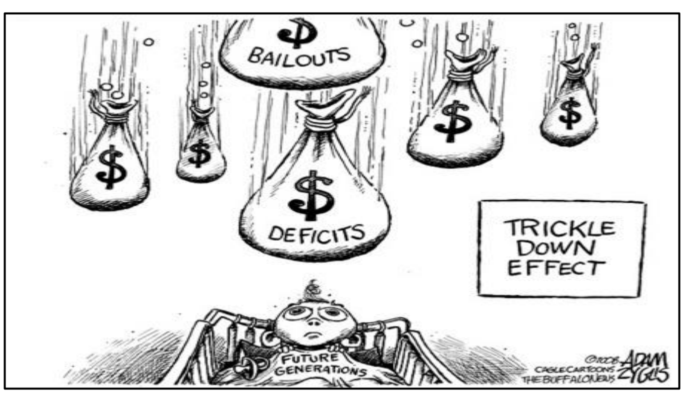
Weekly Relative Value

Trickle Up

"You're kidding yourself if you think cutting taxes is really cutting taxes… We're simply deferring massive taxes unfairly and immorally putting huge debt burdens on future generations and that is just wrong."
– David Stockman, Former Director of the Office of Management and Budget under President Ronald Reagan

Let me be totally clear up front. I am in favor of reduced taxes. But I also believe any tax cut proposed by Democrats or Republicans should be "deficit neutral." In other words, if you want to cut taxes then cut spending. Tax cuts – without corresponding deficit reduction – that increase our already precarious debt and deficit levels and are fiscally irresponsible. As Mr. Stockman points out, putting our onerous debt burdens on future generations is just wrong.

Finally, excessive debt is the primary reason why the long-term trajectory of U.S. growth will underwhelm in the years ahead. Recall that the recovery from the Great Recession was the slowest on record. After we exit the next recession (yes, there will be another recession) the recovery will be even slower due to the debt albatross around our necks. Remember that if debt is not self-funding; it is future consumption brought forward. We are currently enjoying consumption and growth that cannot happen in the future. Debt, then, will be a drag on future growth. And the amount of debt the world now has will be a monster drag on future growth.



Source: Cagle Cartoons

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THIS WEEK…

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PORTFOLIO STRATEGY

With that preamble, here's a little history.

In 1981, David Stockman, the former "wonderkid" and "beltway boy wonder" of the Reagan administration, crafted the trickle-down policy that promised stronger economic growth, higher tax revenue and lower deficits. But trickle-down economics was a wish, not a reality. It never worked. Lower taxes didn't generate more revenue. They generated lots of debt and deficits for the future generation to pay.

Stockman- the primary cheerleader for 'trickle down" economics- later stated that trickle-down economics was pure bunk. Shortly thereafter, Stockman was famously "taken to the woodshed" by President Reagan for his statements in 1981 that "supply-side economics" — the backbone of the Reagan economic revolution – was a "Trojan horse" that would ultimately benefit the rich.

Trickle-down economics often has been referred to as the horse-and-sparrow theory*: "If you feed the horse enough oats, some will pass through to the road for the sparrows."* In other words, if you help the wealthy get wealthier, they will create more businesses and jobs, and therefore all Americans will be better off.

But, because the propensity to consume is significantly less for wealthy Americans, what if the wealthy simply sit on this wealth? How many homes and cars does a millionaire need? How does that create stronger growth for the overall economy?

And, what if corporations use their tax cuts to buy back their stock or increase dividend payments? Then the trickle-down theory fails the majority of Americans. That is how you can have high corporate profits and an increase in top levels of wealth for many Americans. This is what we see occurring today.

TRICKLE UP?

"The Trump administration's $1.5 trillion tax cut package <u>appeared to have no major impact on businesses' capital investment or hiring plans</u>, according to a survey released a year after the biggest overhaul of the U.S. tax code in more than 30 years." – The National Association for Business Economics (NABE)

On December 22, 2017, President Trump signed the Tax Cuts and Jobs Act (TCJA). It cut the corporate tax rate from 35% to 21%. The top individual tax rate drops to 37%. The corporate cuts are permanent while the individual changes expire at the end of 2025. The tax cuts came into effect in January 2018.

