BALANCE SHEET SOLUTIONS
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WEEK OF DECEMBER 2, 2019

Weekly Relative Value

Did You Know?

"Bond investors are the vampires of the investment world. They love decay, recession — anything that leads to low inflation and the protection of the real value of their loans." – Bill Gross

Another year, another setback for the conventional wisdom on Wall Street that the bond "bubble" is set to burst. The yield on the 10-year Treasury note is now a fraction below 1.75%. Yes, up 30 basis points from the recent lows, but keep in mind that at this time last year it was sitting at 3.05% and started 2019 at 2.68%.

The Bond Rally of 2019

Source: Bloomberg

The amazing bull run in bonds continues. So, it's no surprise that smart people offer plenty of reasons why bonds can't be in a "bubble" – including the fact debt investors aren't clouded by over-exuberance and relentless demand, with 2020 outlooks projecting basically more of the same in a world short of safe assets.

Stating the obvious, we live in a low-interest-rate environment.

But did you know that not only are rates very low, they are at a 670-year low? The following graph from Visual Capitalist shows interest rates over the arc of time going back to 1350. And today, interest rates for government debt has never been lower. As was written in this space just last week, due to deflationary debt levels and unfavorable demographics, rates could remain low for some time to come.

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

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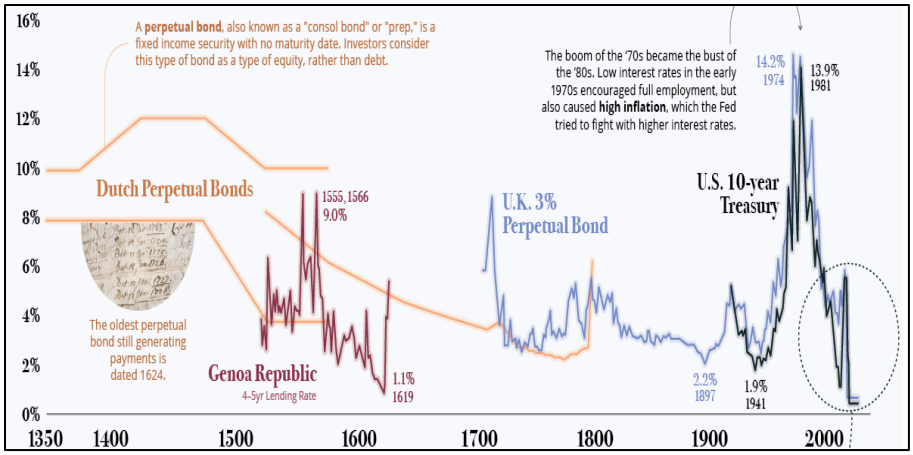
THIS WEEK

But how low can they go?

Visualizing Interest Rates Over History

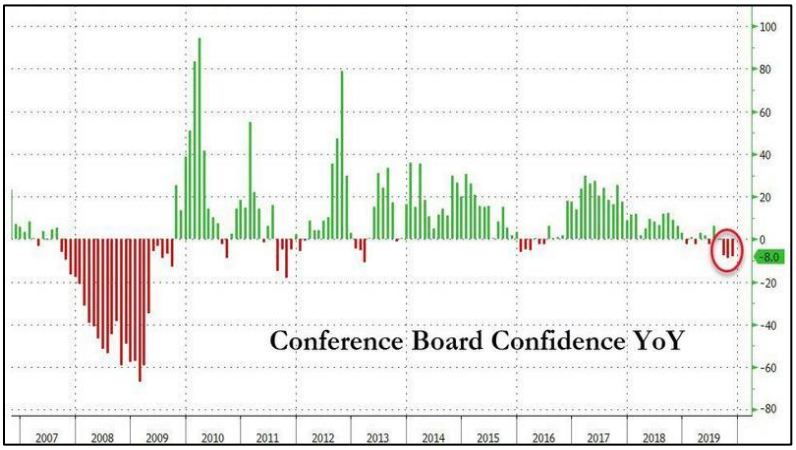


Source: Visual Capitalist

CONSUMER CONFIDENCE DROPS AGAIN

"Consumer confidence declined for a fourth consecutive month, driven by a softening in consumers' assessment of current business and employment conditions…The decline in the Present Situation Index suggests that economic growth in the final quarter of 2019 will remain weak... Overall, confidence levels are still high and should support solid spending during this holiday season."
– Lynn Franco, Senior Director of Economic Indicators at The Conference Board

