Weekly Relative Value

Paradigm Shift

"When big shifts like recessions are on the way, economists just aren't very good at predicting them. The truth is that we really can't foresee where the economy will be heading in a year or two, a limitation that is particularly troubling right now, in the midst of what may be called the Trump economic boom... We don't really know what will do it. But rest assured, the next recession will surely come." – Robert Shiller, PhD, Yale University

From trough to peak, the 2009 – 2018 bull market averaged 17.3% annually. These returns are quite comparable to previous bull markets. But in every prior bull cycle over the past seven decades, bull markets of this magnitude were reserved only for periods of growth that were double what we have experienced so far in this expansion. During the current cycle, nominal GDP rose 3.6% annually, and real GDP rose 2.1%. Depicted on the table below, during the 1982 – 1990 bull run, it reached a similar magnitude at 17.5%, but nominal GDP rose 7.6% and real GDP 4.2%.

Paying More for Slower Growth

Trough Date	Peak Date	S&P 500	Nominal GDP	Real GDP	Months
13-Jun-49	15-Jul-57	17.3%	7.3%	4.6%	97
22-Oct-57	3-Jan-62	15.4	5.4	3.8	51
26-Jun-62	11-Jan-73	23.3	10	5.1	32
3-Oct-74	28-Nov-80	14.1	10.8	3.2	73
12-Aug-82	16-Jul-90	17.5	7.6	4.2	95
11-Oct-90	24-Mar -00	19.0	5.6	3.5	113
9-Oct-02	9-Oct-07	15.0	5.8	2.9	60
9-Mar-09	16-Jan -18	17.3	3.6	2.1	106
Median		**17.3**	**7.3**	**3.8**	**77**

How is it that stocks have risen the same amount on half as much economic growth? If the stock-GDP ratio today had remained what it was back then, the S&P 500 would be around 1,600 (or 30% lower). That's how excessive valuations are now.

CENTRAL BANKS TAKETH

So why have the markets posted such lofty returns given the backdrop of anemic growth? Simply put, it's because of the "free money" that central banks have pumped into the markets.

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

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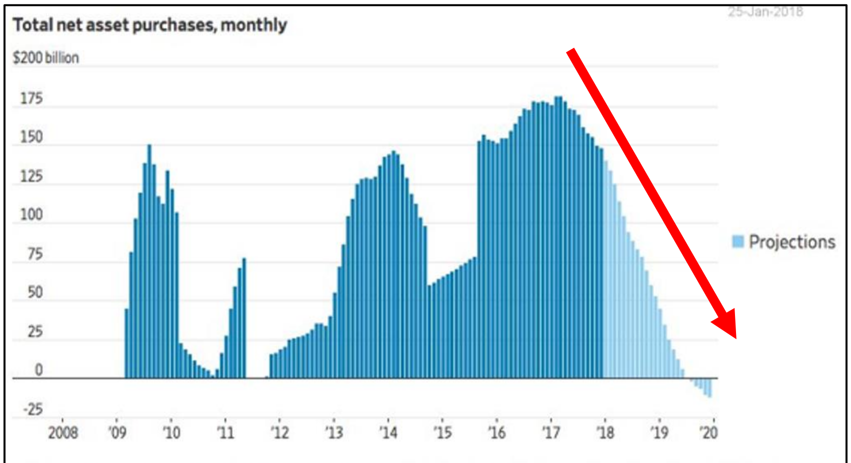
As shown below, global central banks' post-financial crisis monetary policies have been collectively more aggressive than anything witnessed in modern financial history. Over the last ten years, the six largest central banks have printed unprecedented amounts of money to purchase approximately $20 trillion of financial assets that represented 40% of global GDP!

But that is changing. In one year's time, central bank balance sheets will be on the cusp of contracting.

Central Banks Taketh Away



Note: Total purchases include the Bank of England, U.S. Federal Reserve, Bank of Japan and European Central Bank. January 2008-February 2009 and June-September 2011, amounts were between 0 and –$0.05 billion.
Source: Deutsche Bank

Thus, investors will soon face a radical shift in the shape of global central bank liquidity as balance sheets shift from an unprecedented increase to an outright decline. And logic dictates that if quantitative easing (QE) was good for the markets, it is safe to say that the withdrawal of QE will be a negative for the markets.

