BALANCE SHEET SOLUTIONS
an alloya company

WEEK OF NOVEMBER 4, 2019

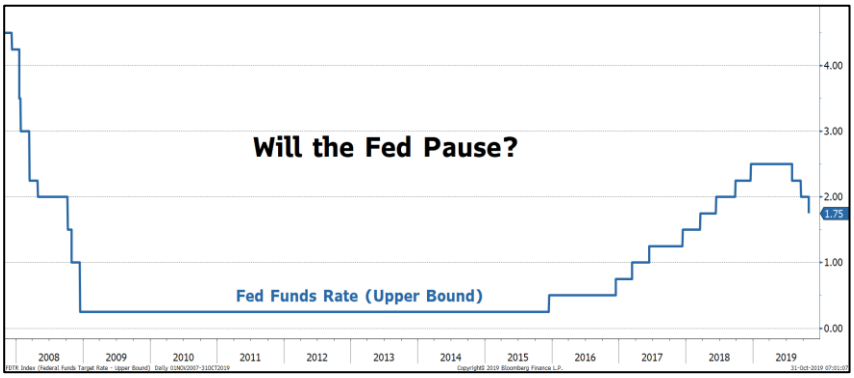
Weekly Relative Value

The Bubble Economy

"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

Going into last week's Fed meeting, the expectation was for a rate cut and then a pause. And that's basically what was delivered. For the third time this year, the Federal Open Market Committee (FOMC) decided to lower the target range for the federal funds rate to 1.50 to 1.75%. Kind of sad and yet funny to think that these same CENTRAL PLANNERS had forecasted three rate hikes in 2019 as of November 2018. Time for a new model perhaps?

Fed Cuts for Third Time in 2019



Source: Bloomberg

In the attending statement**,** language used in June, July and September (in which the FOMC said it would *"act as appropriate"* to sustain the economic expansion) was removed. They replaced that phrase with a milder alternative: *"The committee will continue to monitor the implications of incoming information for the economic outlook as it assesses the appropriate path [of its target rate]***."**

But then during the press conference, Fed Chair Jerome Powell offered something a little extra. In speaking about the prospect for future rate hikes, he said the Fed would need to see **"***a really significant move up in inflation that's persistent before we would consider raising rates to address inflation concerns."* In other words, Powell has raised the bar for future hikes, because in the past they've increased rates even without a significant, persistent upward move in inflation.

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

SUBSCRIBE

THIS WEEK

- FED VS. REALITY
- RATE CUTS AIN'T WHAT THEY USED TO BE!
- LOWER HIGHS, LOWER LOWS
- SCARY SITUATION
- IT'S JOBS, STUPID
- FACT: Q3 GDP 2019 HITS A 12-QUARTER LOW

PORTFOLIO STRATEGY

The bottom line: There is no indication that the Fed is done. But at the same time, it did not signal any more rate cuts this year. Indeed, the futures markets has essentially priced out further rate cuts in 2019 and only one more in 2020.

FED VS. REALITY

There are plenty of careerists working at the U.S. Federal Reserve who come up with these dogmatic "dot plot" projections that are rarely right but, for some reason, considered reasonable forecasts by so called "Blue Chip" Wall Street economists (who, by the way, have the same forecasts). The blind leading the blind.

Anyway, below you can easily see the widest divide between "dot plot dogma" and what the market thinks (Fed Fund Futures) in the history of dot plot projections…

What could possibly go wrong?

What if the Fed's forecast is too optimistic?

What if monetary policy is too hawkish?

