BALANCE SHEET SOLUTIONS
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WEEK OF SEPTEMBER 9, 2019

Weekly Relative Value

Houston, We Have More Than One Problem!

"Overall economic growth was quite slow but apparently positive in both the fourth quarter of 2007 and the first quarter of this year. Activity during the current quarter is also likely to be relatively weak. We may see somewhat better economic conditions during the second half of 2008, reflecting the effects of monetary and fiscal stimulus, reduced drag from residential construction, further progress in the repair of financial and credit markets, and still solid demand from abroad. This baseline forecast is consistent with our recently released projections, which also see growth picking up further in 2009."

From a speech given by Ben Bernanke on June 3, 2008 ... (otherwise known as seven months deep into last recession.)

A global manufacturing recession was already underway. Last week the U.S. joined the party. The headline ISM Manufacturing plunged into contraction, printing 49.1 (well below the 51.3 expectations). To show just how far behind the curve the Fed is, the last three times the nominal ISM was this depressed the funds rate was at, or near, zero.

Manufacturing Contracts

Source: Bloomberg

The internals were also weak as employment declined sharply to 47.4 from 51.7 in July and 54.5 in June, so this was quite the pullback. The jobs index hasn't been this low since March 2016 (when factory payrolls plunged 25 thousand).

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THIS WEEK

- WHAT IS TRUMP'S GOAL?
- JOBS SLOW
- COMPANIES ARE SLOW TO FIRE
- EARNINGS RECESSION
- SO, WHO IS BUYING STOCKS?

PORTFOLIO STRATEGY

And new orders collapsed from 50.8 to 47.2 – which is a seven-year low. Not so long ago they were sitting high and mighty in March at 57.4.

The backlog of orders contracted for four months. Manufacturers cannot use backlogs to maintain employment. So, unless there is a quick turnaround, more layoffs or reduced hours are right around the corner.

The really big news in the report was the spread of the global economic slowdown to U.S. shores, as new export orders plunged 4.8 points to an anemic 43.3. Prices have fallen for three months.

The import index dipped to 46.0, from 47.0 in July and 50.0 in June, which is the lowest since December 2015 – in another vivid sign of softening domestic demand.

The latest downturn underscores how slowing global growth and an escalating U.S. trade war with China are taking an even bigger toll on domestic producers. Although manufacturing only makes up about 11% of the economy, there are concerns that entrenched weakness – and any layoffs that may result – could filter through to the rest of the economy and endanger the record-long expansion.

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*"**The August PMI indicates that U.S. manufacturers are enduring a torrid summer, with the main survey gauge down to its lowest since the depths of the financial crisis in 2009.** Output and order book indices are both among the lowest seen for a decade, indicating that manufacturing is likely to have again acted as a significant drag on the economy in the third quarter, dampening GDP growth."*

*"At current levels, the survey indicates that **manufacturing production is falling at an annualized rate of approximately 3%."***

*"Deteriorating exports are the key to the downturn, with **new orders from foreign markets dropping at the fastest rate since 2009**. Many companies blame slower global economic growth for weakened order books, but also point the finger at rising trade war tensions and tariffs."*

*"**Hiring has stalled as companies worry about the outlook: optimism about the year ahead is at its lowest since comparable data were first available in 2012.** Similarly, price pressures are close to a three-year low, as crumbling demand has removed firms' pricing power."*

– Chris Williamson, Chief Business Economist at IHS Markit

The President says it's 'bad management' and not the tariffs that are undermining business sentiment. Try telling that to Deere and Best Buy, last week's two casualties – cutting their profit estimates and making it very clear as to why.

WHAT IS TRUMP'S GOAL?

First, to be clear, I think China is a despicable communist regime with a record of human rights abuses, but that's what makes it a rather perfect distraction for Americans**.** I'm reminded of the war fever against Iraq after 9/11, and how so many bought into the claim of Iraqi involvement and the lies about WMDs. We don't like dictators, and we don't like China, but many are being duped into thinking the trade war against China is an ideological crusade that will lead to a better America, or a better world.

So, what is the goal of this trade war?

Is it to fill the U.S. coffers with tariffs paid by China?

He does like to talk about the tens of billions being collected.

