BALANCE SHEET SOLUTIONS
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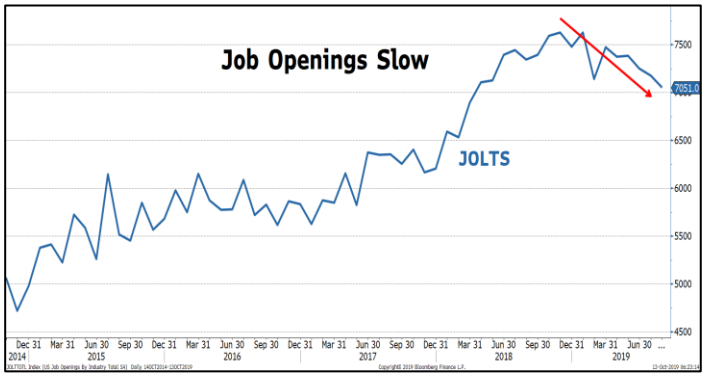
WEEK OF OCTOBER 15, 2019

Weekly Relative Value

What a JOLT!

Given the heightened uncertainties that businesses face, hiring demand has begun to wane. Indeed, the level of job openings once again fell in August to 7.051 million from a downwardly revised 7.174 million showing the month prior. This is the fourth time in the past five months that openings have pulled back representing a decline of more than 13% at an annual rate.

In other words, yet more evidence of cooling in the once red-hot labor market.



Source: Bloomberg

And I have to admit that I am tired of hearing how itsy-bitsy, teeny-weeny the manufacturing sector is when compared to the gargantuan services sector. Manufacturing is the third largest industry in private sector GDP and has been hammered as the Job Openings and Labor Turnover Survey (JOLTS) revealed a record 49,000 decline in non-durable manufacturing job openings in August. And while it's true that one month, a trend does not make… twelve months does. Over the last year, non-durable job openings have sunk -26.5%, a six-year low.

Furthermore, job openings in the Midwest – also known as the Industrial Heartland that includes the states of Illinois, Indiana, Iowa, Kansas, Michigan, Minnesota, Missouri, Nebraska, North Dakota, Ohio, South Dakota and Wisconsin – plunged to a 10-year low of -13.5%. And no, this had nothing to do with the General Motors strike that began on September 15.

Raising more concerns, in the September Institute for Supply Management (ISM) Survey, zero percent of the 18 manufacturing industries in the survey reported increasing backlogs. Zip. Zilch. Nada. And when no one is growing backlogs, the need for warm bodies fades.

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

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THIS WEEK

The goose-egg reading has been rivaled two other times, both being in the depths of the Great Recession in early 2009.

The downtrend means we cannot rely on the industrial sector for job creation anytime soon – or at least until we receive more clarity on the trade war. (Got Tweets?)

Where do we go from here? Well, the backlog share cannot fall any further; it's hit the zero bound. But a further leg down in industrial job openings is likely in the works.

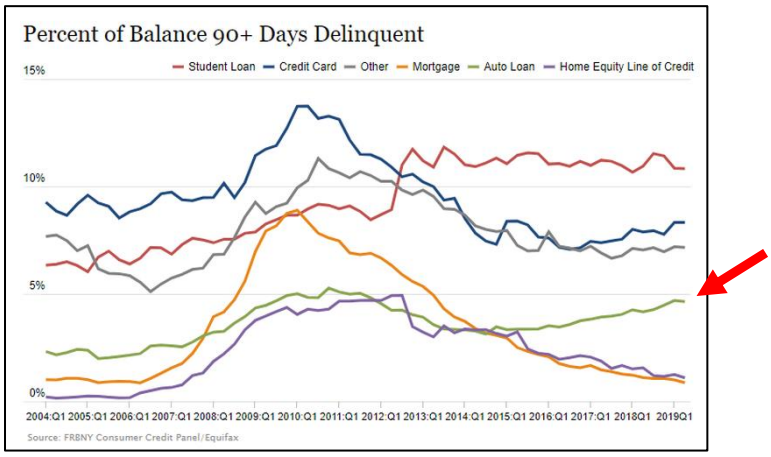
This would then suggest that the unemployment rate has hit rock bottom, and one can expect wage and price inflation to subside.

