BALANCE SHEET SOLUTIONS
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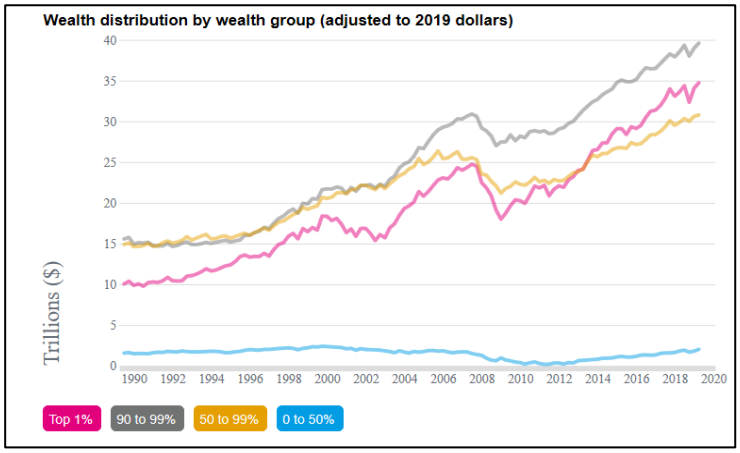
WEEK OF NOVEMBER 18, 2019

Weekly Relative Value

It's Good to be King

"It's called the American Dream because you have to be asleep to believe it."
– George Carlin

The Fed's latest figures on American household wealth – the value of assets subtracted by the liabilities and debts owed – paint a rosy picture. In aggregate, American households have seen their net worth grow 58% from a low of $68 trillion, or $577,000 per household, in the first quarter of 2009 to $107 trillion, or $881,000 per household, in the second quarter of 2019. But drill into those figures and you'll notice that almost all of this new wealth has landed in the pockets of the top 1% of households.



Source: U.S.News

- The wealth of the **top 1% soared by $18 trillion** to $34 trillion; an increase of by 5 percentage points to 32%. The 1% now own nearly one-third of total household wealth.
- The share of household wealth owned by the **next 9% rose by $16 trillion** to $39 trillion. Yet, their percentage of the total wealth fell by 3 percentage points to 37%.
- The wealth of the 50% to 90%, so that's the upper middle class, **has risen by a more modest $13 trillion to $31 trillion**. On a percentage basis, wealth of the 50% to 90%, the upper middle class, also fell by 3 percentage points to 29%.
- Today, the share of the 1% is nearly 4 percentage points higher than the share of the 50% to 90%. As you can glean from the graph above, in 2002 it was reverse: The share of the 1% was about 10 percentage points lower than the share of the 50% to

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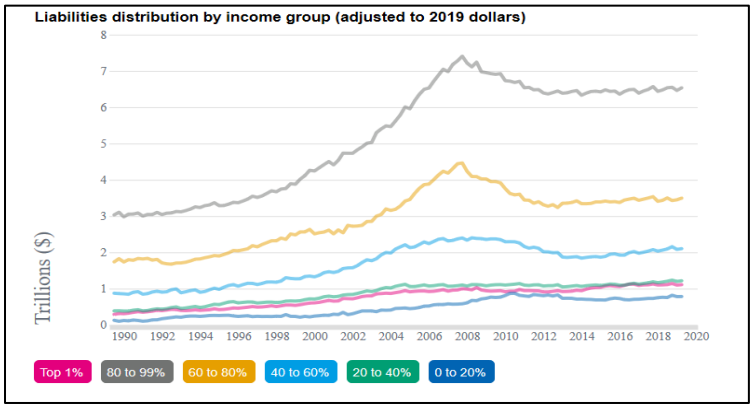
90%. In fact, the biggest decline in household wealth is now coming from the upper middle class, the 50%-99% of households.

- What is not new is that the share of wealth owned by the **bottom 50% of American households has continued to fall,** while their debts have continued to rise: the bottom half own 6.1% of all U.S. wealth.
- But in terms of debt, **the bottom half of households carry 36% of the total debt**, such as mortgages, credit card debt, auto loans and student loans. So, they own 6.1% of the assets and they owe 36% of the debt. When you subtract debts from assets, the bottom **half of U.S. households account for only 1.9% of America's assets** or approximately $2 trillion, a tiny fraction of the wealth of the 1%.

