BALANCE SHEET SOLUTIONS
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WEEK OF JULY 8, 2019

Weekly Relative Value

Rogue Jobs Report

"Subzero interest rates in Europe and Japan are 'net positives' for the global economy."
– Christine Lagarde, nominee for President of the European Central Bank (ECB)

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THIS WEEK…

- FACTORIES SLOW
- CONSTRUCTION FALTERS
- AS SMALL BUSINESS GOES… SO GOES THE ECONOMY
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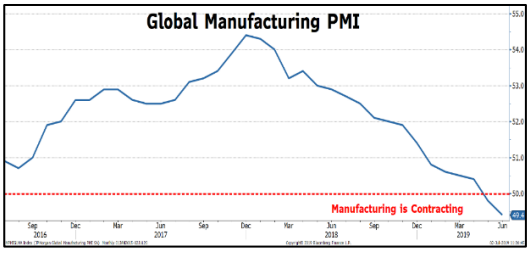
PORTFOLIO STRATEGY

The weakening path of the global economy is unmistakable. The release of the global manufacturing Purchasing Mangers' Index (PMI) data last week confirms that the slide in manufacturing continues unabated. Indeed, the JPMorgan global manufacturing PMI survey declined to the lowest level of activity in nearly seven years. The weakness was broadly based between developed (lowest level since November 2012) and emerging markets (five-month low).

Manufacturing Collapses



Source: Bloomberg

There were some notable countries that remained in contraction territory such as Japan, Germany, the U.K., Italy and South Korea. Meanwhile, the list of countries joining those in contraction (from being above the 50-threshold last month) included China, Spain and Mexico.

In the U.S., the only silver lining is the June Institute for Supply Management (ISM) manufacturing reading, which didn't decline as badly as the consensus had expected. It dropped to 51.7 from 52.1, instead of heading down to 51.0 as was penned in. It's hard to ignore the fact that this was still the lowest headline ISM manufacturing reading since October 2016.

And now the all-important service sector index receded to 55.1 in June from 56.9 in May, which is the lowest reading since July 2017 (months before the tax relief was passed, so that effect has come and gone). The nearby peak of 59.7 back in February is increasingly fading out of view.

When one combines the manufacturing and non-manufacturing PMIs together, the aggregate declined in June to 54.7 from 56.4 in May, which is light years away from September's peak of 60.7. Not just that, but the combined manufacturing-services composite, at 54.7, is not far off the 53.4 reading of October 2007 that led that recession by two months and the 55.0 print in November 2000, which presaged that economic downturn by five months.

It is truly a global synchronized slowdown. The hope will be that a trade truce can stabilize things but there's obviously concern that the damage has already been done. Furthermore, after more than 20 trillion dollars of stimulus, massive deficit spending, zero/negative rates and large incentives to increase capex, manufacturing is in contraction.

Manufacturing is showing the worst side effect of cheap money: stagnation from debt saturation and widespread excess capacity. *No trade war truce or central bank quantitative easing is going to change this trend.*

FACTORIES SLOW

U.S. factory orders fell for the second month in a row (and down three of the last four), down 0.7% month-over-month in May, following April's 1.2% decline (revised lower). However, more notably, factory orders year-over-year growth has contracted (by 1.2%) for the first time since August 2016. The biggest driver of the drop was a plunge in defense spending and non-defense aircraft spending (Boeing!).

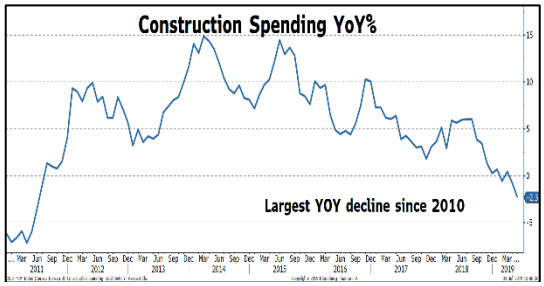
Factory Orders Plunge

Source: Bloomberg

CONSTRUCTION FALTERS

Construction spending fell 0.8% in May, coming in below every estimate. The year over-year trend is what caught my eye. The -2.3% 12-month decline was the largest in eight years. Construction spending is a direct input in GDP. And this is the takeaway: Persistent weakness in construction spending and construction GDP creates growing risk for cuts to construction payrolls and construction employment, as it abruptly fell 36,000 in May.

