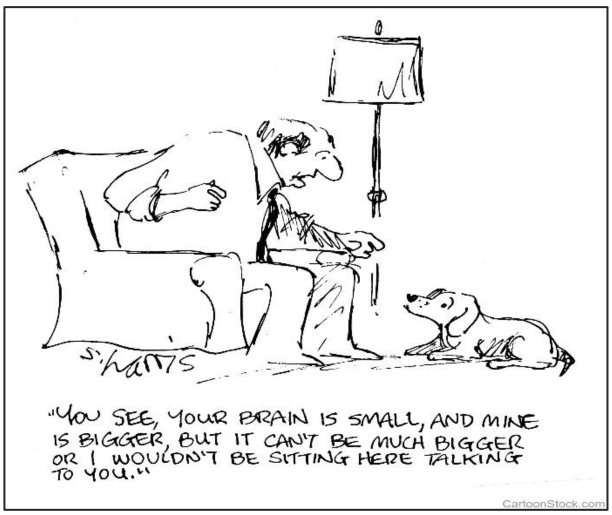
Weekly Relative Value

The Year of the Dog!

The Lunar New Year, also known as the Chinese New Year, started on February 15, 2018 and ushered in the Year of the Dog. According to Chinese astrologers, the dog is a true companion, associated with loyalty, honesty, intelligence and a strong sense of right and wrong. Is it any wonder that dogs are “man’s best friend?” Heck, we humans might learn a few things from our canine friends.



It also appears to be the case that the dog, in addition to being man’s best friend, is smarter than the cat. Researchers at Vanderbilt University put the age-old debate to the test, studying the number of cortical neurons in the brains of a number of animals.

According to their findings, dogs have about 530 million cortical neurons. Cats have less than half that, coming in with 250 million. (We humans have about 16 billion.) Click here to read the complete article.

“I believe the absolute number of neurons an animal has, especially in the cerebral cortex, determines the richness of their internal mental state and their ability to predict what is about to happen in their environment based on past experience.” – Suzana Herculano-Houzel, Associate Professor of Psychology and Biological Sciences at Vanderbilt

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

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THIS WEEK…

- The State of the Housing Market
- Is the U.S. Better Off?
- Trade End Game Scenarios

PORTFOLIO STRATEGY

The findings were published by [Frontiers in Neuroanatomy](), where they noted that the physical size of the brain doesn't necessarily correspond to overall intelligence. For example, researchers found that the brain of a brown bear, while 10 times larger than a cat's, has roughly the same number of neurons. (Raccoons are on par with cats when it comes to smarts.) Regardless, findings show that dogs have the biological capability to do more complex things than cats can.

So, dogs may chew up your best Allen Edmonds, steal a juicy steak off the grill and maybe have an accident, but science has determined once and for all that dogs are significantly smarter than cats. Dogs rule!

Finally, please consider pet adoption. Each year, 2.7 million adoptable dogs and cats are euthanized in the U.S., simply because too many pets come into shelters and too few people consider adoption when looking for a pet.

Consider adoption when looking for a new furry companion – not only will have a new best friend, but you will also save a life!

