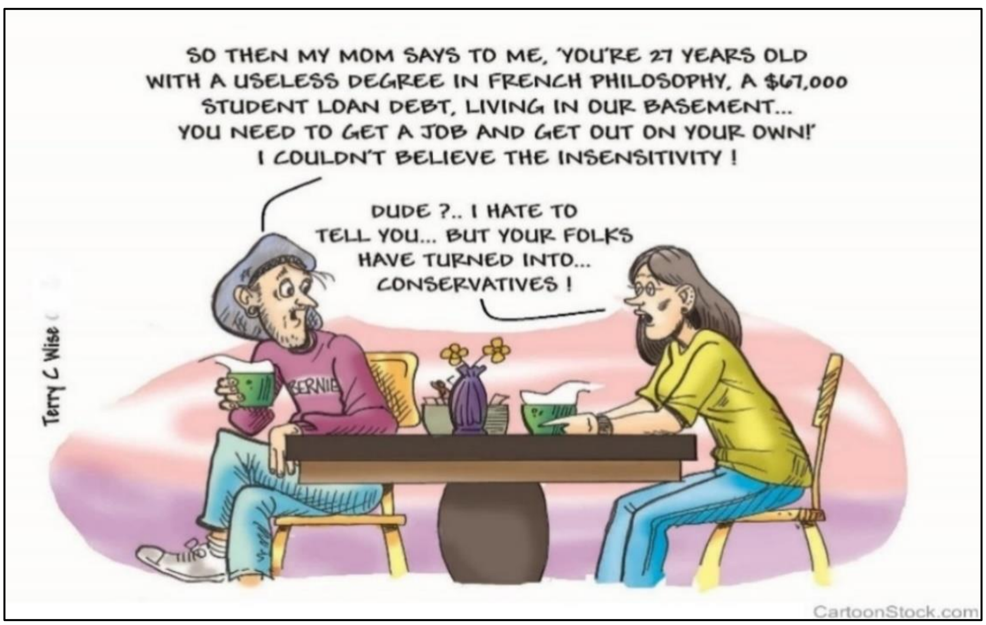
WEEK OF MAY 29, 2018

Weekly Relative Value

The Lost Generation

"The late 2000s recession threw up an obstacle in that dynamic for younger workers… People of the 1980s generation started their working lives in a time of troubled investment markets, high unemployment, and persistently weak wage gains." – Wall Street Journal

Millennials, Gen Y, Echo Boomers, Generation We, Baby on Board, Boomerang Generation, Peter Pan Generation… Call them what you want, but when you see one, you'll know it. Millennials are a breed apart, and at approximately 77 million strong – or 25% of the U.S. population – you can't miss 'em.



Millennials are generally defined as people born between 1980 and 2000. Many pixels have been used to try to define this generation. Time Magazine released an article titled "Millennials: The Me Me Me Generation," where they labeled them as lazy, entitled, self-obsessed narcissists. Ouch!

However, if millennials are lazy, entitled, self-obsessed narcissists, their boomer parents are probably the reason.

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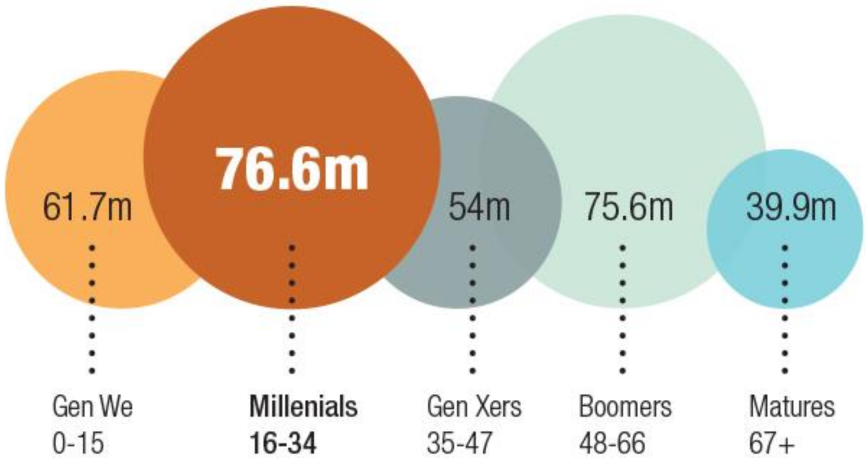
THIS WEEK…
- Lost Generation?
- Political Upheaval
- Peak Housing

PORTFOLIO STRATEGY
- The End of Easy Money

On the positive side, millennials are the most educated generation of all time. There's no doubt they are more tech-savvy than other generations. They are less materialistic and more experiential, open-minded, liberal, self-expressive, upbeat, passionate about equality and social justice, and tolerant regarding race and sexual orientation. They have a totally different value system and are globally focused. Baby boomers potentially could learn a lot from their offspring.

