BALANCE SHEET SOLUTIONS
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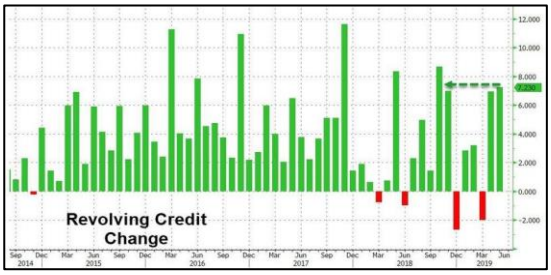
WEEK OF JULY 15, 2019

Weekly Relative Value

America's Debt Addiction

Last week, consumer credit hit another all-time high of nearly $4.1 trillion, which, in turn, was up 5.2% from a year earlier, rising roughly twice as fast as overall GDP. This was entirely thanks to a surge in credit card debt, which rose by a whopping $7.2 billion – the highest since last October when Americans were racking up credit card debt to pay for Thanksgiving.

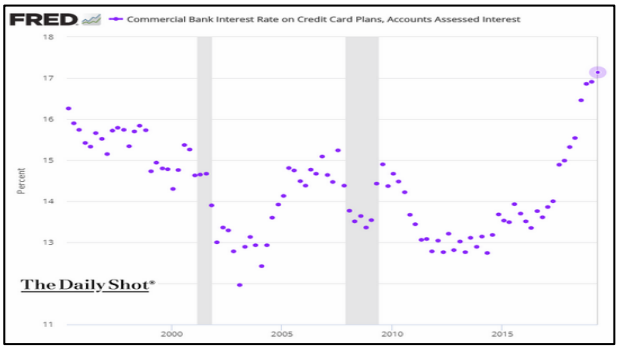
Credit Card Debt Surges



Source: Bloomberg

Credit card debt is now 27% of the total consumer credit. Making matters worse, credit card rates hit the highest level in decades, now exceeding 17% (on average). This is bad for the economy since it has the highest interest rate, which means more of a household's budget will go toward interest repayment and less toward purchases.

Credit Card Rate: Highest in a Decade



Source: Wall Street Journal

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

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THIS WEEK…

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Also reported, the total amount of student and auto loans both hit fresh all-time highs with a record $1.6 trillion in student loans outstanding (a whopping increase of $30 billion in the quarter), while auto debt also hit a new all-time high of $1.16 trillion (an increase of $8 billion in the quarter).

Economic factors and the central bank's manipulation of the economy have decimated the middle class and made it difficult for people to save and prepare for future recessions. Bankrate recently reported that a growing number of Americans have no savings whatsoever. Meaning, if an emergency occurs, they will have no option but to go into debt, or if they have bad credit, worse… have no way to pay for the emergency. **Around 28% of adults in the U.S. have no emergency savings.** One in four have a rainy-day fund, but it's not enough money to cover three months' worth of living expenses. That would mean that a job loss or one missed paycheck would put almost a third of Americans in financial hardship.

The sad reality: Most Americans are blissfully unprepared for any economic hardship or downturn.

In the meantime, let the good times roll… Party on America!

But always remember, debt is like smoking. It is addictive and it can kill you.

HOUSING BUBBLE REBLOWN

Between 1987 and 2000, home prices, rent and wages all rose together. Homes were homes; not speculative playthings or a retirement vehicle. That changed in 2000. Between January 2000 and July 2006, home prices soared 85% vs. 22% for both rent and hourly earnings. Back in 2006-07 the belief was that home prices would never stop rising. But after the pool of greater fools ran out, the housing crash began. At the depths of the housing crisis in 2011, home prices were once again aligned with rent and wages.

That did not last long. Today, home prices on a national basis are nearly as unaffordable now as they were at the peak of the housing bubble as a result of the Fed "flooding the economy with money." Since 2012, housing prices are up 55% while wages and rent are up 19% and 23%, respectively.

Note: All of the following data – house prices, rent and income – shown in the following graphs are adjusted for inflation.

The accompanying graph shows house prices nationwide have risen 121% since 1960 while incomes have risen just 29% and rents have risen 72%.

This is a national average. Obviously, some markets have seen greater home inflation than others. So, let's dig into the regional data.

