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WEEK OF OCTOBER 28, 2019

Weekly Relative Value

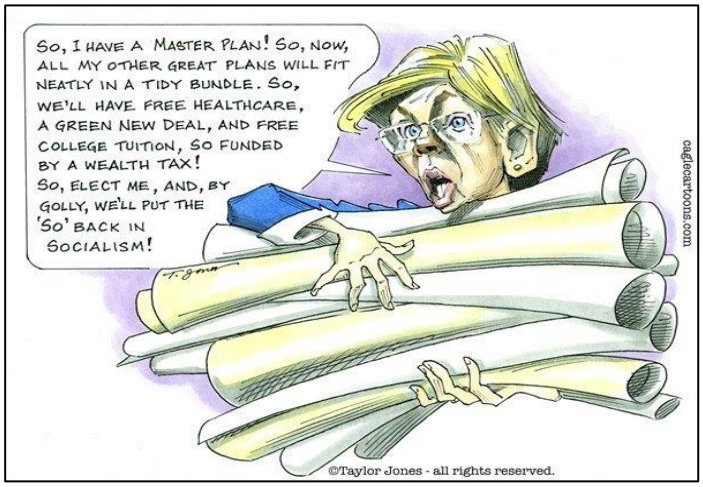
Socialism vs. Capitalism

"This proposal does not eliminate billionaires, but it eliminates a lot of the wealth that billionaires have… and I think that's exactly what we should be doing." – Bernie Sanders

The youth movement is at play and could be a deciding demographic factor in the 2020 elections. I believe it would be a mistake for investors to ignore this message. The latest polling numbers show that young Americans between 18 and 24 give Donald Trump a 29% approval rating and a 66% disapproval rating.

In the last election, the youth voter turnout was just 46%. Hillary took the lion's share of a small turnout category but the older folks at 65+ showed up in droves in November 2016, aching to get Trump in, with a sizeable 71% voter turnout.

However, in the 1992 and 2008 election – even with 70%+ turnout from traditionally conservative 65+ year old voters – there was a significant 50%+ turnout for 18-29-year olds, and Bill Clinton and Barack Obama ended up in the Oval Office.



Source: Cagle Cartoons

And there is no doubt who the youth will vote for. Polls show that 29% of the 18-29 age group favor Bernie Sanders and 26% support Elizabeth Warren. Only 13% would vote for Joe Biden right now. Like Trump, Biden's base comes from the 65+ crowd who simply cannot understand where these young folks come from on taxes, regulation and the

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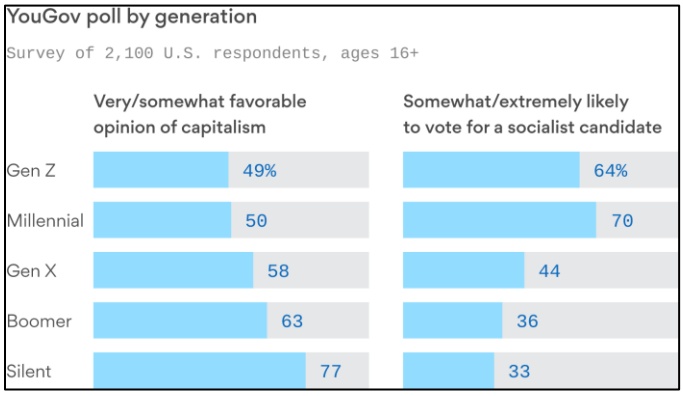
THIS WEEK

environment (interestingly, Warren has 33% support from the 65+ group versus 5% for Bernie). None of the other 16 Democratic candidates have more than 7% of support from the youngest cohort.

As shown below, 50% of millennials and 51% of Generation Z have a somewhat or very unfavorable view of capitalism. Nearly half of Gen Z and millennial respondents said they felt the U.S. economy worked against them. Their sentiments are being driven by the fact that they have grown up in a capitalist country where economic inequality has continued to climb.

Young Americans Embrace Socialism



Source: YouGov

Here's the rub. I realize that many people dislike Elizabeth Warren and Bernie Sanders. Don't forget that Bernie came so close to winning the nomination four years ago. Further, we are going to have nearly 16 million new eligible voters in 2020 (teens and tweens) who don't own property, don't have a business and likely haven't received a significant paycheck in their lives. What matters to them, in no particular order, is climate change, income equality and student debt.