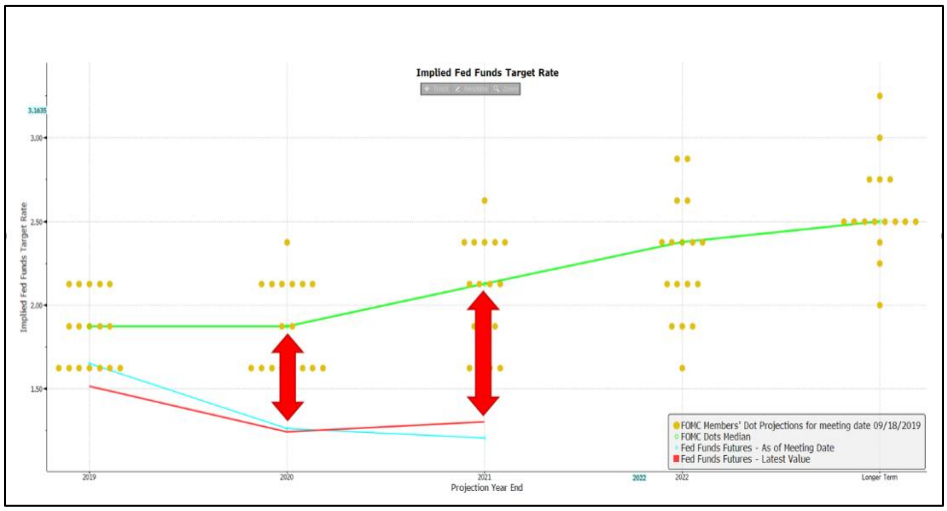
What if U.S. growth continues to slow?

I think the Fed is making a policy error by not capitulating to market expectations. They have to catch up to market expectations for faster and more aggressive rate cuts.

Until they do that, I'll say the Fed is <u>not dovish enough!</u>

And until the Fed gets as dovish as Fed Fund Futures have become, the curve can't "steepen" for real. That's why the curve moves from inversion to wicked steepening when even the Fed realizes the U.S. economy is entering a recession. In other words, the short end of the curve eventually collapses alongside the Fed's dots crashing.

The FOMC vs. Reality



Source: Bloomberg

RATE CUTS AIN'T WHAT THEY USED TO BE!

Rate cuts provide debt-servicing relief, but an economy already choking on an unprecedented debt load isn't about to go on a credit card spending spree like it did in the good ole days. Consider the housing market. Lower mortgage rates have certainly been good for it, driving a rebound in home sales. This, in turn, has been a plus for the overall economy, just not as much as it might have in the past.

That is because housing represents a smaller share of the economy than it used to. Money spent on residential investment, which includes new-home construction, among other items, now accounts for about 3.7% of gross domestic product. In the 50 years before the last recession, that figure averaged 4.9%. Similarly, money spent on furniture and appliances—items that are often bought after a home purchase—also command a smaller share of GDP than they used to.

The same can be said about the business mentality. Companies also don't appear to be responding to low rates as forcefully as might be expected. Business investment contributed far less to growth in the second and third quarters than it ought to have considering the drop in interest rates.

To wit:

> *"One explanation is that low borrowing costs won't induce companies to spend on new equipment if there isn't final demand to put that equipment to use. So, if consumer spending isn't responding forcefully to lower rates, neither will spending by companies. Add in concerns about global growth, trade tensions and narrowing profit margins, and it is easy to see why companies might not be in a rush to go out and spend."*
> *– Excerpted from "Why the Fed is Losing Potency" in the Wall Street Journal*

Well, that's my view in black ink! Yes indeed, rate cuts ain't what they used to be!

LOWER HIGHS, LOWER LOWS

See the chart below? It tells an interesting story. The peak in the funds rate in the tightening cycle for the past three decades has been lower and lower. And the lows have been getting lower and lower too. The Fed stayed too loose for too long for much of the 1990s, and in so doing, the tech bubble took hold by the end of the decade and the Fed, after taking the funds rate to 6.5% and again inverting the curve, caused the inevitable recession to begin with a lag. It was another recession nobody saw coming and the Fed cut and cut and cut all the way to 1.0% and left it there for a year.

