BALANCE SHEET SOLUTIONS
an alloya company

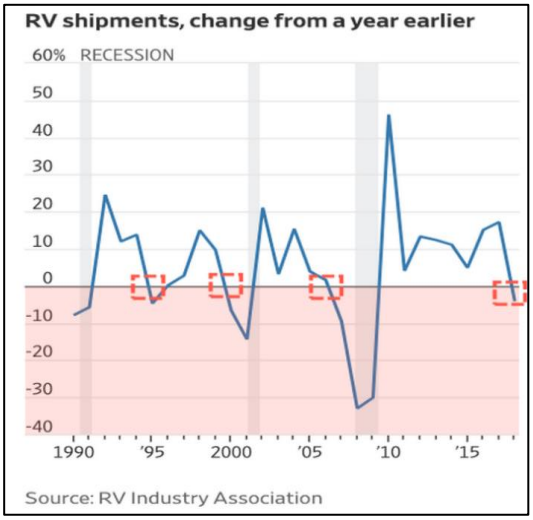
WEEK OF AUGUST 26, 2019

Weekly Relative Value

As RVs Go…So Goes the Economy

"The RV industry is better at calling recessions than economists are."
– Michael Hicks, Ball State University Economist

RV shipments to dealers are down 20% in 2019 on the heels of last year's 4.1% decline. Michael Hicks, a Ball State University economist, warned that the fall in RV shipments could indicate a broader economic downturn is ahead. Hicks said shipments had fallen sharply just before the last three U.S. recessions.



Source: RV Association

While clearly yet another recessionary flag is flying high, it was the whole Indiana thing that caught my eye. In the "who knew" department, Elkhart, Indiana is home to nearly two-thirds of RV production in America.

And Indiana is home to much more than RV production. It's also home to the highest manufacturing intensity in America – its economy is nearly 30% manufacturing. The RV data meshes perfectly with Indiana state jobless claims being up 20% over the prior 12 months. That compares to up 0.2% at a national level. Only Oklahoma and North Carolina are in worse shape. In the last recession, Elkhart's unemployment rate soared to 20% in 2009.

Indiana is waving a recessionary flag and providing a prism into developing national GDP trends

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

SUBSCRIBE

THIS WEEK

- DEFICITS EXPLODE
- BOMBSHELLS
- NOW OVER TO TRUMP'S TWITTER ACCOUNT
- HOW EXPENSIVE ARE BONDS?

PORTFOLIO STRATEGY

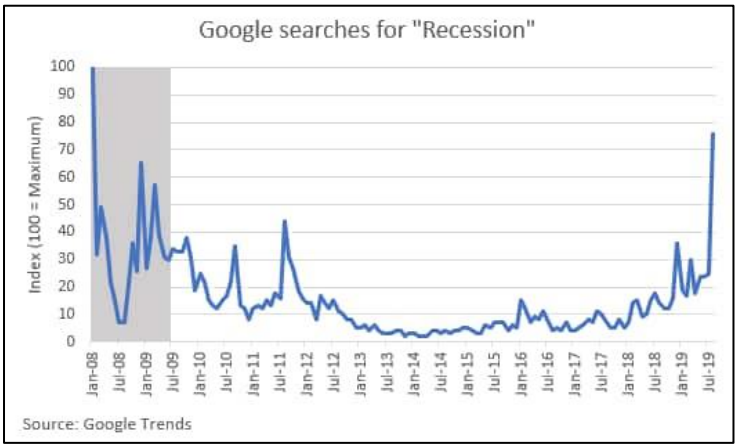
The RV industry's crisis shows how President Trump's trade war has backfired, hurting the industry he promised to protect**.** Tariff-related price hikes have forced RV manufacturers to pass on costs to dealerships, which in turn the American consumer bears the brunt of the tariff, has slowed sales at dealers who are cutting orders and laying off workers.

"The tariff price increases are what tipped the RV business — it started the landslide, no question," – Tom Bond, the materials and purchasing manager at Adnik Manufacturing, an Elkhart-based division of Norco Industries.