And there a lot of them. There are now more millennials than baby boomers – a cold, hard statistical fact of life. In fact, by numbers alone, they are the largest demographic ever!



LOST GENERATION?

> *"The fact that many families suffered large wealth setbacks during their prime earning and wealth-accumulation years raises the question of whether they will be able to rebuild their wealth to meet major saving goals, including for a home purchase, college tuition for their children and retirement." – St. Louis Federal Reserve*

From an economic perspective, millennials entered the workforce during the Great Recession. During this period, they faced a rude awakening when the high cost of an education didn't always lead to higher earnings and a fast track to success.

More than a few years ago when I went to college, I was able to work during the summer and part-time jobs during the school year to pay for an education. Now, kids are graduating from college with mountains of debt and struggling to pay it back. Astronomically high college tuition facilitated by a bottomless ocean of student loans has saddled Americans with a record $1.48 trillion in non-dischargeable debt – an amount that has **more than doubled since 2009.**

According to a new St Louis Fed study, **The Demographics of Wealth,** it is explained how education, race and birth year shape financial outcomes. The study also covers the long-lasting wealth impacts of the Great Recession on young families.

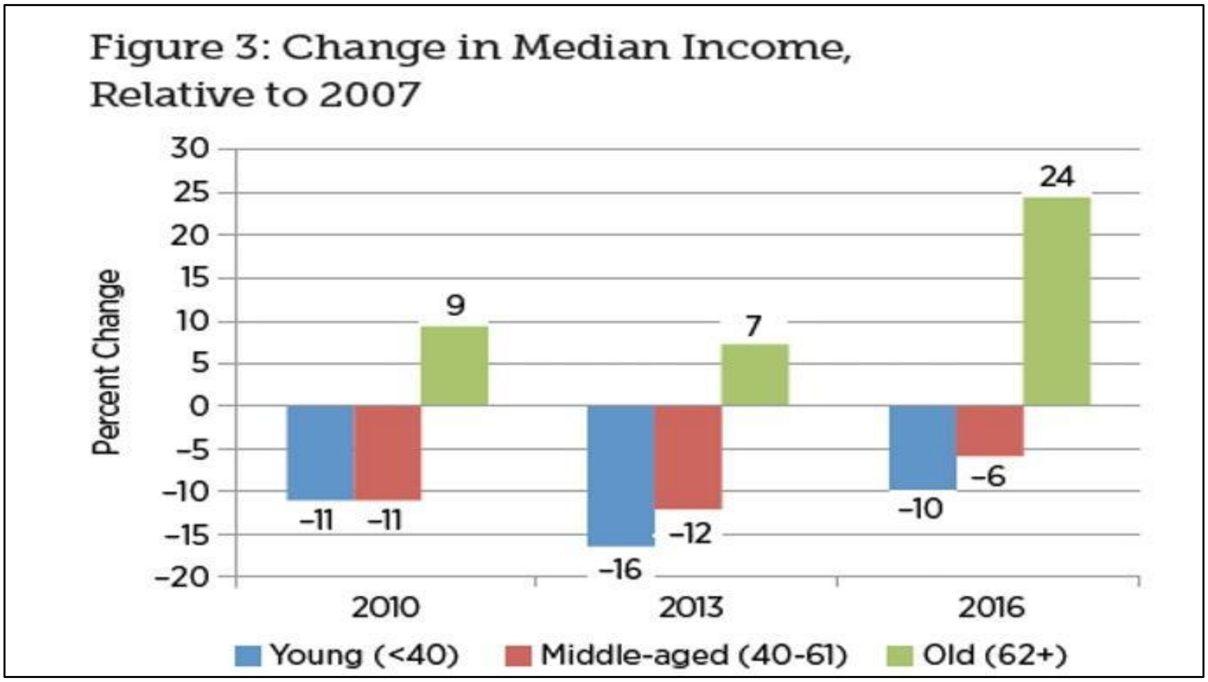
The article's first subtitle reads "A Lost Generation?"