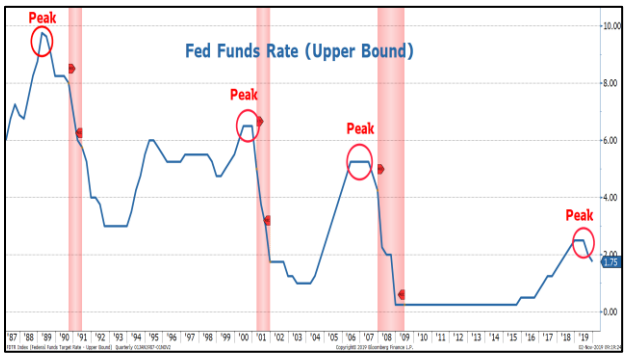
After realizing from 2004 to 2006 that it had created a monster housing and credit bubble, the Fed tightened policy and took the funds rate up to 5.25% at the 2006 peak, and yet again, the curve inverted, and the recession began as the bubbles popped.

Then, at the lows, the funds rate pressed against zero and we ended up with endless quantitative easing measures to create a synthetic negative interest rate. And this increasingly accommodative policy setting was in place from 2008 to 2015.

See the pattern? From 9.975% to 3%, then 6.5% down to 1% and then 5.25% down to zero with a host of nonconventional measures. And you can see that the bottom of the funds rate also represents an elongated flat line

because each time, it takes a longer period of monetary accommodation to finally generate self-sustaining growth. Think about this stepwise function and where we are likely to go once this easing cycle runs its course.

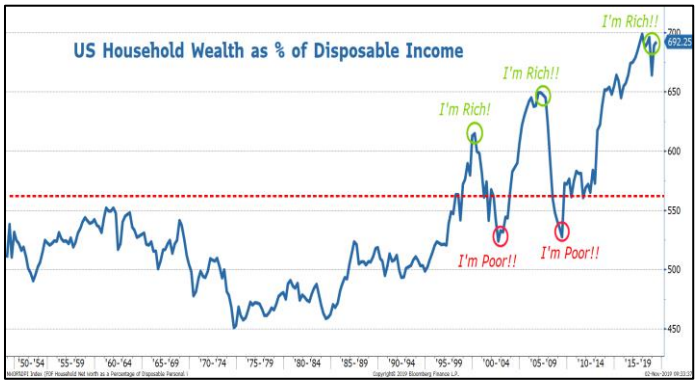
Fed Funds: Lower Highs and Lower Lows



Source: Bloomberg

This is the key point: There are no longer economic expansions that are dictated by the traditional inventory investment cycle. Rather these expansions are dominated by asset price inflation and debt accumulation. This has become a bubble economy. People say there are no bubbles, but when you look at the household net worth-to-disposable income and corporate debt-to-GDP ratios, you will see that there are tremendous excesses on the consumer and business balance sheets. True, there is no apparent economic bubble, but we have financial bubbles, nonetheless.

The Asset Bubble



Source: Bloomberg

The bubble economy really began early in the Alan Greenspan era, as the former Maestro was a big believer in the equity wealth effect on spending. He more often than not did his best to signal to the market that he had your back. But seeing as Greenspan did preside over two recessions, not even he was bigger than the business cycle or Mother Nature.

> *"Not for the first time, America has 'fought a debt bubble by adding on more debt.'"*
> *– David Rosenberg of Gluskin Sheff*

After the Financial Crisis, consumers de-levered a tad, but the state and corporations went on a binge.

Total U.S. debt has now surpassed $23 trillion as of Halloween 2019: truly a scary testament to America's insatiable thirst for debt**.** Putting this increase in context, since November 8, 2016, when Donald Trump was elected U.S. President, and when U.S. debt was $19.8 trillion, the federal debt has increased by $3.2 trillion.

