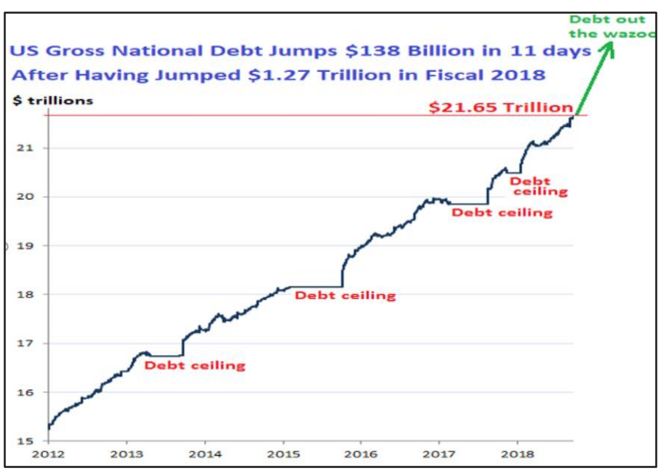
Weekly Relative Value

Debt Out the Wazoo!

We are at the peak of the economic cycle. Debt and deficits should be small and decreasing, if not eliminated. Instead, the national debt continues to climb at a staggering pace. Right now, it's more than $21.6 trillion and soaring by the second. Literally. Check out www.usdebtclock.org to watch it live. The red ink grew in the 2018 fiscal year to $779 billion — up 17% year-over-year (almost four times the pace of nominal GDP) from $666 billion (who doesn't hate that number?). Relative to GDP, the deficit rose from 3.5% to 3.9%. This coming year, it will blow through $1 trillion and likely total 5.1% of GDP.

For most Americans, the numbers are so huge that they almost seem surreal. The increase in the deficit stands out because the U.S. economy is running at full employment and growth is humming along at a decent pace. This is the time when tax receipts should be growing, and government outlays on unemployment benefits and the like declining. In fact, never before have we had labor markets this tight co-existing with fiscal deficits so high. To wit, when the unemployment rate was below 4% in the late 1950s, 1960s and 1990s, the government was running small surpluses. Today, at full employment, the deficits are now unprecedented and soon will start to make the Italians blush.

Uncle Sam Borrowed $1.4 Trillion in Last 376 Days



Treasury Secretary Steven Mnuchin suggested that the rising deficit was the result of "irresponsible and unnecessary spending." While spending is unquestionably an age-old problem for both Democrats and Republicans, the problem has been compounded by the reckless and dangerous tax and spending policies by the current Congress and the Trump administration.

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THIS WEEK…

- Why Debt Matters?
- How Much do You need to Retire?
- What is Wrong with Housing?
- The Fed Hawkometer

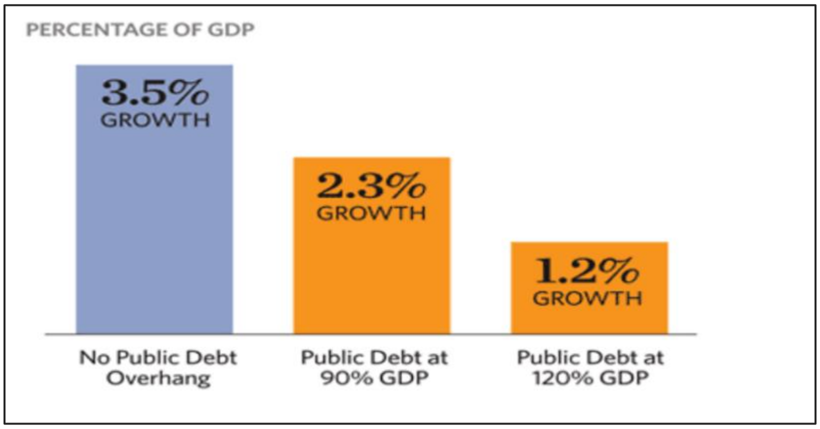
PORTFOLIO STRATEGY

This is no laughing matter.

We are at the point of diminishing returns from fiscal stimulus.

