alloya
INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

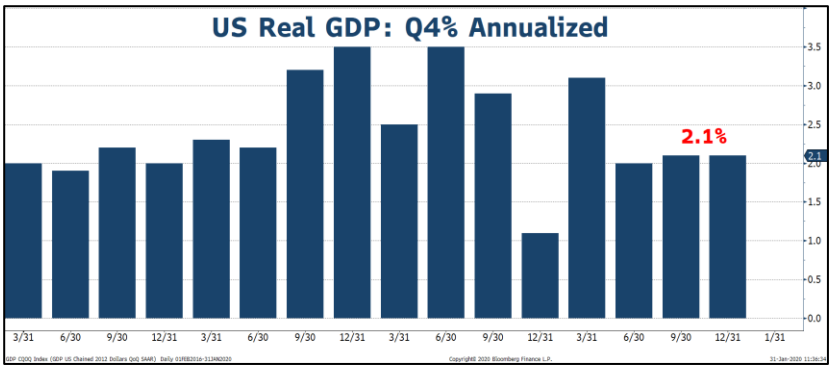
WEEK OF FEBRUARY 3, 2020

The Non-Fake News GDP Report

"I can't stress enough how bad this GDP report was as a signal of the underlying health of the U.S. economy," – Darius Dale, Senior Global Macro Analyst for Hedgeye

After rising 2.1% in the third quarter, fourth quarter (Q4) GDP rose at an annual rate of 2.1%, beating expectations of a 2.0% print. Wall Street cheered!

GDP Advances 2.1%



Source: Bloomberg

Let's dig a little deeper than the headline. As a refresher GDP = C (Private Consumption) + I (Investment) + G (Government Spending) + NX (Exports - Imports)

The Q4 breakdown was as follows:

- Personal Consumption: 1.20%, down from 2.12%
- Fixed Investment: 0.01%, up from -0.14%
- Private Inventories: -1.09%, down from -0.03%
- Exports: 0.17%, up from 0.11%
- **Imports: 1.32%, up from -0.26%**
- Government: 0.47%, up from 0.30%

So, as you can glean from the data above, the biggest source of GDP was… imports. Yes, imports, which actually plummeted by 8.7%, but contributed 1.32% to GDP. The irony is that unless the plunge in imports (a boost to GDP) is a function of rising domestic production (hardly), they actually reflect weaker domestic demand.

THIS WEEK

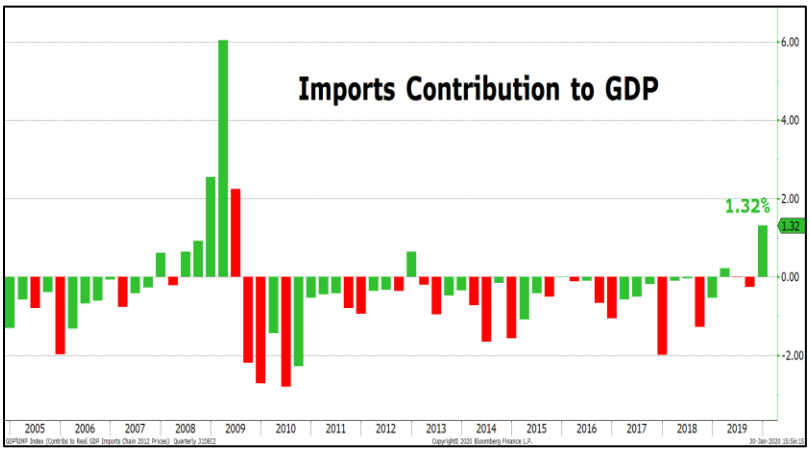
- LESS GROWTH, MORE DEBT
- CREDIT CONTRACTS
- MEANWHILE ON THE POLITICAL FRONT…
- THE YIELD CURVE INVERTS (AGAIN)
- BLACK SWAN

PORTFOLIO STRATEGY

SUBSCRIBE

Also pushing up GDP in a big way, federal government expenditures in Q4 rose at an annual rate of 3.6%. The sum of the net contributions from Net Exports and Government Spending totaled 195 basis points – yes, a whopping 93% of the headline growth rate of 2.1%! That represents the highest net contribution of "NX" and "G" since Q2 2009.

