BALANCE SHEET SOLUTIONS
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WEEK OF OCTOBER 7, 2019

Weekly Relative Value

The Cleanest Shirt Isn't So Clean

From Hong Kong to Japan to South Korea to Australia to New Zealand, growth continues to decline. And in Europe the macro news is even worse; the final manufacturing Purchasing Managers' Index (PMI) came in at 45.7 in September – the steepest decline in seven years. And most importantly, economic powerhouse Germany, is in a full-fledged industrial recession with its index slumping to a 10-year low of 41.7.

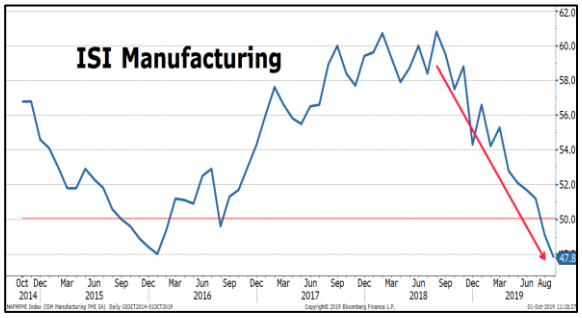
Now we go to the cleanest shirt in the laundry basket: the U.S. economy.

And it isn't so clean, after all.

Last week's shocking Institute for Supply Management (ISM) manufacturing print was the talk of the town. For background, the institute asks a sample of purchasing managers whether various indicators of business, such as new orders and employment, are better, worse or the same. From this comes a diffusion index that suggests the direction, if not the magnitude, of these trends.

And sentiment has turned decidedly negative. Indeed, the September ISM Manufacturing Index was at a decade-low print of 47.8 and also well below expectations for a 50.0 reading. (Numbers above 50 indicate expansion, while those below 50 indicate contraction.) While the headline was a shocker, the bigger story was the fact that only three of the 18 industries in the survey reported growth, the lowest figure since 2009.

Weakest ISM Since June 2009



Source: Bloomberg

Digging deeper, the ISM components were as horrible as the headline.

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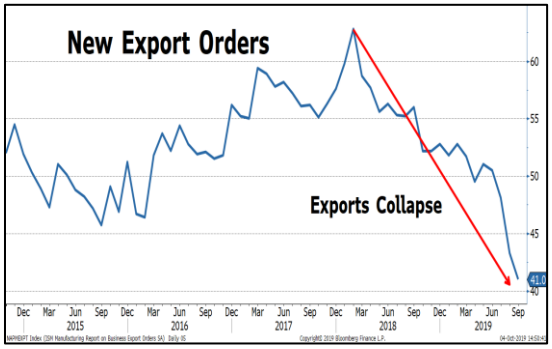
THIS WEEK

New orders stayed in contraction at 47.3. The last time it was lower was during the depths of the Great Financial Crisis in March 2009. Finally, since inception this index has only been lower than it is right now on six occasions.

Source: Bloomberg

And export orders have fallen to 41. Just over a year ago, export orders were hovering near 60.0. Once again, there are no winners from a trade war. We only see export data like this in the context of a global recession. And that's where we are.



Source: Bloomberg

While President Donald Trump was quick to put the blame on the Fed and impeachment proceedings after the ISM data were released, economists cited trade war uncertainty as the main reason for the slowdown.

And this is what U.S. manufacturers are saying:

- "Continued softening in the global automotive market. **Trade-war** impacts also have localized effects, particularly in select export markets. Seeing warehouses filling again after what appeared to be a short reduction of demand." (Chemical Products)
- "**Chinese tariffs** going up are hurting our business. Most of the materials are not made in the U.S. and made only in China." (Food, Beverage & Tobacco Products)
- "Economy seems to be softening. The **tariffs** have caused much confusion in the industry." (Electrical Equipment, Appliances & Components)

Regardless of whether the U.S. is headed for a full-scale recession, what is hard to argue with is that the global manufacturing sector is now very much in a recession.

As an aside, I hear all the time about how manufacturing is such a low percentage of the economy (8.5% of employment and 11% of GDP). In 2007 I heard the same thing and was told not to fret about housing because the sector is so tiny.