Well that's not how tariffs work. When a tariff is paid to the U.S. government it is paid by the company that imports the product. This increases costs for U.S. companies which either absorb the tariff or pass it onto the U.S. consumer. Either way, it is a tax on a U.S. business or U.S. consumer.

Is it to reduce the U.S. trade deficit?

Well tariffs won't do that because the production will simply be moved to other low-cost countries. No company is going to bring its factories to the U.S. when they can build in Vietnam, Taiwan, etc. In many cases, it is cheaper to ship raw materials and products to these countries, have them finished by workers in Asia and then have the items shipped back, than it is to build the product from start to finish in the U.S. The deficit remains, just with countries other than China. So, U.S. business and consumers are paying taxes to change which country the U.S. has a deficit with.

We can talk all day about patriotism, but in the end the average American is not going to buy "Made in USA" for most goods out of a sense of patriotic duty if the price is twice as much or more. Walmart and Amazon dominate the retail market for a reason – they sell things cheap.

Is it to create jobs in the U.S.?

Well tariffs won't bring many jobs home. Trump is already claiming that many companies are moving production out of China to other countries. So perhaps Trumps goal is to tax U.S. companies and consumers to create jobs in these other countries.

Is it to prevent China getting technology transfers?

Many companies want to do business with China. Some of them willingly sign technology transfer agreements as a trade-off to get access to the Chinese market. It is difficult to see how Trumps tariffs will change the behavior of independent companies who see this as an acceptable practice. So again, U.S. consumers and businesses are paying taxes to try to change how some companies operate.

Is it to return the U.S. to the glory days of the 1950s when U.S. manufacturing was the envy of the world and poorly educated / low skilled men could get a good paying manufacturing job that was protected by a union?

Well those days are gone. Manufacturing jobs have been automated to the point where (like farming), you don't need many workers to produce a lot. This automation means that businesses will decide to open new manufacturing facilities closer to where the product is sold, in order to reduce shipping costs. This will bring a tiny number of manufacturing jobs back to the U.S. But manufacturing is a sector that is going to contribute a smaller and smaller percentage of the overall job market. Tariffs will not change this long-term trend in the decline of manufacturing jobs.

Further, if Trump had really intended to bring factories back to the U.S., he should have given corporations tax break incentives in exchange for creating manufacturing jobs on U.S. soil. Instead, he gave corporations tax break incentives for nothing.

In summary, we've been hearing this for well over a year and a half now. Trade wars are "easy to win", right? Every couple of months the trade war deal hype is recycled and every couple of months the markets are hit with renewed disappointment. The latest trade talks are set for October and if they happen at all, it is unlikely they will result in anything of significance. At most, they will be heralded as the "start of a great deal" and both sides will claim "progress was made" and then, once again, nothing will happen, and the conflict will accelerate. You would think people would have figured it out by now, but the investment world learns very slowly and functions solely on blind hope.

Bottom line: Trump is disrupting supply chains that have taken decades to build. All this is doing is creating additional costs for everyone.

JOBS SLOW

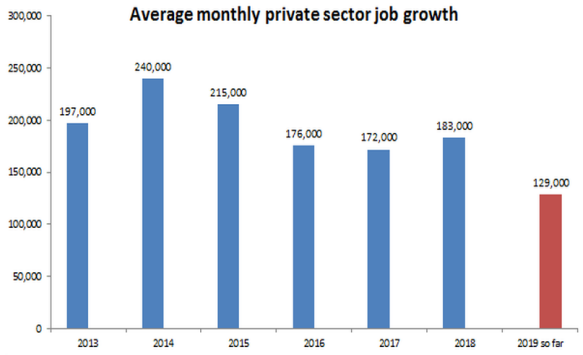
The Employment Report for August showed that the impact of the U.S.-China trade war is not limited to manufacturing activity and business investment. Nonfarm payroll growth slowed down to 130 thousand in August from 159 thousand in July (revised). And this is including 25 thousand census workers boosting federal employment. Otherwise, nonfarm payroll growth would have been only 105 thousand.

Also keep in mind that the fictitious 'birth-death' model added 65 thousand to the headlines the underlying figure was closer to 65 thousand. There were also downward revisions of 20 thousand to the prior two months – so in actuality, the 'real' number here was +45 thousand. That indeed is borderline recession.

