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WEEK OF AUGUST 20, 2018

Weekly Relative Value

Why Aren't Long-Term Interest Rates Higher?

"It's unbelievable how much you don't know about the game you've been playing all your life."
– Mickey Mantle

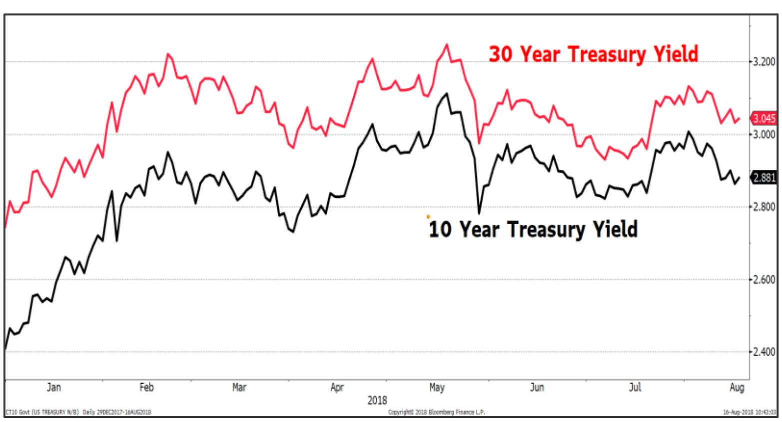
All the talk lately revolves around the economy's "robustness." Some believe we have reached "escape velocity" of over 3% growth and inflation is now rising. According to the Philadelphia Fed's regional report, businesses now see headline inflation averaging 3% annually over the next 10 years – a big move from the 2% expectation in the May survey.

On the monetary side, the Fed has already hiked rates seven times and is expected to hike them two more times this year and four times in 2019. On the fiscal side, the U.S. federal deficits are blowing out and are expected to exceed $1 trillion for years to come. Furthermore, the Fed is expected to continue unwinding its balance sheet to the tune of $600 billion per year.

Yet, the yield on the 10-year U.S. Treasury note yield has risen only 45 basis points since the beginning of the year to 2.85% and the 30-year bond yield has increased only 27 basis points to 3.01%. Is this what they call a bear market in bonds?

Then why aren't rates higher – much higher?

Have Long term Rates Peaked?



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THIS WEEK…

- What Drives Growth?
- Peak Housing
- Peak Autos
- Peak Global GDP Growth
- And What About the Fed?
- Why are Grandpa and Grandma Bankrupt?
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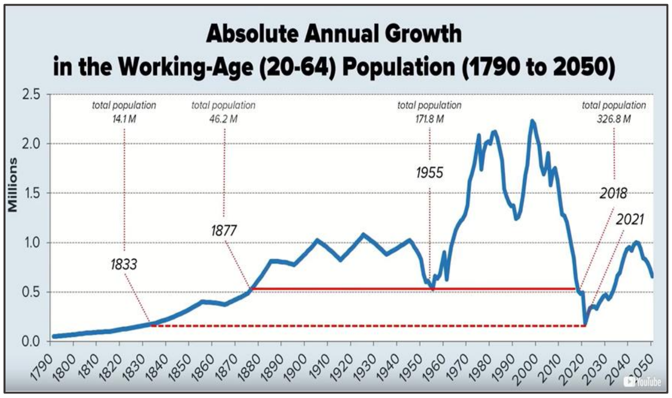
PORTFOLIO STRATEGY

WHAT DRIVES GROWTH?

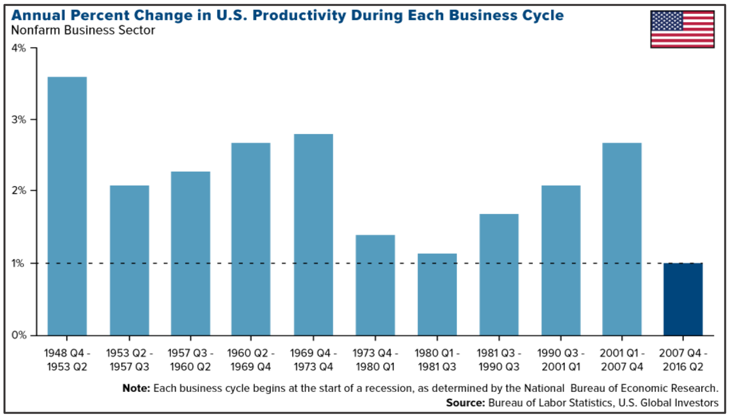
Growth in the U.S. economy is driven by a simple equation: The change in productivity plus the change in the growth of the labor force equals the growth of the gross domestic product.

