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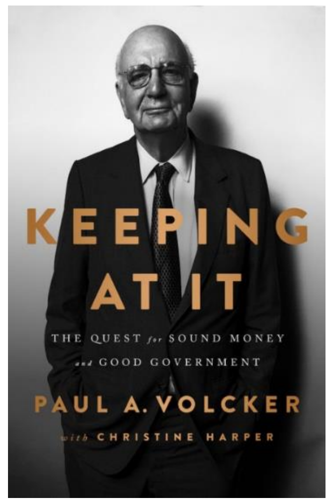
WEEK OF OCTOBER 29, 2018

Weekly Relative Value

The Paul Principle



Paul Volcker – in my opinion, the greatest Fed Chairman of all time – is becoming more vocal of late, sharing his wisdom in a book and a few articles. As chairman of the Federal Reserve (1979-1987), Paul Volcker was transformational in that he managed to curb well-entrenched consumer inflation that was consuming the American economy. "Tall Paul" Volcker's dedication to absolute integrity and his "three verities" of stable prices, sound finance and good government inspired many and restored the world's faith in central bankers.

At his recent book launch, Volker is quoted as saying, "We're in a hell of a mess in every direction." Truer words were rarely spoken. He added, "How can you run a democracy when nobody believes in the leadership of the country?" Good question. His book is titled Keeping at It: The Quest for Sound Money and Good Government. It's on my buy-list.

In a recent missive on Bloomberg – ***What's Wrong With the 2 Percent Inflation Target: False Precision Can Lead to Dangerous Policies*** – this is what I think was the most acute comment from Mr. Volcker. (Bolded fonts for emphasis were my addition.)

"The lesson, to me, is crystal clear. ***Deflation is a threat posed by a critical breakdown of the financial system.*** *Slow growth and recurrent recessions without systemic financial disturbances, even the big recessions of 1975 and 1982, have not posed such a risk.* ***The real danger comes from encouraging or inadvertently tolerating rising inflation and its close cousin of extreme speculation and risk taking, in effect standing by while bubbles and excesses threaten financial markets.*** *Ironically,* ***the 'easy money,' striving for a 'little inflation' as a means of forestalling deflation, could, in the end, be what brings it about.***

*That is the basic lesson for monetary policy****. It demands emphasis on price stability and prudent oversight of the financial system.*** *Both of those requirements inexorably lead to the responsibilities of a central bank."*

While I'm obviously no Paul Volker, I have expressed these same sentiments for quite some time. In efforts to spur consumption and economic growth, the Fed focused on driving asset prices higher (via the so-called wealth effect). Through artificially low rates (amazingly, "real rates" – adjusted for inflation – have been **negative for 10 years**) and massive unprecedented quantitative easing, the Fed's "financial repression" actively promoted speculation and risk taking. This, in turn, has grossly distorted the value of all assets from

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

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PORTFOLIO STRATEGY

stocks to bonds to real estate. In doing so, the Fed has destroyed "price transparency" (market pricing). In essence, they have created the third bubble ("the everything bubble") in 18 years. And, as Tall Paul noted, it is the busting of these bubbles that does serious damage to the economy. We know this all too well from the past two bursting bubbles.

Rate hikes are like vaccines. The worst sickness a market could develop is the delusion that assets can grow to the sky forever without any setbacks and that the Fed will never allow asset prices to fall (aka the "Fed Put"). It's like a fever that overtakes us. John Maynard Keynes called it "**Animal Spirits**." Greenspan called it "**Irrational Exuberance**." But that's when you really get hurt. I believe the Fed is doing its part to inoculate the credit and equity markets before this sickness can spread further. What you're seeing in the stock market is, in part, a reflection of this tough medicine.

Looking forward, if current Fed Chair Jay Powell, who has the full support from Paul Volker – the dean of central banking – is successful in weaning the market of the so-called "Fed Put," he will prove to be transformational but in a different way. Rather than curbing consumer inflation excesses, he will be the one that curbs the well-entrenched era of asset inflation excess.

