Weekly Relative Value

1,2,3,4… Let's Start a Trade War!

"When a country (USA) is losing many billions of dollars on trade with virtually every country it does business with, trade wars are good, and easy to win. Example, when we are down $100 billion with a certain country and they get cute, don't trade anymore-we win big. It's easy!"
– Donald Trump

Last week, with the Director of the White House National Trade Council, Peter Navarro, egging him on, and a handful of U.S. steel and aluminum producer CEOs patting him on the back, Trump imposed global tariffs on steel and aluminum imports. Trump's decision doesn't rely on any economic argument. Instead, it imposes trade restrictions on "national security grounds." The proposed levels are 25% for steel and 10% for aluminum. The tariffs will apply to all source countries.

Yet, the biggest sources of steel imports share a border with the U.S. – Canada, with 16%, and Mexico, with 9%. How Canada stands in the way of American national security interests is anyone's guess. Canada is America's best friend in every way. And we should note that the U.S. exports $2 billion annually in steel to Canada – not than the other way around. This could kill the North American Free Trade Agreement (NAFTA).

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THIS WEEK…

- Homesick
- Financial Stresses Building
- Fun Fact of the Week

PORTFOLIO STRATEGY

- Market Outlook Insights

As an aside, Moody's Analytics believes that if NAFTA is abandoned, 1.8 million jobs will be lost. Not in Canada or Mexico, but in the U.S. Moody's further estimates that a full global trade war would generate a decline of roughly 4 million jobs in the U.S. This is how recessions occur.

What Mr. Trump is failing to understand is that the payroll of steel and aluminum producers totaled 203,000 in January, compared with an estimated 6.5 million in industries that use steel, such as the aircraft, auto and construction industries, which account for about 40% of domestic steel consumption, followed by packaging at 20% and building construction at 15%. All will have to pay higher prices, making them less competitive globally and in the U.S.

Besides, we have tried this before. The George W. Bush administration imposed 30% steel tariffs in 2002, which boosted imported steel products by 14% and domestically produced products by 11%. According to the Consuming Industries Trade Action Coalition – a group of steel-consuming industries – the tariff cost 200,000 jobs. One year later, the tariffs were abandoned.

Instead of importing steel to make goods in America, many companies will simply import the finished product made from cheaper steel or aluminum abroad. In effect, Trump has handed a giant gift to foreign car makers, which will now have a cost advantage over Detroit. How do you think that will play out in Michigan in 2020?

The Editorial Board at The Wall Street Journal believes that Donald Trump made the biggest policy blunder of his presidency:

> *"This tax increase will punish American workers, invite retaliation that will harm U.S. exports, divide the political coalition at home, anger allies abroad, and undermine his tax and regulatory reforms."*

In my view, the decision to tax steel and aluminum imports was a political move that could, in theory, play well with his blue-collar base in Pennsylvania and Ohio. However, from an economic perspective, this move is likely to backfire.

Higher import prices for steel and aluminum may encourage some firms to move more production abroad. From the consumer's perspective, these tariffs mean higher prices on thousands of products – from American-made cars to beer cans. If it's not good for the consumer, it's not good policy.

But it isn't the opening salvo that does the greatest damage. It's what follows that will ultimately reshape the economic landscape. Canada, China and Europe have already said they would respond with tariffs of their own that could lead to billions of dollars in American export losses. European Commission President Jean-Claude Juncker said the bloc is prepared to respond quickly and forcefully by targeting imports of Harley-Davidson motorbikes, Levi Strauss & Co. jeans and bourbon whiskey from the U.S.

More importantly, Trump followed that tweet with an explicit threat aimed at Europe, saying:

> *"If the E.U. wants to further increase their already massive tariffs and barriers on U.S. companies doing business there, we will simply apply a tax on their cars, which freely pour into the U.S. They make it impossible for our cars (and more) to sell there. Big trade imbalance!"*

