BALANCE SHEET SOLUTIONS
an alloya company

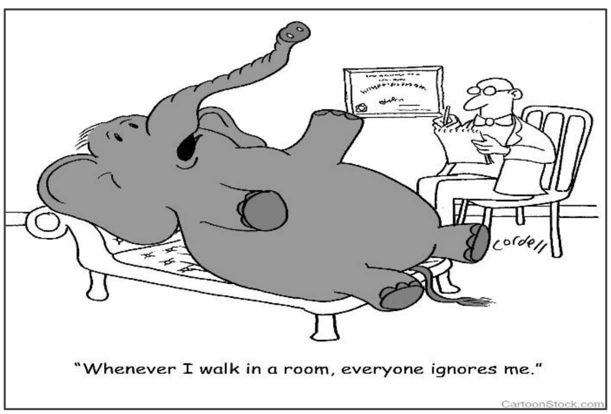
WEEK OF SEPTEMBER 24, 2018

Weekly Relative Value

Can You Handle the Truth?

I realize that many people would prefer to talk about and highlight only the positive news when discussing the economy or markets. No "negativity" or "reality" required. I get it. Good news makes us feel good.

However, as most regular readers will undoubtedly attest, I have devoted much of this space to uncovering and identifying the risks that could negatively impact the economy and markets. Given that we are all in the risk management business, we should always understand what can go wrong. Let's face it, the good news will take care of itself. Remember, it's always the bad news that tends to get us in trouble. I believe a weekly "dose of reality" is the right prescription.



With that, let's take a look at a few "truths" in today's economy and markets:

1. We have never before witnessed a period where the government engaged in deficit-financed tax cuts AND rampant spending growth with the economy expanding, let alone past the point of being at full employment. As DoubleLine Capital LP founder Jeff Gundlach recently stated, "Now Keynesian seems to mean you stimulate all the time." Of course, while so-called **"conservative fiscally responsible Republicans"** are breaking their arms to pat themselves on the back for **getting the economy going again,** the reality is they have likely doomed the economy to another decade of sluggish growth once the short-term burst from massive deficit spending subsides. The unbridled surge in debt and deficits is set to get materially worse in the months ahead as real revenue growth slows.

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

SUBSCRIBE

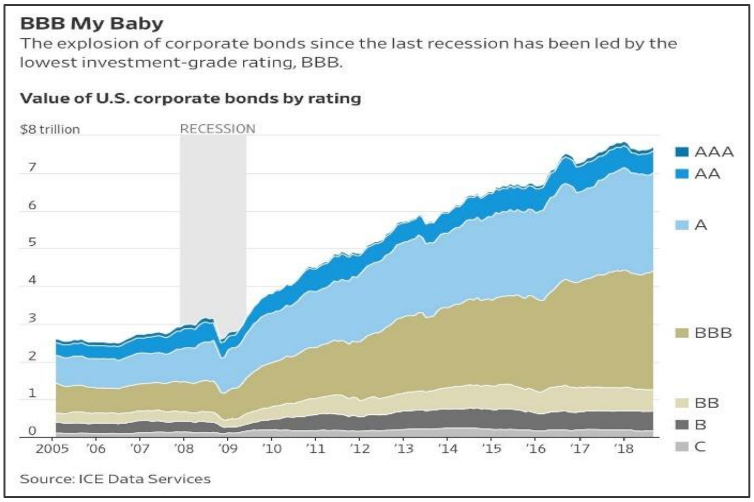
THIS WEEK…
- It's Good to Be King
- Why It Matters
- The Threat of a Trade War

PORTFOLIO STRATEGY
- Why Higher Rates Matter

2. Corporate tax payments are down a whopping 40% from a year ago because of the fiscal stimulus. At the same time, government spending has increased 30% year-over-year. Is it any wonder that the economy has had a nice bump? But the sugar-high will wear off and the bill will come due. The Office of Management and Budget (OMB) projects debt to rise by $10 trillion over the next ten years. The Congressional Budget Office (CBO) is forecasting a $12.5 trillion increase – but what's a couple of trillion dollars between friends? The cost of servicing this ever-burgeoning debt load is projected to rise about five percentage points – to nearly 13% – in ten years' time. So much for U.S. Treasury Secretary Steven Mnuchin's ridiculous assertion that *"not only will the tax cut pay for itself, but it will pay down the debt*." (What a laugh!) It would be all too funny if it weren't so sad, as the U.S. budget deficit rapidly approaches the trillion-dollar mark. Make no mistake, there will be a price to pay for this generosity down the road.

