Weekly Relative Value

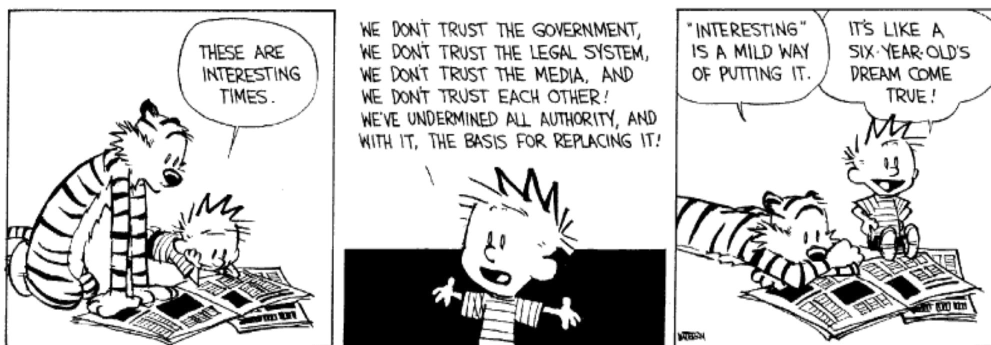
"May You Live in Interesting Times"

"Like it or not we live in interesting times. They are times of danger and uncertainty; but they are also more open to the creative energy of men than any other time in history."
– Robert Kennedy, 1966

"May you live in interesting times." This may sound like a blessing, but the expression is used ironically, with the insinuation that "uninteresting times" of peace and tranquility are more life-enhancing than "interesting times" of chaos or disorder. While the origin is unknown, the expression is commonly referred to as the "Chinese curse."

The country is socially and politically divided. Central banks are experimenting with monetary policy with unknown long-term consequences. Governments are printing debt as if it does not need to be paid back. Trade tariffs, nationalism, fake news, alternative facts, wealth inequality, "winner take all," globalism, Brexit, climate change, "witch hunt," the Wall, you name it. No one seems to agree on much of anything these days.

But I think we can all agree that **we are living in most interesting times.**



Source: Cagle Cartoons

In this week's article, I thought I would start with excerpts from Seth Klarman's annual letter. Seth Klarman is the legendary founder of the $30 billion hedge fund: The Baupost Group. Klarman is highly regarded and one of the world's greatest investors of all time. He may not be Warren Buffet, but he is in his league.

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

SUBSCRIBE

THIS WEEK...
- Tax the Rich?
- These are the Good Times
- Monetary Policy is a Failure
- Five Weeks to Go
- Trees Don't Grow to the Moon

PORTFOLIO STRATEGY

Introducing

Contact us for more information.

And as you will quickly discern over the next few pages, Klarman has turned dire on the future of capitalism, politics and society. He is sending a warning to Washington and business leaders that the world has changed, and the implications are quite serious for investing.

Below I have highlighted select excerpts from Klarman's letter.

"Social frictions remain a challenge for democracies around the world*, and we wonder when investors might take more notice of this. The recent 'yellow vest' marches in France, which subsequently spread to Belgium, Holland, and Canada, began as a petition against fuel tax hikes, and grew through social media into a mass protest movement led by suburban commuters, small business owners, and truck drivers. The demonstrations, which appear to have broken out spontaneously throughout the country, became widespread and even violent. While the French government is clearly concerned—in December, it reversed the planned tax increases while announcing a higher minimum wage—the financial markets have taken the unrest largely in stride, as the French 10-year note at year-end yielded a meager 70 basis points...*

"Social and economic advancement in America today seems increasingly dependent on demography and geography*. The economic advantages enjoyed by college graduates continues to grow. Unsurprisingly, income growth in most major metropolitan areas surpasses gains in rural areas of the country.* ***Economic inequality continued to worsen in 2018, and for many, real wages have not increased in decades. It seems clear that economic anxiety contributed to the election of Donald Trump in 2016.***