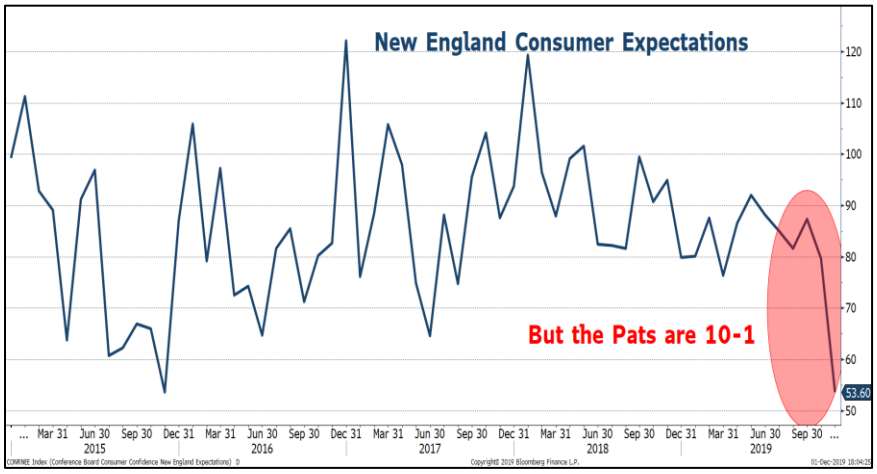
Confidence Declines Again



Source: Bloomberg

I found it incredible that the Wall Street narrative coming out of the November Consumer Confidence report was how high it remains. There was no mention that it has fallen now for four months in a row and to its lowest level since June. High, indeed, but on a new downward path.

On a regional basis, the most pronounced weakness in confidence was New England (a record 35-point plunge to a four-year low of 79.9 and that's with the Patriots at 10-1!).



Source: Bloomberg

It wasn't just New England; Michigan (113.5 from 128.3), Ohio (118.3 from 119.6) and Pennsylvania (105.5 from 122.4) all posted declines. If there was a big trade deal coming, someone forgot to tell these trade-sensitive states.

The one state that did well was New York, where confidence jumped to 103.7 from 97.4 in October. Guess why? The boom on Wall Street! Indeed, the share of households who are bullish on equities rose sharply from 31.8% to 38.6% in November, a four-month high. At the same time, the bear share retreated to 27.1% from 31.7%.

NEW HOME SALES POP!

Following the upside surprise in existing home sales, new home sales were expected to rebound after September's dip. And sure enough, the 733,000 annualized rate was much higher than the expected 705,000, and the fastest pace in more than 12 years.

New Home Sales: Fastest Pace in 12 Years

Source: Bloomberg

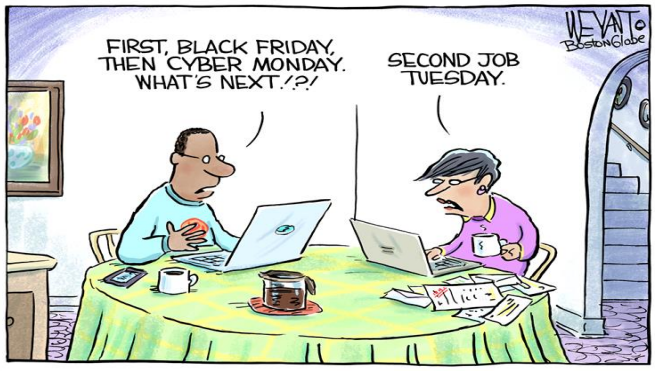
Even with the gains, the pace of new home sales remains well below levels reached during the housing boom of the 2000s, when purchases peaked at 1.39 million. Notably, though the median sales price decreased 3.5% from a year earlier to $316,700.