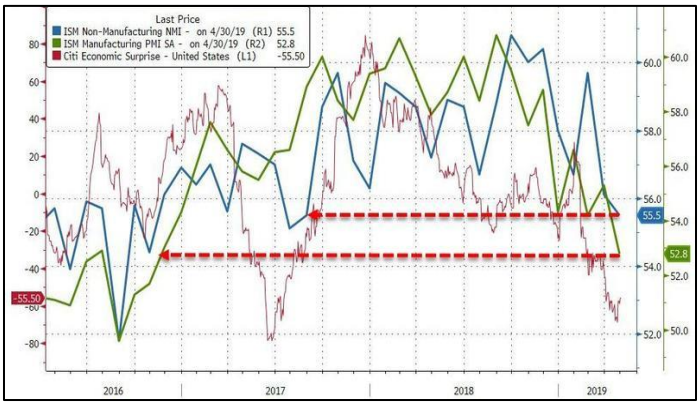
That is called looking at the trees and not the forest past the trees. Housing is a leading indicator and has powerful multiplier impacts. As we found out big-time.

The same is true for manufacturing. It is not about size; it is about the effects on the rest of the economy and the leading properties. You are dreaming if you think the services sector is immune. These same economists telling you about how the ISM survey is not signaling recession were the same ones telling you to dismiss the National Association of Home Builders' (NAHB) home builder sentiment index 12 years ago. Best to ignore them.

And sure enough, following manufacturing's collapse, the services sector slumped to its weakest since August 2017. In the latest sign of weaker economic momentum.

Under the hood, it's just as ugly with new orders and employment both tumbling**.** In the past two decades, when the ISM Non-Manufacturing Employment Index falls to 50.4, the Fed is easing. Furthermore, after the first NFP print, the data deteriorate rapidly. The main cycles featuring this phenomenon have been the Tech Bubble and the Great Financial Cycle. But there's probably nothing to see here, right?

ISM Service Sector… Weakest in 20 Months



Source: Bloomberg

JOBS GET A C+

The headline from the employment report was that non-farm payrolls rose by 136,000, a bit shy of consensus forecasts of 150,000, but that was after upward revisions totaling 45,000 in the two previous months.

Here's the thing: Of that +136,000 payroll gain in September, 63,000, or over 40% of the headline, came from the Birth-Death Model, even though incoming data show that the growth in new business creation has all but vanished.

The U.S. added 114,000 private payrolls, which also missed the 130,000 expectation, and was below the upward revised 122,000 in August (up from 96,000 previously). More importantly, the three-month average of private payroll gains dropped to 119,000, the smallest since 2012.

The only thing many will remember is that the unemployment rate fell to a new low of 3.5% after stabilizing at 3.7% in each of the prior three months. This is the lowest jobless rate since December 1969. And sure enough, Trump wasted no time to bask in the near record low unemployment rate, tweeting:

"Unemployment Rate, at 3.5%, drops to a 50 YEAR LOW.
Wow America, lets impeach your President (even though he did nothing wrong!)" – President Donald Trump

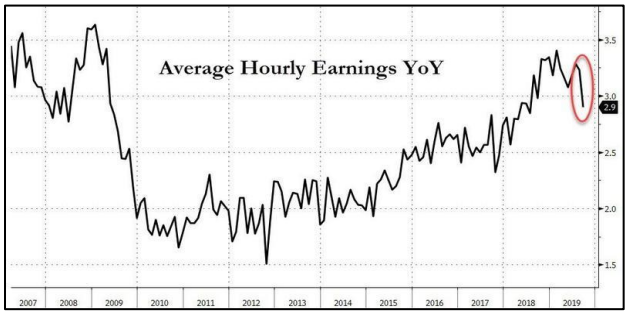
However, before we celebrate the last time unemployment was so low (in 1969) a recession began a month later, in January 1970. Further, while September's unemployment rate hit a 50-year low, the internals of the job report were less headline-worthy; 46% of industries saw contracting worker payrolls. Maybe best to put the cork back in the champagne bottle.

Unemployment at 50-Year Low

Source: Bloomberg

Also, worth noting, high-paying job growth is at a three-year low and accounted for 56% of private sector job creation these past seven months compared to 63% in the 19 preceding months, which featured stronger private sector gains. These dynamics explain falling average weekly earnings growth. Earning grew 2.9% year-over-year, far below the 3.2% in August. All this happened as the average weekly hours-worked remained unchanged at 34.4. So, despite a near record low unemployment rate (and continued payroll growth), wages rose at the weakest pace in more than a year. Of course, the lack of wage growth means that the Fed can now go ahead and cut rates even more.

