BALANCE SHEET SOLUTIONS
an alloya company

WEEK OF NOVEMBER 25, 2019

# Weekly Relative Value

## Low Rates are Here to Stay

*"When my information changes, I alter my conclusions. What do you do, sir?"*
*– John Maynard Keynes*

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

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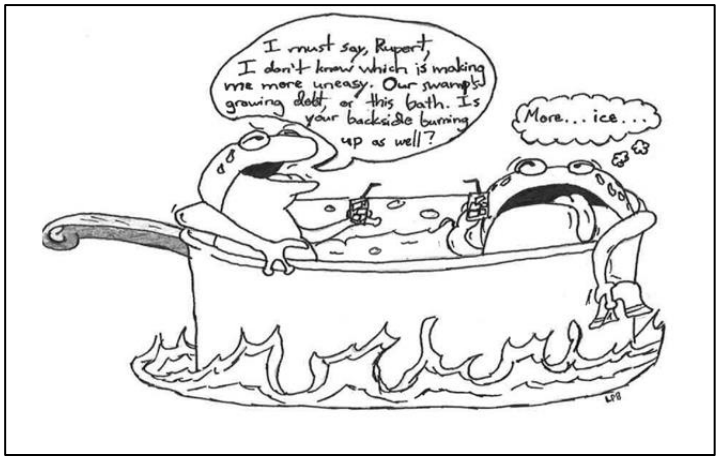
John Maynard Keynes' seminal work, *The General Theory of Employment, Interest, and Money,* was published in 1936. Keynes argued it was the government's responsibility to stimulate investment and consumption via **deficit spending**. This meant that during hard times, governments must engage in deficit spending via public works projects, infrastructure spending, etc. in order to stimulate economic activity.

**Debt is Like a Frog Being Boiled in Water**




*Source: Cagle*

Importantly, Keynes argued that in order for deficit spending to be effective, the "payback" from investments being made must yield a higher rate of return than the debt used to fund it. **In other words, the debt must be self-funding.**

It's also important to note that Keynes did **NOT** support government deficit spending in *good* times. He believed that during expansionary times the government should be building surpluses and saving for a rainy day.

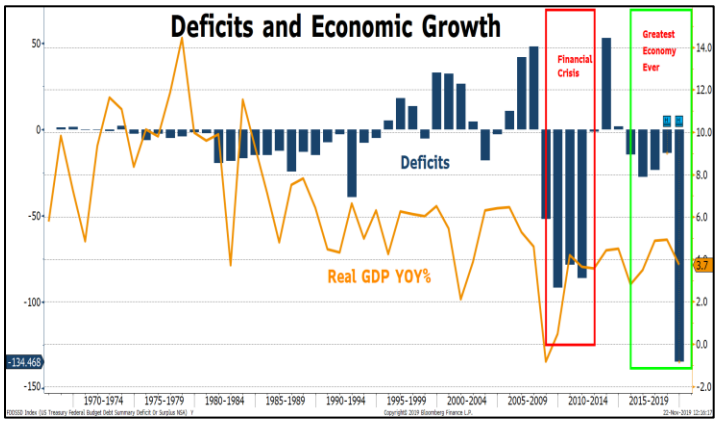
### THIS WEEK

However, beginning in the early '80s, those in power only adhered to the deficit spending part. After all, if a little deficit spending is good, a lot should be better, especially if you are running for office, right?

And sure enough, like a frog being boiled in water, the temperature has been slowly rising for the last 20+ years as debt and deficits have grown to support unbridled largesse from the powers-to-be in DC.