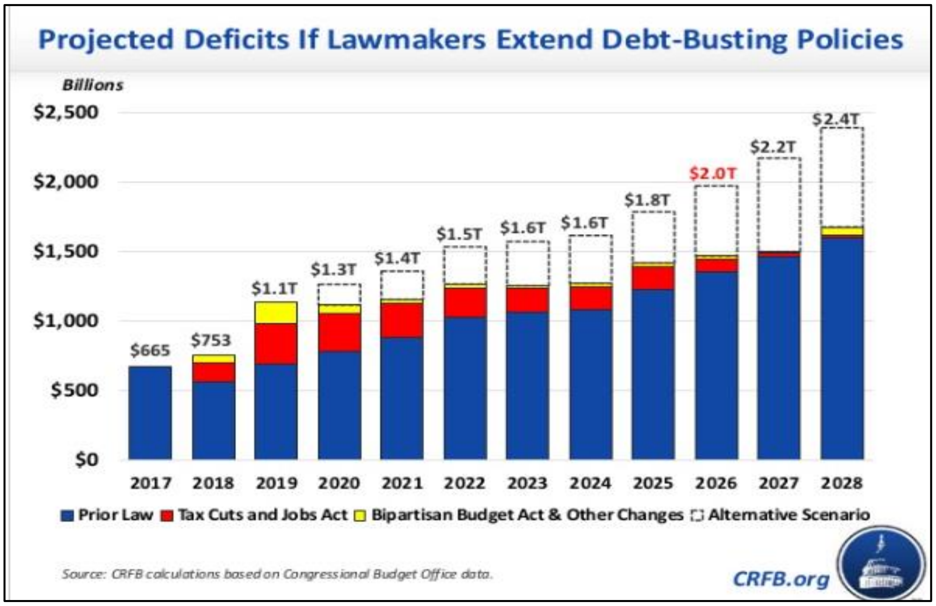
There are many investors who believe an expanding fiscal policy will offset a contractionary monetary policy. And the bulls are pointing to a new round of fiscal stimulus. The underlying presumption for their economic and market optimism is that consumers will spend their tax cuts. However, the early evidence isn't encouraging. Regardless, fiscal stimulus is absolutely no match for the liquidity shift we are seeing in real-time, and likely to see for the next year or two.

We have also learned that instead of deleveraging following the epic 2007 – 2009 credit collapse, the exact opposite happened: policymakers decided to fight one debt bubble with another debt bubble. Former Fed Chairs Ben Bernanke and Janet Yellen pursued policies that punished good behavior and rewarded bad behavior. What we are left with is an all-in debt (including households, businesses and governments) to GDP ratio of 250%, taking out the 2007 bubble peak of 225%.

The shills who claim this debt is highly serviceable are ignoring the fact that interest rates are not static. We are already seeing rising delinquency rates in credit cards and auto loans – in advance of any rise, at least just yet, in the unemployment rate. Debt matters.

And then there's the massive $1.3 trillion spending bill that has blown a hole in the budget. Another **$300 billion** (including additional interest) has now been added to the annual red ink by the Trump/GOP tax cuts. And on top of that, there's another **$200 billion** owed to the bipartisan spending spree for defense, domestic appropriations, border control, disaster relief and Obamacare premium bailouts that have already been enacted or are pending near-term action.

The public debt will likely reach ***$*22.5 trillion** and **110%** of GDP by the end of 2019, and it is off to the races from there. Even without another recession through the end of fiscal year 2028 – which implies the absurdity of a 20-year recession-free span – the projected cumulative ten-year deficit now totals **$15 trillion**, which would take the public debt to **$35 trillion** and **140%** of GDP by the end of the period. This is ridiculous. Every member of the GOP and Democratic party should truly be embarrassed.



Meanwhile at the White House, Mr. Trump also believes there are "winners" from trade wars. President Trump used "national security" as the rationale for the tariffs on steel and aluminum. This broke with a long-standing protocol that "national security" not be used to invoke trade impediments, not to mention the rehearsed but misleading line that "a country is not a country without a steel industry," since the U.S. does produce more than two-thirds of the steel it consumes.

But who needs the truth?

In sum, from tax reform to deregulation, all the "good stuff" is in the past and priced in. Now, we have trade uncertainty, Fed uncertainty, and political and geopolitical uncertainty. We have fiscal policy that is simply on steroids. And, of course, monetary policy has been reversed.

