Weekly Relative Value

The U.S. is Not an Island

"There is an old adage, 'When America sneezes, the world catches a cold.' What if the world's two largest economies (U.S. and China) sneeze at the same time? Wait. I can top that. What if the U.S., China, the EU, Japan and the U.K. all sneeze at the same time? What if all mentioned are either involved in trade disputes, and/or the perverse use of both fiscal and/or monetary policies while suffering from heightened political risk? Oh, and at least temporarily, the U.S. faces a partial government shutdown as well. That's a strong sort of fiscal/political mix."
– Stephen Guilfoyle, Director of floor operations for the New York Stock Exchange

In 2017, every prominent economic forecasting entity was shouting from the rooftops about **"synchronized global growth."** Growth was widespread and fueling more growth in what seemed to be a virtuous and sustainable way. The world economy was firing on all cylinders.

Then, in 2018, the global growth story came screeching to a halt. Japanese growth went negative in the third quarter of 2018. Germany also went negative. And so did Switzerland and Sweden. The U.K slowed partly due to confusion around Brexit. French growth slid amid riots triggered by a proposed carbon emissions tax. Chinese growth continued its drop (6.5% in the third quarter) instead of stabilizing.

The U.S. economy held up fairly well in 2018, with 4.2% growth in the second quarter and 3.5% growth in the third quarter. But it is critical to understand that a significant part of U.S. growth last year came from a rise in U.S. inventories.

In a somewhat arcane accounting methodology, building inventories is what counts for GDP, not actual sales. Many businesses created inventory ahead of what was feared to be a significant tariff at the end of 2018. Those inventories will be sold in 2019 and often not replaced. Thus, the U.S. economy will be slowing in 2019 due to a reduction of inventories. In essence, the apparent robust growth of the last half of 2018 was essentially pulling production forward from 2019.

That said, it appears the U.S. growth rate has reached its cycle peak. The fourth quarter growth rate is currently projected at 3.0% or less, continuing the downtrend from the second quarter.

So why is growth slowing around the world?

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

Much of the global slowdown has to do with the high degree of interconnectedness of the global economy. Just as growth in one economy can lead to increased exports for trading partners, a slowdown leads to reduced exports. In other words, the flip side of synchronized growth is a synchronized slowdown.

What is striking is the speed with which synchronized global growth has turned to synchronized slowing. Indications are that this slowing is far from over. While growth can create a positive feedback loop, slowing can do the same.

Let's take a look around the world.

EUROPE (AKA GERMANY)

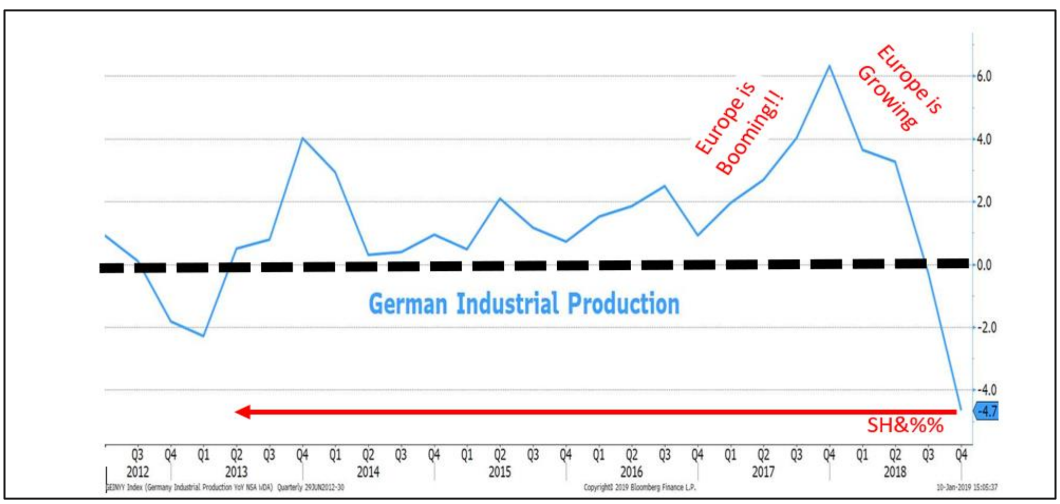
If Germany sneezes, the rest of the continent catches a cold. And it is sneezing hard right now.