According to research from Rogoff and Reinhardt, 30% debt-to-GDP helps a little bit with growth, at 90% debt-to-GDP you're through the looking glass, above 90% you're actually retarding growth. For every dollar of debt, not only are you ***not*** breaking even – you get only 50 cents of growth.

We're now at 105% and heading north. The Trump tax cut is a $1.4 trillion deficit on top of the existing deficit we've already got. Reinhardt and Rogoff say that when the deficit gets to 100% of GDP, you're really screwed.



This is why the economy is not expanding nearly as much as it has in the past from such government largesse — in part because the debt loads are simply far too big, and in part because of where we are in the cycle: late.

And the situation is worse. Much worse. If we add the **unfunded liabilities (Medicare, Social Security, Medicaid) which are conservatively estimated to be approximately $50 trillion** we're in **excess of $70 trillion of total debt** outstanding relative to an economy that is $20 trillion in size.

In this Ponzi scheme, public debts will never get repaid and the social contract written during the Great Recession, otherwise known as entitlements, will have to be broken and the benefits means-tested. If you thought Middle America was peeved heading into the last election, you ain't seen nothing yet.

WHY DEBT MATTERS?

Interest on U.S. debt is now **$1.5 billion dollars per day** and projected to **total $7 trillion over the next decade.** By 2026, it will become **the third largest category of the federal budget.** In other words, that's $7 trillion that could be spent on things like roads, bridges, schools and other programs that benefit Americans every day.

More debt and higher deficits drive up interest rates, which leads to slower economic growth. Slower growth leads to lower wages, which results in a lower standard of living for Americans.

The massive fiscal-induced bulge in Treasury borrowing needs will be to crowd out private sector funding for capital spending projects. The old "crowding out" effect is what college professors teach in Economics 101; it raises the cost of capital and hurts economic growth.

Higher interest rates mean it will cost more to borrow money to buy a house or a car and pay college tuition.

Government programs like food stamps or unemployment benefits that help the most vulnerable in society could face cuts if the government has less money to spend. It also may be more difficult to prop up financially strapped programs like **Medicare, which is projected to run out of money by 2026**, and **Social Security, which is expected to be insolvent by 2034,** unless benefits are cut, or other steps are taken to shore up the programs.

Growing deficits leave the U.S. with less flexibility to respond to a financial crisis like the Great Recession of 2008. It should be noted that the U.S. had relatively modest debt when the Great Recession hit, so that meant the government could direct many of its financial resources into a stimulus package to help rescue the economy. If the country continues its current path of mounting debt, it may not have the ability to respond to such unforeseen crises in the future. That means another recession could be deeper, longer and more painful.

This is the bottom line: **Borrowing at that level is financially irresponsible and unsustainable**. Despite what you hear from the White House and the media, there is no such thing as a free lunch. All the borrowed government money to give the economy and investors a transitory "sugar high," as has been the case this year, will come with a payback on the economic and market front in the coming quarters and even years.

HOW MUCH DO YOU NEED TO RETIRE?

"You need at least $5 million, or $6 million... Really, you might need $10 million [to retire early]." – Suze Orman

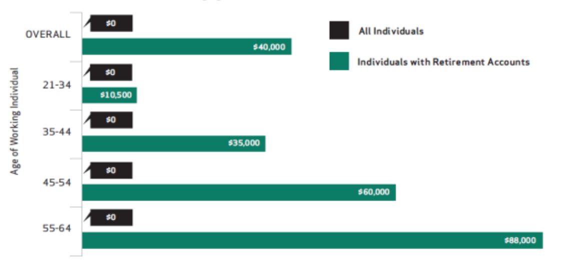
According to [a new study by the National Institute on Retirement Security](), the U.S. retirement savings shortfall is worse than we thought. The study shows that retirement savings **"are dangerously low"** and that the U.S. retirement savings deficit is between **$6.8 and $14 trillion.**

Here are a few "uplifting" stats from the study:

- **Nearly 60% of all working-age Americans do not own assets in a retirement account.**
- **The typical working-age American has no retirement savings. When all working individuals are included—not just individuals with retirement accounts—the median retirement account balance is $0 among all working individuals. Even among workers who have accumulated savings in retirement accounts, the typical worker had a modest account balance of $40,000.**
- **Three-fourths (77%) of Americans fall short of conservative retirement savings targets for their age and income based on working until age 67, even after counting an individual's entire net worth—a generous measure of retirement savings.**
- **Among individuals approaching retirement (age 55 to 64), the median balance was $88,000 for account-owning individuals, while the typical individual in that age group (when all workers were considered) had NO assets in a retirement account.**