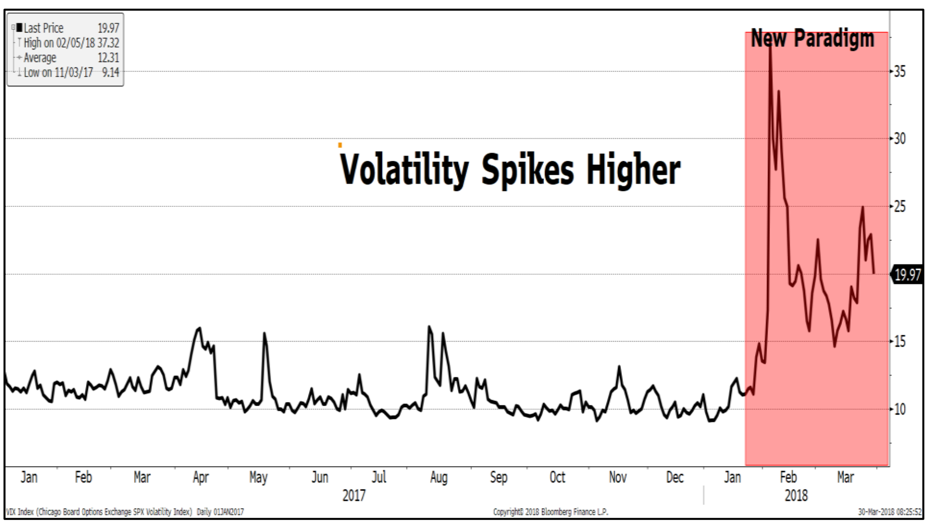
VOLATILITY IS THE WORD

Last year, the U.S. launched missiles at Russians fighting in Syria, and the market closed up. The U.S. made ominous-sounding threats against the rogue regime of North Korea, and Mr. Market shrugged. President Donald Trump was beset by multiple scandals that could threaten his presidency, yet markets kept rising.

The Volatility Index (VIX) was trading at near-hubristic certainty that nothing could go wrong for a bull market. Rarely have we seen a stretch where investors made such consistent, steady gains with stock volatility at its lowest in a half-century.

But that calm is in the rearview mirror.

As shown below, the VIX has skyrocketed in 2018, and is almost three times higher than the eerie calm in 2017. Over the last week, the Dow has moved 345, 669, 425 and 724 points. That's an average of 541 points. For comparison, in 2017 the average daily move was 68 points, and there were only three days with a move of at least 300 points. Last year, we had a grand total of zero such swings. In other words, last year, the market cared about nothing. This year, it cares about everything. If there is a bull market, it is in volatility.



The increase in volatility that is heralding in an entirely new investing environment – where what worked during the multi-year era of free money, fiscal correctness and relative global harmony are all now in the past.

We are entering a new paradigm.

There are millions of Americans today that are newly employed in the financial markets, and all these newbies have ever known in their professional lives are ZIRP (zero interest-rate policy) and QE (quantitative easing). Now the movie runs backwards; the ones who will succeed are the ones that will be playing by the new rules.

As we move forward, it all comes down to fundamentals. More eventful weeks likely lie ahead.

In terms of fundamentals, it appears recession risk is relatively low for the next nine months. But as Robert Shiller stated at the beginning of this piece, recessions are hardly ever predicted in advance. Meanwhile, the economy is entering its 105th month of recovery and is very "long in the tooth." In late stage expansions, pent-up demand is exhausted as big-ticket items have already been purchased. The lack of such demand makes the economy susceptible to either slower growth or an outright recession. As such, the potential for a recession by mid-2019 is very real.

A slowdown would hit corporate earnings and eventually stock prices. When the economy turns down, the stock market begins to price it in ahead of time and, typically, the S&P 500 is down at least 20% – so we have already seen half that down payment.

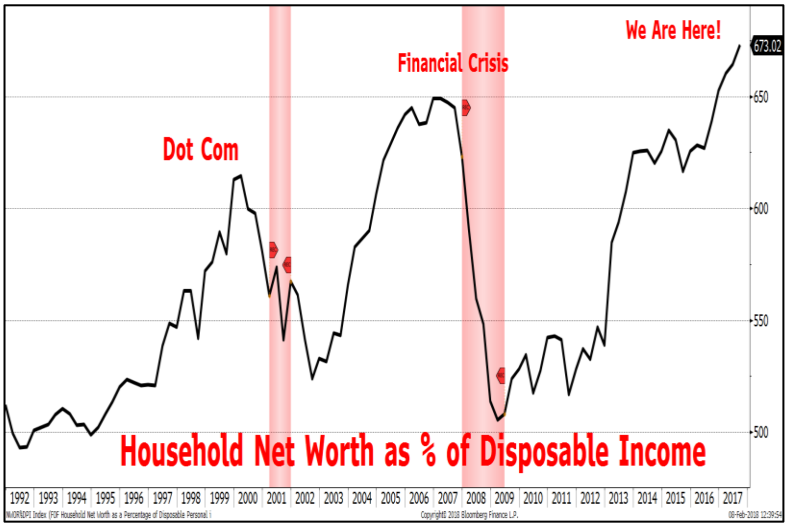
We are now entering the reporting season for Corporate America. If earnings do not meet or exceed the hyped lofty expectations put forth by the Wall Street crowd, we could be in for an extremely volatile and challenging period.