"The divide between Americans has been exacerbated by the echo chambers of modern-day media and the internet*. Many have written of how, in only about four decades, an America of three broadcast networks has become an America of hundreds of cable channels. A few decades ago, we had less connectivity but more connection. David Brooks and others write regularly about the challenges of increased loneliness and isolation****. A person today can have a thousand Facebook friends—and few, if any, actual friends.***

"Amid all this turmoil, should investors simply hunker down and keep their focus on markets? That might be a challenge. By way of illustration, on December 18, on the FedEx earnings call, ***CEO Frederick Smith noted that 'most of the issues that we're dealing with today are induced by bad political choices, I mean, making a bad decision about a new tax, creating a tremendously difficult situation with Brexit, the immigration crisis in Germany, the mercantilism and state-owned enterprise initiatives in China, the tariffs that the United States put in unilaterally.*** *So, you just go down the list, and they're all things that have created macroeconomic slowdowns.*

"These days, Americans do not seem to agree on much of anything*. Some of it is today's politics: 'Deep state' or dedicated civil servants? 'Witch hunt' or legitimate investigation into crimes? 'Fake news' or free press? 'Alternative facts' or facts? Accomplished adversary or 'lock her up?' And some of it goes beyond politics into the realms of scientific inquiry and American values. Climate change or 'climate hoax?' Refugees seeking sanctuary or 'caravan of foreign invaders?'*

"Does this matter? We think it does. ***It's hard for our leaders to guide us when we don't agree on our values or even on how we decide what is true.*** *Worse, our enemies, including but not limited to Russia's autocratic government, are using social media and internet postings to confuse us and divide us further. They know which hot buttons to push.* ***Moreover, our willful disbelief of facts, truth, and science increases the chance that we will fail to recognize or take seriously growing threats.*** *In 1993, Senator* ***Daniel Patrick Moynihan, who famously said that 'everyone is entitled to his own opinion, but not to his own facts,' observed that America was 'defining deviancy down.' His point was that behavior that had once been seen as deviant was now considered acceptable. To paraphrase Moynihan, today we may instead be defining reality down.***

"This post-truth moment is quite dangerous. Imagine an incident that threatens national security*. Will Americans see eye-to-eye on the seriousness of the threat? If our leaders are truth-challenged, will Americans believe the official explanation of the threat and the wisdom of the proposed response? Should they?*

"We would argue vehemently that democracy, and the liberties and protections it provides, is not just of importance to individual citizens, but also to businesses and markets*. In a democracy, businesses have the benefit of equal treatment under the law, including unbiased regulation.*

"We would also argue that social cohesion is essential for those who have capital to invest. Businesses need a long-term horizon to plan, and social unrest makes planning more difficult. It can't be business as usual amidst constant protests, riots, shutdowns, and escalating social tensions. It is not hard to imagine worsening social unrest among a generation that is falling behind economically and feels betrayed by a massive national debt that was incurred without any obvious benefit to them. If things get bad enough, we could see taxes once again raised to confiscatory levels. We should all be rooting for (and acting to support) social cohesion and a renewal of the American dream."

Here are a few more thoughts from Seth.

In a recent article in the New Yorker, Klarman argued that American capitalism has been damaged by the obsession with short-term stock prices: ***"I don't think it's too late for business leaders to start doing the right thing for their employees, their clients, and their communities… And if they don't? It could lead to regulations that, in his mind, would go too far in constraining corporate behavior…When capitalism goes unchecked and unexamined, and management is seduced by a narrow and myopic perspective, the pendulum can quickly swing in directions where capitalism's benefits are discounted, and its flaws exaggerated… If every businessperson, or enough businesspeople, don't act as stewards of more than just the bottom line, somebody's going to come along and do it for them."***

"Does anyone really believe that shareholders are the only constituency that matters: not customers, not employees, not the community or the country or Planet Earth?"

In his view, companies that operate with integrity rarely get enough credit for it from investors or the press. "***You have people who are princes, who have good values, who treat people right. We don't tend to pay a lot of attention; we don't get a lot of stories about them."***

"It's a choice to do things that 'maximize profits,' to pay people as little as you can, or work them as hard as you can… It's a choice to maintain pleasant working conditions or, alternatively, particularly harsh ones, to offer good benefits or paltry ones."