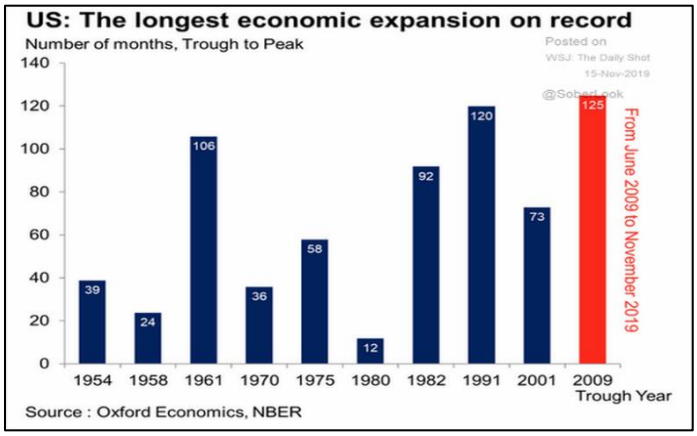
The chart below shows the U.S. federal deficit and GDP growth. Since the federal government began ramping up debt, and running an annual deficit, economic growth has continued to decline. Thus, even with outsized spending both at home and abroad – and trillion-plus deficits as far as the eye can see – the efficacy of **"deficit spending"** has been clearly and greatly marginalized.

**More Debt, Higher Deficits and Lower Growth**




*Source: Bloomberg*

What is key to understand is that this surging deficit is occurring during the longest economic expansion on record. At this point in the economic cycle, debt and deficits should be small and declining. Today, unfortunately, debt and deficits are large and rising. Keynesian economics has been hijacked by free spending politicians. Too few lawmakers are willing to stand on principle that you should pay for what you spend, the principle that you should run up the debt to near-record levels even during an economic expansion, or the principle of generational theft. Can one imagine what happens to debt and deficits when a recession occurs and revenue declines by 30-40%. And guess who picks up the tab? Our children and grandchildren. Yes, Keynes is surely rolling over in his grave.

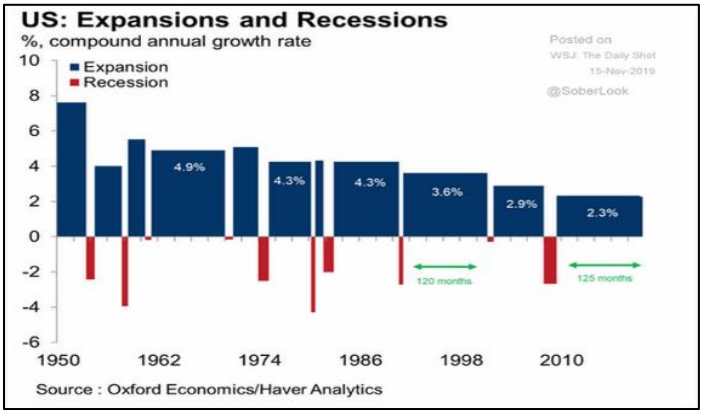



*Source: Wall Street Journal*

You might be able to justify this multi-trillion-dollar debt binge *if* growth was accelerating. But what if it was merely allowing us to run in place? Or, Heaven and Earth forbid, it was actually retarding growth. In fact, in the past two decades, there has been a NEGATIVE correlation between the federal debt-to-GDP and real economic growth to the tune of -22%. Simply put: More debt is slowing growth.

As one can glean from the table below, current economic expansion pales in comparison to every recovery this country has ever experienced. Historically, the U.S. economy expanded at 4.5-5.5% in economic expansions. The current economic recovery has been 2.3%. And that growth occurred in the context of unprecedented spending and artificially lower rates. Moreover, the economy is expected to grow at just 2% over the long-term while the economic deficit has never been greater.

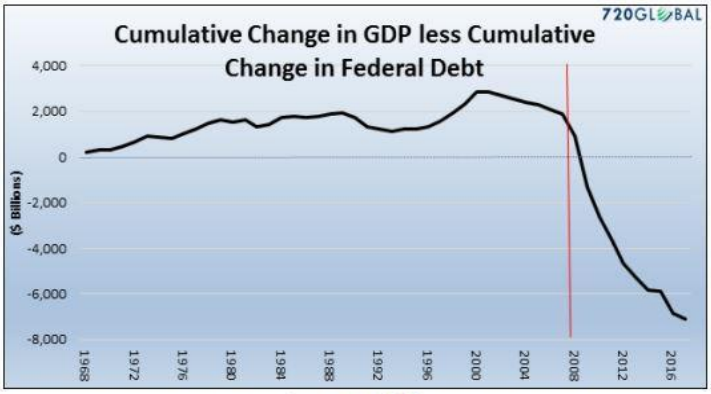
**The Longest and Slowest Recovery EVER**