Private payrolls, the surest reflection of the real economy's strength, came in at a whopping 96,000 in August. This was the fourth lowest private jobs print in the past three years.

Smoothing out the monthly noise, this gauge has slid from an average of 129,000 over the past three months, 165,000 over the past 12 months and 215,000 in 2018. Powell graded this clear trend as indictive of the labor market being in "quite a strong position." Say what?

Private Sector Jobs Slow



Source: Bureau of Labor Statistics

With employment growth weakening, and business investment and manufacturing activity declining, the escalation of the U.S.-China trade conflict is a threat to the economic expansion. In fact, a deterioration in the labor market could hurt consumer spending, bringing us closer to a recession.

Meanwhile, average hourly earnings growth slowed down to 3.2% from 3.3% in year-on-year terms. But in month-on-month terms there was an acceleration to 0.4% from 0.3%. However, this is not enough to avert the Fed's next rate cut.

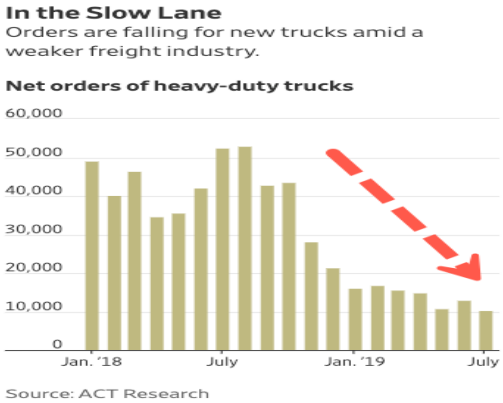
Year-on-year this is still a wage growth rate that the Fed back in 2015 imagined at the start of the hiking cycle, rather than after the end of the cycle.

While the Household survey showed a different, and more constructive, headline at +590 thousand, this seemingly bullish number was blunted by the fact that those working part-time for economic reasons soared 397 thousand, or 10%, on the month. This doesn't tend to happen in a solid economic backdrop.

There were some bright spots for the consumer in this report even with the slowing in the pace of job creation. The labor market remained tight with the U-3 jobless rate stuck at 3.7% for the third month in a row. While the U-3 unemployment rate was a nice number, at the margin, the broader U-6 jobless rate ticked up in August to 7.2% from 7.0%. So, there is some non-confirmation here.

Manufacturing employment was virtually unchanged and the recovery in hours worked was washed out by the decline in overtime (to a 28-month low of 3.2 hours, from 3.3 hours in July and 3.4 hours in June). The impacts from the spreading demand downturn abroad, the strong dollar and the disruption to global supply chains from the trade war have visibly impaired industrial activity – which is in a recession of its own.

Not just manufacturing, but transportation services as well — employment in the trucking industry fell 4.5 thousand, and rails slipped 0.6 thousand and has contracted for seven consecutive months (for a cumulative 10.7 thousand drop). This hasn't happened since the spring of 2016.



Source: ACT Research

But the big surprise – or perhaps not – was retail, where the Amazonification of America is accelerating, in the process destroying the legacy brick and mortar sector, which peaked in January 2017, and has lost jobs for seven consecutive months, and eight of the past nine, as the legacy retail sector is getting gutted.

The Amazonification of America

Source: Bloomberg

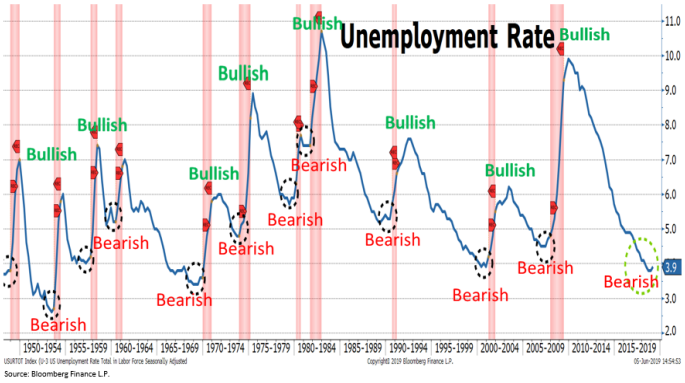
COMPANIES ARE SLOW TO FIRE

Unemployment is a lagging indicator. It tells us nothing about the future. In fact, it is counterintuitive because low unemployment suggests that the economic cycle is coming to an end.