And according to Hick's comments, the next recession may have already arrived with declining RV shipments expected to fall for 2019 and 2020.

Whether it's the word "recession" spooking them – searches for the keyword have hit a six-year high – or the schizophrenic stock market, the University of Michigan's (UoM) August Consumer Sentiment index was floored and returned to levels not seen in six years. The index assessing labor market conditions has proceeded to decay rather quickly — hitting 98 in July and is now down to 92, a six-month low. The share seeing unemployment rising in the next six months jumped to 28% in August from 25% last month. Income expectations fell hard to 53.8 from 58.0 in July, and real incomes even harder to 85 from 92 — the lowest in 14 months. Car buying intentions hit a six-year low while those to buy a major appliance hit the lowest since October 2014. More to the point, consumers are telling us in no uncertain terms they've no appetite to consume.

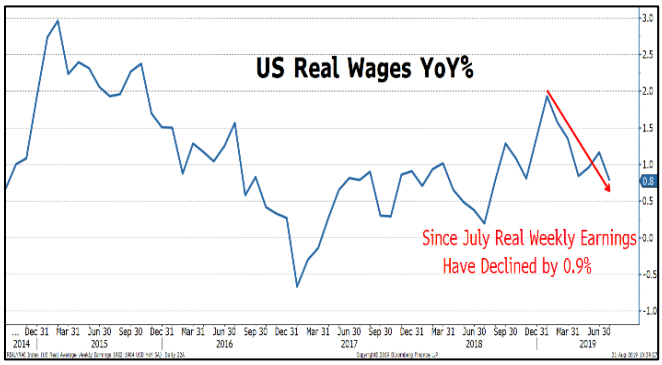
"The RV industry is a great bellwether of the economy," because the vehicles are an expensive and discretionary purchase, easily delayed by consumers who start to worry about their financial stability." – Michael Hicks



Possibly wages are becoming a source of stress. Seven straight months of slowing in weekly paycheck wage growth inevitably leads to discussions about what can be trimmed from the budget. Most school children return to school this week and next. That means new clothes, backpacks, school supplies and lunch money ate up a big chunk of disposable income.

It should also be noted that real average weekly earnings actually fell in July and have been flat to down now in six of the past eight months. Over the six months to July, real average weekly earnings actually declined at a 0.9% annual rate. When you count in the workweek, employment and wages and then strip out whatever inflation there is, real work-based income is negative. So spending is great, but the fundamentals supporting said spending is far less than great — or good.

Real Wages Disappoint



Source: Bloomberg

It's also important to note that credit card delinquency rates have been rising in July at Citigroup, Capital One and Synchrony. Across lenders, the New York Fed reports 5.2% of credit card balances were 90 days overdue at the end of June, up from 5.0% in this year's first quarter. The deterioration started in 2017. Not all is well with all consumers.

And yet, everyone has been gushing about that July retail sales report. CNBC devoted a full day session to "The Great American Consumer." I get that July headline retail sales were strong. But so was credit card borrowing which hit a 15-month high last month. And we know Amazon Prime sales rocked, pulling demand forward.

DEFICITS EXPLODE HIGER

Last week, the Congressional Budget Office (CBO) updated its U.S. economic and budget forecasts and it's not a pretty picture. They now expect the fiscal deficit to widen to $960 billion this year or around 4.5% of GDP, worse than their prior forecast for 3.9%. The worsening outlook will also result in trillion-dollar deficits beginning in 2020, two years earlier than before. Apparently, the White House economists didn't consider that when they cut taxes and increased spending. It saddled the government with total budget deficits in the next decade accumulating to an eye-popping $12.2 trillion. In just the past month, the CBO has boosted this number by $809 billion. I know, I know — this only becomes a problem when it does. Just like a smoker would say.

