BALANCE SHEET SOLUTIONS
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WEEK OF MAY 28, 2019

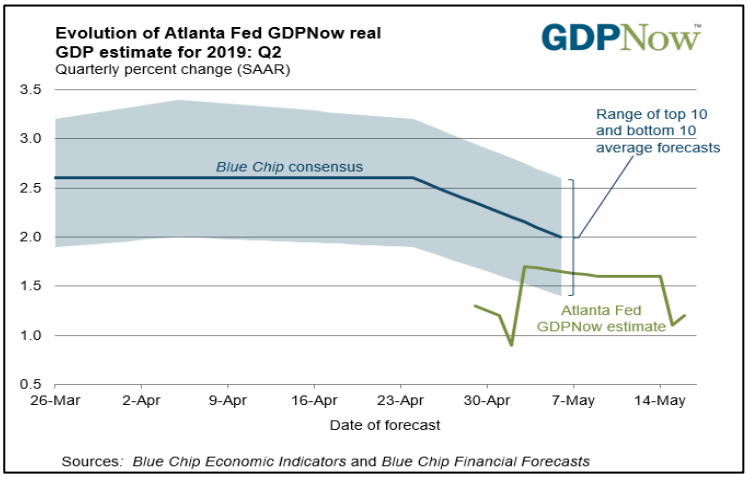
Weekly Relative Value

How Strong is the U.S. Economy?

"It's said now that our economy is the strongest it's ever been in the history of our country, and you just have to take a look at the numbers." – President Donald Trump

The President proclaims that this is the "greatest economy ever." With all due respect to the President, let's call that "fake news." As I have argued for a number of months, that simply is not the case. Of course, the economy received a short-term boost from tax cuts and massive spending. Let's face it – if you spend $2 trillion on the economy it had better grow. But the "sugar-high" is now ending and the payback is coming as the deficits explode. There are no more tax cuts and the government is tapped out. Now the economy will have to stand on its own two legs.

Yet, the Trump tweets continue to boast about the "3.2%" that ended in March. As I have highlighted in the past, the first quarter GDP report was goosed by an array of idiosyncratic factors including sliding imports, booming soybean exports and a jump in the Pentagon budget, which gave the allure of economic strength. In my assessment, this was arguably the most misleading Potemkin-like GDP reading of all time. Real underlying growth in the first quarter – based on final sales – was closer to 1%. Regardless, both the Atlanta Fed and New York Fed now have "1-handles" on second quarter growth. The Atlanta Fed is now at a mere +1.2% real GDP growth for the second quarter. The New York Fed's Nowcast, which is reported every Friday, was taken down to 1.4% growth. That's a cut of 0.79% in just two weeks! While not recessionary, we are approaching stall speed.



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

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THIS WEEK…

- BUSINESS SENTIMENT SOURS
- CHICAGO FIRE
- DISMAL DURABLES
- HOUSING WOES CONTINUE
- BUYBACK MANIA
- THE TROUBLE WITH TARIFFS

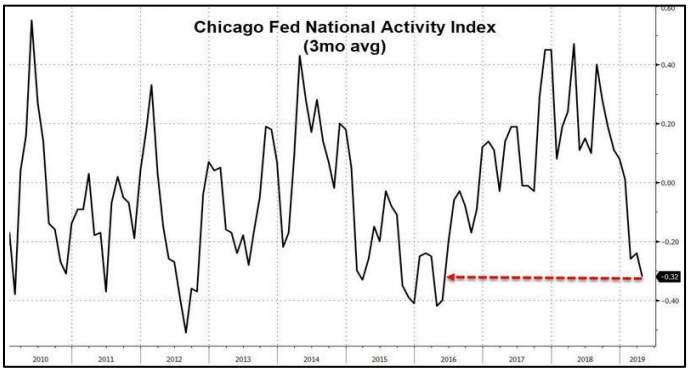
PORTFOLIO STRATEGY

CHICAGO FIRE

There's no better index that gives you more information about the economy than the Chicago Fed National Activity Index (CFNAI) – a monthly index designed to gauge overall economic activity and inflationary pressure across the country. And the picture isn't pretty. The CFNAI, which draws on 85 economic indicators, was -0.45 in April, the third negative reading in the past four months. The consensus was looking for a -0.2 number and instead received a number approaching a recessionary print. A reading below zero indicates below-trend-growth in the national economy and a sign of easing pressures on future inflation.

