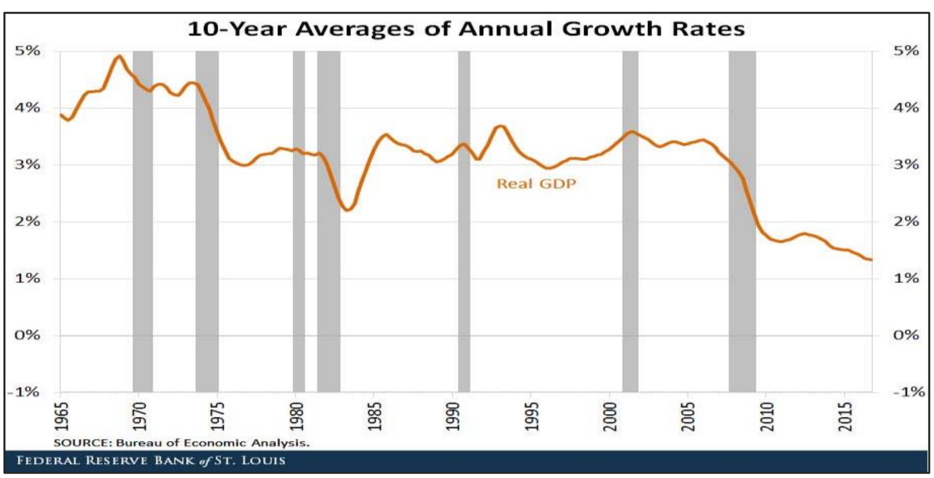
Weekly Relative Value

Can America Return to its Glory Days?

For the past 10 years, we have witnessed the "greatest monetary experiment of all time." The Federal Reserve and all central banks have cut rates to zero and below. The Fed has printed $4 trillion via quantitative easing (QE). G7 central banks have collectively printed the equivalent of $20 trillion in dollars, yen, euro and sterling. On the fiscal side, U.S. government debt has doubled since 2008. In other words, policy makers have pulled every lever possible to generate growth here and now.

Despite the massive monetary/fiscal stimulus, growth this recovery has been the weakest on record. Growth has averaged 2% this recovery cycle versus an average 5% during prior economic recoveries. Prior to the Great Recession, U.S. real (inflation-adjusted) economic growth averaged 3.5%. Many have defined the past 10 years as "secular stagnation" where the private economy – without extraordinary monetary and fiscal stimulus – is subject to slow growth due to declining demand.

The graph below shows the 10-year moving average of growth from 1955 through 2016. (Hence, the first observation in the graph is the first quarter of 1965, and the last is the fourth quarter of 2016.)



Long-run growth rates were high until the mid-1970s. Then, they quickly declined and leveled off at around 3% per year for the following three decades.

In the second half of the 2000s, around the last recession, growth contracted again sharply and has been declining ever since. The 10-year average growth rate as of the fourth quarter of 2016 was only 1.3% per year.

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THIS WEEK...
- What Drives Economic Growth?
- What About Productivity?
- Is a Liquidity Crisis on the Horizon?
- Trump's Trade War

PORTFOLIO STRATEGY

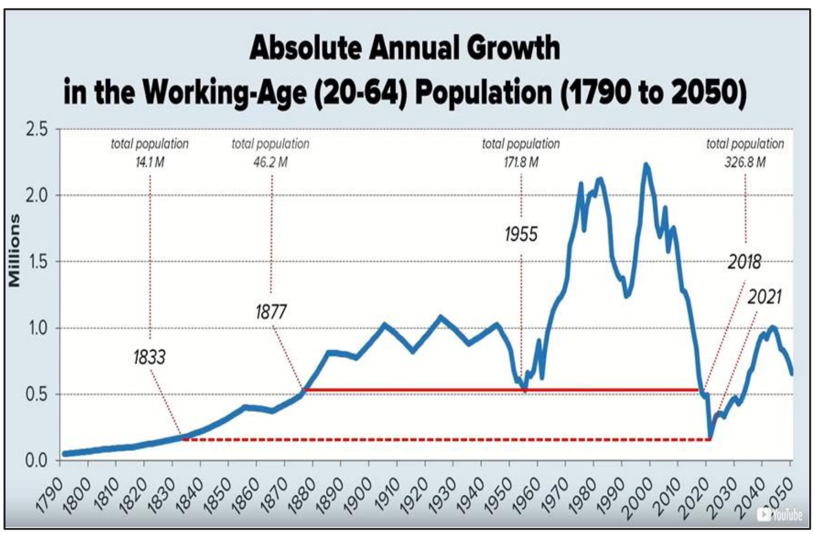
So, as we move forward, inquiring minds are wondering whether the U.S. economy can grow like it used to in its glory days where the U.S. was the economic envy of the world.