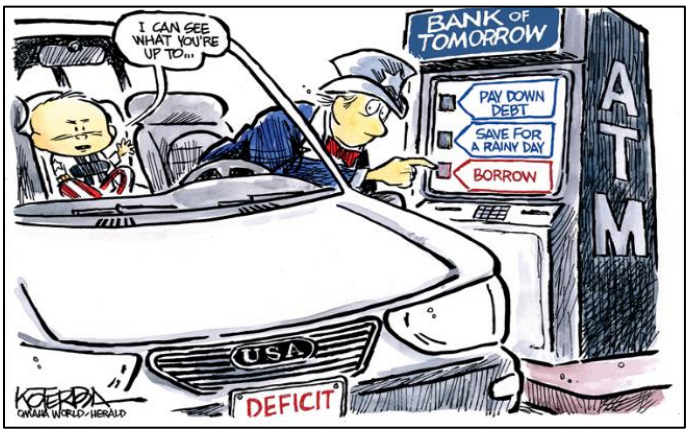
The CBO's report shows:

- Under current law, debt held by the public will rise by more than $12.8 trillion over the next decade – from $16.5 trillion today to **$29.3 trillion** by 2029.
- Debt as a share of the economy will rise rapidly, from today's post-World War II record of 78% of Gross Domestic Product (GDP) to **95% of GDP** by 2029. If the 2017 tax cuts and other policies are extended, it would reach 101% by 2029.
- Annual budget deficits will exceed the trillion-dollar mark next year and rise to **$1.4 trillion**, or 4.5% of GDP, by the end of the decade. Over the next 10 years, deficits are expected to rise by $12.2 trillion.
- Growing debt and deficits are driven by a disconnect between spending and revenue. Under current law, spending will grow from 20.8% of GDP this year to 22.7% of GDP by 2029, while revenue will remain roughly

between 16 and 17% of GDP through 2025 and rise to 18.2%of GDP by 2029, assuming recent tax cuts expire as scheduled.

- The Bipartisan Budget Act of 2019 substantially worsened the fiscal outlook, adding $1.7 trillion to projected deficits over the decade.

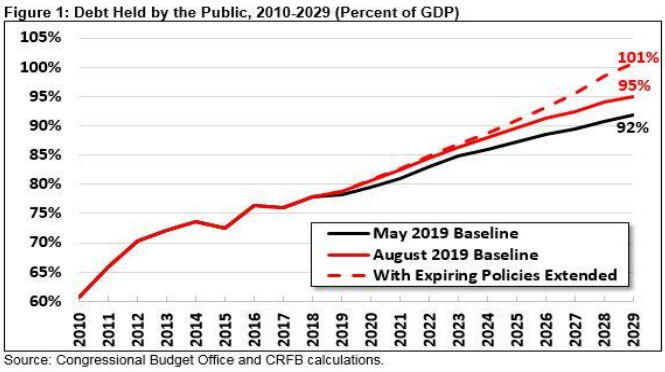
Kids Say the Darnedest Things



Source: Cagle

In sum, the CBO's latest projections show our fiscal situation will continue to deteriorate as a result of irresponsible tax and spending policies and the growth of health, retirement and interest spending. Specifically, the Committee for Responsible Budget (CRFB) estimates debt will grow by $14.6 trillion over the next decade, to $31.1 trillion, or **101% of GDP**, by 2029. This suggests debt would exceed its previous record – 106% of GDP set immediately after World War II – around 2030.

Debt out the Wazoo!