In terms of components:

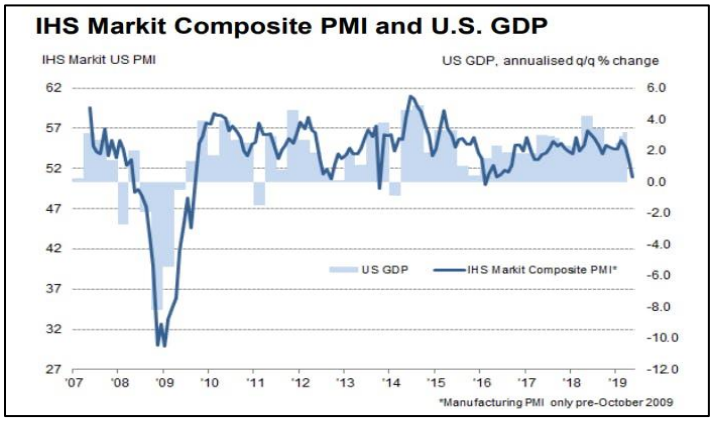
- **52 of the 85 monthly individual indicators made negative contributions.** This is the weakest level of national economic activity since May 2016 and makes one wonder where all the bullish narrative about the U.S. economic landscape comes from.



Source: Bloomberg

BUSINESS SENTIMENT SOURS

Markit's U.S. Manufacturing Index for May slid to 50.6, just above the contraction level. Of greater concern was the decline in the Services Index to 50.9, a three-year low, as the manufacturing slowdown spreads to services. New manufacturing orders were also dismal as inflows of new business showed the smallest rise seen this side of the global financial crisis. Concerns about economic conditions have dragged business confidence to a 2012 low.



Source: IHS Markit

Markit didn't sugar-coat a thing. How could it when new manufacturing orders slid into an outright contraction?

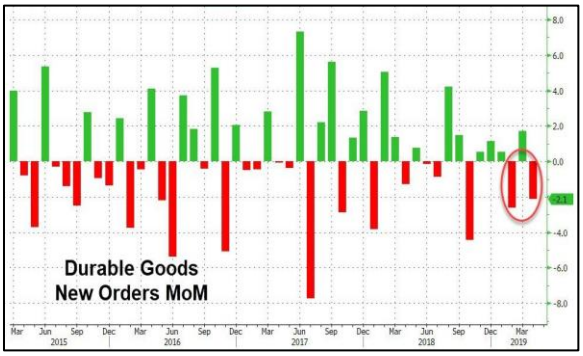
IHS Markit noted for manufacturing and services combined, with disconcerting implications going forward, that the rise in new orders **"was the softest recorded since the series began in October 2009."**

"Worse may be to come, as inflows of new business showed the smallest rise seen this side of the global financial crisis. Business confidence has meanwhile slumped to its lowest since at least 2012, causing firms to tighten their belts, **notably in respect to hiring…** The slowdown has been led by manufacturing **but shows increasing signs of spreading to services**."

DISMAL DURABLES

The durable goods report was supposed to be a bad one. Orders for durable goods – such as cars and appliances and other items designed to last at least three years – fell 2.1% in April compared to March, to $248.4 billion (seasonally adjusted). This report was made worse by a notable downward revision to March (from +2.8% to +1.7%). Obviously, the troubles at Boeing played a role as non-defense aircraft orders plunged 25% in April (as Boeing impacts start to hit) and are down 36% year-over-year.