WHAT DRIVES ECONOMIC GROWTH?

Economic growth in the U.S. economy is driven by a simple equation: the change in productivity + the change in the labor force = the growth of gross domestic product.

$$\begin{array}{r} \Delta\ \text{Productivity} \\ +\ \underline{\Delta\ \text{Labor Force}} \\ \text{GDP Growth} \end{array}$$

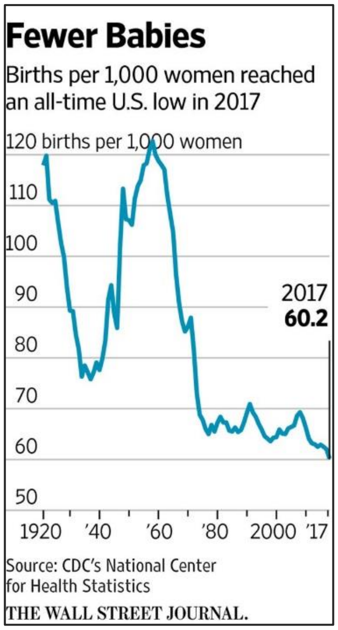
The biggest reason for slower economic growth in recent years is the growth in the labor force, and the demographic trend known as the “baby boom.” As shown below, growth in the labor force hit a post-war high in excess of 3% during the 1970s. It has slowed down to today’s 10-year forecasted growth rate of 0.5%.



Growth will slow even further into the early 2020s as more boomers retire. Looking at the absolute annual growth in the working-age population, the U.S. is headed for a slowdown unlike anything seen since the post-Civil War Reconstruction era of the 1870s.

Consider the basic facts. The official employment rate is now 3.8% – the same level as April 2000. However, over those 18 years, labor force participation among Americans of prime working age (25 to 64 years) dropped by 2.5%. When looking at the details, the labor force participation for U.S. women age 25 to 64 fell from eighth to twenty-sixth among nations in the Organization for Economic Cooperation and Development (OECD). For men, the ranking dropped from eighth to twenty-ninth.

Amazingly, American men experienced the largest decline of any OECD country. Equally amazing, American women were the only female cohort in the entire OECD whose workforce participation fell. Reasons for the declining labor participation include opioid usage, incarcerations, lack of education and a counter-productive social welfare system.



And make no mistake. America is aging rapidly. The year 2000 was the last year in which the entire baby boomer generation was of prime working age, and 2019 will be the first year in which none of it is. By itself, this slowing growth of the workforce will be enough to make a big hole (estimated to be approximately 1%) in economic growth.

Making matters worse, there is no sign of a new baby boom on the horizon. On the contrary, the birthrate reached an all-time low in 2017, continuing six decades of decline. Let's not forget the current administration's anti-immigrant policy, which restricts labor force growth.

The bottom line: Without an increase in the labor supply, it will be difficult to achieve the growth rates realized in the past.

WHAT ABOUT PRODUCTIVITY?

The decline in the labor supply could possibly be offset by a ramp higher in productivity. Productivity is driven by investment in the workforce, research and development, infrastructure, automation and technology.

As shown in the following graph, productivity has slowed over the post-WWII period, and that, combined with the declining labor force, explains the lower economic growth rate experienced in the seven-year recovery since the Great Recession.

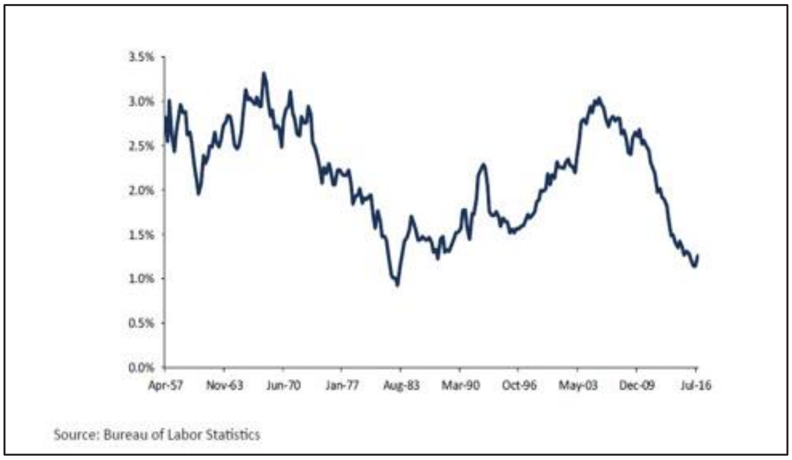
Between 1950 and 1973, productivity grew at 2.4% annually before collapsing to just 0.7% from 1974-1981. It accelerated to 1.7% between 1982 and 1990, and to 2% from 1991-2001. But then, just when analysts began to hail a new golden age of information technology, productivity growth fell to 1.4% in 2002-2007, and to 0.9% during the past decade. I guess Facebook does not increase productivity after all.