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 baby boomers retire and reduced immigration hinders labor force growth. 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. Simply put, less growth in the labor force goes a long way to explain why growth in the economy is slower.



The other half of the equation – labor productivity – has slowed over the post-World War II period and is now running only 0.7% on average this decade. This metric, combined with slowing labor growth, explains the lower economic growth rate experienced in the seven-year recovery since the Great Recession.

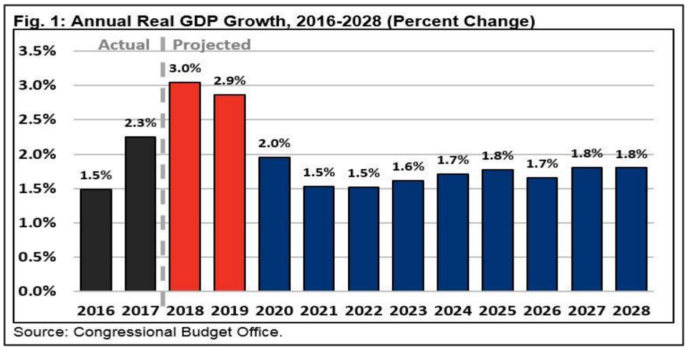
The bottom line is, the economy simply cannot sustain the faster growth rate of previous decades, given today's fundamental growth drivers.



Don't be fooled by the current economic "sugar high!" As we have discussed, short-term growth gets a boost from the debt-financed tax cuts and spending, but it does NOT reflect secular trends.

If, in fact, long-term growth is a function of the growth in the labor force and productivity, then the U.S. government's projections of 3-4% GDP growth over the next decade appear to be completely unrealistic. And, as shown below, the Congressional Budget Office (CBO) expects growth to return to sub-2% from 2020-2028.

My Take: I have been asked how do we achieve strong sustainable growth? I believe we need to pursue pro-growth strategies to increase the labor force, promote productivity, support investment, and encourage innovation and fiscal discipline.



PEAK HOUSING

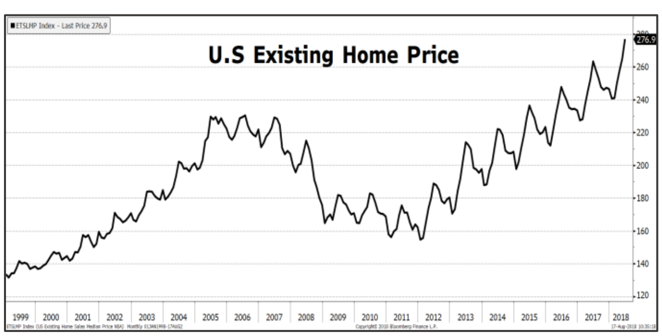
"For the first time in years, we are getting reports from managers of some markets that homebuyer demand is waning, especially in some of Redfin's largest markets." – Glenn Kelman, Redfin CEO

With mortgage rates at a seven-year high and the average home price at a record high, mortgage applications fell 2% in the latest week's data and are now down for the fourth consecutive week. Refinance applications also fell by 4.5% week-over-week and 35% year-over-year. This index stands at the weakest level since December 2000. This follows new home sales, existing home sales, and housing starts reflecting a plateauing in the pace of transactions.

From my perch, a combination of sky-high home prices (which in many areas of the country are back above the cyclical highs of the mid-2000s) and rising mortgage rates are squeezing home affordability, and peak housing is upon us.

To gauge the underlying trend in the residential construction sector, simply focus on the six-month pace of housing starts – which have collapsed at a 23.3% annual rate. If the housing recession is here, the economy is likely not that far behind.

Have Home Prices Become Unaffordable?