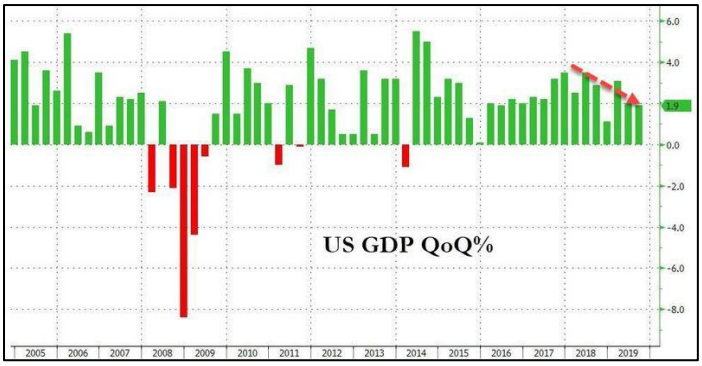
"Reaching $23 trillion in debt on Halloween is a scary milestone for our economy and the next generation, but Washington shows no fear… Piling on debt like this is especially unwise and unnecessary in a strong economy."
– Michael A. Peterson, CEO of the conservative Peter Peterson Foundation

<u>And these are the good times. What happens in a recession?</u>

Well, I'll tell you. If the growth of the federal debt outruns the economy during these good times, what will the debt do when the recession hits? When government tax receipts plunge and government expenditures for unemployment and the like soar? The federal debt will jump by $2.5 trillion or more in a 12-month period. That's what it will do.

While the key drivers of U.S. government spending are mandatory programs such as Social Security, Medicare and anti-poverty programs, a major fiscal stimulus enacted by the Trump administration – which has failed to achieve any sustainable increase in U.S. GDP – has grown the deficit considerably.

More Debt: Less Growth



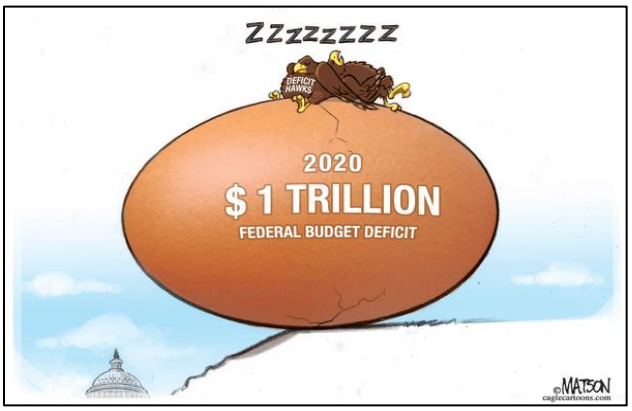
Source: Bloomberg

Over the 12 months through the third quarter, the U.S. gross national debt rose by 5.6% from the same period a year earlier. But nominal GDP over the same period rose only 3.7%, meaning the growth of the debt is outrunning the growth even in what President Trump called just last week, the "Greatest Economy in American History!" That means there is no growth. We're having an illusion of growth. It means we're issuing IOUs and spending it, and it shows up in the calculations as growth. But spending is not growth.

The ominous side effects of this record debt pile-up are starting to be felt in the U.S. budget as well. In fiscal 2019, the government spent just shy of $600 billion on interest payments, equivalent to nearly the entire U.S. Medicare budget, and more than the amount spent on the combined costs of education, agriculture, transportation and housing.

Meanwhile, the so-called "deficit hawks" are in a deep slumber over trillion-dollar deficits…

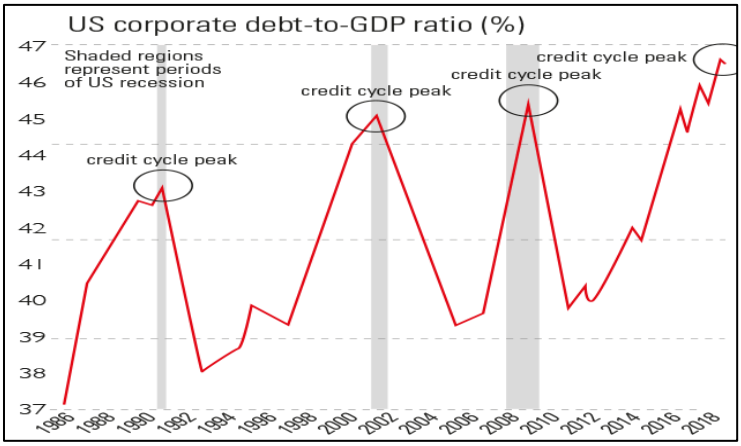
Nobody in Washington seems to worry because they think the Fed will monetize it**.** Maybe they're right. People have given up on the idea that we're going to pay our debt back. I don't think anybody believes it. I don't see how. The U.S. debt is so high that to pay it back, we would have to retrench so much.