According to the Fed study, those born in the 1980s are at the greatest risk of becoming a "lost generation" for wealth accumulation.

The study points out that, as of 2016, people born in this decade had wealth levels 34% below where they would most likely have been if the financial crisis hadn't occurred.

While the Great Recession "inflicted deep and widespread losses of income and wealth on the typical American family," and wealth losses affected all ages, families younger than retirement age suffered the most. And they've been scrambling to catch up ever since.

Change in Median Income

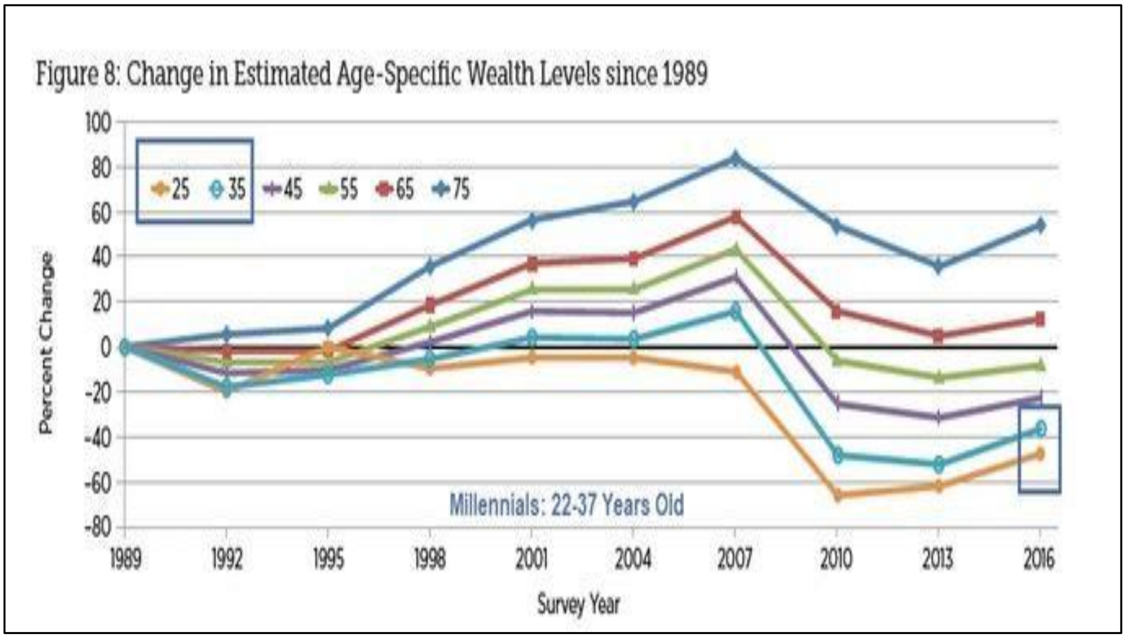


As the graph depicts, the younger generation has not seen the income gains experienced by the older cohort. Those under the age of 40 have been the biggest underperformers in terms of income gains. However, the problem is not just income. More likely, the divergence of wealth is a result of debt and homeownership. Households headed by someone born in the 1960s and 1970s were more likely to own homes than expected prior to the Great Recession. As the housing market recovered in recent years, those that did own property were able to recover some of their wealth.

The 1980s millennials, however, were generally too young to own homes prior to the Great Recession. Even by 2016, fewer than 45% had bought homes. And according to a new Gallup poll, only 37% of American adults under the age of 35 have money in the stock market. Before the 2008 collapse, 52% of this age cohort owned stocks. Once burnt, twice shy?

So, while robots and quants have managed to make the most of the mother of all liquidity-induced bull markets, in this cycle, a whole generation of investors said a simple “no thanks.”

Change in Wealth Levels



Rent, home prices and college tuition have all increased faster than incomes in the U.S. – and that’s not to mention increasing costs for childcare, healthcare and entertainment. Millennials are still heavily in debt, which increases their financial fragility. Even worse, the main types of debt they owe are student loans, auto loans and credit card debt. Unlike mortgages, these do not finance an appreciating asset, which, again, is one reason these families failed to boost their wealth in the last few years.