AUTO DELINQUENCIES RISE

"Auto lenders are belatedly tightening lending standards, but it may already be too late. The economy is masking the true performance of auto loans. ***If we hit a downturn today, the performance of auto loans would not look very good."*** *– Warren Kornfeld, a senior vice president on Moody's financial institutions team*

Despite supposed "economic growth" and low unemployment, more than seven million Americans are already late by 90 days or more on their car loans, according to data from the New York Federal Reserve. Hardly surprising, delinquency rates among borrowers with low credit scores have seen the fastest acceleration. And the rising delinquency rates are being blamed on weaker lending standards in recent years.

"American consumers have become too comfortable with debt and subprime customers have been 'poisoned' by easy access to capital for much of the long economic expansion. But he added those customers will be forced by tighter underwriting to seek even older vehicles." – Ken Shilson, President of the National Alliance of Buy Here, Pay Here Dealers (NABD)



Source: Federal Reserve Bank of New York

New York Fed data show that delinquencies among subprime borrowers have been rising and have been the catalyst pushing up the overall delinquency rate. About 8% of loans originated by buyers with a credit score under 620 are categorized as seriously late.

Lack of supply and rising demand has caused prices on used cars to spike, with the average price of a 10-year-old used vehicle coming in at $8,657, nearly 75% higher than 2010. Over the same time, the average increase in new car prices is only 25%.

Poor Americans are stretched so much that they literally can't afford to pay more.

"The American way is to always live beyond your means and Americans aren't good at making life adjustments," Shilson said. "But there's a reality check coming, and many subprime buyers will be forced to find more affordable transportation."

Ominously, he said, "the market feels like it did before the financial crisis hit in 2008, when consumers were over-extended with debt."

Brian Irwin, who leads the automotive and industrial practice for consulting firm Accenture, says the auto industry has reached the end of its run, stating: "It's a step down from where we thought we would be a few months ago. I expect to see stronger incentives coming out."

Subprime auto loans are blowing up at rates not seen since the worst days of the Financial Crisis – and these are the good times. But this is not an employment crisis, when millions of people lose their jobs and cannot make the payments on their auto loans.

What will this chart look like when the economy turns, and unemployment surges again, and people cannot make their car payments?

LEAVING LAS VEGAS

"The economy is in a good place." – Fed Chairman Jerome Powell

Jobless claims in Nevada, the top tourism state, are up 20% over the past 12 months. And consumer bankruptcies rose 6% over last year. I have heard from a friend who recently visited Las Vegas that there was minimal traffic on the strip and nary a wait for anything, anywhere. In fact, Viva was downright quiet, which I assume is a no-no at the Chamber of Commerce. Nevada is, after all, the No. 1 travel state in the nation; its economy keys off tourism more than any other.

With fresh JOLTS and credit card delinquency data flagging job market weakness before he hit the podium, it appeared the Fed staff had cut Powell off from his access to data releases.

Perhaps a weekend in Vegas would open Jay's eyes.

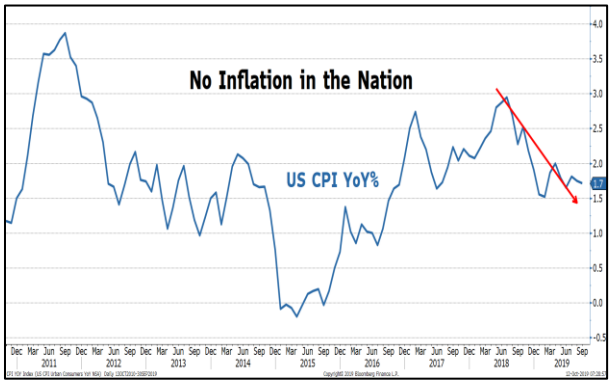
NO INFLATION IN THE NATION

The PPI, CPI and import price data released last week for the US were wildly bullish for the fixed income market, even if investors were pre-occupied with the trade talks. Have a read of *A Recession Like No Other* of Bloomberg Businessweek and *The End of Inflation?* of The Economist

US producer prices rebounded in August offering some hope, but September has now massively disappointed with a headline tumble of 0.3% MoM (+0.1% exp). **This was the biggest headline drop MoM since Sept 2015**