Source: Cagle Cartoons

And as one can glean from the graph below, total U.S. non-financial corporate debt has hit a record of more than 46% of GDP. Indeed, the chart of corporate debt-to-GDP this cycle looks "a lot like the mortgage debt-to-GDP ratio of a decade ago." And just as we saw with the mortgage market, the "junky nature" of company debt is a major worry.

The Corporate Debt Bubble



Source: Moneymaven

Half the $6 trillion investment-grade corporate paper market is made up of BBB-rated debt – the lowest level before it officially becomes junk. The value of the BBB segment has soared fivefold in a decade.

And making matters worse, the corporate bond market in the U.S. is rated higher than it deserves to be. Kind of like securitized mortgages were rated way too high before the global financial crisis. Corporate credit is the thing that should be watched for big trouble in the next recession.

Morgan Stanley research analysis concluded that by only looking at leverage ratios, over 30% of the investment grade corporate bond market should be rated below investment grade. So, with the corporate bond market being vastly bigger than it's ever been, we'll see prices probably decline a lot once the economy rolls over.

SCARY SITUATION

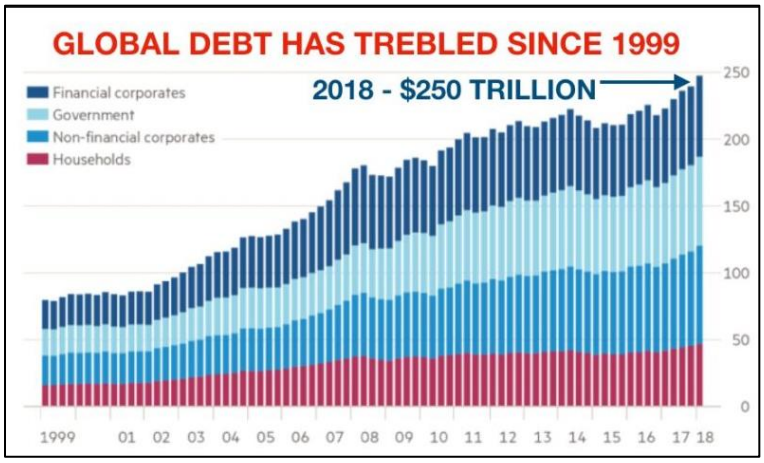
Ray Dalio, whose investment management firm Bridgewater Associates is the largest hedge fund globally, is quoted in Bloomberg as saying the world economy faces a "scary situation." According to Dalio, central banks have run out of firepower to fight the next economic downturn saying the global economy is under threat from an explosive mix of ineffective monetary policy, a rise in the wealth gap and climate change. The combination will lead to a "scary situation" over the next decade.

And he's not wrong. The wealth inequality gets worse every minute. It's already beyond the point of sustainability, and when the next downturn comes, there will be a lot of anger and unrest.

From one bubble peak to the next from 2002 to 2007, global debt rose nearly 25% faster than global GDP. From the 2007 bubble peak to where we are today, worldwide debt at all levels – government, businesses and households – has increased by almost $100 trillion. Wow!!!

And we called that 2002-2007 cycle the mother of all credit bubble collapses.

What will this one be called?