*Source: Wall Street Journal*

This is the truth: Paper has been rolling off the printing presses of central banks all across the world in an attempt to mask reality. The influx of monetary stimulus from QE and massive government deficit spending has created the illusion of more pent-up demand and growth than exists. It's just more and more cheap debt that brings consumption forward. And because debt is future consumption denied, the void needs to be filled with more and more debt to keep the economy from collapsing. The evidence, should the politicians care to examine, is that using debt to **pull forward consumption** has had long-term negative effects on economic prosperity.

**Debt Creates the Illusion of Growth**

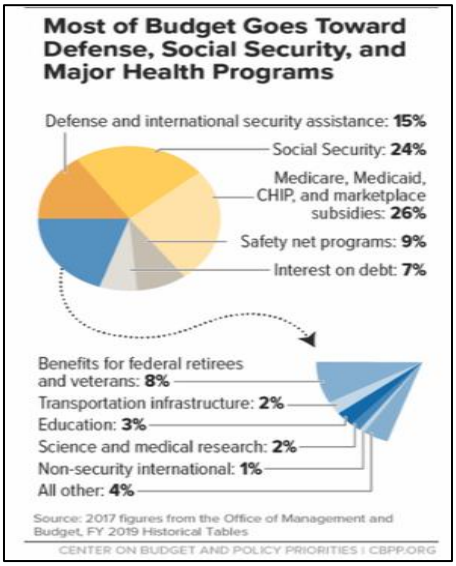



*Source: 720 Global*

To be crystal clear, I am not saying that all debt is bad. Debt used for productive investments (infrastructure and development) can stimulate economic growth in the short-term and provide a long-term benefit. This is good debt.

However, deficit spending has shifted away from productive investments, which creates jobs to primarily social welfare and debt service. This is bad debt. In fact, according to the Center on Budget & Policy Priorities, roughly 75% of every tax dollar goes to non-productive spending.

Since the bulk of the debt issued by the U.S. is for social welfare programs and debt service, there is a negative return on investment. Therefore, the larger the balance of debt becomes, the more economically destructive it is by diverting an ever-growing amount of dollars away from productive investments into the service of debt and social welfare.



*Source: Center on Budget and Policy Priorities*

And, it's not just the U.S. government debt. It is the total debt that drags on the economy. Total debt – national and state government, corporate, individual – is over $72 trillion and it now requires nearly $4.20 of debt to create $1 of economic growth. In 1980 it took $3 of debt to generate $1 of growth. Broadly, the country is adding debt two to three times faster than GDP.

**The Diminishing Returns from Debt**

| | Additional Debt Per GDP Growth |
|---|---|
| 1970 | $1.50 |
| 1980 | $3.00 |
| 1990 | $3.30 |
| 2018 | $4.20 |

While the Federal Reserve believed that suppressing interest rates to artificially low levels would repair the economic ills of the Great Recession, it only succeeded in creating a credit-fueled boom and an even bigger debt bubble a decade later.

This Fed-driven credit boom has led to artificially stimulated borrowing, which has forced money into widespread mal-investments and created the "everything bubble." In 2007, we clearly saw it play out in everything from sub-prime mortgages to derivative instruments. Today, we see it again in accelerated stock buybacks, low-quality debt issuance, debt-funded dividends, and speculative investments. But heck, it works until it doesn't!

