BALANCE SHEET SOLUTIONS
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WEEK OF SEPTEMBER 2, 2019

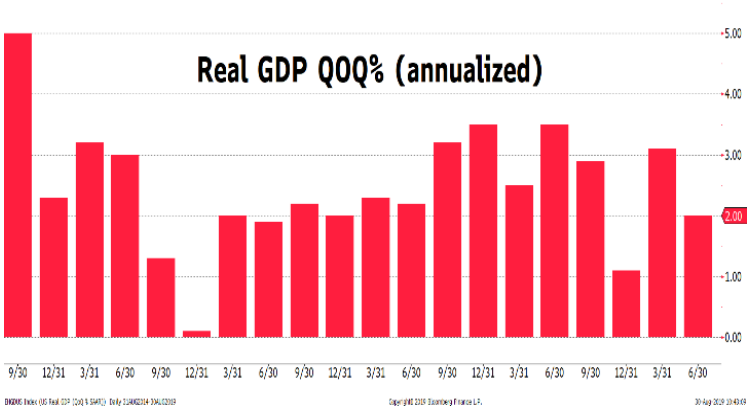
Weekly Relative Value

As the Consumer Goes… So Goes the Economy

"The recent decline is due to negative references to tariffs, which were spontaneously mentioned by one in three consumers…*Trump's tariff policies have been subject to repeated reversals amid threats of higher future tariffs. Such tactics may have some merit in negotiations with China,* ***but they act to increase uncertainty and diminish consumer spending at home****."- Richard Curtin, Director of the University of Michigan consumer survey*

Real gross domestic product (GDP) increased at an annual rate of 2% in the second quarter of 2019 according to the "Second" Estimate released by the Bureau of Economic Analysis. In the first quarter, real GDP increased 3.1%.

Real GDP Revised to 2%



Source: Bloomberg

Although the headline number was essentially unchanged, the report did shift significant growth to the consumer sector from commercial and governmental activities. In fact, besides government outlays, it was the only major GDP component that contributed positively to growth in Q2. To be sure, the American consumer is holding in better than anticipated (for the time being).

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THIS WEEK

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- ZERO PROFIT GROWTH
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PORTFOLIO STRATEGY

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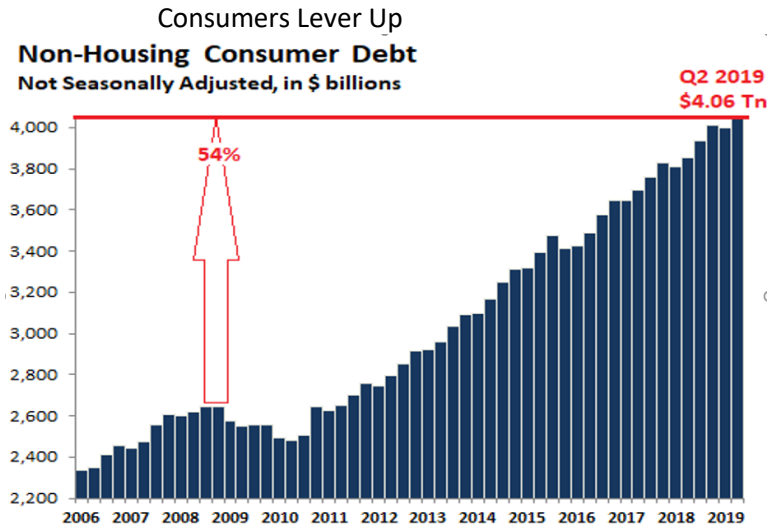
Much of the consumption over the last several months has been charged to credit cards. In effect, US consumers are propping up the US economy with money they don't have. Total outstanding consumer debt surged over $4.1 trillion in the second quarter of 2019. Over the last 12 months alone, American consumers have piled on an additional $208 billion of debt.

Revolving credit – primarily credit card debt – increased at an annual rate of 5.3% in Q2. Americans currently owe $1.07 trillion on their plastic. This was a record for a second quarter and was only topped by the "holiday shop-and-borrow" season in Q4 2018.