If a new generation of robotics and artificial intelligence yields a productivity boom, we could return to the growth of the post-war years. However, I am not willing to bet on it. With or without the deregulation thrust and tax reform, the grim reality is that we have gone through a cycle of share buybacks, and other forms of financial engineering, as opposed to capital spending that could provide any meaningful productivity growth in the years ahead.

Given the expectations around labor force growth and productivity growth, it should not be surprising that the Congressional Budget Office is forecasting that the economy will grow by ONLY 1.9% over the next decade. Visions of 3%

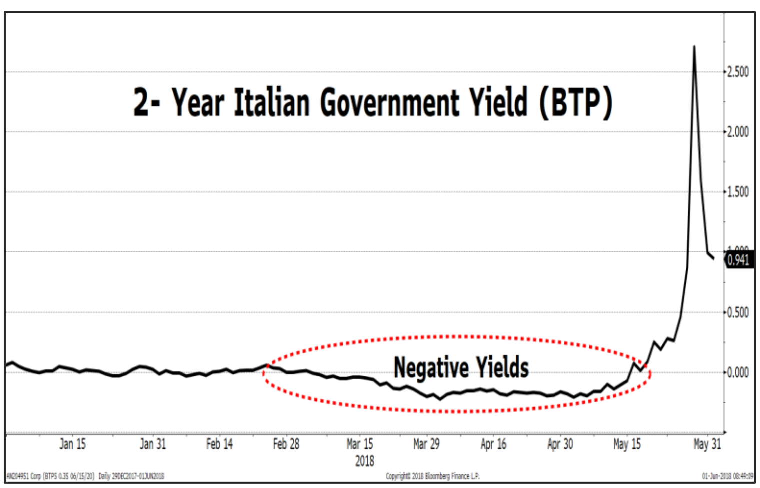
real GDP growth or more, on anything beyond the odd quarterly spasm, are pure fantasy. The only people that really take this number seriously work for the administration. The bottom line is that the economy simply cannot sustain the faster growth rate of previous decades, given today's fundamental growth drivers.

10-Year Average of Productivity



A LIQUIDITY CRISIS ON THE HORIZON?

On the heels of the failed struggle of two anti-establishment parties to form a coalition government (for now), Italian bonds had their worst day in eurozone existence – even worse than any day during the worst periods of the 2011 debt crisis. And this happened even as the European Central Bank (ECB) is carrying out its QE program, including the purchase of Italian government bonds, and even as it pursues its negative-interest-rate policy (NIRP). As shown in the following graph, the spike in the two-year yield was spectacular, going from 0.3% to 2.7% and back to 0.94% in **two days!** Needless to say, this is NOT normal.



Note that until May 26, the two-year yield was still **negative** as part of the ECB's interest rate repression. But here's the thing: Italian bonds – no matter what maturity – should never ever have traded with a negative yield. Their yields should have always been higher than U.S. yields, given that the Italian government is in even worse financial shape than the U.S. government. Italy's debt-to-GDP ratio is 131%, and more importantly, it doesn't even control its own currency.

Is there no default risk? No eurozone exit risk? Of course, there is.

But those bonds trade where they do because the ECB is engaged in QE to a far greater extent than the Fed ever did. As an aside, close to $7 trillion in European and Japanese government bonds still trade with a negative yield. The figure was close to $10 trillion at one point. Once again, that is not normal.

At week's end, calm was restored to the markets for now. However, the recent market volatility is a stark reminder of what can happen when liquidity vanishes. This was the case with the buyers' strike on Italian bonds. And what happened in Italy led to significant market volatility around the world. Thus, the events in Italy should serve as a stark reminder of how radically interconnected the world is. A world, by the way, that is awash in debt.

While Italians made the headlines last week, the story of excess debt and leverage is not confined to the land of lasagna, lemoncello and Lamborghinis. I say this as a citizen of the U.S., whose total public and private debt-to-GDP ratio is over 300%!

TRUMP'S TRADE WAR

"This is dumb… Europe, Canada and Mexico are not China, and you don't treat allies the same way you treat opponents."
– Republican Senator Ben Sasse, Nebraska

Trump has been itching for a global trade war ever since he took office, and last week he confirmed one. The U.S. announced that it will impose tariffs on steel (25%) and aluminum (10%) imports from the European Union (EU), Canada and Mexico.