Signs of a shift in the unemployment trend are key to watch at the end of a cycle and without doubt, employment growth has slowed in 2019. Get a couple bad job reports and the trend shift may come a lot sooner than people expect. Certainly, Friday's disappointing jobs report sends a further warning signal on this front.

But it hasn't turned yet and that keeps hope alive of course but note the shift to a change in trend is precariously close. As you can see in this graph, every time the unemployment rate has declined to such low levels it does not stay low for long and a recession follows.

Watch for a Trend Reversal

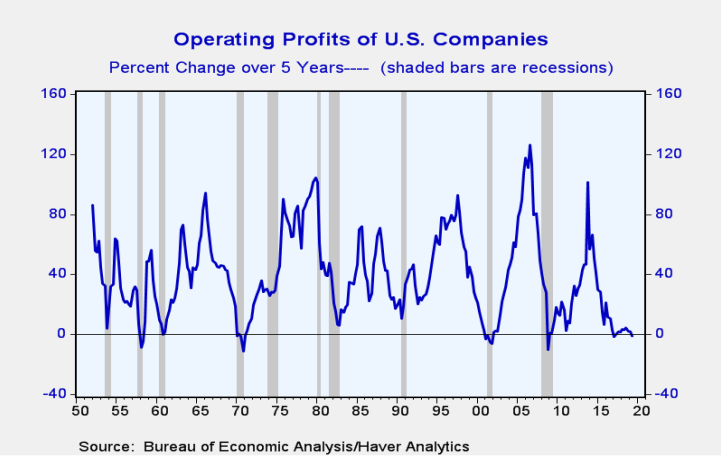


Source: Bloomberg

EARNINGS RECESSION

Of all the real economy indicators pointing to the potential of recession, the profit data are the most telling because businesses need earnings and cash flow to sustain existing operations (payrolls, rents, inventory, etc.) and to meet hefty debt obligations. And don't look now but corporate profits – despite the massive corporate tax rate cut – have been flat to slightly negative now for the past five years, while profit margins have plunged to the lowest level since 2010. The flat

trend in profits and the long slide in margins have important economic consequences as both have ***always*** preceded recessions in years past.



Source: Bureau of Economic Analysis/Harver Analytics

A "true" earnings recession appears to be in train, with the potential to trigger cuts in investment and inventories. Companies will then resort to layoffs quickly when revenue shrinks, because they will have little else to cut. And then consumer spending will decline. That's the standard sequence of events following a downturn in corporate profits.

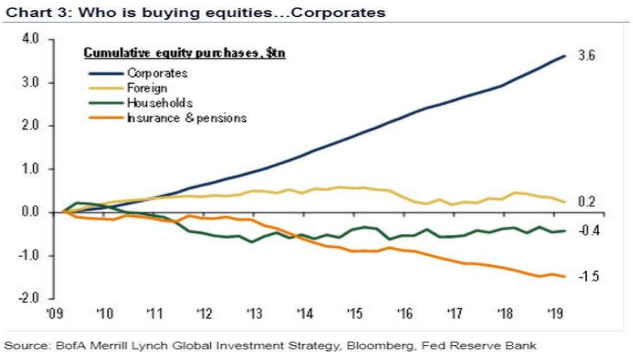
To be fair, the economy has not been, nor is it currently in recession, based on the GDP figures. Nonetheless, the profit and margins data show how vulnerable the economy is at the present time, especially with business leverage at record highs.

SO, WHO IS BUYING STOCKS?

"Stock buybacks enrich the bosses even when business sags."

The sole buyer of U.S. stocks remains corporate buybacks. Why this rush by companies to buy back their own stock, and in the process artificially boost their earnings per share? There is a very simple reason: s**tock buybacks enrich bosses even when business sags.**

Who's Buying Stocks?