Wage Growth Slows



Source: Bloomberg

Looking at the composition of the report, manufacturing fell by 2,000 jobs, while service providers added a four-month low of 109,000 jobs; and while leisure and hospitality workers added 21,000 jobs, a six-month high, retailers cut jobs for

an eighth consecutive month. Most notably, since reaching a peak in January 2017, retail trade has lost 197,000 jobs. Thanks Amazon.

Bottom line: For those who believe that +136,000 means the recession isn't coming, I have news for you. The historical record shows that, on the eve of the recession, the median payroll gain was 154,000 and the average was 89,000. That's why employment, for an investor, is a lagging indicator.

The employment report, in other words, did not spin the dial in favor of the bulls, no matter what they may say about the data. Nor will the Fed be deterred from cutting rates at the end of the month, and beyond. Even if you believe the headline, the lack of wage growth is going to be a big problem for the consumer heading into the holiday shopping season, even with the delayed tariffs (which I am sure will get delayed again).

DID YOU KNOW?

I probably don't have to explain why so many Americans have to resort to debt just to buy a car: the reason is simple – less than one in five U.S. households have enough liquid assets to cover the cost of a new car.

And thanks to a new menu of loans, people can get into very expensive cars. Households are taking on, on average, more risk. Incredibly, roughly one-third of new vehicles sold in the first half of 2019 were for terms longer than six years. A decade ago, that number was 10%. The average loan now stretches out to an amazing (record) 69 months and it is becoming more common now to see 85-month terms or longer (these never existed before).

All this means is that more car buyers won't pay off the debt before they trade in their car for new ones. About 33% of new car buyers who trade in their cars, rollover debt from old vehicles into their new loans, according to Edmunds. That is up from about 25% before the financial crisis.

In sum, Americans now have a total of $1.3 trillion of auto debt on the liability side of their balance sheet that compares to $740 billion a decade ago. Yet another in the long line of low-quality economic cycles built more on leverage than on productivity.

And debt is not being used just for cars. Millennials are now putting everyday items, like shoes and sweaters, on payment plans. Yes, installment plans and layaway – constantly the butt of jokes for those who were always far too broke to afford whatever they were buying – have now become an everyday reality. But not for big ticket items, for everyday purchases, like shoes.

THE RISE OF ELIZABETH WARREN

The Ukraine fiasco and the telephone call (remember, for Nixon it was just a tape!) has likely torpedoed both President Donald Trump and 2020 presidential hopeful Joe Biden in one fell swoop. Donald has been an unabashed cheerleader for the stock market and Biden is the only moderate candidate in the running in the Democratic race who has a chance at the nomination.

Ahead of this week's trade negotiations, it appears that Chinese officials are signaling their reluctance to pursue the broad deal that President Trump is seeking. In other words, narrowing the scope of what's to be on the table, and I'm sure intellectual property is not going to be one of the bargaining chips on offer. Maybe a sign that Beijing is going to look at Mr. Trumps impeachment headache as a problem and perhaps in their eyes, dealing with a lame duck (especially with more whistleblowers surfacing). Or they simply think that he needs a big win and will settle for anything. Imagine if helping the Trump team dig up dirt on Joe Biden makes it on the agenda! The White House press secretary stating that

he has done nothing wrong reminds me of *I did not have sexual relations with that woman* circa January 1998 by one former President who thought he did nothing wrong, and *I am not a crook* circa November 1973 from another. Things promise to get even more interesting.