Thus, millennials born in the 1980s face a “formidable challenge” in rebuilding their net worth. This could have long-lasting consequences for that generation and the economy.

On the bright side, millennials born in the 1980s have time on their side. With high education levels and more time to earn and save, it is possible that the income and wealth trajectories of this segment of the generation will accelerate, allowing many families to achieve their long-term financial goals.

The study concludes:

“It is far too soon to know whether families headed by someone born in the 1980s will become members of a lost generation for wealth accumulation... To be sure, there are grounds for optimism. Yet there are reasons to be very concerned about the financial outlook for many young Americans.”

POLITICAL UPHEAVAL

> *"The boomers inherited a rich, dynamic country and have gradually bankrupted it." – A millennial*

Ouch, as a baby boomer myself, that hurts!

Unquestionably, there is plenty of blame to go around. But undeniably, boomers have overseen Congress and the power structure for years. Under the boomer watch, state and national deficits have exploded, infrastructure has crumbled, and the education system has badly deteriorated.

So, the "unnamed" millennial above (hopefully, not one of my sons) has a point.

Moving on. We are now into month 107 of the economic recovery. Recessions are like Mother Nature; they cannot be avoided! The only question is *when* – not *if*.

Those millennials who are now buying homes are buying them at close to record-high prices. Ditto for the stock market. Future equity and real estate appreciation will be muted relative to the outsized gains experienced since 2008.

Social security is projected to be bankrupt by the time millennials can collect. Thus, millennials will likely see reduced benefits or higher taxes. Or both.

Millennials will be saddled with the egregious public pension promises made to boomers.

Sadly, millennials are likely to be the first U.S. generation in history that is not better off than their parents, if not worse.

It has been said that one potential saving grace for millennials is that they will inherit their boomer parents' wealth. And unquestionably, some will be enriched by a nice inheritance package. But most likely, any inheritance will be split among many siblings. And sadly, many boomers will die broke. Thus, any inheritance will be very skewed.

If the generational wealth divide continues, this country may experience a widening political divide as the two largest generations of all time compete for limited tax dollars. Millennials will seek increased government help (think Bernie Sanders) while boomers will insist on "promised" levels of social security and Medicare.

Within a decade, millennials will be running the country and they may not be sympathetic to the plight of boomers. (See quote above.) There are plenty of reasons to believe the stage is being set for a major political upheaval.

PEAK HOUSING

In stark contrast to the ongoing bullish narrative, the U.S. housing market peaked long ago, and is in a prolonged process of rolling over under the weight of ever-eroding affordability. After reaching multi-decade lows in mortgage interest rates, their inevitable rise was bound to hurt the U.S. housing market. The 30-year fixed rate on mortgages hit cycle lows of 3.6% in September of 2017, and now have increased for seven months running to reach their highest level (4.47%) in five years. The basic rule of thumb is a 100-basis-point change in rates gives you a 10% reduction in affordability.

With mortgage rates climbing, new homes are increasingly out of reach for some Americans. Below are the monthly mortgage payments on a median new and existing home. As one can glean from the graph, monthly mortgage payments for new homes have surpassed levels seen during the first housing bubble. Remember: Americans buy payments, not homes.