BOMBSHELLS

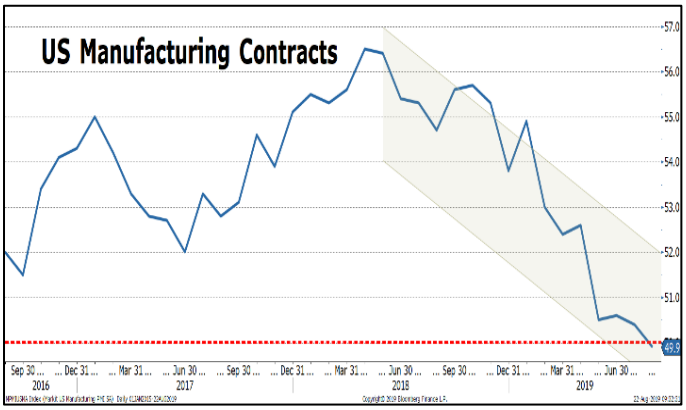
"August's survey data provides a clear signal that economic growth has continued to soften in the third quarter. ***The Purchasing Managers' Indices (PMIs) for manufacturing and services remain much weaker than at the beginning of 2019 and collectively point to annualized GDP growth of around 1.5%...*** *Manufacturing companies continued to feel the impact of slowing global economic conditions, with new export sales falling at the fastest pace since August 2009…* ***The continued slide in corporate growth projections suggests that firms may exert greater caution in relation to spending, investment and staff hiring during the coming months."***
– Tim Moore, Economics Associate Director at IHS Markit

From a macro standpoint, the first big bombshell came from the Bureau of Labor Statistics (BLS). I have written and warned that the employment figures were being enhanced by the birth-death model. Indeed, as per the BLS, *"The preliminary estimate of the benchmark revision indicates a downward adjustment to March 2019 total nonfarm employment of -501,000."* How big is that? Oh, well, it comes to an average monthly change in 2018 of 192,000 from 223,000 and would "only" represent the sharpest downward move since the 2009 recession year, that's all. Now, the final numbers won't be issued until February 2020, but that doesn't exactly paint an inspiring picture. In other words, in general, the jobs reports looked too good to be true, and they were too good to be true.

The second bombshell came from Markit reporting that the U.S. manufacturing PMI unexpectedly tumbled into contraction territory, down from 50.4 last month. This was the first print below the 50.0 expansion threshold for the first time since September 2009. The forward-looking new orders sub-index was particularly soft — falling to 50.8 from 53.7, the lowest it has been since data collection began in October 2009. Part of this can be attributed to a collapse in new export orders — to 46.8 (another fresh all-time low) from 50.2, the largest month-to-month decline in the history of this data series. So much for trade wars being "easy to win."

But wait, there's more. Until now the U.S. services segment appeared immune to the slowdown in U.S. manufacturing, but in August the service PMI tumbled to 50.9, down from 53.0 in July, matching the lowest print in at least three years.

U.S. Manufacturing in Recession



Source: Bloomberg

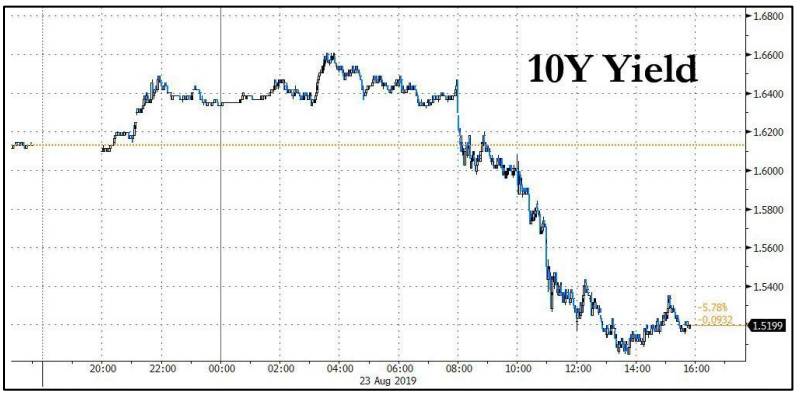
In the meantime, all I hear is that the current downturn is limited to trade and manufacturing and will remain contained. Does this sound like shades of former Fed Chair Ben Bernanke in 2006-07? We were told when housing rolled over that residential construction only represented 5% of GDP, so who cares? Obviously, with the benefit of hindsight, I think it was quite reasonable to care. You don't shock one part of the economy without a partial effect on the other parts of the economy. It seems foolhardy to think the consumer won't be feeling the effect as companies begin to cut their hiring intentions just as they have already done to capital spending. Thus, while not apparent yet, the contraction in global trade volumes, capex and industrial production will be followed by slowing consumer spending.