In the West — Alaska, Arizona, California, Colorado, Hawaii, Montana, New Mexico, Oregon, Utah, Washington and Wyoming. The median house price has soared 195% and rents rose 72%. But household incomes rose only 26%. Obviously, out West some markets have far surpassed the regional average. Of note, San Francisco has seen home prices rise 531%, while household incomes rose 91% or about six times faster than incomes. In LA, house prices have outpaced income by 11 times with the median house price increasing 358% while the median household income rose only 32%. In Seattle and Denver, household incomes rose in near-lockstep 56% since 1960, while house prices in Denver soared 239%, and in Seattle 286%.

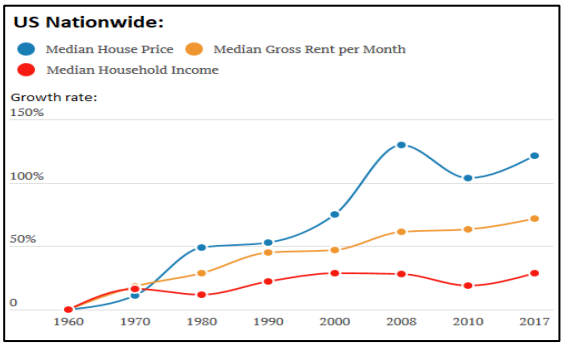
In the Northeast — Connecticut, Maine, Massachusetts, New Hampshire, New Jersey, New York, Pennsylvania, Rhode Island and Vermont. House prices are now up "only" 159% from 1960 while rents are 84% higher. But household incomes rose only 38%. House prices in Boston are back where they were during the peak of the prior housing bubble and are up 228% from 1960. Median household incomes have risen only 71%, far outstripped by the surge in house prices.

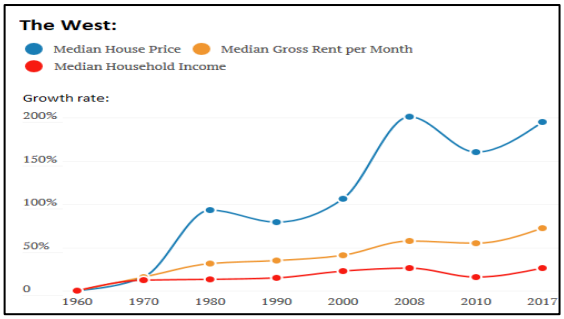
In the South — Alabama, Arkansas, Delaware, D.C., Florida, Georgia, Kentucky, Louisiana, Maryland, Mississippi, North Carolina, Oklahoma, South Carolina, Tennessee, Texas, Virginia and West Virginia. House prices rose 156% since 1960, and rents 93%, while household incomes rose only 49%.

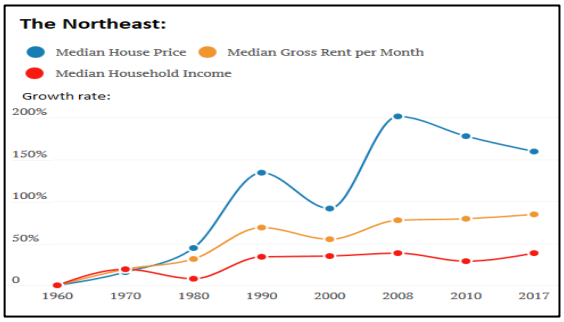
Finally, in the Midwest — Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin. House prices increased a more modest 82% since 1960, while rents rose 37% and incomes 29%.

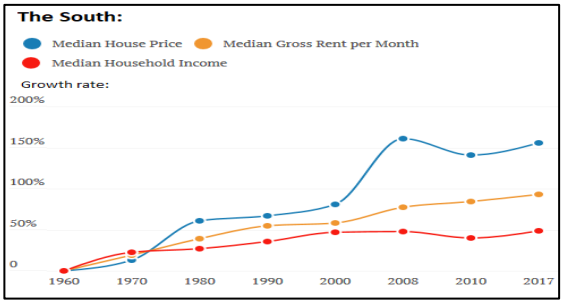
As house prices and rents have soared, the cost of housing has been eating up more and more of household incomes. In many cities in the U.S., families can no longer afford to rent or buy adequate housing. Or too much of their income is spent on housing, with nothing left for other things. Many have no savings and live paycheck to paycheck.