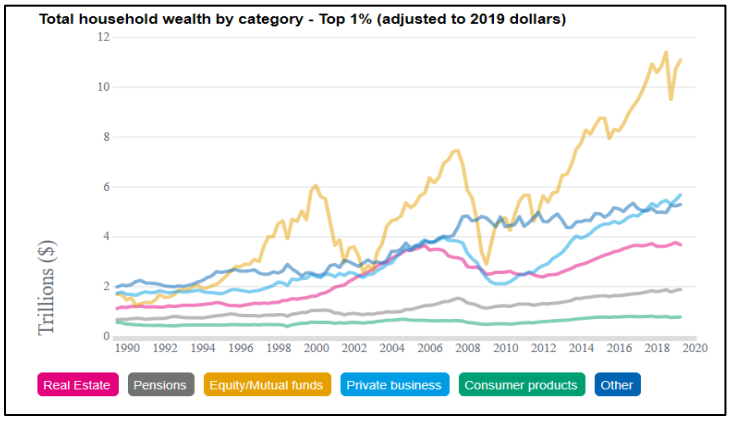


Source: U.S. News

So, what's behind this massive and growing wealth inequality in America?

That's simple. The Federal Reserve.

Over the past 10 years, the Fed – via quantitative easing (QE) and artificially low interest rates – has engineered an enormous amount of asset price inflation in the form of equity, mutual funds and similar investments since the Great Recession. And while the stock market is open to all, the wealthy have access to other types of investments. Many hedge funds, private equity firms, and venture capital funds require a $5 million minimum investment. Households that don't have an "extra" $5 million to invest are excluded from the club.



Source: U.S. News

So, the so-called "Wealth Effect" is reserved for the already wealthy that have the most assets, and when asset prices surge, those that hold the most assets benefit the most.

Still waiting...

Source: Cagle

Meanwhile, the most common assets for the lower to middle-income class has been certificates of deposit and savings accounts. Households hold approximately $10 trillion in these products. These types of products are a classic way of saving money at the lower income levels, and people have mostly been penalized for doing it as the Fed's interest rate repression has destroyed returns on these products over the past decade.

And the things that define middle-class life – quality health care, post-secondary education, decent housing – have soared in cost, far, far ahead of the modest gains experienced by the 50-99%. These are the people who cannot save anything because their expenses for housing, healthcare, education, transportation, childcare, etc. are eating up their income. And because they cannot save anything, they have no means to invest.

It boils down to this: The households in the bottom half of the wealth spectrum are spending all their money just getting to the next paycheck, and they cannot accumulate money to invest, and they cannot benefit from the Fed's ingenious Wealth Effect.

This economy – and I will point my finger straight at the policies of the Federal Reserve – is set up to shift an ever-larger share of the wealth to the top 1% and away from everyone else, according to the Fed's own data. It is truly ironic that the Fed puts out the data, as if to show off its handiwork, its success, as measured by how much of the wealth is increasingly concentrated at the top 1% of households.

"It's a big club, and you ain't in it. You know which club that is, don't ya? It's the same club they use to beat you over the head!" – George Carlin

Is it any wonder Elizabeth Warren and Bernie Sanders are both proposing wealth taxes as a part of their bid for the 2020 Democratic presidential nomination?

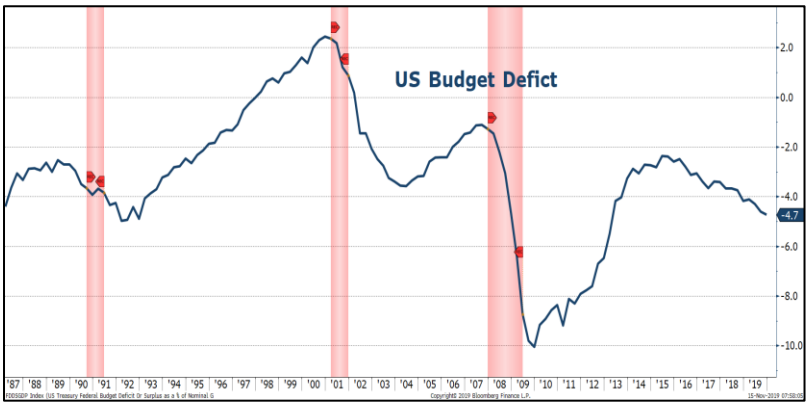
Do we remember the occupy Wall Street movements? I suppose it died out because the economy eventually improved. But when it slows again, I can see how the movements will be much worse as people realize the system is flawed and designed to benefit the wealthiest Americans.