In the land of super-stimulus via the European Central Bank's negative-interest-rate policy and years of quantitative easing (QE) that were supposed to perform miracles, industrial production in Germany (which includes construction) dropped 1.9% in November. Compared to a year earlier, the production index dropped an ugly 4.7%, which is the worst since the depths of the financial crisis a decade ago. This makes three months in a row of declines. These are not only horrid numbers, they are unexpectedly and shockingly horrid numbers.

The latest GDP forecasts peg German growth at 1.5% for full-year 2019. I think that is aggressively optimistic, coming after a 0.2% contraction in third quarter 2018 and only 0.5% growth the quarter before. This is key because of the size — the largest economy in Europe, the fourth largest on the planet, accounting fully for one-third of all manufacturing production on the continent.

This raises the risk that Germany, the largest economy in Europe (not to mention swaths of its banking system — as if the policy of negative interest rates really helped), is entering a recession. Data show France following closely behind. Italy's economic slippage seemed to begin in last year's third quarter.

Germany Heading for Recession



This economic slowdown is not unique to Germany but has been spreading across the European Union (EU). Italy, Switzerland and Sweden posted negative growth in the third quarter. Thus, while the causes may vary, growth in all of the major economies in the EU and the U.K. is either slowing or has already turned negative.

And this economic slowdown is occurring despite, or perhaps because of, the mother of all stimuli engineered by a major central bank – negative interest rates and massive QE – that has benefited a few hedge funds. And it has allowed even junk-rated companies to borrow money for a song from beaten down investors, savers and pension funds. But the real economy in Europe languishes.

If eurozone growth ends at 1% in 2018, it's a good bet 2019 will be no better and possibly bring a true recession. What happens to German banks in that scenario? And if they go wobbly, what happens to U.S., Canadian and Asian banks? If Europe goes into a recession, it will have a significant impact on the world and the U.S.

Paying attention to Europe will be important in 2019.

BREXIT

Let's not forget the Brexit issue. In the U.K., society is completely divided; the rift between the "Exit" camp and the "Stay" camp is even wider than the divide between the Democrats and Republicans in the U.S. The U.K. is supposed to vote on January 15 on Theresa May's Brexit plan. At the moment, it looks like it will not pass. Even if it does, the details and implications are hideously complex, with very little time to sort them out before the March 29 departure date. The resulting confusion will, at the very least, temporarily paralyze some businesses and disrupt EU/U.K. trade, of which there is a lot. Some 48% of U.K. exports go to the EU, far more than it sells to the U.S.

It increasingly looks as though a "hard Brexit" will win the day, barring another referendum. And it seems likely that this will cause a significant disruption to economic activity. But the bigger problem is that the U.S. will get hit on both sides. A hard Brexit will hit both the EU and U.K. economies, including China, and the damage from both will then spread worldwide, including to the U.S.

MIDDLE KINGDOM

The U.S. and China are the world's largest and second-largest economies. They are also entwined with each other in so many ways that it can be hard to know where one stops and the other starts. Some call it "Chimerica."

China has produced enviable growth rates, but a slowdown is inevitable. China is still subject to the law of large numbers. They can't maintain 6% or higher GDP growth indefinitely. And last week there were more signs revealing economic stress during the latter half of last year. Factory orders and consumption indicators slumped, and its housing bubble is on the verge of bursting.