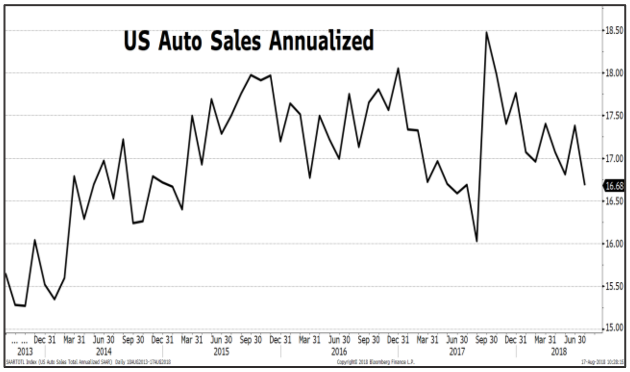
PEAK AUTOS

"Plans to buy an automobile exhibited the weakest back-to-back showing in over five years." – David Rosenberg

"Auto sales in the last month will underscore investor fears that auto sales have peaked and that, without ever higher incentives to keep consumers interested, demand will continue to soften." – Bloomberg

U.S. auto sales for the month of July were reported at 16.7 million (seasonally adjusted annual rate). That's the weakest July data in four years.

Peak Auto?



And it would appear that auto sales are going to get much worse in the year ahead.

Despite stagnating real personal incomes and large household debt loads, the proliferation and the popular extension of subprime auto debt ("a dollar down and off to the races" and the perpetual extension of loan maturities) and large auto price incentives have served to lift car sales over the last few years well above replacement needs. For several reasons, the favorable gap previously seen between auto sales and replacement needs is likely to reverse over the next few years.

Most importantly, with interest rates rising and likely to rise further, it is getting prohibitively expensive for manufacturers to offer incentives and deals tied to loans, so the consumer will be faced with fewer discounts on new cars. Indeed, J.D. Power reports that for the first time in almost five years, the auto industry recently has cut back spending on incentives.

Perhaps the most significant is the record level of new and used car loans for average vehicles (at $31,100 and $19,500, respectively). But, as rates rise, so do monthly payments – on average, $515 per month on new vehicles, which is stretching affordability for most borrowers. Meanwhile, the average loan terms of 69 months for new cars and 64 months for used cars are also likely stretching limits.

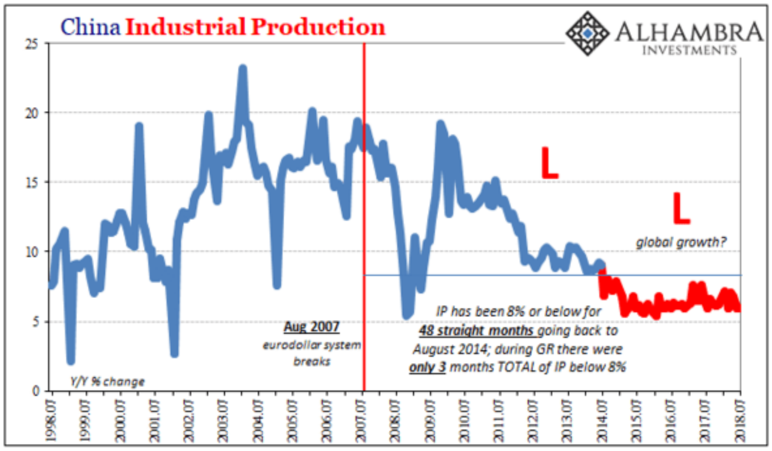
Banks and other financial institutions are seeing the risks and are aggressively slashing their auto loan origination activity, leaving captive original equipment manufacturer (OEM) finance companies to fill the void.

If so, look out below, and brace for a sharp fall in auto industry sales over the next year.