OCTOBER SURPRISE

"I'm expecting a downward trend and more volatility. We're done on the bull market. We're done on the economic cycle. We're not in free-fall, but the best days are behind us. It's winter."
– Société Générale's Kit Juckes, chief foreign exchange strategist

This month is living up to the reputation of past October debacles; perhaps not as cataclysmic as the those of 2008 or 1987 or 1929, but bad enough. And Halloween is just around the corner.

In the week just ended, the Dow shed 3% while the S&P 500 lost 3.9% – on track for the worst month in eight years – and the Nasdaq dropped 3.8% as the U.S. stock market surrendered all of its 2018 gains. According to Wilshire Associates, reckoning U.S. stocks suffered a loss of $1.2 trillion in the latest week, with some $3.3 trillion of equity values evaporating in the past five weeks. From their respective peaks, equity markets have taken a pounding, with the S&P, Nasdaq and Russell 2000 -10%, -13% and-16%, respectively.

But it wasn't just the U.S. that suffered. Global stocks have lost almost $8 trillion of value and are set for the biggest wipeout since the height of the financial crisis a decade ago on concerns ranging from peak earnings growth and the U.S.-China trade war, to the end of easy money and rising rates.

The current swoon, while similar in magnitude to the drop in early February, has not been helped by a generally good corporate earnings reporting season. According to Evercore ISI, aggregate profits of S&P 500 for the third quarter 2018 will be up a hefty 24% year-over-year.

So, one may ask, "Why? Why now?" With earnings growth running at 24%, is the stock market in a state of angst? Here are a few reasons:

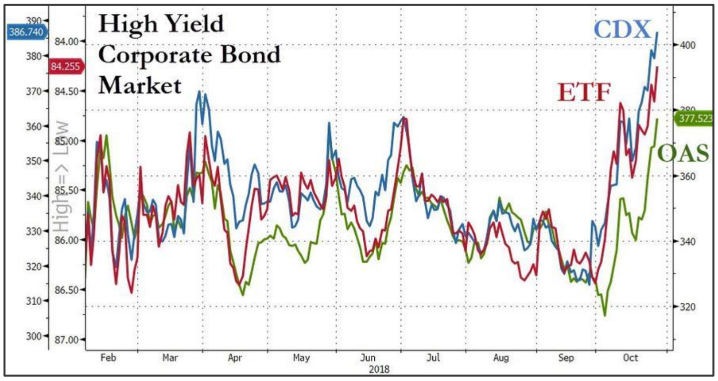
1. **Peak Valuations:** As I have opined more than a few times in this space, many valuation metrics have indicated that the stock market is ludicrously overpriced. And that sort of thing eventually and invariably unravels. Ben Graham – widely known as the "father of value investing" – used average earnings over a period of 7-10 years when valuing companies. The reason being, average earnings help smooth the ups and downs of the business cycle. The main idea is that earnings are mean-reverting. This methodology is reflected in the Shiller Cyclically Adjusted Price-Earnings Ratio (CAPE) which plots price versus 10-year average of earnings. And, as one can glean from the graph below on that basis, stocks are more overvalued than any time other than the dot-com era. But, like all valuation metrics, it's not a timing mechanism. In fact, stocks have remained over valued for quite some time. Rather, it's a warning mechanism. And the warning should be loud and clear that stocks are priced to more than perfection.

Or consider the price-to-sales ratio, which cuts out a lot of accounting games and manipulation in managing, or should I say, manufacturing earnings. This ratio is arguably the simplest valuation metric investors can use to identify cheap versus expensive markets. Currently the price-to-sales ratio of the S&P 500 is around 2.2x sales after hitting an all-time high at 2.3x. Only in 1929 and 2000 was the ratio over 2.2x. At the bottom of the previous two bubbles (housing and dot-com) this ratio plunged to 0.80x!