AND NOW OVER TO TRUMP'S TWITTER ACCOUNT

The biggest bombshell came on Friday when President Trump may not have intended to launch the second Cold War, but his tweets laid out one path to get there. After Beijing announced an additional $75 billion tariffs on the U.S., Trump responded to China's trade war escalation with a barrage of tweets.

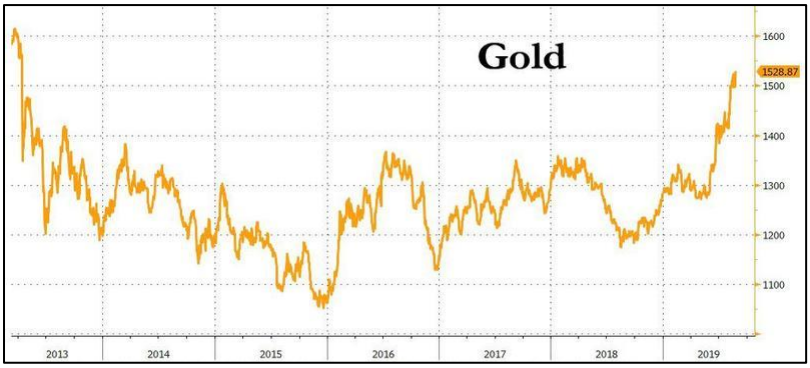
The escalation of the U.S.-China trade war sent stocks reeling as the Dow Jones fell 2.4%, and the S&P 500 slumped 2.6%.

While bond yields crashed…



Source: Bloomberg

And gold exploded higher hitting a six-and-a-half-year high...



Source: Bloomberg

And it did not take long before China responded. On Saturday, China's Commerce Ministry issued a statement calling on Washington not to "***misjudge the situation and underestimate the determination of Chinese people… The U.S. should immediately stop its wrong action, or it will have to bear all consequences."*** Finally, China said it would continue fighting the trade war with the U.S. "**until the end"** as tit-for-tat escalation is now virtually assured with no end in sight.

"Mr. President, we implore you to end this trade war before the damage is irreversible… If uncertainty spreads from Wall Street to Main Street, the record expansion we're enjoying will undoubtedly come to an end and it will be the American consumer, not China, who will suffer."
– Brian Dodge, Chief Operating Officer of the U.S. Retail Industry Leaders Association

---

It is now abundantly clear that we are heading into a new chapter in this China-U.S. trade/currency/economic war. Can we now all admit that trade wars are NOT easy to win?

This is where I stand.

Should we be dealing aggressively with China on its theft of intellectual property, its lack of a fair playing field, its mercantilist policies and government subsidies of companies? Absolutely.

But tariffs are hurting U.S. consumers. China is not paying those tariffs, we are, and any economist worth their salt knows it. There has been a series of articles for the last five months pointing out that the Trump tax cuts averaged around $900 per taxpayer. Tariffs have already eaten about $800 of that tax break, essentially nullifying the benefits of the tax cuts.

Get tough with China? Yes. But don't make Americans pay for it. If you're going to fight a trade war, then don't point the gun at yourself.

But it was not just China. Trump was expecting much more from Fed Chair Jerome Powell. Apparently, he was hoping for a 100-basis-point rate cut announcement or at least "some QE." The President lashed out at Powell, and blasted on Twitter:

"As usual, the Fed did NOTHING! It is incredible that they can 'speak' without knowing or asking what I am doing, which will be announced shortly. We have a very strong dollar and a very weak Fed. I will work 'brilliantly' with both, and the U.S. will do great. ***My only question is, who is our bigger enemy, Jay Powel or Chairman Xi?"***

Wow… I never ever thought I would hear the President of the U.S. compare a Fed Chairman – who he appointed, by the way – to a Communist Dictator.

HOW EXPENSIVE ARE BONDS?