Monthly Mortgage Payments Rising Fast

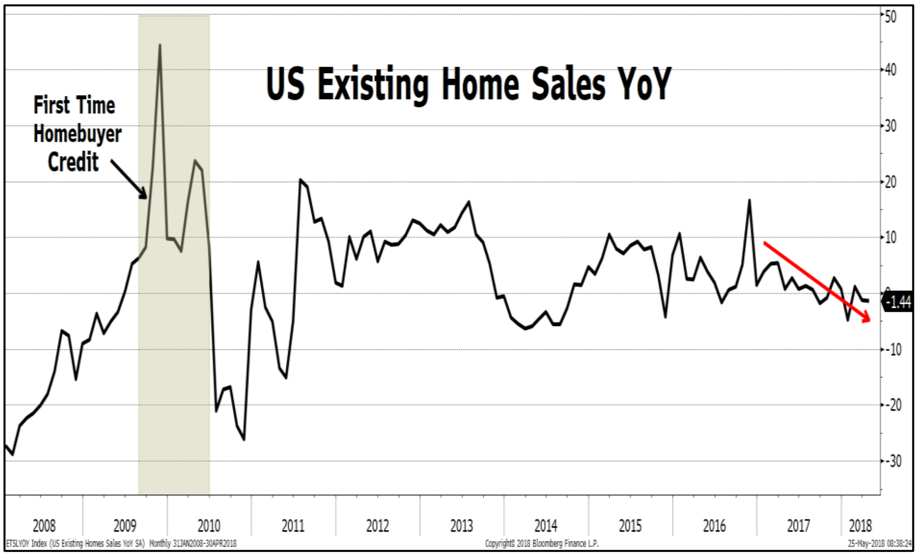
And according to the Joint Committee on Taxation, the Republican tax reform claims for mortgage deductions will fall 30% in 2018. The change to the mortgage deduction will mostly hit high-income earners with expensive homes in urban areas. The other big change is the ability to deduct state and local property taxes from income taxes.

Because homeownership will become more expensive due to rising rates and fewer tax write-offs, the benefits of owning a home could be diminished.

The latest data points to “peak housing.” Following the drop in new home sales amid record-high average prices in April, there was another disappointing housing data point – this time courtesy of the April existing home sales data release.

Resales retreated 2.5% during the month and are now down 1.4% from year-ago levels. In fact, at 5.46 million annualized units, sales are lower now than they were in April 2016! Not just that, but the breadth of the report was weak too, as not a single region recorded a gain. Purchases fell in three of four regions, including a 2.9% decline in the South and a 3.3% drop in the West.

Home Sales Slowing



There is little doubt that the housing inventory is low, representing just four months of supply at the current sales pace, and the lowest level on record for the month of April. However, I believe the demand-side of the equation is the bigger reason for slowing sales, as affordability conditions are worsening. Home prices have risen 74 straight months. Year-over-year home prices have risen 5.3%, which is well above the pace of income growth. This helps to explain why first-time buyers represented a miniscule 33% of all transactions in April (a "normal" market would see something closer to 40% to 50%).

If rates continue to rise, expect the housing slowdown to accelerate.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Fed is in its advanced stage of their prolonged tightening cycle. The federal funds futures market is now priced for 50% odds that the Fed will hike rates two more times this year. Historically, real GDP growth averages close to 5% at the time of the first rate hike. By the time the Fed has completed its rate hike cycle, the economy is running at roughly half that pace. With an approximate lag of twelve months, recessions have occurred rather unexpectedly more than 80% of the time in the past.

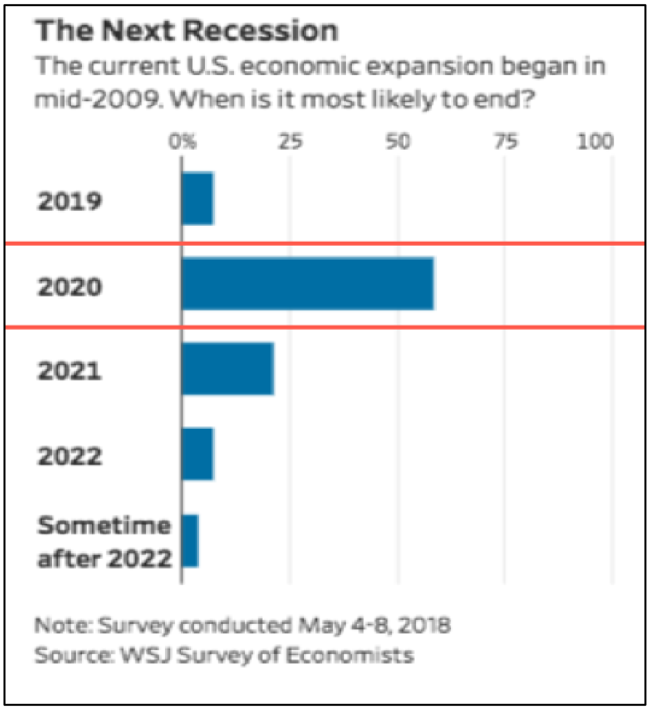
Last week it was reported that 59% of economists polled by the Wall Street Journal are calling for a recession. But here's the catch – not until 2020. Let's face it, things do not always arrive on schedule. I believe the surprise will be the timing of the next recession. It may be next year's event.