3. The $21.5 trillion national debt will continue to expand. It's true that the U.S. will never default because the U.S. has the reserve currency of the world, along with a gigantic printing press and free ink. But, the Treasury supply binge will pressure interest rates and end up crowding out private sector funding. By forcing borrowing costs up, the Trump deficit contributes to rising interest rates. That makes it harder for working families to buy homes and cars.

4. According to an op-ed titled "*Get Ready for the Next Financial Crisis"* in the Wall Street Journal, total debt (government + corporate + household) has soared 75% across the planet. Sovereign debt has more than doubled from $29 trillion to $60 trillion. Corporate debt – much to finance a wave of merger and acquisition activity and record share buybacks – has skyrocketed 78% to an incredible $66 trillion. Non-financial bonds outstanding having exploded 172% in the past decade – from $4.3 trillion to $11.7 trillion. The highly leveraged balance sheets have forced 40% of the U.S. corporate sector into BBB status, or one notch away from "junk."

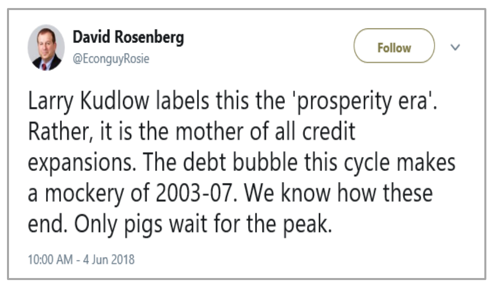


5. In its latest quarterly report, the Bank of International Settlements (BIS) discusses *"The Rise of Zombie Firms: Causes and Consequences."* So-called "zombie firms" are firms that are unable to cover debt-servicing costs from current profits over an extended period. Globally, the number of zombie firms is over 12%. In the U.S., the number approaches 15%. Zombies weigh on economic performance because they are less productive and because their presence lowers investment in, and employment at, more productive firms. Tesla is an example of a zombie firm. If and when Tesla and other zombie corporations are unable to roll over debt, they will immediately go bankrupt.

The following is an excerpt from the aforementioned Wall Street Journal op-ed, *"Get Ready for the Next Financial Crisis."*

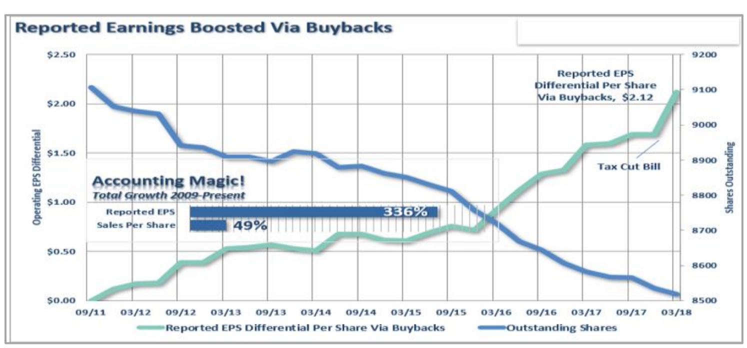
> ***"This is what zero interest rates and quantitative easing have wrought – more debt and lower credit quality.*** *Yield-starved majority of which is scheduled to be refinanced in the next eight years, disregarding the additional $1 trillion required by the 2017 tax reform and an estimated $100 trillion of unfunded entitlement spending ahead. The Fed still owns $2.324 trillion it bought from banks as part of quantitative easing, which will need to be refinanced at maturity. Foreign sovereigns own $6.5 trillion, 40% of which is in the hands of China, Japan and Saudi Arabia. China and Japan are increasingly refinancing their own debt... the European Central Bank's anticipated policy normalization suggests Europe too will be competing with the Fed for buyers in sovereign refinancing markets... cautious as the Fed may be about raising short-term interest rates, and even should economic growth naturally slow as the one-time spike of fiscal easing subsides, supply-demand dynamics suggest the "belly" of the U.S. Treasury curve is headed higher...* ***when credit turns, stocks have never been far behind. The longest-ever bull market may be closer to ending than we think – and that could be the least of our problems."***
> – Daniel J. Arbess, CEO of Xerion Investments.