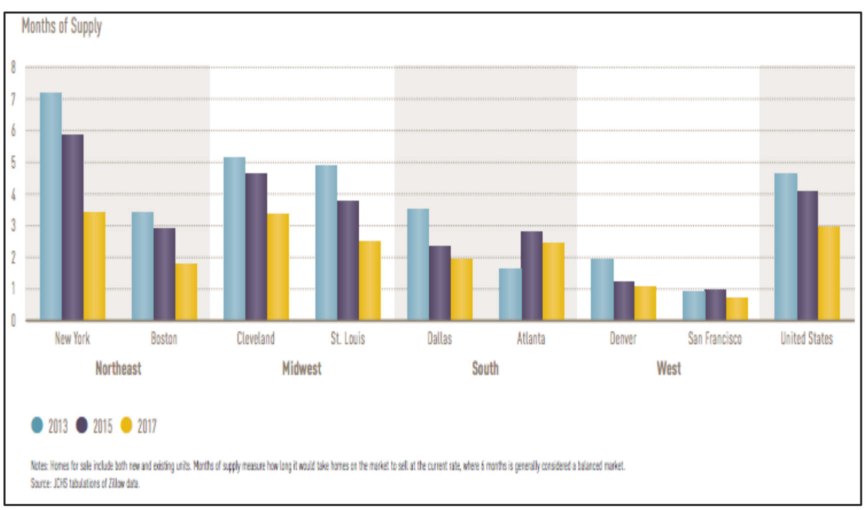
THE STATE OF THE HOUSING MARKET

Another week, another disappointing housing data point. Existing home sales undershot expectations in May – contracting 0.4% sequentially (the consensus forecast was for a +1.1% uptick).

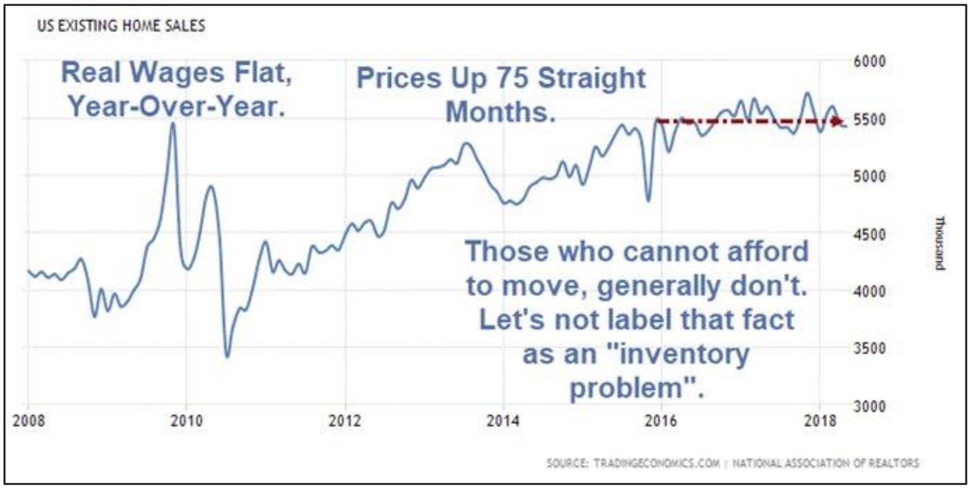
Over the past 12 months, sales have contracted 3.1%. For the year-to-date, that trend is -5.5% (at an annual rate). In fact, existing home sales are now less than 2% higher than where they were three years ago. Call it nearly three years of nothing.

Undoubtedly, the current supply backdrop is a major headwind. In May, there were just 4.1 months of supply at the current sales pace, down from 4.2 months a year ago. This is causing home prices (+4.9% year-over-year) to rise for the 75th straight month of year-over-year gains. The median existing home price for all housing types sold during the month was $264,800 – an all-time high.

Inventories of Homes for Sale Continue to Shrink in Markets Across the Country



To make matters worse, home prices have far exceeded the recent average weekly wage growth of 3.3%. Over a longer period of time, the trend is even more dramatic: Prices have increased 75% nationwide since bottoming in 2012, while average weekly wages have only increased 13% during the same period. How sustainable is this?



ATTOM Data Solutions released its housing affordability report for the second quarter of 2018 and determined that homes are at their least affordable level since the third quarter of 2008.

In fact, somebody earning the average wage wouldn't qualify to buy a median-priced home in 326 countries (roughly 75%) of the 432 counties analyzed in the report. ATTOM determined whether a home was affordable for the average wage earner by calculating the amount of income needed to make monthly mortgage payments, plus property taxes and insurance.