This is what Fed Chair Powell recently said about the dangerous debt levels:

> *"The debt is growing faster than the economy — that's unsustainable. It's not the Fed's job to say how the government should cut the deficit, but we need to get the economy to grow faster than the debt. Otherwise, future generations will be paying more of their taxes to cover the government's debt costs than for other things like health care, etc.… I think the new normal now is low interest rates, low inflation and probably lower growth. Even with the lower interest on its debt, the government still needs to reduce its budget deficit." – Jerome Powell, Fed Chairman*

Despite Powell's desires, we are in a Catch-22. The economy needs to deleverage to achieve sustainably higher long-term growth. On the other hand, over the short-term, the economy simply cannot sustain itself without the debt.

The economy is now fully addicted. Acting today would require more economic pain today for long-term gain tomorrow. This is a sacrifice that politicians are unwilling to accept. Thus, kicking the can further and further down to road is the modus operandi.

**This is the essence of why interest rates MUST remain lower for longer, and debt MUST grow faster than the economy, just to keep the economy from stalling out.**

But remember, nothing is forever, not even debt. The damage has been done as trying to grow one's way out of this deficit is simply not possible. The damage has been done. There will have to be a debt jubilee or a great reset.

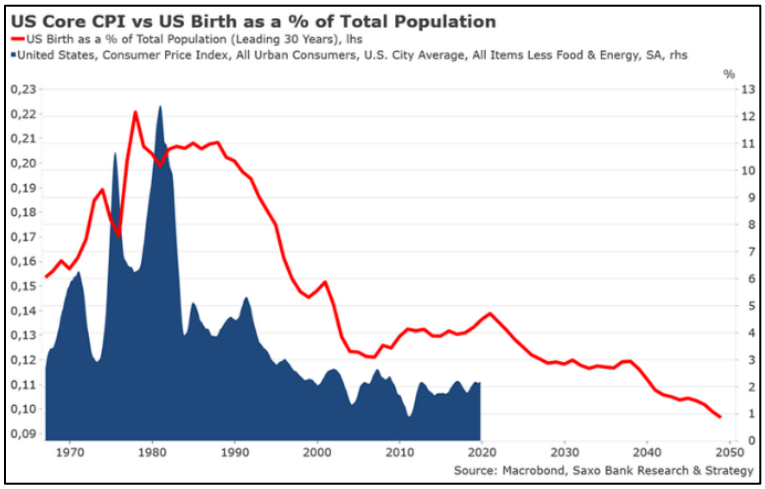
I once heard an addiction expert say that people have to reach a point at which the pain of staying the same is worse than the pain of making a change. Only then will they take the hard steps. Are we there yet? I fear not. But we need to get there, and soon, or the economic angst will boil over into something none of us will like.

## LOW INFLATION IS THE NEW NORM

As shown below, U.S. births as a percentage of total U.S. population leads inflation by 30 years. This graph shows that aging has a direct impact on the trend of inflation. On the top of demographics, new technology and global debt accumulation are other strong structural forces driving inflation lower.

In the developed world, inflation is under 2% but what is probably most striking, is that inflation is also decelerating at a very steady pace in emerging national economies, where it used to be very high. Based on the latest data, average inflation in the BRICS (Brazil, Russia, India, China and South Africa) + Indonesia is around 3.5% year-over-year versus an

average of 7% in the immediate post-Global Financial Crisis. In other words, in just about a decade, global inflation has been cut in half.




One can see the impact of the above factors most clearly in the yield on the 30-year Treasury. And while many have argued that yields can only drop so low before inflation returns and the monetary situation is normalized, ending the 30-year bull run in interest rates, what they forget is that in 2015-2018, central banks tried just that – to normalize interest rates. It ended in disaster, with the Fed resuming quantitative easing and undoing 40% of two years of quantitative tightening in two months.

Demographics are yet another reason why rates will remain lower for longer.