It was this same crucial democratic group that up-ended last November's midterms and stripped the GOP of its majority in the House. If the youth voter turnout rate is above 50% next year, Democrats always win when this happens, though it is rare. The question is whether they the youth turn out again.

History shows that when there is large youth voter turnout, it favors the Democrats. And rare is the four-year-period where 16 million newbie teenagers have the ability to head to the polls at a time when there are more than 8 million fewer older voters. That could end up being a huge swing factor. The question is whether the youth turn out again.

Ordinarily, I wouldn't pay so much attention to politics. However, at this juncture there appears to be a rising probability that America veers to the left. To be clear, I hope it doesn't happen! But the risks are rising. And we should be paying close attention.

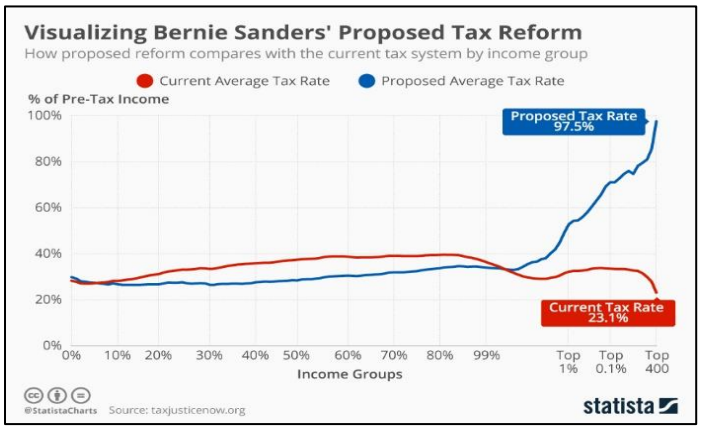
Perhaps outside the 1930s and Franklin Delano Roosevelt, there has never been an election where there was such a policy divergence within the Democratic Party, and versus the GOP. In essence, it's a battle between capitalism and socialism. And unless the polling data is "fake news," young Americans have decidedly moved to the far left.

Here is a quick summary of what both Warren and Sanders are calling for.

Warren is calling for a 2% tax on household wealth above $50 million and 3% above $1 billion. Her plan siphons off $2.75 trillion to pay for her proposals over 10 years. But, as Statista's Niall McCarthy details, Sanders' proposals go much

further. The data show that while Sanders would tax the majority of income groups at a lower rate than the current tax system, it starts to increase dramatically when it comes to the top 1% of earners. And it doesn't stop there. The country's 400 wealthiest individuals would have to pay 97.5% tax compared to the current 23% – bad news for people like Jeff Bezos and Bill Gates. Overall, it is estimated that Bernie's plan would generate $4.35 trillion.

Not Good News for the Billionaire Club



Many of the Wall Street type say it will never happen.

Remember, in 2008 America took on a risk for something new, the first black president, who was also widely viewed at the time as being a socialist. Nobody ever could have believed Obama would be president but McCain, was seen as too establishment.

And in 2016, voters took another jump into the unknown by electing a billionaire casino operator. America wanted an anti-establishment President. In 2016, Hillary was viewed as an establishment player. And despite the pledges to drain the swamp, Trump's three primary economic gurus are all from Wall Street (Larry Kudlow, Steven Mnuchin and Wilbur Ross). So, Trump looks pretty establishment himself.

The question is whether the youth turn out. If they show up, they will be a very disruptive voting force. As a risk manager, this is no time to have your head in the sand and be partisan and dogmatic; it is a time to have your eyes and ears wide open and to be as flexible and pragmatic as possible.

WEALTH INEQUALITY IN AMERICA

One of the themes the younger population is focused on is the massive and rising inequality that has now exceeded the wealth inequality of the Robber Barons of the Gilded Age.

According to Bloomberg, the income needed to enter the elite top 1% of taxpayers was $515,371 in 2017. That's up 7.2% from a year earlier. So, if you want that precious membership card to the "1%" you're going to need to work a little bit harder and earn a little bit more. To join the top 0.1%, you would have needed to earn $2.4 million in 2017, an increase of 38% since 2011**.** To join the top 0.01%, the threshold has jumped 46%. Meanwhile, the truly elite top 0.001%, a group of 1,433 taxpayers, pulled in at least $63.4 million each in 2017, up 51% since the Occupy protests.