Figure 7: **Typical Working Age Individual Has $0 in Retirement Account Assets; Among Individuals with Positive Retirement Accounts, the Median Balance is $40,000**

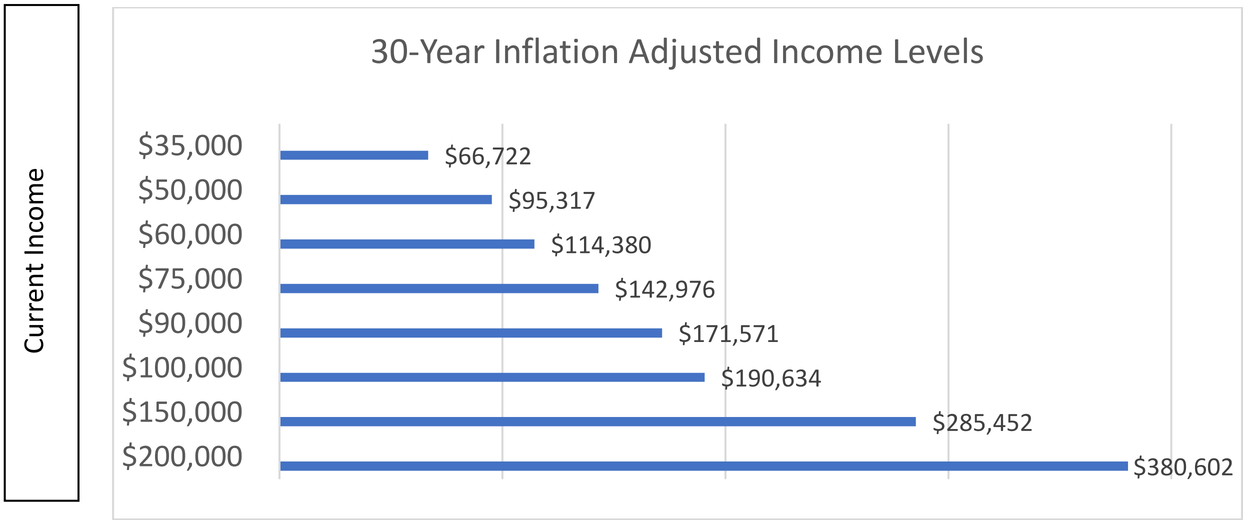
Median retirement account balance of working age individuals with positive retirement account balances versus median account balances for all working age individuals



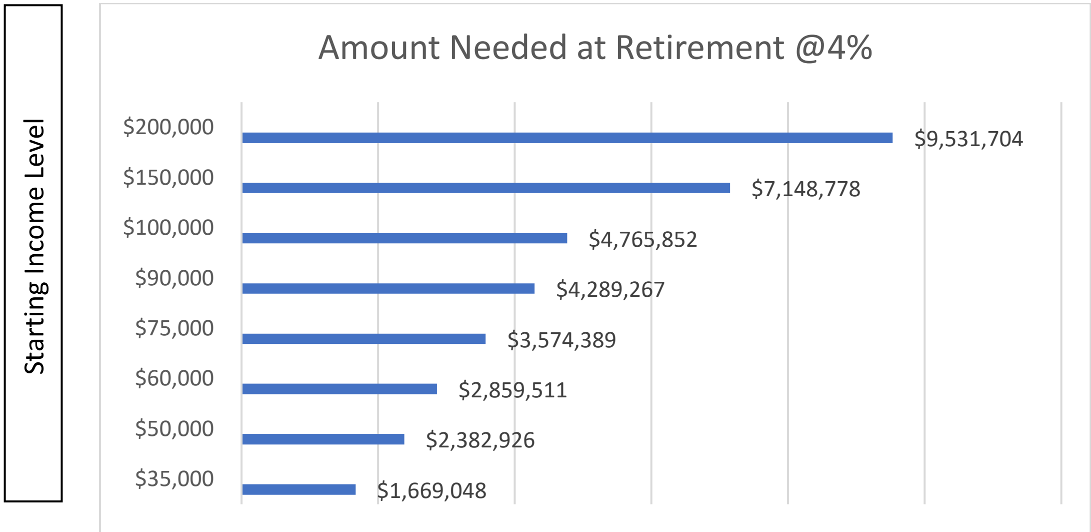
Source: Authors' analysis of SIPP 2014, Wave 1 data. Universe is individuals age 21-64. Retirement account ownership status reported for December 2013. Numbers are weighted using final person weight. DB plan ownership is not accounted for.