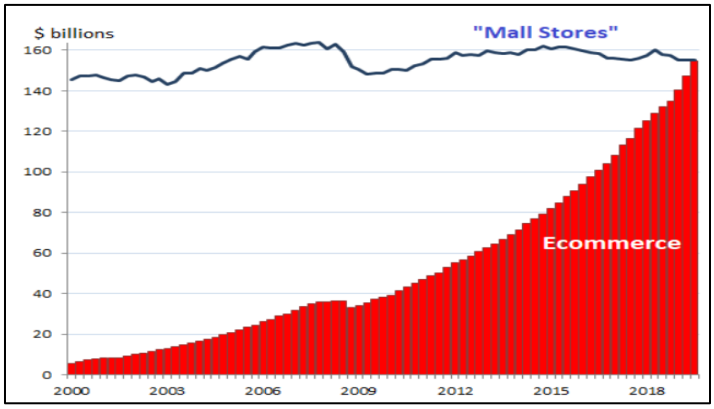
**The 39-Year Bull Market in Bonds Continues**


*Source: Bloomberg*

## GRAPH OF THE WEEK

E-commerce is wiping out department stores one by one. The long-cherished destination for American shoppers is doomed. Sears is just the latest example of a long list of examples. Others will follow. Sales at department stores have collapsed by 41% from the peak in 2000. Over the same period, e-commerce sales have multiplied from $21 billion to $155 billion. That they're now equal is an astounding metric for people who have long denied that e-commerce will ever amount to more than a niche thingy. People who still think that this trend is somehow going to turn around are fooling themselves.

**Brick & Mortar Stores Melt Down as E-commerce Jumps by Most Ever**

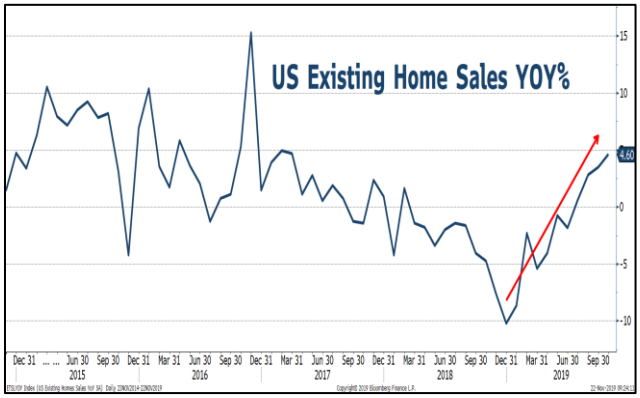



*Source: Wolf.com*

## HOUSING NEWS IS MIXED

Existing home sales rose +1.9% in October to a 5.46 million annualized unit pace. However, this didn't even fully recoup September's 2.5% decline, and this basically just takes us back to the high-end of the range over the past five years. A decline in mortgage rates of 117 basis points over the last year and this is all we get? This is more evidence of the pushing on a string theme.

**Will Home Sales Continue Higher?**



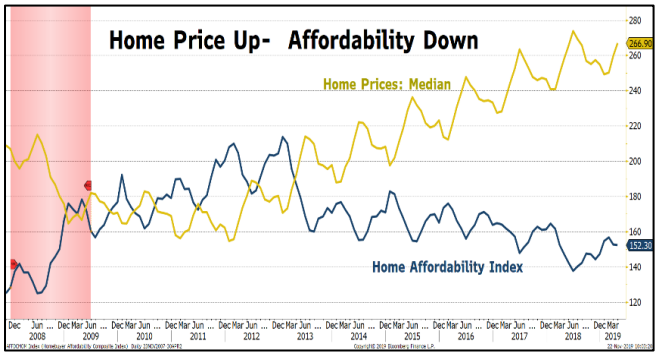

*Source: Bloomberg*

I remain skeptical that housing's recovery will prove sustainable.

Part of this is due to the fact that supply is once again emerging as an issue; the total number of homes for sale are down 4.3% year-over-year. For context, at this time last year, inventory was expanding nearly 3%. And home prices have risen twice the trend of wage growth.

Furthermore, as home prices have risen, housing affordability has declined for many prospective home buyers, especially the all-important millennial cohort.

