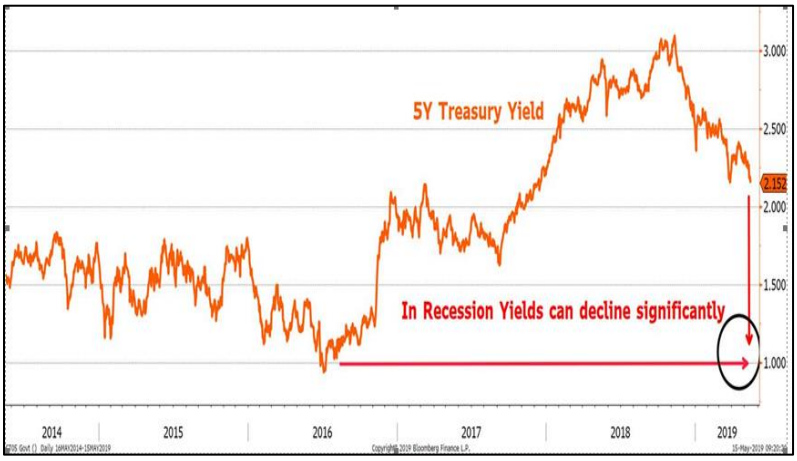
The Amazing Bull Market Continues



Source: Bloomberg

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.

In terms of value, the intermediate (five-year) securities appear attractive on a risk/return basis. To wit: the five-year note yields 2.26%, versus 2.46% for the benchmark 10-year Treasury. That means the five-year maturity provides 92% of the yield of the 10-year, with half the risk. And should the economy weaken, and the Fed reverses its interest rate policy and cut rates, the five-year part of the curve could perform quite well.



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- Economic Outlook
- Dueling Market Views featuring Tom Slefinger and Steven Rick
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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.

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