And as far as individual tax cuts go, this one was hugely one-sided. The middle class got peanuts. The tax cut did not trickle down, it trickled up; it produced a further widening in the gap between the haves and have nots. The non-partisan Tax Policy Center found that those earning in the top 1% would receive a larger tax cut percentage than those in lower income levels. By 2027, those in the lowest 20% of income levels would pay higher taxes.

In addition, the White House predicted that the massive fiscal stimulus package, marked by the reduction in the corporate tax rate to 21% from 35%, would boost business spending and lead to increased jobs.

As stated above, that has not been the case. The National Association for Business Economics (NABE) just released its quarterly Business Conditions Survey report (presenting the responses of 106 economists employed by major firms in corporate America), which found that while some companies reported accelerating investments because of lower corporate taxes, **84% of respondents said they had not changed capex or hiring plans**.

The NABE survey also suggested a further slowdown in business spending after moderating sharply in the third quarter of 2018. The survey's measure of capital spending fell in January to its lowest level since July 2017. Expectations for capital spending for the next three months also weakened.

In sum, the Trump administration's $1.5 trillion tax cut package appeared to have no major impact on businesses' capital investment or jobs.

So, what did corporate America do with their tax cut? That's easy. Stock buybacks, of course. Companies spent a record $1.1 trillion buying back their own stock in 2018, helping prop up the market as a whole. Companies actually spent more on buybacks than on capital investments in 2018's first half, and remember, capex weakened as the year went on. The numbers couldn't be clearer: Corporations, big shareholders and top corporate executives reap the lion's share of the gains from the 2017 tax cut.

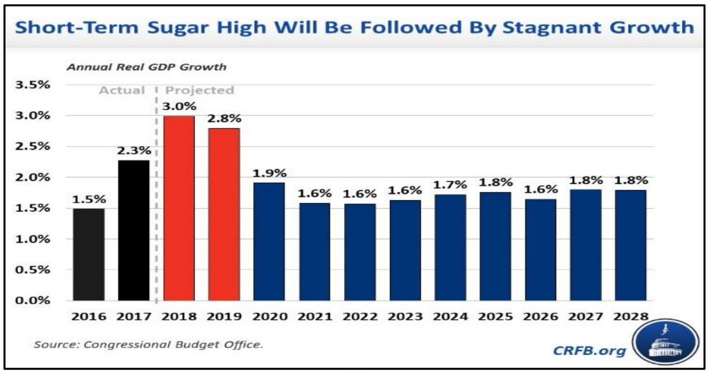
$2 TRILLION AND BEYOND

"It'll be fantastic for the middle-income people and for jobs, most of all… I think we could go to 4%, 5% or even 6% [GDP growth], ultimately. We are back. We are really going to start to rock."
– President Donald Trump, December 2017

The Trump tax plan promised stronger economic growth and higher tax revenue and lower deficits. Simply put, the plan would pay for itself.

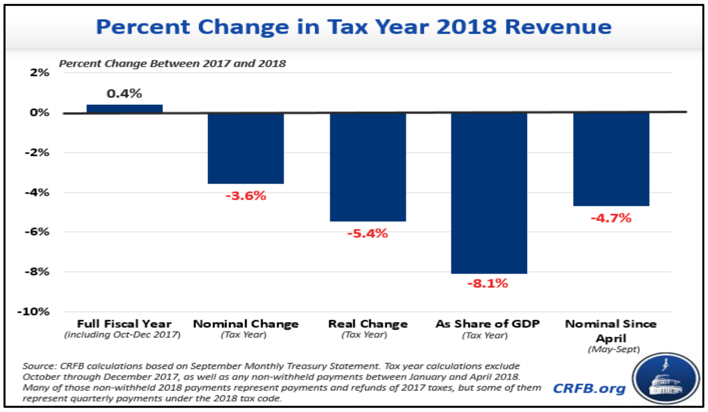
Has it worked? Following the January 2018 tax cut, real U.S. GDP surged to 4.2% in the second quarter of 2018. Well, of course, growth accelerated. Anytime you spend $2 trillion on the economy and cut taxes, growth will accelerate. But would the growth be self-sustaining or nothing more than a sugar high? The data thus far would suggest the growth boost will be short-lived. Growth has already moderated, and the rate of change continues to decelerate. As shown in the following graph, as we move forward, the sugar high will fade further with growth falling to 1% to 2% in 2020.