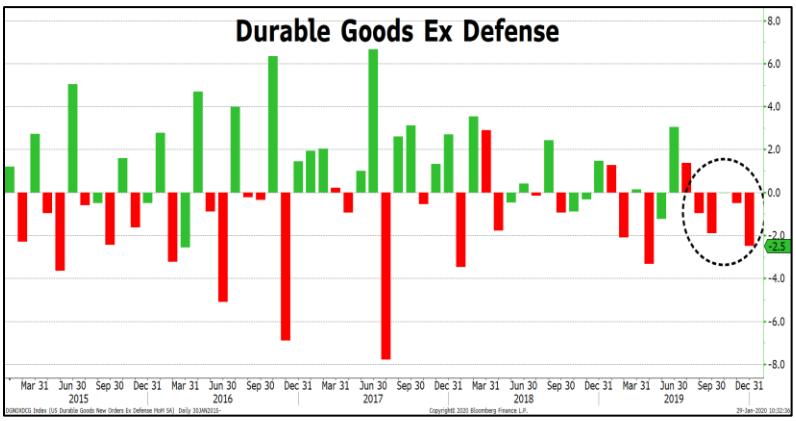
Slumping Imports Drove GDP



Source: Bloomberg

Meanwhile, CapEx is back in recession with consecutive quarterly contractions. Interestingly, investment grade corporate bond issuance in January exceeded $130 billion, surpassing 2018 for the second most intense January on record. The thing to understand is these proceeds aren't going into business spending. Companies are just not interested in committing capital to the real economy, opting instead to buy back their stock in droves. Isn't it amazing how a bull market can take hold, as it did in 2019, in the context of an outright business recession? Once again, the vagaries of the zany world of Fed intervention and financial engineering are on full display. You have heard it before but let me remind you again: the stock market is NOT the economy. Don't be fooled!

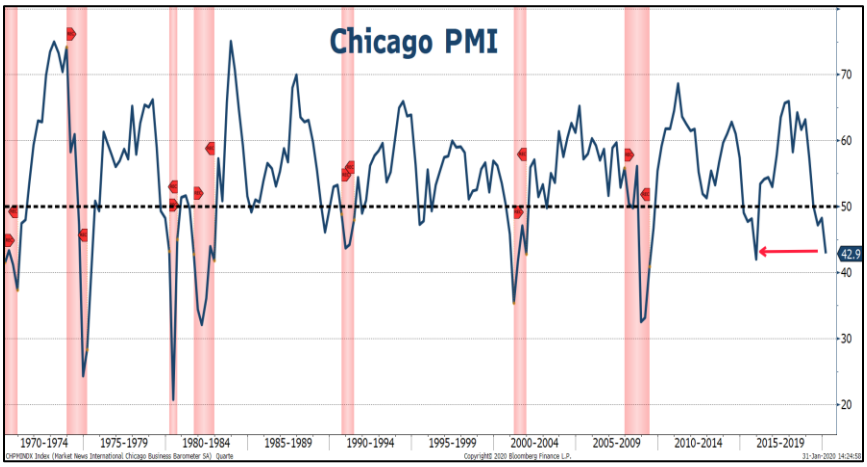
Business Recession Continues



Source: Bloomberg

Another way of ascertaining the health of the manufacturing sector is shown below. The Chicago Purchasing Managers' Index (PMI) measures the economic health of the manufacturing sector in the Chicago region. A reading above 50 indicates expansion of the manufacturing sector; a reading below indicates contraction. Having tumbled by the most in 39 years last year, Chicago PMI has now been in contraction (sub-50) for seven months in a row – something it has not done outside of recession... ever!