SHOP UNTIL YOU DROP

"When you live for things, things are never enough, greed grows, other people become obstacles in a race… consumerism is a virus that corrodes faith… [because it clouds the minds of many who forget] the brother who knocks at your door." – Pope Francis

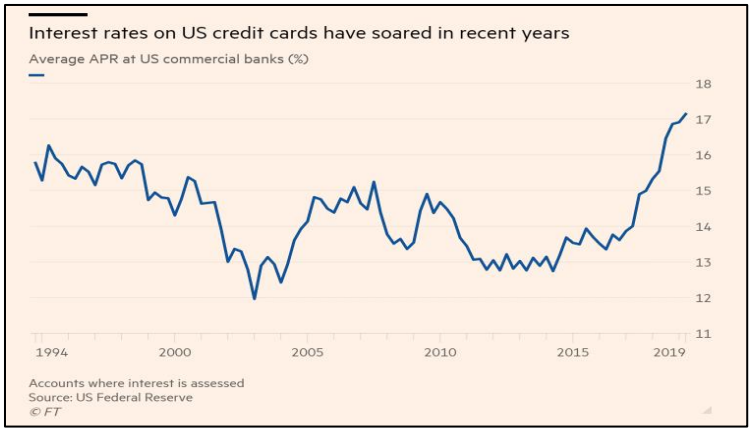
According to a recent Harris Poll, nearly 40% Americans say the U.S. economy is headed toward a recession, while 43% say the economy is currently stable and about 20% characterize it as "booming."

Black Friday… Cyber Monday



Source: Cagle Cartoons

But perhaps more important than their perception is how it could affect shoppers' holiday spending. While over half (60%) of holiday shoppers say their perception of the economy will not affect how much they spend on gifts this year, 30% say they'll spend less because of it. For perspective, that's 66 million Americans who are tightening their purse strings in response to their perception of the economy.



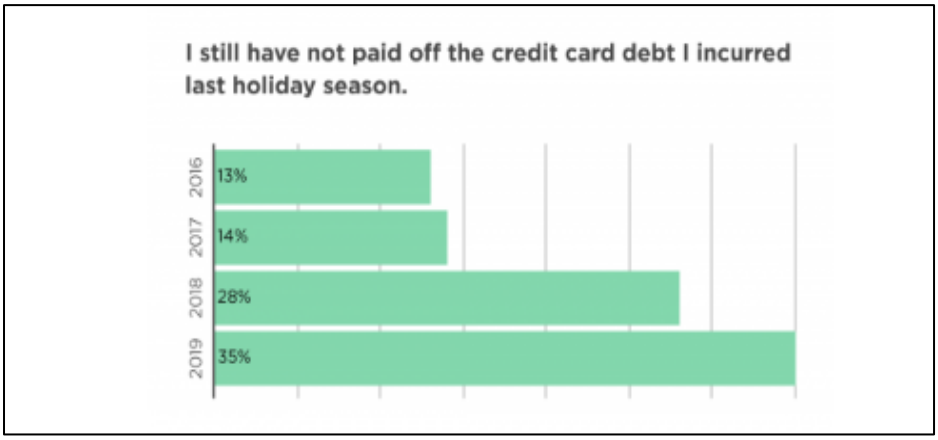
Source: Financial Times

Even with some saying they'll spend less this year (thus far anyway), there have been record online sales of $7.4 billion over the weekend. And Cyber Monday starts today with sales expected to exceed last year's record by almost 20%. Overall, on average, 2019 holiday shoppers plan to spend $825 on gifts this season, 6% more than last year. So once again, advanced marketing techniques have sucked in broke consumers, buying products they can't afford, nor need, with credit card rates at 25-year highs.

