BALANCE SHEET SOLUTIONS
an alloya company

WEEK OF SEPTEMBER 16, 2019

Weekly Relative Value

It's Not as it Appears

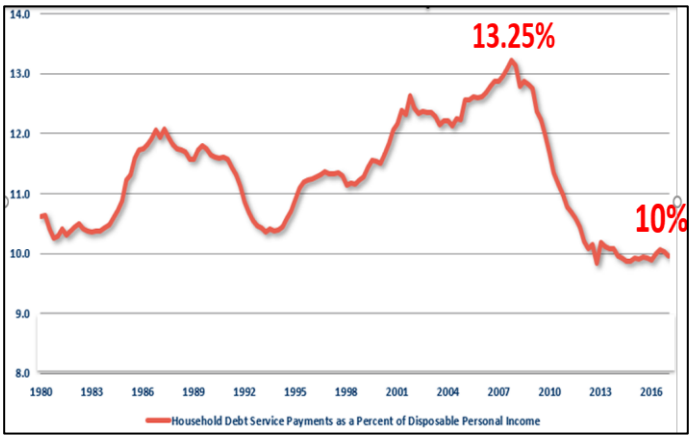
"Lies, damned lies, and statistics." – Mark Twain

On the surface the consumer has deleveraged with household debt as a percentage of disposable income declining from the highs of 13% in 2007 to 10% today. But as Mr. Twain quips, statistics can be very misleading.

Lumping all American households in one basket gives a false signal of financial health. If we look at averages, debt levels are reasonable, incomes are notching higher and so expectations of rising household debt and spending are reasonable.

But this grossly distorts reality: only the top 20% are creditworthy and have rising incomes; the bottom 80% are over-indebted, poor credit risks and their income is stagnant and/or precarious.

Household Debt as % of Disposable Income



Source: Federal Reserve

The distribution of wealth has deteriorated significantly over the past 20 years and is now so skewed toward the top that average U.S. household wealth is close to $1 million, though the median household wealth is only around $70,000.

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

SUBSCRIBE

THIS WEEK

- DEBT AND DEMOGRPAHIC DEAD ENDS
- FREE STUFF
- RECESSIONARY SIGNS
- TWEET OF THE WEEK

PORTFOLIO STRATEGY

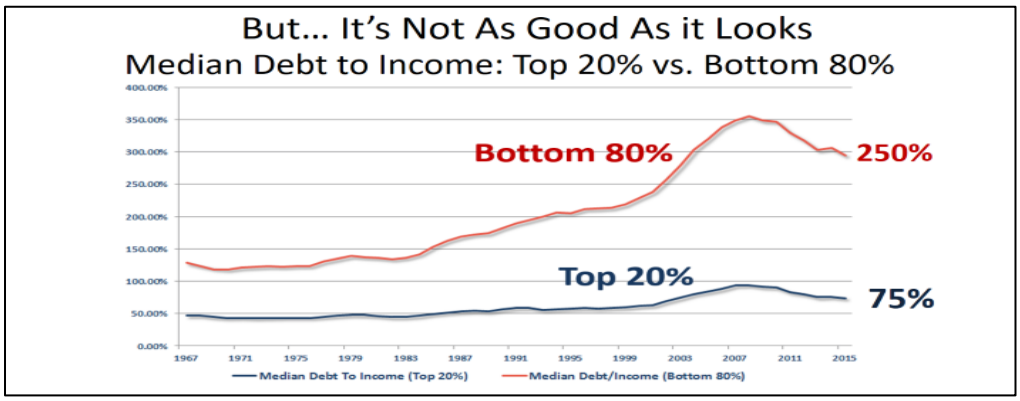
-

In fact, the **aggregate level of wealth** of the bottom 50% peaked in the first quarter of 2000, the height of the dot.com bubble, and is down almost 10%. Whereas the aggregate wealth level of the top 1% is up almost 120% over the same period.

Another under-appreciated reality is the top 20% of households have much lower levels of debt (relative to their income) than the average middle-class household. There is a vast difference between the level of debt for those in the bottom 80%, versus those in the top 20%.

The top 20% of Americans tend not to carry large balances… but the bottom 80% of Americans do. Many Americans live day-to-day and rely on debt to make ends meet. Thus, those in the bottom 80% are still having a large chunk of their disposable income eaten up by debt payments. This reduces discretionary spending capacity even further.

The consumer is already heavily leveraged, and with stagnant wage growth, the capability to increase consumption to foster higher rates of economic growth is limited. This data put the current political climate and debate around debt forgiveness in context. They also reflect the two-speed U.S. economy.