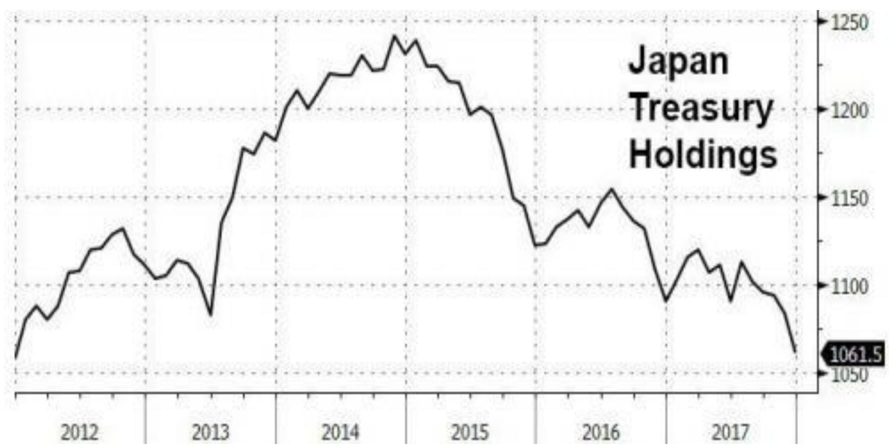
This is how trade wars escalate.

As Bloomberg noted, Juncker's threat heightened the prospects of a global free-for-all. The World Trade Organization said the potential of escalating tensions "is real" and the International Monetary Fund warned the restrictions would likely damage the U.S. and global economy.

We shall see how this all plays out if China's form of retaliation comes by way of boycotting the Treasury auctions at a time when the U.S. is going to require the kindness of foreign savers like never before, given this decision to ramp up record fiscal deficits.

The federal fiscal deficit will widen next year to 5.4% of gross domestic product from 3.4% last year. The current account deficit should also increase to 3.9% of GDP in 2019 from 2.3% in 2017.

Remember, China owns $1.2 trillion (19%) of U.S. Treasury securities — and the latest data out of Japan shows that it too has over $1 trillion of U.S. bond holdings, which has become more prudent with its taste for the Treasury market recently. What happens if the U.S. steps up trade pressure on China, just as the Treasury's borrowing needs swell?



In other words, there are different ways to retaliate. It doesn't have to be China raising duties on imports of U.S. soybeans. If the bidding at the Treasury auctions begin to weaken, given the forthcoming supply deluge, interest rates will rise, and the U.S. economy will be hurt.

You will be hard-pressed to find a serious economist of any stripe or persuasion that thinks a trade war is easy or winnable. Needless to say, markets hate this idea because, as Trump's own Chief Economic Adviser Gary Cohn stated, the tariffs are "obviously stupid." The Dow Jones immediately plunged 500 points as the impromptu declaration was made in front of an audience of steel CEOs. For the week, the Dow Jones Industrial Average plummeted 3%, while the S&P 500 Index fell 2% and the Nasdaq Composite declined 1.1%. On a side note, I doubt that Mr. Trump will continue to ask anyone how their 401(k) is doing.

In summary, this is the latest evidence of a wrongheaded and dangerous U.S. trade policy. Wrongheaded because it is based on poor economics. Dangerous because it will inevitably result in a trade war with no winners. And at the end of it all, it is the consumer that will be hurt.

"If President Trump puts in place steel and aluminum tariffs recommended by the Commerce Department, his administration will be crossing an unspoken line in the sand no country has crossed since World War II… Once the U.S. starts invoking national security to protect industries, everyone can do it. That's why no one has done it. The international trade system is built on trust, and no one has violated that trust to this degree." – Linette Lopez, Business Insider

HOMESICK

Last week we witnessed a trifecta of poor housing data. For the month of January, existing homes sales plunged 3.2% – the worst since 1999. New home sales declined 7.8% and are at or below where they were for much of 1963.

After new and existing home sales had already disappointed, pending home sales plunged 4.7% in January (massively below the 0.5% expected rise in sales). Economists consider pending sales a leading indicator because they track contract signings; purchases of existing homes are tabulated when a deal closes, typically a month or two later. All told, January was a bloodbath for the real estate market.