"By passing much-needed tax reform, we will finally unleash the economic growth engine which will more than pay for these tax cuts in the future." – President Donald Trump, December 2017

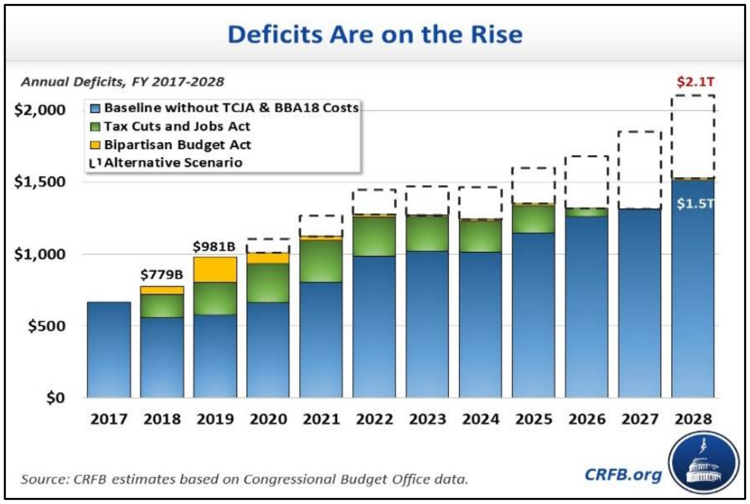


According to the Committee Responsible for Fiscal Budget (CRFB), since the tax plan has been enacted, actual revenue fell by 3.6% between tax year 2017 and tax year 2018. Revenue fell by 5.4% after inflation, and by 8.1% relative to GDP. So much for the plan paying for itself, as was promised.

So, what did we get out of this? More debt. The non-partisan CRFB expects deficits to return to nearly $1 trillion this fiscal year (2019) and stay above that level indefinitely.



In fact, if lawmakers extend the costly tax cuts and spending increases indefinitely, deficits will be **more than $2 trillion by 2028**. And quite humorously, these forecasts are based on the following assumptions: no recessions, no inflation and no deflation in the next decade. Seriously? One hard recession in 10 years will kill these projections.



Numbers don't lie, and anyone with a calculator on their phone can see that debt is a problem that can't be ignored. If lawmakers continue recent tax cuts and spending increases without offsets, the fiscal situation will be even more dire.

The debt doesn't just burden future generations, it also stands in the way of economic progress today. High and rising debt will slow wage growth, raise interest payments, reduce fiscal flexibility, and increase the risk of an eventual fiscal crisis. Action must be taken to avoid these consequences.

The first step to prevent these outcomes is to stop making the fiscal situation worse. First among them is a commitment to truth, which must be rooted in rigorous analysis. There can simply be no good policymaking without first establishing a common set of facts about what is happening in the world and what any given policy or proposal will likely accomplish. Don't be blinded by ideology.

Bottom Line: The largest tax cut in more than three decades has failed to catalyze business investment and economic growth. Instead, it has created a massive hole in our deficits and fostered greater inequality. Anyone who takes a "fair and balanced" approach recognizes that the trickle-down theory is a flawed theory. The far-right conservatives that advocate a pure free market without government intervention based upon this idea will create a lopsided balance that could damage the middle class and consistently keep the poor, well, poor.

A strong blended economy that promotes a market-based economy where people can acquire wealth and intelligent and necessary government intervention is what is needed to create a strong and sustainable economy.