Source: Real Investment Advice

Those who want to borrow more are poor credit risks while those who are creditworthy don't want more debt, regardless of how low interest rates fall. If we set aside the top 20% of households and focus on the creditworthiness and precariousness of the bottom 80%, we get a much more accurate picture of debt saturation.

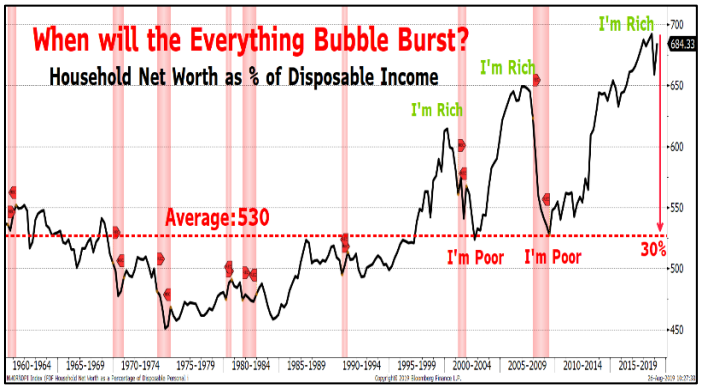
Despite the massive wealth inequality, the top 10% of households – a mere 12 million households – are also precarious, as much of their wealth and income is based on overvalued asset bubbles in stocks, bonds and real estate. We seem to be near the top of the "everything bubble." Almost nothing is cheap… anywhere. These markets are so artificial. There's no honest price discoveries or supply and demand; nobody's discounting the future of economic growth, productivity and investment. They're just chasing what the central banks are doing. Everything's overpriced right now because of this huge financial distortion. You've got the chart monkeys, 29-year-old day traders who are in charge of the market.

U.S. household wealth recently hit a record of **535% of the GDP,** while the historic average since 1952 is **384%.**
The **wealth effect** fuels their free-spending ways (recall that the top 10% collect roughly half of all income and account for almost half of all consumer spending).

So, the wealth effect is real for 10% of households. But, here's the rub. When U.S. household wealth reaches an extreme relative to the underlying economy or GDP (as it did in the prior two bubbles), a mean-reversion or a correction is in the cards. As the asset bubbles pop, the reverse wealth effect kicks in. Once households feel poorer, they tighten their borrowing and spending.

If the S&P 500 drops by 20-30%, the corporate C-suites will wake up like they did in October 2008 and say, "we've got too much inventory, we've horded too much labor, and we've got a lot of assets that aren't producing returns." And then they go into these big restructuring programs where they lay off workers by the tens of thousands and take huge write-downs, close facilities, and so forth. The next thing you know, you have a C-suite-triggered recession. That's how it happens these days.

Here's the point: Recessions don't happen because the Fed is tightening credit costs for Main Street. That's your grandfather's economy and your grandfather's Fed. But we're now in the era of bubble finance. The Fed basically inflates the financial system until it collapses, and then it spills over into the mainstream economy through corporate C-suite panics.



Source: Bloomberg

I don't know when it will happen. It could happen before November 2020 or after. No one can really predict. I remember in the spring of 2008 they were still talking about the Goldilocks economy. And in November 2008, they were talking about the end of the world.

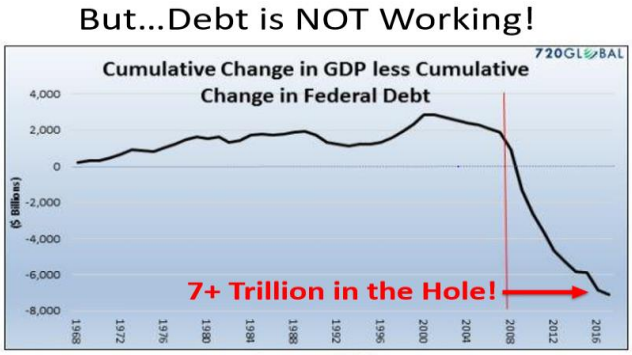
Here's my prediction: If the stock bubble bursts before the 2020 election, Trump will lose. Elizabeth Warren will be the next President of the United States. And if the stock market is faltering or it has crashed and the economy's in trouble, you'll have a populist, redistributionist, big government statist president and Congress. Think about that!

DEBT AND DEMOGRAPHICS DEAD END

We are fiscally bankrupt. The official debt of the U.S. government is $22 trillion. That's what the first 44 presidents in American history have managed to accomplish — including the last two before Trump, who took it from about $4 trillion to $19 trillion. But this is the killer. The real debt of the country today is not the $22 trillion that's on the books. That's backward looking. It's really $42 trillion. That's because we have $20 trillion more baked into the cake under almost any scenario you can look at over the next decade.