PEAK GLOBAL GDP GROWTH

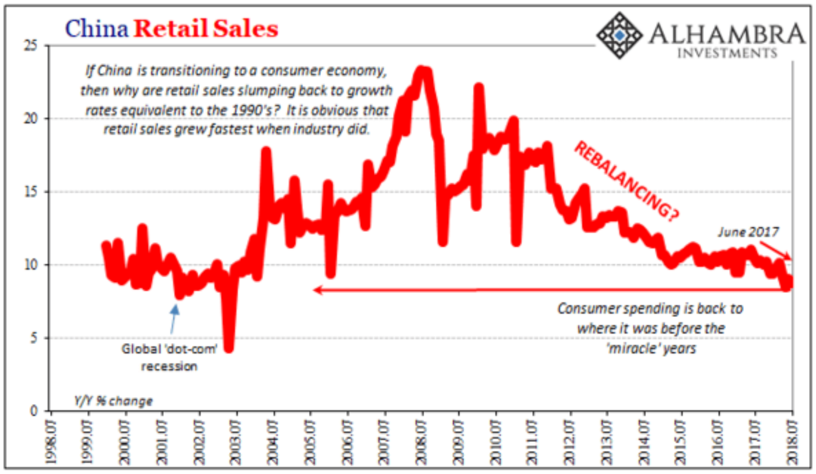
Weakening auto and home sales are not outliers. Those two sectors tend to lead the U.S. economy. Therefore, I believe first quarter GDP in the U.S. was PEAK growth for this cycle.

Not only are we facing peak GDP in the U.S., but also peak GDP growth globally, as witnessed by a two-year low in Citigroup's European Economic Surprise Index and grim statistics in China. China's industrial production (IP) has declined steadily; July makes four straight years of IP at 8% or less, a level which used to suggest global economic cancer. It still does, only economists refuse to believe it.



Retail sales, like IP, have been slowing since last year. The last time retail sales growth was less than 10% for any length of time was 15 years ago, before the full weight of China's economic miracle.

It was only seven months ago that synchronized global growth was the buzz.



Bottom Line: While bulls are anticipating acceleration in the rates of U.S. and non-U.S. economic growth, the reality is, based on recent high-frequency economic data, the U.S. and global economies are slowing in its trajectory.

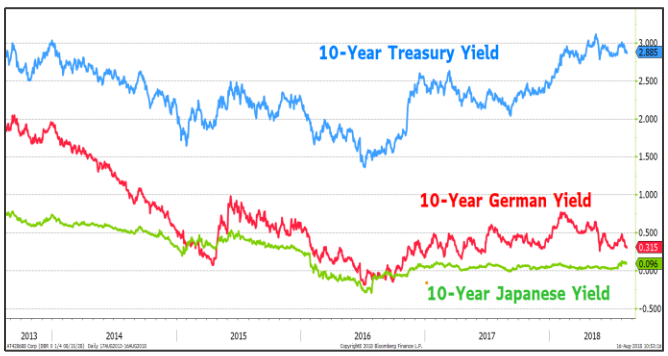
AND WHAT ABOUT THE FED?

“But the Fed is hiking! Shouldn’t long-term rates reflect the tighter policy?” The further out the yield curve, the less that Fed action affects yields. Over the entire post-World War II era, a 100-basis-point rise in the federal funds rate resulted, on average, in a 44-basis-point hike in the 10-year Treasury note yield, but only a 24-basis-point rise in the 30-year bond yield. In other words, the long end of the yield curve has discounted the Fed moves.

Don’t forget that foreigners love U.S. government obligations because of their safety and attractive yields relative to their own sovereign debt. The 10-year Treasury yield of 2.88% compares with only 0.31% for the 10-year German sovereign, 0.09% in Japan and -0.04% in Switzerland. In fact, the U.S yield spread is positive versus 15 other developed countries’ sovereign debt markets. With the dollar appreciating, foreigners also receive a positive currency translation to boot.

So long as German bunds are pinned to 0.3% and Japanese Government Bonds are less than 0.1%, then there is a firm ceiling on where U.S. longer-term yields can go. Remember, 3% has been major support every step of the way.

The U.S. is a High Yield Market



Meanwhile, everyone is on the same side of the boat. In other words, everyone’s bearish! Big bank and hedge fund positioning reveals an overwhelming majority of Wall Street is short on Treasury bonds. In other words, they expect long-term rates to rise. Meanwhile, rates are falling. The 10-year Treasury yield has fallen 27 basis points from its May high of 3.12%.

CFTC data shows that Treasury bears are running record-short for 10-year Treasury futures. They may be disappointed. Historically, the speculative positioning data works well as a contrary indicator. There’s plenty of potential demand for longer-term Treasuries if the bearish speculators get squeezed. Hence, in the absence of a major shock (like a jump in wage inflation) I'm more than happy to be on the other side of a growing bearish consensus.