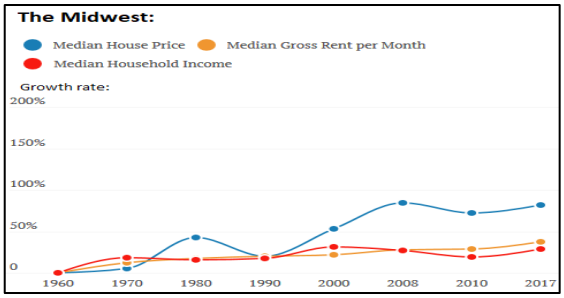
The so-called American Dream is dying for many. It is no wonder that young Americans are not buying homes. Would-be buyers waiting to buy have generally made matters worse because the price of rent has outstripped wage growth. That's without factoring in the albatross of student debt and changing attitudes about home ownership.











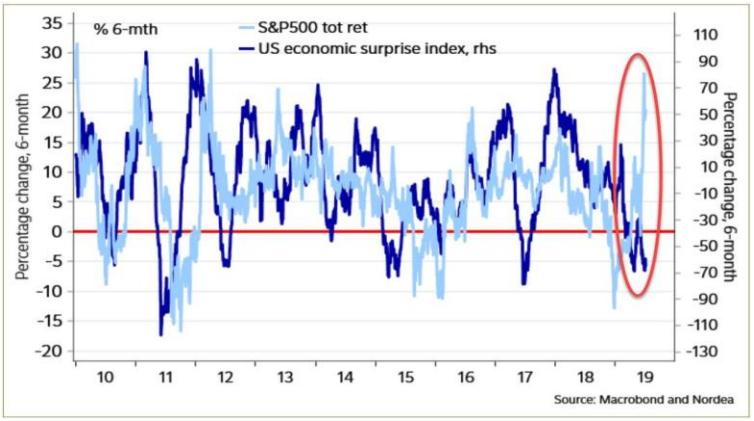
Source: Clever Real Estate

If this keeps up, U.S. cities will start to look like Rio de Janeiro with significant portions of the populations living in tin shacks around the cities.

A WORD ON STOCKS

If you don't know where you are going, any road will get you there. In today's central bank and fiat money-controlled world, sound thinking can hurt investors. See the graph below, which shows the S&P vs. the Economic Surprise Index. Whenever economic data disappoint, stocks go. Conversely, when economic data are good, stocks go down.

Why? The stock market is no longer about future earnings or business profits or being rich or cheap. Stocks are all about the central bank liquidity and cheap credit. The stock market is now a commodity. Valuation means virtually nothing in today's investment climate. That is why weak economic reports, which provide cover for more monetary stimulus, are bullish. But if the Fed raises rates, there will be less cheap credit to speculate on stocks with. Therefore, stocks will go down. Remember what happened last December when the Fed was intent on raising rates? Stocks plummeted. Then we experienced the first Powell Pivot with the Chairman saying that rate hikes would be put on hold and may even be cut. That was the green light for the machines to buy, buy, buy!



POWELL PIVOTS AGAIN

"The Fed only has room to cut about 2%, which isn't much because past recessions needed about 5% of cuts. These cuts, together with quantitative easing, might be enough to prevent a recession for a few more years. But interest rates in Europe and Japan have no significant room to decline at the same time that printing money and buying financial assets will have very limited effects. So, we'll see 'pushing on a string' in that part of the world." – Ray Dalio, Chairman and Co-Chief Investment Officer of Bridgewater Associates

Here are the important excerpts (italicized) and my comments (bolded) from Chairman Jay Powell's testimony to Congress last week:

"Congress has given us an important degree of independence so that we can effectively pursue our statutory goals based on objective analysis and data. We appreciate that our independence brings with it an obligation for transparency so that you and the public can hold us accountable."

This was a subtle shot at the President to back off, with the term "independence" deployed twice. He reports to Congress — just a reminder.

"However, inflation has been running below the Federal Open Market Committee's (FOMC) symmetric 2 percent objective, and crosscurrents, such as trade tensions and concerns about global growth, have been weighing on economic activity and the outlook."

The Fed appropriately is going to alter policy based on shifting risks to the outlook as opposed to the old refrain of "data dependency," especially since so much of said data tell us what already has happened and not what will likely happen.