So how much money will you need in the future, on an annualized basis, to live the same lifestyle you live today?

The chart below shows various income levels today and the amount of income you will need in 30 years to live the same lifestyle you are living today. In other words, the future income is adjusted for the higher cost of living in the future (inflation). In this scenario we are assuming 2%. Obviously, if inflation is higher in the future, the future income needed to maintain a certain standard of living will be significantly higher. These numbers become materially larger.



The chart below takes the inflation-adjusted level of income for each bracket and calculates the asset level necessary to generate that income assuming a 4% withdrawal rate.



Looking at these numbers, Suze was right.

According to the study above, the typical working American needs to replace roughly 85% of pre-retirement income to maintain their standard of living in retirement. This replacement rate may seem high, but it does not fully account for medical costs, which can escalate rapidly during retirement. Social Security, under the current benefit formula, provides a replacement rate of roughly 35% for a typical household. This leaves a retirement income gap equal to 50% of pre-retirement earnings that must be filled through other means.

So how much do you need?

If you are trying to fund a lifestyle of $100,000 or more today, you are going to need $5 million at retirement in 30 years. But, as shown above, $5 million is completely out of touch for most Americans.

If you don't expect to "travel the world" in retirement, you may be able to get by on $50,000. Even still, maintaining that income level will require $2,382,926 in assets.

Sadly, many Americans are due for a rude awakening.

WHAT IS WRONG WITH HOUSING?

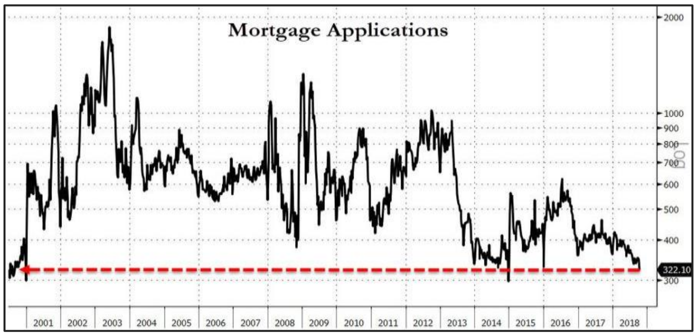
Housing starts declined 5.3% in September to an annual rate of 1.2 million units. New building permits fell 0.6% month-over-month in September, versus expectations for a 2.0% increase. In fact, in five of the past six months, permits have declined, over which time they have receded at nearly an annualized 20% pace.

New home sales are down 11.7% from their peak last November through August. Existing home sales fell for the sixth straight month in September, with that month's 3.4% drop the biggest since early 2016, bringing the decline since last November's peak to 9.3%. Please don't blame hurricanes. And you can't blame supply either, as it rose notably: 4.4 in September vs. 4.3 in August.

Existing Home Sales Drop for Seventh Straight Month

Finally, I would be remiss if I didn't also mention the weekly mortgage loan application data, which were downright horrible. The 7.1% plunge in the week of October 12 was the largest such decline in over a year — a strong sign of higher interest rates starting to bite. And it wasn't just refinancings (-9.0%) that took it on the chin — purchase applications (-5.9%) also peeled back and are now down a hefty 7.8% from year-ago levels.

Mortgage Applications Hit Lowest Rate Since September 2000



And given the backdrop, it is no wonder that this has been the worst year for homebuilder stocks since 2007. The S&P Homebuilders ETF (XHB) exchange-traded fund is down by more than one-third from its peak, touched in early January.

Home Builders Crash!