So, Yes, Americans have been spending money, but they've been spending borrowed money. That's all well and good until the credit cards become maxed out. This is the epitome of "unsustainable."

The US economy's strength depends so much on consumption. And the economy has become riskily dependent on the overleveraged consumer.

Clearly, any shift in consumer psychology/behavior could knock a critical support out from under our economy.

In fact, there are already signs that this could be happening. As shown below, consumer sentiment is falling. The University of Michigan Sentiment index was expected to bounce modestly (given the exuberance in stocks), but instead tumbled further as Americans expressed concern about how tariffs will affect the economy.

The University of Michigan final sentiment index fell to 89.8 in August from a previously reported 92.1 and 98.4 in July. This was the biggest drop in six years. The gauge of current conditions dropped to the lowest since October 2016, while the expectations index matched January as the weakest since that same period.

Sentiment Sours

Source: Bloomberg

The data indicate that the erosion of consumer confidence due to tariff policies is now well underway**.** Compared with those who did not reference tariffs, consumers who made spontaneous negative references to tariffs also voiced higher year-ahead inflation expectations, more frequently expected rising unemployment, and expected smaller annual gains in household incomes.

This may already be happening among the rich.

According to a CNBC report, *"The rich have cut their spending on everything from homes to jewelry, sparking fears of a trickle-down recession that starts at the top."*

Luxury real estate is having its worst year since the financial crisis. Sales at art auctions are down for the first time in years. Retailers that cater to the wealthy are also struggling. Barney's has filed for bankruptcy and Nordstrom has posted three quarterly revenue declines.

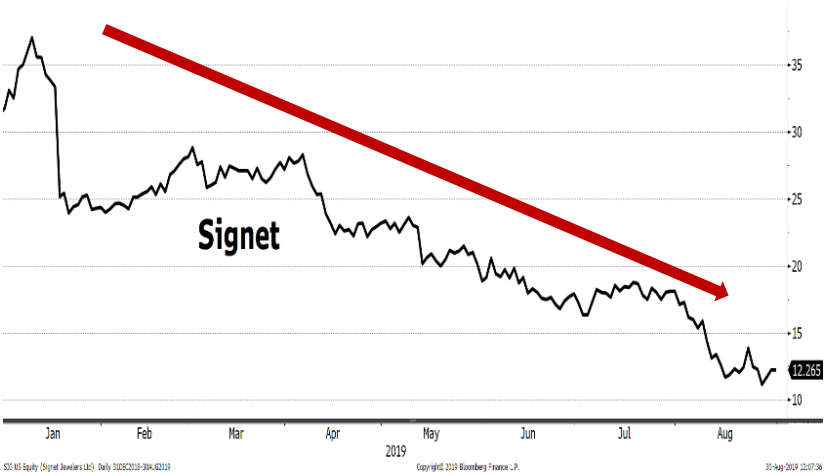
The Financial Times states that De Beers', the world's largest diamond miner, has seen a collapse in sales this month, as the entire industry is on the brink of a downturn amid weaker consumer demand.

De Beers sold just $280 million of diamonds this month, compared with $503 million in the same period a year ago, which represents a 44% drop. The miner's sales so far this year are down $1 billion from the same time in 2018.

Declining demand from the world's two largest diamond-consuming countries, the U.S. and China, has fueled uncertainties for the overall industry. Along with macroeconomic risks about a structural decline of the global economy and an out of control trade war between the U.S. and China.

Shares in Signet, the world's largest retailer of diamond jewelry, have crashed 60% this year. While diamonds may be forever, diamond demand from consumers isn't - and that demand tends to collapse ahead of (and during) recessions**.**

Signet Plunges



Source: Bloomberg

Meanwhile, “savings of the rich has also exploded, more than doubling over the past two years, suggesting that the wealthy are hoarding cash.”

It would make sense that it would start with the wealthy since they tend to be more attuned to what’s going on in the economy. The fact that the rich have shifted from spending to saving could be a canary in the coal mine.

The open question, that no one can answer now is "How long can debt-overloaded consumers prop up the economy?"

The rest of the economy is struggling, and it may soon become apparent that consumer spending, currently our primary recession deterrent, has ground to a halt.