The National Association of Realtors consistently blames the lack of inventory as the problem:

> ***"Inventory coming onto the market during this year's spring buying season – as evidenced again by last month's weak reading – was not even close to being enough to satisfy demand… That is why home prices keep outpacing incomes and listings are going under contract in less than a month – and much faster – in many parts of the country." – Lawrence Yun, Chief Economist, National Association of Realtors***

Month after month, Chief Economist of the National Association of Realtors Lawrence Yun repeats the same nonsense. Supply is not the issue; **supply of affordable homes is the issue.** Sellers cannot get what they need because it will cost them more to move. They are stuck. And due to the legacy of the financial crisis, which left many people in homes they could not afford, many people are thinking twice about moving or upgrading to larger homes. Many buyers simply cannot afford the prices. So, let's not label this as an "inventory problem."

Furthermore, with mortgage rates now rising for a seventh straight month – to 4.59%, the highest since May 2011 – this is another factor weighing on demand from prospective buyers.

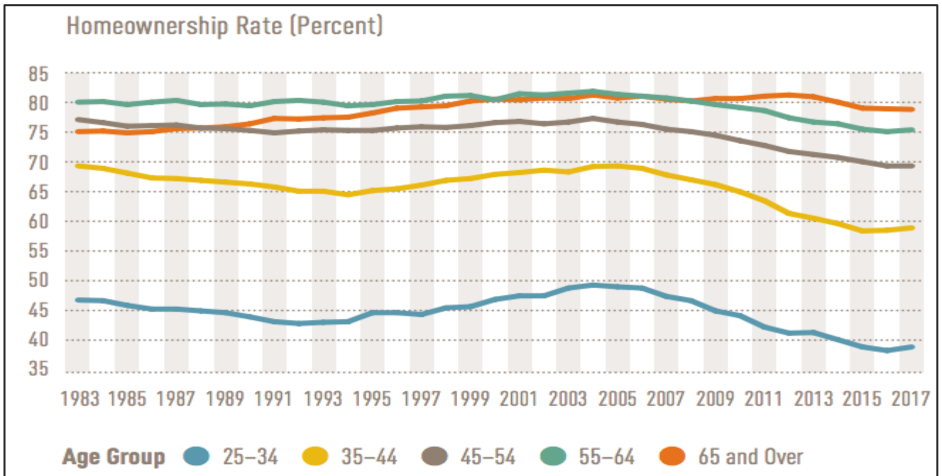
This dynamic of high home prices and rising rates is hitting first-time buyers particularly hard – in fact, they represented just 31% of transactions in May, down from 33% both last month and a year ago. Normally, first-time home buyers would be closer to 40-50% in a healthy housing market. Without this critical buyer cohort providing a bigger lift to sales, it's hard to envision further upside from here.

"Affordability challenges are hurting first-time buyers… [Higher prices are] terrific news for homeowners, but not all Americans are owners…
They're feeling left out by the constant outpacing of home-price growth over wage growth… The housing affordability issue is becoming a crisis."
– Lawrence Yun, Chief Economist, National Association of Realtors

In terms of millennials, homeownership rates are significantly lower than three decades ago, as student debt and the gig economy have severely limited their economic mobility.

If millennials – particularly those living in expensive coastal cities – ever want to afford a home, **housing prices need to substantially correct or personal incomes need to rise quickly.** Otherwise, most will need to rely on help from parents if they ever want to afford a home. **And if they don't have parents capable of helping, well, they may never realize the American dream of homeownership.**