In sum, Seth is suggesting that the capitalist system is broken. **The main flaw with capitalism** is that nowhere is it practiced as it is meant to be: capitalism is supposed to be hellishly competitive; and, in addition to featuring an invisible hand, it's supposed to have a heart. The way capitalism has **been practiced has been corrosive to some of the conditions that made it an attractive system.** The practice has undermined some of the cultural supports that made it successful. And if business leaders don't take charge, changes may come that they won't like.

As a side note: I am grateful and proud to work at a company and in an industry that constantly tries to do the right thing for its members, customers and community.

TAX THE RICH?

Consider the following:

- **Three-quarters of people** living in developed countries feel they are not getting a fair shake, according to the Edelman Trust Barometer.
- **Real pay for all but the richest** people has been almost flat for at least three decades. And when Americans have lost a job, almost half have moved to a lower-paying one, jeopardizing their place in the middle class.
- **Home prices** in U.S. and European cities are often unaffordable, again for almost anyone but the wealthiest.
- **Only one in five people says the system is working for them.** One in three says their children will be worse off.

That is really scary. So, with that backdrop, is it any wonder that a recent survey showed 61% of Americans aged between 18 and 24 have a positive reaction to the word “socialism” — beating out “capitalism” at 58%. Overall, 39% of Americans are well-disposed toward socialism.

As we move forward, Seth believes politics will have a greater impact on markets than ever before. We may be entering an era unlike anything in our own experience or in our history books.

Last week, Democratic Senator Elizabeth Warren proposed 2% wealth tax on Americans with $50 million-plus in assets. For Americans with assets above $1 billion, that tax rate would increase to 3%. The wealth tax is projected to apply to less than 0.1% of U.S. households, and would raise $2.75 trillion over 10 years. To counter tax evasion, the proposal would levy a one-time tax penalty on people with more than $50 million who try to renounce their U.S. citizenship.

Warren’s idea comes alongside Representative Alexandria Ocasio-Cortez’s proposal for a 70% marginal rate on income above $10 million. Her proposal would directly affect about 30,000 Americans, or roughly 0.01% of the population. That might seem like a small number, but these Americans currently earn about 5% of the nation’s pretax income and pay roughly 9% of all federal income taxes.

While Ocasio-Cortez’s plan is a tax on income, Warren’s proposal would tax wealth. The wealthiest 0.1% of households account for 17% of the stockholdings of all households, while the top 1% own 50%, according to Fed data. Those percentages are up from 13% and 39%, respectively, in the late 1980s. Supposedly, this wealth tax would raise almost $3 trillion over 10 years. The avowed aim of these levies is also to reduce inequality.

While sounding a bit socialistic, according to numerous studies, the impact of a 70% top marginal tax rate could actually be positive for the overall economy. In this situation, raising taxes on the ultrarich to transfer purchasing power to the rest of society could end up making everyone better off by boosting aggregate spending on goods and services.

Taxing wealth, meanwhile, is unlikely to be positive for asset prices, which could have a negative effect on spending and GDP.

Were the ultrarich to have to render unto President Warren under her proposed wealth tax, they presumably would have to sell liquid assets. Some billionaires might simply write a $30 million check (3% of $1 billion), but it’s more likely that most would unload some liquid stocks or bonds, rather than putting a Palm Beach mansion up for sale.

In addition, there has been the rise of economic illiterate Modern Monetary Theory, which states that debt does not matter. Create and spend whatever we need for the common good. You simply monetize the debt when the debt becomes too large. Seriously?

Others have argued that the government should literally print more money and hand it to the masses.

In any case, these policies reflect the disenchantment with the status quo and are examples of how politics could quickly and radically change the investment landscape.

Regardless, the debate is certain to become increasingly intense as the 2020 election approaches.

THESE ARE THE GOOD TIMES

Sales of "existing homes" — including single-family houses, townhouses and condos — in December, plunged 10.3% from a year earlier, to an annualized rate of 4.99 million homes. This was the biggest year-over-year drop since May 2011, during the throes of the housing bust. This was the lowest number of existing sales in three years, and the lowest but one month in four years.