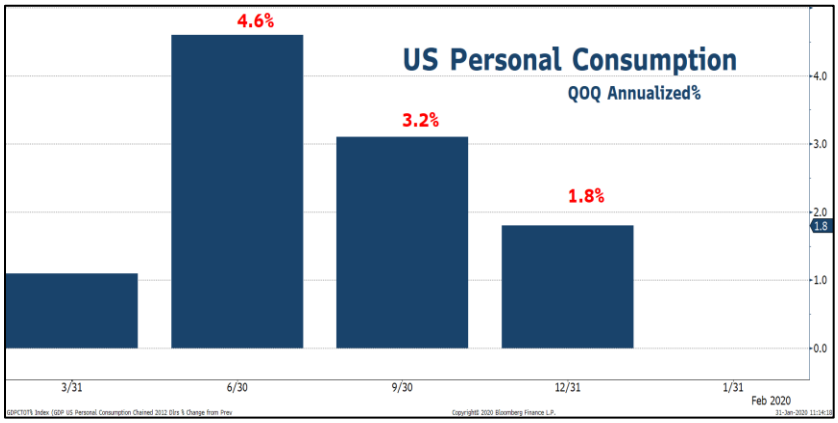
The Chicago Blues



Source: Bloomberg

More importantly, consumers (70% of GDP), long held up as the driver of U.S. expansion, showed signs of fading. Consumer spending (personal consumption expenditures (PCE) adjusted for inflation) grew at an annual rate of 1.8% in Q4. While this growth rate was down from Q3 (3.1%) and Q2 (4.6%), this is the slowest pace in three quarters. Almost all categories of consumer spending on goods slowed, including cars and furniture. Household spending on services showed more resilience, although spending on eating out slowed, in a sign of flagging confidence. So, the narrative of the "resilient" consumer continued but may be on its final legs as the negative feedback loop from the eroding business sector works its way into wages and overall sentiment.

Is the Consumer Running Out of Gas?

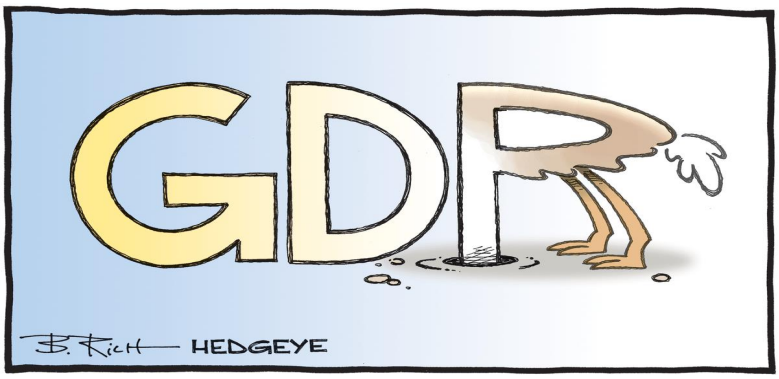


Source: Bloomberg

Adding it up… Q4 GDP just had the lowest net contribution of "C" (Consumption) and "I" (Investment) since Q1 of 2011. On balance this is one of the more misleading headline numbers I have ever seen. It simply does not reflect the overall

weakness in the data. Let's face it, when the fastest "growing" segment of GDP is plunging imports and government spending, you know the economy is not that strong.

Buried



Source: Hedgeye

LESS GROWTH, MORE DEBT

"The [budget deficit] is the nation's most serious long-term problem."
– Senate Majority Leader Mitch McConnell, 2012

"When the federal government spends more each year than it collects in tax revenues, it has three choices: It can raise taxes, print money, or borrow money. While these actions may benefit politicians, all three options are bad for average Americans. Deficits mean future tax increases, pure and simple. Deficit spending should be viewed as a tax on future generations, and politicians who create deficits should be exposed as tax hikers."
– Dr. Ron Paul, former U.S. Representative

The dreams of 3%-plus economic growth in the U.S. remained dreams in 2019, despite tax cuts and ballooning federal government spending. Federal government spending surged $1.23 trillion while nominal GDP totaled only $849 billion. In other words, debt is growing significantly faster than GDP even while we're still in a business expansion.