Bonds may be expensive in the U.S., but in Europe there are currently over 17 trillion of bonds with negative yields. Of course, the question becomes: Who on earth would ever buy a -70 basis point yield on a German 10-year bund or -15 basis points for a 30-year maturity for that matter? It all comes down to what inflation expectations are.

Let's look at what we know today. We know that Germany is about to head into recession. In the past, core inflation in a German recession declined 3.3%. Where is the starting point right now? Try 1.2%. If we get a plain-vanilla recession, that 1.2% falls to -2.1%. All of a sudden, the "real yield" on long-dated German piece of government paper is actually +1.5%. This is why some investors may be tempted to buy an instrument with today's negative "nominal" yield.

We can extend this idea to the U.S. Historically, as shown below, core inflation drops nearly 400 basis points in a recession. Today core inflation is 2.2%. A garden variety run-of-the-mill recession will drive the core rate of inflation to negative -1.7%. In other words, deflation. In this environment the "real" rate of interest on 10-year Treasuries would approximate 3.4%.

Peak to Trough in Core Consumer Price Index Year-Over-Year as %

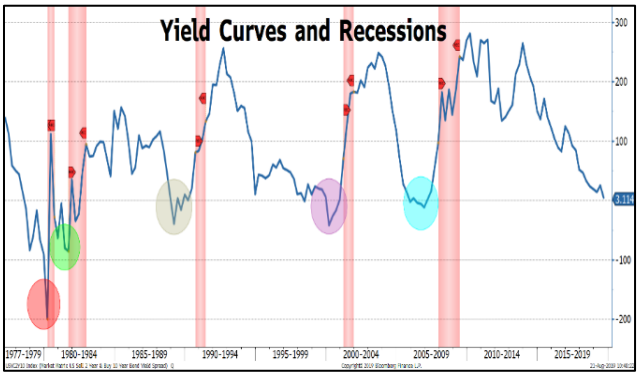
Recession	Peak	Trough	Change
1961	2.7	0.7	2.0
1970	6.6	2.8	3.8
1974	11.7	5.9	5.7
1980	13.6	9.4	4.2
1981	11.8	2.9	8.9
1990	5.6	2.8	2.9
2001	3.1	1.9	1.2
2008	2.9	0.6	2.3
Average			**3.9**

Source: Bloomberg

Could it be that investors have not factored in the deflationary risks that come with the next recession? And let's face it with the world choking on a record amount of debt and awash with excess capacity in the goods market, one can see how deflationary pressures could continue to build.

Everyone is now debating the merits of the yield curve. As noted in this space the past seven times the 2s/10s spread has inverted a recession has followed. The record is quite impressive. I should also note that the Fed and virtually every Wall Street economist did not predict any of the past seven recessions. While there are no guarantees and this time could indeed be different, who should you trust: a market-based yield curve index with a perfect track record or a group of biased Fed officials and Wall Street "asset gatherers" who have a perfect record of missing every recession since 1950?

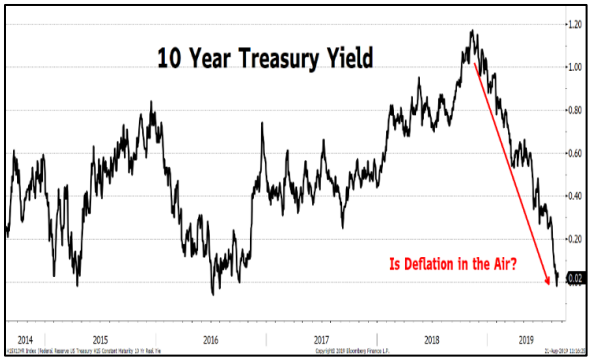
Willing to Bet Against This?



Source: Bloomberg

Meanwhile real interest rates are collapsing. Real rates on 10-year Treasuries at an all-time record low. That does not happen in a strong economy and amid rising inflation. Yes, indeed recession risks are rising whether or not the curve inverts. The bond market realizes this… Only the traditional sell-side economist doesn't seem to see this.