THE EARNINGS RECESSION HAS ARRIVED

Well, well. The earnings recession has arrived.

The consensus on Q3 earnings growth (YoY) for the S&P 500 has gone from 11.7% a year ago, to +4.6% at the end of 2018 and to -3.1% now.

Think about that — a 7.7% swing to the downside this year for current quarter earnings and the stock market is still up 14% YTD!

This may be about as bizarre as nearly one third of the world’s bond market trading with a negative yield!!

That said, while the major stock indices are only 4.5% shy of the highs, they also have generated no price advance for about 20 months. And we know that it is machine as opposed to man (and woman), that has prevented a more serious decline... given that the individual investor has, on net, redeemed some $70 billion of equities so far this year (mutual funds and exchange traded funds) while plowing $260 billion into bonds of all types.

Look at the entire evolution — a classic bear market in U.S. corporate earnings. Undeniable.

- Q1 was seen at +7.3% YoY a year ago, then trimmed to +3.5% at the end of 2018 and the actual number was -0.4%.
- Q2 was estimated to come in at +7.8% YoY a year ago and by the end of 2018, the consensus was down to +4.1%. The final tally was -0.7%.

Corporate earnings were -0.4% for Q1, then -0.7% for Q2 and -3.1% the current estimate for Q3.

This is not just a profits recession, but one that seems to be getting worse.

Looking forward,a similar pattern is emerging in Q4. The consensus was at +10.1% this time last year, wound down to +7.9% at the end of 2018 and is now at +3.9%.

To sum it up: earnings expectations are coming down at the same time that the interest rate structure is tilting towards a recession outcome.

ZERO PROFIT GROWTH

Lost amid the late-July news torrent was a big revision to the Commerce Department's "national accounts" data. That's where we get Gross Domestic Product (GDP).

Previously, the data showed a big jump in pretax corporate profits beginning in 4Q 2016 (coincident with Trump's elections). The revisions now show pretax profits were essentially flat since then.

Flat profits overall do not mean flat profits **everywhere**. Some US companies are doing just fine. They tend to be those with less international exposure, or those benefiting from Trump regulatory changes and deficit spending. Rarely is it because customers are spending more.

Which means, these companies aren't prepared to withstand a recession. Many are highly leveraged, having borrowed enormous sums to finance share buybacks. They will resort to layoffs quickly when revenue shrinks, because they will have little else to cut.

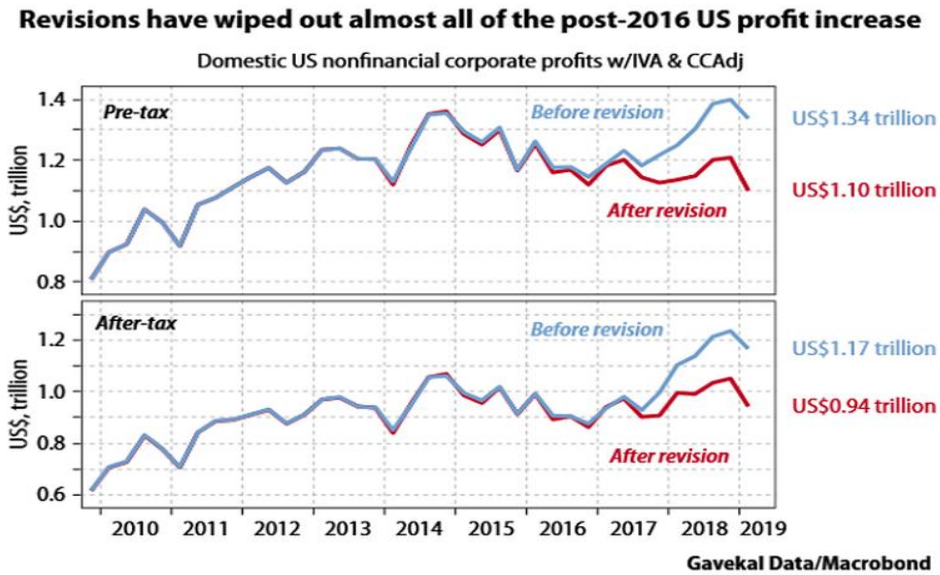


Chart: *Gavekal Research*

Why is profit growth down to practically zero?