Let that stew for a moment: What would the economy have done with a more moderate increase, or no increase, in federal borrowing and spending? Can the economy really stand on its own legs without fiscal and monetary stimulus?

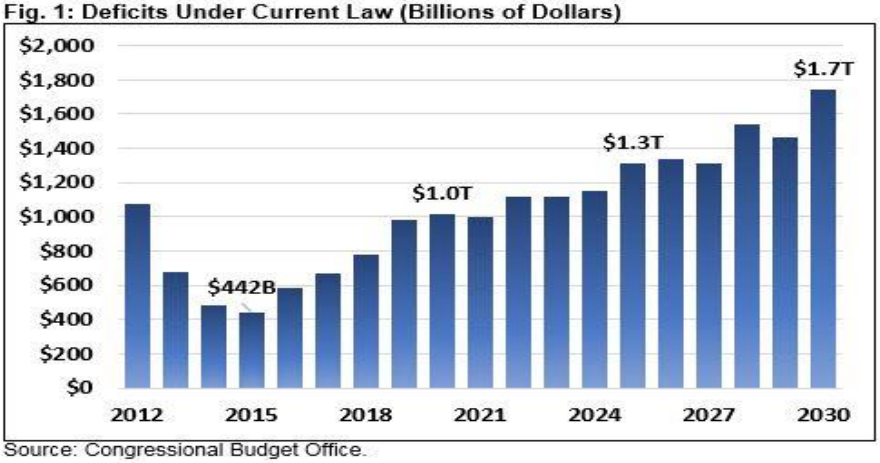
In 2019, the debt-to-GDP ratio hit 81% and the official deficit was $984 billion, or 4.6% of GDP. By 2030, and assuming years of low rates and no recession, the deficit balloons to $1.7 trillion and the public debt surpasses $31 trillion or 98% of GDP from 81% today (the looming crisis in Social Security and healthcare spending will ensure that these numbers are even bigger barring a fundamental shift in fiscal priorities).

Throw in a recession, and you are quickly at total debt of $40 trillion… with an economy of only $26 trillion and a debt-to-GDP ratio closer to 150% than 100%.

Deficits of 4% of GDP or more for a full decade would be the longest such stretch in a century (as in, go back to the Great Depression). With or without Bernie, capitalism has gone on a long sabbatical.

In terms of our elected officials in Washington, the rule is that debt doesn't matter. Former fiscal hawks have been converted. And debt truly doesn't matter until it suddenly does. This is a dangerous experiment.

Fig. 1: Deficits Under Current Law (Billions of Dollars)



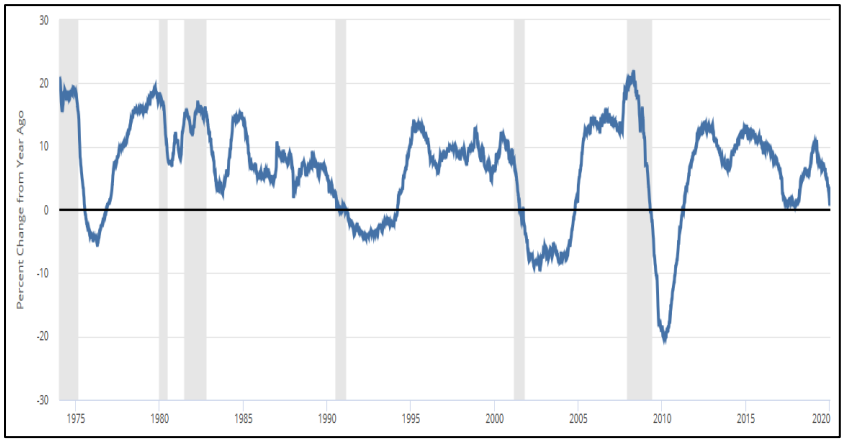
Source: Congressional Budget Office.

CREDIT CONTRACTS

The party goes on in the financial economy but for the real economy, it actually is quite a struggle. Bank credit has gone from 9% annualized growth at the end of November to 1% today. The best indicator of economic activity in the bank lending numbers is commercial and industrial (C&I) credit.