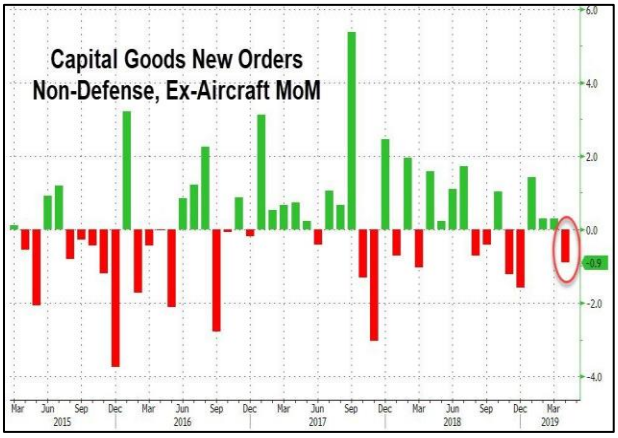
Durable Goods Order Decline Again



Source: Bloomberg

But the weakness was not confined to Boeing alone. Core capex orders have receded at a 3.2% annual rate over the six months to April, and that is all anyone needs to know. With a lag, this will hit the jobs market, and Jay Powell will be crying 'uncle' (we have seen this movie too many times before).

First Negative Read in 2019



Source: Bloomberg

Here are the key points from the report:

1. Shipments are down. Shipments feed GDP.
2. Unfilled orders are down. That's a reflection on future hiring needs.
3. Core capital goods are a measure of future business expansion. The March revision to the downside was massive, from +1.3% to +0.3%. April was -0.9%. Economists expected +0.1%. Oops.
4. Inventories are up for the ninth time in 10 months. I suspect Trump's tariffs might be the reason. Companies were stocking up to get ahead of price increases. This artificially boosted GDP in the first quarter.

This was a very weak report and it does not yet reflect much of Boeing. Coming on the heels of the collapse in Purchasing Managers' Indices (PMIs), this should be no surprise and reinforces "lower for longer" rates.

HOUSING WOES CONTINUE

"First, we are seeing historically low mortgage rates combined with pent-up demand to buy, so buyers will look to take advantage of these conditions… Also, job creation is improving, causing wage growth to align with home price growth, which helps affordability and will help spur more home sales."
– Lawrence Yun, Chief Economist National Association of Realtors

In April, existing home sales fell 0.4% after that horrible 4.9% "Slides of March." Instead of rebounding to 5.35 million annualized units as expected, sales declined to 5.19 million, back to where they were at the turn of the year — not to mention 4.4% below year-ago levels.

Home Sales Down Year-Over-Year for 14 Months

Source: Bloomberg

Can this be due to a government shutdown? No. Bad weather? Nice try, but not this time.

A faltering stock market? Not when we're back near the highs.

How about this one — a lack of inventory? Again, this is not the case as available supply on the market popped up 9.6% to 1.83 million units, and this took the months' supply measure up from 3.8 months to 4.2 months.

Was this a regional skew? Not really — one area of the country managed to gain ground (the West).

Could interest rates be at play here? How can they be, with mortgage rates plunging 90 basis points in just the past six months?

The first-time buyer remains AWOL, accounting for just 32% of the sales turnover, and this continues to reflect secular behavioral forces at play, such as fundamental shift away from homeownership. Once the American dream, housing is now seen by millennials as a ball and chain.

Keep in mind that the sales data were for April. The problem is, for the latest week, new mortgage applications declined 2.1%. Not just that, but they have declined now in four of the past five weeks to a two-month low even with borrowing costs down to early-2018 levels. Could this be an early sign of "pushing on a string?" You can bring the horse to water – as the bond market has tried to do with rates stimulus of its own before the central bank has done a bloody thing – but that doesn't mean it's going to drink. If home sales don't gain traction, the easy money isn't the fix.

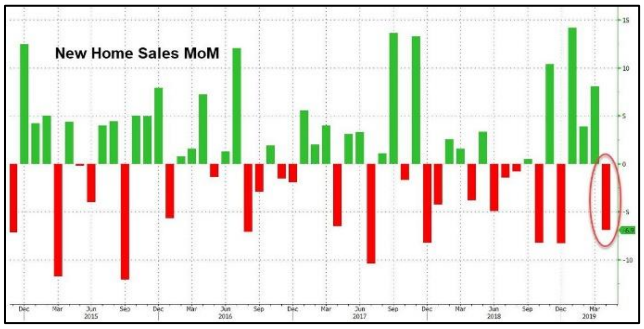
30-Year Freddie Mac Mortgage Rates

Source: Bloomberg

Understanding cycles means knowing that housing is a well-known sector that leads the economy into and out of recessions. Existing home sales cover nearly 90% of the residential real estate market. New homes sold by builders make up the remaining 10%. That means existing sales tell you more about Main Street U.S.A. than any other housing indicator.