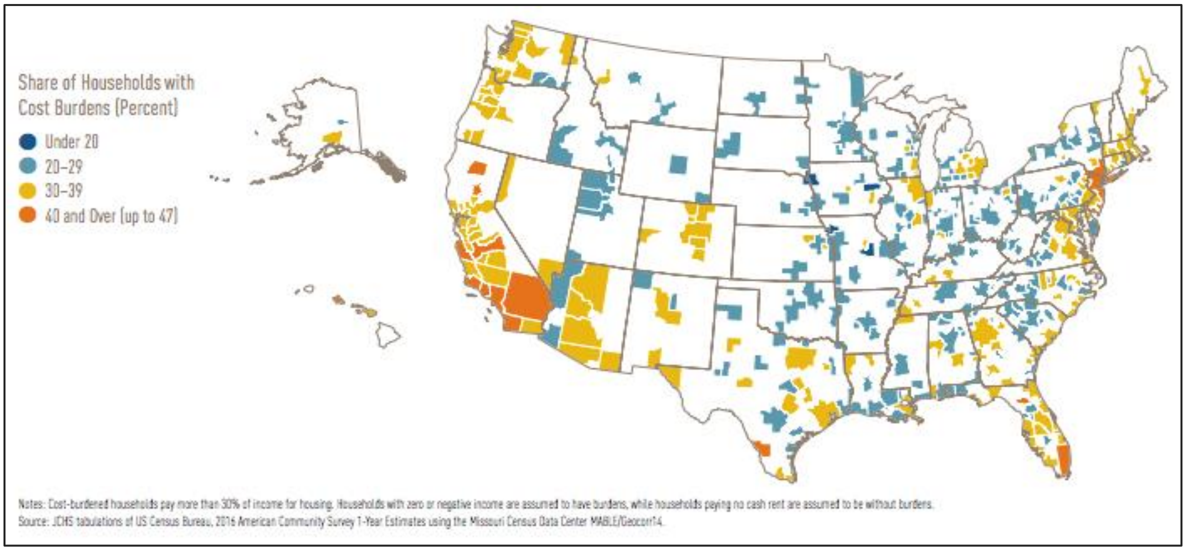
Millennial Homeownership Collapses



Source: JCHS tabulations of US Census Bureau, Housing Vacancy Surveys.

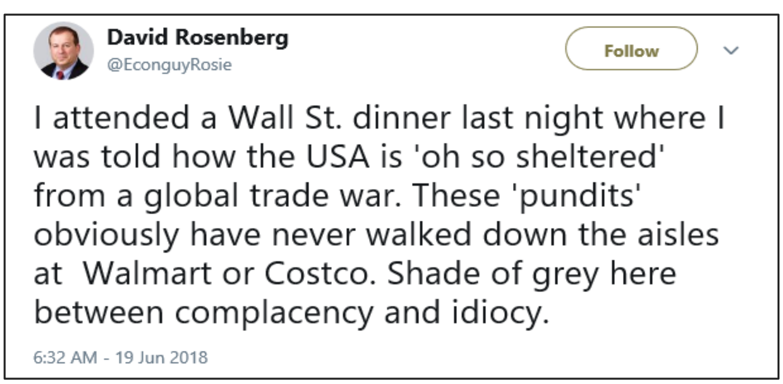
Also, almost 50% of all renters in America are paying more than 30% of their income for housing. Hence, the personal savings rate collapse over the years. In the last 30 years, the national median rent rose 20% faster than overall inflation. Thus, housing costs are crushing personal budgets. Americans are unable to spend money on the basics.

About One-Third of All Households in Most Metros Are Cost Burdened



IS THE U.S. BETTER OFF?

By starting a global trade war that is? This isn't bluster by the way – 25% tariffs on steel and 10% on aluminum already have been imposed. We have already seen what the tariffs so far have done to lumber prices and the housing market. And the Wall street Journal reported that the duties imposed on aluminum have already caused the prices of appliances like washing machines to soar 17% just in the past three months.


David Rosenberg
@EconguyRosie
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I attended a Wall St. dinner last night where I was told how the USA is 'oh so sheltered' from a global trade war. These 'pundits' obviously have never walked down the aisles at Walmart or Costco. Shade of grey here between complacency and idiocy.