Does This Market Look Cheap?

The point is, while companies have been able to manufacture earnings via stock buybacks over the past years, they simply cannot manufacture revenue. Revenues are a better reflection of business health than earnings.

2. **Credit Spreads Widening:** While credit markets' "tightness" had been proclaimed as a pillar of support for the bull thesis by many still clinging to hope, that is no longer the case. Interest rates are rising, and funding for credit-dependent companies is going to get scarcer and more expensive. With over $10 trillion of global corporate bonds maturing over in the next five years and with one look at corporate leverage, it's clear that as risk "normalizes" in credit markets, spreads are set to blow dramatically wider. Should the corporate debt bubble blow, equities will feel the pain. As shown below, that trend has already started.



3. **Policy Mistake:** The Fed is now on autopilot (and is jacking up interest rates). The "fear" is that the Fed won't know when or where to stop raising rates. Chairman Powell, in an interview earlier this month, suggested that the monetary authorities had a ways to go before reaching a neutral federal funds rate from the "extremely accommodative" current target range of 2% to 2.25%. The problem is, many do not believe the Fed has a clue as to what the neutral rate is.

   As I have highlighted previously, the Fed has historically "hiked until something breaks." In fact, 10 out of 10 prior hiking cycles have led to a financial crisis. And 10 out of 13 rate hike cycles have led to a recession. In other words, the Fed's batting average is pretty horrific. As a result, investors are re-pricing financial assets to reflect the increasing probability of a monetary policy mishap.

4. **All In**: Then there is the technical, sentiment and fund-flow picture. According to JPMorgan, hedge funds continue to have elevated exposure to global equities and may yet still have to "capitulate" to the market's slide. "Real money" investors – mutual funds, pension funds, insurance companies, endowments and sovereign-wealth funds – also remain overweight stocks. Last but not least, on the individual front, equity allocations are at the highest since the financial crisis of a decade ago, while their bond and cash allocations are near their post-crisis lows. So, it appears that investors are all in. So, who's left to buy? All of this poses further downside for equity markets from here if negative momentum and sentiment eventually induce real-money investors to capitulate.

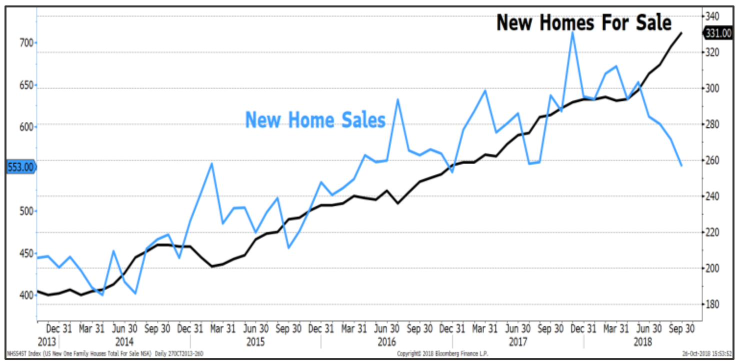
5. **Peak Growth:** The U.S. economy is not as strong as the "Cheerleader in Chief" has proclaimed. Despite the popular narrative of a booming U.S. economy, auto sales have slowed and the housing market, one of the best leading indicators, is no longer just sputtering but outright rolling over. These two industries punch above their weight in terms of aggregate impact on the U.S. economy.

   Consider the graph below. On a year-over-year basis, new home sales are down 13.2%. Not just that, but sales declined in each of the past four months and in five of the past six, during which they have plummeted at a 32% annual rate.

At the same time, because the builders did not adjust quickly enough to the sudden plunge in demand, the number of new unsold single-family houses on the market keeps surging and in September jumped 16% from a year ago, to 331,000 houses (**the highest number since January 2009** during the middle of the housing bust).