We can do better. We can have a great future.

Source: Cagle Cartoons

CAPITAL "D"

Last week, Fed Chair Jerome Powell said the Fed is actually now at neutral.

"In light of global economic and financial developments and muted inflation pressures, the Committee will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate to support these outcomes." – Fed Chair Jerome Powell

And on the balance sheet …

"The Committee would be prepared to use its full range of tools, including altering the size and composition of its balance sheet, if future economic conditions were to warrant a more accommodative monetary policy than can be achieved solely by reducing the federal funds rate." – Fed Chair Jerome Powell

Frankly speaking, one could not have envisaged a more dovish assessment without an actual rate cut.

It is hard to believe this is the same Federal Reserve that said the central bank was miles away from being at “neutral” and that the Fed may have to overshoot “neutral” (and that was 3% on the funds rate) on October 3 of last year. That was less than four months ago!

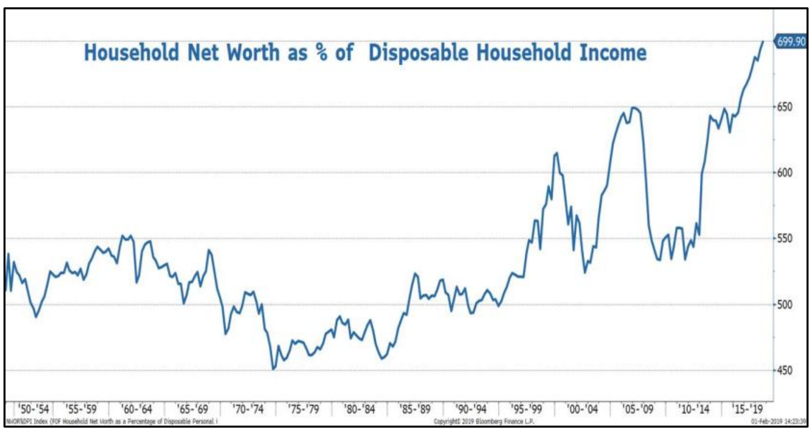
Obviously, the statement was dovish with a capital “D.” Interestingly, this change in tone took place with the Fed retaining its uber-bullish view on the domestic economy. Overall, activity is rising at a “solid rate.” The labor market is “strong” and consumer spending is expanding “strongly.” In the first three sentences, we hear “solid,” “strong,” and “strongly.”

So why the change?

The Fed cited “global and financial developments” (mostly from China) and “muted inflation” pressures as a rationale for turning dovish. More likely, the memory of what happened on December 19 — an 1,800-point plunge in the Dow over four sessions — weighed heavily on Mr. Powell.

Keep in mind that never before has the economy been so hitched to asset inflation for its success. So, as the wealth effect begins to run in reverse, the implications for consumer spending are more negative than they otherwise would have been in the past. The Fed knows this all too well. They are afraid of the consequences of bursting the bubble they created.

Household Wealth to Disposable Income Has Never Been Higher!



Source: Bloomberg

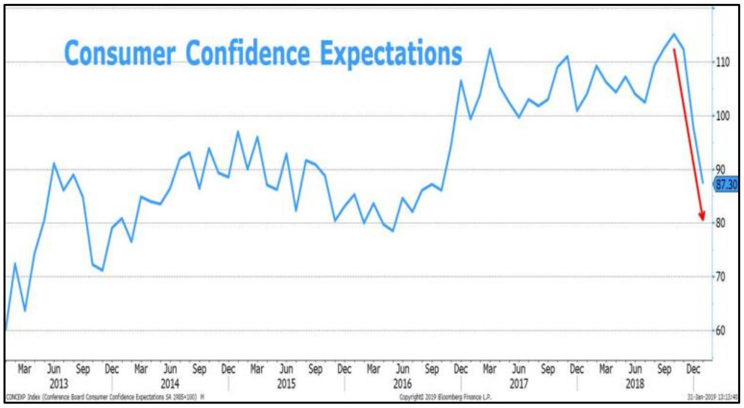
While it is easy to criticize the Fed for caving in to the markets to do a complete 180-degree turnaround in the blink of an eye, I believe Powell is correct in pressing the pause button. While rates remain low by historical standards, the Fed has already tightened the equivalent of more than 300 basis points into the most leveraged economy in modern history. And don’t forget that monetary policy impacts the economy with a lag. It’s unclear how the recent tightening campaign will impact the economy over the next 12 months.