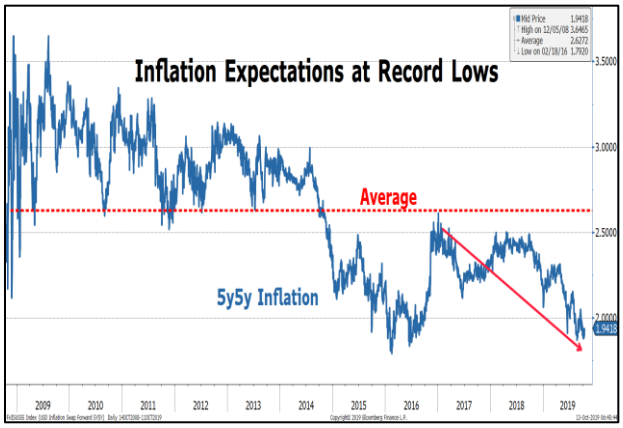
U.S. producer price data were extremely benign and Consumer Price Index (CPI) came in at the grand total of 0.0% in September, holding the year-over-year trend at 1.7%, well below the nearby peak of 2% back in April. Excluding food, shelter and fuels was flat as well. Excluding medical care prices was flat for the second month in a row and for the third time in the past four months (prescription drugs prices have fallen 0.5%, slipping in four of the past five months). Imagine where this trend goes as recession-like conditions deepen.

The goods sector – hitched to the economic cycle – deflated 0.4% after a 0.3% decline in August. Clothing prices slipped 0.4%, the first decline in five months and is a segment of the economy tied to the jobs cycle. Used car/truck prices sank 1.6% and that is a leading economic, inflation and credit indicator.



Source: Bloomberg

Finally, while the trade war has taken a visible toll via depleted backlogs and job openings, in the Treasury market, it manifests in falling inflation expectations. Every basis point that the 10- and 30-year yields go up these days, with data like this, just entices me to buy more bonds.



Source: Bloomberg

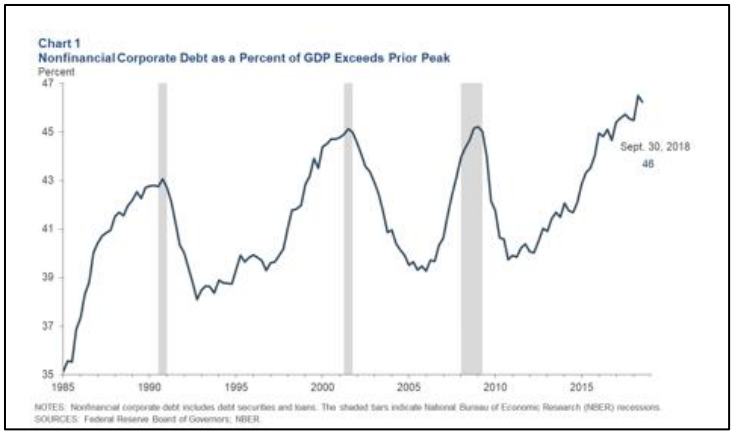
THE TROUBLE WITH NEGATIVE RATES

A study published by a number of professors at the University of Chicago found that the negative side effects from central bank policies today are overwhelming the positives. These policies are fueling market concentration and keeping zombie companies alive, thereby depressing productivity growth, which is the mother's milk for living standards. Indeed, the Bank for International Settlement (BIS) has produced estimates of the number of zombie firms globally and they represent an incredible 12% share of the corporate sector up from just 2% three decades ago before central bankers believed they had supernatural powers.

Keynesian central banks continue to promote more and more debt at a time when the corporate sector has the most leveraged balance sheet in modern times. Corporate debt to GDP at 47% stands at levels that accompanied the prior three recessions.

And while the debt levels are precariously dangerous, the quality of the corporate debt and the covenants behind it are the weakest they have ever been. This, my friends, is a deadly cocktail. If corporate cash flows recede to a point of delinquency, default or even a ratings downgrade cycle, the results could be catastrophic. This is because the high yield bond market would not be able to handle the volume of vulnerable BBB, or crossover credits, that are at risk of becoming fallen angels.