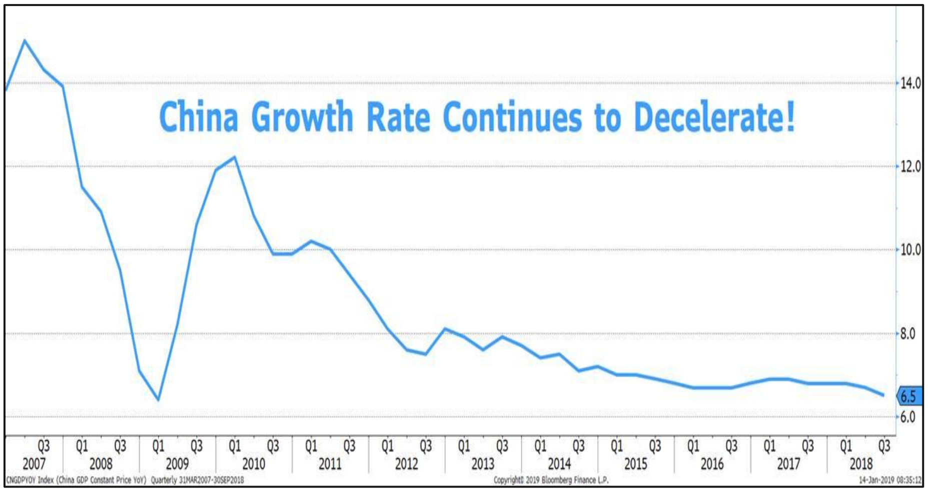
China is expected to report later this month that its GDP expanded by 6.6% in 2018 – the weakest rate since 1990. And looking forward, China announced that they plan to set a lower economic growth target of 6%-6.5% in 2019 as Beijing braces for weaker domestic demand and more fallout from the U.S.-China trade war.

However, it's important to keep in mind that China likely inflates its GDP figures, though one academic who recently suggested that growth in 2018 might have been below 2% was subject to an aggressive government censure. That should tell you all you really need to know about growth in China.

Regardless, the uncomfortable fact is that a great deal of world growth is directly tied to Chinese growth. Business has built 6% Chinese growth, compounded forever, into its models. And when that growth doesn't meet expectations, we get surprises. Apple is just the first of many.

The important thing to understand here is that, in the depths of the Great Recession, Beijing unleashed a stimulus the likes of which the world hadn't seen since World War II. It amounted to some 19% of its GDP. Aside from its size, what made China's stimulus unique was the way it was administered. The central government didn't borrow a lot of money itself to use on infrastructure, but rather pushed local governments and state-owned companies to do so. The result was a web of debt that's been even harder to clean up than it might have been because of all the money that unregulated lenders — so-called shadow banks — were frantically handing out above and beyond what Beijing had been hoping for.

The Slow Down in China Accelerates



It took us 100 years to borrow enough to get a debt-to-GDP ratio of 300; they did it in 10. As the International Monetary Fund reports, China simply seems to have reached a point of diminishing returns with this kind of credit stimulus. So much new debt is either going to pay back old debt or into economically questionable projects that it takes a lot more of it than it used to just to achieve the same amount of growth. Three times as much, in fact. Whereas it had only taken six-and-a-half trillion yuan of new credit to make China's economy grow by five trillion yuan a year back in 2008, that had risen to 20 trillion yuan of new credit by 2016.

It's long been said that when the U.S. sneezes, the rest of the world catches a cold. Well, it's been a long time since China has sneezed, but with its industrial profits falling for the first time in three years and its car sales dropping for the first time in nearly 30 years, we might find out just how sick it can make everyone else.

That's one Chinese export we don't want.