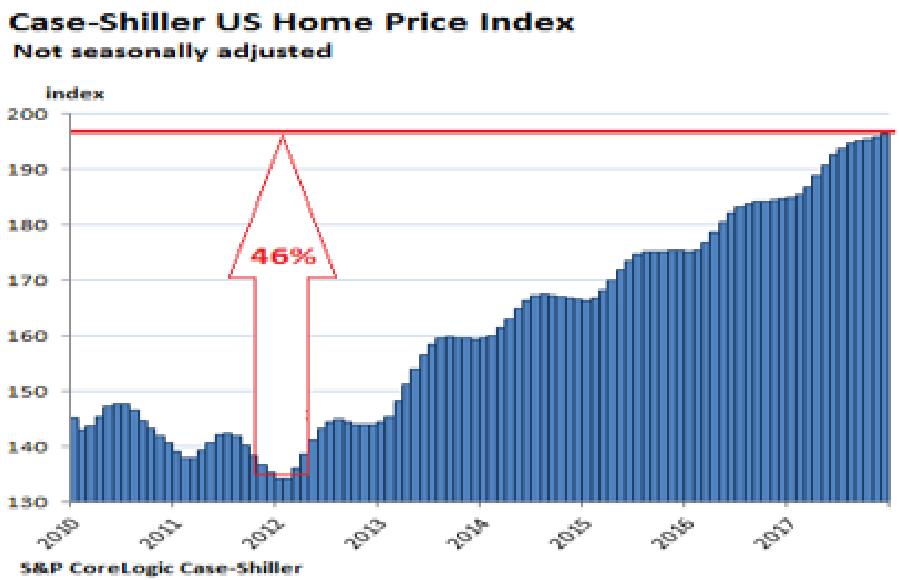
Peak Housing?

So, what gives?

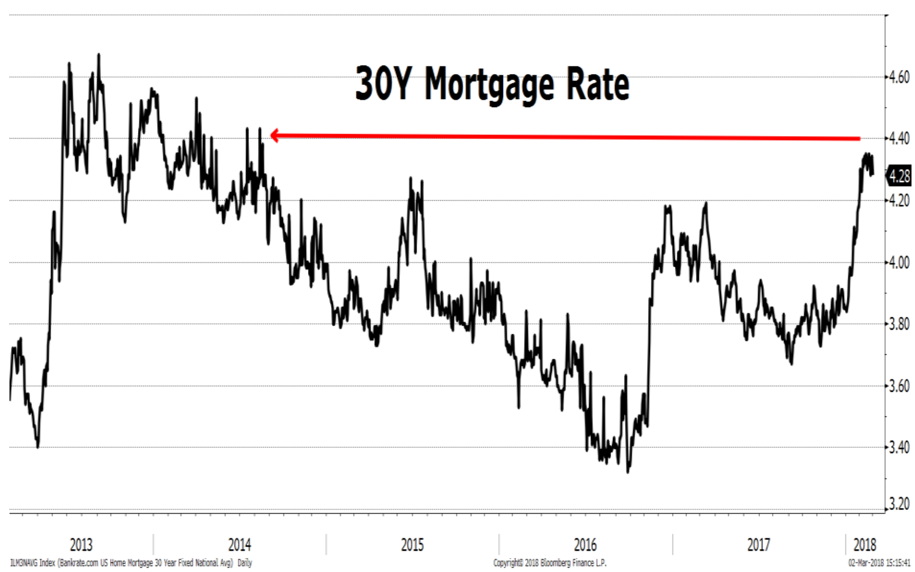
The National Association of Realtors (NAR) is desperate to convince home-buyers and sellers that this is nothing but an inventory issue.

Could it be the new tax law, sky-high home prices and higher interest rates?

As shown below, home prices have soared 46% since the beginning of 2012. Income growth has paled in comparison.



Despite the average mortgage rate remaining very low, it has surpassed its brief peak in 2013, and the previous peak in April 2011. The January move in mortgage rates was just a baby step; imagine what would happen if mortgage rates rose above 5%, or perhaps close to 6% by year-end. These far higher home prices with the same mortgage rates would result in higher monthly mortgage payments – hence the affordability crisis for many households.



January was the first month in which higher mortgage rates, eliminated homeownership tax benefits, and soaring home prices (thank you, Fed) came together in one package. If pending home sales are any indication, the confluence of these three factors might turn out to be more quickly disruptive.