Construction Spending Collapses



Source: Bloomberg

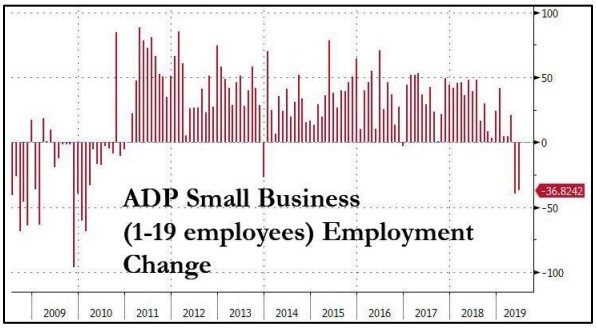
AS SMALL BUSINESS GOES… SO GOES THE ECONOMY

"The small business sector leads the cycle and employment here has plunged 61,000 in the past two months. Haven't seen this in over nine years; same decline we saw in February-March of 2008 when the consensus was busy calling for a soft landing. This isn't a repeat of 2016 by any stretch." – David Rosenberg, Chief Economist & Strategist, Gluskin Sheff, July 3, 2019

The ADP headline came in light for the second month in a row in June, coming in at just +102,000 versus the consensus of +140,000. The dismal May tally of +27,000 was revised a smidge to +41,000, so this was no fluke. The average of the two months (+72,000) is the lowest in over nine years and is pretty well close to what we experienced in January 2008 when the recession had actually already begun but nobody seemed to notice. FYI, the National Bureau of Economic Research didn't make the declaration until 12 months later!

But the biggest shock in the most recent ADP number was the small businesses and goods-producing sector. Small businesses, which lead at turning points in the cycle, posted back-to-back declines — down 38,000 in May and 23,000 in

June. Mining and construction were hardest hit. Manufacturers saw jobs contract for the second month in a row. And specifically, companies with 1-19 employees cratered in both May and June.



Source: Bloomberg

ROGUE JOBS REPORT

Unquestionably, on the surface, the June non-farm payroll report was surprisingly strong. Payrolls rose +224 thousand, substantially beating the consensus estimate of +160,000. According to the Bureau of Labor Statistics, job gains were broad-based and included rebounds in manufacturing, which added 17,000 jobs, and construction payrolls rising by 21,000.

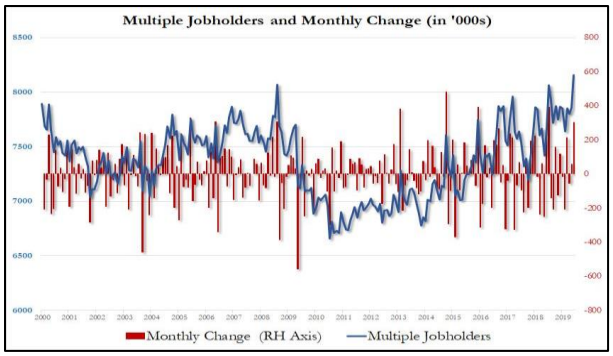
That said, this report appears to be an aberration and stood in stark contrast to the weakness in the consumer confidence, ADP and ISM reports released last week. How is it possible that the U.S. labor market is in its own little oasis of prosperity while the economy is slowing?

Let's dig a little deeper.

As noted above, the ISM manufacturing report was the weakest in three years yet. According to the Bureau of Labor Statistics (BLS), factory payrolls rose +17,000, the best tally this year. Likewise, construction spending has remained remarkably weak, and yet construction employment managed to rise 21,000. The ADP report released one day earlier highlighted job losses in construction and manufacturing. With all due respect to the folks at the BLS, it simply does not add up.

Here are a couple of metrics that suggest the headline number was not as good as Wall Street hyperventilated over.

Multiple-Job Holders Surge



Source: Bloomberg

First, multiple-job holders soared from 7.85 million to 8.15 million, a monthly surge of 301,000 and an indication that the jobs number was far weaker than the headline represents.