To the final point highlighted, the swaths of businesses falling due to debt excesses are likely to spark highly problematic social consequences. As recently espoused by billionaire investor and hedge fund manager Ray Dalio, the next recession will happen with income and wealth disparities at their highest levels ever, and the unrest will likely be a tad more forceful than the well-behaved Occupy Wall Street movement was. Chief economist and strategist for Gluskin Sheff + Associates, David Rosenberg, succinctly summarizes the situation:



Finally, as David Rosenberg pointed out last week, when you strip out the one-time gain from the tax cuts, full-year depreciation expensing, and the huge share buybacks, while also looking at "all" U.S. companies on a pre-tax basis (not just the S&P 500) you get essentially zero year-over-year profit growth in the second quarter. Wow! In other words, the profit surge of the second quarter was a mirage. Don't be fooled by the earnings landscape and the stock market. It is the classic Potemkin rally.

Potemkin Earnings?



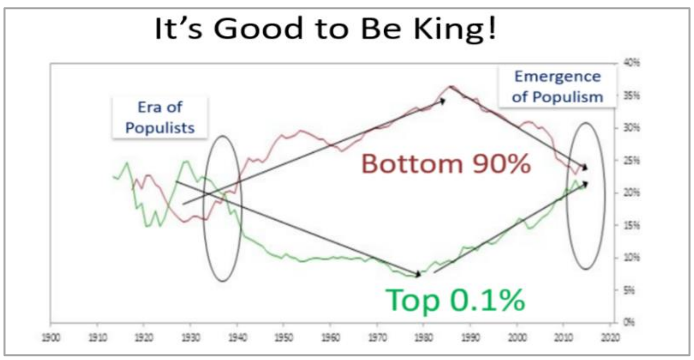
IT'S GOOD TO BE KING

What's better? A trillion-dollar economy where one person has a trillion dollars buried in his backyard, or where everybody has $10,000 and is scrambling to buy stuff from each other?
The economy is a flow, not a stock.

Congratulations, America! According to the latest Flow of Funds report, **the net worth of U.S. households rose to an all-time high $106.9 trillion** as a result of rising real estate values and financial assets like equities, mutual funds and pension funds, as the market soared to just shy of new all-time highs in the second quarter.

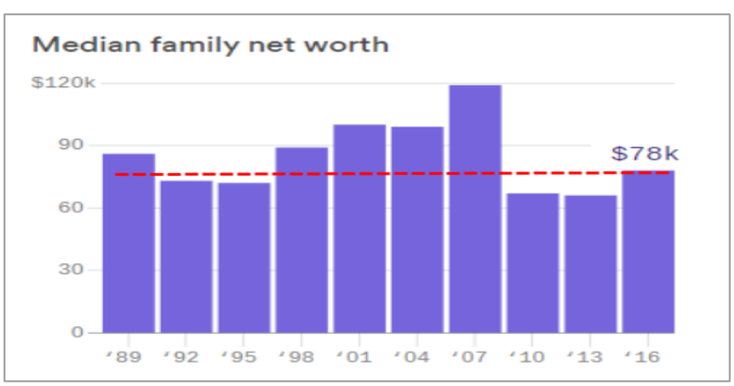
But here's the catch: virtually all the net worth, and associated increase thereof, has only benefited a handful of the wealthiest Americans.

As the following chart shows, the wealth inequality in the U.S. is now just as bad as it was during the Great Depression, with the top 0.1% of the U.S. population owning as many assets as the bottom 90%.



In the CBO's latest report on "Trends in Family Wealth," <u>just 10% of the U.S. population owns roughly $93 trillion of all U.S. assets</u>, while half of the U.S. population has virtually no wealth and, if anything, is deeply in debt.

As shown below, median net worth is below where it was in 1989. But perhaps the most **shocking stat of all is that, on an inflation-adjusted basis, net worth may be the worst in history.** Let's face it, **$78,000 is not worth what it was in 1989.**



On the income side of the ledger, nobody has experienced the same cumulative growth in after-tax income as the "top 1%." Real wages for most U.S. workers have increased little if at all since the early 1970s, but wages for the top 1% of earners have risen 165%, and wages for the top 0.1% have risen 362%.

And there – quarter after quarter – is your "recovery." The wealthy have never been wealthier, while half of America, some 50% of households, owns virtually zero wealth, and America's poor have never been more in debt.

WHY IT MATTERS

Inequality, in addition to creating political and social unrest, is slowing U.S. economic growth by shifting an ever-larger share of income to rich households that save rather than spend. Middle class to poorer people spend more of their income, so if they get less of the pie, that implies lower consumption and a weaker economy. In fact, the Economic Policy Institute (EPI) estimates that rising inequality has slowed growth in aggregate demand by 2-4% of GDP annually in recent years.

