BALANCE SHEET SOLUTIONS
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WEEK OF NOVEMBER 12, 2019

Weekly Relative Value

The World Has Gone Mad

"I believe that the world is approaching a big paradigm shift." – Ray Dalio

Ray Dalio, founder, Co-Chairman and Co-Chief Investment Officer of Bridgewater Associates, L.P., one of the world's largest hedge funds, penned an article titled The World Has Gone Mad and the System Is Broken. Yes, it sounds a bit downcast. Yet, while I may differ on some of the specifics and solutions, I believe that Mr. Dalio is on the right track. I would recommend that everyone take a few minutes and read this article in its entirety. Below I have are some quick excerpts. All bolding and graphs/images are personal additions for emphasis.

*"**Money is free for those who are creditworthy because the investors who are giving it to them are willing to get back less than they give.** More specifically investors lending to those who are creditworthy will accept very low or negative interest rates and won't require having their principal paid back for the foreseeable future. They are doing this because they have an enormous amount of money to invest that has been, and continues to be, pushed on them by central banks that are buying financial assets in their futile attempts to push economic activity and inflation up... **This dynamic is creating a 'pushing on a string' dynamic**… As a result of this dynamic, the prices of financial assets have gone way up, and the future expected returns have gone way down while economic growth and inflation remain sluggish."*

Source: Cagle

*"Because investors have so much money to invest and because of past success stories of stocks of revolutionary technology companies doing so well, more companies than at any time since the dot-com bubble **don't have to make profits or even have clear paths to***

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THIS WEEK

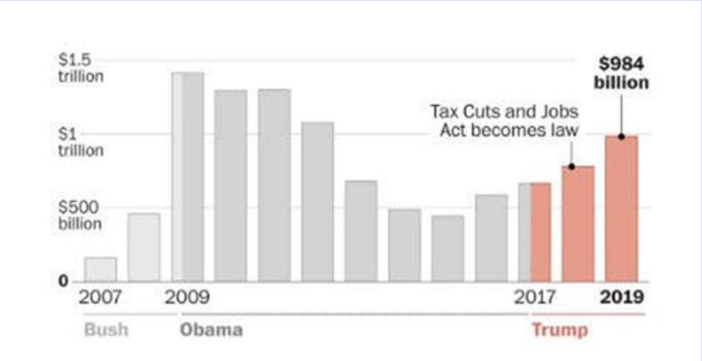
- WHY IS PRODUCTIVITY DECLINING?
- TIGHTER CREDIT STANDARDS, WEAKER DEMAND

PORTFOLIO STRATEGY

making profits to sell their stock because they can instead sell their dreams to those investors who are flush with money and borrowing power."

"At the same time, ***large government deficits exist and will almost certainly increase substantially,*** *which will require huge amounts of more debt to be sold by governments—amounts that cannot naturally be absorbed without driving up interest rates at a time when an interest rate rise would be devastating for markets and economies because the world is so leveraged long.* ***Where will the money come from to buy these bonds and fund these deficits? It will almost certainly come from central banks, which will buy the debt that is produced with freshly printed money.*** *This whole dynamic in which sound finance is being thrown out the window will continue and probably accelerate…"*

Deficits are Rising in "Good Times"



Source: CBO

"[P]ension and healthcare liability payments will increasingly be coming due while many of those who are obligated to pay them don't have enough money to meet their obligations… Since there isn't enough money to fund these pension and healthcare obligations, there will likely be an ugly battle to determine how much of the gap will be bridged by 1) cutting benefits, 2) raising taxes, and 3) printing money (which would have to be done at the federal level and passed to those at the state level who need it). This will exacerbate the wealth gap battle. While none of these three paths are good, printing money is the easiest path because it is the most hidden way of creating a wealth transfer and it tends to make asset prices rise."

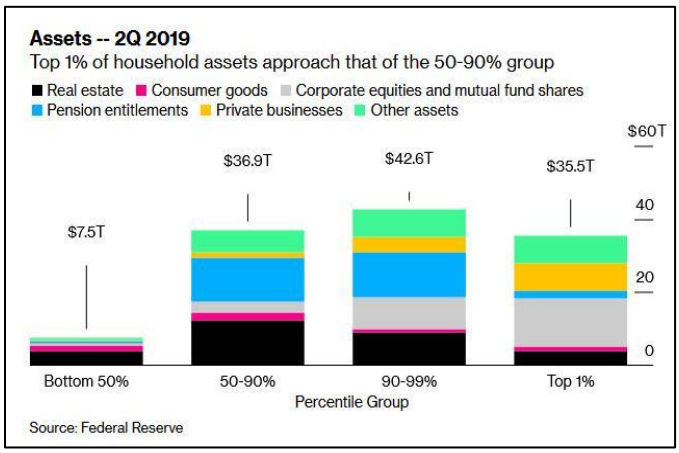
"At the same time as money is essentially free for those who have money and creditworthiness, it is essentially unavailable to those who don't have money and creditworthiness, which contributes to the rising wealth, opportunity, and political gaps."