$255 TRILLION IN DEBT

The world's debt is rising to unprecedented levels. Global debt surged by $7.5 trillion in the first half of the year, hitting a new record of more than $250 trillion, according to the Institute of International Finance (IIF). The world's debt has now risen to 320% of what it produces, the highest level ever recorded. And the U.S. and China are leading the debt binge with more than 60% of the world's total — and IIF economists say they see "no sign of a slowdown."

We learned this week that U.S. budget deficits rose a whopping 34% in October from a year earlier. For the fiscal year ending September, the deficit rose above $1 trillion and the deficits as a percentage of GDP approached 5%. So, the trend towards higher and higher debt and larger deficits continues unabated. Never has this country – outside of World Wars and recessions – experienced such high deficits with no end in sight. With GDP weakening to 0.4% or below, and without a significant trade deal (something more than just around the margins for optical reasons), we can expect lower government revenues and higher government spending to further increase the deficit. If this is the "greatest economy ever," debt and deficits should be small and declining. They are unequivocally not!

Budget Deficits Deepen



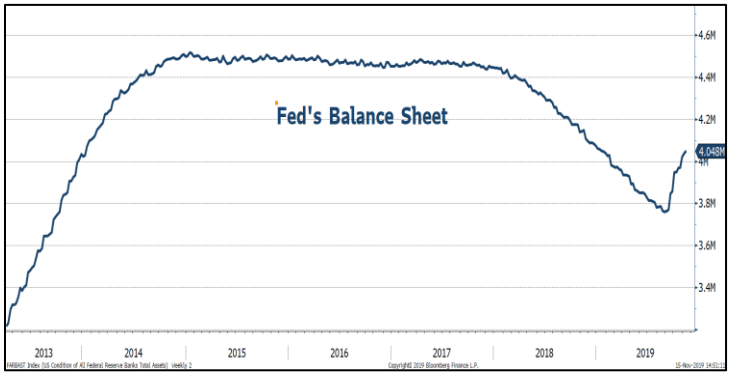
Source: Bloomberg

Even Fed Chair Jerome Powell, who has been consistently upbeat and focused almost exclusively on the strengths of the U.S. economy, was dour in his assessment of current U.S. debt levels.

> *"The federal budget is on an unsustainable path, with high and rising debt… Over time, this outlook could restrain fiscal policymakers' willingness or ability to support economic activity during a downturn… I remain concerned that high and rising federal debt can, in the longer term, restrain private investment and, thereby, reduce productivity and overall economic growth." – Jerome Powell*

As an aside, how ironic is it that Powell criticized fiscal largesse even as the Fed is now back to monetizing the deficit? Its balance sheet has expanded by about $280 billion since August… incredible. This is a faster rate of increase than that observed during QE3. The Fed is conducting QE that it dares not advertise as QE; it is de facto monetizing more than just the entire fiscal deficit.

QE4



Source: Bloomberg

This is the reality. Republicans are fiscal conservatives only rhetorically and, like all politicians, will respond to constituent demands. Everybody wants lower taxes (for themselves) and higher spending (on their own priorities). Not good, but it's reality. And so, the debt grows ever larger.

No candidate can run on anything close to fiscal balance, because to do so would mean either advocating higher taxes or cutting entitlement programs. Both are guaranteed vote killers.

I realize some readers are of the progressive persuasion that debt doesn't matter, we owe it to ourselves, etc. This is not correct. Debt **does** matter, and there are limits to how much an economy can bear. I'll admit, the limit is proving higher than I thought, but there is one and every day brings us closer to it.

Our leaders have no real plan to reduce the debt, much less eliminate it. They just want to spend, spend, spend forevermore. And most citizens are okay with that. The Republican Party I grew up with, which back then seemed to constantly talk about deficits and debt, is now comfortable with 5% (and growing) of GDP deficits.

