BALANCE SHEET SOLUTIONS
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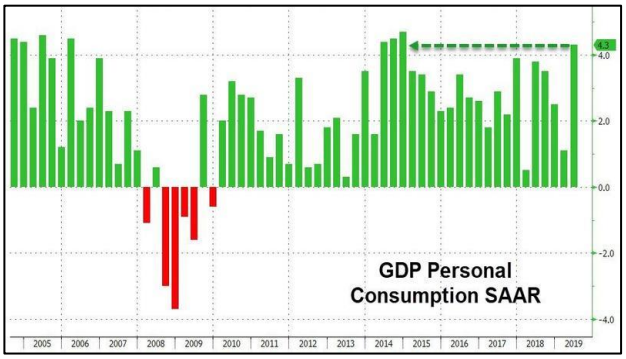
WEEK OF JULY 29, 2019

Weekly Relative Value

A House of Straw

Last week, headline second quarter real GDP growth came in at a +2.1% annual rate and above consensus expectations of +1.8%. The stronger-than-expected growth was attributable to consumers going on a shopping spree. After two very dismal quarters, consumer spending perked up to 4.3% annualized, the fastest pace since 2017.

The Consumer is Back



Source: Bloomberg

The increase in consumption reflected a drawdown in the savings rate and an 8% surge in credit card debt. Why the credit splurge as opposed to paying with cash? Either it's pure confidence in job security and income or perhaps it's consumer stress. Further, with credit card rates averaging 17%, let's hope they can all pay it off quickly, otherwise those high interest rates will demand a reckoning. That is, of course, unless you consider carrying record credit card debt and paying record interest rates to be smart.

> *"27% of adults would need to borrow or sell something to pay for an unexpected expense of $400. One quarter of adults have no retirement savings, and skipped necessary medical care in 2018 because they were unable to afford the cost."*
> – Federal Reserve Report on the Economic Wellbeing of U.S. Households for 2018

Fact is 58% of Americans have less than $1,000 in savings. Large swaths of the American population live paycheck to paycheck.

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

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THIS WEEK

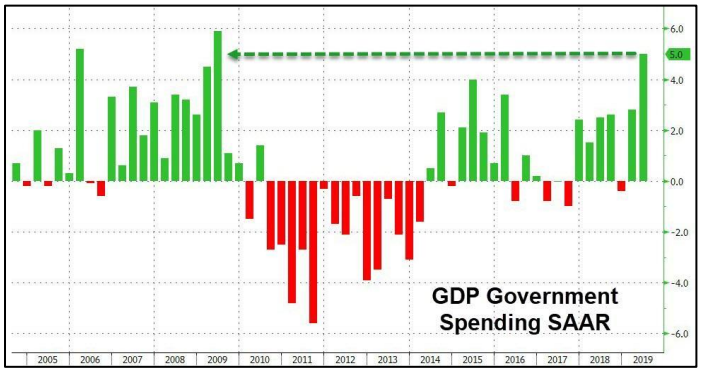
That's called living on the edge. And what better way to prepare for the next downturn than having little to no savings but record credit card balances, paying record interest rates and piling on more credit card as we speak?

Best economy ever. Not if you look at the details. The credit card splurge is warning of a coming storm.

Extrapolating the first quarter pick-up in consumer spending may be the most dangerous thing anyone can do.

The second quarter GDP also got a nice boost from Uncle Sam. Government spending jumped at a 5% annual rate, which was the strongest run-up since the second quarter of 2009 when the economy was in the deepest recession since the 1930s. But here's the thing: like the consumer, there is little chance of a repeat of this in the coming quarters.

Sustainable?



