Weekly Relative Value

What If the Consensus is Wrong?

"Ask the working people in Ohio, Pennsylvania and Michigan about Wall Street. Wall Street supported and cheered on the export of their jobs. ***To hell with Wall Street if they don't like it.*** *It's time somebody stood up to them and Donald Trump is the perfect guy. Wall Street is always short-term. Trump is trying to protect the beating heart of American capitalism – our innovation."* – Steve Bannon, former White House Chief Strategist

Last month, Trump authorized tariffs on aluminum and steel imports. The move has increased costs for U.S. factories that buy raw materials from overseas, tightening their profit and forcing the National Association of Manufacturers to ask Trump to seek a truce in his trade war with China. Instead, the President has threatened to escalate it, putting himself at odds with some of his advisors and members of his own party who support free trade.

Last week, Trump imposed another $50 billion in tariffs on China. The Trump list would affect 1,300 *categories* of goods. Consumers and businesses will pay more, not for 1,300 *products*, but rather 1,300 *product categories*. The tariffs will take effect May 22. In the interim, businesses have a chance to respond, but they will promptly be ignored.

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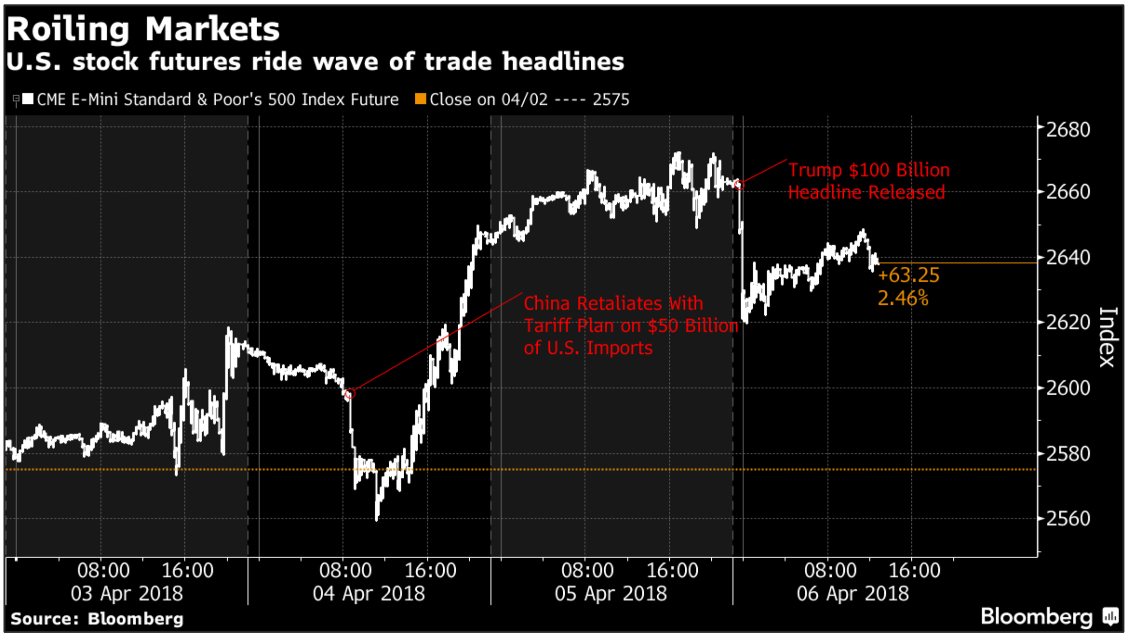
In the tit-for-tat trade war, China struck back with tariffs hitting right in the American heartland, which is home to Donald Trump's base, with a proposed 255 tariffs on imports of 106 American-made products ($50 billion worth of levies) from autos to chemicals to aircrafts to farm products.

Soybeans are the most valuable U.S. export to China, worth nearly $23 billion last year. As an aside, go and look at the ingredients on the groceries you buy next time you go shopping and see how prevalent soybeans are – they are in just about everything, not to mention there is a feed cost impact for farms around the country.