Corporate Debt to GDP at Record High



Meanwhile, European banks are trading near the lows of the Great Financial Crisis in 2009. Negative, or even microscopic, yields are a major headache for insurance companies and pension funds as well. And did you know that the top 100 state and local public pensions in America have a funding gap of $1.1 trillion (with crazy return assumptions of 7.25%). And the unfunded liability for all U.S. pensions is estimated today at $6.2 trillion (that doesn't include Social Security). As pundits ponder Modern Monetary Theory (MMT) and how central banks will use their already-bloated balance sheets to fund green energy, infrastructure and student debt forgiveness. And don't forget public pension funds, which will end up being the biggest bailout of all.

But here's the point: with low rates, quantitative easing and mountains of fiscal stimulus in the past decade, where did it get us?

Not very far.

GREEKS TAKE THE CAKE

Greece managed to raise 1.5 billion euros of 10-year money at a record-low yield of 1.5%. Keep in mind the yield on the 10-year Treasury note is at 1.70%%. The U.S. is rated AAA; Greece is a lowly B+. The U.S. has a debt-to-GDP ratio of 80%, and while that is very worrisome, Greece is north of 180%. Let's just say truth is stranger than fiction. But last week's event really took the cake, as Greece sold three-month bills with a negative yield. Yes, you read that right, at -0.02%.

This insanity exists because the European Central Bank (ECB) has been and continues to subsidize the bond markets in the eurozone. All the countries in the eurozone benefit from having their fixed-income markets supported actively by the ECB and a very generous negative cost of carry of -50 basis points. The Fed may well have gone into the unknown

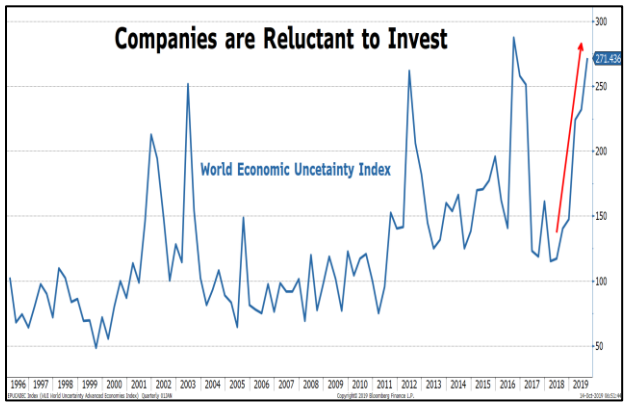
with repeated rounds of quantitative easing this past cycle, but they never bought the bonds of Illinois, California and Puerto Rico to support their failed fiscal regimes.

Source: Cagle

LOW RATES ARE HERE TO STAY

Here are five fundamental factors supporting lower for longer:

1. Bond market investors can see the forest past the trees. Central bankers have become less powerful with every dose of stimulus provided. The laws of diminishing returns are intact. Any fiscal thrust will only come when things get much worse as it stands.
2. The world is awash with excess manufacturing capacity. Labor markets may be tight, but robots are picking up the slack and hence wage growth is now decelerating. Technology is an inflation killer.
3. There is a global savings glut. Worldwide capital spending has plunged this year as sagging profits have bumped against surging levels of uncertainty. This is a big reason for this year's slide in market interest rates.



4. Demographics are an added secular factor continuously supporting the trend towards ever-lower long-term interest rates. The debt-based U.S. economic system premised on perpetual consumption growth is now facing long-term depopulation from the bottom-up while the numbers of elderly surge. Births in America continue to tumble despite a growing childbearing population. The growth among the childbearing population (20 to 40-year-old Americans are responsible for over 90% of the births) is decelerating and this population will begin outright declines around 2029.

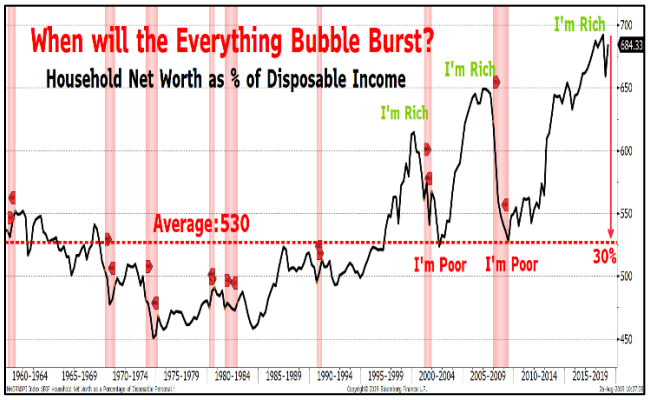
Among the 45+ year-olds, the majority of population growth over the coming decade will be among 75+ year-olds, a segment with less than 10% labor force participation, consumes at very low relative levels, and utilizes little to no credit (nor should they, primarily living on fixed incomes).