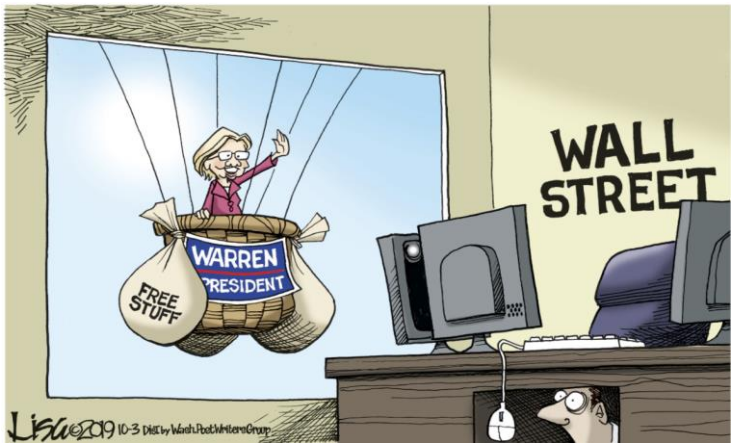
So… for equity investors whose attention is consumed right now with trade issues and China, as well as the litany of global concerns cited above (did I mention the message from the level of world debt that is priced with negative yields?), the number-one issue should actually be the rising prospect of an Elizabeth Warren presidency coupled with the House staying Democrat and the Senate flipping the same way.

Warren may claim that she is not a socialist, but her policy platform sure walks and talks like that duck between Medicare for all, a boost to top marginal tax rates, hikes in capital gains and dividend taxes, and a wealth tax on top of all those other revenue-raising measures.

So just as Bernie Sanders has said he does not want there to be any billionaires in society, Elizabeth Warren has made it very clear that she is no friend of the equity market.

Investors have to start paying attention to her polling numbers and to more than just the ISM and employment reports, because her success will undoubtedly overhaul the economy and redistribute income and wealth that will impair how investors value equities as an asset class. Perhaps investors are waiting for the primaries to actually start before giving this the attention it deserves. My advice is to get ahead of this file and not to wait.

The Rise of Elizabeth Warren



Source: Cagle Cartoons

WHAT IF?

These days, we measure our net worth by the value of stock portfolios. At $113.5 trillion, U.S. household net worth as a percentage of income hit 692% in the second quarter. With stocks within a whisper of all-time highs, it's possible we see this metric cross the 700% line in the quarter. That would mark a record high.

While that sounds like it would be great news, it's actually the opposite.

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 shown on the graph above, since 1960 the historical average is 530%. If markets revert to the mean, the S&P could lose 30% of its value.

Source: Bloomberg

One thing is for sure an S&P 500 trading with a 19x P/E multiple on trailing earnings and 16.7x on forward is not a market remotely close to pricing in a recession, even though those odds are the highest they have been since the last downturn just over a decade ago.

If you want to know how low that multiple can go in a recession, try 14x-15x, which actually represents the highest trough in past economic contraction phases, and then tack on a typical 20% decline in earnings. That would hurt!

And imagine where bond yields would go in that environment try sub-1% for the 10-year T-note with ease. And if we have a recession, the decline could be even greater.

Remember: markets typically overshoot to the upside and downside.

So how would a bursting of what has been called the “everything” bubble impact the economy?

The bursting of the bubble would reverse the so-called wealth effect. And Americans would end up consuming less, which in turn could drive the economy into a tailspin.

Think about it this way: The top 10% own 80% of stocks and the top 10% account for 50% of consumption.

Remember that when the next time you hear that a fall in stocks won’t hurt the real economy because only about half of Americans own stocks.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

We learned last week that the recession in manufacturing (ISM manufacturing PMI at a 10-year low) is spreading to the service sector (ISM non-manufacturing PMI at a three-year low).

We also learned how the foreign economy is having its impact on the U.S. economy with the trade deficit in August widening to a three-month high of $54.9 billion. The trade balance does not appear to be very supportive for third quarter growth and at a time when the data point to an inventory reversal, which sets us up for a very soft GDP performance of little better than a 1% annual rate.

We found out that the slump in capital spending plans is now infecting hiring intentions. The reality is that private sector payrolls have gone from averaging 181,000 in the past 12 months, to 119,000 in the past three months and is now down to 114,000 as of the very latest month. The pattern of a growth downturn is unmistakable.