This is the root financing tool for business operations, and it is disturbing to see outstanding lending decline at nearly a 7% annual rate over the past four weeks. The year-over-year trend has virtually collapsed as well, as the chart illustrates. In the past when C&I lending has collapsed, the economy was in or on the verge of a recession.

U.S. Commercial and Industrial Loan Growth (Percent, Year-Over-Year)



Source: St Louis Fed

MEANWHILE ON THE POLITICAL FRONT…

Nobody in the markets seems to care, or even notice, how well Bernie Sanders is doing in the polls. Perhaps this is a sign that investors are 100% convinced that nobody can beat President Trump in November. Indeed, the electoral college

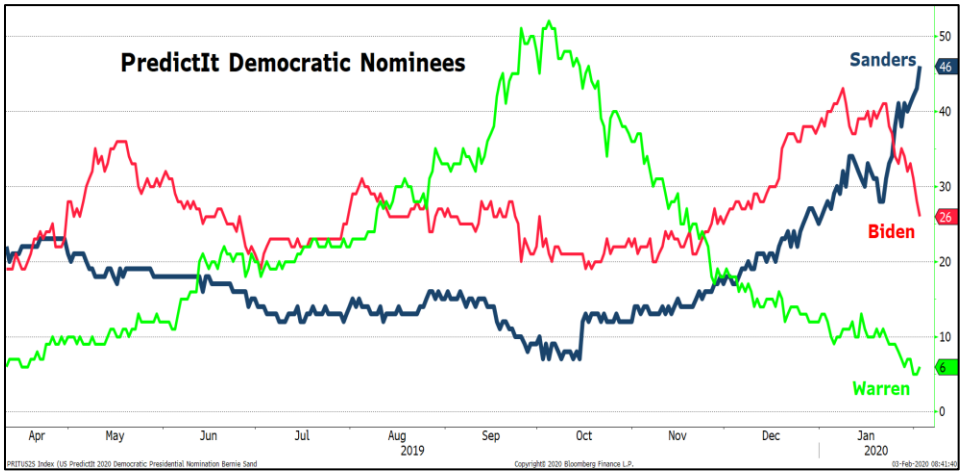
map overwhelmingly favors the President. Thus, the election is still Trump's to lose given the unimpressive slate of Democratic candidates.

Let's review the Democratic nominees. Few think Biden will last. First, Joe is simply too gaffe-prone, and Trump would eat him alive in any debate. Bloomberg is a long shot. Warren's credibility is gone. That leaves Bernie. And Bernie, if anything, has credibility and authenticity and can take on Trump in any debate. Not to mention that he is a populist of a different kind; he speaks to the "everyday blue-collar man" and can bring the union vote back into the tent. Here is a quick summary of his views: raise the minimum wage, legalize marijuana, pass Medicare for All, protect women's reproductive rights, fight climate change, restrict gun access, and overhaul immigration policy.

As the primaries in Iowa kick-off today (February 3), Bernie has surged and opened up a big lead according to the latest PredictIt, which tracks implied probability of the Democratic nominee. He is cleaning up the in the younger-than-thirty crowd (nobody else is close). If the young crowd actually votes in the upcoming election, Bernie could surprise everyone!

While it's very early, one has to give Bernie a 33% chance of winning the nomination and then another 33% chance of being President. Maybe it's lower. Call it 25%. Whatever the odds, they aren't zero. The question is, at what point do the markets start to weigh the probabilities? Bernie is a likeable guy, but his fiscal policies are pretty scary if you have a capitalist bone in your body. Anyway, if the self-avowed socialist is the Democratic contender, it is tough to believe the stock market will react positively.

The Bernie Surge



Source: Bloomberg

THE YIELD CURVE INVERTS (AGAIN)

The three-month/10-year Treasury spread has correctly predicted the last seven recessions. It's such a reliable indicator that the New York Fed and the Cleveland Fed calculate the probability of a downturn in the coming 12 months based on the slope of the yield curve.