There are realtor offices in every little city and town across America. Strength or weakness in existing home sales drives earnings for realtors; they earn a commission on each sale. And these brokers' commissions matter in the bigger economic picture; that line item in the GDP is designated "residential investment."

New Home Sales Plunge



Source: Bloomberg

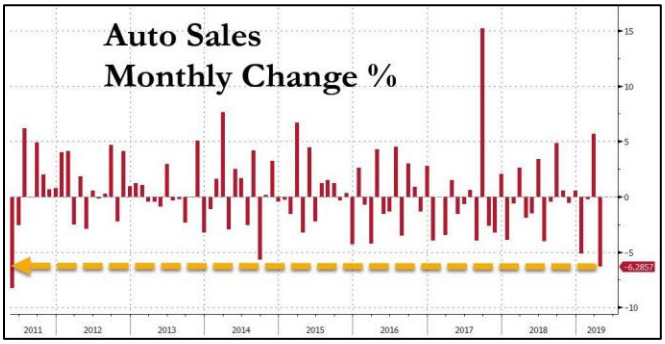
Following the disappointment in existing home sales, the recent spike in new home sales was expected to slide 2.5% month-over-month in April, but instead it crashed back to reality, plunging 6.9% month-over-month (after an upward revision for March).

Of note, the entire 7% new home sales decline came from homes priced below $300,000. The sweet spot category has turned sour on the tongue.

From my perch, it looks like housing is already in a recession.

But it's not just homes. U.S. auto sales in April tumbled by 6.1% – the biggest monthly drop since May 2011 – to just 16.4 million units, the lowest since October 2014. Aside for an incentive-boost driven rebound in March, every month of 2019 has seen a decline in the number of annualized auto sales. Furthermore, as Gluskin Sheff's Chief Economist David Rosenberg notes, the -4.3% year-over-year trend is the weakest it has been for the past eight years.

April U.S. Auto Sales Crash 6.1%, Worst Slide In 8 Years



Source: Bloomberg

BUYBACK MANIA

According to the Wall Street Journal, roughly 86% of the S&P 500 companies that have reported first quarter results thus far repurchased $168 billion of their own stock. That was the second highest amount on record. Fully, 25% of S&P 500 firms saw an earnings-per-share tailwind of at least 4% from their buyback programs (14% did so a year ago, so the impact is becoming even more pervasive). Analysts over at the venerable Ned Davis Research house estimate that, if not for this source of support, the S&P Index would be 19% lower today.

Meanwhile, Corporate America has tightened capital spending. Last year, at the peak of the fiscal giveaways, year-over-year capex growth for the S&P 500 universe was 20%, and currently that run rate is down to a microscopic +3%.

To wit: Apple got its investors excited with its extended $75 billion share buyback program, but at the same time did little to contribute to economic growth as it trimmed its capex budget by $1.8 billion compared to last year. Much the same story for Google, which sliced its capital spending by a whopping one-third to $4.6 billion. These are called "growth" companies, for what reason exactly?

The real killer, and likely recessionary forbearer, is FedEx, which took a knife to its capex budget to $1.1 billion from $1.4 billion a year ago. Not to mention Caterpillar, which said on its April 24th earnings call that it was lowering its capex plan to $547 million from $757 million a year back.

The people who constantly say "I can't see the recession" aren't looking in the right places. By the time all this shows up in the labor market, and these people wake up, it'll be too late.

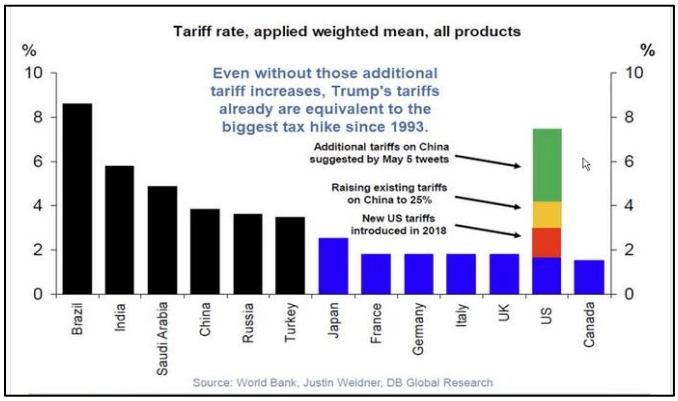
THE TROUBLE WITH TARRIFFS

"I am a Tariff Man. When people or countries come in to raid the great wealth of our Nation, I want them to pay for the privilege of doing so. It will always be the best way to max out our economic power. We are right now taking in $billions in Tariffs. MAKE AMERICA RICH AGAIN." – Donald J. Trump