So, let's get this straight – demand is down to near a two-year low and supply is up to a 10-year high. Time will ultimately tell how this plays out, but don't make the mistake of ignoring what this critical segment of the economy is indicating.

Peak Housing



6. **Trade Wars:** Tariffs are a tax on the U.S. consumer and trade talk is now impairing global trade. The International Monetary Fund has once again downgraded worldwide growth projections for 2018 and 2019 (as of last week). The global economy is flat and interconnected and our country's largest companies are called "multi-nationals" for a reason – and their future prospects are increasingly tied to the health (of non-disruptive) world trade and sound trade policies.

   Thus, harsh rhetoric (with China) is serving to jeopardize economic growth. We are already seeing rising costs and supply chain problems in the current third quarter earnings reporting period – much of which is directly derived from the trade disputes with China. We don't know what's going to happen, but it's not looking great for our biggest manufacturers and materials producers at the moment.

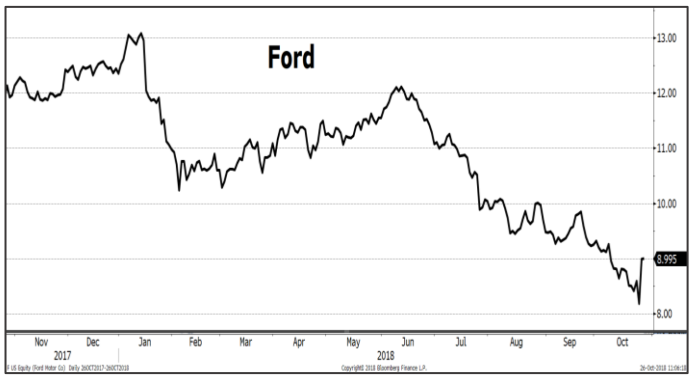
   Have a look at what the global slowdown and tariffs are doing to U.S. steel. It looks like death warmed over, not exactly what you'd expect to see if markets believed in the expansion continuing past 2018.

U.S. Steel Has Declined by 50% Since February

Here's Ford, another unmitigated disaster. Ford's selling at a 6 PE at this point. The company tried to play Trump's way – press releases about U.S. manufacturing onshoring, being a good soldier about tariffs, sucking it up as their Chinese auto sales figures collapsed, etc. It hasn't worked.

Ford, like all U.S. manufacturers of scale, relies on global supply chains to make products cost effectively and in a timely manner. They need Canada. They need Mexico. They need China. By extension, their customers and employees needed these supply chains to remain intact as well.

Ford Down 32% Year-to-Date



7. **Debt and Deficits:** The tax cuts and the increase in government spending in the form of a tax giveaway to the segment of the population that needed it **least** (stock market investors and corporations, LOL!) is just the icing on a cake that's already been baking.

   Considering the age and "strength" of our economy, we should be achieving a surplus; instead, the deficit is expanding. Over the last decade, the tools of monetary ease **(**providing more and more liquidity) and rising government spending have been increasingly less productive – every $3 in debt created has only resulted in $1 of GDP in the U.S. We are now at a point of diminishing returns of policy and potentially even at a point of saturation. Economic growth is greatly debt dependent and is therefore unsustainable in a very real sense.

   Rising government debt, sanctioned in the U.S. by both parties, is fiscally irresponsible and, with rising interest rates, growth will be sapped. While providing a short-term **"sugar high,"** tax cuts and relentless government spending only serve to push forward and borrow from future economic growth. The only thing we know for sure – a **promise** – is that the trillion-dollar deficit we'll be left with from the tax cuts will be a gigantic souvenir that we can enjoy and then pass down to our children.

Is the stock market correction over? The answer is that it ends only once the question is no longer asked. Even if you do not believe this will morph into an outright bear market, this isn't even yet an average plain-vanilla correction despite all the angst. To wit, during the 22 corrections post WWII the S&P declined on average 13.8%. The average correction lasted five months.