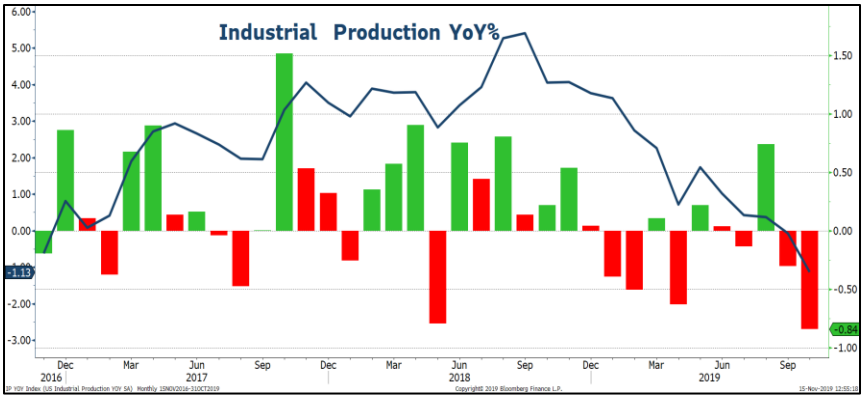
IS THE U.S. ECONOMY IS IN A GOOD PLACE?

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

You be the judge…

After contracting year-over-year in September for the first time since President Trump was elected, October's 0.8% collapse in Industrial Production is the worst since March 2009... Manufacturing production decreased 0.6% in October. Much of this decline was due to a drop of 7.1% in the output of motor vehicles and parts that resulted from a strike at a major manufacturer of motor vehicles. However, it's not all strike related. Weakness was across the board. Business equipment was down 0.06% month-over-month and a whopping 2.5% year-over-year. And construction is down for the third time in four months.

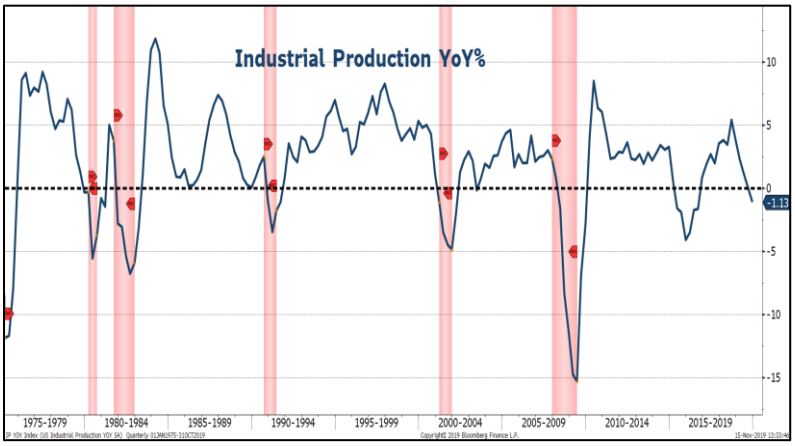
U.S. Industrial Production Plunges Most Since March 2009



Source: Bloomberg

And, as shown in the following graph, as industrial production goes so goes the economy.

Industrial Production vs. Recessions



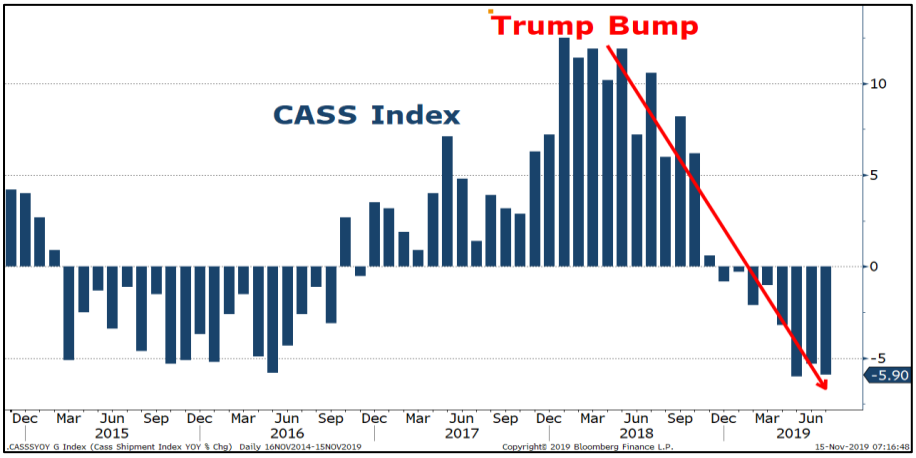
Source: Bloomberg

A key barometer of the U.S. economy that I have continued to keep an eye on is the transportation sector. As a group, they say a lot about the state of the economy and their performance has been lackluster to say the least.