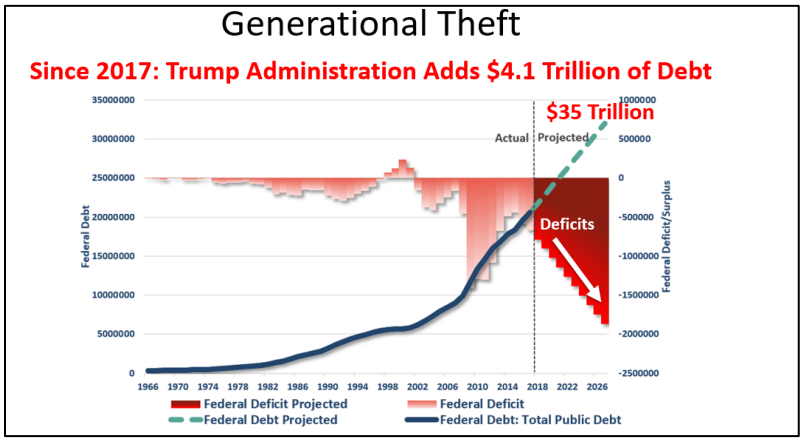
You "might" be able to justify this multi-trillion-dollar debt binge *if* growth was accelerating. But what if it was merely allowing us to run in place? Or, heaven and earth forbid, it was actually retarding growth? In fact, in the past decade, there has been a NEGATIVE correlation between the federal debt-to-GDP and real economic growth to the tune of -22%! As shown above, debt has outpaced growth (GDP) to the tune of $7 trillion since 2008. The mushrooming of government debt inhibits economic growth by pulling resources away from the far more productive private sector and transferring it to the public sector. Yet, we are doing more of what's failed for 10 years. This is the definition of insanity.

With Trump's recent budget deal with the Democrats, the last semblance of financial responsibility in U.S. politics — which was a charade anyway — is explicitly dead. The deal was an abomination. It added $1.7 trillion more to the debt over the next 10 years. It eliminated entirely these spending caps that we've had since 2011. The U.S. is headed for record deficits under Trump. The federal government just announced that its deficit for the 11 months of fiscal year 2019 was more than $1 trillion or more than 4% of GDP, a deficit normal during recessions, but not in the eleventh year of an expansion. Never before has this happened in a sub-4% jobless rate environment. Ten years into the expansion, and government spending (+7.0% year-over-year) is running at more than double the pace of revenues (+3.5%) ...you know, the tax revenue that was to offset the tax cut from the "economic boom" that never materialized.



Source: 720 Global

Amazingly, Trump is now hinting at a middle-income tax cut for 2020, which will just blow a further hole into the fiscal deficit that nobody, not even the Tea Party, seems to care about any longer. An election must be around the corner.



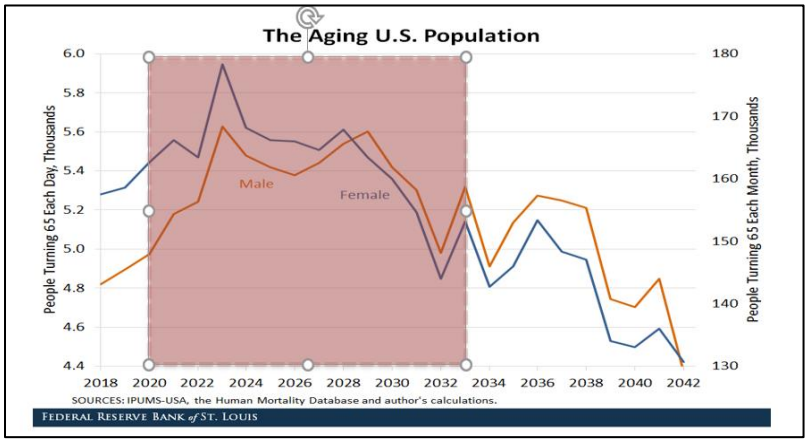
Source: CRFB

But the more important point is that deficits at the top of the longest business expansion in history are an absolute abomination. After 10 years of economic growth, debt and deficits should be small and declining. Instead we have record debt and deficits that are rising.

Even Keynes himself said that when the economy is doing well or near the end of the business cycle, you have to reduce the deficit and even run surpluses. In other words, save for a rainy day! Well, at the time when you're supposed to be reigning things in, the President has actually pushed the deficit over the trillion-dollar mark.