Think about it. The U.S. Treasury two-year yield has doubled since late 2016 to 2.53%. The short end of the market is responding to the Fed's tightening cycle. By raising rates and unwinding quantitative easing, the Fed wants to tighten financial conditions. In other words, the Fed wants to make it harder and more expensive to raise funds, and it wants investors to become more risk averse. This is the mechanism by which it transmits its monetary policy to the markets.

The 10-year Treasury note yield has ratcheted up 200 basis points from its all-time low yield. Oil prices have been soaring – up 57% over the past year with an increase of 18% this year alone.

In prior periods when we experienced such moves, we either ended up having a recession or, in the case of 1987, an equity market collapse.

There is no "get out of jail free" card.



Moving on. Across the ocean, Europe is losing momentum. Last week, European Purchasing Managers' Indexes came in much lower than consensus expectations, raising another recent concern of mine – that global economic growth signposts are growing more uncertain.

Japan is on the verge of another recession. China is slowing.

The emerging debt markets have been thrown into chaos recently; Italy and Turkey are sowing the seeds of a new European debt crisis. It's been some time since we've seen the possibility of a break-up in the monetary union back on the front pages – and Italy is a much bigger deal than Greece ever was.

Note: Late last Friday, when U.S. investors were long departed for their long Memorial Day weekend, Moody's Investors Service said it was placing its rating of Italy at Baa2 – two notches away from junk – under review for a downgrade.

THE END OF EASY MONEY

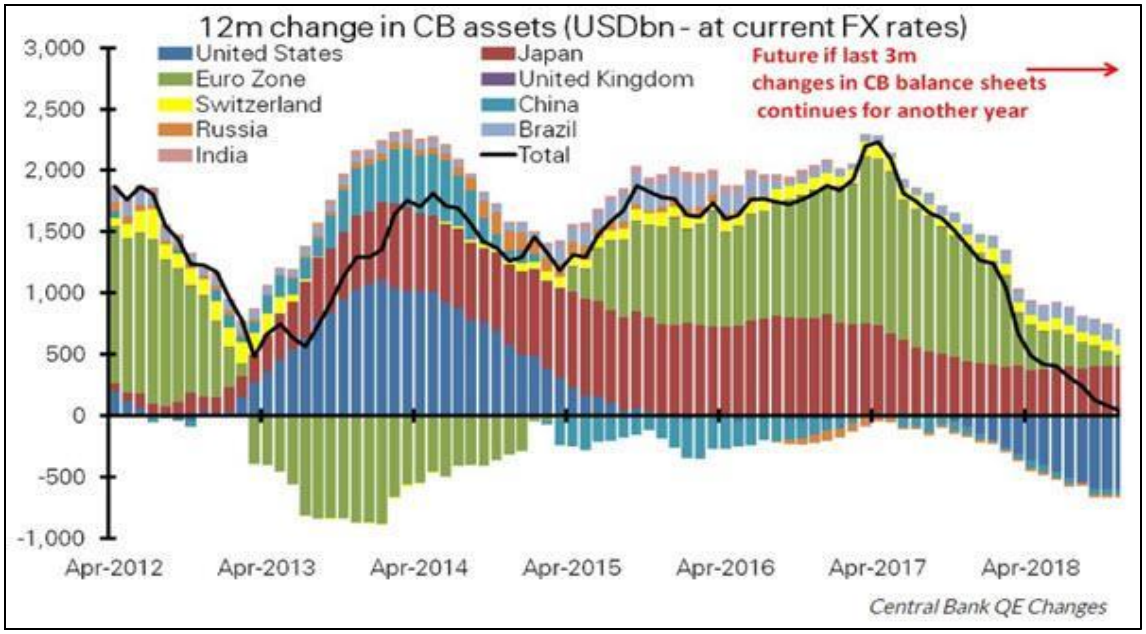
Since 2008, the economy and markets have become addicted to cheap money. Central banks have force-fed stimulus into the global economy to create a "recovery" and higher asset prices.

But the Fed is no longer a liquidity provider. As of right now, central banks are on track to end worldwide stimulus in early 2019, when their collective net change in assets will dip below $0 for the first time in many years.