As an aside, we will know if this is a bear market if the down-move exceeds 20%. But considering prior blow offs, even then it will not be too late to de-risk. Because, in the past century, the typical peak-to-trough slide in this phase is closer to 40%.

So, while the market has declined, only a fool would tell you "the bottom" is in. Going forward, I fully expect the market to have intermittent and potentially powerful rallies near-term. Markets don't typically go straight down or up. Ouch!

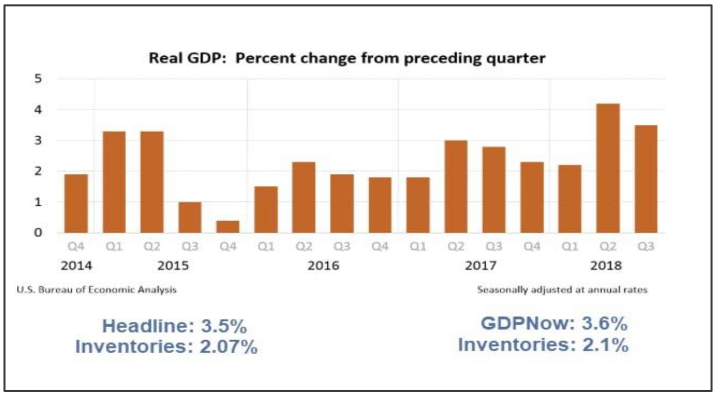
All that said, best to leave the bottom-picking to the proctologists and the catching of falling knives to the circus travelling shows. Nobody ever rings a bell at the lows or the highs, but the history of past corrective phases, let alone bear markets, leave me with a view that we're not there yet, in terms of there being signs of any definitive "bottom."

NOT AS GOOD AS IT LOOKS

There were only two items that the growth bulls can hang onto in the third quarter GDP report. The first is the headline number +3.5%, which was a smidge above the consensus view of +3.3%. The consumer number was red-hot at +4%, which was the best performance since the fourth quarter of 2014.

The good news ended there.

Peak Growth?



Inventories alone added 2.1% to the headline. In other words, real GDP growth was 1.4% at an annual rate absent the huge inventory shift. This was the largest contribution in over three years and second largest in seven years. In other words, such a massive stockpile contribution doesn't exactly happen every day. Remember, inventories net to zero over time.

Tack on a 3.5% annualized slide in exports – retracing nearly 40% of the soybean-induced surge in the second quarter – and we had a massive widening in the trade deficit slicing off 1.8% from the headline reading on GDP growth.

In sum, inventories added the most since early 2015, and net exports declined the most since the second quarter of 1985! This shows how the administration's policies are wreaking havoc on the business community.

So, just as the 4.2% headline in second quarter was skewed by the transitory effect of fiscal stimulus, the 3.5% headline for the third quarter was skewed by the temporary effect of business stockpiling ahead of the tariffs. Actually, when you strip out the fiscal and trade-related distortions, the underlying trajectory in real GDP growth is sub-2% and getting softer. This will likely come into a clearer view in the fourth quarter.

MARKET OUTLOOK AND PORTFOLIO STARTEGY

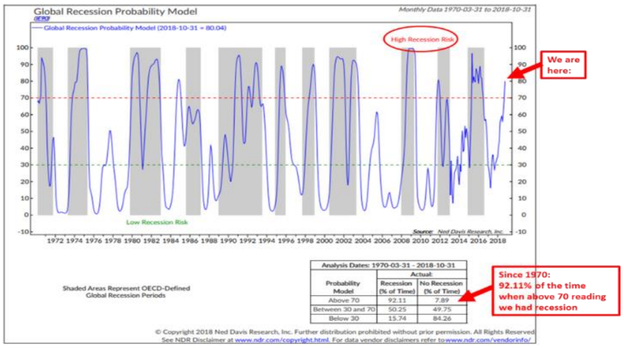
"Our economy and the people and the workers and entrepreneurs, they're killing it. We're the hottest in the world. We're crushing it right now, and I think that's going to continue regardless of China… I don't think this is anything resembling a sugar high… America is on a tear… It has strong legs." – Larry Kudlow, White House chief economic advisor

Currently, it is believed that the U.S. can remain an island of economic growth in a world struggling with weakness. According to JPMorgan, the U.S. economy has a roughly 28% chance of falling into a recession in the next 12 months. The recession probability surges to 60% if the forecast period is extended to two years.