"In other words, only 8% of the time in the past has the stock market in the United States been as richly priced as it is today. And if you want to come up with reasons why that's the case, that's fine. But just understand that we are extremely pricey. We're more than just a one standard deviation event versus the historical average."
– David Rosenberg, Chief Economist and Strategist at Gluskin Sheff & Associates Inc.

The U.S. economy has never been so dependent on asset inflation for its success.

Stock values move up to a critical level (which holders likely believe are permanent), which stirs the animal spirits and kicks economic growth into gear. Interest rates move higher, the asset bubble pops, stock values go down, confidence declines, aggregate demand softens, and deflation now becomes the headline issue. This is Bubble Finance in a nutshell.

The ratio of household net worth to disposable income has soared to a record 673%, taking out the 2006 – 2007 bubble high of 652%, and even the dot-com peak of 612% posted in 1999.

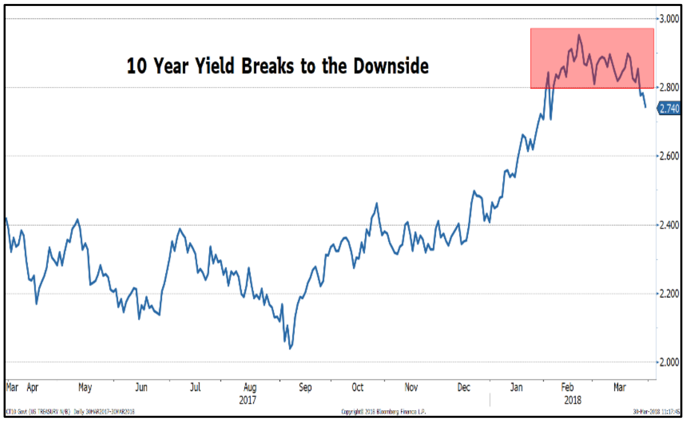


The Oxford Global Economic Model suggests a 25% equity correction would potentially cut U.S. growth to around 1% by 2019. The risk of such a damaging stock price slump could prompt early Fed action to restrain markets if valuations continue to stretch.

MR. BOND SPEAKS

As is the case with equities, rates peak ahead of the economic reversal.

Could it be that this has already happened?



As shown in the following graph, a super-tight 20-basis-point range for the 10-year Treasury yield has been broken. The yield on the U.S. 10-year Treasury note is down to 2.74%, and is now almost 20 basis points below the recent high and further away from all those bearish calls earlier for a return to 3% plus.

Making this move that much more impressive, the market had to digest some $300 billion of new issuance. Undeniably, to rally in the face of such a supply deluge is impressive.

This reversal to below the 50-day moving average was not supposed to happen. Fiscal reflation was going to create over 3% of economic growth to infinity and raise inflationary pressures.

Let me ask – why all this faith in fiscal policy to create a climate of "escape velocity" in the real economy when nine years of "free money" couldn't do?

The bond market seems to be calling bluff on the central bank's heightened confidence in the stronger economic outlook. Could it be that the bond market is sniffing out a debt-strained U.S. economy that may be in more trouble than many realize?

The yield curve is flattening big-time – the spread between 2s and 5s is down to a mere 30 basis points and the gap between 5s and 10s is now just over 20 basis points. The 2s/10s spread dropped below 50 basis points. That's made it the flattest since the financial crisis. The history of the yield curve suggests caution.

Folks, we could be just one rate hike away from yield curve inversion. In fact, we may end up seeing the Treasury market rally into one. It wouldn't be the first time.

Why is the Yield Curve Flattening?

Meanwhile, the Fed – which is on track for another two, and maybe three, 25-basis-point interest rate increases this year – sees nothing and hears nothing until something breaks.

As I have highlighted numerous times, there have been 13 Fed tightening cycles since 1950, and 10 of them ended in recession (while the others have often ended in emerging market blow-ups, like the 1994 Mexican peso crisis).

Could the breaking point for the economy come sooner than the Fed and bulls expect?