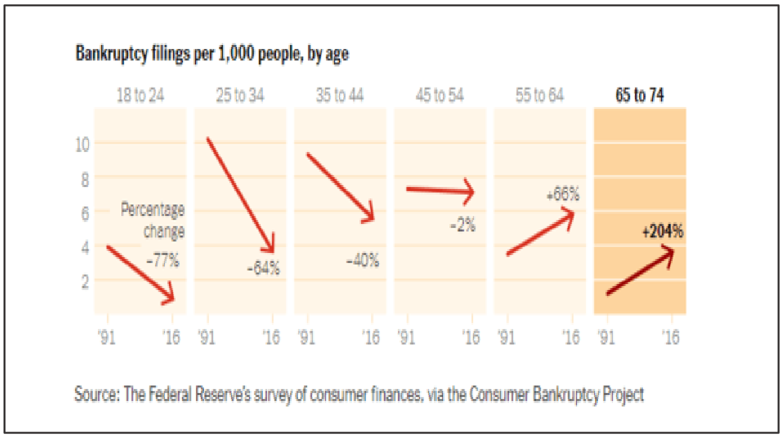
As discussed above, there are numerous fundamental and technical factors that explain why interest rates are not skyrocketing higher. Yet, most economists and pundits still believe we are in a bear market in bonds. But hey, this is nothing new. For the past 15 years, Wall Street economists have predicted that long-term rates would be higher by year-end. In each of those 15 years, they have been proven wrong by Mr. Bond.

As an aside, I am frequently asked what the bond market can see that the stock market doesn't see. Well, maybe they see renewed economic slowdown past the fiscal juice. With over 35 years in this business, I have learned that the bond market typically gets the story right.

WHY ARE GRANDPA AND GRANDMA BANKRUPT?

"Bankruptcy can offer a fresh start for people who need one, but for older Americans it is 'too little too late'… By the time they file, their wealth has vanished and they simply do not have enough years to get back on their feet."
– Study by the Consumer Bankruptcy Project

A recent bankruptcy study led by four esteemed academics – Professor Deborah Thorne, Professor Robert M. Lawless, Professor Pamela Foohey and Professor Katherine Porter – found that personal bankruptcy rates have declined for virtually every age bracket under 55. However, the rate of bankruptcy for Americans age 65+ has sextupled from 2.2% to 12.2%.



The causes of the dramatic increase in bankruptcies are:

- First, and foremost: Stagnating income and wealth inequality.
- The elimination of employer-provided health insurance. This is obviously a huge risk for anyone under age 65.
- The shift from “Defined Benefit” to “Defined Contribution” pension plans. Sadly, many of these DC plans are often hollowed out before retirement by life’s unexpected events (i.e. divorce, health bills, or paying for the kids’ college loans)

Oh, and let’s not forget that four letter word- ‘d-e-b-t’, especially mortgage debt.

To wit: In 1991, only 28% of homeowners age 60-64 still had mortgages. Today, 60% do. And the boomers are a generation of worsening economic trends, first birth cohort to last. Thus, we may not have seen the worst of what may come over the next decade. “The people who show up in bankruptcy are always the tip of the iceberg,” said Robert M. Lawless

LET’S TALK TURKEY

Turkey’s currency is in free fall, its stock market is plunging, and interest rates are spiking. But it’s safe to assume that most people don’t understand exactly what’s causing this chaos, why it’s happening now, or what “external dollar debt” has to do with it**.**

So, here’s a quick primer.

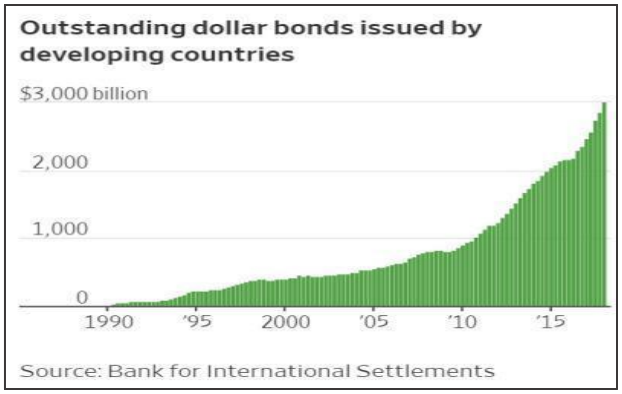
Pretend for a second that you’re Turkey. Your economy is in pretty good shape and, because of this, people are willing to lend you money. Your internal domestic rates are around 6%. But when you look overseas you notice you can borrow in U.S. dollars for around 2%. So, you borrow (issue debt) in dollars. In fact, Turkish banks and businesses borrowed hundreds of billions of U.S. dollars and euros to fund a domestic construction boom in the years after the global financial crisis.