No region was spared — the Northeast sagged 6.8%, the Midwest plummeted 11.2%, sales were down 5.4% in the South and the West fell 1.9% (following a 6.3% fall-off in November).

The first-time buyer was AWOL. First-time sales dipped to a puny 32%. In a healthy market, first-time sales should be near the 40% levels. Cash-strapped and saddled with student loans and other debt, millennials — a generation of more than 70 million now in their 20s and mid-30s — have delayed buying a home later than their parents did, but their participation is crucial in buoying home sales.

Source: Bloomberg

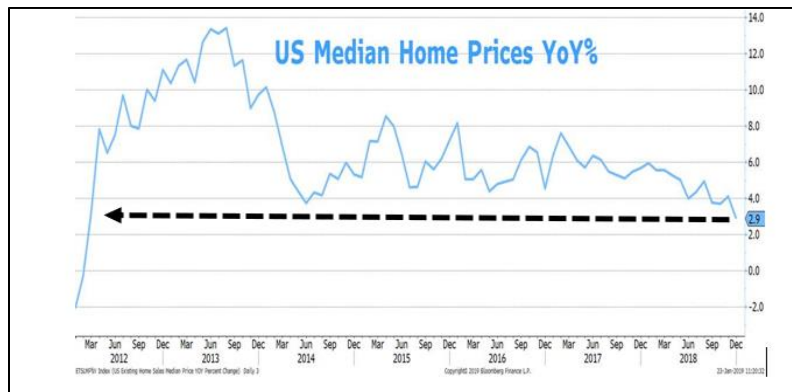
Existing home sales are about where they were in 1998 when mortgage rates were generally in the 6.5% to 7.5% range. Today, 30-year fixed rates are under 4%. Population-adjusted, these sales numbers are a disaster. Clearly mortgage rates are not the overriding factor. Affordability, jobs and sentiment towards buying a home count more than mortgage rates. If that were not the case, existing home sales would not be at the 1998 sales level with allegedly millions more people wanting a home.

U.S. Existing Home Sales 1970 to Present

Source: NAR

And home prices are eroding. Prices are still rising sharply in some local housing markets and they're declining in others. However, on a national basis, median prices deflated 1.4% in December, the fifth decline in the past six months. Across the U.S., the median sales price – meaning that half of the homes sold for more and half sold for less — still rose 2.9% year-over-year to $253,600, but it was the lowest growth rate since the price declines in seven years.

Home Price Appreciation Slows

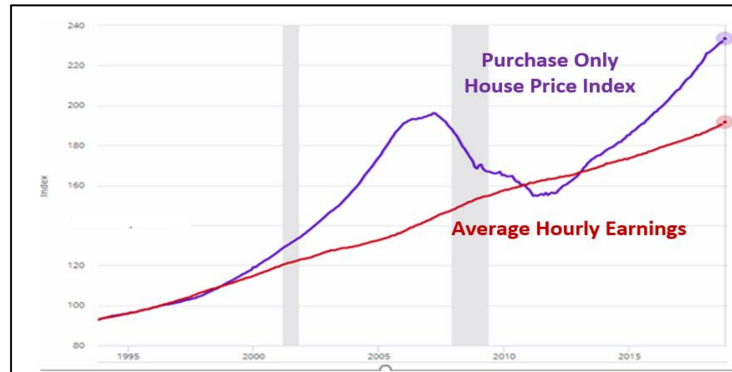


Source: Bloomberg

As discussed many times in this space, the problem remains one of affordability. While the slowing in home prices and recent decline in mortgage rates should ease the burden somewhat, affordability for first-time buyers is flirting with cycle lows. The typical starter home is some 8% less affordable now than it was a year ago.

Unquestionably, home prices have risen far more than wage growth. That's what matters the most. As long as home prices rise more than wages, the pool of eligible buyers shrinks. The following graph shows the relative increases in home prices versus wages, suggesting that affordability will be an issue for some time.