Source: BofA Merrill Lynch Global Investment Strategy, Bloomberg, Fed Reserve Bank

According to various estimates, the outstanding share count for the S&P 500 declined by over 5% in the past 12 months or so. This is notable not only because it means that without the buyback bid (made possible by record cheap debt, which is used to fund corporate stock repurchases) stocks would be far, far lower. The reduction in the share count made the year-on-year earnings per share gains paint a more optimistic picture than what was actually occurring. With the benefit of the tax reduction in the rear-view mirror S&P earnings will now be more aligned with the current state of the economy. That creates the potential for an increasing number of corporate earnings reports disappointing relative to market expectations. Question: When will investors open their eyes to the earnings trend in corporate America?

MARKET OUTLOOK AND PORTFOLIO

"The most likely outlook is still moderate growth, a strong labor market and inflation continuing to move back up… Our main expectation is not at all that there will be a recession." – Federal Reserve Chairman Jay Powell

Jay Powell said last Friday that the Fed doesn't forecast a recession. What else do you expect him to say? Be serious. No Fed Chair will ever go out in public and forecast a recession. It's an exercise in shoring up confidence. This is the truth: The Fed has never forecasted a recession, even after they have started. It reminds me of Bernanke's quote at the beginning of this missive.

Meanwhile HOPE prevails:

- Hope that central banks can save the world by once again going on another intervention cycle, hence I've stated numerous times no bull market without central bank intervention.
- Hope that the European Central Bank (ECB) will bring out the bazooka next week and re-introduce quantitative easing and cut rates to further negative.
- Hope that the Fed cuts more and more and stays beholden to markets and makes record loose financial conditions even looser.
- Hope that the U.S. and China agree to a trade deal even though both sides remain far apart on core issues.
- Hope that the global slowdown and emerging earnings recession prove temporary and can be fixed by central bank intervention.
- Hope that the yield curve is sending a false signal**.**

<u>While we all HOPE that the economy avoids a recession, HOPE is not a good investment strategy.</u>

Advice: 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 housing, manufacturing, earnings and capital spending.

Source: Hedgeye

The U.S. consumer is almost tapped out. While retail sales in certain areas remain steady and this has been used by the media and the Fed to promote the idea that the economy is still "going strong", this is not the big picture. The reality is that U.S. consumption is driven by historic levels of debt. Household debt is now FAR above levels last seen after the last financial crisis, with total debt at $1.2 trillion higher today than its last peak in 2008. Imagine what happens when layoffs commence, and unemployment begins to rise.

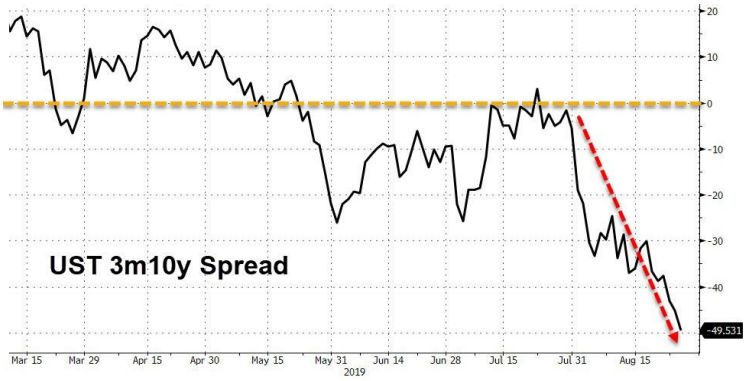
As for those yield curve naysayers, the "it's different this time" crowd, in purely friendly financial literacy fashion, we've added the 3-month/10-year curve. Every time – yes, 100% of time – this curve has inverted and stayed inverted for three months a recession has followed.

The Fed is downplaying this signal because quantitative easing is supposed to be distorting the yield curve. I'm sticking with the yield curve. In other words, this time is not different.

The inversion of the yield curve points to a recession in 2020. I expect the Fed to cut rates by at least 25 basis points at the Federal Open Market Committee (FOMC) meeting on September 18. What's more, I think rate cuts will continue. In fact, if we have a recession in 2020 the Fed will go all the way back to zero next year.

In terms of portfolio strategy, credit unions should reduce excess reserve and focus on the "belly of the curve." I still love bonds, but the best value may be in the short to intermediate end of the curve right now. While the long bond has made new yield lows below 2.0%, the five-year has lagged and, at 1.4%, has a long way to go before retesting the all-time low of 0.53%.

100% of the Time



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.