Besides steel and aluminum, the U.S. administration is studying whether tariffs should be imposed on imported cars and auto parts under the same law that gives Mr. Trump wide authority to erect trade barriers under the banner of "national security." According to newswires, Trump said he would maintain his trade policy until no Mercedes models rolled on Fifth Avenue in New York.

Trump's grudge against the German automaker – and especially against Mercedes models in New York – is not new. In January 2017, prior to his inauguration, he said in an interview: "When you walk down Fifth Avenue, everyone has a Mercedes-Benz in front of their house... But that's not reciprocity. How many Chevrolets do you see in Germany? Not too many, maybe none at all, you do not see anything over there, it's a one-way street."

Trump seems to be forgetting that popular SUV models, such as the BMW X5 or Mercedes GLE, are built in the U.S. – not Germany. Regardless, if Trump wanted a global trade war, he just started one. Hardly surprising, the move has prompted swift retaliatory measures from its three allies. Canada will impose tariffs on $13 billion worth of U.S. imports beginning July 1, Mexico will impose tariffs on U.S. farming and industrial products, and the EU will take "immediate steps to retaliate," which suggests higher tariffs on $3 billion of U.S. imports from June 20.

The Peterson Institute for International Economics (PIIE) says Trump's proposed auto tariffs would throw U.S. automakers and workers under the bus. PIIE estimates Trump tariffs will cost 195,000 to 624,000 jobs depending on how countries retaliate.

	US autos and parts percent change				
	Imports	Exports	Production	Employment	Change in total US employment
25% Tariffs Alone	–5.29	–2.53	–1.50	–1.92	–195,000
Retaliation in Kind	–6.70	–8.80	–3.98	–5.07	–624,000

"Tariffs on steel and aluminum imports are a tax hike on Americans and will have damaging consequences for consumers, manufacturers and workers. I will continue to push the administration to change course."
– Senator Orrin Hatch, chairman of the Senate Finance Committee

As a matter of national security, we allegedly need to harm the U.S. auto sector, consumers and workers?

The problem is that Trump thinks it's easy to "win" a trade war. As a result, he is alienating the U.S. from its allies and friends, in addition to its enemies. He insists on winning by making others lose. No country would ever sign a trade agreement where they willingly lose to let the other side win. There is a chance this ends badly for everyone. In fact, the U.S. could end up isolating itself, while the rest of the world continues to establish more free trade agreements among themselves.

All this will do is raise the cost of living in the U.S. Cars and aluminum cans would rise in cost and U.S. consumers will be taxed with higher prices. And if it's bad for the consumer, it's bad for the economy.

President Trump's threat of stoking a trade war between its trading partners is unsettling. Remember, it was the Smoot–Hawley Tariff Act of 1930 that exacerbated the Great Depression as retaliatory tariffs by America's trading partners reduced global growth. We are in a central bank-induced economic expansion that is now entering the second longest cycle – and nearing the latter innings of the credit cycle. President Trump's proposed trade war with trading partners might not be the best solution this late in the game if history means anything.

This policy is misguided. It would be great if we had a president who would focus instead on controlling government spending, but he is obviously not interested in that.

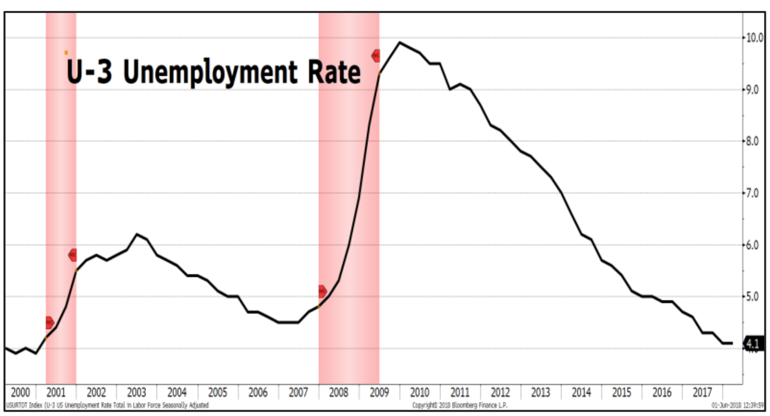
MARKET OUTLOOK AND PORTFOLIO STATEGY

Three cheers for the labor markets!

May headline payrolls rose a healthy 223 thousand, topping expectations of a 190 thousand gain. The number of U.S. full-time jobs rose from 127.7 million to 128.6 million – a 904 thousand increase in one month – offset by a 625 thousand plunge in low-quality, part-time jobs. This was the biggest jump in full-time jobs on record.