Remember, the new tax law removes some or all the tax benefits of homeownership for first-time buyers. The near-doubling of the standard deduction puts renting and owning on the same tax level in most markets – so there's one less reason to buy.

In addition, the attitudes of millennials – the largest group of potential home-buyers – toward homeownership has changed dramatically.

Many saw their parents or friends' parents argue over debt and lose their homes.

Mobility is a rising priority; the norm of the 1960s to stay in one place and in one job for extended periods no longer stands.

And need I remind everyone that many millennials are mired in student debt?

Attitudes toward family formation have changed, too. Buying a home was necessary to buy into a neighborhood with a good school. As increasing numbers of millennials are choosing not to have children, or plan to move around, the value of homeownership has flown out the window.

The NAR believes there has never been a better time to buy a house – but have you ever heard them say otherwise? I respectfully disagree. As we move into the spring season, there will be no rush to buy a home. People, especially first-time buyers and those clobbered by the Fed's inflation policies, cannot afford the asking prices.

FINANCIAL STRESSES BUILDING

If there was ever going to be a "goldilocks" period for consumer debt holders, it should be now. Unemployment is at a generational low and interest rates are still near zero; this is as good as it gets if you like to run a credit card balance.

Yet that appears not to be the case. Overdue U.S. credit card debt – at least three months behind repayments – has increased to approximately $12 billion; a rise of nearly 12%. Stressed debt is now at a seven-year high. More Americans are also falling behind on their mortgages, for which problematic debt levels rose 5.2% over the same period to $56.7 billion.

Clearly, many Americans have once again overextended themselves and are living beyond their means. We have millions of consumers in high debt with limited savings and rising debt obligations.

Now add six-to-eight rate hikes over the next 24 months and what do you get? Sustaining debt payments, which are already rising, in a much higher rate environment – a huge headwind to the economy.

We are still in a low rate environment and unemployment is still at the lowest it's been in a long time. If you would like to believe unemployment will remain at cyclical lows forever, be my guest, but there is little evidence that this will remain so. Unemployment does not stay low forever; its historic mean is always higher.

As soon as recession hits, unemployment will pick up and defaults and charge-offs will mount. Then, suddenly, debt matters.

Overdue U.S. Credit Card Debt Hits Seven-Year High

FUN FACT OF THE WEEK

U.S. firms have spent roughly $4 trillion on buybacks since 2009, making corporations the biggest single source of demand for U.S. shares. Buybacks have accounted for more than 40% of the total earnings-per-share growth since 2009, **and an astounding 72% of the earnings growth since 2012.**

That's a big number and it reveals the extent of the mirage that has been propagated for the past few years.

Here's the reality: Earnings growth is heavily reliant on buybacks, which have been financed with debt and now with tax cuts, courtesy of unwitting tax payers, but the structural growth component remains MIA.

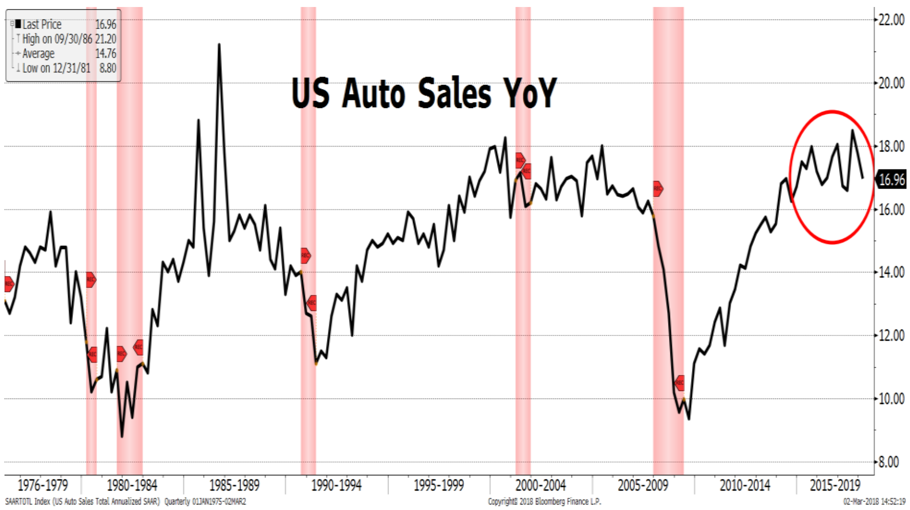
MARKET OUTLOOK AND PORTFOLIO STRATEGY

For years, the market could depend on the central bank stepping in to prop up the market, through good news and bad. Now, things are different. If the economy shows real signs of life, expect the Fed to pick up the pace of its rate hikes. But even if the data disappoint, don't be surprised if the Fed keeps on tightening anyway. It's a world where bad news is bad news, and good news is bad news too.