**Housing Affordability Continues to Decline**



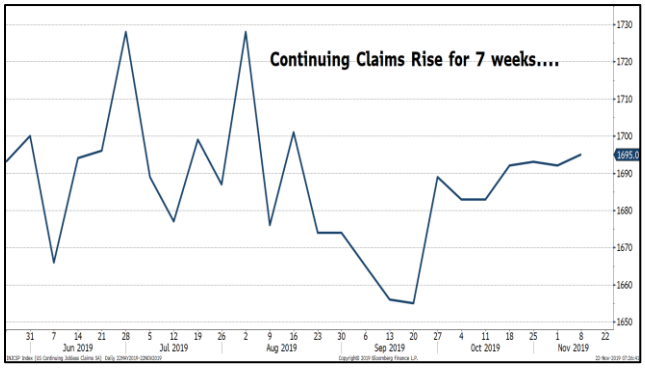

*Source: Bloomberg*

## KINKS IN THE LABOR MARKET

Many pundits are far too sanguine about the outlook for jobs and consumer spending because they focus their attention on what is happening today and what has already happened yesterday. Unlike non-farm payrolls, unemployment claims are a real-time, un-revisable, hard data point. As such, everyone should keep their eyes squarely focused on claims. They are my favorite leading indicator.

Indeed, initial jobless claims were unchanged at 227,000 for the latest reporting week but there was a 2,000 upward revision to the prior week and was far above the consensus view of 218,000. Compared to a year ago, initial claims are up 1.3%. It's not a great sign when the number of jobless claims is greater than it was a year before. In fact, this trend has been positive in seven of the past 13 weeks, a stretch we have not seen since December 2009.

**Continuing Claims Point to Labor Market Weakness**




*Source: Bloomberg*

On a four-week moving average basis, the level increased (221,000 from 217,000) to a five-month high and have now risen for three consecutive weeks. The historical median increase from the trough in the four-week average until the onset of the recession is 66,000. Given that we bottomed at 201,000 back in April, we are now 30% of the way there up from 25% last week.

And continuing jobless have now risen year-over-year over the last seven weeks. Yes, this is an established trend. And no, it's not good news. As for context, the last time this figure was rising (up is bad) outside the recent turn was December 2009. Positive readings have preceded all prior recessions since at least 1970, but it's not a fool-proof indicator as there have been a number of false signals.

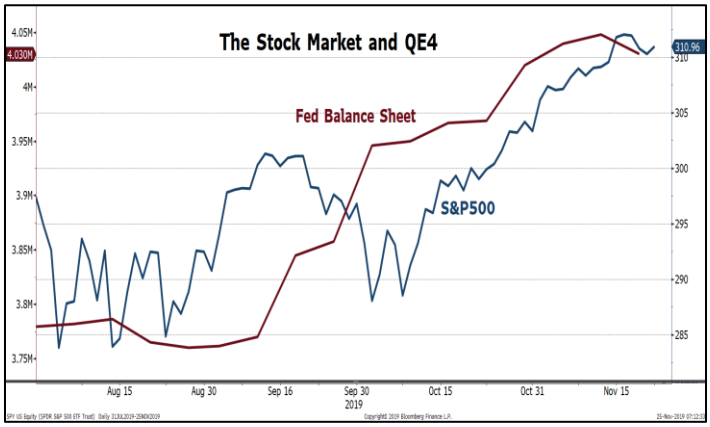
Fed officials will milk the 50-year low in the unemployment rate meme for as long as they can. But even the sleepy leather-elbowed, academic Fed staffers must have noticed this development by now.

## LOOK AT THE TOP LINE TOO!

***"Enjoy it while it lasts but think of how artificial it all really is and how to prepare yourself,*** *at these lofty price levels, for the reversal that is as inevitable as night following day and vice versa.* ***The stock market surely remains on wheels and is being driven by concentrated gains in certain large-cap names*** *and a major shift in economic sentiment, with views that a 'phase one' trade agreement is coming our way soon."*
*– David Rosenburg, Chief Economist & Strategist at Gluskin Sheff*

The bottom line is that the Fed has taken massive steps over the last few months to provide liquidity to the financial markets. This is why the stock market has rallied over the past seven weeks.