Interestingly, as seen in the graph above, many Americans still owe on last year's gifts. According to a Harris Poll, 35% of Americans (or 48 million), are still paying off credit card debt from the 2018 holiday season. In 2018, when asked the same question, 28% of 2018 holiday shoppers were still paying off debt from the 2017 holiday season.

The Pope may have a point!

48 Million Americans Still Owe From 2018 Holiday Splurge



Source: Harris Poll

DELINQUENCIES RISE

These are the good times, but why are subprime credit cards, auto loans, and short-term installment loans blowing out?

Back in 2009, people were defaulting on their auto loans and credit cards and their installment loans because over 10 million people had lost their jobs. This is not the case today. Back then, new unemployment claims – a sign of layoffs – spiked to astronomical levels. These days, they've been hovering near historic lows. So today, these people are working, and they're still falling behind.

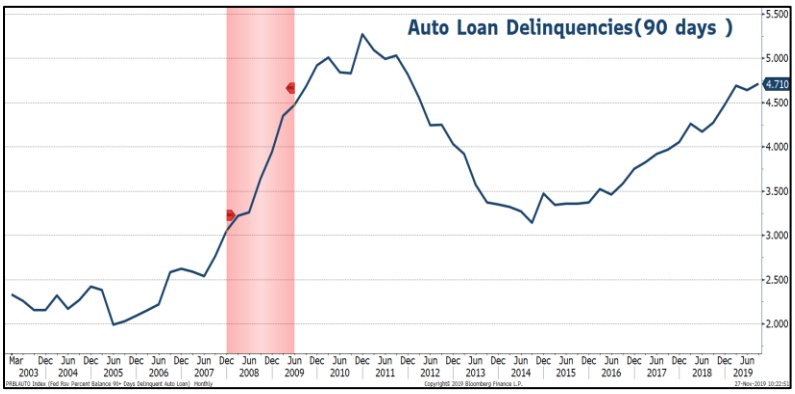
According to Federal Reserve data, the delinquency rate on credit card loan balances at the nearly 5,000 smaller commercial banks is blowing out. In the third quarter, the delinquency rate at these banks rose to 6.25% – exceeding the peak of the financial crisis.

And in the auto sector, we are seeing first-hand the erosion in the quality of credit.

As per the New York Federal Reserve, we now have a huge $1.3 trillion of outstanding auto debt (many owners are upside down on their loans, as subprime mortgaged homeowners were in 2007) and almost 5% of those obligations are now seriously delinquent – fast approaching the 5.2% peak during the financial crisis.

For investors, this is yet another sign, among many, that we are late in the credit cycle game and so the strategy for this phase is to move up on the credit quality ladder.

Delinquencies in Good Times?



Source: Bloomberg

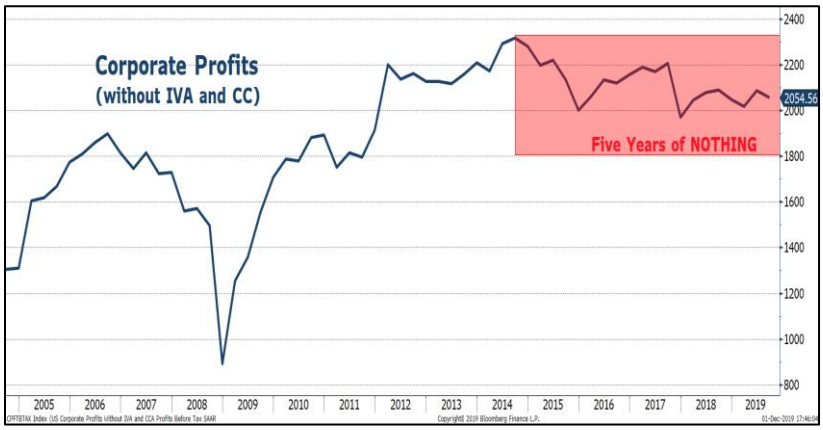
THE STOCK MARKET IS NOT THE ECONOMY

*"The stock market just hit another all-time in history high, meaning 401(k)s and jobs… Everybody's getting rich, and I'm working my a** off…" – President Donald Trump*

Ask any Wall Street analyst why stocks are at all-time highs and the instant answer will be because profits and net income are similarly at or near all-time highs.