By comparison, since 2011 the median taxpayer, at the 50th percentile, has seen income rise 20% to $41,740. Lower-income consumers have seen very little net worth improvement in the last decade. So much for The Occupy Wall Street movement.

It did absolutely nothing to change the tremendous and growing wealth inequality in America. In fact, the divide has grown significantly.

It is Good to Be King

.001% Club

Americans need $63.4 million to join the top .001%; $41,740 to be in top half

Percentile	Number of returns	AGI cutoff
0.001%	1,433	$63,430,119
0.01	14,330	12,899,070
0.1	143,295	2,374,937
1	1,432,952	515,371
5	7,164,758	208,053
10	14,329,516	145,135
20	28,659,032	97,870
30	42,988,548	72,268
40	57,318,064	54,672
50	71,647,580	41,740

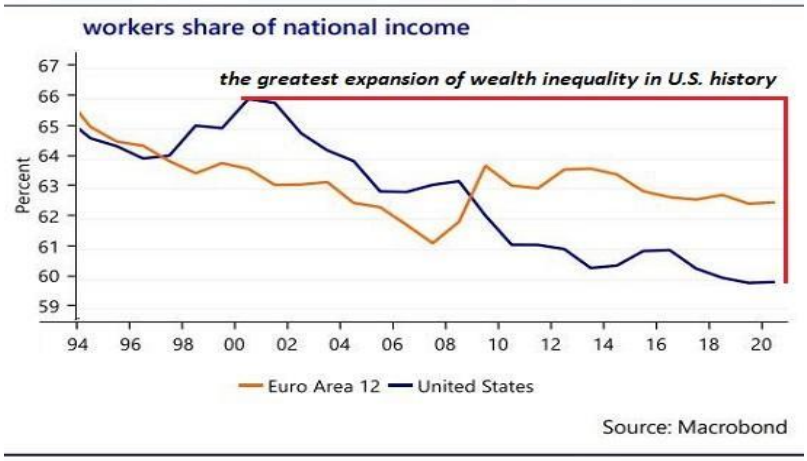
Source: IRS
Note: AGI= Adjusted gross income

Bloomberg

Source: Bloomberg

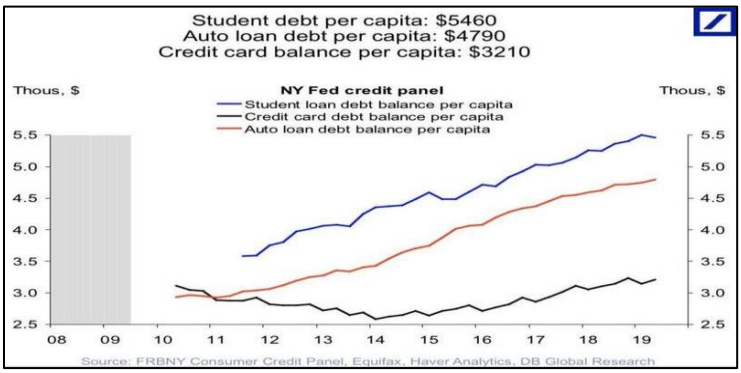
As such, low-income consumers have struggled to make ends meet despite the "greatest economy ever." To maintain a certain standard of living, Americans have increased their debt burdens significantly through credit cards, auto loans, and student debt.

Wealth Inequality Has Never Been Greater in America



According to UBS, a Swiss investment banking company, 44% of consumers don't make enough money to cover their expenses. And if a recession strikes or the employment cycle continues to decelerate, this could mean the average American with insurmountable debts will likely fall behind on their debt servicing payments.

Half of U.S. Consumers Report Their Incomes Don't Cover Their Expenses



Source: UBS

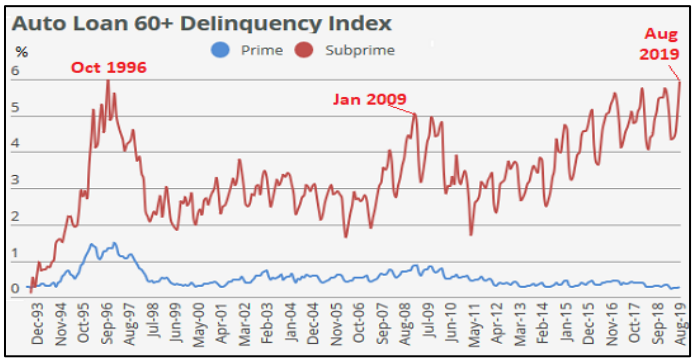
And the stresses are already showing. Today, the percentage of student loans that are 90 days or more delinquent has jumped from a year ago. Credit card delinquencies are at a seven-year high despite record low unemployment.