Real 10-Year Yields at Record Lows



Source: Bloomberg

So, are bonds expensive? They are only expensive for people who haven't done the math on what happens to pricing power in an economic downturn.

MARKET OUTLOOK AND PORTFOLIO

Economic growth and inflation are slowing in the world economy – including the U.S.

In this environment central banks will do what they do best and once again cut rates to the bones. Expect the European Central Bank (ECB) to make an announcement next month to take rates deeper into the land of negativity while buying virtually any/every asset that trades. However, based on the most recent results, one could argue that this "whatever it

takes" policy will be just as ineffective as what's happened thus far. Nevertheless, they will proceed with their experiment.

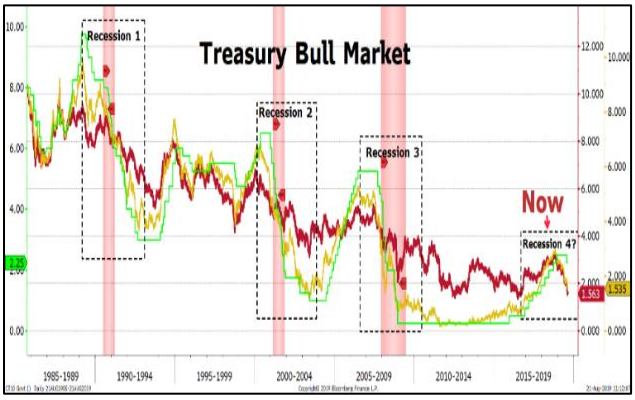
And as the U.S. economy slows here at home, Jerome Powell and company will unwind the recent rate hikes. Even if the economy ends up in a soft landing, thus avoiding a recession, the Fed will still reduce rates by another 50-75 basis points. If a recession rears its ugly head, expect a round trip back to Zero Interest Rate Policy (ZIRP).

Prayers

From a longer-term perspective, as we move forward, the scenario many think is most plausible is a "Japanification" of Europe and the U.S. If so, more economies will be stuck in a rut of anemic growth and perpetually low interest rates. Loaded with debt, economies can't grow. And after years of easy monetary policy, central banks are impotent. This is consistent with the "lower for longer" theme.

As such, even though interest rates have collapsed by over 100 basis points since October 2018, interest rates could drop further from here. To wit: currently the two-year Treasury yield is 1.55%. If the Fed reverts to a zero-rate policy, the two-year yield (yellow line in graph below) could approach all-time lows of 0.16% if not lower.

We continue to advocate that credit unions maintain a risk appropriate ladder strategy. Conversely, excess cash will likely continue to be a drag on income.



Source: Bloomberg

PREMIER PORTFOLIO

Since its launch in September 2018, Balance Sheet Solutions' online trading platform – Premier Portfolio – has been making a positive impact at credit unions across the corporate's membership.

> *"Premier Portfolio's online services allows me to access statements and overall market analyses, review a list of available security offerings, as well as purchase SimpliCD's and Alloya's certificates. Premier Portfolio is convenient, easy, secure, and has become my go-to place for investing!"*
> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

> *"While it's always great to connect with our Balance Sheet Solutions Account Executive one-on-one, Premier Portfolio is an amazing and easy tool to use in purchasing investments. We have access to statements, online trading and the ability to look at all of the offering in one place. I highly recommend trying this out!"*
> – Shawn Nikkel, Finance Director of Denver Fire Department FCU

> *"Premier Portfolio is user-friendly and modern. It allows us to browse current offerings and make immediate purchases at any point throughout the day. The tracking mechanism in Premier Portfolio is very hand. Since the system knows what dollar amount is currently owned in a financial institution, there is no room for error. We love the ability to check term and rate on a single summary. Premier Portfolio takes the guessing out of the equation. It is a highly useful tool and would recommend to anyone using Balance Sheet Solutions."*
> – Darin Higgins, President of Western Illinois Credit Union

Visit **www.alloyacorp.org/premierportfolio** to learn more about Premier Portfolio and how it can benefit your credit union!

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.