Sidebar: Every central bank, notably the Fed, lives with a mindset that rising equity markets produce wealth and, in turn, creates a "wealth effect" on spending. Make no mistake, the reason equity markets are rising is because of the Federal Reserve's intervention which has injected $280 billion in fresh liquidity in just the past two months, pushing the Fed's balance sheet above $4 trillion for the first time since February.

Undoubtedly, the "wealth" has certainly boomed but spending and the real economy have been quite unimpressive. All that the policy has really done is exacerbate the wealth inequalities. We have a situation where net worth for the top 1% of Americans (roughly 1400 households) now have $35.4 trillion in assets (Elizabeth Warren and Bernie Sanders are coming after you!) that comes close to the $36 trillion assets held by the tens of millions of the middle and upper-middle classes who make up the 50th percentile to the 90th percentile of Americans. Think about that. The top 1% has nearly the same net worth as the next 40% that occupy that middle-upper cohort. Never mind everyone else!

What about the bottom of U.S. society? Well, if the super-rich own almost all stocks, **the "bottom 90%" (i.e., 90% of the entire U.S. population) owns the vast majority of debt, some 72.4% of the total pile.**

The Rich are Getting Richer off the Fed's Largess



We do know from history that there are dangers to having a system where the gap between the haves and the have-nots hits extreme levels. Democracy and capitalism are always a tenuous dance, and what makes the American experiment so unique is how the two have tangoed for so long. But again, as the history of civilization teaches us, greed always seems to get in the way at some point.

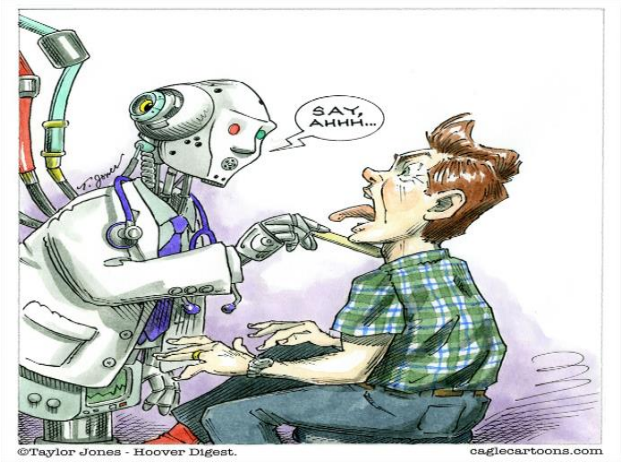
Wealth Inequality Has Never Been Higher

This is the essence as to why populist movements have gained such traction here in the States and abroad as many Americans on the left and right demand either wealth redistribution, higher taxation or outright punishment of those billionaires who have benefited from the Fed's **artificial levitation** of the stock market.

Back to Ray…

"Also contributing to these gaps are the technological advances that investors and the entrepreneurs that I previously mentioned are excited by in the ways I described, and that also replace workers with machines. ***Because the 'trickle-down'***

process of having money at the top trickle down to workers and others by improving their earnings and creditworthiness is not working, the system of making capitalism work well for most people is broken."



Source: Cagle

Dalio concludes: *"This set of circumstances is **unsustainable** and certainly can no longer be pushed as it has been pushed since 2008. I believe that **the world is approaching a big paradigm shift."***

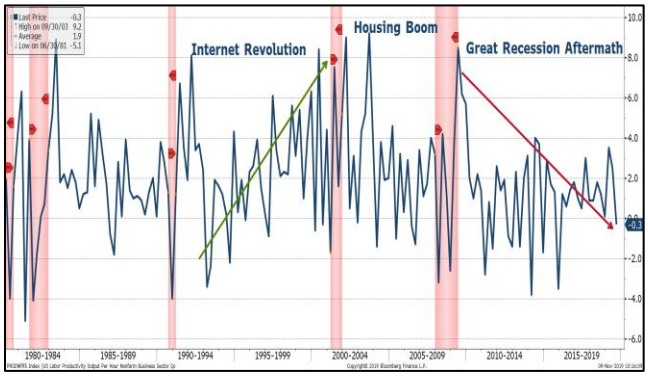
And there you have it. While you may not agree with everything, the gist of the message is right on.