Late last week, Trump threatened to place tariffs on an additional $100 billion of Chinese goods.

China vowed to "attack" Trump's tariffs **"to the end at any cost"** and urged the European Union to join the fight against U.S. protectionist moves.

> *"We are fully able to inflict [the] same losses on the U.S. as those on China. The U.S. will have to repay whatever loss and harm it has caused on China with huge economic and political cost... [Americans] must choose whether to support Trump's unscrupulous move or to hold the President accountable."*
> *– China's Ministry of Commerce and Ministry of Foreign Affairs*

And, as the Farm Belt anger rose, Trump administration officials went out of their way on the Sunday morning news programs to once again soften some of the rhetoric. As in, they were reassuring everyone that there is still plenty of time to iron out a deal and the duties are far from imminent. Like he did a few months ago on his reckless verbal commentary on the dollar, Treasury Secretary Steven Mnuchin did a classic 180° turn on trade, now saying, "I don't expect there will be a trade war."

Trump tweeted that the U.S. and China will remain friends and that, "China will take down its trade barriers because it is the right thing to do."

Supposedly, China will do the right thing, just because it's the right thing to do. By that logic, the U.S. would remove all tariffs and subsidies and China would do the same.

Yeah, right.

Meanwhile, the "experts" on bubble-vision talk about how the U.S.-Chinese trade frictions are mere negotiation tactics. How do they know for sure?

I don't know for sure, but this rhetoric sounds pretty trade-war-ish to me.

Keep in mind that China has another weapon – their $1.2 trillion ownership of U.S. Treasury securities ($1.6 trillion when Agency debt is included). As the budget deficit balloons, the White House is going to need these guys to show up at the auctions, so it isn't just soybeans that are at stake, but mortgage rates too.

It's difficult to say whether the U.S. or China has more to lose from a trade war, but unequivocally trade wars are not "easy" and there are few "winners." These escalating trade tensions will increase the cost of doing business, raise the level of uncertainty, and destabilize an integrated global economy, causing job losses across the U.S. Corporate profits would take a substantial hit as well.

As an example, if this tit-for-tat tariff dispute between the two countries erupts into a full-blown trade war, auto production in both nations will be affected. However, U.S. factories would feel the strongest effect because China imports nearly 270,000 U.S. vehicles, worth $11 billion, and sends relatively few back.

We call that "winning"?

Maybe those tax cuts will pay for themselves through tariffs on U.S. consumers. (Sarcasm intended.)

SLOW DOWN AHEAD

During the first two months of the year, real U.S. consumer spending has fallen at a 1.3% annual rate (the weakest since October 2009) and real retail sales are down three months in a row… And this is **with** the tax cuts!

Where has the "windfall' gone? Well, the lottery has done extremely well. What a great way to spend your tax cut, don't you think?

Meanwhile, consumers have completely shunned spending on furniture, home improvement, sporting goods, books (opting to watch *Roseanne* instead), groceries and cosmetics.

Auto sales did shoot the lights out in March, with the tally at 17.4 million units (annualized), far above the 16.9 million consensus view. But remember, the selling month of March contained the Easter holiday weekend, including Monday, April 2! Easter is always a big sales weekend. Last year, Easter fell in the middle of April.

And then there were huge incentives. J.D. Power estimated that the average incentive spending was $3,849, amounting to 10.3% of MSRP. The strong vehicle sales merely proved that Americans will always respond to a bargain.

It should also be noted that banks are tightening up on their credit scoring. Not a bad time of the cycle to be doing so, I might add.

In the past three weeks, there has been no growth at all in net new consumer credit borrowing. The same is true for auto loans. The first quarter Federal Reserve's Senior Loan Officer Survey showed standards for residential mortgage loans tightening to an extent not seen in a year, and the second tightest since mid-2014.