An inverted curve has a simple meaning. It is a market message that the policy rate is too high. I have argued that, rather than predicting a recession, an inverted curve actually causes a recession. Every day the curve is inverted, the economy accumulates more damage. Eventually, this results in a recession.

What is not known is how much damage an economy can withstand from an inverted curve before a recession occurs.

Was the 2019 inversion enough to sink the economy into recession? On average we have to wait 311 days after an inversion to find out. The curve notched its tenth consecutive day of inversion on June 6, 2019. Based on the historical average, this suggests a recession could start in Q2 2020. If this instance is more like 2006, a recession may start 487 days after the inversion. That would push a potential recession into Q4 2020. So, we will not know if the yield curve was projecting a recession for another year. And it is way too early to dismiss it as a bad signal.

From a market perspective, the most important thing to consider is how the Fed reacted to the inversion throughout last year. Powell and company came into 2019 expecting to raise interest rates twice. But then the yield curve inverted in March and by rear end the Fed ended up dropping them three times.

March: The curve continued flattening. The Fed shifts their "dot plot" to forecast no interest rate increases in 2019, down from two in their previous forecast.

May: The curve inverted in earnest. By June, Fed Chair Jerome Powell was indicating that the central bank was prepared to cut interest rates at its July meeting.

August: The curve inversion deepened, and the Fed reduced the fed funds rate in September.

October: After three 25-basis-pont interest rate cuts, the yield curve was no longer inverted.

Will the Fed Follow the Bond Market?

Source: Bloomberg

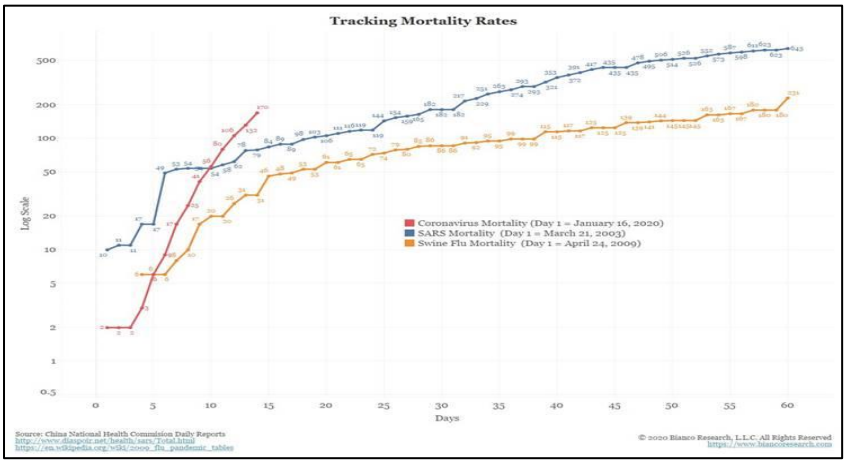
Always remember that the bond market leads the Fed. In other words, the Fed is reactive and not proactive. And as the sequence above demonstrates, the Fed has felt compelled to act when the yield curve inverts.

This year, the Fed has reiterated that the U.S. economy and monetary policy are both in a "good place" and that they will probably keep interest rates steady throughout the year. Sound familiar? That may have seemed reasonable at the end of the year, when the slope of the curve was 35 basis points. But now?

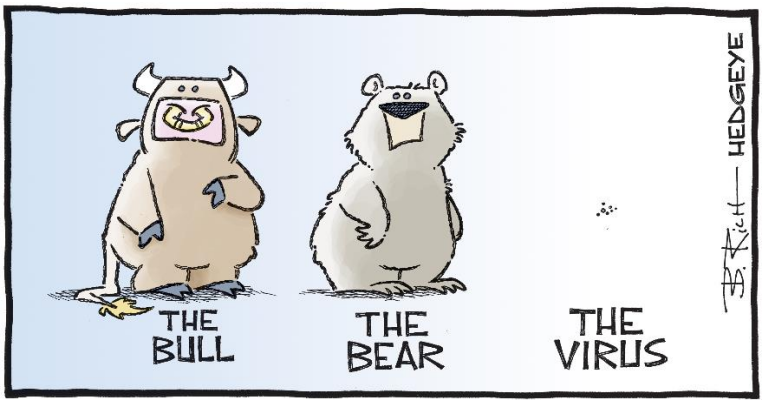
BLACK SWAN

The coronavirus has sickened more than 17,000 people in Asia. Many other cases are suspected but not confirmed. Researchers at Northeastern University estimate that the number of cases may be five or ten times higher than what has been reported. As of Sunday morning, at least 300 people have died, all but one (Philippines) in China. The disease has