Many reasons, but the trade war is a big one. But tariffs actually aren't the worst part of all this. The worst part is that businesses are paralyzed, unable to make growth decisions because they have no idea what government policy will be next week, let alone a year from now. That, I believe, is the main reason business profits aren't growing. Boards have gone into survival mode–just trying to hold what they have and using buybacks to create the illusion of growth.

'PUSHIN ON A STRING'

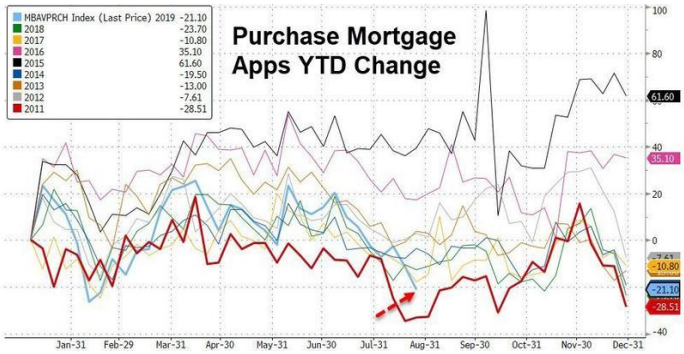
"Super-low mortgage rates have not yet consistently pulled buyers back into the market…
"Economic uncertainty is no doubt holding back some potential demand, but what is desperately needed is more supply of moderately priced homes."- *Lawrence Yun, NAR's chief economist*

Pending home sales are often considered a leading indicator of existing-home purchases and a measure of the health of the residential real estate market in coming months. Pending home sales fell 2.5% month-over-month in July (consensus: 0.0%) in its worst monthly showing since January 2018. The weakness was broadly based to boot, with sales declining in the West (-3.4%), Midwest (-2.5%), South (-2.4%) and the Northeast (-1.6%).

Housing Flounders

Source: Bloomberg

The high frequency weekly mortgage application data do not point to a housing sector turnaround in the August numbers either. New purchase applications have fallen in six of the past seven weeks (and by 15% over this time frame!).



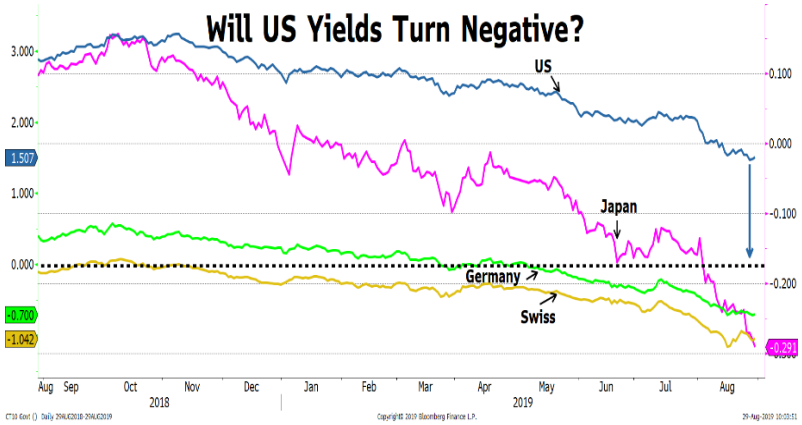
Source: Bloomberg

What is troubling is that the level of mortgage purchase applications is all the way down to where it was on February 15th, even though mortgage rates have come down 70 basis points since that time. Definitely not encouraging, and it suggests that there is little chance the central bank will be any more successful in kick starting the credit-sensitive sectors than has already been the case with the bond market. This keeps with the 'pushing on a string' theme.

THE BIG THEME

Treasuries remain a beacon of foreign investment. As such, the odds are high that U.S. bond yields play 'catch-down' to the rest of the world, rather than the other way around. I say that because the first country to have its 10-year yield go negative was Switzerland, and that was back in January 2015. Japan did this in February 2016. Germany went there in 2016. Finland and Denmark in the Fall of that year. Eight other countries have done so since (Ireland, Latvia, Slovenia, Slovakia, Belgium, Sweden, Austria and France).