So far so good, but then the turn comes.

The dollar appreciates sharply, and it becomes much more expensive to service the U.S. dollar denominated debt. And it’s not just a strong dollar; Turkey has gotten hit by the separate collapse of its own currency.

This is the key point. A country like Turkey can destroy its own currency and, thus, diminish the burden of its local-currency debt – but it cannot do this with foreign-currency debt. Instead, the reverse is true: foreign-currency debt becomes more burdensome. This creates a vicious cycle; as this debt becomes more difficult to service, the default risk rises, and foreign currency investors are then even more inclined to stay away, leading to more capital outflows, and making it nearly impossible to refinance and service that debt – thus speeding up the trip to a default.

While the headlines are in Turkey, it should be noted that many emerging market economies have issued debt in U.S. dollars. The period between 2008 and 2017 (during which this surge in foreign-currency debt occurred in the emerging markets) happens to be the era of experimental monetary policies in the U.S., Europe and Japan that entailed an enormous amount of money-printing to artificially repress interest rates – in other words, cheap debt. These experimental monetary policies had the express purpose of encouraging a debt-fueled binge of consumption and investment. That is now in the past, and what remains is the hangover – the debt that these countries cannot control or inflate away. It's a vicious cycle, kicked off by cheap debt that's suddenly not cheap, after eight years of experimental monetary policies.



Make no mistake, the key to the current turmoil in Turkey is Fed tightening and the strong dollar. The Fed always tightens until something breaks. And when the liquidity tide goes out, we always find out who is swimming naked. If it hadn't been Turkey, it would have eventually been someone else. As I have highlighted repeatedly, since 1950 we've seen 13 Fed tightening cycles, 10 of which ended in a recession and the others usually saw a financial crisis.

Let's face it, virtually everybody knew this was coming. But in the frantic quantitative-easing-inspired hunt for yield, no one cared. This is always the problem while liquidity is washing through the financial markets because of loose monetary policies. Investors, drunk on the elixir of free money, think the good times will roll on forever.

Of course, it's not only Turkey and emerging markets that are at risk of blowing up if the Fed keeps tightening (and the European Central Bank and even the Bank of Japan decide to join in). So many financial markets are surfing high on the tsunami of liquidity that has flooded the world over the last decade. This extends to corporate bonds, equities and real estate prices. It is a global "everything bubble."

The key to whether the "risk dominoes" will continue to fall is the Fed tightening cycle. I repeat, 10 of the last 13 Fed tightening cycles have ended in recession.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Data-wise, this week appears relatively sparse. New and existing home sales data for July are the key U.S. economic reports. Elsewhere, the minutes from the recent Fed and European Central Bank meetings will be released on Wednesday and Thursday, respectively. To cap off the week, we have the annual Jackson Hole Economic Policy Symposium, where Fed Chair Jerome Powell will speak on Friday. Occasionally, this get-together offers signaling of a major policy shift, but there's no indication that it will this year. Nevertheless, it is still worth watching. We also expect to see plenty of headlines regarding the restarting of U.S./China trade talks at the end of the month.

In terms of portfolio strategy, we continue to advocate a fully invested, risk appropriate diversified ladder strategy.

Can't Miss Opportunity: The ALM Workshop – Registration is Now Open!

The Asset-Liability Management (ALM) Workshop is coming to West Covina, CA on Thursday, September 27, 2018. This one-day event will provide ALM insight and analysis from our team of experts, helping you gain a better understanding of interest rate risk, net economic value, net interest income and more! Plus, take advantage of up to 7 CPE credits.

View the agenda and register at www.balancesheetsolutions.org/almworkshop2018.

MORE INFORMATION

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.