This is something the market hasn't experienced in a long time – real uncertainty. Uncertainty about the strength of the economy and the rate of monetary tightening. Uncertainty about the impact of trade policy on economic growth. Uncertainty on how quickly inflation will rise and how high yields will go with it.

Since early March, around 60% of the incoming high-frequency data has surprised to the downside. Housing data is starting to fall as higher rates make housing less attractive. Likewise, auto sales appear to have peaked. Back-to-back declines in core capex orders are a shot across the bow regarding the outlook for business spending. The Atlanta Fed, which pegged first quarter real GDP growth at 5.4% on February 1, is now down to 2.6% (from 3.0%).

Have Auto Sales Peaked?



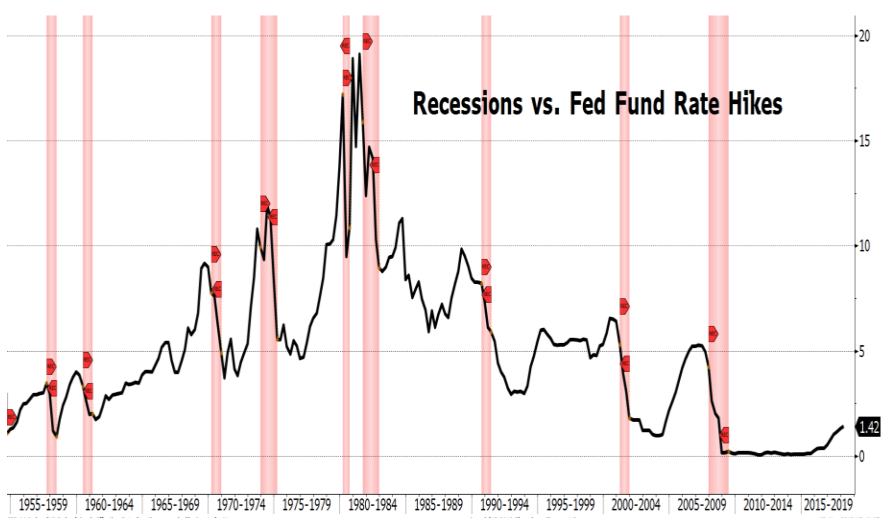
The economy is weakening and the Fed, fearing inflation, is hiking right into it.

Every major stock market decline and every recession in the last 100 years was preceded by the Federal Reserve raising short-term interest rates by enough to provide the pin to prick the balloon.

And let's not forget the QE-Unwind is progressing like clockwork. For February, the plan called for shedding up to $20 billion in securities: $12 billion in Treasuries and $8 billion in mortgage-backed securities. **The Fed didn't miss a beat.**

The QE-Unwind proceeded as planned throughout the equity sell-off, and I expect this to continue.

Higher Rates and Recessions



Jerome Powell delivered his first testimony to Congress as Fed Chairman last week, and essentially confirmed that the central bank remains on track for three quarter-point interest hikes this year, although a fourth hike has a nontrivial 31% probability.

The February Employment Report may bring a clue about the course of rates. While the consensus guess is for a gain of 200,000 in non-farm payrolls, **the real focus will be on average hourly earnings**. The January year-over-year rise of 2.9% spurred the interest-rate fears that incited the market riot and increased volatility across all asset classes. Investors will be on alert for signs if further wage gains augur higher inflation and interest rates.