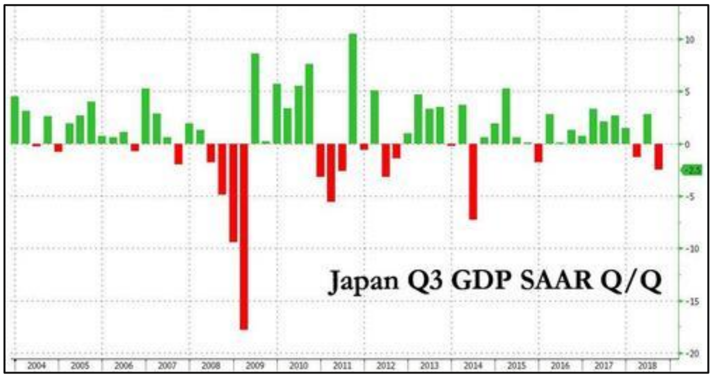
THE LAND OF THE RISING SUN

In Japan, the world's third largest economy, third quarter GDP was far worse than initially estimated, printing at -2.5% quarter-over-quarter annualized. Of note, exports dropped an annualized 71% overall for the third quarter of 2018, with a 5.6% decrease in imports during the same timeframe. Household consumption also declined 0.5% and corporate investment declined 0.9%.

Natural disasters and a decline in overseas demand of Japanese goods may have exacerbated the slowdown (a series of typhoons disrupted supply chains and a quake knocked out power in northern Japan). Then again, it is also possible that Japan's economy has been gripped by the broader contraction resulting from the trade war between the U.S. and China.

Whether fourth quarter GDP prints green, or Japan enters a technical recession, in a world where economic growth is rapidly slowing down, and in many cases contracting outright, the latest news out of Japan will hardly boost confidence that an economic recovery is just around the corner.

Japan's GDP: Negative Again



WITHER INFLATION

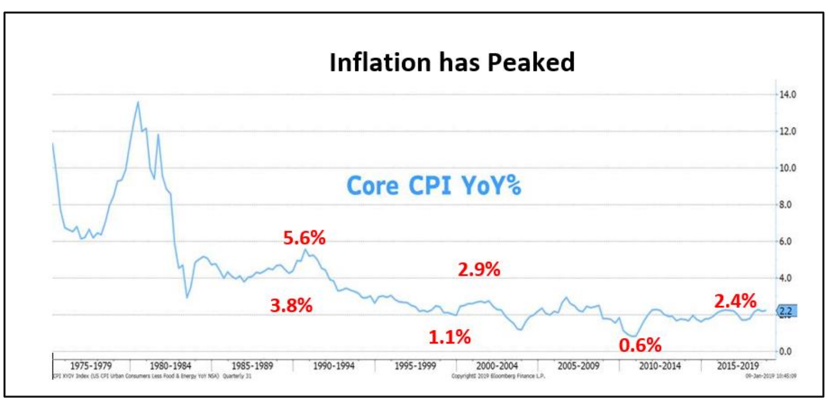
"With the muted inflation readings that we've seen coming in,
we will be patient as we watch to see how the economy evolves." – Federal Reserve Chair Jay Powell

---

So, the global economy is slowing and so is inflation.

Based on the latest read, the headline Consumer Price Index (CPI) is now back below the Fed's mandated 2.0% Maginot Line. CPI printed exactly in line with expectations +1.9% year-over-year (the weakest growth since August 2017).

The situation is all the more impressive given how the tariffs have boosted costs and the lack of skilled labor has forced wage expenses higher. The structural factors such as aging demographics, excessive debt burdens and accelerating technological shifts are all at play.



Inflation has Peaked

See the pattern here. Over the past 30 years, since the late 1980s, the cycle-lows in core inflation have gone lower, while the highs have also peeked out at lower levels.

Eurozone inflation is rolling over, and the core is a mere 1.0%. The Bank of Japan has basically abandoned its ever-elusive 2% target. China's inflation rate is 1.9% and well below the People's Bank of China's target rate of 3%. The Bank of Canada is being forced to revise its inflation outlook lower as well.

This is all very constructive for the Treasury market outlook. The lows keep getting lower, and the low this past cycle was also a record-setting trough at a mere 0.6%. Imagine where inflation bottoms out during the next recession. Perhaps we go to outright deflation in the next go around given the pattern in play and the lower starting point. Throw in mild deflation in coming years, along with average real growth in low-single-digits, and it isn't difficult to see the yield on the 10-year Treasury-note heading back below 2%.