This is the very worst time for massively increasing the structural deficit because we're entering the 2020s when all 80 million baby boomers are going to retire. We're going to be having 10,000-11,000 retirements a day for most of the

decade. And by the end of the decade, there will be 80 million more people on Social Security, Medicare and Medicaid. The cost of the welfare state is going to soar even as the political environment will become totally nonfunctional, because no one wants to pay more taxes or cut spending.



There is no meaningful force in U.S. politics that could reign in the out-of-control spending**.** There's just no give anywhere, not on taxes, not on defense spending, not on entitlements, not on the entire welfare state. What do you think the implications of these political trends are for the future of the country?

We're in a demographic and fiscal dead end. It's a very dangerous prospect and one with no obvious answer on how to escape.

FREE STUFF

Despite this troubling fiscal backdrop, never before have so many politicians promised to spend so much. Among some candidates, the 2020 presidential campaign has turned into a contest to see who can offer the most "free stuff."

Source: John Stossel

The top three Democrats, Kamala Harris, Bernie Sanders and Elizabeth Warren are duking it out for the "Free Stuff Blue Ribbon." Kamala Harris currently is in the lead topping the $4 trillion mark. Bernie Sanders is in second place at $3.976 trillion. Elizabeth Warren is a close third at $3.806 trillion. But it's a close race and the numbers are

guaranteed to go up. Joe Biden is not even in the race. He only seeks an additional $297 billion, not much more than Trump at $267 billion.

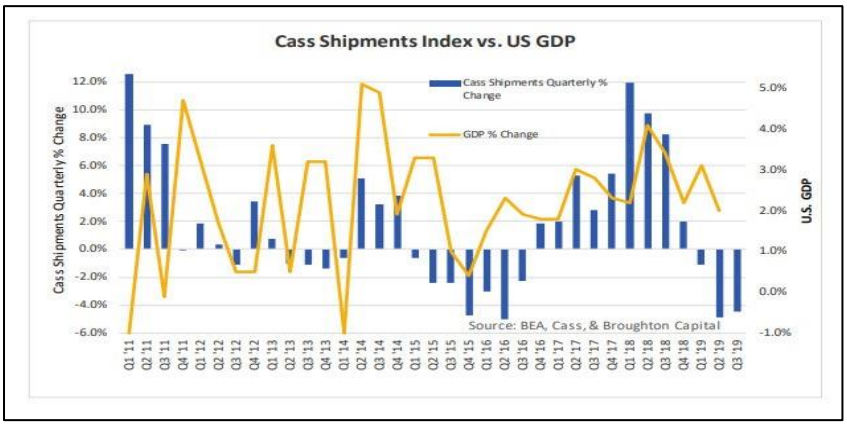
Free healthcare for illegal immigrants? Reparations? Universal basic income? Student debt forgiveness? But wait... who is supposed to pay for all this free stuff?

Source: Cagle Cartoons

RECESSIONARY SIGNS

Maybe the shipping and retail sectors are incredibly robust on Sirius B, but here on Planet Earth the global economy is weakening, trade is stagnating, shipping is in recession, and retail sales and profits are stagnating.

The Cass Index tracks shipment volume by all modes of transportation – truck, rail, air and barge – of consumer and industrial goods but not of bulk commodities. Year-over-year freight volume is down nine consecutive months starting December of 2018. Those reported monthly drops are not what they may seem at first glance. They are year-over-year drops, not sequential drops. The report says, “another 3% in August.” It's really another month of year-over-year contraction.



Source: BEA, Cass

So, what does this mean for the economy?

According to Cass, a recession is on the horizon.

> *"Based on the trend since the beginning of the year, but especially the data over the last four months,* ***the Cass Shipments Index is signaling that GDP may be negative, or at least come close to being negative, in Q3.*** *If it does not, since reported GDP often lags the economic activity represented by freight flows,* ***continued weakness in the Cass Shipments Index at the current magnitude should result in a negative Q4 GDP."***

As shown above, the U.S. trucking industry had a blockbuster year in 2018, but since freight demand was artificial, sparked by importers pulling forward to get ahead of tariffs, the good times were destined to end and end rather sharply.

According to new data, the boom in trucking jobs could be over. More than 4,500 truckers lost their jobs in July and August as the freight industry continued trending lower. And in the first half of 2019, nearly 640 trucking firms failed. That equates to 20,000 trucks that have been pulled off the road.

And I've routinely pointed out that freight is a leading indicator of where the economy could be headed. At least 70% of domestic goods are moved on heavy-duty trucks, so when freight companies are cutting their workforce, it's typically the onset of an economic downturn.

Bottom Line: Nobody should be feeling too comfy over the fact that job creation in the transportation industry has completely vanished over the past six months. Transportation makes up a good chunk of GDP.