Faster wage growth for low- and middle-wage workers is the solution. In the longer run, we need to stop or reverse rising inequality by enacting policies that spur faster wage growth for low- and middle-wage workers. Raising these workers' wages would not only raise living standards for American families, it would also ensure robust economic growth.

THE THREAT OF A TRADE WAR

Last week, JPMorgan Chase CEO Jamie Dimon commented that we are in a trade "skirmish," not a trade "war." But, this is just a case of definition. After all, the Merriam-Webster definition of "skirmish" is: *"a minor fight in war usually incidental to larger movements."*

Over the weekend, in response to Trump's imposition of more tariffs, China responded with tariffs of its own and walked out of talks. As long as Trump is escalating trade wars against China, and the rest of the world too, there is nothing to be optimistic about. China is not about to back down and lose face.

But I believe the threat of a trade war is best encapsulated in the following comments:

> ***"Trump is doing everything he can to bring on the end of the days when the U.S. can borrow whatever it wants in whatever amounts it wants.*** *To be sure, there is no recipe book. The dollar is now so entrenched as the world's money that if your assignment were to bring the curtain down on that – and thus the ability of the U.S. to borrow whatever it wants whenever it wants – it's not at all clear what you would do. But you'd start by doing everything that Trump is doing –* ***pick fights with all your allies, blow the government deficit wide open at the peak of an economic recovery, abandon any notion of fiscal responsibility, threaten sanctions on anyone and everyone who seeks to honor the deal Obama struck with Iran (thereby almost begging everyone to figure out some way to bypass the U.S. banking system in order to do business), throw spanners into the works of global trade without any clear indication of what it is precisely you want for a country that structurally consumes more than it produces and thus by the laws of accounting MUST run trade and current account deficits."*** – Currency expert Taggart Murphy

That's strong language but it seems to be on the mark to me. The U.S. will run a trade deficit unless we accept some combination of higher savings and lower consumption. That's not my opinion; it's math. Threatening China will not change it.

Trying to wean the U.S. public off consumption and force higher savings is just not going to work either, which means we are going to run trade deficits.

But what Trump seems to think is that, as long as we have the world's reserve currency, we can run trade deficits with essentially no consequences.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

There's no question that the Federal Open Market Committee (FOMC) will raise rates by 25 basis points at the end of its two-day meeting ending Wednesday. What will be far more telling, however, will be clues from the Committee and Fed Chairman Jerome Powell about the timing of future rate increases into next year and beyond.

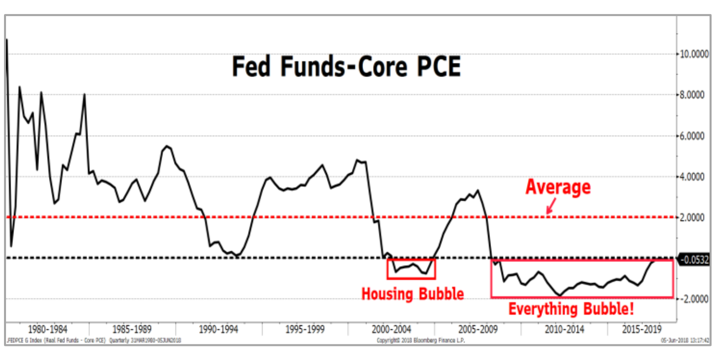
Economic projections from FOMC members – notably the "dot plot" graph of their guesses (and in reality, that's what they are) of federal funds rates at the end of 2018, 2019 and 2020, and a long-range equilibrium – will be closely scrutinized. The FOMC's projection has been for three 25-basis-point increases next year, while the fed funds futures market has priced in only two 2019 boosts, at most.

There has never been a rate-hike cycle this slow and this drawn out. We're now almost three years into it, and rates have come up, but it hasn't produced the results the Fed is trying to achieve: a tightening of financial conditions, an end to yield-chasing in the credit markets and more prudence. And the Fed will keep going until it thinks it has this under control.

Even still, relative to the Fed's annual inflation target of 2%, the current real fed funds rate is negative. Such a below-zero reading is appropriate during a slump, not the late stages of an expansion, with the jobless rate below 4%, the economy growing faster than 4%, and stock prices hitting records.

But what if inflationary pressures accelerate and the Fed hikes more than is expected? As shown above, the average fed funds rate – core personal consumption expenditures have been 2%. Imagine if the Fed hiked real rates by an additional 2%.