The Cass Freight data hit the wires last week. But it wasn't the depressed string extending into an 11th month that caught my attention. It was this: *"The Index on a 2-year percentage change basis went negative (-0.1%). This suggests that the great surge of 2018, or 'Trump bump' as it was characterized by many, has now been completely erased at least from a freight flow perspective."*

The transportation sector is in its deepest rut since the Great Recession. Donald Broughton, founder of Broughton Capital and author the Cass Freight Index says the index signals contraction, possibly by the end of the year. That's just one month away.

Shipping Continues to Decline

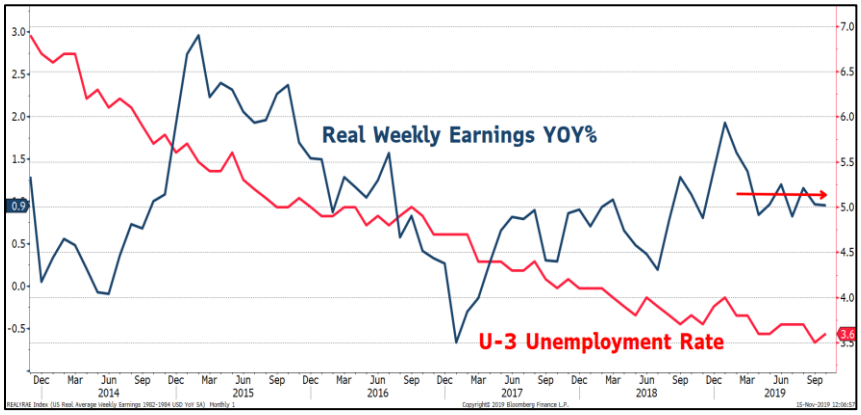


Source: Bloomberg

What is more important to a consumer driven economy than personal income?

And yet, to very little fanfare, last week real average weekly earnings dipped 0.1% in October and they have declined (or been flat) now in three of the past four months. This is the wage growth that the alleged most wonderful labor market in 50 years can manage to generate. That's it!

Real Earnings Pancake

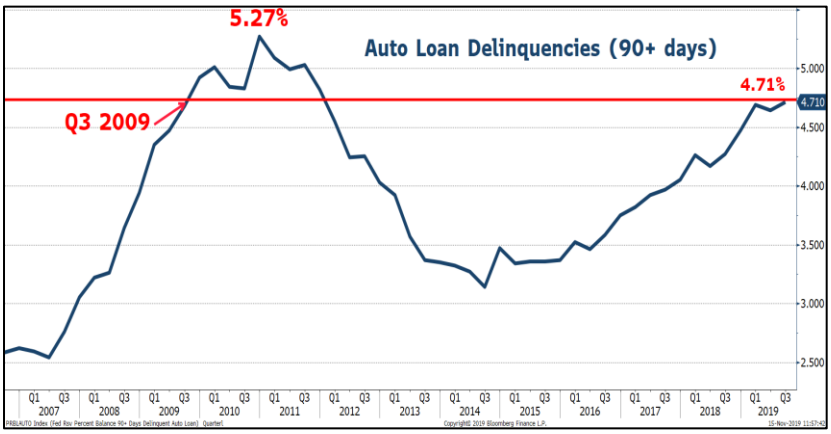


Source: Bloomberg

And serious auto loan delinquencies – auto loans that are 90 days or more past due – in the third quarter of 2019, after an amazing trajectory, reached a historic high of $62 billion. Of the $1.32 trillion in auto loans outstanding, about 22% are subprime, so about $300 billion. Of them, roughly $62 billion are seriously delinquent – or around 20% of all subprime loans outstanding. One in five. Overall, the current rate of 4.71% is just 56 basis points below the peak of fourth quarter 2010. But these are the good times – and not an employment crisis, when millions of people who lost their jobs cannot make their loan payments.