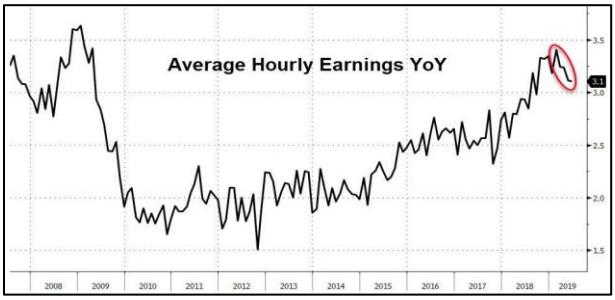
Remember, in the payroll survey, three part-time jobs count as three jobs. The BLS does not weed out duplicate Social Security Numbers so the potential for double-counting jobs in the payroll survey is large. Think about this: all of the jobs and then some came from people taking on a second (or third) job. Not exactly a bullish economic signpost.

Second, the BLS birth-death model accounted for roughly half the payroll gain in June. As a refresher, the birth-death model estimates the number of new jobs from new businesses. In other words, it's pure guesswork. And the BLS counts ALL business formations as creating employment. However, in reality, only 20% of businesses created each year actually have an employee. The rest are created for legal purposes like trusts, holding companies, etc., which have no employees whatsoever. In fact, since February, nearly every single job that has been added to non-farm payrolls has come via the birth-death model. Color me skeptical. And in the decade between 2006 and 2016 *(the latest update from the Census Bureau)* the BLS added roughly 7.6 million more employees than were created in new business formations.

The data go a long way in explaining why, despite record-low unemployment, there is a record number of workers outside the labor force, 25% of households are on some form of government benefit, and wages remain suppressed.

Third, according to the household survey, employment for the prime adult 25-54-year-old cohort eked out just a 29,000 increase after a three-month slide. So far this year the number of jobs for this breadwinner group has plunged 168,000. And if you are a male in this age group, employment actually sagged 97,000 in June and has collapsed 338,000 over the past three months. This has not happened since September 2009.

Wages Cool



Source: Bloomberg

Fourth, the official U-3 unemployment rate inched up to a three-month high of 3.7% from 3.6% in May; the U-6 rebounded to 7.2% from 7.1%. Still a tight labor market, don't get me wrong, but less so. As a result, average wage growth remained very well contained at 3.1% and the slowest in nine months. And on a weekly basis, earnings growth has slowed to 2.7%, well off last June's brisk 4.0% rate.

So, in conclusion, outside of students, multiple-job holders, government workers and fictitious additions from the birth-death model, there wasn't really a whole lot here to get excited about. In fact, if you are a male between the ages of 25 and 54, you have grounds to be outright depressed.

When the cross currents are as strong as they are, with strong headline non-farm payroll growth advertising "strength" in the labor market, it pays to keep a close eye on the devil in the underlying details. Factor in shrinking paychecks and workweeks, and moonlighting madness and reality paints a much different picture.

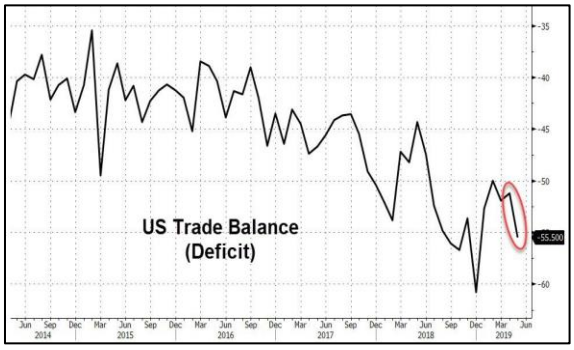
Finally, as mentioned last week, the jobs report is probably one of the *"worst"* indicators to look at due to its "lagging" effect to the economy. Further, the monthly ups and downs are laden with statistical noise. Unless the labor markets have become detached from the economy, don't be surprised to see downward revisions next month.

Source: Cagle

ON THE TRADE FRONT

We see now that the emperor had no clothes from the G-20 meeting as Beijing reported there is no deal until all the tariffs are removed. Anyways, the U.S. trade deficit widened a huge 8% in May. This was another validation that all the tariffs in the world are hardly helping resolve the chronic U.S. trade imbalance.