From my vantage point the reversal in policy is the right decision. But could it have come too late? Historically, the Fed rarely shifts in time, which is why 13 of the tightening cycles since 1950 were followed by recessions few saw coming (the three “soft landings” happened because the Fed didn’t just talk about easing, it eased dramatically).

Further, when the Fed takes a decisive shift from tightening to easing bias, the next move is always to walk the walk. And it tends to happen very quickly. As we move forward into late 2019 early 2020, don't be surprised if the Fed is cutting rates and balance sheet normalization is halted. And yes, equity and risk assets as a whole will celebrate until they begin to realize why the policy switch is taking place.

FLASHING YELLOW

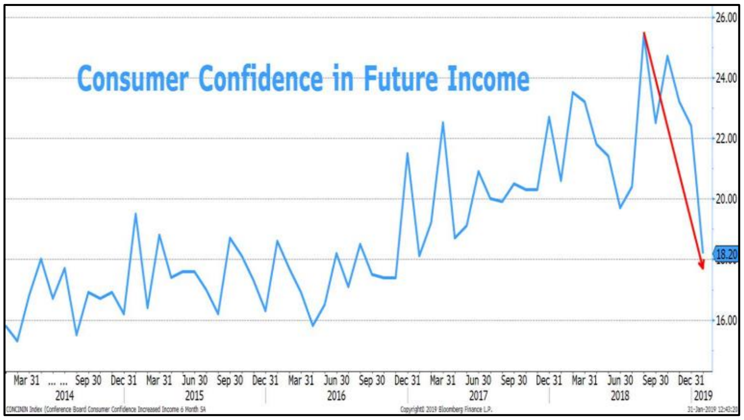
The January consumer confidence reading slumped even more than expected, to 120.2 (vs. 124.0 expected) from a downwardly revised 126.6 in December. The present situations index was broadly flat at 169.6. However, the expectations component – future jobs, income and business activity – fell to 87.3 and the lowest since 2016.



Source: Bloomberg

Expectations that business conditions will "get better" in the next six months fell from a cliff**,** down to 16.0% from 18.1%, to stand at the lowest level since July 2016 — four months before the election. The 10.3-point slide since October is the sharpest contraction in over 25 years and in any of the past five recessions.

Future expectations for personal income declined to 18.2% from 22.4% to the lowest it has been since January 2017. Is there anything more important to the U.S. economy than personal income? It "only" represents 80% of the economy!



Source: Bloomberg

Finally, look at this chart: ratio of "present situation" to "expectations." The Conference Board's Consumer Confidence Survey for January showed the widest gap between current sentiment and expectations since March 2001, the first month of the U.S. recession that year. As one can glean from the graph below, this indicator has been a great leading indicator at turning points because it either coincides with the recession or occurs a few months prior. The consumer expectations were "flashing yellow" for recession.

"The most recessionary signal at present is consumer future expectations relative to current conditions. It's one of the worst readings ever." – Bond guru Jeffrey Gundlach

Source: Bloomberg

MORE ON THE JOBS FRONT

There was a lot less to the outsized 304 thousand non-farm payrolls jump in January than meets the eye. January's sharp rise in payrolls—vastly higher than the consensus guess of a gain of 165 thousand—was offset by downward revisions totaling 70 thousand in the two preceding months.

The other employment report – Household Survey – showed that employment plunged 251 thousand in the first decline in five months. While some of this can certainly be attributed to the government shutdown, the non-farm private sector job tally sagged 130 thousand. That does not confirm the headline payroll data.