U.S. consumers – those whose personal savings rate is already near record lows – have not only retrenched, but have substantially slowed their credit card usage, which suggests more negative surprises for first quarter GDP for an economy in which 70% of GDP is consumer spending.

Meanwhile, personal savings have expanded by nearly $150 billion. That's an estimated 75% of the Trump tax cut being saved, not spent. Frankly, this is what one would expect for households with little pent-up demand and loaded up with debt and savings constraints. As a side note, the tax relief should have been saved for the next recession. This is no time for a pro-cyclical fiscal stimulus. Yet, once again, the ideologues in Washington got in the way.

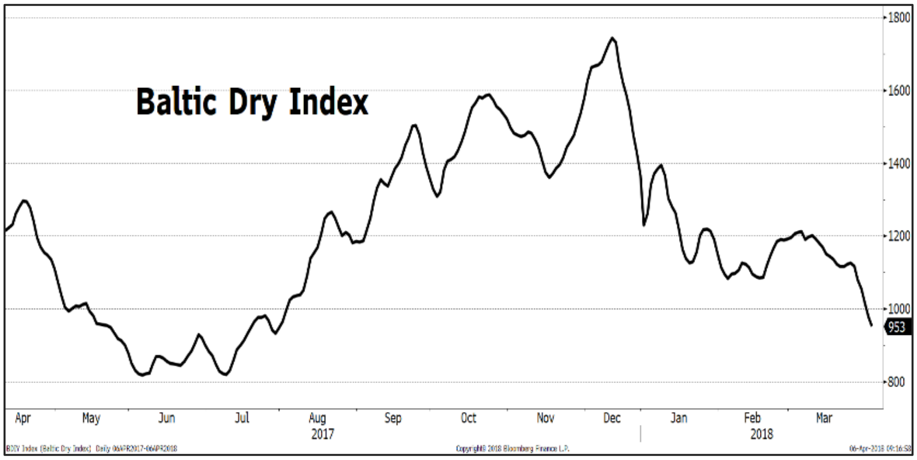
Housing starts over the past three months have collapsed at an 18% annualized pace. It is clear that the bond-induced backup in mortgage rates is impinging on housing, as the mortgage applications data for the week of March 30 slid 3.3% (-1.7% on a year-over-year basis).

In a sign of more deeply-rooted structural problems for homeownership, Freddie Mac's latest survey showed that 20% of renters have absolutely no interest in becoming an owner, up from 17% last August and 13% two years ago.

DESYNCHRONIZED GROWTH

The strong synchronization story is yesterday's news. Global economic growth has hit a notable plateau in recent months in both survey-based takes of the economy, as well as among the more important hard data, as shown in the following chart summarizing Citi's G-10 Economic Surprise Index. After peaking at the start of the year, the index has tumbled into negative territory in just a few months.

The Baltic Dry Index – a shipping index that measures change in the transportation cost of raw material – has rolled over in a very significant way. Since year-end 2017, the index has slumped 40%. This is a harbinger for slower global growth ahead – the "synchronization" story has desynchronized.



I, for one, am not impressed and fail to see the "escape velocity" that the bulls do at the current time.

The underlying structural drivers of real economic growth (labor force growth and productivity) have progressively slowed in recent decades toward what it now about a 1% structural trend.

Even a meaningful acceleration in productivity would push real GDP growth scarcely beyond 2%, unless the unemployment rate also falls toward zero.

Yet, we are promised 3% to infinity by the politicians.

WHAT IF THE CONSENSUS IS WRONG?

Few see a recession on the horizon, even though most of the data have sputtered of late. What if the February jobs pop was a head-fake? Pundits see the current market sell-off as a "healthy correction." But what if the market is sending a different sort of signal? The mantra that there are no strains or excesses, or that corporate fundamentals are strong, ignores the fact that business balance sheets have never been as leveraged as they are today.

The Fed has the most sophisticated macroeconomic models on the planet. Even so, it has missed every recession in the last four decades. Remarkable track record!