The headline U-3 unemployment rate fell further to 3.8% from 3.9%. The Fed's own estimate of the sustainable unemployment rate is 4.5%. Thus, it can hardly be said any longer that there is any slack at all left in the U.S. labor market. The low unemployment rates coincide with the latter stages of economic cycles. The last time the jobless rate touched 3.8% was in 2000.

The Unemployment Rate is as Low as it Gets

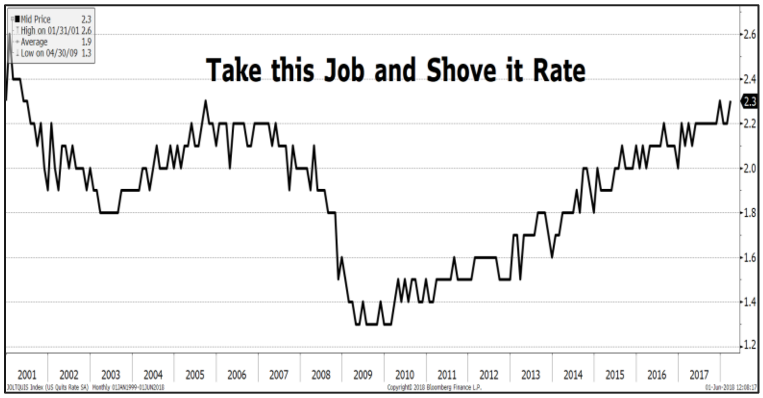


And workers see that their bargaining position has improved, underscored by the sharp run-up in the voluntary "quit rate" to 13.8% in May from 12.7% in April – the classic "take this job and shove it" index. It now sits at its highest level in 18 years.

And it would seem as if these quitters are finding greener pastures. In turn, this is compelling businesses to start ponying up to prevent the turnover pick-up. Average hourly earnings rose an above-expected 0.3% and pushed the year-over-year trend higher to 2.7% from 2.6%.

In fact, the year-over-year wage trend for non-supervisory production workers is now running at +2.8% from +2.6%, and the three-month pace is at a hot +3.6% annual rate. This is a cycle-high for this group, which represents 80% of the jobs pie – so it can no longer be said that wage growth is absent. It's arrived.

Voluntary Quit Rate Soars!



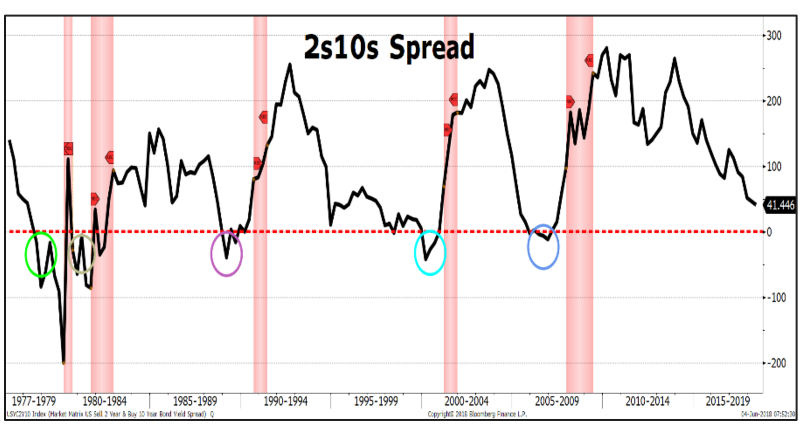
On the inflation front, both the headline and core personal consumption expenditures price index firmed +0.2%, which held the former at +2.0% year-over-year and the latter at +1.8%. Note the core index is up +2.3% year-to-date – comfortably above the Fed's 2% objective. Is the Fed behind the curve?

Make no mistake, the Fed is going to have to raise rates at the June meeting and signal more to come. Another quarter-point hike in the central bank's federal funds rate target (currently 1.5% to 1.75%) is a near certainty at the June 12-13 Federal Open Market Committee meeting. The futures market has priced in just one more rise after that, most likely in September. However, if the Atlanta Fed is anywhere near the ball park on second quarter real GDP – +4.8% – then the Fed most assuredly is going to have to start to pick up the pace

This means a flatter curve and a stronger greenback.

One final note: The yield curve has been the single best predictor of recessions. Every single time the spread between the two-year and 10-year Treasury yield has turned negative, a recession has followed. Today, the 2s/10s spread is ONLY 41 basis points away from inverting. If the Fed hikes two more times and the long end of the yield curve remains relatively stable, we could see an inversion by year-end. This is yet another late cycle warning.

The Most Important Graph in the World



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.