Favorable demographics, with millennials starting to form new households, jobs growing strongly and consumer confidence high, should be the formula for a housing boom.

But that is not the case.

To be sure, rate hikes, plus the prospect of more to come, have rippled through home mortgages, lifting the 30-year fixed rate to near 5% in the latest week, up nearly a full percentage point from a year earlier. Affordability is dropping to where it was around the turn of the century.

In addition to mortgage rates, real wages also matter. The Atlanta Fed's Wage Growth Tracker shows pay for prime-age employees improving but stuck around 3.5%—only a bit more than 1% after inflation. That's not enough for younger families, many of whom are still shouldering student loans, to carry a mortgage.

In addition to rising mortgage rates and lagging real incomes, the tax laws have changed housing affordability for many.

The $10,000 annual cap on federal deductions of state and local taxes has already hit states with high income tax rates, such as California and many in the Northeast.

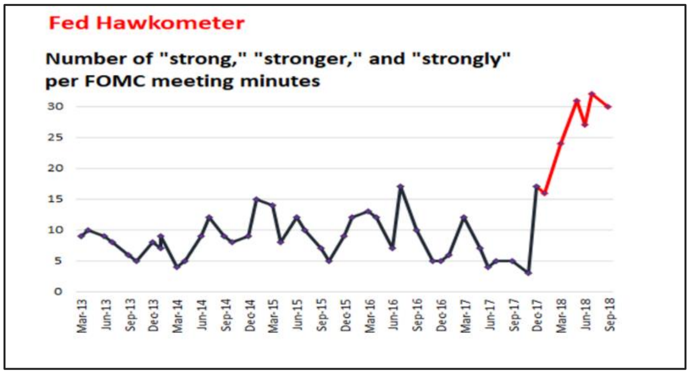
THE FED HAWKOMETER

"FOMC Minutes confirm that the Fed will ultimately move to restrictive policy next year. Expect the overnight rate to rise another 125 basis points, and the curve to flatten more." – Scott Minnerd, Global Chief Investment Officer at Guggenheim

In the September 25-26 Federal Open Market Committee minutes released last week, the words "strong," "strongly" and "stronger" were used 30 times to describe the economy. To put that number in perspective, the average frequency of "strong," "strongly" and "stronger" between January 2013 and December 2017 was 8.7 times per meeting minutes. That's an increase of 240% from average!

In light of the Fed's view on the economy and in the face of inflationary pressures and low unemployment, the Fed will have no choice but to forge ahead into restrictive territory. Even former doves like Fed Governor Lael Brainard are now arguing that the short-run neutral rate may be rising, and that policy will eventually need to become restrictive relative to that.

As such, unless something breaks, the Fed will likely continue raising the target range to 3.25-3.50% next year.



No matter how strong the economy is, **nothing is more important than Fed policy and liquidity. That was the lesson** learnt from Black Monday on October 19, 1987 when the S&P fell nearly 30%, making it the biggest daily drop in Wall Street history.

Worst Day Ever in the Stock Market

After Black Monday, then-Fed Chairman Alan Greenspan cut rates and kept on cutting well into 1988 as insurance. This came to be known as the "Greenspan put," a policy that aimed to boost equity wealth as a means to boost spending.

His successors continued the policy, most notably during the 2007-08 financial crisis, when then-Federal Reserve Chief Ben Bernanke pulled out all the stops by cutting rates to zero and quantitative easing.

Janet Yellen didn't have to ease, but she halted interest rate hikes for most of 2016 after the crash in oil and other commodities, and ahead of the Brexit vote and its aftermath.

Many investors have come to the belief that the Fed will never allow the markets to sell off. "The Fed has their back," they are told. But what if this confidence is misplaced and the Fed ends the "Fed put," letting the market trade on its own merits? In other words, what are equities worth without the central bank's massive and unprecedented liquidity injections? I think lower… maybe a lot lower.

This is what David Rosenberg believes.