Take a look at the following table. On average, the Fed economists projected real GDP growth of 1.7%, while real GDP contracted 1.0% for a typical "miss" of 2.7%.

Fast forward to the present. The Federal Open Market Committee (FOMC) is forecasting real growth to 2.7% in 2018 and 2.4% in 2019. The Congressional Budget Office sees growth of 2% this year, an average of 1.5% the next two years, and then miraculously 1.9% annually from 2021 as far out as the eye can see.

The consensus doesn't see a recession, currently pegging the odds at 17%. These are the same odds that have been applied before every downturn over the past three decades. Just a word to the wise: It may be best at this late stage of the cycle to take the "under" on that forecast.

The Fed is not done raising rates and we have never had such an overleveraged economy so dependent on central bank accommodation. No Fed tightening cycle has ever ended well – ten recessions and three "soft landings" (and even the "soft landings" triggered volatility in the financial arena). (Think: Kidder, Peabody & Co., Orange County or Long-Term Capital Management.)

The Fed Never Sees a Recession			
Recession Start	**Forecasted Growth%**	**Actual Growth %**	**Delta %**
Dec-69	1.2%	-0.1%	-1.3
Nov-73	2.4	-1.9%	-4.3
Jul-81	0.9%	-2.6%	-3.5
Jul-90	2.0	0.0%	-2.0%
Mar-01	2.6%	1.4%	-1.2%
Dec-07	1.3%	-2.7%	-4.0
Average	1.7%	-1.0%	-2.7

So, what if the consensus is wrong?

History says that after the late-cycle spasm in 10-year Treasury note yields, they decline an average of 225 basis points to the recession-lows. As shown in the table below, the average decline in 10-year Treasury yields is 160 basis points during a recession.

How do 10-Year Treasury Bonds Perform in a Recession?				
Expansion Date	**Peak Before Recession**	**Recession Start**	**Low in Recession**	**End of Recession**
Feb-61-Dec-69	8.1%	7.9%	6.3%	6.5%
Nov-70-Nov -73	7.6	6.7	6.7%	8.1
Mar-75- Jan 80	11.2%	11.3%	9.5%	10.8%
Jul-80-Jul-81	14.7	15.0%	10.4%	10.7%
Nov-82-Jul-90	9.1%	8.3%	7.8%	8.1%
Mar-91-Mar- 01	6.8%	5.0%	4.2%	4.8%
Nov-01- Dec -07	5.3%	4.0%	2.1%	3.6%

And just as bond yields peak before the downturn, so do equities. The S&P 500 peaks an average of seven months before the recession, declining 10.3% from the peak to the start of the downturn. It then slides an additional 20.9% over the ensuing 6.5 months, bottoming ahead of the recovery, in classic leading fashion.

How do Equities Perform in a Recessions?						
Expansion Date	**Peak to Recession Start**		**Recession Start to Recession Trough**		**Peak Recession Trough**	
	Months	% Decline	Months	% Decline	Months	% Decline
Oct -49- Jul-53	6	-7.2%	2	-8.2%	8	-14.8%
May -54- Aug -57	12	-9.1%	2	-13.8	14	-21.6%
Apr- 58- Apr 60	8	-10.4%	6	-3.8%	14	-13.9%
Feb-61-Dec-69	13	-15.1%	5	-24.7%	18	-36.1%
Nov-70- Nov-73	10	-20.2%	11	-35.1%	21	-48.2%
Mar-75-Jan-80	0	-0.9%	2	-14.0%	2	-14.7%
Jul-80-Jul- 81	8	-6.8%	13	-21.8%	21	-27.1%
Nov-82-Jul-90	0	-3.5%	3	-17%	3	-19.9%
Mar-91-Mar -01	12	-24.0%	6	-16.8%	18	-36.8%
Nov-01- Dec -07	2	-6.2%	15	-53.9%	17	-56.8%
Average	7.1	-10.3%	6.5	-20.9%	13.6	-29.0%

As I look forward, I think a recession is likely. Very likely. Maybe not in the next three or six months, but within a year. It could be even earlier.