**Why the Stock Market is at All-Time Highs**




*Source: Bloomberg*

But let's look at the fundamentals:

FactSet reported that earnings per share (EPS) had declined 2.3% versus a year ago. And analysts' fourth-quarter guidance is more bearish for earnings compared to the third quarter indicating the industrial slowdown has spread to services. And you thought recession risk was a thing of the past just because the yield curve un-inverted.

The bottom line (earnings) gets all the attention each quarter. But the top line (revenue) should never be overlooked. Revenue growth is the heartbeat of U.S. economic activity. It proxies GDP. And on that score, FactSet reported that revenue growth slowed to 3.1% in the third quarter, the slowest pace since the 2016's third quarter.

And as we move forward, capex budgets are apt to be hamstrung by tight-fisted management so long as concerns about the top line refuse to fade. In the short-run, companies will likely endeavor to cut costs, including labor, to draw a line under earnings as revenues deteriorate; given revenues are a proxy for demand, a concurrent slowing in GDP is also foreseeable. And that applies whether you're in a red state or a blue state or you're a rabbit or a duck.

If economic and earnings data don't begin to improve markedly, as currently expected by Wall Street, the current overvaluation of asset price is going to become more problematic to justify.

## MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"I would bet that there would not be a recession in the coming year. But I would have to say that the odds of a recession are higher than normal and at a level that frankly I am not comfortable with."*
*– Former Fed Chair Janet Yellen*

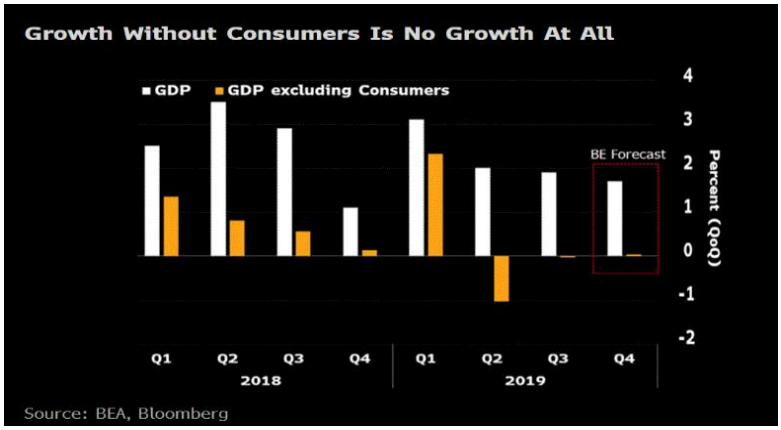
It sounds like if Janet were on the Federal Open Market Committee (FOMC) today, she would be voting for lower rates.

Citi's U.S. Economic Surprise Index recently flipped back into negative terrain, which is the first time we have seen this occur since the beginning of September. This reflects the fact that an increasing number of economic indicators have come in below market expectations, a development that has historically been bullish for high-quality debt.

Indeed, as I have stated many times previously, outside of consumer spending and government expenditures, the rest of the economy is contracting. And recent evidence suggests a slowdown on the consumer front. Retail sales are flat over the last two months, auto sales volumes have pulled back to a six-month low, and wage growth has rolled over.

The possibility of either a flat, or even fractionally negative, showing for real GDP cannot be ruled out for the fourth quarter.