WHY IS PRODUCTIVITY DECLINING?

"In large part, the productivity slowdown—and the associated productivity paradox—are real." – Brookings Institute

Economists universally view the growth in labor productivity, or output per worker, as the single most important variable in an economy. It's what lifts the standard of living, helps keep prices low, reduces government budget stresses, and drives corporate profits. And as one can glean from the graph below, productivity has slowed over the post-WWII period, and that partially explains the lower economic growth rate experienced in the 10-year recovery since the Great Recession.

Productivity Continues to Decline



Source: Bloomberg

There are many who believe that productivity is understated or measured imperfectly. I would argue that productivity is overstated. Think about it. How many overtime hours do supervisory workers at Walmart, Target, etc., actually work while getting paid for 40? Or how many hours do employees work at home and on vacation while not getting paid for them?

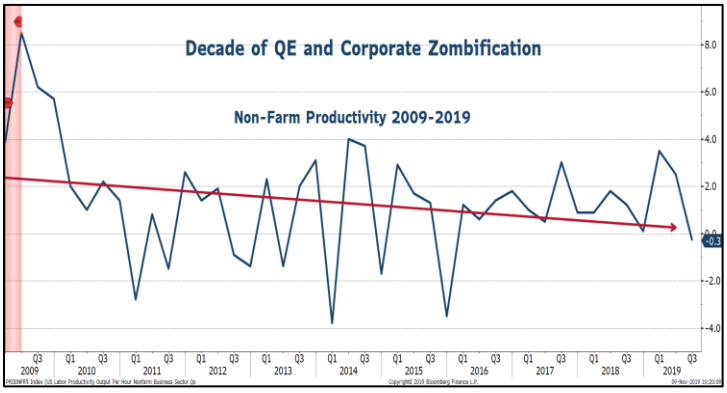
Below I list a few reasons why productivity has declined:

1. There simply isn't a lot of room for productivity growth in a service economy. Cutting hair takes as long as it takes. Manufacturing is where you get productivity growth through the design and creation of new tools and materials. So, productivity growth can only really grow along with the portion of the population employed in manufacturing.

   And investment in manufacturing only happens when there is either an increase in demand or an increase in costs, primarily wages. And since wages have been stagnant over the last 40 years, there is little increase in demand or labor costs. Ergo, no need to invest in increased productivity.

2. The Fed's easy money policies sponsored numerous corporate zombies. Those zombies survive only because of ultra-easy financing. Zombie companies are unproductive, by definition. Zombie firms are companies that are unable to cover debt servicing costs from current profits over an extended period. Cheap financing is the primary cause. The result is low productivity.

The Zombification of America



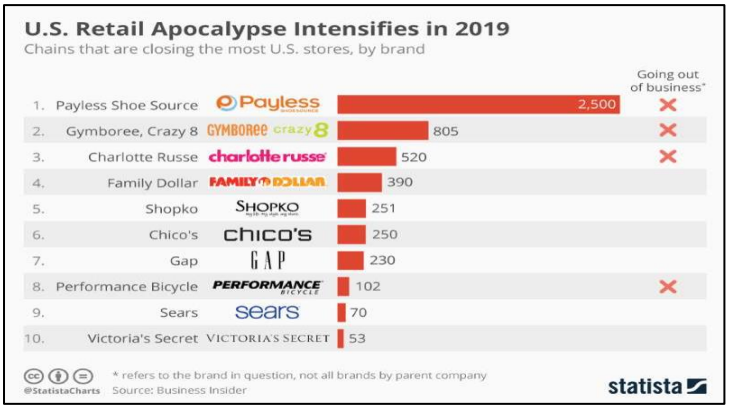
Source: Bloomberg

   I might also add that by keeping these companies intact, it has created a global economy awash with excess capacity in the business sector (the fact that they don't have to lay anyone off has kept the labor market tighter than it should be based on where global demand growth is... (but this is like the story of the little boy with his finger in the dike). We have had this lesson in Japan for years, then it went to Europe, and now to China. The U.S. is certainly not immune from this new world of excessive indebtedness rendering incremental credit stimulus as being a deflationary, not an inflationary development.