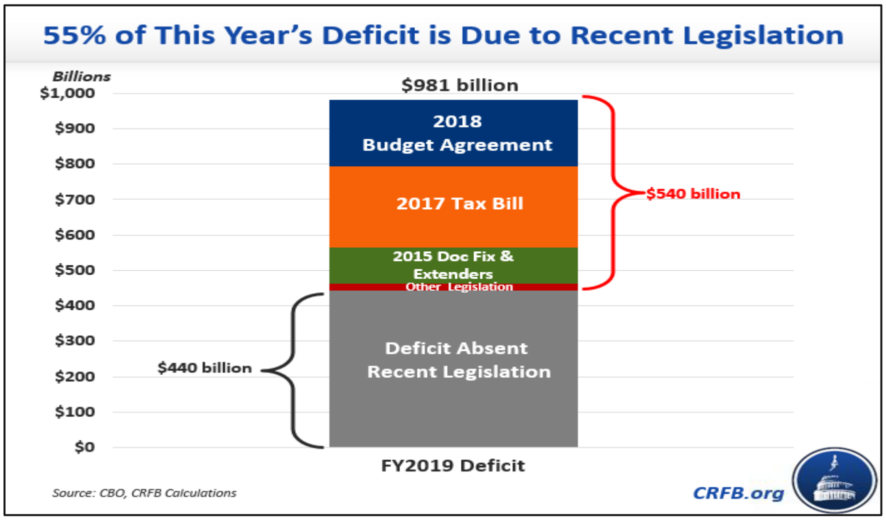
From the standpoint of a bond guy that started in 1980, when 30-year bond yields were close to 15%, the current 30-year Treasury rate at 3% seems ridiculously low. In the near future, at 1.5%, the 3% yield will seem generous.

DEBT: THE FOUR-LETTER WORD

If there is one common denominator that explains the slowing growth around the world it is debt.

In the U.S. we are building towards some sort of fiscal crisis as the U.S. government in 2018, at the peak of the economic cycle, managed to tap the debt markets for$1.48 trillion (triple the $515.9 billion in 2017), which takes the debt outstanding to $21.974 trillion — a number set to explode even further in the coming years.

This past year, the enormous increase in debt added to economic growth; however, this also added to the already onerous debt burden, meaning it will act as a drag on future economic growth. The U.S. debt-to-GDP ratio is now 106%, the highest since the end of the Second World War.



The Trump corporate tax cuts likely will cost $2 trillion over the next 10 years, up $400 billion from the prior estimate. In 2018, the tax cut saved S&P 500 companies $144 billion, but resulted in less growth than expected.

Over the next five years, the Congressional Budget Office (CBO) projects the deficit will expand by $5.661 trillion. If federal debt continues to rise in by the same amount as the past five years, then total debt outstanding will reach $28.9 trillion in 2023, compared with the CBO's projected GDP estimate for that year of $24.6 trillion. Debt, therefore, will reach 117% of a total year's income/output of the U.S. economy in just five short years.

But debt is not unique to the U.S.

The Chinese debt-to-GDP ratio (including the debts and guarantees of provinces, state-owned enterprises, banks, wealth management products and numerous other entities that the government in Beijing is directly or indirectly obligated to support) is close to 300%, about the same as Japan's.

And this is why it matters.

Debt-to-GDP ratios below 60% are considered sustainable; ratios between 60% and 90% are considered unsustainable and need to be reversed; and ratios in excess of 90% are in the red zone and will produce negative growth along with default through nonpayment, inflation or other forms of debt repudiation.

The world's three largest economies — the U.S., China and Japan — are all now deep in the red zone.

NO BULLETS LEFT

The risk of a recession has continued to rise in recent months with plenty of warnings already showing up from a near-inverted yield curve, declining economic momentum, low nominal and real bond yields, and struggling stock prices.