Auto loan delinquencies remain elevated from last year. Sub-prime auto loans – approximately 21% of auto loan originations in the first half of 2019 – have seen a record rise in delinquencies. In August the 60-day delinquency rate surged to 5.93%, substantially higher than during the peak of the Financial Crisis at 5.04% in January 2009. But "prime" auto loans are holding up very well. Their 60-day delinquency rate is hovering around a historically low 0.28%.

These sub-prime loan delinquencies are very worrisome for the industry, for the sub-prime lenders, for investors, and for automakers because when lenders tighten up, sales go down. However, they're not going to cause a financial crisis of any sort.

That said, we're seeing these numbers in good times. If the economy gets an unemployment shock of some sort, sub-prime delinquencies will blow out. And even prime delinquencies will rise. But prime delinquencies are so low now that even if they soar by a factor of 10 to something close to 3%, it's still manageable for the industry.

Sub-Prime Auto Loans Blow Up

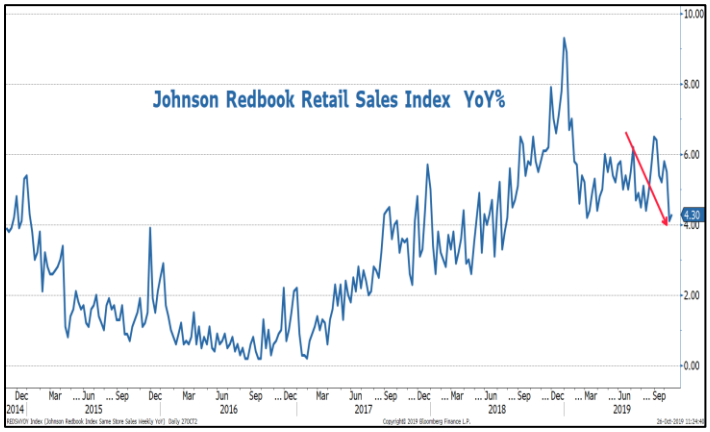


Source: Fitch

From a broader perspective, the weakness from a manufacturing recession has already filtered into services and employment. This means that the economic slowdown in the U.S. has already broadened, now affecting consumers. And it's when the consumer shifts into a holding pattern, pulling back on all spending, that is when the broader economic downswing will be seen.

According to the Johnson Redbook Retail Sales Index (does not include online sales), spending growth slowed to 4.1% in the week of October 12, from 5.5% the week prior and 5.8% before that. As a result, this marks the worst year-over-year trend in this index since July of 2018, further ratifying the squishy soft retail sales report for September.

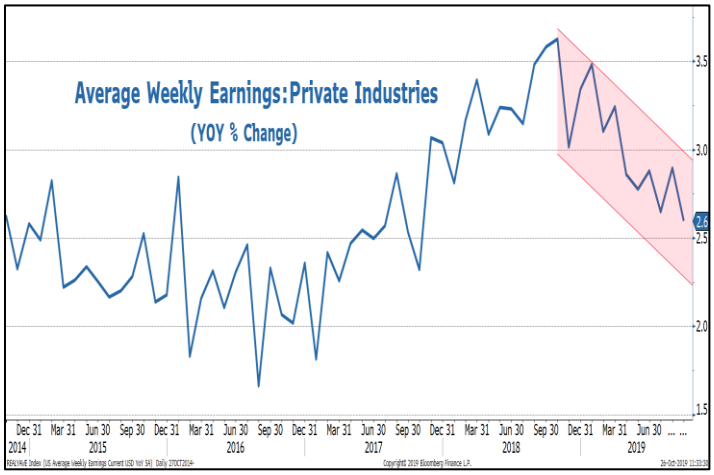
Retail Sales Slow



Source: Bloomberg

This development can largely be traced to three factors. First, average weekly earnings growth has pulled back to just +2.6% year-over-year, quite the erosion from +3.6% at this time last year. This means that, in inflation-adjusted terms, real work-based income is up just +0.9% from year-ago levels.