But is that really the case? Not really…

Earnings… Going Nowhere Fast

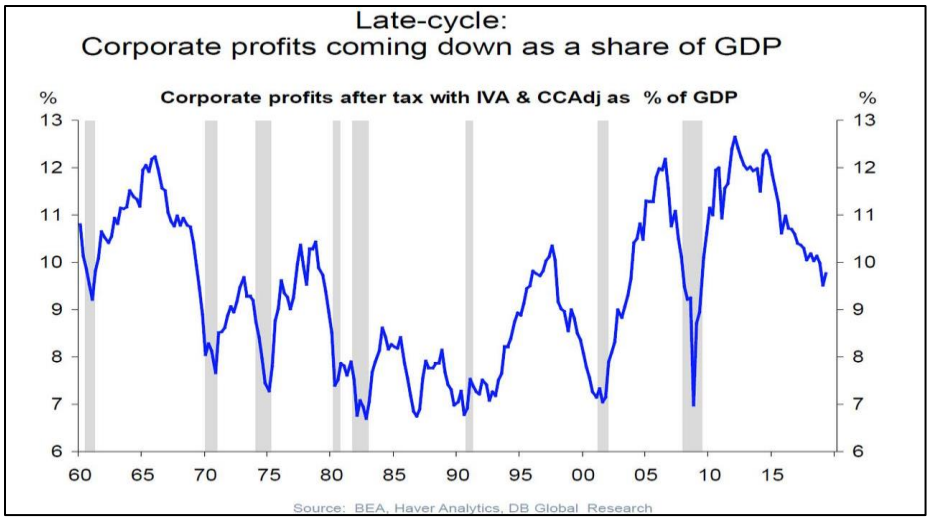


Source: Bloomberg

Corporate earnings dipped in the first two quarters of 2019 and are all but certain to do so again in the third quarter. And earnings in the S&P 500 Index are now projected to decline in the fourth quarter from the year according to FactSet. That is… four quarters of negative earnings growth.

Amazingly, as shown in the following graph, corporate profits (before tax with IVA and CC adjusted) are no higher today than in 2014. Five years of NOTHING!

Arguably, a more accurate way of showing profits is as a share of GDP. After all, U.S. corporations generate profits not only to boost the pockets of their shareholders, but to stimulate the U.S. economy. It is here that something shocking emerges – as the following chart shows, corporate profits (after tax with IVA and CC adjusted) as a percentage of GDP have not only tumbled to the lowest level this decade, but are in fact lower than where they were when the U.S. was sliding into the 2007 recession!



Let's be perfectly clear. The bull market in stocks is not a function of booming earnings, a strong economy or frankly President Trump. It's a function of the Fed. Period.

Today, the number of companies producing earnings is the lowest since the dot-com bubble because "companies can sell dreams rather than earnings." That's thanks to the $15 trillion sloshing around the financial system that has been injected by central banks. As such, the relationship between the S&P 500 and GDP has practically vanished this cycle.

"Because the world is looking for yield, companies can sell dreams rather than earnings. The number of companies that produce earnings is the lowest since the dot-com bubble in terms of their need because you can sell a dream."

"As a result of the accumulation of the money at the top and technology we have a situation where, naturally, those who have a lot of money also have a lot of money in credit...but it doesn't trickle down. And as a result, we have a situation with a large wealth gap."
– Ray Dalio

Central planners at the Fed – like other major central banks – have taken monetary policy to a state of madness. These central bank schemes have fostered massive growth in public and private debt with nothing but lackluster economic growth to show. What's more, these schemes have produced massive asset bubbles that have skyrocketed wealth inequality and inflamed countless variants of new populism.