The question is, what do we do when growth momentum peaks?

I wonder why nobody else dares to call for a recession? Simple. They are paid NOT to!

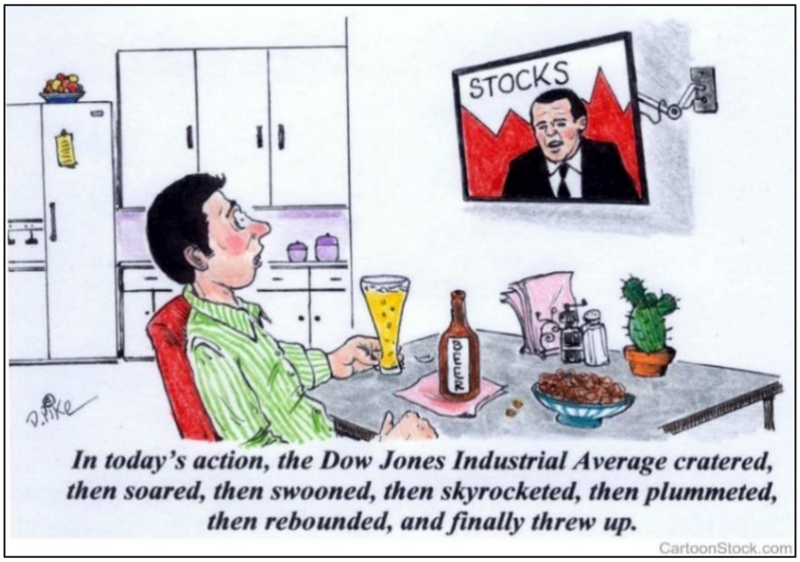
Remember, most economists work for "asset-gathering" Wall Street firms. Bad news, or should I say ***fair and balanced news***, does not help in the gathering of assets.

INFLECTION POINT

> *"Change of a long-term or secular nature is usually gradual enough that it is obscured by the noise caused by short-term volatility. By the time secular trends are even acknowledged by the majority, they are generally obvious and mature. In the early stages of a new secular paradigm, therefore, most are conditioned to hear only the short-term noise they have been conditioned to respond to by the prior existing secular condition. Moreover, in a shift of secular or long-term significance, the markets will be adapting to a new set of rules while most market participants will be still playing by the old rules." –* Bob Farrell, Wall Street veteran and former analyst for Merrill Lynch, August 3, 2001

Last year was easy. Deregulation and corporate tax reform supported the bullish case. Inflation was tame, and the 10-year Treasury note yield had reached only 2% by Labor Day. But, this year, the markets are being bombarded with heightened uncertainty on all fronts. The tax reform, coupled with both tax cuts and spending increases, has resulted in the fiscal deficit doubling to $1 trillion. The relentless attacks on parts of Corporate America are also quite new. One day it is Facebook, then Amazon comes under the presidential tweet attack.

Also consider that the year is just over three months old, and already we have seen more than 22 sessions with intra-day moves in the Dow of 400 points or more. In 2017, we had a grand total of one. In fact, in the past 60 years, the average number of trading sessions with such a daily move is two. As an aside, only during October 2008 to January 2009 have we ever seen so many 400-point moves in the Dow bunched into such a short period. It is symbolic of a market in transition.



Whether the culprit is feared trade wars, monetary policy or recurring stock market volatility (which ebbs and flows so quickly that some measures can't keep up), I believe we are observing the very early effects of risk-aversion in a hyper-valued market. High or rising volatility often corresponds to declining markets; low or falling volatility is associated with good markets. The current period of rising volatility portends further market declines unless volatility subsides soon.

Remember, this is the most over-leveraged U.S. economy ever. Households and businesses will roll over their debt into much higher borrowing costs in the coming months and quarters.