TWEET OF THE WEEK

> *"It is only the naïveté of Jay Powell and the Federal Reserve that doesn't allow us to do what other countries are already doing. A once in a lifetime opportunity that we are missing because of 'Boneheads.'" – President Donald Trump*

One day before the European Central Bank (ECB) cut rates further into negative territory and restarted quantitative easing, President Trump resumed his feud with the Fed piling more pressure on Fed Chair Jerome Powell to cut rates ***"to ZERO or less"*** because the U.S. apparently has "***no inflation,"*** while also saying the U.S. ***"should then start to refinance our debt. INTEREST COST COULD BE BROUGHT WAY DOWN, while at the same time substantially lengthening the term…"*** Trump's conclusion: *"It is only the naïveté of Jay Powell and the Federal Reserve that doesn't allow us to do what other countries are already doing. A once in a lifetime opportunity that we are missing because of 'Boneheads.'"*

What I don't know is just what school of monetary thought Trump belongs to because while on one hand Trump claims that "we have the great currency, power, and balance sheet" on the other the U.S. President also claims that "the USA should always be paying the lowest rate." In a normal world, the strongest economy tends to pay the highest interest rate, but in this upside-down world, who knows anymore.

MARKET OUTLOOK AND PORTFOLIO

Across the pond, the European Central Bank's official monetary moves this past week consisted of a 10-basis-point cut in its policy rate to -0.50%, and a resumption of the ECB's asset purchases of up to 20 billion euros ($22.15 billion) a month.

ECB President Mario Draghi also confirmed it is "Time for Fiscal Policy to take Charge," challenging governments with "fiscal space to act in an effective and timely manner." And rather than worrying that more eurozone borrowing portends a debt crisis, ECB purchasing should hoover up the bonds sold to cover deficits. Strip it to the core and you could argue all that's really happening is the ECB is printing lots of money for European states to juice their economies. This is modern monetary theory (MMT) in a nutshell. Basically, MMT would allow fiscal deficits to be financed by the central bank, with the constraint being when this debt monetization boosts inflation near an unacceptable level.

But here's the catch. Under the current charter, the ECB has now almost run out of bonds to buy, as an aside, before hitting its statutory limit... So, the central bank buys more bonds so governments can then refill the vacuum with some hefty debt-financed fiscal stimulus. This is when the government bond market rally reversed course.

Japan could also be ready to expand its fiscal stimulus after nearly three decades with the world's lowest interest rates, which have failed to end that nation's near economic stagnation and deflation.

The problem, of course, as we have already seen multiple times in Japan and more recently in the U.S., is that there is no multiplier impact (no follow-through, no lingering effects) of fiscal stimulus at these gargantuan public sector debt-to-GDP ratios. It's the Law of Diminishing Returns.

Be that as it may, the fact that Treasury Secretary Steven Mnuchin is talking openly about the introduction of a 50-year ultra-long bond has the markets thinking that the government is going to embark on a fiscal binge that would make Franklin Delano Roosevelt extremely proud. Though, for the record, the latter did have the Great Depression and World War II as his reasons.

Moving on, this week the Federal Reserve will hold its policy meeting. The federal funds futures market on Friday placed an 89% probability on a 25-basis-point cut. The new expected federal funds target range of 1.75% to 2% would put its midpoint even with the 10-year note's yield of 1.8%.

Moreover, the Fed already has stopped shrinking its balance sheet and will be buying more Treasury securities with reinvested interest and maturing issues. A resumption of active buying, aka quantitative easing, would seem likely in the next recession. All of which sounds as close to modern monetary theory as "damn" is to swearing.

And because of the risk of fiscal stimulus and debt monetization we have witnessed the steepest back-up in yields since they peaked late last year. By week's end, the 10-year Treasury note's yield was 1.88%, more than 35 basis points above its recent low. But please remember what has happened since last October. The 10-year Treasury yield has declined approximately 155 basis points!

While the bond markets have entered a hiccup phase, don't lose sight of where the economy is heading. The Atlanta and New York Fed district banks have both cut their third quarter real GDP growth estimates to around a 1.5% annualized pace, from 2.2% barely more than a month ago. Commercial and residential real estate are in a funk, CAPEX has collapsed, global trade is plunging, and employment has peaked. The New York Fed model pegs recession odds now at 84%, the highest it has been since we were actually in an official National Bureau of Economic Research-defined economic downturn just over a decade ago.

My advice to investors is to sit tight and let the market be your guide. Wait for signs that the upside yield pressure is reversing course, then dive back into the pool.

In terms of recommendations, we believe the five-year part of the yield curve offers an attractive risk-reward at current levels.

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.