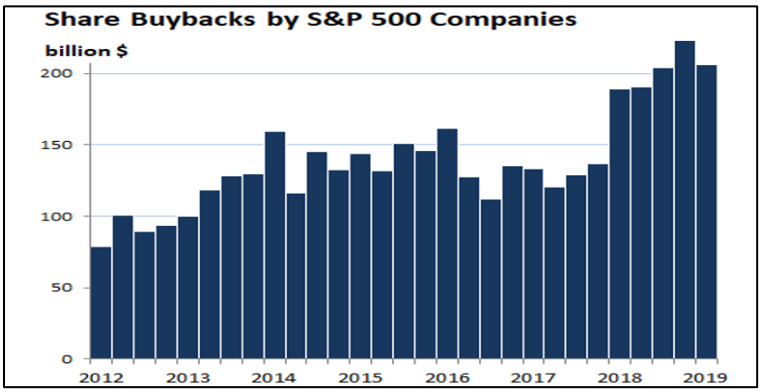
3. Demographics. As skilled workers retire, those workers are replaced by workers with lower skills.

4. Health and drug-related issues are on the rise as are time-off needs for those reasons. Obese workers have more health-related issues and thus need more time off. They also move slower and do not function as well as healthy workers.

5. The Fed's easy money policies also sponsored a "store on every corner." In fact, there are more U.S. retail stores per capita than in any other country in the world. So yes, we're over-stored. And marginal stores have to be manned by somebody and they are, by increasingly marginal employees as the unemployment rate declines. (Think Sears.)



6. Corporate buybacks mainly benefit CEOs and executives who cash out their shares and options. It takes careful investment, not reckless expansion nor buybacks to have productivity gains.



Source: Standard and Poor's

7. Militant unions demand and receive unwarranted pay, time off, and control over workplace conditions. To wit: GM agreed to a lot of worker protections, guaranteed hours, plant improvements, etc., that will not make any sense if there is an economic slowdown.

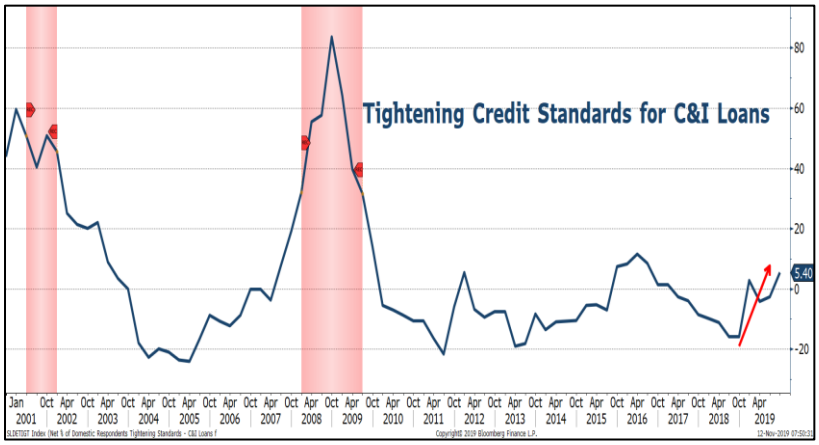
8. It's the debt, stupid. Fiscal deficits are totally out of control. Interest on the national debt by itself is $574 billion. What are we getting for it? Government does not spend money wisely to say the least. It collects money via taxes then wastes in on counterproductive military operations and other nonsense. When it spends on infrastructure, it overpays because of prevailing wage laws and collective bargaining

Here's the point: Since economic growth is dependent on productivity growth (and population growth), and since these are both slowing, it would seem as if we are entering a prolonged period of slow economic growth, no matter how much governments attempt to stimulate the economy.

TIGHTER CREDIT STANDARDS, WEAKER DEMAND

According to the Fed's Senior Loan Officer Survey, the third quarter saw the largest net tightening in credit standards for commercial and industrial (C&I) firms (both large and small) in more than three years.