The point being the move to below Zero yields out as far as the 10-year part of the bond curve is no flash in the pan. Switzerland started this trend and it's been nearly five years; and about four years of these negative rates in Japan. So, the template is there — don't expect this to be a passing phenomenon. It is here to stay, and it is coming to the U.S., so be prepared. That is until Modern Monetary Theory, or some form of inflationary debt monetization strategy comes to fruition, which is the potential endgame to this deflationary era.



Source: Bloomberg

That said, the impediments in the way of preventing a recession, let alone allow for a return to vibrant global growth, are far too powerful to be solved by lower interest rates. Negative rates in Japan have not worked, and now we are seeing that a move in 10-year bund yields, to an unprecedented -70 basis points, is not going to stop Germany from moving into an economic downturn. The same can be said about the U.K., where sub-50 basis point 10-year gilt yields are proving to be no antidote for the escalating level of uncertainty there.

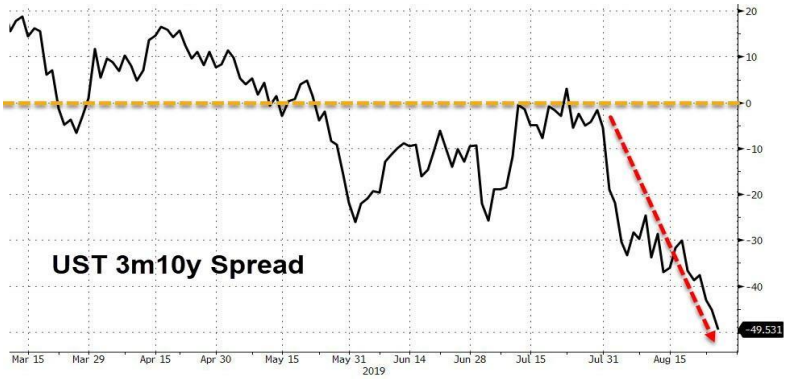
The United States serves as a case in point too and is the one major country where there is plenty of room for yields out the curve to fall — and for the Fed to ease. There are more bullets there than in many other countries, though we never have started an easing cycle with the funds rate peaking at 2%.

MARKET OUTLOOK AND PORTFOLIO

When the Fed meets on September 18, officials should consider the following: The federal funds rate, the rate we administer, is now the single highest interest rate in the developed world. Market measures, like the yield curve, are saying this is wrong.

Note: The 3-month to 10-year Treasury yield has been inverted for over 3 months. And every time that has happened in the past a recession has followed. \ While the Wall Street Economists (aka Asset gathers) tell me that "it is different this time" who wants to bet against an index that has been right 100% of the time.

100% 0F THE TIME



Source: Bloomberg

The Treasury market is screaming at the Fed that it is at least 100 basis points "behind the curve." Yet, many on the Federal Open Market Committee (FOMC) either can't afford a Bloomberg terminal or simply have their heads in the sand. On this point, the President is quite correct in my view (though cajoling through the back channels may work better than threatening via tweets). The Art of the Deal should have contained a chapter on how to get what you want out of the central bank.

But the key message here is that the overtightening by the Fed this cycle had already blazed the trail for a recession, and the global trade war has only complicated matters further and reinforced the prospects of an outright economic turndown. So far this has hit the business sector first, and with a classic lag, will hit the consumer in the coming quarters.

With that said, Fed fund futures continue to price in a near certain rate cut next month, plus around a 12% chance for a larger 50 basis point cut instead. We also heard from the Dallas Fed's Robert Kaplan and the San Francisco Fed's Mary Daly with both reinforcing last week's message from Chairman Jerome Powell that a September rate reduction is likely. Kaplan said, while consumer spending has been "strong,'' the central bank needs to be "forward looking'' in setting interest rates and voiced concern that continued weakness in manufacturing would eventually seep into the jobs

market, undermining consumer outlays. On dramatic decline in bond yields, Kaplan called it a "reality check" and attributed the decline in yields partly to global liquidity but added, "part of it is expectations of future growth have gotten a lot more pessimistic.".

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.

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.

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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.