So, what is going to happen to auto loan delinquencies when employment experiences a pullback, even a fairly modest one, such as when one million people lose their jobs? That was a rhetorical question. We know what will happen: The serious delinquency rate will set a record for the annals of history.

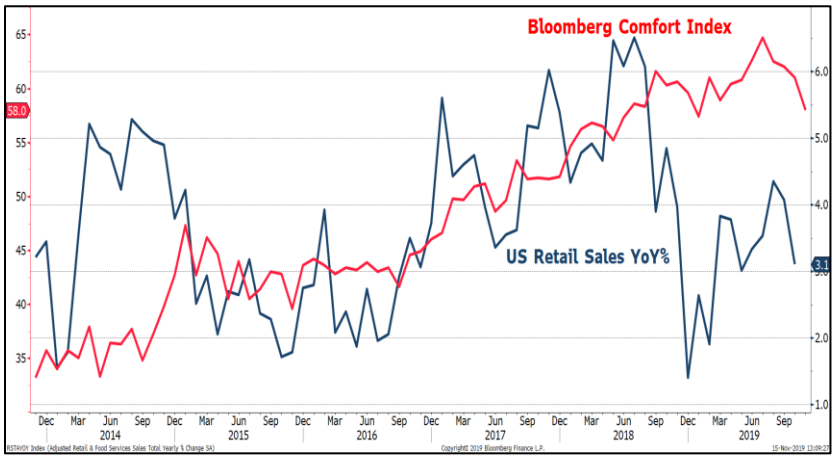
Auto Delinquencies Surge



Source: Bloomberg

Is it any wonder retail sales have slowed down significantly? Are consumers losing faith?

Retail Sales Decline



Source: Bloomberg

This slowdown in high frequency economic indicators has not been lost on strategists, and in just the past week, tracking estimates for fourth quarter GDP have tumbled by over 0.4% in just the past week, with both the Atlanta Fed and New York Fed now expecting a sub-0.40% GDP print in the current quarter.

This would be only the fifth time in the 42 quarters since the third quarter 2009 exit from recession when U.S. growth has risen by less than 0.5% quarter-over-quarter. Frankly, I would not be surprised to see the fourth quarter is in a deeper hole than even the New York and Atlanta Fed may be estimating.

Is the economy in a good place? Not really. From 3.0% growth in the first quarter to sub-2% in the third quarter to perhaps zero in the fourth.

GDP Estimates Crash on Dismal Economic Reports

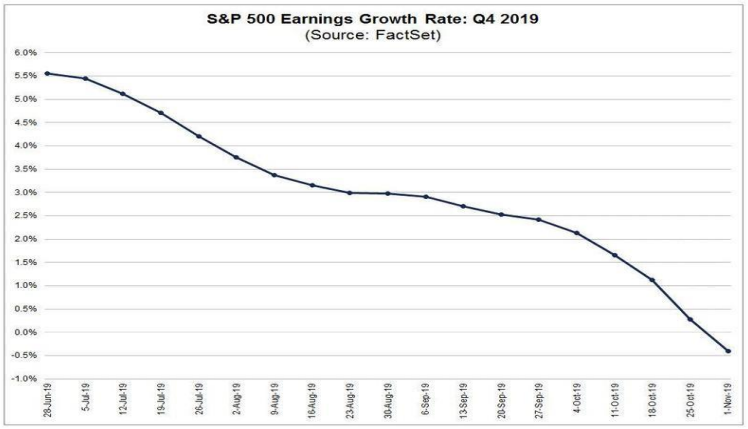
Source: Bloomberg

MOTHER'S MILK

"Profits are the mother's milk of the stock market." – Larry Kudlow, White House Economic Advisor

As for profits, earnings are on pace to decline 2.4% year-over-year so far in the third quarter and have contracted now for three quarters in a row. Estimated revenue growth of just over 3% is the slowest in three years. Yet the view is that profits are strong.