"It seems to me as though this prolonged cycle of Fed policy aiming to create asset cycles has come to an end with current Fed Chairman Jerome Powell. He will be every bit as transformational as former Fed chief Paul Volcker was—the latter killed inflation and the former will kill the economy's chronic dependence on asset inflation, instead of real fundamentals like productivity." – David Rosenberg, chief economist and strategist for Gluskin Sheff

Rosenberg points to statements that Powell made as a Fed governor before being named chairman, warning of overly easy policy encouraging **"frothy financial conditions"** that could ultimately destabilize markets. Since being named to the top spot, Powell has warned that the past two recessions were preceded by **"destabilizing excesses mainly in financial markets,"** instead of inflation – which traditionally had led to Fed tightening that ultimately hamstrung the economy.

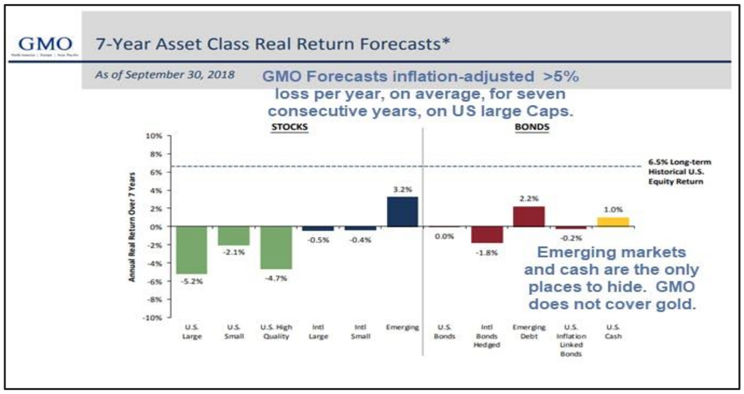
In the U.S., it's been many decades since stock investors have had to cope without a Fed put to protect them. It might come as a shock if "Rosie's" scenario plays out.

Famed value investor Jeremy Grantham and his firm GMO believe the returns from equities over the next seven years will be quite unattractive. According to their models, equities are priced to **generate a 5% plus loss per year for the seven consecutive years.**

CAPE Index Valuation at Second Highest Ever

With valuations currently on par with those on the eve of the Great Depression and only bettered by the late 1990's tech boom, it should not be surprising that many are ringing alarm bells about potentially low rates of return in the future.

Equity Returns look Paltry Going Forward

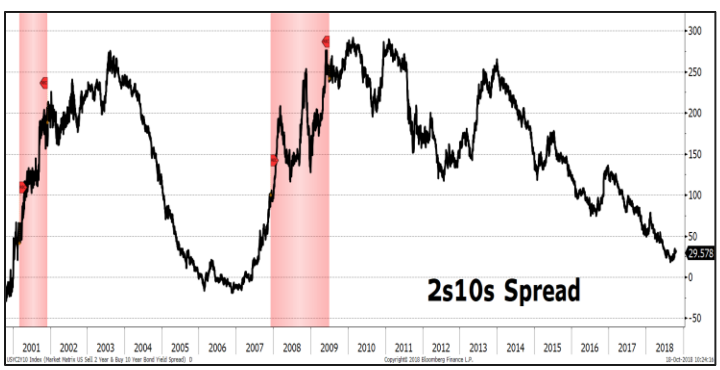


The problem with fundamental measures, as shown with CAPE, is that they can remain elevated for years before a correction (or a **"mean reverting"** event) occurs. It is these long periods where valuation indicators **"appear"** to be wrong and investors dismiss them (and chase market returns instead). This has always had an unhappy ending.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Most pre-recessionary periods share a common set of characteristics. They start with an economy growing above potential, putting downward pressure on unemployment. The Fed then raises interest rates—eventually into restrictive territory—to try to limit the growth of imbalances. This is the key recession trigger.