Powell also downplayed the June jobs reports (see comments below and last week's Weekly Relative Value – Rogue Jobs Report – for a more in-depth analysis of the so-called strong jobs report) saying that while it was positive, it did not shift the Fed's policy outlook.

"Since our May meeting, however, these crosscurrents have reemerged, creating greater uncertainty. Apparent progress on trade turned to greater uncertainty, and our contacts in business and agriculture report heightened concerns over trade developments. Growth indicators from around the world have disappointed on net, raising concerns that weakness in the global economy will continue to affect the U.S. economy. These concerns may have contributed to the drop-in business confidence in some recent surveys and may have started to show through to incoming data."

This paragraph above says it all. The payroll data on Friday are squarely on the back burner. Powell is really concerned, especially about capital spending and export prospects. He did say that incoming labor market, retail sales and GDP data will be important for deciding about future policy, but it feels like the outlooks for global growth and U.S. inflation will in fact be the key variables to watch.

And Powell commented on the longer-term structural issues facing the U.S. economy:

"The nation also continues to confront important longer-run challenges. Labor force participation by those in their prime working years is now lower in the United States than in most other nations with comparable economies. As I mentioned, there are troubling labor market disparities across demographic groups and different parts of the country. The relative stagnation of middle and lower incomes and low levels of upward mobility for lower-income families are also ongoing concerns. In addition, finding ways to boost productivity growth, which leads to rising wages and living standards over the longer term, should remain a high national priority. And I remain concerned about the longer-term effects of high and rising federal debt, which can restrain private investment and, in turn, reduce productivity and overall economic growth. The longer-run vitality of the U.S. economy would benefit from efforts to address these issues."

Aside from that, Mrs. Lincoln, how was the play?

If this comment above is from someone still with a bullish "base case" view, imagine what things look like when he turns the corner. I have highlighted these issues numerous times in this space.

"In our June meeting statement, we indicated that, in light of increased uncertainties about the economic outlook and muted inflation pressures, we would closely monitor the implications of incoming information for the economic outlook and would act as appropriate to sustain the expansion. Many FOMC participants saw that the case for a somewhat more accommodative monetary policy had strengthened. Since then, based on incoming data and other developments, it appears that uncertainties around trade tensions and concerns about the strength of the global economy continue to weigh on the U.S. economic outlook. Inflation pressures remain muted."

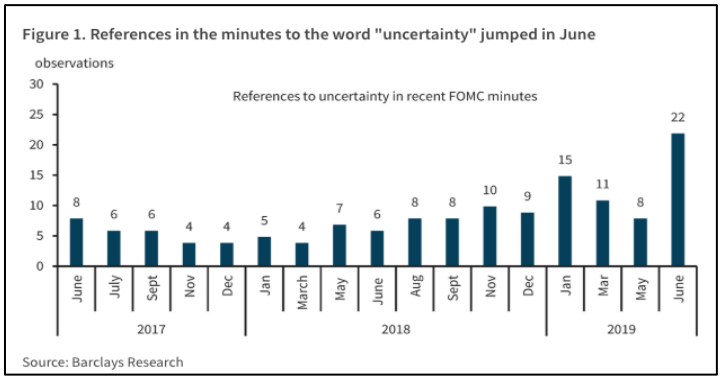
This last paragraph tells me that the case for rate cuts has actually strengthened in the past month.

UNCERTAINTY IS THE WORD

"Many participants noted that the economy appeared to have lost some momentum, [and accordingly] many participants indicated that the case for somewhat more accommodative policy had strengthened..."

It's all about "uncertainty," which came through both in Powell's congressional testimony and in the June Fed minutes, released Wednesday. The word "uncertainty" appeared 22 times.

Uncertainty



Source: Barclays

One other interesting point from the minutes was the assertion that *"a number of participants anticipated that the return to 2% would take longer than previously projected."* Well, what ever happened to the word *"transitory?"* At any rate, this would be consistent with a more prolonged easing cycle rather than a one-and-done.