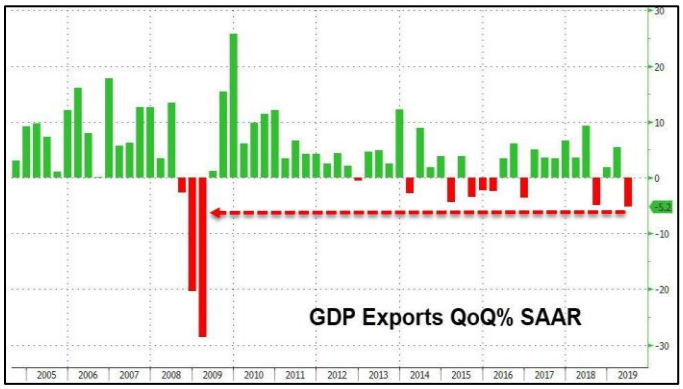
Source: Bloomberg

Business spending declined 0.6% annualized in the second quarter (capex was flat and nonresidential spending collapsed at a 10.6% annualized rate) — for the first decline in three years. Something else to consider is that if businesses are pulling back on plant & equipment outlays, then hirings aren't far behind, and this will lead to renewed weakness in consumer spending.

Meanwhile, don't tell anyone in the housing sector about a strong U.S. economy because residential construction contracted at a 1.5% annual rate — the sixth decline in a row and down in eight of the past nine quarters in a string of negativity not seen since the 2008-09 Great Recession.

Export volumes sagged 5.2% and the sustained firmness in the dollar both suggest that more trouble lies ahead on this front.

Exports Plunge



Source: Bloomberg

The bottom line: This was one of the most lopsided GDP reports in that consumer and government spending together expanded at a 4.4% annual rate, and the rest of the economy — business capex, nonresidential investment, housing, inventory accumulation and net exports — collectively contracted at a 12.1% pace. Talk about a bipolar economy.

Also, I have got to ask: did anyone notice that there were also significant downward revisions to 2018 GDP growth?

I surely did not hear this on the news and nor will you. However, revisions were made to GDP in the fourth quarter of 2018 (now at 1.1% instead of 2.2%), third quarter of 2018 (now 2.9% instead of 3.4%) and the second quarter of 2018 (now 3.5% as opposed to 4.2% prior). The best economy ever lost a step or two. This is another reason why one must not accept government data at face value.

On the inflation front, the core personal consumption expenditures (PCE) deflator rose at a 1.8% annual rate. However, the year-over-year trend just keeps grinding lower and lower at 1.5%. As the Great Recession was steamrolling in the fourth quarter of 2008, the core PCE inflation rate was 1.5%, right where it is today.

OBSCENE BUDGET

"Fiscal responsibility is dead… The obscene budget is just another example of an unintended consequence of global central banks cancelling market signals… Politicians will continue to engage in myopic policies until markets revolt."
– Stanley Druckenmiller, former chairman and president of Duquesne Capital

During the 2016 presidential campaign, then Republican candidate Donald Trump promised he would eliminate the nation's debt in eight years. This past week, Trump announced he had reached an agreement with Congress to pass a continuing resolution which will suspend the debt ceiling until July 2021. According to the non-partisan Committee for a Responsible Federal Budget (CRFB), when Trump signs the new budget deal his administration will have added $4.1 trillion to the national debt.

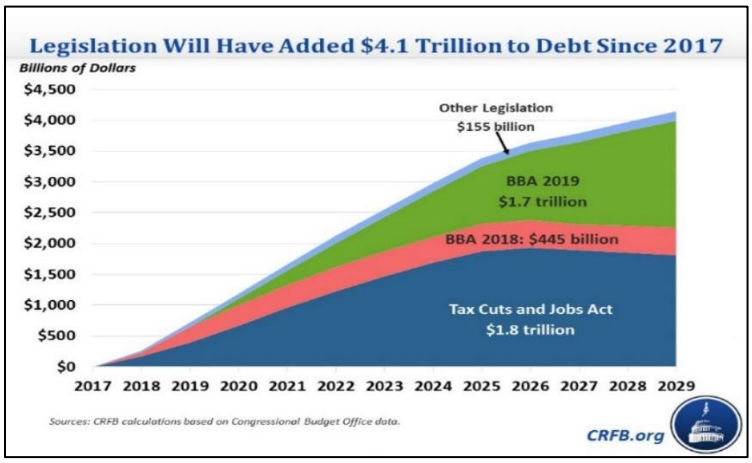
The biggest contributor to the $4.1 trillion added to the national debt through 2029 is the Tax Cuts and Jobs Act. This tax cut legislation in 2017 single-handedly increased the debt by $1.8 trillion, according to CRFB.