The Yield Curve Remains in a Flattening Bias

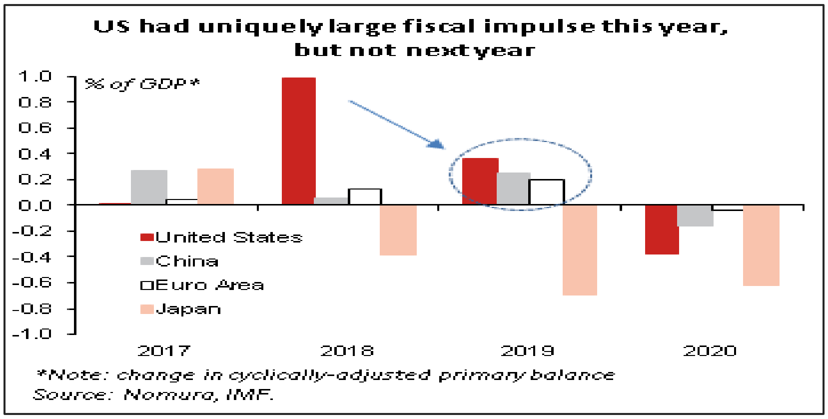


Evidence that policy is getting tighter can be seen in the flattening of the Treasury yield curve. After pushing as wide as 38 basis points on September 9, the 2s/10s spread has since shrunk back to 30 basis points as the curve has resumed flattening. But even if you don't believe the yield curve, there are still reasons to believe that a recession is around the corner. One is that consumer and business surveys give the same late-cycle signal as the Treasury market.

In China, Europe and emerging markets, economic growth is already rolling over, and if the U.S. continues to raise rates into the year end, we might even see U.S. growth taking a hit by first quarter of next year.

According to a new real-time economic monitor launched by J.P. Morgan, the U.S. economy has a roughly 28% chance of falling into a recession over the next 12 months. The recession probability surges to 60% if the forecast period is extended to two years, **or more than even odds that the U.S. will be in a recession sometime around the next presidential election.**

Recession risk is expected to grow substantially by 2020 – assuming it does not strike in 2019. A recession may strike then because Trump's fiscal stimulus is expected to shift from an economic tailwind to a headwind, all the more so if Democrats win the House and prevent any further fiscal stimulus from being enacted.



And speaking of recessions, Guggenheim Chief Investment Officer Scott Minerd expects a recession in just over a year, during which **a 40% drop in equities is "justifiable to me on a technical and a fundamental basis"** and that "**by the end of the second quarter next year, I expect risk-off everywhere."**

But don't be alarmed. According to Minnerd, **"The Fed will cut rates to zero, employ aggressive forward guidance, and resurrect quantitative easing (QE)."**

Whether these tools will be as effective as the Fed claims they were in the last cycle remains to be seen. If we went into a recession tomorrow, (I'm not saying we are, but if we did), you could cut rates 2.25% and then that's it. You're out of bullets.

Round four of QE? Really, the Fed has a balance sheet $4 trillion, are they going to go to $8 trillion?

Put differently, the Fed will probably wish they had more powerful tools when the time comes to use them. This will ultimately ensure the next recessionary drag will likely be larger and last longer than most expect as both fiscal and monetary policy tools were spent during the boom, rather than saved for an eventual **"rainy day."**

Regardless, this will put to rest questions about whether the 35-year bull market in bonds is over. It isn't.

As discussed last week…

"With the economic expansion nine months from being the longest in U.S. history, the yield curve nearly flat and housing market indicators peaking earlier this year, ***it doesn't take much imagination to see what's next: a recession and falling interest rate cycle – i.e., a U.S. Treasury bull market."*** – Eric Hickman

and…

"It is counterintuitive, but U.S. Treasury bull markets begin when the economic weather is the sunniest. It happens when the unemployment rate is the lowest and consumer and industrial confidence the highest. ***By the time a recession is obvious, a good chunk of the move lower in rates will have taken place.*** *Of course, there are no hard and fast rules to make money in finance, but to the extent that 'this time isn't different,'* ***now is the time to get ready for a large opportunity in the U.S Treasury market."***

Waiting for the recession headlines to hit the front page of the Wall Street Journal will be too late. Credit unions should begin to transition and position their balance sheets and investment portfolios for the end of the current economic cycle. Now is the time to upgrade the quality of the loan and investment portfolio. If a recession does indeed strike in 2019 or 2020, interest rates will decline dramatically, and high-quality fixed income investments will be the star performers.

INTRODUCING THE PREMIER PORTFOLIO PORTAL

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  Gain access to educational content that tracks market and economic trends, analyzes key releases and watches ongoing political developments. Understand the impacts of current events on credit unions.
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  See current investments online and easily export into a spreadsheet format.
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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.