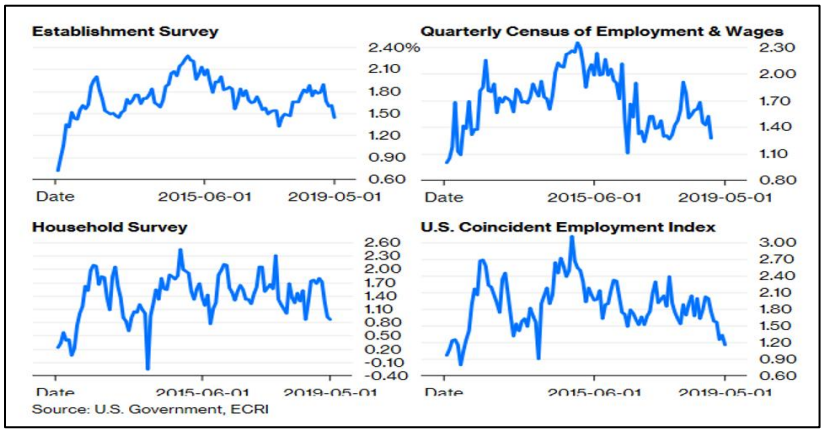
What happens after the July cut is anyone's guess. But keep in mind, the Fed has not been "1 and done" in decades. And rate cuts only work if there's a series of rate cuts. Further, a lone "insurance" rate cut means there is one less bullet in the clip at our disposal when we do some day hit a recession.

My take on the Fed is quite simple. It overtightened this cycle. Including the unwinding of the balance sheet, the Fed has raised rates by 4% during this hiking phase. And the drift down in core inflation has not proven to be "transitory" and is sufficiently below target to justify multiple rate cuts.

HOW STRONG IS THE LABOR MARKET?

"Lies, damned lies and statistics." – Mark Twain

Despite the ballyhooed June jobs report, multiple labor market indicators suggest a slowdown in the labor markets is underway.

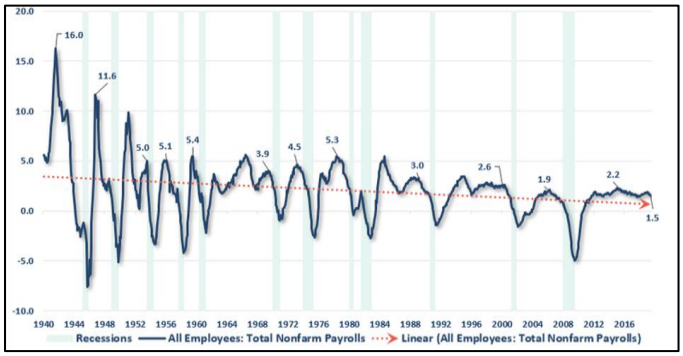


Consider the following from Lakshman Achuthan of the Economic Cycle Research Institute (ECRI):

"Jobs growth…has been slowing much more than most probably realize. Despite the better-than-forecast jobs report for June, the fact is the labor force has contracted by more than 600,000 workers this year… Certainly, that caused year-over-year payroll growth, based on the Labor Department's Establishment Survey – a broad survey of businesses and government agencies – to decline to a 13-month low. But year-over-year job growth, as measured by the separate Household Survey – based on a Labor Department survey of actual households – that is used to calculate the unemployment rate is only a hair's breadth from a five-and-a-half-year low." – Lakshman Achuthan, Co-founder, ECRI

As shown in the following graph, the annualized rate of employment growth is now 1.5%, which, in turn, is lower than any previous employment level prior to a recession in history. So, if employment growth is 1.5%, how strong can the real economy be?

Annualized Change in Employment



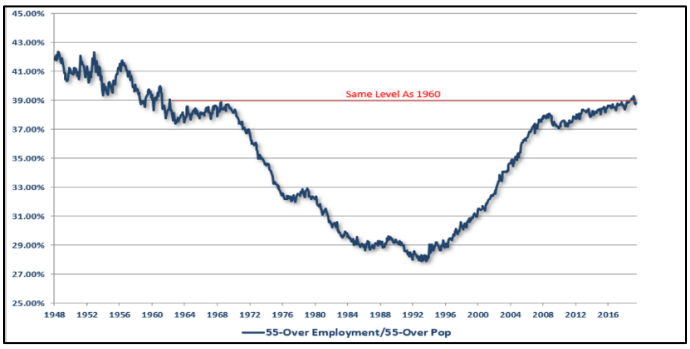
Source: Lance Roberts

Also, with jobless claims at historic lows, and the unemployment rate below 4%, then why is full-time employment relative to the working-age population at just 50.10% (only slightly above the 1980 peak)?