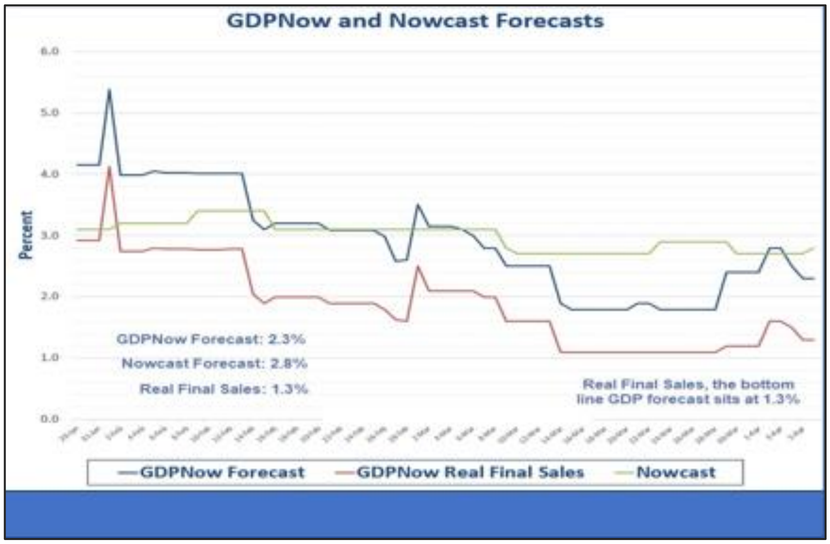
We are at an inflection point with a new fiscal policy, a new trade policy, a new untested and less dovish Fed, less muted inflation pressures, and feverish trade tensions. And, come November we'll likely have a new Congress, with the House a shoo-in for Democrats. We also have the most hawkish foreign policy stance in recent memory and, for better or for worse, this is something new for investors to digest. CIA Director Mike Pompeo and National Security Advisor John Bolton are going to be ushering in something totally different.

History teaches us risk needs to be repriced at inflection points.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

In his first non-FOMC speech at the Economic Club of Chicago, Fed Chair Jerome Powell stressed that growth has picked up and did not indicate that there were risks to the outlook from the trade tensions or financial market volatility. What a hoot!

Does the chart to the right look like growth is picking up? Nope. Growth has once again faded with real final sales forecasted at only 1.3%. Final sales are the true bottom line for the economy, as they exclude inventory changes, which net out at zero over time.



More generally, tighter credit looms, with the Federal Reserve still on course for two more 25-basis-point hikes, which wasn't changed by the weaker-than-expected payroll gains in the March Employment Report, released on Friday. The federal funds futures market continues to price in a quarter-point increase in the Fed's interest rate target, from the recently raised 1.50%-1.75% range at its June 12-13 meeting. An additional hike is only slightly above even money for the September 25-26 gathering, but a target range of 2%-2.25% or higher has a 74% probability.

"Many people underestimate the possibility of higher inflation and wages, which means they might be underestimating the chance that the Federal Reserve may have to raise rates faster than we all think. We have to deal with the possibility that, at one point, the Federal Reserve... may have to take more drastic action than they currently anticipate." – Jamie Dimon, CEO of JPMorgan Chase

Could the markets be roiled by the prospect of the Fed going too far? Remember their track record. In 10 out of 13 rate hiking cycles, a recession has occurred.

That's the possible message from the forward markets. Market expectations are pricing in a rising Fed rate target until the first quarter of 2020, which would mean the forward market anticipates that the central bank would be easing policy by then.

This inversion of the so-called "forward curve" happens only rarely; most recently in 2005, 2000 and 1998. That has typically been followed by the most popular depiction of an inverted yield curve, the spread between the Treasury two- and 10-year note yields.

Even without a trade war, an inverted yield curve is a bearish portent.

<u>Note:</u> 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.