The problem is, the next recession may well fall outside of the capability of the Federal Reserve and government to neutralize.

Since 1980, the eventual and inevitable unwind of an overly leveraged system was met by a drastic drop in the federal funds rate to stimulate debt-induced consumption and spur economic activity. The problem is that each effort by the Fed to limit the impact to the system has required a lower interest rate than the one that preceded.

With rates near the lowest level on record still, the next event will once again require dramatic measures to stem the unwinding of a decade-long, debt-supported economic cycle.

If a recession comes anytime soon, the U.S. government will not have the tools to fight it. The White House and Congress will once again prove inept at deploying fiscal policy as a counter-cyclical stabilizer, and the Fed will not have enough room to provide adequate stimulus through interest rate cuts. As for more unconventional policies, the Fed most likely will not have the nerve, let alone the power, to pursue such measures. As a result, for the first time in a decade, Americans and investors cannot rule out a downturn. At a minimum, they must prepare for the possibility of a deep and prolonged recession, which could arrive whenever the next financial shock comes.

THE WALL

> *"The partial government shutdown is now the longest on record, with little chance of a near-term resolution. It has now lasted long enough that we have to start thinking about the impact on first quarter GDP growth, which was already set to slow as a result of the drop in stock prices in the fourth quarter and the fading fiscal push...* ***if the shutdown were to last through the whole quarter, we would look for an outright decline in first quarter GDP."***
> *— Pantheon Macroeconomics Chief Economist Ian Shepherdson*

Trump's demand for $5.7 billion in funding for his border wall has resulted in a nearly three-week shutdown, currently the second longest in history. The partial government shutdown is entering its 24th day for the longest in American history.

Here's the latest on the impact of the shutdown:

- **800,000 federal workers,** who are either furloughed or working without pay, missed their first paychecks last week.
- **Three federal employee organizations** have sued the Trump administration over having to work without pay.
- **Hundreds of TSA agents** have called in sick to at least four major airports after being forced to work without pay, and the Miami airport was forced to close one terminal early for three days due to TSA absences.
- **FBI agents** said the shutdown could be a threat to national security.
- **The Food and Drug Administration** has suspended all routine inspections of domestic food-processing facilities.
- **Emergency aid for farmers** hurt by the trade war between the U.S. and China could be delayed.

"Listen, we KNOW your dream is to be a federal government employee, we're just asking you to consider a career with more job security, like a street performer, or a poet."

h/t John Slefinger

How will this stalemate end?

Trump may be within his right to declare a national emergency. What's questionable is whether or not Trump can bypass Congress on funding. I do not know for sure how the courts would rule, nor does anyone else.

However, I do know that declaring a national emergency would be a perilous decision.

If Trump claimed a "national emergency" in order to secure the funding for his border wall between the U.S. and Mexico, consider the precedent he would create. For example, in the future a Democratic president could declare a "national emergency" over gun violence and ban guns. Rising carbon emissions or even income inequality could be declared national emergencies.

That's the problem with declaring a "national emergency" when it is not a true emergency. This is now 24 days without a paycheck for some 800,000 civil servants — they're the ones in need of emergency funding. Instead, they are being used as pawns in this border security argument.

Big picture: This could go on for a long time. Trump is no longer talking to Democrats. In recent days he has sounded less enthusiastic about the exit strategy he had been considering — declaring an emergency to build the wall without Congress — as Republicans have expressed serious concerns.

The pressure to end the federal financing freeze will increase as many workers go unpaid. And we're beginning to see the effects of the standoff in the macro data. Last week there was a big uptick in jobless claims, as furloughed workers are entitled to unemployment benefits until the shutdown is resolved. Meanwhile, the U.S. economy has lost about $3.6 billion so far because of the shutdown, according to estimates by S&P Global Ratings. Wall Street houses are trimming first quarter real GDP forecasts by 25 basis points.