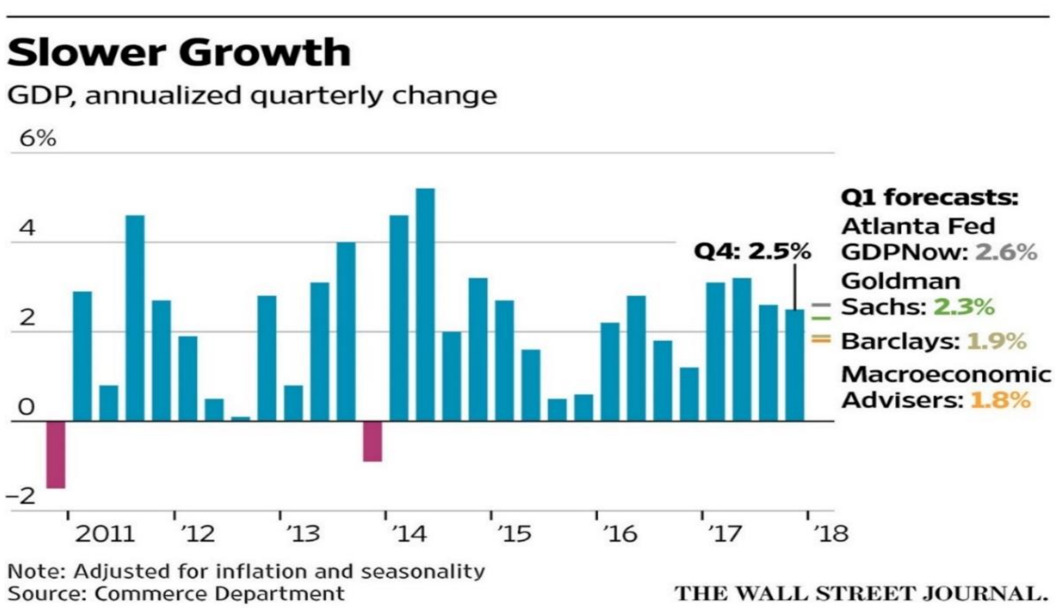
So, is the bond bull heading out to the pasture? With Ray Dalio, Jeffrey Gundlach, Bill Gross, Alan Greenspan and Paul Tudor Jones (to name a few) now firmly in the camp of "the bond bear market is here," it is almost a forgone conclusion that the long-term secular bull market in bonds is over.

Or is it?

Ten-year Treasury yields have obviously adjusted higher since the lows of September, but I don't believe they are poised to move higher in a sustained manner. Undoubtedly, higher debt issuance and the unwinding of the balance sheet will pressure rates higher over the forthcoming months.

Yet, there are tremendous secular disinflationary forces still in the world, including worsening demographics, which I view as critically important, as well as the outsized debt burden, both of which will ultimately constrain economic growth and cap bond yields.

Of course, growth and inflation have increased cyclically, but I would think about it this way: Against a backdrop of tremendous historic central bank monetary support, growth and inflation have finally come off the bottom. And we are very late in the economic cycle. With most forecasters expecting growth to decelerate next year, 2018 will likely mark the peak of this cycle. In other word, have we already seen the best news from the economy?



In terms of portfolio strategy, we continue to favor short-duration, high-quality bank notes. The income returns of select bank notes are shown below compared to the income earned on maturity-matched Agency bullets. As discussed last week, even if the Fed was to increase the federal funds rate three-to-four times over the next 12 months, the income earned on bank notes would be superior to a wait-and-hold approach.

To determine if bank notes are risk appropriate for your investment portfolio, please contact your Balance Sheet Solutions Fixed Income Representative.

Bank Notes	Income	Maturity Matched Agency (Income)	Difference
FRC 2.375 06/17/19	**$125,801**	**$108,946**	**+16,855**
PNC 2.60 07/21/20	**143,143**	**114,244**	**+28,899**
WFC 2.60% 01/15/21	**145,023**	**125,593**	**+19,430**

Note: Registration is now open for the **2018 Credit Union Executive Leadership Symposium**, September 5-7 at the Westin River North in Chicago, IL! You will hear from a wide range of speakers, including NFL Legend Mike Ditka, "The Attitude Guy" Sam Glenn, as well as credit union industry experts. Plus, back by popular demand, CUNA Mutual's Steven Rick and Balance Sheet Solutions' Tom Slefinger will battle it out in another round of "Dueling Market Views."
Please visit alloyacorp.org/symposium2018 to view the agenda and to register.

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.