Trade Deficit Widens by 8%



Source: Bloomberg

Meanwhile, the White House is now openly barking about currency manipulation by the Chinese as well as the Europeans. What ever happened to the refrain that a strong U.S. dollar reflects strong U.S. fundamentals?

Anyways, the President says on the one hand that his economy has never been better, and yet on the other hand he believes we need a weaker exchange rate and zero percent rates. I'm not a clinical psychologist, but this does sound like a case of cognitive dissonance to me.

Face it: the U.S. is no longer primarily a manufacturing economy. It is a high-technology, knowledge-based and service economy. Trying to re-energize industries that you no longer can compete in is foolhardy at best.

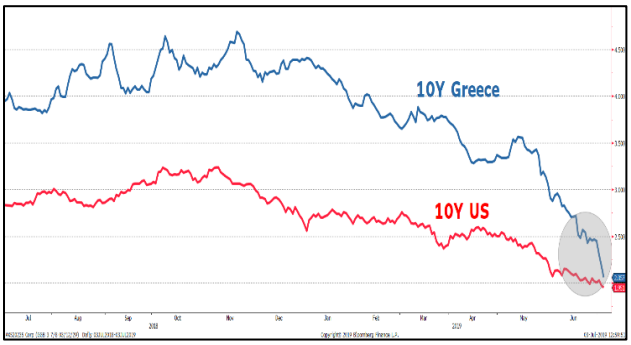
This is the reality. The U.S. will continue to run trade deficits until such time as it can compete with other countries in making the products that are being imported. To become competitive would require a substantial drop in wages for Americans working in those industries or a substantial price increase for consumer goods. Since that isn't going to happen, it is a waste of time to try to pursue those low-paying jobs in manufacturing.

SURREAL!

While we were at America's birthday bash, bond yields continued their relentless decline. The headline grabber was in Germany where 10-year bunds fell to -0.40% and below the European Central Bank (ECB) deposit rate for the first time ever. Yesterday's bond moves mean the German bund curve is now negative at all maturities out to 2040. In fact, 90% of the outstanding $850 billion German government market is negative. Amazing stuff! France has also become further entrenched in negative territory at -13 basis points. Of course, Japanese JGBs are a big part of the global negative yielding debt stack too with yields negative at all maturities out to 2033. When it was all said and done, the global stack of negative yielding debt held at the record high of $13.4 trillion. In other words, you earn a higher yield – an honest zero percent, with no counterparty risk – in gold bullion.

The yield famine leads hungry people to take extreme measures to earn negligible returns. Think about this: Portugal is rated BBB and Spain is an A- credit and their respective 10-year yields are now just 30-35 basis points away from 0% and 175 basis points lower than the U.S. And 10-year Greek government yields at 2% are about to converge with U.S. Treasuries. Greece has a B+ credit rating, which is junk, and for all the warts, scars and pimples, the Treasury market has an average ranking of AAA. And yet 10-year yields are about the same in both countries. This is yet another case of an investment world turned topsy-turvy. It is all too surreal!

Greek Yield Converge to US: How Can This Be?



Source: Bloomberg

Finally, take the new 100-year Republic of Austrian bonds which mature in September 2117. They currently yield 1.09%. I will likely not be around in 2117. And if by fate I am, it will not be a pretty picture (I would be 162 in 2117). While that may not be a pretty picture, I will almost certainly be in better shape than the holders of the Austrian 100-year bonds. A lot can go wrong in 100 years.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The central bank doesn't have a clue and was our most difficult problem... If the Fed knew what it was doing it would cut rates. Fed policy is putting the U.S. at a disadvantage versus Europe and suppressing gains in the stock market." – President Donald Trump