Real Fed Funds Rate is Negative



WHY HIGHER RATES MATTER

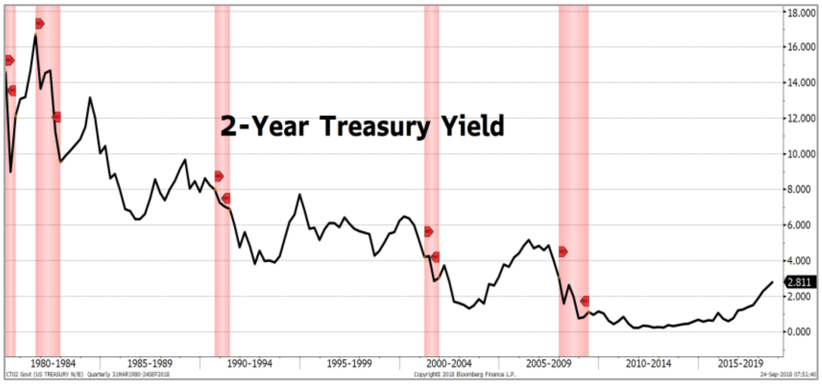
Remember, credit is the **"lifeblood"** of the economy and with government, corporate and consumer credit now at record levels, higher rates will definitely impact the economy and markets in the following ways:

1. Rising interest rates have already and will continue to slow the housing market. People buy payments, not houses, and rising rates mean higher payments.
2. As rates increase, so do the variable rate interest payments on credit cards.
3. Defaults will rise, which will negatively impact banks
4. Higher interest rates mean higher borrowing costs, which leads to lower profit margins for corporations.
5. Many corporate share buybacks and dividend issuances have been done through the use of cheap debt, which has led to increases in corporate balance sheet leverage.
6. Corporate capital expenditures are dependent on borrowing costs. Higher borrowing costs lead to lower capex.
7. The deficit/GDP ratio will begin to soar as borrowing costs rise sharply. The many forecasts for lower future deficits will crumble as new forecasts begin to propel higher.
8. The corporate credit markets are at risk. Much of the recovery to date has been based on suppressing interest rates to spur growth.
9. The "stocks are cheap based on low interest rates" argument is being removed.

I could go on, but you get the point.

The two-year Treasury note has doubled in the past 12 months from 1.4% to 2.8% – this has only happened three other times in the past. And whenever the two-year yield has broken out like this in the past, it ushered in a completely different investment landscape and bad things have tended to occur, such as the crash of 1974, the crash of 1987, Long-Term Capital Management, the Russian financial crisis, the Asian financial crisis, the dot-com crash, and the global financial crisis.

The 2-year Treasury Yield has Doubled



Meanwhile, the 10-year yield climbed over the 3% hurdle again, yet there was no financial media excitement about it as there was when that happened last time. On Friday, the yield closed at 3.08% and it was met with shrugs.

While the equity and risk markets are currently ignoring the risk of higher rates, we are near the point where **"rates will matter."** And I will remind everyone, what caused the 10% correction in the S&P 500 this past January/early February was the rise in interest rates.

The Fed's tightening is already rattling emerging markets. When the American markets start feeling it, the results are likely to be very different from 2008. As Fed Chairman Powell has pointed out, the past two downturns have been precipitated by financial excesses.

So where will the next financial crisis come from? With household debt relatively tame by historical standards (excluding student loans), mortgage debt nowhere near the relative levels of 2007, the most likely catalyst to emerge is **corporate debt.**

Fed Governor Lael Brainard said last week, *"Rising risks are notable in the corporate sector [where the debt] could be vulnerable to downgrades in the event of unexpected adverse developments."*

Forewarned is forearmed – this time, nobody will be able to say that the Fed didn't give you plenty of opportunity to de-risk. But, as is always the case at the peak of the cycle, everyone considers themselves to be brilliant enough to time the market and know when to start de-risking. Boil it down to greed and human nature.

There is a wave of corporate debt maturities in the next five years – $2 trillion on average, annually – as the sins of the past get resolved. A cycle of rising defaults for lesser quality credit is a matter of when, not if. And remember this is a $3 trillion market, or triple that of the subprime mortgage space at the 2007 peak.

That pain could become more severe as the Fed increases the pace of its balance sheet reduction to $50 billion per month in the fourth quarter, from $40 billion per month currently. The major central banks, which together are pumping $500 billion per month into the global financial system, will stop doing so entirely by early next year. As for the implication of that cutback and how all that will end, nobody can say, "it won't be different this time," because there's never been any time like this before.

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

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.