Source: Institute of International Finance

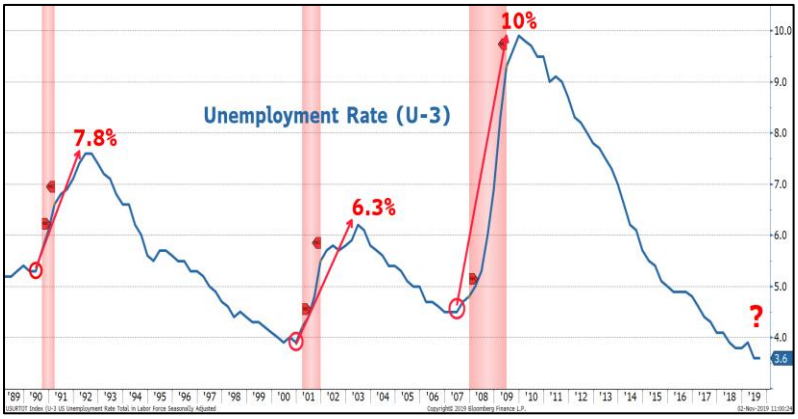
IT'S JOBS, STUPID

Never mind parsing the FOMC statement. It's the deterioration of labor market growth that will drive rates lower. Job growth in October came in at 128,000. It decelerated to a new year-over-year low of - 1.4%. This is a classic late cycle progression. You run out of people to hire, wage growth accelerates, and labor growth slows. This happens at the end of every cycle.

In the last three economic cycles, the subsequently declared onset of the recession coincided with the unemployment rate climbing only about 0.5%from the cycle low. The real pain for workers came afterwards

- In 1990, unemployment rose to 5.5% pre-recession from a nadir of 5% in 1989. It subsequently peaked at 7.8%
- In 2001, unemployment rose only to 4.3%, from the 3.8% in 2000 before the recession started. It then climbed to 6.3%.
- In 2007, unemployment rose from the cycle low of 4.4% to 5% before the recession started. It topped out at an impressive 10%.

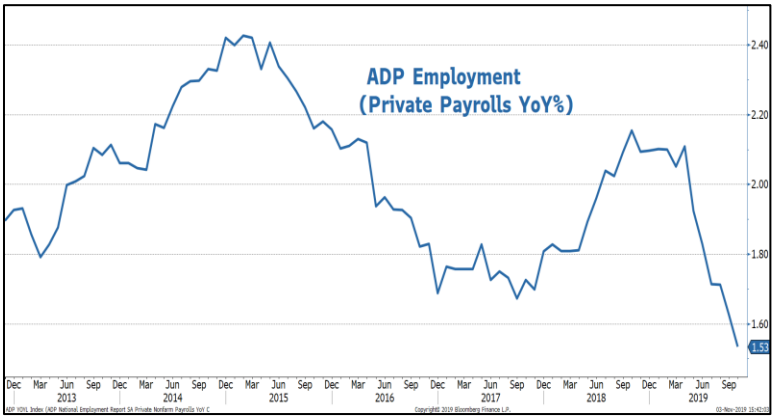
Unemployment Lags the Economy



Source: Bloomberg

And last week's ADP report concluded the worst six-month period for jobs since 2010. Of course, it's only a slowdown from very strong levels (i.e., labor market growth is eroding as opposed to major job losses). But before complacency sets in, it's a reminder that unemployment is a lagging indicator.

Payroll Growth: Lower Highs, Lower Lows



Source: Bloomberg

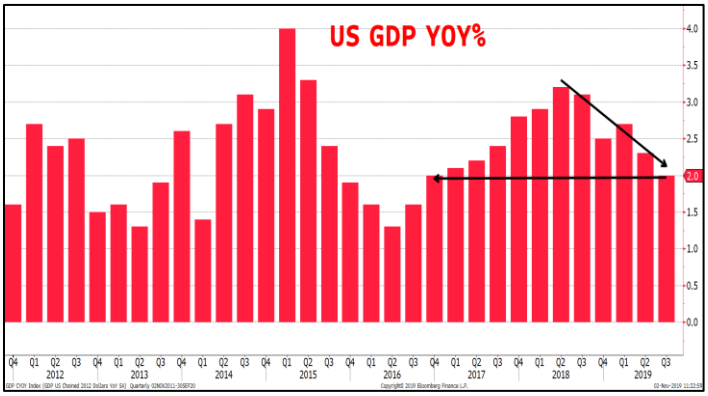
In 2020, will the recession coincide with unemployment rising to 4% from September's 3.5% print? How long will that take? Given the pace at which the jobs market is deteriorating, second quarter next year does not seem an unreasonable benchmark.