been detected in at least 23 other countries, most involving people who traveled from China. Seven cases have been confirmed in the U.S. As shown below, the mortality rates are rising faster than SARS or the swine flu.



From an economic perspective, this is why it matters. The SARS that started in Asia 17 years ago in 2003 lopped off 2% from Chinese GDP growth for one quarter, but back then China was expanding by 11% at an annual rate, not 6%. Many now expect China's Q1 GDP to decline to 4.5%. Furthermore, the SARS episode did not take place in the most important time of the year for spending (the New Year festivities).



Source: Hedgeye

At the same time, China is far more important to the global economy than was the case 17 years ago. China accounts for 17% of global GDP, up from 4% in 2003. It occupies a central place in many supply chains used by other manufacturing countries and is a voracious buyer of raw materials and other commodities, including oil, natural gas and soybeans.

And consumer spending and travel/tourism services now command a much larger share of the Chinese economy than ever before. In 2018, 160+ million Chinese tourists made trips overseas – accounting for more than a third of travel retail sales worldwide. For comparison, in 2003 only 20 million Chinese traveled abroad. So, the implications for the global economy are very serious, especially for the near-term.

In the past, these outbreaks (SARS, MERS, Avian Flu) tended to last six months, on average, before being snuffed out and the eye of the storm for the markets tends to last closer to three. So, this is still early days, and one can reasonably assume that this will dominate the headlines for three months.

With global growth already slow, and the U.S. dragging its feet along at roughly 2% annual growth, there isn't much room to absorb the impact of an event that potentially curtails consumption.

While the fears of a pandemic may be overstated by the media, it would be premature, to dismiss the risk of a viral contagion on an already weak global economy, at a time when asset prices are grossly deviated from economic reality.

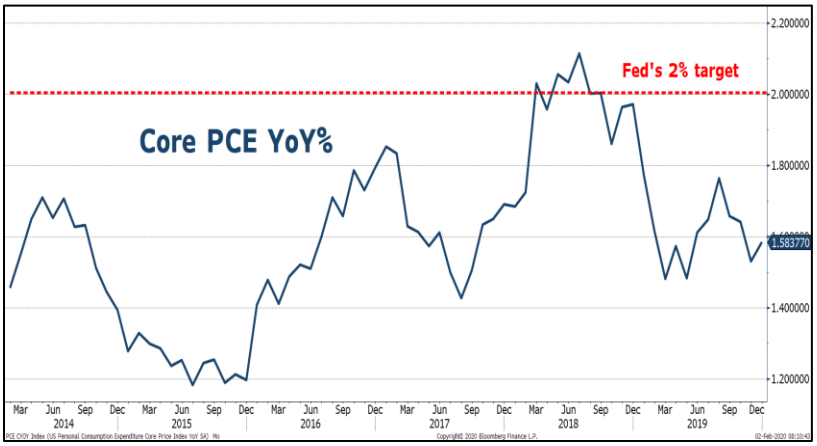
Let's hope for the best but prepare for the worst.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Economic activity shrank in eight U.S. states and was stagnant in three others during the fourth quarter. While gauges increased in 39 states, a measure of economic activity for the nation as a whole fell to 62 at the end of the fourth quarter, the lowest reading since 2010." – The Federal Reserve Bank of Philadelphia.