Given the importance of central bank purchases and market interventions, the following chart is probably the most important in existence for deducing where financial asset prices are headed. If global monthly stimulus indeed drops to $0, then **watch out below!**

I believe investors fail to appreciate how unpredictable this central bank unwind will be at the same time we have historic high valuations in virtually every asset class.

The Most Important Chart



We have entered a new secular paradigm on all fronts in addition to unprecedented large-scale fiscal deficits.

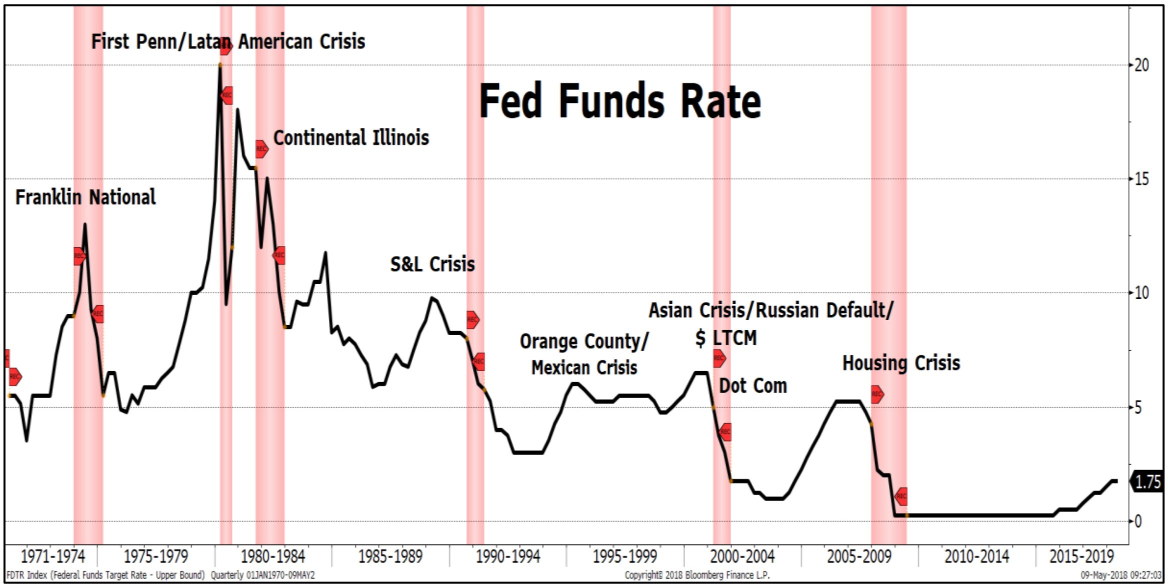
As I have highlighted previously, 10 of the last 13 rate hike cycles have led to a recession. I think everyone would agree that's a bad batting average. And equally disconcerting, every Fed tightening cycle has created a meaningful crisis somewhere.

Going back in history, the past 10 Fed rate hike cycles have led to 10 financial crises. In the 1970s, stagflation was the theme as the Fed was behind "the curve." Eventually, the Franklin National, one of the most profitable banks in the country at that time, collapsed. The early 1980s included the Latin American debt crisis and Continental Illinois collapse. The late 1980s tightening ushered along the S&L (savings and loan) crisis. Former Fed Chair Alan Greenspan's first tightening in 1987 helped trigger Black Monday before the Fed eased and the "Greenspan put" took off in earnest. The early 1993-1994 tightening phase included the bond market turmoil and the Orange County and Mexican crisis. In the late 1990s, the Fed's stop/start tightening cycle included the Asian crisis, Long-Term Capital Management and the Russian collapse. When tightening resumed, it resulted in the pop of the Nasdaq bubble. The 2004-2006 Fed tightening created the U.S. housing collapse and catalyzed the global financial crisis.

Lightning never strikes twice in the same place. The catalyst for the next crisis could be the "great unwind" of ultra-loose monetary policy/quantitative easing around the world at a time of record debt levels.

Warren Buffet once quipped, "You only find out who is swimming naked when the tide [of liquidity] goes out." So, where and when will the next crisis erupt originate?

When Rates Go Up, Things Blow Up!