The gap between the rich and the poor continues to grow.

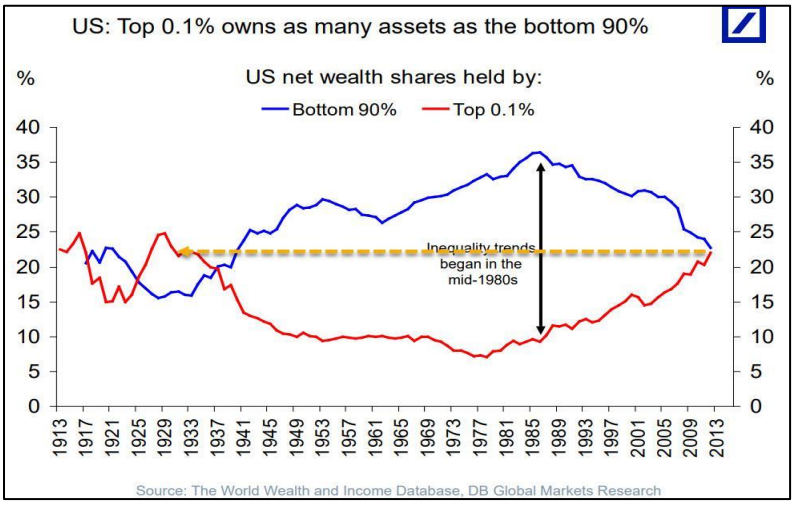
In America, 84% of all stock market wealth is owned by the wealthiest 10% of all Americans. Roughly half of all households don't have a cent invested in stocks, whether through a 401(k) account or shares in General Electric.

And at this point, the wealthiest 0.1% of all Americans now have as much wealth as the poorest 90% of all Americans combined.

Let that sink in for a moment.

As Dalio suggests, if we don't find a way to fix the system and fix wealth inequality, bad things are going to happen. But Ray Dalio insists that increasing the size and distribution of the pie is still possible.

"The system doesn't work, it's gone mad, then the reason the system is broken is because it's not an equal opportunity system. There are justifiable complaints about education... it needs to be reformed in a way that works better – we can increase the size of the pie in the same way that you can divide it better." – Ray Dalio



MARKET OUTLOOK AND PORTFOLIO STRATEGY

Third quarter GDP was revised higher from 1.9% to 2.1% (2.130% to be precise), and up from the 2.0% GDP print in the second quarter. According to the Bureau of Economic Analysis, the revision to GDP reflected upward revisions to inventory investment.

The fact is that outside of consumer and government spending, the economy contracted for two consecutive quarters. And despite the uptick in third quarter GDP, the year-over-year trend shows a discernable slowdown – from 2.7% in the first quarter to 2.3% in the second quarter and now 2.1% in the third quarter.

And as one can glean from the following table, fourth quarter GDP is expected to be below 1%.

Tracking Estimates for the Q4 Change in Real GDP			
	15-Nov	8-Nov	change
St. Louis Fed	**1.50%**	1.87%	-0.37%
Now-Casting.com	**1.12%**	1.41%	-0.29%
New York Fed	**0.39%**	0.73%	-0.34%
Atlanta Fed	**0.30%**	1.00%	-0.70%
Average	***0.83%***	1.25%	-0.43%

Source: Federal Reserve Banks of St. Louis, Atlanta and New York; IFR Markets (J. Hall)

And, as discussed above, corporate profits continue to slow. If the narrative is that Purchasing Managers' Indices (PMIs) have "bottomed," Wall Street is going to need a new one. The Chicago PMI just plunged to 46.3. And durable goods reported last week were recessionary, falling to -0.7% year-over-year (while durable goods excluding defense and aircraft fell to a 32-month low).

In other words, despite Wednesday's pre-Thanksgiving, no-volume equity rally to all-time highs, there are some disconcerting developments underneath the macro hood.