6:32 AM - 19 Jun 2018

If other countries start to retaliate in "non-tariff" ways (as China is already threatening to do since it's imports from the U.S. are relatively small), it will be interesting to see how the counter measures by China and the rest of the world start biting into the bottom lines of American companies. U.S. companies make more than $400 billion from their offshore operations. According to the Bank of America, the biggest risk facing the U.S. economy is globalization going in reverse because it has boosted 40% of the rise in S&P 500 margins over the last two decades. This is where the term "the law of unintended consequences" may apply.

On June 18, the White House announced that it would impose 10% tariffs on an additional $400 billion of products from China if intellectual property policies and related issues are not addressed, or if China retaliates. China vowed to retaliate immediately.

Put in context, this would potentially involve tariffs on two successive rounds of $200 billion each. Previously, President Trump had proposed a 25% tariff on a second round of $100 billion in imports from China. This latest proposal amounts to a net $300 billion increase in products affected.

If implemented this would raise the total amount of tariffs the Trump administration has proposed from around $500 billion to nearly $800 billion – or about four times the cumulative amount that had been proposed as of a month ago – before President Trump proposed tariffs on global auto imports on grounds of national security.

Beijing is fully set to retaliate against the new $50 billion in U.S. tariffs on Chinese imports, and Trump already has said he will retaliate right back. This means war. Reports out of China suggest President of the People's Republic of China Xi Jinping is willing to fight this to the end.

This isn't just about China. It is also about the global auto industry, with Trump threatening to impose duties on the $190 billion in cars and light trucks the U.S. imports (including parts) in the name of national security.

The sector accounts for a non-trivial 8.5% share of global trade flows, and the countries hardest hit are Canada, Mexico, Germany and Japan. Canada exports more than $40 billion of cars and parts to the U.S. – the impact here alone drains over 50 basis points from Canadian growth. In conjunction with all the other moves, the White House the lag in Canadian growth could easily exceed one percentage point.

All of capitalism revolves around trade. Now, Trump is making it more expensive.

Disrupting complex supply chains that cross borders poses a bigger threat to global growth than the tariffs' dollar impact. So, you get higher prices, and lower economic activity.

The argument for tariffs usually centers around this: other countries already place them on our goods, so we are just getting even.

Well, you know what they say about an eye for an eye leaving the whole world blind.

Yes, it's a race to the bottom.

TRADE END GAME SCENARIOS

As the Trump administration has emphasized, China cannot match the U.S. by putting tariffs on $250 billion, let alone $450 billion in U.S. exports. The U.S. just doesn't export that much to China.

However, China also could respond asymmetrically, and look toward other levers that it may have over the U.S.

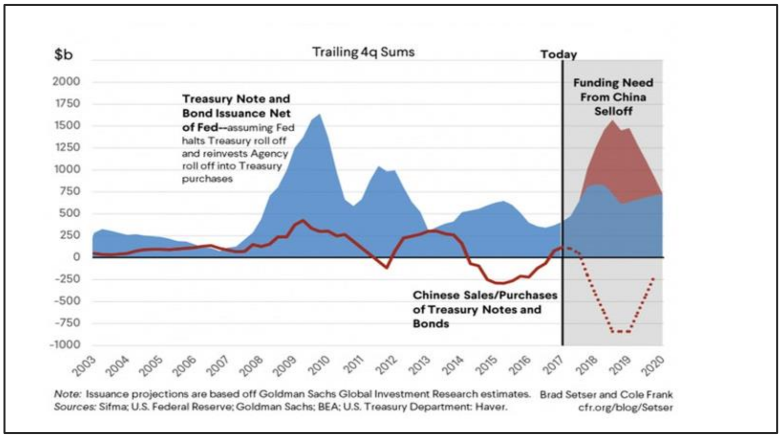
So how will these wars end?

Here are the potential scenarios:

Scenario 1: Treasury boycott. Foreign entities fund half of the U.S. deficit, which is set to double in short order. Imagine if the locals have to fund the fiscal gap. This in turn would force the savings rate up which would negatively impact spending. And a recession would be sure to follow.