"While I remain hopeful that the goals of what we're trying to accomplish with China can be had, the decision to lay tariffs all over the place in order to get there has threatened the global expansion. We've sprayed bullets (tariffs) into the sky and while some may drop on the intended target, many go where they weren't meant to land." – Peter Boockvar, Chief Investment Officer, Bleakly Financial Group

Trump says he loves collecting tariffs – it "makes America rich again." What he really means is he loves to collect taxes. If you love big tariffs, you love big taxes, because that's what tariffs are. As shown in the graph below, even without the additional tariff increase, the Trump tariffs are equivalent to the biggest tax hike since 1993.

Tariffs are Tax Hikes



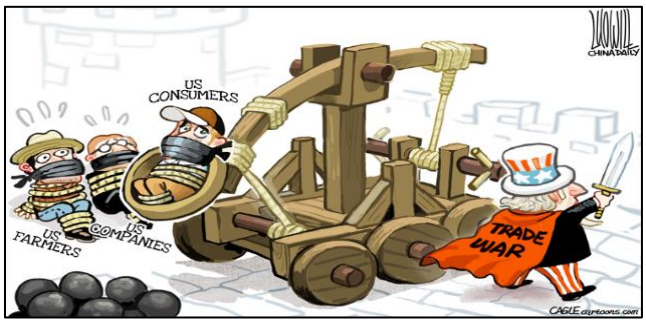
Source: DB Global Research

It's tempting to believe President Trump's insistence that Chinese companies will bear the costs of U.S. tariffs, but as many trade experts have pointed out, this simply isn't true. Thus far, the victims have been U.S. farmers, consumers and businesses.

American consumers will bear at least some of the costs of the new tariffs, though the extent will depend on how companies react to the new taxes (that is, whether they will pass it on to consumers). That said, the Federal Reserve Bank of New York has calculated how much this latest round of tariff escalation (going to 25% from 10% on $200 billion in Chinese goods) will cost the average American household. **They plugged in the new tariff rates and came up with a cost of $831 per household per year.**

The Fed's estimate is hardly the most extreme: A study published late last year by ImpactECON warned that the tariffs, as they stood before the most recent escalation, **would cost households $2,000 per year**.

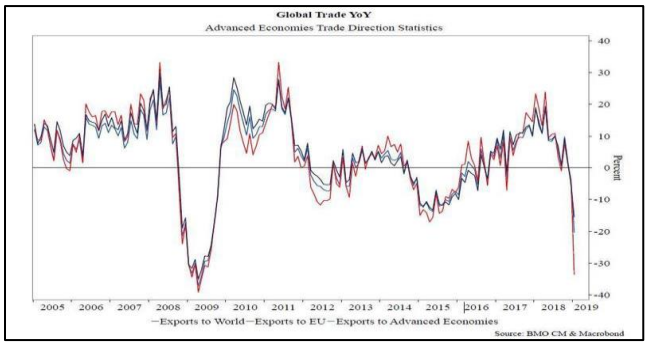
Trade War Victims



Source: Cagle

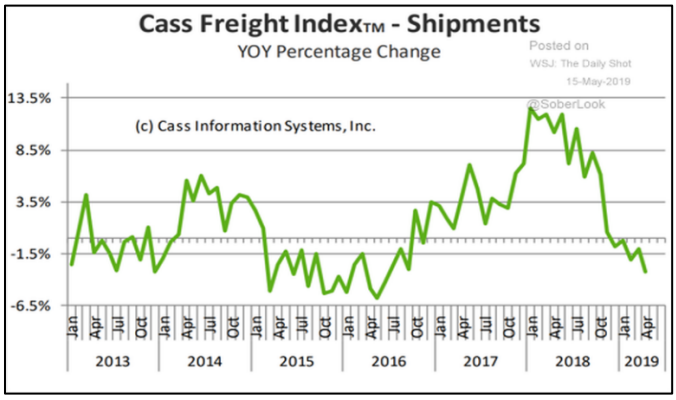
Meanwhile, as shown in the following chart, global economic trade has collapsed to levels not seen since prior to the financial crisis. Since almost 50% of corporate revenue and profits are generated from international activity, it is not surprising to see a problem emerging