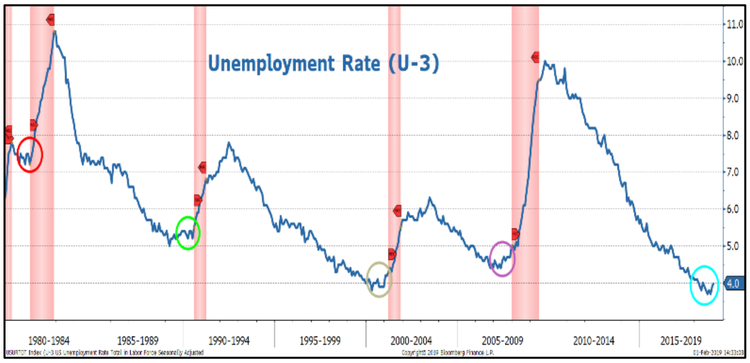
Consider the following:

- Employment for prime working-age adults (aka "bread winners") — those between 25 and 54 —slumped 46 thousand in January. This followed an 11 thousand retreat in December and a 48 thousand falloff in November. Please note this marks the first time since October 2009 that "bread winner" jobs declined for three months in a row.

- Is this healthy? Full-time jobs dropped 76 thousand. The number of people working part-time "for economic reasons" jumped 10.5% to 5.15 million (16-month high). The number doing so because of "slack work business conditions" skyrocketed 19.4% to 3.45 million (23-month high). For both metrics, this was the sharpest run-up since September 2001, and before that, February 1982. For those without a sense of history, both took place during recessions.

- The official U-3 unemployment rate ticked up again from 3.9% to 4.0%, the highest since June 2018. As highlighted below, the U-3 is now up 0.3% from the cycle low. The average rise from the U-3 cycle low is 0.04% before a recession ensues. In other words, we are 75% of the way there. Further, data back to 1950 show that never have we seen a 0.6% increase off the trough without seeing a NBER-defined recession. Keep any eye on this metric going forward.

Unemployment Rate Has Bottomed



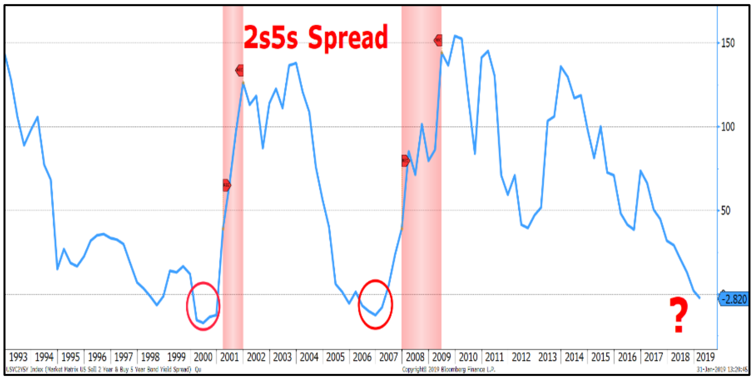
Source: Bloomberg

- Of special note, the U-6 unemployment rate jumped a whopping 0.5% to 8.1%. The number of discouraged workers has now risen 0.7% from the cycle low of 7.4% five months ago.

When the economic cycle turns, it is the Household Survey that leads, not the Payroll Survey. To wit, in December 2007 the Payroll Survey revealed a 110 thousand job gain. Many were lulled into the mistaken view that all was well. The Household report showed a 322 thousand decline that month and shortly thereafter we were in a recession.

Finally, as noted numerous times in this space, the yield curve has been the single best metric in predicting a recession. And the yield curve between 2s/ 5s has turned negative. Historically, 80% of the time the curve inverts a recession follows. The graph tells the story. Of course, this may be the one in five chance that we do not have a recession, but who wants those odds?

Inverted Curves Point to a Recession



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"If you don't read the newspaper, you're uninformed. If you read the newspaper, you're mis-informed."
– Mark Twain.