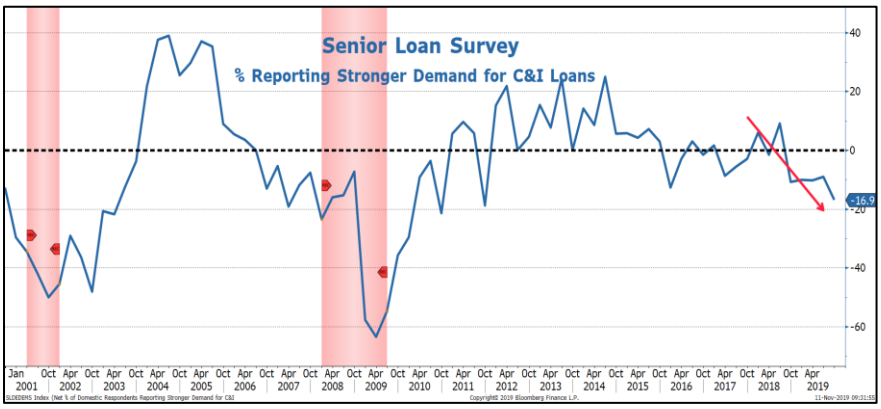
Credit Standards Tightening



Source: Bloomberg

C&I loan demand continues to roll over. In fact, the net percentage of banks reporting stronger demand from large firms (-21.6%) was the worst it has been since the first quarter of 2010. The situation for small firms was down to -16.9% from -9.0% previously. As the following charts vividly illustrate, readings as weak as this have usually occurred in the lead-up to recessions.

Loan Demand Declining



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

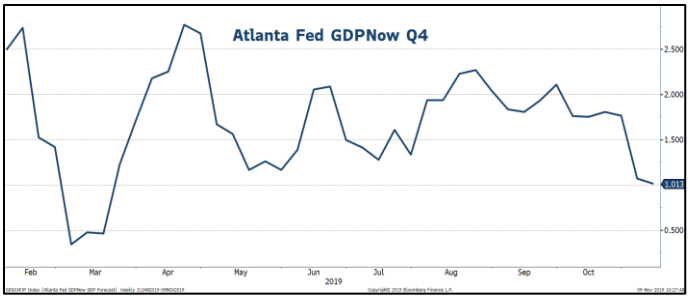
The S&P 500 is coming off posting a fifth consecutive week of gains and the longest winning streak in two years. In the face of declining earnings-per-share (EPS) estimates, and a rise in bond yields, the forward price-to-earnings (P/E) multiple has staged a Houdini act and expanded to 17.5x, which is insane.

It is tough to say why the stock market has been behaving so well. All I know is it has nothing to do with the economy. The following data were released in September:

- Housing starts: -9.4%
- Building permits: -2.4%
- Existing home sales: -2.2%
- Core capex orders: -0.6%
- New home sales: -0.7%
- Core capex shipments: -0.7%
- Wholesale inventories: -0.3%
- Commercial construction: -0.6%
- Industrial production: -0.4%
- Retail sales: -0.3%

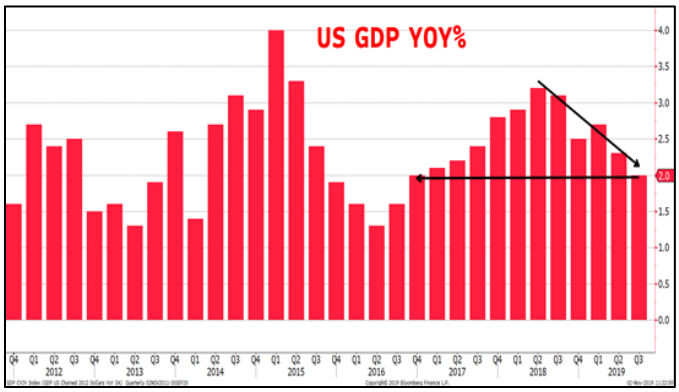
The fourth quarter GDPNow and Nowcast forecasts start off on a weak footing, 1% or less.

Growth Below 1% in the Fourth Quarter?



Source: Bloomberg

Meanwhile, here is the trend in year-over-year GDP: Q1: 3.0%; Q2: 2.3%; Q3: 1.9%; and Q4: <1%??



Source: Bloomberg

So please, when you hear those on TV telling you how great the U.S. economy is, that proverbial best house in the bad neighborhood, ask them if they have any clue about what the economy is actually doing. Opinions only carry you so far.