Corporate Profits Down for Three Consecutive Quarters



Source: Fact Set

I understand why the stock market has risen. It's all about buybacks. Yet, in a perverse way, the buyback wave reflects a somber business sector outlook for economic growth because, if CEOs have clarity or believed that their perceived return on capital exceeded the cost of capital, they would be deploying their cash into the real economy, not into share buybacks. In fact, the weaker the economy seems to be, the better the stock market does as rates go down. This creates the financial incentives to buy back shares. And every percentage point decline in capital goods orders seems to translate into an extra 5% rally in the S&P 500, since the cutbacks in capex allows for more room for the most powerful source of demand for equities today. Therein lies the anomaly: the lack of any connection, or maybe even an inverse

correlation, between equities and the economy since the buyback support for share prices *ipso facto* is symptomatic of a fairly bearish macro outlook from corporate executives.

I only bring this up to point out that the S&P 500, which is printing at all-time highs well above 3,100, is clearly no longer reliant on the U.S. economic outlook, even if U.S. GDP is now expected to print dangerously close to contraction due to a sharp slowdown in household spending, capex, residential investment and inventories.

Patience. Discipline. In any event, keep your hands on the wheel and eyes on the road. Don't be lured into the view that the equity market is providing you with any meaningful economic information at all. There is no correlation any longer between the S&P 500 and GDP. Be that as it may, pundits are taking their macro cues from the market and this is a mistake.

THANKSGIVING FOOD FIGHT

Source: Cagle

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Just ignore what they say and look at what they do," Peter Schiff of Euro Pacific Capital

Jay Powell cemented the view that there will not be another rate cut in December. Markets had already repriced for and have swung the pendulum so far that the central bank has been priced out altogether as far as the eye can see. The futures market is priced now more than 50-50 for the Fed to stand pat through the end of 2020 and those odds just a month ago were being pegged at just over 30%.

And please don't tell me what Powell said. The Federal Reserve has traditionally been, and remains, among the most vocal cheerleaders around. Have you ever once seen them issue a forecast that didn't have them reaching their inflation, growth and unemployment rate objectives at some point on the published forecasting horizon?

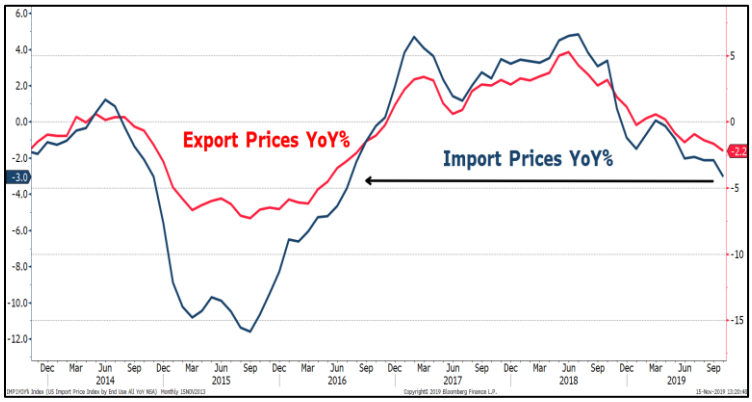
What investors need most right now is a detective, not a cheerleader. I hope to continue to fill that void.

But even with this rosy view, Powell does acknowledge that "*noteworthy risks to this outlook remain."* Unsurprisingly, weak global growth and trade developments are cited, but he also emphasizes the risk posed by muted inflation pressures and low inflation expectations.

I don't believe it's different this time and I don't believe that the business cycle has been repealed. It's always tough to time, but the recession is out there. It is inevitable. And I doubt it's a 2021 story; much sooner than that.

What I do believe, we are looking at stall speed in the fourth quarter, and the inflation peak is behind us and the deflationary lows in Treasury yields are ahead of us.

Not an Inflationary Picture...



Source: Bloomberg

If this ends up taking hold, then rest assured the Fed will not be done with their rate cut cycle. In fact, Powell came out and said as much last week, "*if developments emerge that cause a material reassessment of our outlook, we would respond accordingly.*"

I sense the Fed will end up reloading the gun next year and we revisit a fourth rate cut at the first FOMC meeting in 2020.

In terms of portfolio strategy, we recommend that credit unions maintain a broadly diversified ladder strategy. Any selloffs should be viewed as attractive entry points.

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> – Darin Higgins, President of Western Illinois Credit Union

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> – 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.

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