Last year was supposed to be the year that the bond market finally "broke," as the Fed raised rates and started to shrink its balance sheet. The Wall Street narrative was that the economy was booming, and rates had to go higher and higher.

Needless to say, I disagreed and wrote the following in the October 29, 2018 edition of the Weekly Relative Value, *The Paul Principle*.

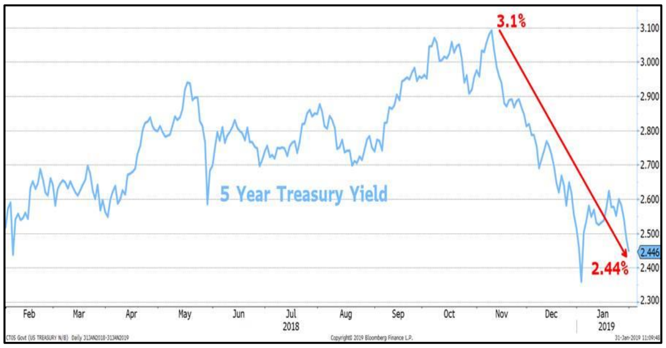
"As highlighted over the past weeks, I believe growth and inflation have peaked. Further, the Fed's pledge to raise rates will negatively impact the asset markets and stifle economic growth… ***For the past 10 years, U.S. Treasury yields have traded in a range of 1.4% to 3.9%. Each time yields get too high, the economy slowed, and yields collapsed****. The unmistakable long-term trend of yields has been lower highs and lower lows. I believe the pattern will hold true as we move forward. In other words, the bull market in bonds is far from over.*

Both short-term and long-term yields have risen from their cycle lows and are beginning to weigh on the markets and on the economy as witnessed by the weakness in housing and autos. If rates continue higher the economy and markets will come under increased pressure. *Eventually a recession will unfold.* ***As such the Fed will reverse its tightening monetary policy by reducing rates and potentially resuming QE.*** *It should be noted that during every recession the Fed has reduced rates by at least 300 basis points and 10-year Treasury yields have declined by approximately 150 basis points.*

Now is the time to position investment portfolios for lower rates. We advocate buying into markets' weakness while maintaining a disciplined ladder strategy of high-quality investments."

At that time, five-year Treasury yields were just over 3%. As shown below, yields have plunged. And for this reason, we have strongly advocated that credit unions maintain a disciplined ladder strategy. Do NOT try to time the markets.

Five-Year Treasury Yields Plummet



Source: Bloomberg

This is not to say I told you so. I know better. But it is why I have recommended week after week that credit unions maintain a risk appropriate ladder strategy. Do not try to time the markets. Turn off the noise!

Further, for the past 10 years my view has consistently been that while rates will fluctuate on "short-term noise," intermediate- to long-term interest will have a difficult time rising in a sustained fashion given the unprecedented leverage in the U.S. and global economies. Leverage combined with long-term secular disinflationary forces (i.e., demographics, technology and globalization) should effectively cap any rise in rates. Simply put, as rates rise the economy slows. And once again, that has been the pattern.

Meanwhile, Wall Street and its myopic media are focused on the Fed and Trump tweets. Ignore the narrative. It is the economic cycle that matters most. From a cyclical basis, I believe that the economic cycle is coming to its natural end. Growth is slowing in Asia, Europe and the U.S. Italy is in recession with very troubled banks. Germany and France are on the cusp. And in the U.S., Amazon just reported its slowest North American retail sales growth since the fourth quarter of 2014. Overall, the earnings growth rate of the S&P 500 was just cut in half to +12% year-over-year from +24% year-over-year last quarter.

And, if anyone is listening, that is why Treasury yields are in a well-defined downward path — down three months in a row, the longest such stretch since the Spring of 2017, which would otherwise seem to defy the pro-growth message being flashed in the equity market.

Bottom line: I am sticking with the data and the call for slower growth and the bearish ramifications therein. Should the U.S. fall into a recession, expect the Fed to cut rates aggressively toward zero bound. In the meantime, any short-term temporary back-up in yields should be viewed as a buying opportunity.

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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.