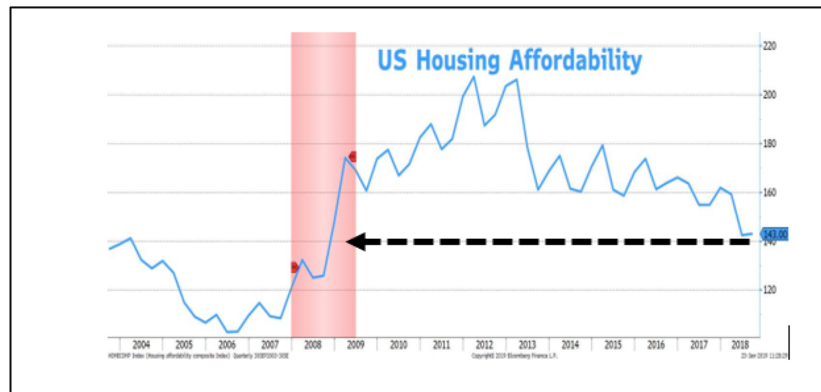
Home Prices Far Exceed Wages



Source: Fred

And, it is not just the size of the monthly mortgage payment that affects affordability. Property taxes (Yes, I live in Illinois) and homeowners insurance rates have gone ***THROUGH THE ROOF***, and in many cases are now nearly equal to the monthly mortgage payment. I would claim that on this basis, affordability is at an all-time low, by a wide margin.

Housing Affordability at 10-year low



Source: Bloomberg

There is data and there is the real world. The real world, when it comes to housing, doesn't look so pretty.

But these are still the good times.

This housing downturn moved into the scene in 2018, a year when the economy was strong and created 2.6 million jobs. We are still adding jobs, but home sale declines have been triggered by sky-high prices and rising mortgage rates, not by a recession or job losses. Those events – unavoidable as part of the business cycle – are still waiting in the wings.

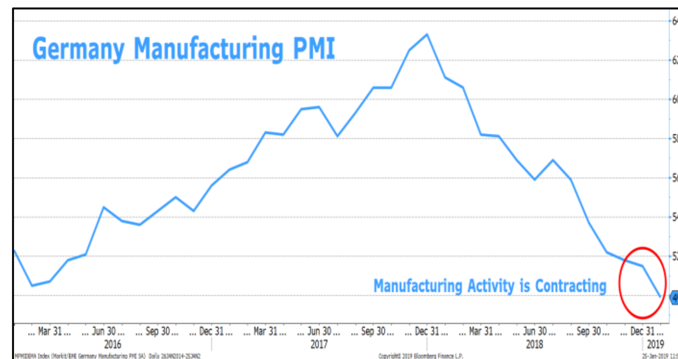
What will the professional economists say when we do actually enter an official recession and job growth craters?

Oh, wait, economists never forecast a recession.

MONETARY POLICY IS A FAILURE

Last week, the German Manufacturing Purchasing Managers' Index (PMI) missed badly, printing 49.9, below the 51.3 expected, the lowest point since November 2014 and in contraction for the first time in five years. Both manufacturing and services weakened during the month, highlighting the broad-based nature of the slowdown. According to economists, the data are consistent with GDP growth of just +0.1% (not annualized). As Germany goes, so goes Europe.

Germany's Manufacturing PMI Dips Below 50



Source: Bloomberg

Of note, the eurozone and German Manufacturing PMIs have both been sequentially down 12 months out of the last 13. This paints an interesting picture of a slowdown in manufacturing in countries that have built up their export machinery in order to boost their economies. Germany (and the eurozone overall), Japan and China have vast merchandise trade deficits with the U.S. They're the most vulnerable to changes in the U.S. – the auto sector in particular, with vehicles and components from Germany and Japan, and with components from China.