The Fed has concluded that over the past 30 years, demographic trends have sliced 1.25% from potential GDP growth and the neutral real interest rate and the bulk of that decline has taken hold since the early 2000s.

The bottom line: There is now an excess of capital relative to labor as the baby boomers retire in droves (the ones who can afford to) and this excess savings pool has depressed the low rate of return on capital.

5. It also is no coincidence that since the late 1990s, the economy has become ever so much more hitched to asset inflation and debt accumulation (to an extreme). Wealth-to-income ratios in the household sector have soared to new record highs even higher than in the late 1990s dotcom bubble and the 2003-07 housing mania. U.S. household wealth recently hit a record of **700% of the disposable income,** while the historic average since 1952 is **530%.**

   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.



Source: Bloomberg

This is why it matters… <u>The top 10% of Americans own 80% of stocks and account for 50% of consumption.</u>

The ballooning balance sheet of individuals and corporations globally is a key reason why the interest rate cycles of the past two decades have become increasingly short in duration and in magnitude. Remember, the Fed was stopped out at 2.5% and is back to tinkering with balance sheet expansion again. And the ECB, after trying to move to the sidelines, is back taking policy rates more negative and stepping up quantitative easing. Japan has been stuck in this environment for decades. Japanification has reached Europe and it would appear the U.S. is not immune.

There's enough here to leave me bullish on the safety and deflation protection from long-term, high-quality bonds.

WHO PAYS?

There are other risks to consider beyond lingering trade risks there also are home-grown political risks to consider. The latest poll by website FiveThirtyEight shows that public support for impeachment is now up to 49.3% versus 43.5% who do not. Meanwhile, Elizabeth Warrens numbers continue to improve, and she is behaving as the front-runner. Her ascendency is bad news for the stock market and at some point, investors will be shifting their attention to the high, and

rising, prospect that she is the next President. This uncertainty is an added key constraint on the outlook for capital spending.

The 2020 election is all about taxes and who pays them. I recommend a read of *Elizabeth Warren Vows to Remake Capitalism. Businesses Are Bracing.* in the Wall Street Journal. She runs a slightly different form of populist policy than the President does and caters to a totally different demographic (including all the teens who didn't vote last time). And something tells me that her form of populism isn't going to have billionaires like Wilbur Ross running the Commerce Department.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I'm skeptical that there is anything that could be objectively called a deal… It appears that the U.S. was looking to find a way to avoid raising tariffs in the next couple months and reassure financial markets, and so it was willing to accept only an oral agreement on a narrow range of issues to take this step. Xi Jinping has to be quite satisfied with this outcome." – Scott Kennedy, an expert on the U.S.-China economic relationship at the Center for Strategic and International Studies in Washington

Stocks surged on Friday in anticipation of what President Donald Trump described as a "very substantial phase one deal" with China, including a suspension of tariffs slated to take effect on Tuesday. That capped a 0.9% weekly advance in the Dow Jones Industrial Average and the Nasdaq Composite and a 0.6% gain in the S&P 500. Further, the inverted yield curve was removed, as the benchmark 10-year note's yield rose to 1.75%, above the 1.68% on the three-month bill.

Beans

Source: Hedgeye

Never in the history of the greatest deals in in the history of humanity have I seen such a deal trumpeted into what amounts to an epic hill of soybeans. After fifteen months of a trade war, that increased recession risks globally, we are left with platitudes and more Chinese soybean purchases and nothing truly fundamental. The thorniest disputes remain outstanding. U.S. goals in the trade war center around accusations of intellectual-property theft, forced technology transfer and complaints about Chinese industrial subsidies. China has no intention of changing its behavior and such an outcome will not lift the uncertainty clouding the fate of the global supply chain.

In essence, there wasn't really a whole lot new, in tangible terms, outside of China agreeing to step up its purchases of U.S. soybeans and pork to between $40 and $50 billion. But this last point is less about any major inroads on trade issues

and more to do with feeding a Chinese population reeling from the African swine fever that has wiped out nearly 40% of the country's pig herd over the past year.