Further, there are now an estimated 95 million working age Americans who are not counted as being in the labor force. How credible is the "official" employment rate when 33% of the population is AWOL?

Some say this is due to the tens of millions of baby boomers retiring. This argument is spurious due to the fact that the larger millennial generation is simultaneously entering the workforce. Further, many of the boomers aren't retiring because they can't! As shown below, due to spendthrift habits and poor financial planning, more individuals over the age of 55 are still working than at any other time since 1960.

55-Over Employment as % of 55-Over Employment



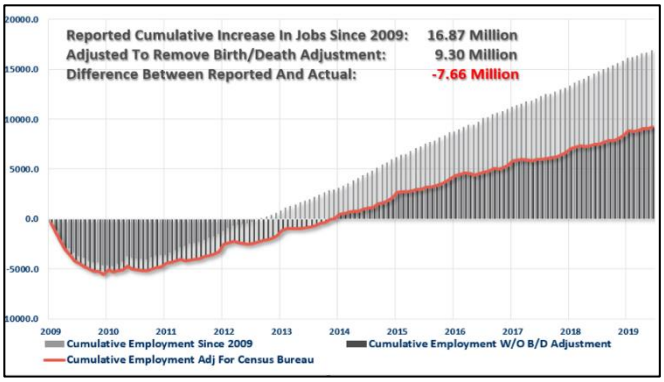
Source: Real Investment Advice

Also, while the market singularly focuses on the headline employment number, the many distortions and assumptions of the employment calculations go unchallenged. For example: each month the government estimates how many new jobs are being created from new business formation.

As a refresher, every month, the government counts ALL new business as creating employment. However, the fact is only 20% of the new businesses created have any employees. Most new businesses are created as legal entities such as holding companies and trust, etc. There are no employees.

And these fictious additions to the employment ranks are not insignificant. According to Census Bureau data, between 2006 and 2016 the Bureau of Labor Statistics (BLS) added roughly 7.6 million more employees than were created in new business formations. The graph below tells the story quite well.

Employment Gains (including/excluding the B/D Model)



Source: Real Investment Advice

"But there's even more cause for concern. Months from now, the Establishment Survey will undergo its annual retrospective benchmark revision, based almost entirely on the Quarterly Census of Employment and Wages (QCEW) conducted by the Labor Department. That's because the QCEW is not just a sample-based survey, but a census that counts jobs at every establishment, meaning that the data are definitive but take time to collect.

The Establishment Survey's nonfarm jobs figures will clearly be revised down as the QCEW data show job growth by more than 25%." – Lakshman Achuthan, Co-founder, ECRI

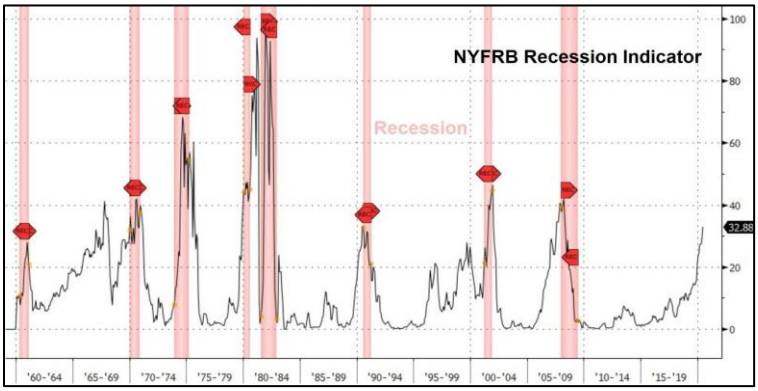
Wow! Think about that. What if the jobs figures are inflated by 25%? Will anyone notice?

Maybe all of the above goes a long way in explaining why, with the country at record low unemployment, there are still a record number of American workers not in the labor force, wages remain suppressed and a record 25% of households are on some form of government assistance.

Those who have been skeptical about the economic recovery and the "robust" economy have had good reasons to do so. Could it be that the Fed is weighing rate cuts because they understand that the economy is weaker than advertised?