CRFB estimates that the new budget deal will bring debt to 97% of GDP in 2029 once that $4.1 trillion figure is added to the existing $16.2 trillion in debt and $9.8 trillion projected to be borrowed over the next 10 years.

And it could get much worse. If you were to extend all the expiring provisions from the Tax Cuts and Jobs Act, it would be about a trillion more on top of that, so it's hugely expensive. It's all part of a culture of no longer worrying about how we're going to pay for things and just assuming that future generations are going to cover the bill.

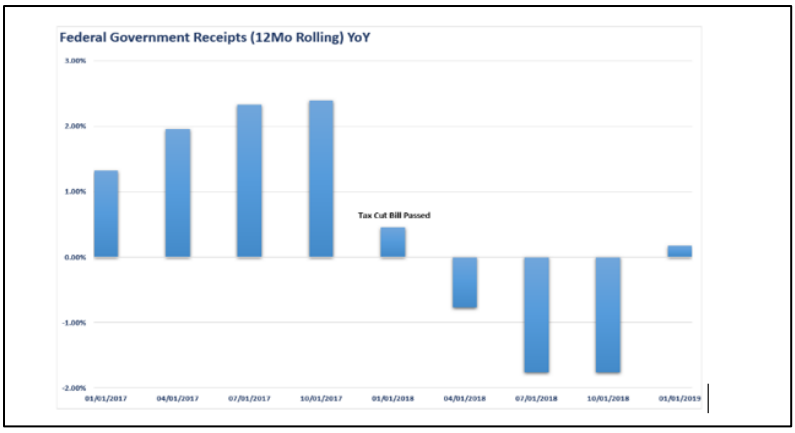
Of course, the real question is how are we going to "pay for it?" Without achieving accelerated rates of economic growth, the debt will balloon. And that will happen because *there is absolutely NO historical evidence that cutting taxes, without offsetting cuts to spending, leads to stronger economic growth.*

In 2018, the Federal Government spent $4.48 trillion, which was equivalent to 22% of the nation's entire nominal GDP. Of that total spending, ONLY $3.5 trillion was financed by Federal revenues, and $986 billion was financed through debt.



More importantly, Federal Tax Revenue is DECLINING. Such was NOT supposed to be the case, as the whole "corporate tax cut" bill was supposed to lift tax revenues due to rising incomes.

But I thought...



Over the next 12-18 months, spending will expand, and the deficit will quickly approach $2 trillion. The larger the debt becomes, the more economically destructive it is by diverting an ever-growing amount of dollars away from productive investments to service payments. We're already headed towards 2% growth, and the higher our debt is, the lower that will be.

But, here's the scary part: The projected budget deficits are happening at the end of a record-long expansion and while the economy is at full employment. While budget deficits can be helpful in recessions by providing the necessary stimulus, we should be saving for a rainy day. As President Kennedy once said, "The time to repair the roof is when the sun is shining." Instead, we are punching more holes in the fiscal roof.

During the next recession, revenue will drop sharply, deficits will explode, and the government will be forced into another round of bailouts.

But yet, the current administration believes our outcome will be different. More debt, and lack of any budget controls, will somehow lead to surging levels of economic growth despite no historical evidence of that being the case.