**Giving Thanks to the American Consumer**

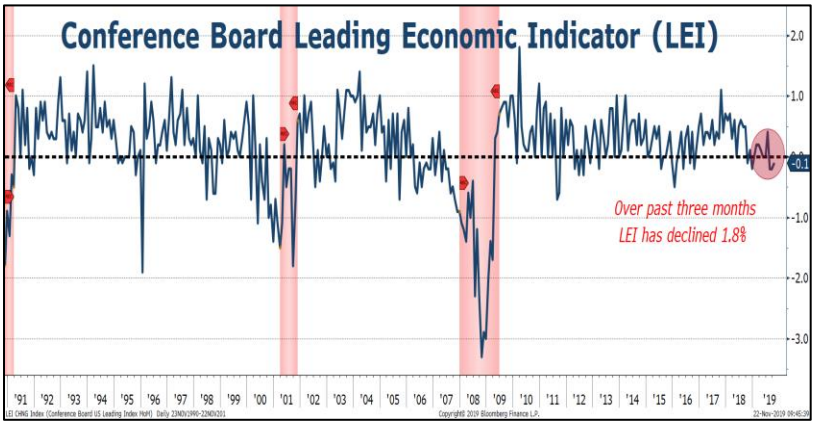



*Source: Bloomberg*

Meanwhile, the world is waiting for the **"DEAL**" to be completed. But has anyone noticed that nothing has yet been announced? But just keep on saying that the talks are constructive. Maybe we never reach one, we only need to believe we will get one eventually. Perhaps the worst thing that can ever happen for the bulls is that this deal actually reaches a conclusion. What will they do next? Is this a classic case of buying the rumor and selling the news?

Where do I stand? Chinese economic and U.S. economic data continue to slow. China's is a secular (long-term) slow-down in heavy construction, partly empty cities, etc. The U.S.'s slow-down is a renewed industrial and manufacturing recession combined with a garden variety late-cycle slow-down in consumption and profit growth. To wit: The Conference Board's Leading Economic Index (LEI), over the last three months, has declined at a 1.8% annualized rate, which is the worst pace since early 2016. This should throw some cold water on the notion that the U.S. economy has stabilized. And there is no "**DEAL"** or made up progress that is going to change the direction of things in the fourth quarter. It's the end of November. There should be no caution or confusion about that.

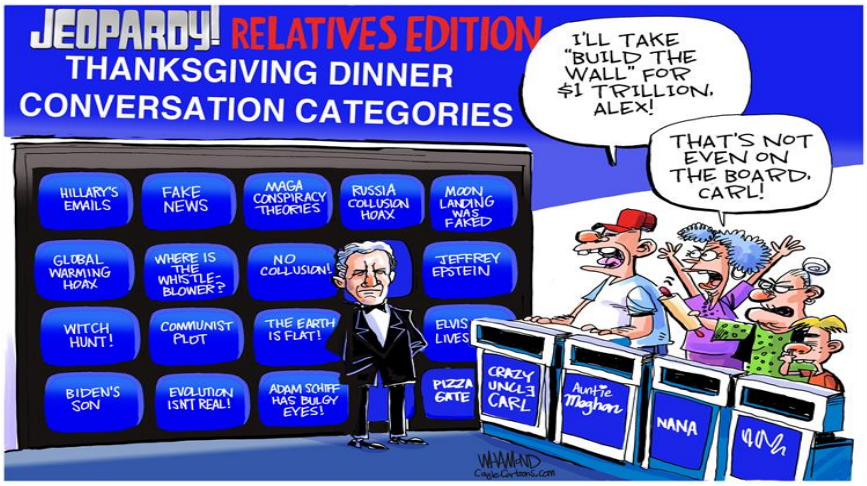
**Leading Economic Indicators Decline Again**




*Source: Bloomberg*

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.

## HAPPY THANKSGIVING, EVERYONE!




*Source: Cagle*

## ALLOYA INVESTMENT SERVICES – COMING JANUARY 2020


We are excited to announce that the broker/dealer services provided to credit unions under the name Balance Sheet Solutions will be rebranded as Alloya Investment Services on January 1, 2020. The broker/dealer services and relationships currently provided to Balance Sheet Solutions' credit union clients will not be impacted by the name change to Alloya Investment Services. To learn more about the rebrand of Balance Sheet Solutions, visit www.alloyacorp.org/invest/alloya-investment-services.

## 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.