But Trump will now go to his farm base and boast about his big win. Both sides have been hurt enough that at the very least, they don't want any more escalations in this trade war.

Call it an uneasy truce but incrementally, it's better than having the tariff actions go through with China retaliating. Markets don't always need good sometimes, less bad can spin the dial and that's what happened last week

That said, U.S. and global economic data are still slowing, which have nothing to do with hyperbolic tweets, CNBC trade deal headlines or impeachment inquiries.

This is what the founder of the largest hedge fund in the world says about what matters.

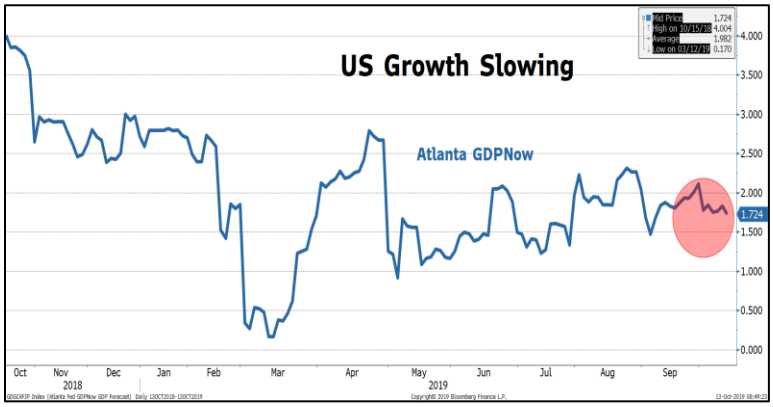
"I knew which shifts in the economic environment caused asset classes to move around, and I knew that those relationships had remained essentially the same for hundreds of years. ***There were only two big forces to worry about: growth and inflation." –*** *Ray Dalio, founder of Bridgewater, the world's largest hedge fund*

Bloomberg Economics' global GDP tracker shows the pace of expansion has slowed to 2.2% in the third quarter, down from 4.7% at the start of 2018. Meanwhile, the Atlanta Fed GDPNow model shows third quarter growth tracking at 1.7%.

Research conducted by the Brookings Institution and *Financial Times* points to anemic global economic growth for the foreseeable future, a situation called "synchronized stagnation."

The coming recession is a when, not an if. As Kristalina Georgieva, the new boss of the IMF put it last week (rather succinctly I may add): *the global economy is now in a synchronized slowdown*.

And frankly, with a global government debt-to-GDP ratio in excess of 80%, it isn't clear to me that the government has any more policy bullets in its gun than the central bankers do at the moment.



Slow growth, slow inflation. Let's call it "slogflation." When do I get my Nobel Prize in economics? LOL

Seriously though, the economy continues to do what I have been saying for years. We have had close to a decade of slow 1.5-2% growth despite unprecedented fiscal and monetary stimulus. Whether or not we have a recession this year or next, growth will continue to slog through.

And we are now entering the third quarter earnings season that may not be overly bullish. The consensus is penning in a 4% year-over-year decline for the third quarter. At the beginning of the year the same analysts were expecting a 4% gain. So, when the fundamentals come back to the front burner, Wile E. Coyote will start looking down again.

In summary: Recession risks have not gone away just because the President backed off the round of tariffs that were supposed to take place today. And it's not often that there has been a recession in which bond yields failed to decline, and on average, the 10-year Treasury rate dives 160 basis points in the context of an economic downturn. So do the math, and yes, the yield at some point will be following Europe and Japan into microscopic terrain. Stay patient; stay in the game.

October's rate cut will be here soon enough and with it, a fresh focus on market pricing further out. Rate cuts beyond October and credit-era quantitative easing will likely be forced upon the Fed as incoming data invalidate Powell's rosy assessment of the economy. Note I said rate "cuts," plural. The Fed would have to ease more than rates traders currently anticipate. That requires going beyond three reductions from here and the dubious dot-plot getting lowered again in December.

<u>Our long-standing investment recommendation remains intact:</u>

1. Reduce excess cash reserves.
2. Do not time the markets.
3. Maintain a risk-appropriate ladder strategy.
4. Diversify your investment portfolio.
    - Underweight traditional Agency dentures (bullets and callables)
    - Overweight CMBS, select MBS/CMOs and Bank notes

PREMIER PORTFOLIO

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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.