Or what if the end-game was a U.S. debt default, which Trump hinted at during the election campaign. U.S. pension funds, insurance companies, banks and households currently own trillions of dollars of what purportedly would be worthless paper down the road.

Chinese Treasury Sell-Off Scenario



Scenario 2: Devaluation with known immediate consequences that are certain to be bad for everybody. China could devalue the yuan enough to counteract the value of U.S. tariffs. Of course, Trump could ban Chinese imports in response, but prices at Walmart, Costco, Target – virtually everywhere – would skyrocket.

Scenario 3: This whole thing could blow over. Trump and China may come to an agreement that brings us back from the brink.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Cycles die, and you know how they die? Because the Fed puts a bullet in its forehead."
– David Rosenberg, Chief Economist and Strategist, Gluskin Sheff + Associates

In the U.S., second quarter economic data looks strong, but there are plenty of indications of weakness, including slowing sales of cars and houses, and a decline in mortgage refinancing. The cumulative effect of interest rate hikes, stagnating real income, and rising oil prices will also weigh on the public's buying power.

On the labor front, the decrease in unemployment is offset by stagnant real wages and the historically low labor-participation rate, let alone that unemployment is mostly a lagging economic indicator.

In the corporate space, the boom in stock buybacks, which in May reached an astounding $174 billion, comes directly at the expense of capital investment that would boost economic growth. A potential global trade war is also detrimental.

In the rest of the world, the picture is even gloomier.

In China, retails sales and fixed asset investment are growing at the slowest pace in years. Fiscal and monetary policy are tightening, in contrast with previous years. Regulation is also getting tougher, and companies are deleveraging under government instruction. The Shanghai Composite Index has already dropped 14% since the beginning of 2018. After all, this is the Year of the Dog!

Japan's economy registered negative growth in the first quarter of 2018, with lower exports and a decline in industrial production. South Korea also is undergoing a major slowdown. Elsewhere in Asia, there are signs that all isn't well in the currency and stock markets, with massive capital divestment reminiscent of the late 1990s.

Europe is operating under its own negative dynamic now. The trade frictions have already shown through in various softer data points. Politically, German Chancellor Angela Merkel is under pressure again. In the U.K., Prime Minister Theresa May is facing a revolt in her own party and it is uncertain what happens to Brexit if there is no trade deal to be had with the European Union. As Greece exits its bailout program, the economy remains extremely fragile and the government debt-to-GDP ratio sits uncomfortably high at 180%. The Italian banking system is in grave danger and potentially could pull down the entire European financial system. And then there's Brexit; the United Kingdom's March 29, 2019 exit from the European Union looms large.

Other major emerging markets also have problems. Brazil, Russia, Argentina and Turkey all have political and economic turmoil.

In a speech last week to a European Central Bank forum, Fed Chairman Jay Powell reiterated that the case is strong for further rate hikes. But he also emphasized the danger from "financial imbalances," rather than inflation, considering that the past two recessions followed market crashes – the dot-com bust of 2000 and the financial crisis a decade ago.

While markets obsess over prospects for further increases in the Fed's key policy interest rates, the reduction of the central bank's holdings of Treasury, Agency, and mortgage-backed securities continues apace. The pace is about to pick up, to a cut of $120 billion per quarter starting in July, from $90 billion in the current quarter. The Fed, by reducing its balance sheet, is effectively draining the punch bowl.

Why should investors care?

The aim of quantitative easing (QE) was to force investors out on the risk spectrum by pushing returns on riskless assets to zero. We must pay attention to what happens when the movie runs backward. Quantitative tightening (QT) ought to do the reverse, reducing the attraction of risk assets versus riskless ones. On that score, that the yield of one-month Treasury bills, at 1.85%, nearly matches the 12-month trailing dividend yield of 1.89% on the S&P 500.