Yet, Fed Chairman Jerome Powell put on the full cheerleader uniform last week in a speech, asserting, "*At this point in the long expansion, I see the glass as much more than half full.*" He also reinforced the view that the Fed is now on hold and emphasized that the odds of seeing a rate hike on the horizon are extremely high.

Interestingly, the bond market isn't buying it. Most core government bonds were firmer as in modestly lower yields.

Meanwhile, Wall Street is hanging their collective hats on the hope that the U.S.-China trade deal will heal all that ails. Last week, comments from the President indicated negotiations were close to reaching the initial "phase one" deal, but that he is the one holding up the process to ensure a favorable outcome. As I have said before, it's remarkable how many times markets can react to the same piece of news over and over again. Yeah, I know. We're in the "final throes" of what's been thrown and tweeted at us about "trade progress" for almost a full year now (as both U.S. GDP and corporate profit growth have done nothing but slow).

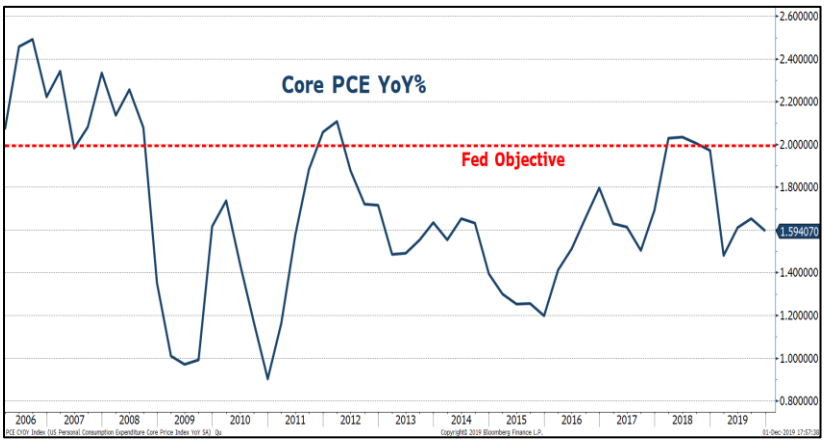
This has the potential to be a classic "buy the rumor, sell the news" moment. While some trade tariffs could be removed, a "phase one" trade deal is likely to be symbolic rather than substantial or comprehensive in scope. As such, U.S. business leaders will remain skeptical about future policy.

And as Washington D.C. is already on the campaign trail for the November elections (and the Democrat-held House is trying to impeach the President), it is unlikely that fiscal policy will play a big role in stimulating the economy in 2020.

The crucial question is what happens to the U.S. consumer. I expect the job market to start to weaken, likely hurting consumer spending. Some recent forward-looking indicators such as job openings or some consumer surveys show the employment is indeed slowing and will slow further. In addition, recent resilience in headline job growth belies falling gains in crucial cyclical sectors such as construction and temporary help employment, which we see as the "canaries in the coal mine."

Finally, inflation remains subdued. Both the headline and the core personal consumption expenditures (PCE) measures came in below market expectations.

No Inflation in the Nation



Source: Bloomberg

If growth stays on the weak side, coupled with modest inflation pressure, the Fed could resume rate cutting at some point in 2020.

Once it becomes clear that there will not be a V-shaped rebound in the economy in the first quarter of 2020, as the Fed currently anticipates implicitly, I believe we will see the first 25-basis-point cut in June 2020, followed by further cuts of in months thereafter.

Chairman Jerome Powell had a long career at a private equity fund before joining the Fed, and as an admirer of former Fed Chair Alan Greenspan, he firmly believes that the bulk of the transmission of Fed policy is via financial markets—hence the focus on keeping markets "happy."

So, while rates are at a six-century low, it does not mean that rates can't go lower.

From an investment strategy perspective, credit unions should eliminate the "noise" and focus on the tried and true discipline of investing in a well-diversified, duration-appropriate ladder strategy.

Any temporary back-up in yields should be viewed as an opportunity to invest excess cash reserves.

In other words, buy the dip!

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> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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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.