Also note that, ironically, the Fed is the only central bank in the bunch that has taken its foot off the gas, has been raising rates since late 2015, and has been unwinding its balance sheet since late 2017. But Japan and the eurozone are still mired in negative-interest-rate policy. The European Central Bank (ECB) has stopped quantitative easing (QE) but has no plan to unwind it. And the ECB has now accepted the fact that the eurozone's economy is stalling and raises doubts as to whether the ECB can even raise rates this cycle at all. The Bank of Japan continues its QE in fits and starts. And China is in a struggle all of its own, boosting its economy while also trying to keep its debt bubble from imploding all at once. **Which should be proof that this central bank stimulus does little if anything for the real economy, though it's very good at inflating asset bubbles and creating debt monsters.**

Debt is strangling long-term global real economic growth and productivity. Total global debt is now at $244 trillion, or roughly 3.2 times the size of global GDP. In the year 2000, the global debt-to-GDP ratio was 1.7 times. As a related stat, amazingly there's still $8.3 trillion of negative yielding debt swimming around in the world.

Monetary policy has been an absolute failure.

FIVE WEEKS TO GO

U.S. Trade Secretary Wilbur Ross said the U.S. and China were "miles and miles" away from a resolution, but then followed by saying that there is a "fair chance" that the two countries would arrive at a trade deal. He also added that it

was “unlikely” that this week’s meetings between the Chinese delegation, including Vice Premier Liu and Trade Rep Robert Lighthizer, would result in a final solution. In other words, the trade war saga continues.

That said, as of today, the U.S. and China do not appear close to agreement on a range of key issues, from China’s handling of intellectual property to China's trade surplus with the U.S. With only five weeks remaining until the deadline for escalating tariffs on $200 billion in Chinese goods, investors should start to get an idea of the likelihood of an amicable outcome. One thing is clear: the situation is growing increasingly dire every day.

Who will blink first?

TREES DON’T GROW TO THE MOON

Complacency is back and comes in the form of recession denial in the face of slowing global data**.** We didn’t see the slowdown coming but we are confident it will not produce a recession, so the narrative goes. Not even a risk of a recession. You’re hearing it from the Fed, the White House, the International Monetary Fund and every Wall Street firm, the ECB and the Bank of Japan. The chorus is sung in unison: no recession.

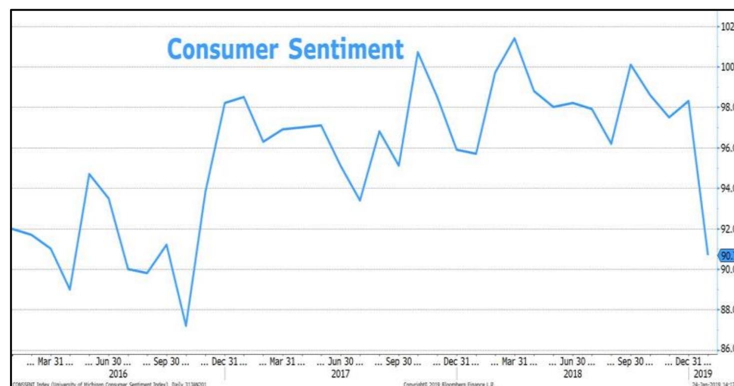
But how can anyone be sure that the slowdown in data will not produce a recession? After all, recessions come not only on inversions of yield curves, but historically they are coming at the end of business cycles with low unemployment rates and waning confidence.

As shown below, consumer confidence has taken one of the sharpest declines in five years.

And we know that after 10 years of expansion. Trees don't grow to the moon.

At some point, we will have a recession; this time, exacerbated by extraordinarily high corporate debt. Just like subprime mortgage debt triggered the last recession, corporate debt will trigger the next one.

It’s tough to pin this down to the month or quarter — except to know that it’s out there before year-end.



Here are the facts:

1. History says we have an 80% chance of seeing a recession following a Fed tightening cycle.

2. History says you don’t need the 2s/10s curve to invert; recessions follow 80% of the time once the 2s/5s curve flips negative and this has already happened.

Undoubtedly, recession is not a slam-dunk or guarantee. Possibly this will prove to be one of the 20% of the time when we manage to avert a downturn. Let us hope and pray. But the facts are the facts. The odds are four-in-five that we see a recession in the not-too-distant future (late 2019-early 2020). Who would really be brave enough to bet against those odds?