FACT: Q3 GDP 2019 HITS A 12-QUARTER LOW

And the more I dig through that third quarter U.S. GDP report, the more I don't like it. Strip out a 32.5% annualized surge in real automotive output, at a time when consumer spending in autos practically stagnated, and real GDP growth barely came in better than a 1.0% annual rate.

Beyond that, restaurant/accommodation activity slowed. Recreation services, among the most discretionary household spending item of all, fell and has dipped now in two of the past three quarters. Ditto for apparel, which declined. And in a nation of drivers, it was surprising to see gasoline purchases in volume terms sagging. That is not typically the behavior associated with a robust consumer.

Growth Slows to Lowest Level in 3 Years



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Last week the Fed cut rates for the third time this year, which was widely expected by the market. What was not expected was the following statement.

> *"I think we would need to see a really significant move up in inflation that's persistent before we even consider raising rates to address inflation concerns." – Fed Chair Jerome Powell, October 30, 2019*

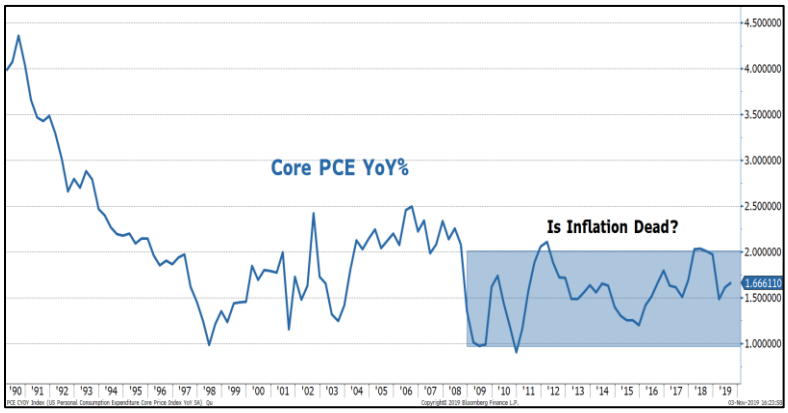
Powell is not only saying that they will allow a significant move up in inflation, but going one better by adding the word "significant." Unlike the prior few Fed Chairmen, who claimed to be vigilant towards inflation, Powell is clearly telling us that he will not react to inflation that is not only well beyond a "really significant" leap from current levels, but a rate that lasts for a period of time. If inflation is not only a really significant increase from current levels and stays at such levels for a while, they will only consider raising rates to fight inflation**.**

In making this statement, Powell basically admitted that the Federal Reserve is caught in the same **"liquidity trap"** that has been the history of Japan for the last three decades.

Here is the definition of a liquidity trap.

"A liquidity trap is caused when people hoard cash because they expect an adverse event such as deflation, insufficient aggregate demand, or war. Signature characteristics of a liquidity trap are short-term interest rates that are near zero and fluctuations in the monetary base that fail to translate into fluctuations in general price levels." – Wikipedia

No Inflation in the Nation



Source: Bloomberg

With an aging demographic, which will continue to strain the financial system, increasing levels of indebtedness and unproductive fiscal policy to combat the issues restraining economic growth, it is unlikely monetary interventions will do anything other than simply continue the boom/bust cycles in financial assets. The U.S., like Japan, is clearly caught in an ongoing "liquidity trap" where maintaining ultra-low interest rates are the key to sustaining an economic pulse.

If interest rates rise sharply, it is effectively "game over" as borrowing costs surge, deficits balloon, housing falls, revenues weaken and consumer demand wanes. It is the worst thing that can happen to an economy that is currently remaining on life support.

This is why every interest rate increase is nothing but a spasm, why every bond market correction is to be bought, why deflation trumps inflation, and why global aggregate demand growth is so putrid despite its longevity. After 124 months of economic growth, the 10-year Treasury yield is ONLY 1.8%!

In terms of portfolio strategy, credit unions should maintain a fully invested diversified ladder strategy. Any weakness in the bond market should be viewed as an attractive entry point to redeploy excess cash.

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.