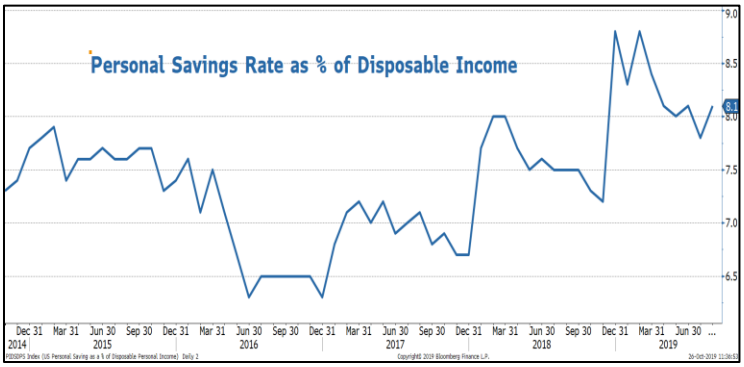
Average Weekly Earnings (Year-over-Year)



Source: Bloomberg

Uncertainty, largely owing to domestic politics, has resulted in a rise in the savings rate to 8.1% from closer to 7.5% over the course of 2018. While this may be beneficial for the economy down the road it does not bode well for spending growth in the near term

Individuals Becoming More Cautious



Source: Bloomberg

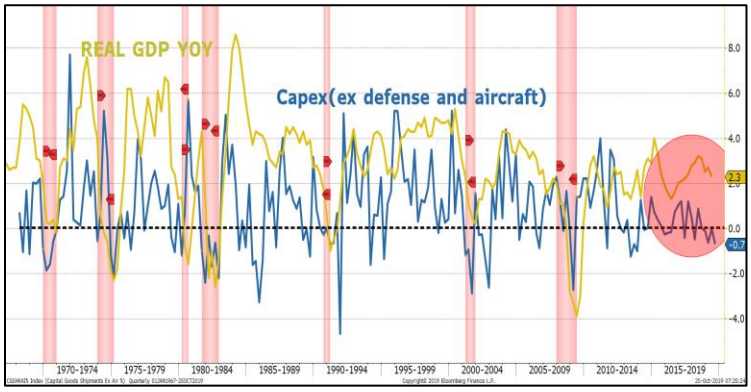
At the same time, the stock market, even as it sits close to an all-time high, has cooled off considerably. Indeed, since January 2018 the real return (including dividends) for the S&P 500 index is a mere +1%. In other words, after many years of rampant asset inflation, the "wealth effect" that drove consumer spending has vanished.

So, with the evidence increasingly suggesting that the consumer is slowing, it should come as no surprise that the economy is embarking on a below-potential growth trajectory. After all, consumer spending is 70% of the economy.

DISMAL DURABLES

U.S. durable goods orders fell by 1.1% in September, larger than the 0.7% decline that had been penciled in by economists. This appears to have partly reflected the GM strike as orders for motor vehicles and parts fell by 1.6%. Nonetheless, bookings were weak outside of this category highlighted by the 0.3% setback in the segment excluding transportation. This held the year-over-year trend at the zero-line, or in negative terrain in real terms.

Core CapEx Leads the Economy



Source: Bloomberg

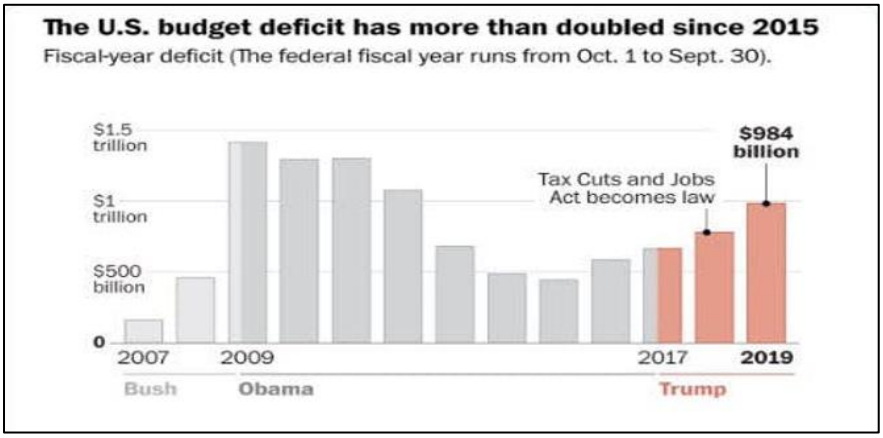
Of course, in terms of economic growth, core CapEx shipments (excluding defense and aircraft) matter the most. Orders here fell 0.5% following the 0.6% setback in August and flat reading in July. As a result, over the past three months, core orders have retreated at a 4.5% annualized pace, and are 0.8% lower than year-ago levels.