Then again, as has been pointed out numerous times in this space, the single best predictor of economic growth and inflation is the yield curve. And the yield curve has been screaming that the labor markets and economy are not quite what they appear to be.

The New York Fed's recession probability estimate (based on the yield curve) keeps climbing. Using the 3m/10s spread, the New York Fed Recession Probability Indicator is now suggesting a 33% chance of a recession hitting the U.S. economy within the next 12-months. In the past, every time since 1960 that this index has breached 30%, a recession followed.



Source: Bloomberg

NEGATIVE YIELDING "JUNK" BONDS!

As market expectations increase for another and even bigger and grander round of quantitative easing by the European Central Bank, which would also be buying corporate bonds and old bicycles, the total amount of bonds with negative yields has risen to nearly $13 trillion or 25% of the total debt.

Even more startling, 66% of AA-rated euro-denominated bonds, over 30% of single A-rated bonds, over 20% of BBB-rated bonds and nearly 10% of BB-rated bonds yield less than zero at the moment. Here is the shocking punchline: 33% of the 2.2 trillion of euro-denominated IG corporate bonds have a negative yield.

And in Switzerland, more than eight out of 10 corporate bonds have a negative yield. To wit: Nestlé bonds due in 2024 have a negative yield of 0.15%. That means investors are paying a company – not a country – for the "privilege" of issuing debt.

Rationality no longer applies because negative-yielding debt is irrational by definition. Why would you pay someone to borrow money from you?

And this irrational behavior has spread to so called "junk" bonds issued by over-leveraged companies with iffy cashflows and a considerable probability of default, especially during a downturn. If the company defaults, you're out part or all of your principal investment. For taking this considerable risk, you're being rewarded with a "negative" yield.

Yes indeed, there are now 14 junk-rated companies with euro-denominated bonds that have negative yields. Not all euro junk bonds are adorned with a negative yield just yet, but yields on junk bonds no longer compensate investors for the inherent risk. According to the Bank of America Merrill Lynch Euro High Yield Index, the average yield of junk bonds is a measly 2.83%.

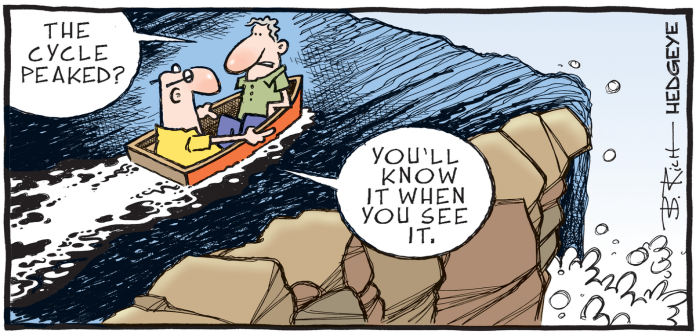
Central bankers have gone mad and have distorted market pricing in unfathomable ways. Investors are now buying junk bonds at negative yields because they are being told by the bankers that surely yields will even be lower and more negative in the future.

Of course, none of this makes sense. And obviously, this will not end well.

Pure idiocy!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Pay attention to the cycle. All economic cycles come to an end. Economic growth is slowing. Inflation is slowing and corporate profits are slowing. We are seeing weakness in auto sales, housing, manufacturing, earnings and capital spending. The U.S. consumer, who is the main driver of the U.S. economy, is already spending less due to a decline in personal spending and is more likely to save than borrow when rates decline because of current relatively high levels of household debt. Imagine what happens when layoffs commence, and unemployment begins to rise.



Source: Hedgeye

Further, given the lags with which monetary policy changes work their way through the economy, actions by the Fed now will have little effect for many months. If a recession is in the cards or potentially is already underway, the Fed will ease in coming months.

But, fighting a recession at such a low starting point for the funds rate means the Fed is going to have to become even more aggressive than it was in the prior three downturns. If so**,** the funds rate will melt, the yield curve will steepen, and everything out to the long bond will be trading well below 2%. As an aside, that is hardly that brave a call considering that the Treasury market is the only one in the major industrialized world today that doesn't have a single maturity trading with a negative yield.

In terms of portfolio strategy, maintain the discipline of building/maintaining a high-quality, broadly diversified and duration-appropriate ladder strategy for your balance sheet.

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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.