Talking about something doesn't make it so. Not talking about something doesn't make it go away. But agreeing to ignore something to avoid doing anything about it, is just plain irresponsible.

Forewarned is forearmed.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"If we don't get a fair deal from Congress, the government will either shutdown on February 15 again or I will use the powers afforded to me under the laws and the Constitution of the United States to address this emergency."

Friday's news of the end of the partial federal shutdown helped the Dow Jones notch its fifth straight weekly gain. Arguably more important to financial markets was the hope that the Fed may end the run-off of its balance sheet sooner than currently anticipated, thus ensuring more liquidity in the financial system.

That said, no actions are expected at the Federal Open Market Committee that meets this Wednesday, but the key will be the panel's policy statement and Fed Chairman Jerome Powell's press conference.

After December's 25-basis-point increase in the key federal funds range (to 2.25%-2.50%), incredibly, the fed funds futures market began to price in a chance of a rate cut in early 2020. Meanwhile, the pace of economic activity is soon to recede substantially, and this alone will cause the Fed to ease, no matter what the S&P 500 does.

Finally, in terms of portfolio strategy, we continue to advocate that credit unions maintain the "tried and true" risk management process of maintaining a well-diversified, high quality "laddered" portfolio. While it may be tempting to "guess" what happens with rates, the overwhelming evidence suggests that market timing is a poor strategy. Sitting in cash and waiting for the "opportune" time to invest is frankly wishful thinking. There are simply too many variables (known and unknown) that can impact market pricing (and fast).

Below, I show the long term returns of various Treasury laddered portfolios ranging from 5-20 years. The returns are shown over bear (rising rates) bull (declining rate) markets and over the complete market cycle.

As you can quickly glean from the tables, no matter which way rates go, the laddered portfolios generate very steady returns. Even in the worst bear bond market of all time (1965-1980), the 5-10-year ladders generated average returns of 4.6%-5.5%. Equally noteworthy, in no single year did these ladders post a negative return. Thus, by maintaining the discipline of reinvesting maturities on an ongoing basis, you can eliminate the stress and worry of forecasting and timing the market. Needless to say, you will sleep better at night knowing that the ladder discipline will keep you out of trouble.

1965-1980	Bond Ladders: Secular Bear Market				
	5-Year	7-Year	10-Year	15-Year	20-Year
Average Return	5.5%	5.1%	4.6%	3.7%	3.0%
Minimum Return	3.2%	2.2%	1.7%	-0.3%	-1.9%
Maximum Return	9.6%	10.3%	9.9%	11.0%	11.0%

Likewise, in declining fate environments the simple ladder portfolio generates very consistent returns.

1981-2018	Bond Ladders: Secular Bull Market				
	5-Year	7-Year	10-Year	15-Year	20-Year
Average Return	6.1%	6.6%	7.2%	7.8%	8.4%
Minimum Return	-0.1%	-0.4%	-0.2%	-1.2%	-1.1%
Maximum Return	15.5%	15.7%	16.2%	19.3%	21.0%

And over the full market cycle, the ladder proves to be an all-weather approach to bond investing.

1965-2018	Bond Ladders: Modern History				
	5-Year	7-Year	10-Year	15-Year	20-Year
Average Return	6.0%	6.2%	6.4%	6.6%	6.8%
Minimum Return	-0.1%	-0.4%	-0.2%	-1.2%	-1.9%
Maximum Return	15.5%	15.7%	16.2%	19.3%	21.0%

Source: Crestmont Research

The bottom line: Leave the market timing and forecasts to the soothsayers.

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.

Information contained herein is prepared by ISI Registered Representatives for general circulation and is distributed for general information only. This information does not consider the specific investment objectives, financial situations or needs of any specific individual or organization that may receive this report. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities. All opinions, prices, and yields contained herein are subject to change without notice. Investors should understand that statements regarding prospects might not be realized. Please contact Balance Sheet Solutions to discuss your specific situation and objectives.