As discussed in last week's Weekly Relative Value, I believe the next crisis will spring from **high yield corporate debt** (aka junk debt). Since 2009, the level of global non-financial junk-rated companies has soared by 58%, representing $3.7 trillion in outstanding debt (the highest ever), with 40%, or $2 trillion, rated B1 or lower. As a percentage of GDP, corporate debt is at a level in which a financial crisis has followed on every prior occasion.

Many of these companies are so marginal that even a mild economic downturn could render them unable to make bond payments. These so-called "zombie" companies exist ONLY because of the artificially low interest rate environment imposed by the Federal Reserve and its central bank peers following the crisis.

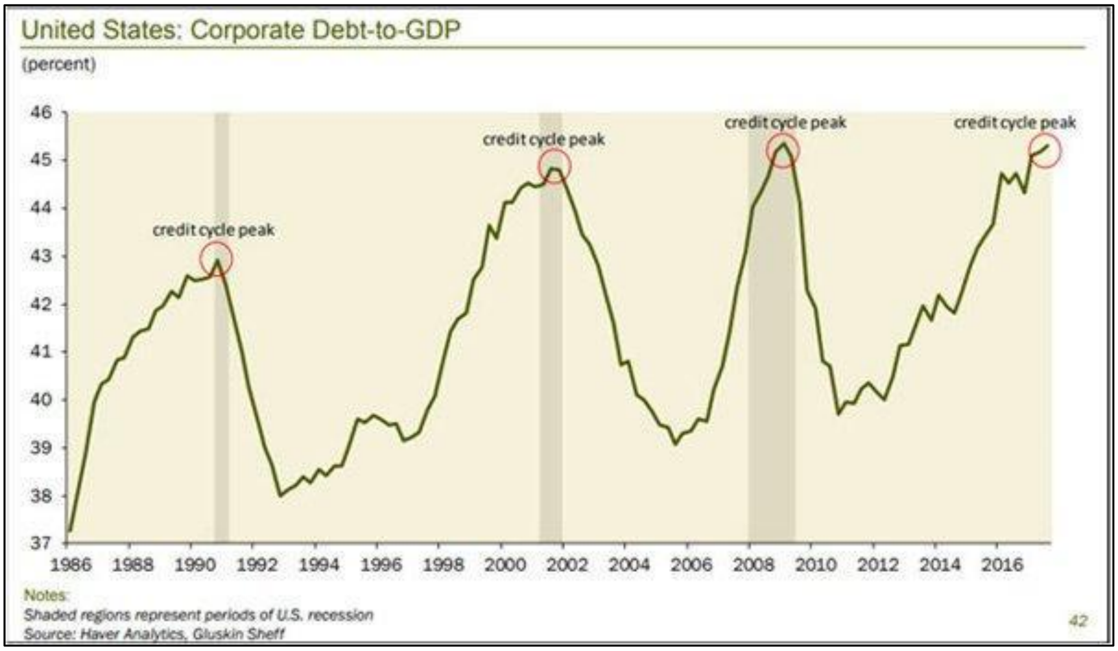
Yet, despite the tightening monetary policy and suspect nature of the junk market, yields on the lowest rated sectors (CCC and below) of the high-yield market have continued to decline. Reckless investors, in a search for yield in the wrong places, are throwing caution to the wind and plowing money into a ticking time bomb. This is typical late stage investment behavior.

Today, there are approximately $2 trillion invested in high-yield mutual funds and exchange-traded funds that are marked to market every day. If market values decline and investors redeem funds, they will be forced to liquidate holdings.

In a panicky market, liquidity dries up completely. There are no buyers (only sellers) for the lowest rated riskiest debt. Valuations cascade lower. Thus, fund managers, to meet redemptions, sell what they **can**. Which means that spreads on higher rated debt will widen as well. It's called contagion.

During the financial crisis, we saw a so-called "self-contained" subprime mortgage debt crisis bleed into the rest of the markets. I think this time the high-yield debt crisis will have the same result.

Is Corporate Debt the Next Crisis?



So, what should credit unions be doing now? Currently, markets are still quite liquid, but as we witnessed during the crisis, liquidity is a "state of mind" that can change in a heartbeat. Now is a great time to begin to de-risk. Credit unions should strengthen credit quality and reduce and/or avoid marginal/sub-prime credit exposures. In the investment portfolio, credit unions should maintain a disciplined, risk appropriate ladder strategy of high quality investments.

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 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.