Trade Collapses



Source: BMO

But importantly, watch what is also happening domestically with traffic as well.



Source: SoberLook

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The U.S. economy is slowing and is close to stall speed. The broad-based softness in retail sales, housing, auto and industrial production cannot be shrugged off. And the array of manufacturing surveys for this month have left much to be desired. As we move into the last half of 2019, the economy will weaken further as the latest rounds of tariffs, which take effect June 1, begin to impact the economy.

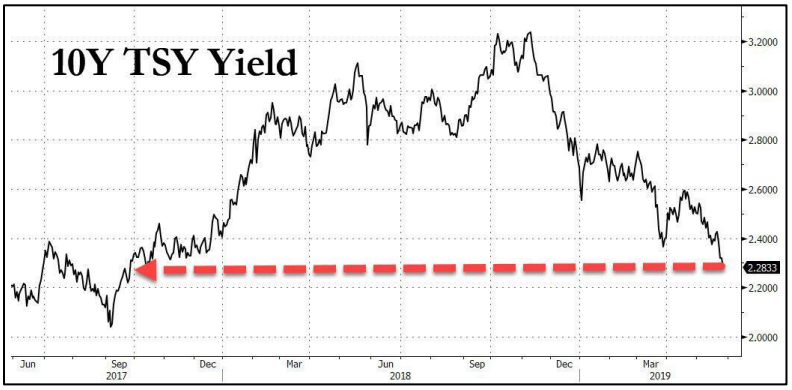
And yet, I see every Tom, Dick and Harry economist on bubblevision telling the masses just how solid the U.S. economy is performing. Oh yes —the most oft-cited reason for the bullish view on the macro back drop? The ultra-low unemployment rate — never mind that absent the recent plunge in the labor force, it would already have gripped a '4-handle'.

The employment number from the Bureau of Labor Statistics is adjusted, tweaked and mathematically abused. As an indicator, it is one of the worst to watch and is subject to very large negative revisions in the future. **Most importantly, the labor market is the LAST thing to turn in a cycle as employees are slow to hire and slow to fire.** For a better understanding of employment, look at the household survey. It is showing signs of weakening employment, which supports why companies are now laying off workers.

The last time the U-3 jobless rate was as low as it is today was in December 1969. Guess when the recession started? Try January 1970. And why? Because the economy finally started to feel the lagged effects of the Fed tightening cycle — a cycle that in the past created the conditions for ten unforeseen recessions and three ballyhooed 'soft landings. We can't rule out a 'soft landing' of course, but history suggests that it is a lower-odds event. Forewarned is forearmed, as grandma used to say.

As I have stated many times in the past, arguably the single best predictor of the economy is the bond market. Watch what the bond market is telegraphing. The yield on the 10-year Treasury note has declined 90 basis points in six months and is now all the way down to 2.28%; the lowest since November 2017.

What's the Bond Market Screaming?



Source: Bloomberg

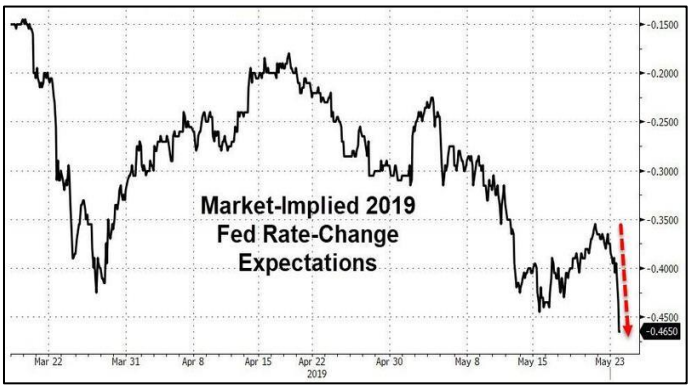
The yield curve – as measured by the three-month/10-year Treasury yield – has crashed back into inversion. The rose-colored glasses crowd can be expected to explain away the further inversion of the yield curve as they did in 2000 and again in 2007 (best to smile politely as you ignore them).