It's sufficient to say that the dysfunction in Washington is getting worse, not better. Democrats took charge of the House of Representatives on January 3, and they will use their committee control to launch literally dozens of investigations into "Russian collusion," Trump's business dealings, Trump's inaugural financing, Trump's tax returns, campaign finance, regulatory reforms, appointments and much more.

But Republicans continue to hold the U.S. Senate. They will use their committee control to hold hearings on FBI corruption, Intelligence Community abuse of spying powers, Hillary Clinton's private server that held classified information and Democratic coverups on Benghazi, tea party IRS attacks, the Clinton Foundation "pay for play" deals with former Secretary of State Hillary Clinton, false accusations related to the confirmation of Justice Brett Kavanaugh and more.

Beyond the economic effects, the impasse between President Trump and Congressional Democrats offers a dismal preview of divided government. The next test will be passage of a new debt ceiling when the present suspension ends on March 1. When the debt limit was used as a political football in 2011, the U.S. suffered its first-ever credit downgrade, resulting in a market rout.

I think virtually all Republicans and Democrats alike are becoming increasingly frustrated with President Trump's negotiating tactics and refusal to compromise at this stage of the government shutdown.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"We can now invest with confidence that the new boss is, in fact, the same as the old boss…Risk is dead."
– Stephanie Pomboy, President and Economist at MacroMavens, LLC

Already in this new year, Fed Chair Jerome Powell staged a full capitulation with comments that policy makers are "listening carefully" to markets. The Fed Chairman has emphasized the central bank's willingness to be patient in raising interest rates while indicating some flexibility on the pace of reduction of its balance sheet. That represented a reversal from expectations that there would be two rate increases of one-quarter percent in 2019 and that the reduction of the central bank's assets was to proceed on autopilot.

The alleged Fed flip-flop appeared to stem from the vicious late-2018 sell-off in risk assets. In other words, the Fed "put" option – an insurance policy against losses provided by the central bank by easing money whenever stocks and other risk assets tank – lives on. In essence, the Fed Chair has morphed from "pragmatic" Powell to Powell "put," and the markets have been throwing a party since then.

After reading the dovish tone of the minutes, one is left wondering why the December 19 rate hike was even necessary. Federal Open Market Committee (FOMC) officials discussed downside risks to growth until they were blue in the face, and from a myriad of sources – slower than expected global growth, fiscal stimulus withdrawal, the tightening in financial conditions, to name a few. The emphasis was more on inflation rolling over than any residual concerns of heightened price pressures. To a man and a woman, there was far less certainty about whether any additional rate hikes would be needed – at a minimum, the future path was far murkier than had been the case in the recent past. The emphasis was more on inflation rolling over than any residual concerns of heightened price pressures.

And there was this little ditty from the Fed minutes:

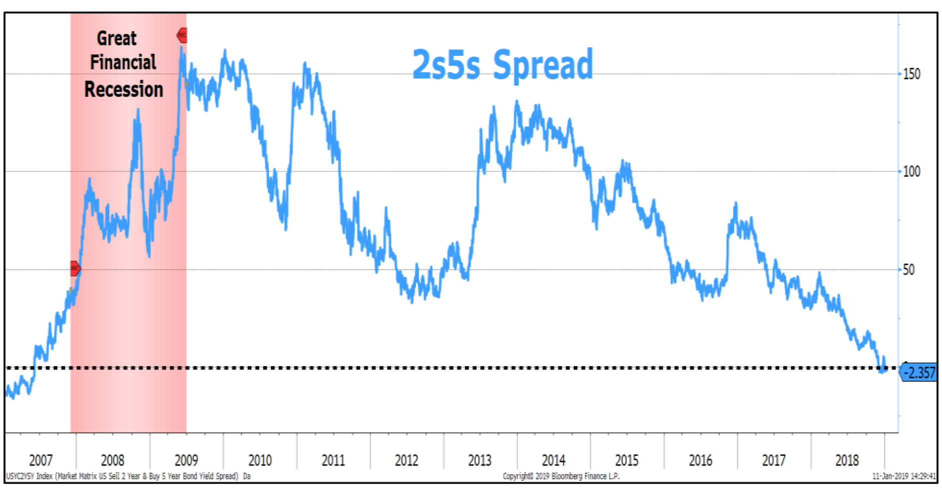
"Participants also reported hearing more frequent concerns about the global economic outlook from business contacts."