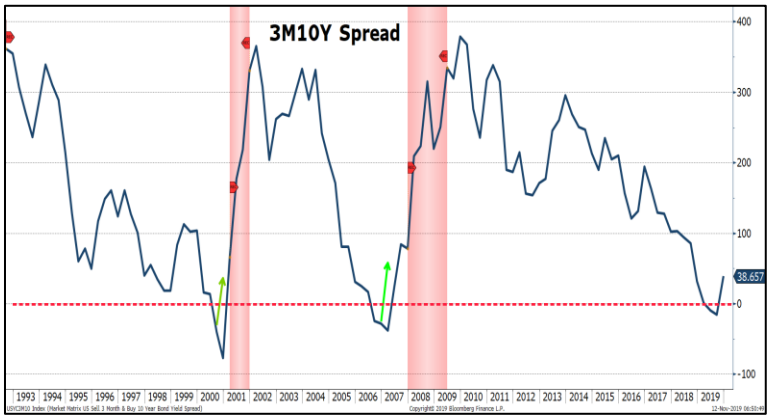
Yes, the "deal" is coming, and the world economy will be off to the races… There is this consensus view that global economic growth is bottoming out or is close to doing so. This is interesting seeing as the U.S. economy is throttling back

to 1% or even sub-1% growth in the fourth quarter. And I see that Oxford Economics is looking for Chinese growth to ease further in 2020 to 5.7%.

Hope is not a risk management process.

While the bond market has endured a steep correction in the past two months, the secular bullish trendline has scarcely been broken. As for the view being promoted in this week's Barron's (i.e., that the three Fed rate cuts in recent months are bullish for growth) ignores how long the policy lags are. This won't show up until 2021. We are still feeling the lagged impact of the near 400-basis-point de facto tightening, via rates and quantitative tightening, from 2016 to 2018. And all the Fed has really done here is take away the excessive tightening that it had previously administered and has since apologized for. Now for this view that the un- or de-inverted yield curve is something to get excited about, I beg you, give it a giant break. The damage is done. After a two-year tightening cycle, the Treasury curve inverted (both three-month bills/10-year yields and two-year notes/10-year yields) in June/July 2006. The Fed stops tightening and just over a year later started to cut rates. The yield curve always steepens when the Fed eases! And this time, there is the added help from this "Oh, it's not a quantitative easing move to hoover up $60 billion of Treasury bills each month." Funny how when the curve inverted, the gurus out there said to ignore the inversion because of the bond market distortions that quantitative easing provided. Yet now that quantitative easing is distorting the front end of the curve, these folks have gone silent... interesting.

The Yield Curve Uninverts



Source: Bloomberg

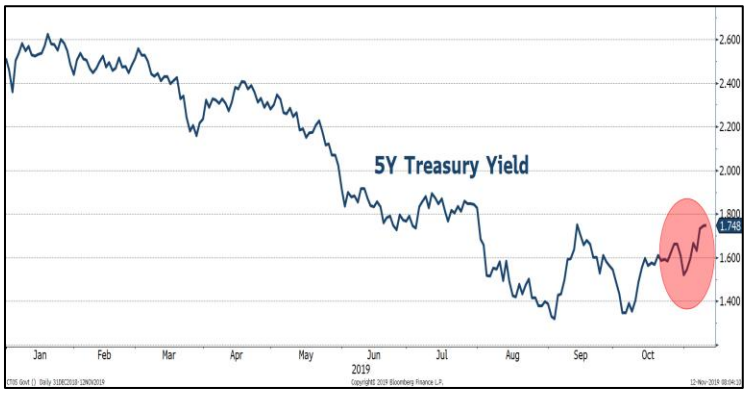
Here's a bit of history. Back in 2007, the Fed cut rates, and cut rates and cut rates. The economic expansion ended in December 2007 and the recession started the very next month. The Great Recession, as it turned out. And guess what? At the point the recession began, the three-month/10-year yield curve had a positive 65-basis-point spread and 2s/10s was +103 basis points.

This is the bottom line: A recession is eventually coming and even a relatively weak one will set off the dominoes. Highly leveraged, unprofitable companies will default on their debts and lay off their workers, sending government debt higher as safety net spending rises and tax revenue falls. To think this happens without a significant bear market in equities is rather implausible.

Now consider the Atlanta regional Fed forecasts that this will unfold in a highly contentious election year, and possibly with the U.S. still embroiled in a trade war with China and/or others. We've seen how reports that negotiations are going well, or not going well, can move markets. In a few months we will start seeing similar responses to political poll results.

In terms of portfolio strategy, we advise that credit unions maintain the "tried and true" discipline of laddering their investment portfolio. In terms of yield curve positioning, we believe the five-year part of the yield curve offers the best relative value. In terms of sectors we favor the higher yielding CMBS (Freddie Ks and DUS), select well-structured CMOS and high-quality bank notes. Finally, we encourage credit unions to take advantage of intermittent selloffs to commit excess cash.

The 5-Year Sector Offers Good Value



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.