The deterioration in the three months ended September doesn't just validate CEO and CFO capital spending plans; it sets up the fourth quarter behind the 8-ball.

EXTEND AND PRETEND

As our national debt rapidly approaches $23 trillion, nothing is as sobering as looking at the National Debt Clock. Check it out here: www.usdebtclock.org.

The Office of Management and Budget announced, the full year deficit for fiscal 2019 was shy of $1 trillion, but just barely, printing at $984.4 billion. This was $24 billion more than the Congressional Budget Office's (CBO) own forecast in August, which predicted a 2019 deficit of $960 billion and a whopping $205 billion, or 26.4% increase, to the $779 billion deficit hit in 2018.



Source: Office of Management and Budget

But making matters worse the deficit is actually higher than the U.S. Office of Management and Budget (OMB) suggests. In fact, it is so preposterous, one has to wonder if it is a purposeful lie.

Because the projected deficit does not include all of the amount owed to the Social Security Trust Fund, that amount is called off-budget. But when the calendar year rolls over, the difference magically appears on the balance sheet as actual debt. In other words, excluding Social Security from the deficit is an accounting scam.

These deficits are expanding after month 124 of the of economic recovery. At this point in the economic cycle debt and deficits should be low and declining. Instead we find debt and deficits are high and rising. So much for saving for a rainy day.

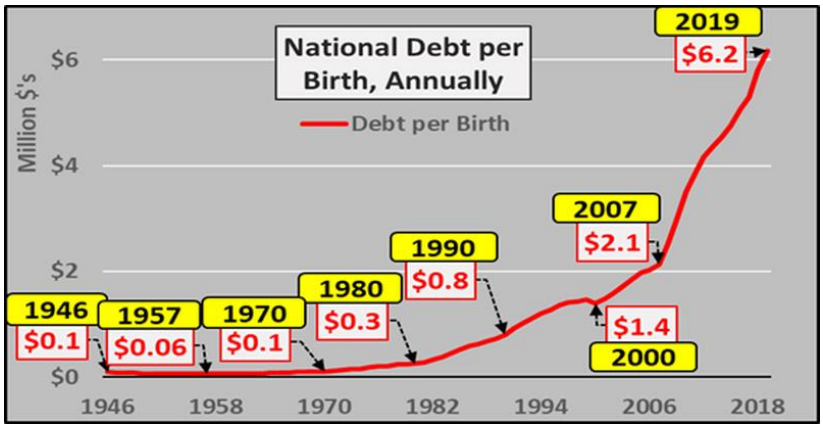
Sadly, this massive deficit is what is propelling the economy forward, and it is not sustainable.

Furthermore, since debt is an obligation to be repaid or serviced in the future, the graph below shows federal debt continuously divided by the quantity of annual births. And total births have declined almost 14% versus a 150% increase in federal debt since 2007. And everything points to declining fertility rates into the future. Translation, federal debt will continue skyrocketing while present and future births are likely to continue tumbling.

The bottom-line is that it is far easier to spend or waste money than to pay it back. This can be seen in the chart below, showing the debt each child is born shackled with. From $100 thousand in 1970, to $300 thousand in 1980, to $800 thousand in 1990, $2.1 million in 2007... and as of 2019, every child born a citizen of the U.S. is liable for a ludicrous $6.2 million in federal debt. And this is just a fraction of the actual liability that is owed, if even faster rising unfunded liabilities were included. Of course, there is no way the U.S. could ever repay this mounting debt even with a rising population of young... let alone a declining population of young.

I hope by now everyone realizes that no politician is going to address this; it's "extend and pretend" from here on out.