MORE ON LIBOR

Markets make the news, rather than the other way around, according to the old traders' line. Over the past month three months, LIBOR has continued its relentless upward creep and is now up a whopping 62 basis points higher to 2.31%.

As many claim, if the move is a benign technicality and a temporary imbalance in money market supply and demand, largely a function of tax reform or the $300 billion surge in Treasury bill supply in the past month, the LIBOR move should start fading. If it doesn't, it will be time to get nervous.

Whether the reason for its sharp rise in LIBOR is systemic or technical remains irrelevant in the context of the big picture. What is relevant? The $300+ trillion in debt instruments, which reference LIBOR debt-service charges, rising inexorably. This alone will exert an overwhelming drag on a global economy – one that is more addicted to debt and sensitive to shifts in interest rates than at any other time in recorded history.

According to the data in the following table, a 35-basis-point widening in the LIBOR spread could raise the business sector interest burden by $21 billion.

For ordinary households, the increase in debt service costs because of the three-month LIBOR spike will mostly come through adjustable rate mortgages. The recent increase in LIBOR has added about $5 billion to the annual interest expense.

Which begs the question: How much more upside in LIBOR can banks, markets and the Fed stomach before something snaps, and the Fed is forced to cut rates or proceed with more QE?

Table 1: LIBOR-linked debt of businesses and households

	Volume ($bn)	% LIBOR related	$bn LIBOR related
Syndicated loans[1]	3400	97	3298
Corporate business loans[1]	1650	40	660
Noncorporate business loans	1252	40	501
CRE/Commercial mortgages	3583	40	1433
Retail mortgages	9608	15	1441
Student loans	1131	7	79
Credit cards, auto loans, consumer loans	1795	Low	

1. Some overlap exists between estimates of syndicated and corporate business loans.
Source: Federal Reserve Board, NY Fed, J.P. Morgan

Possibly, investors should be more focused on the spread between three-month LIBOR versus the 10-year Treasury yield as a harbinger of the next recession.

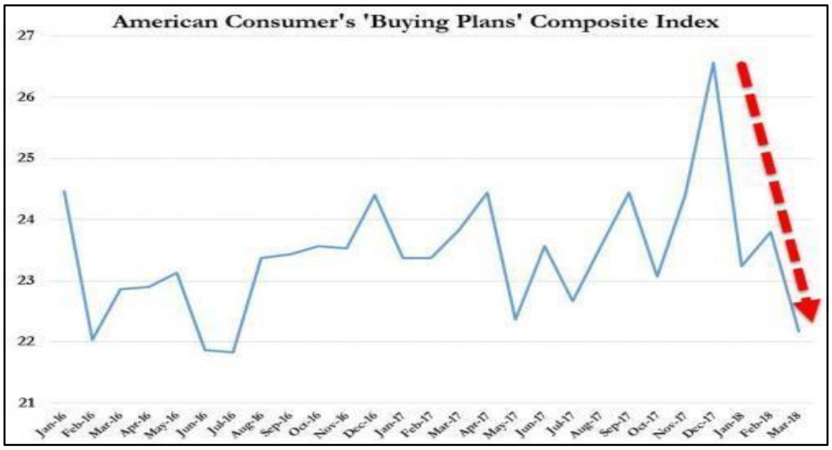
MARKET OUTLOOK AND PORTFOLIO STRATEGY

The global economy seems to have moved past its peak rate of growth. The U.S. is still a 2% growth economy. Meanwhile, China, Europe and Japan are slowing again. So much for the synchronized global growth narrative peddled by Wall Street.

Back in January, Americans were spending like drunken sailors (sending their savings rate to the lowest on record). Consumers had basically taken every penny they socked away and spent it. However, for the second month in a row, the savings rate ticked up (from 3.2% to 3.4%), as perhaps a new frugal normal is dawning in America.

Rising savings (not to mention maxed out credit cards) and plunging spending plans suggest that Americans are once again tapped out. As a reminder, the 13-week annualized credit card balances in the U.S. went completely vertical in the last few months of 2017, a troubling sign and yet another confirmation that U.S. household savings are almost gone.

And judging by the "buying plans" of Americans (from the recent Conference Board Survey), things may have hit the tipping point. This is what that dive looks like: Conference Board "plans to buy" homes, autos and appliances have all plunged in the last three months.



What does it mean when we have booming employment and massive tax cuts, and household buying plans take a deep dive? Here's what it means – the consumer is debt-strapped and tapped out. Pent-up demand is a relic of the past.

Is it time to start taking the umbrella out just in case it starts to rain?

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

In terms of relative value, please see the Relative Value Analysis.

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.

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