Source: Bloomberg

Deflation is the common denominator. Amazingly, inflation expectations have plunged despite the trade war. Lower inflation expectations should drive the push for the yield on the 10-year Treasury benchmark to 2% for two reasons. First, the Fed will be sidelined for some time, so don't expect rate cuts to boost inflation expectations anytime soon. Second, core inflation is set to underperform as there are now clear downside risks to core personal consumption expenditures (PCE) inflation from deflating Cass freight volumes, below-trend Chicago Fed National Activity Index, auto manufacturing risking house price disinflation, and a stronger dollar. Technicals also are favorable; the next support level for 10-year yields: 2.04%.

While we expect no immediate change in policy, sinking inflation expectations and the inversion of the fed funds/10-year yield cannot go ignored for long at the Fed. Market-based odds of a rate reduction as early as the September 2019 Federal Open Market Committee (FOMC) meeting have doubled to nearly 50% in just the past month and the market now expects a stunning 45-basis-point rate cut!

When will the Fed Cut Rates?

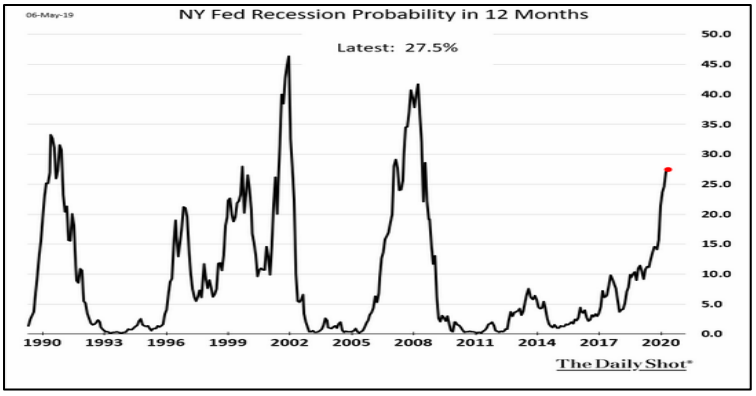


Source: Bloomberg

I sense these folks share my view on just how not robust the U.S. economy actually is. Or how deflation risks now dominate over inflation risks, with or without the ongoing effects from the trade war. Fed Governor Lael Brainard sees it this way too and, in a speech last Thursday, appeared to break ranks with Fed Chair Jay Powell when she said that inflation below target *"may not be entirely due to labor market slack or to transitory shocks."*

And, when you add it all up, as shown below, recession risks are the highest seen since 2007.

Recessions Risks: Highest Since 2007



Despite hopes to the contrary, the U.S., and the globe, will experience another recession. The only question is the timing. And when the "greatest economy ever" falls into a recession, the Fed will move to cut rates aggressively. Thus, while bond markets have already partially discounted forthcoming economic weakness, if the Fed reduces official rates, yields will continue their downward trajectory. The short end of the yield curve (1-5 years) would be the biggest beneficiary of any change in monetary policy.

Here's the key point: If you wait until the Fed announces a rate change or wait to read about it in the Wall Street Journal, you will have waited too long and will likely have missed out on the opportunity to lock in the higher yields that exist today. For this reason alone, we have constantly recommended that credit unions reduce or eliminate "excess cash reserves" and stay fully invested via a risk-appropriate diversified ladder strategy. Even with the flat-to-negative sloped yield curve, we strongly believe this is the most prudent approach to managing the risk inherent in the investment portfolio.

Our new call is the same as the old call. Stay invested! Maintain the ladder strategy. And finally, do NOT hold excess cash reserves.

One final note: Markets do not move in a straight line. Any back-up in yield provides an attractive entry point for credit unions looking to put new money to work.

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- Football Night with Alloya – NFL Opener
- Economic Outlook
- Dueling Market Views featuring Tom Slefinger and Steven Rick

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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.