National Debt per Birth

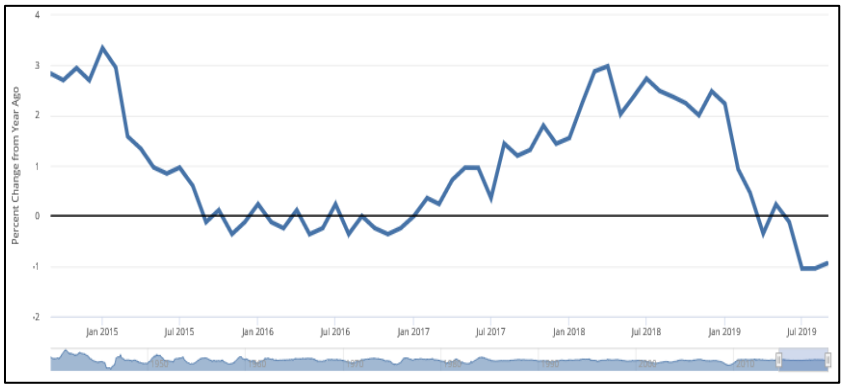


Source: Econimica

MANUFACTURING IS NOT BAAACK

The last thing you can say about America's alleged "best economy ever" is that manufacturing is baaack! There is no better barometer of that than the index of aggregate labor hours. That's because this index captures changes overtime and scheduled hours, which track the path of actual output far more closely than the monthly payroll report.

Aggregate Weekly Hours Worked: Manufacturing



Source: St. Louis Federal Reserve

Ironically, the upward jump in manufacturing labor hours during late 2017 and 2018 reflected the fact the Chinese President Xi had cranked-up the credit machine to nearly warp speed in order celebrate his coronation as Emperor for

Life in October 2017. A few months later in Washington, the GOP enacted a $1.8 trillion draw on Uncle Sam's credit card to reward the business lobbies that have so faithfully filled its campaign coffers.

Needless to say, these policy-induced surges have now vanished completely. This can be gleaned from the graph above, which shows manufacturing labor hours in September actually lower than one year ago. Here's another little ditty. The annual rate of manufacturing labor hour growth during Obama's last six years was ***1.31%*** per annum. During the Donald's first 32 months it has been 1.15%.

Industrial Production Declines Year-over-Year

Source: Bloomberg

And, with September's Industrial Production declining -0.14% year-over-year it is now clear the sugar high of last year is long gone. In fact, the rate of change has come full circle and is now essentially on the flat-line—-the very place it stood when Trump took the oath.

So, if you want to talk about how the MAGA policies have brought the manufacturing sector roaring back, you can't. In fact, without the aid of a magnifying glass, you really can't tell when Obama left, and Trump arrived in the Oval Office in the chart above.

As a final note: I realize that manufacturing is just an 11% share of the U.S. economy and just 8.5% of the workforce. So why worry? Back in 2006/07, all I heard was how housing was just 6% of GDP so don't worry. Or in 2000 how the dotcoms didn't even amount to 1% of GDP so what's all the fussin' about?

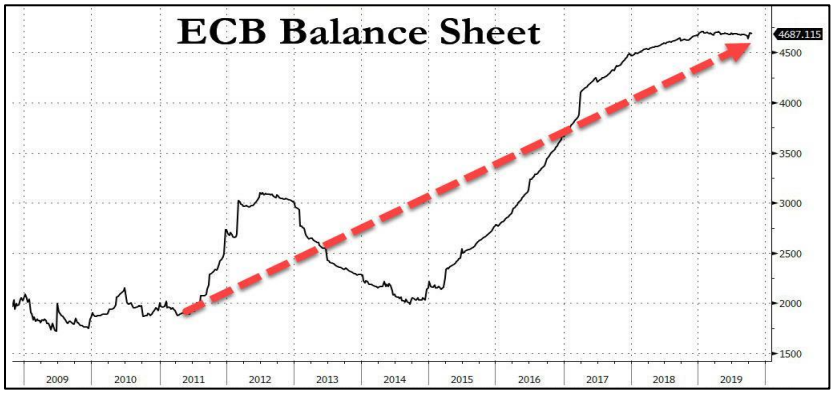
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The Federal Reserve is derelict in its duties if it doesn't lower the Rate and even, ideally, stimulate. Take a look around the World at our competitors. Germany and others are actually GETTING PAID to borrow money. Fed was way too fast to raise, and way too slow to cut!" – President Donald Trump

In the past three months alone there have been 40 rate cuts by monetary authorities around the world. And at his final European Central Bank (ECB) meeting Thursday, President Mario Draghi maintained negative rates and implemented the previously announced resumption of securities purchases.

Draghi said the new round of quantitative easing will start next month with asset purchases of 20 billion euros ($22 billion) a month and won't end until "shortly" before the first rate hike. Since economists don't expect the ECB to lift rates before late 2022, that implies another $800 billion spree of money printing at the ECB.