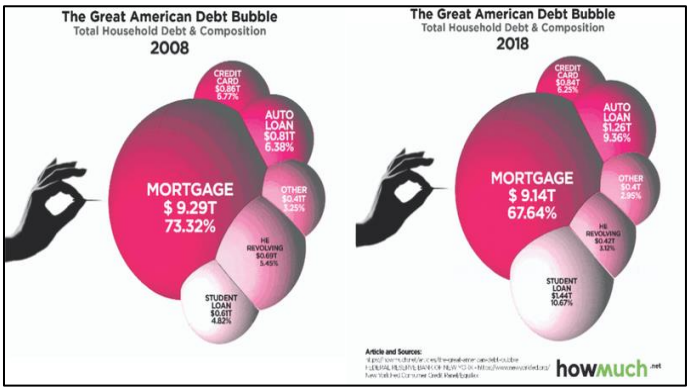
HOUSE OF STRAW

This is the most acute Potemkin rally in the economy of all time.

Here's something to ponder: Without the massive expansion of debt, there is no global economic growth to speak of. In fact, this 2009-2019 cycle makes a mockery of the debt bubble that formed from 2002 to 2007.

Global debt liabilities at all levels of society — household, business and government — ballooned $3 trillion alone in the first quarter of 2019 and now totals $250 trillion (yes, that says "trillion"), or an amazing 320% of world GDP. Think that ever gets repaid?

The problem with the exceedingly high debt levels is that since economic growth is a function of debt-supported spending, there is a finite limit to how much debt can be absorbed. This is why it matters:



As "*HowMuch"* shows in the image above, 10 years after the financial crisis, individuals are more levered today than they were then. (Notice the doubling of auto and student loan debt in particular.)

Central banks are playing the role of all the kings' horses and all the kings' men as Humpty Dumpty sits on this dangerous and unsustainable wall of debt.

And to think the bright lights in Washington believe that continuous increases in the debt ceiling are a good thing. They clearly don't know their history, or simply don't care since they won't be around to clean up the mess.

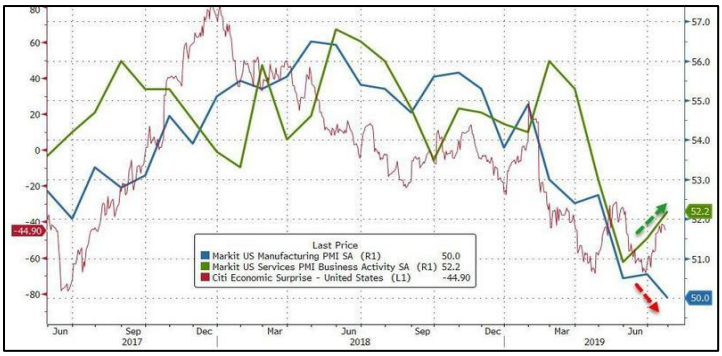
If I recall, building houses out of straw is not a sound strategy.

MANUFACTURING MATTERS

Manufacturing output contracted for the first two quarters of this year. And that was the first back-to-back decline since the soft patch in 2015 and 2016.

And as shown below, the U.S. has joined Japan, Germany and the eurozone with the Manufacturing Purchasing Mangers' Index (PMI) in contraction.

U.S. Manufacturing in Recession



Source: Bloomberg

While many will say manufacturing is inconsequential because it represents ONLY 15% of the domestic economy, I believe manufacturing matters more than most think.

Try to imagine a (pulp & paper) town (where I grew up) in which you have grocery stores, theaters, police, hospitals, finance, banks, real estate, retail, shopping, shoe repair, day care, schools, doctors, vacations, etc. Now take away the pulp & paper plant, what happens? Try to imagine this for a whole country without manufacturing. Just a thought experiment.