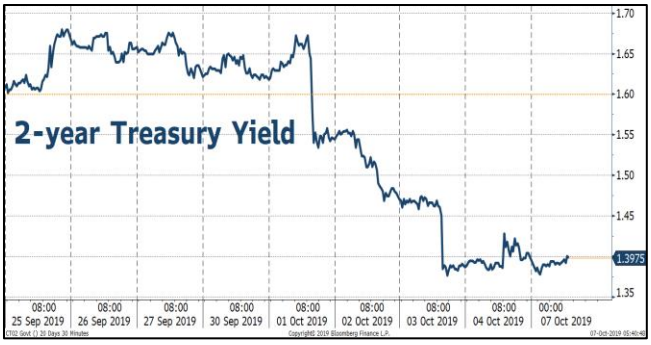
And yes, we found out that Germany is in recession. GDP contracted in the second quarter and all signs point to the same for the third, so the world's fourth largest economy is in an official downturn. It won't be alone, that much I can tell you.

As we enter the final – and historically, most turbulent-quarter of the year – growth has been slowing from the lagged effects of previous Fed tightening, as well as the negative impact of the contraction in global trade resulting from the trade war between the U.S. and China.

The ISM data last week touched off a resumption of the bond rally and raised the odds that the Federal Reserve will lower short-term interest rates at the end of October.

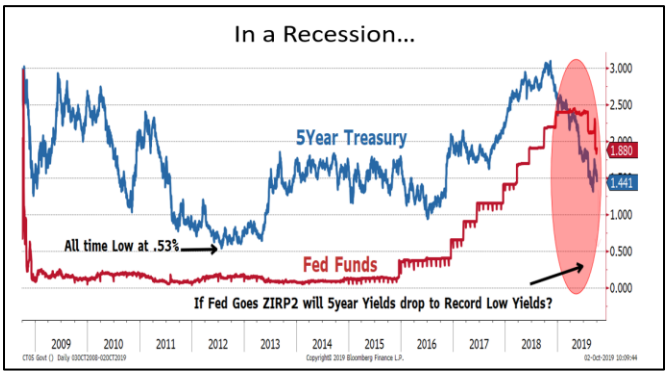
After last week, the Treasury two-year note yield is not where the central bank is, but where it's headed. And last week the two-year yield plunged 25 basis points to 1.40%

The Two-Year Treasury is Telegraphing Lower Rates



Source: Bloomberg

The probability of a quarter-point cut in the fed funds target, currently 1.75%-2%, at 77.5% on Friday, is nearly double that of a week earlier. The odds of an additional quarter-point cut are slightly less than even money at the December Federal Open Market Committee (FOMC) meeting, but rise to better than 2-to-1 at January's Fed gathering.



Source: Bloomberg

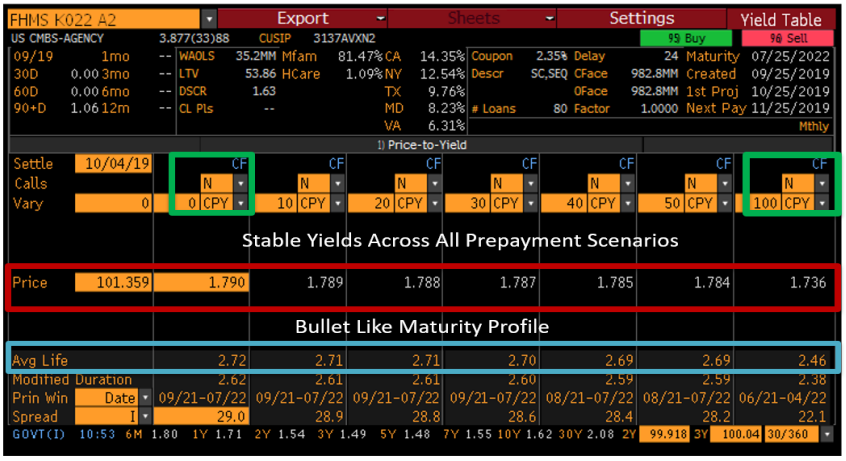
In terms of positioning, we continue to believe the five-year part of the yield curve offers the most attractive risk/return trade-off. Even if we do not end end up in a recession, yields are likley to remain relatively low as the Fed remains accomodative.

And if a recession rears its ugly head and the Fed does what I expect (a return to ZIRP2) then five-year yields could approach the all-time historical low yields of 0.53% seen in 2012.

Time to lock in higer yields before they melt away.

In terms of relative value, we believe the CMBS sector offers an attractive alternative to traditional agency bullets. As shown below, select CMBS (Freddie Ks) offer a yield pick-up over agency debt while providing protection against declining rates.

Why Freddie K's



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

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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.