Americans like to think we are insulated from the world. The lesson of the last recession is that there is no such thing as global decoupling. As discussed above, it seems as though Germany and the rest of Europe is heading into a recession. China is on weak legs and Japan's economy turned south in the third quarter. Problems in those markets are ultimately problems for the U.S., too. I see significant potential for global recession, and it will bleed over into the U.S. market. A few unforced errors on the part of the U.S. central bank or government could bring recession sooner rather than later.

On top of that, the stock market's capitalization, since the market's September highs, has seen some $4.5 trillion of investor gains wiped out in three months. Because there is such an intense symbiotic relationship between the "financial economy" and the "real economy," the combined impact of what the stock market has already done (including the recent relief rally), via a depressed "wealth effect" on spending, will be to drain on economic growth in 2019. In other words, what starts on Wall Street, rarely stays on Wall Street.

Consumer confidence has begun to ebb and could fall further as the losses sink in – probably with the receipt of year-end statements. Based on estimates, the wealth effect of a drop between two and five cents for every dollar lost in wealth, a back-of-the-envelope calculation suggests consumers could cut spending by $90 billion to $225 billion. The wealth drag could lower real consumer spending by 0.7-to-1.7%. That by itself cuts the underlying economic trend in half to less than 1.5%. That's not including the other negative effects of tariff and trade wars, corporate debt servicing burdens this year, and fiscal stimulus withdrawal.

The Yield Curve is Pointing to a Recession



The current economic expansion, which has been driven by massive infusions of liquidity, extremely accommodative interest rate policy, and a surge in debt accumulation, is just four months away from setting a new record. However, all good things come to an end. Despite the hope that the economy will continue into an everlasting expansion, such has never been the case. It's called the business cycle. And that is what the yield curve above is signaling.

As things now stand, the futures market is still clinging to a 19% probability that the Fed hikes at least one more time this year, though this is down from 51% just one short month ago. Before too long, the Fed will be forced to ease policy. But, as is often the case, they are far too late. History will show that the last two tightenings in September and December were overkill.

In terms of portfolio strategy, we continue to advocate that credit unions maintain a risk-appropriate, high-quality ladder investment portfolio. It may be tempting to stay in overnight funds or in the front end given how flat or inverted the yield curve has become. However, the medium/long-term risk is that if/when the Fed reverses policy, credit unions will have missed an opportunity to lock in higher yields and returns. Also, by remaining fully invested, credit unions will minimize the reinvestment rate risk. In other words, while staying in cash may seem like a risk averse strategy, it may in fact be adding risk to the balance sheet and reducing income.

PREMIER PORTFOLIO

For the first time, Balance Sheet Solutions, LLC credit union clients are now able to perform many of their daily investment activities all in one location, including…

- **Access Documents and Reports**
  Easily access key documents, monthly statements and overall market analyses.
- **View Portfolio Holdings**
  See current investments online and easily export into a spreadsheet format.
- **View and Buy Offerings**
  Review a list of available security offerings and highlighted specials – place "buy" orders right from the convenience of your desk, AND… connect directly into the SimpliCD website to make CD purchases.
- **Quickly View Current Rates**
  Stay in the know – view daily rates in the same location where purchase decisions are made.
- **Read Daily Commentary & Weekly Relative Value**
  Gain access to educational content that tracks market and economic trends, analyzes key releases and watches ongoing political developments. Understand the impacts of current events on credit unions.

Watch the overview video here: www.alloyacorp.org/premierportfolio

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.