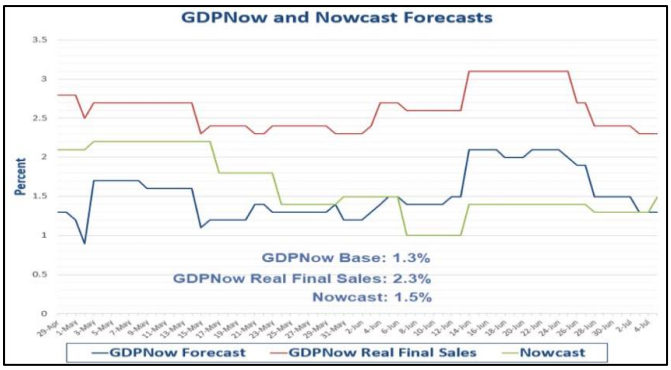
Wall Street, clamoring for three to four rate cuts this year, was hoping and praying for a lousy jobs report that would "force" the Fed to cut rates. As noted previously, those hopes and prayers were not fulfilled. As discussed above, the employment data should raise concerns about the real strength of the economy. However, it is NOT data the Fed considers with respect to monetary policy decisions. Accordingly, the futures market quickly priced out any notion of a 50-basis-point rate cut at the end of the month but has left a 25-basis-point move intact.

The stock market, being in a "bad news is good news" mentality, did not responded favorably to the "good news" since for equities, it's really all about the Fed. Who needs a strong labor market?

And for the first time in a while, yields actually rose with two-year Treasury yields up 10 basis points on Friday, its biggest one-day increase in six months, while 10-year Treasury yield jumped by 10 basis points from 1.95% to 2.05% resulting in a big flattening (2s/10s) to 17 basis points. Please keep in mind that this sharp move occurred in very thin holiday trading.

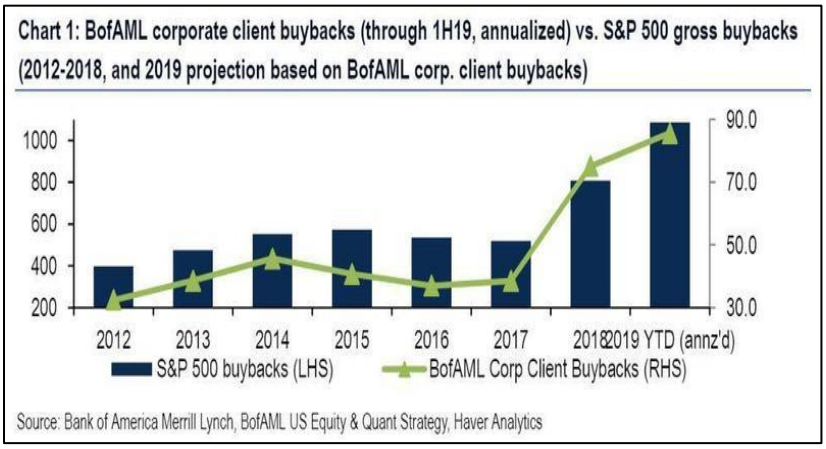
Meanwhile, a recent Bloomberg poll shows 30% risk of recession, double the 15% at the end of 2018. And the Fed economic forecasts for the second quarter have downshifted. The Atlanta Fed cut its second quarter real GDP growth estimate to 1.3% from 1.9%; and the New York Fed is at 1.5% for the second quarter and cut to 1.2% for the third. The U.S. economy is on the knife's edge — this is a cross between "stall speed" and "growth recession." One employment number does not change this trajectory.

Slowing Growth



Despite the economic slowdown, stocks remain at record highs. Why? Buybacks, according to Bank of America, are on pace for a record at $43 billion so far this year versus just $75 billion for the entirety of 2018. This suggests a record of over $1 trillion in S&P 500 buybacks for 2019. Once again, the stock market is not the economy.

If buybacks are indeed supporting market performance, it is worth noting that such support can be turned off like a water spigot.



While the June jobs report reduces the case for the Fed to cut rates aggressively in the near term, it will go 25 basis points, nonetheless. The fact is, the central bank overtightened this cycle and underlying inflation and inflation expectations are below target. These are reasons enough for the Fed to start cutting — and sooner rather than later.

In this coming week, Federal Reserve Chairman Jerome Powell will offer the latest outlook for monetary policy to the House and Senate finance committees. Powell's testimony will help set expectations for the timing of the onset of an easing cycle. Key to the rate discussion will be the June Consumer Price Index (CPI), which is predicted to show inflation of just 1.6% in June, a decline from the 1.8% of May.

In terms of portfolio strategy please continue to build/ maintain a high quality, broadly diversified and duration appropriate ladder strategy for your balance sheet.

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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.