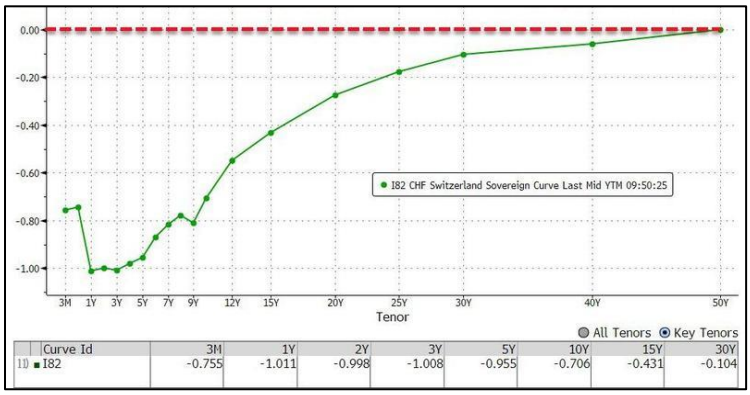
It seems safe to say that what happens in manufacturing doesn't stay in manufacturing. Instead, it spills over to the economy at large.

So, ignore the small yet significant manufacturing sector at your own peril.

MEANWHILE, IN THE WORLD OF MAKE BELIEVE

Every government bond in Switzerland has a yield below ZERO! Spend a minute and try to absorb this simple fact.

How Can This Be?



Source: Bloomberg

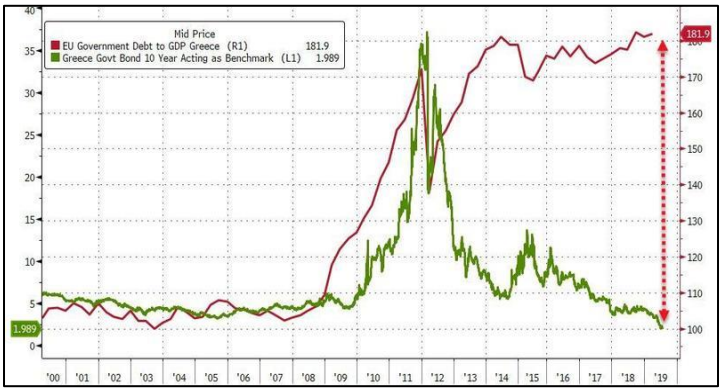
This has added to the new record high – over $13.7 trillion – in global negative-yielding debt... (and that includes some junk European bonds!).

And in Greece a true comedy is being played out. For the first time in history, the yield on Greece's 10-year government bonds dropped below 2.00% – having crashed from around 4.00% at the start of the year – and is below U.S. Treasury debt costs.

With a debt-to-GDP ratio of 182%, do you think Greek debt "deserves" a sub-2% yield?

Time to buy some gold?

This Makes NO Sense



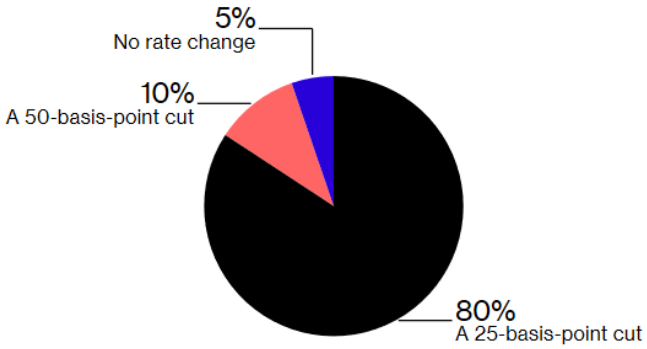
Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The U.S. economy is decelerating and the early data flow for July continues to paint a picture of softness. And central banks are moving back into the easing mode last seen in 2015-16. The European Central Bank (ECB) has signaled it will cut rates further into negative territory and is assessing its options for quantitative easing. The Bank of Japan will likely join in on the rate cutting party this week.

And this week the Fed will most likely cut interest rates for the first time in more than a decade.

Some predict the Federal Open Market Committee (FOMC) will cut their benchmark by 50 basis points (my vote) but as shown below, 80% of Fed watchers believe they will cut by 25 basis points.



Source: Bloomberg

In terms of portfolio strategy, we continue to advocate a fully invested, risk appropriate ladder strategy.

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> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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– Shawn Nikkel, Finance Director of Denver Fire Department FCU

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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.