The Federal Open Market Committee (FOMC) kept the target range for the federal funds rate unchanged at 1.50%-1.75%. Powell repeated that it would take a "material reassessment" of the economic outlook to change the current stance of monetary policy. But, overall, the FOMC statement and Powell sounded dovish with an acknowledgement of the serious nature of the coronavirus; and the acknowledgement of remaining trade policy uncertainty. Furthermore, the FOMC decided to keep supporting the repo market and will continue its purchases of Treasury bills, at least into Q2. On balance, it sounded as if any "material reassessment" of the outlook is more likely to lead to a rate cut than a hike.

Disinflation in the Nation



Source: Bloomberg

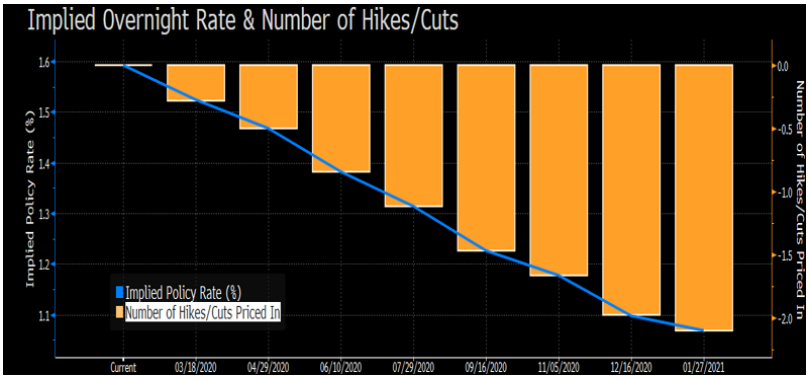
For all the talk about the Fed's newfound commitment to delivering something they have repeatedly proven for a decade they are near-powerless to produce (i.e., > +2% core PCE inflation). The Fed's preferred inflation metric (core PCE) rose only 1.58% and missed expectations.

We are in a structurally low inflation environment for many reasons. Excessive debt, negative demographic trends, globalization and technology are secular disinflationary forces. Another factor for low inflation is the long-term decline of union membership. Fifty years ago, nearly a third of U.S. workers belonged to a union. Today, it's one in 10.

In the past, a high degree of unionization and COLA clauses ("Cost of Living Adjustments") led to wage-price increases that only Paul Volcker and severe back-to-back recessions in the early 1980s could manage to destroy. Compare that to what happened in 2019. Even as the U.S. economy added 2.1 million jobs to the non-farm payroll, union workers declined 170,000.

As shown below, the fed funds futures are now pricing in two rat cuts by January 2020.

Two Fed Cuts Priced In



Source: Bloomberg

I have long warned that the U.S. economy is late in the cycle, rather than the Fed's assessment that their "mid-cycle adjustment" will be sufficient to keep the economy humming along nicely. Much like the U.S.-China trade war contributed to but did not singularly cause last year's deceleration in domestic economic growth, #coronavirus concerns only add to the downside risks associated with the late-cycle realities. And, it is just a matter of time before the FOMC realizes this as well. Confounded and frustrated, the Fed will undoubtedly have to ease policy further.

Let me conclude by saying the bond market was not fooled by the GDP report or the Fed's assessment that the economy is in a "good place." Yields plunged across the curve. As shown below, the benchmark 10-year Treasury yield plunged by 30 basis points and is now approaching all-time low yields reached in 2016.

Approaching All-Time Lows

Source: Bloomberg

What has transpired year-to-date is yet another reason why we advocate a fully invested, risk-appropriate, broadly diversified ladder strategy. Throw away the crystal ball. Any back up in yields provides an attractive entry point. In terms of sectors we favor CMBS (Freddie K) and well-structured CMOs.

PREMIER PORTFOLIO

Alloya Investment Services' online trading platform, Premier Portfolio, has been making a positive impact at credit unions across the corporate's membership since its launch in 2018.

> *"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 (now Alloya Investment Services)."*
> – Darin Higgins, President of Western Illinois Credit Union

> *"While it's always great to connect with our Balance Sheet Solutions, (now Alloya Investment Services), 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'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

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@alloyacorp.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 Alloya Investment Services, 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.