The Fed already has raised rates seven times, but together with the shrinkage of the balance sheet, the net "tightening" has come to over 200 basis points in funds rate terms. The Fed says it wants to do 125 basis points more in traditional terms by the end of 2019, and together with the $1 trillion reduction in the balance sheet by the end of next year, that will mean 225 basis points. So, tallying it all up, by the end of next year, the cumulative de facto tightening this cycle will have amounted to 525 basis points. And markets respond to changes, not levels.

If you don't think a 525-basis-point net tightening is enough to generate a recession, just consider that all it took was 425 basis points from 2004 to 2006 to do the trick. Given that the U.S. economy is almost twice as levered now as then (at $50 trillion of outstanding debt in aggregate), what the Fed does today incrementally has a much larger debt-servicing impact.

In the two prior hiking cycles, tight Fed policies eventually helped burst bubbles, even though those policies appeared relatively benign at the time. History might not repeat, but it often rhymes.

The widespread narrative is that that robust growth and burgeoning inflation will prompt the Federal Reserve to raise interest rates to 3.5% within the next year, pushing the 10-year U.S. Treasury yield, now 2.9%, closer to 4%.

But when I look at the screens I wonder if the market is getting nervous on global growth? How ironic would it be if this is the case?

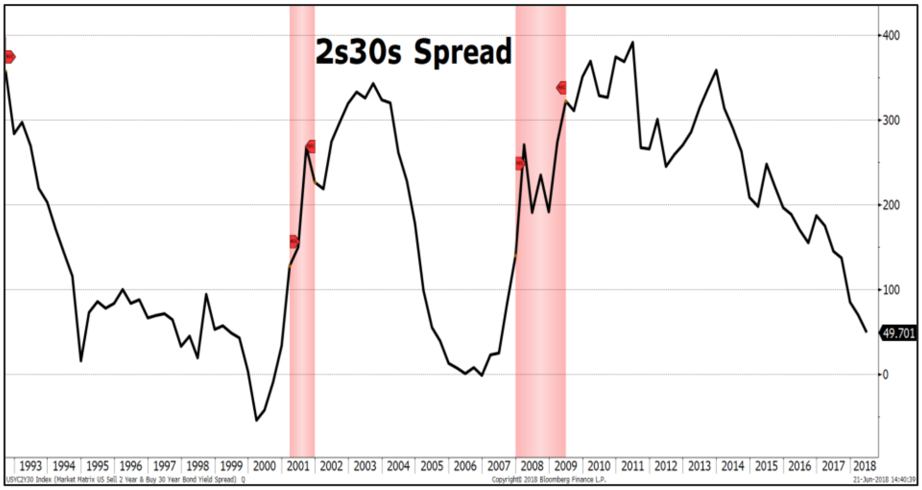
What if June's interest rate hike was the last hike in the current cycle?

If growth is so robust, why is it that the yield on the 10-year Treasury note is range-bound, as it can't seem to move above 3% (which must really frustrate the bond bears and growth advocates seeking validation from the fixed-income market)?

And if growth is so strong, why has the yield curve flattened to levels not seen in a decade. This happened in a week when growth estimates were being ratcheted higher. Many economists are now forecasting over 4% growth in the second quarter. Note: The seven-year/10-year spread is just four basis points away from inverting.

Could it be that the U.S. has reached peak growth?

What if the next major move by the Fed is to lower rates, followed by more QE? That realization will bring about a dramatic change in investors' views and will return U.S. bond yields to the 1.5-2% level. The development, I believe, could be rapid and surprise many. The only issue is, of course, timing.



Given the narrative above, should the market consensus change, the markets and interest rates will adjust quickly, if not instantaneously. As such, we continue to advocate that credit unions maintain a disciplined, risk appropriate laddered strategy with their investment portfolio. Over a full interest rate cycle, credit unions will be rewarded with this tried and true approach.

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.