Super Mario ("Whatever it Takes") managed to kick the can for eight years. However, in the process made the accumulated imbalances, and the coming crisis, that much worse. You need look no further than the red arrow on the subsequent graph, which tracks the explosion of the ECB's balance sheet during his eight-year tenure, which more than doubled the already bloated ECB balance sheet that Draghi inherited.



Source: Bloomberg

Over Draghi's tenure the balance sheet has grown by an ***11%*** annualized rate at a time when the GDP of the eurozone grew at just ***2.4%*** per annum. It really doesn't get any more insane than that. Yet the financial world has been so mesmerized and dumbed-down by Keynesian central banking that it today lauds the tenure of the lunatic who made this happen.

Moving on. The Bank of Japan also is keeping negative short-term rates but is attempting to boost longer-term bond yields to produce a positive yield curve, which helps induce banks to lend.

And it might not be a surprise in Europe or Japan anymore, but pundits who think this will no longer be an option for the Fed aren't surfing the central bank's website very often. Below is an excerpt from San Francisco Fed economist Jens H.E. Christensen, published on October 15, 2019, titled *Yield Curve Responses to Introducing Negative Policy Rates*. It doesn't get much fresher than that. And just have a look at the conclusion, because it does not get any clearer than this (for those who think the Fed believes that nonconventional measures won't work).

"Given the low level of interest rates in many developed economies, negative interest rates could become an important policy tool for fighting future evidence from economies whose central banks have already deployed such policies. Analyzing financial market reactions to the introduction of negative interest rates shows that the entire yield curve for government bonds in those economies tends to shift lower. ***This suggests that negative rates may be an effective monetary policy tool to help ease financial conditions."***

At any rate, the Federal Open Market Committee (FOMC) is all but certain to lower its federal funds target rate a third time this year on Wednesday. As of Friday morning, the fed funds futures market had priced in a 93.5% probability of a quarter-point cut in the central bank's key policy rate, currently 1.75%-2%.

The real question at the conclusion of the two-day FOMC confab Wednesday will be: What's next? According to the fed funds futures market, odds of an additional quarter-point cut after Wednesday's are only a bit better than even money by next March and April.

Here's the economic reality.

The U.S. manufacturing economy is sliding into recession (with CapEx, reported this week, continuing its slide into negative territory). Meanwhile, Chinese and European economic data continue to deteriorate. Earnings continue to **slow** to negative territory today from the halcyon, 20%-plus levels of 2018. fact that year-on-year EPS for Q3 is still on track for a 3.7% decline, the third contraction in a row, in what is clearly a mild earnings recession. And not to mention that at the start of the year, this very same market was penning in a 4% increase for a near 800 basis point swing.

Remember: The biggest stimulus package in the history of China in 2015-2016, followed by U.S. tax reform signed by President Trump in late 2017, created “artificial sugar highs” for both the U.S. and Chinese economies. I believe that the U.S. and Chinese economies will continue decelerating from these artificially inflated periods.

The most important thing to watch is the year-over-year growth of an economy measured by the level of GDP last year relative to what it is today. In other words, today’s GDP has to exceed (or “comp”) last year’s level in order to realize any growth. Third quarter GDP, released later this week, is expected to show the economy growing at 1.6%, which would be a significant drop from the prior two quarters. And I see some estimates as low as 1%. Nobody is higher than 2.1%. The second quarter was 2.0% if you recall. Maybe I've been doing this for too long, but I remember the days when numbers like these would have had economist alarmed and writing about a 'stall speed' economy.

From an intermediate-term perspective, if the growth turndown morphs into a full-blown recession, the Fed will join the European Central Bank and Bank of Japan. And it isn’t hard to see the yield on the 10-year Treasury note slipping below 1% and the long bond not too far behind. The Treasury curve will steepen, for sure, but yields will melt right out to the back end.

In terms of portfolio strategy, we continue to advocate that credit unions maintain a risk-appropriate, broadly diversified ladder strategy. While rates have risen over the past weeks and may continue to rise near-term on the belied that the Trade War is over and Brexit risk has been defused, credit unions should look to capitalize on market weakness. Simply put: Buy the Dips!

In terms of sectors we continue to favor high-quality bank notes and CMBS (Freddie Ks and FNMA DUS) over traditional agency bullet debentures.

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> – Darin Higgins, President of Western Illinois 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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> – Rhonda Schroeder, CEO of Blackhawk Area 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.