However, as shown in the Ned Davis Research chart below, recession risk on a global scale has now surged above 70.

"Readings above 70 have found us in recession 92.11% of the time (1970 to present). Several months ago, the model score stood at 61.3. It has just moved to 80.04. Expect a global recession. It either has begun or will begin shortly. Though no guarantee, as 7.89% of the time since 1970 when the global economic indicators that make up this model were above 70, a recession did not occur." – Stephen Blumenthal, founder and CEO of Capital Management Group, INC.

Recession Probability Rising



According to Lakshman Acuthan, co-founder of the Economic Cycle Research Institute, the U.S. already is in a stealth slowdown with inflation turning lower. **"That downturn is now a fact, not a forecast, with [year-over-year] headline [Consumer Price Index (CPI)] growth falling to a seven-month low and [year-over-year] core CPI growth falling to a five-month low in September."** He further points out that his firm's leading inflation indicator **"is in a full-blown downturn, pointing to a further decline in inflation in the months ahead."**

"The biggest risk is the Fed…" – President Donald Trump

Can the Fed continue to raise rates into a rate of change slow-down in both U.S. growth and inflation? How about into ongoing melt-downs in global stock markets? Yes. In fact, most of the time, that's what the Fed does. **It reacts on a lag to lagging economic data.**

Meanwhile, in their most recent set of Federal Open Market Committee (FOMC) meeting minutes, it was stated explicitly that ***"a number of participants noted that financial conditions remained accommodative."*** This is code for:

"**There is still more work to be done."** The FOMC's projection at its meeting last month envisioned four more 25-basis-point boosts by the end of 2019. Nevertheless, odds heavily favor a move at the December 19 meeting. There is a 70% probability of a hike of at least 25 basis points then, although that's down from more than 80% a week earlier.

For 2019, the probability of multiple rate increases has been receding, with the futures market predicting only a single hike, to 2.5% to 2.75%. The Fed is also reducing its balance sheet at a quickening pace; it's down by $271 billion over the past year and is shrinking by $50 billion a month. **History has taught us that monetary policy, in the end, always wins out.**

"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."

As highlighted over the past weeks, I believe growth and inflation have peaked. Further, the Fed's pledge to raise rates will negatively impact the asset markets and stifle economic growth. I'm not the only one. **In fact, 66% of mainstream economists believe that the next recession will strike in either 2019 or 2020.** So, the majority of economists see that the next recession will arrive within the next two years, and many are suggesting that it will be even more painful than the last one. I agree. The next recession will be much larger and deeper than most currently expect due to the massive amounts of leverage built up during the current cycle.

For the past 10 years, U.S. Treasury yields have traded in a range of 1.4% to 3.9%. Each time yields get too high, the economy slowed, and yields collapsed. The unmistakable long-term trend of yields has been lower highs and lower lows. I believe the pattern will hold true as we move forward. In other words, the bull market in bonds is far from over.

Both short-term and long-term yields have risen from their cycle lows and are beginning to weigh on the markets and on the economy as witnessed by the weakness in housing and autos. If rates continue higher the economy and markets will come under increased pressure. Eventually a recession will unfold. As such the Fed will reverse its tightening monetary policy by reducing rates and potentially resuming QE. It should be noted that during every recession the Fed has reduced rates by at least 300bps and 10-year Treasury yields have declined by approximately 150bps.

Now is the time to position investment portfolios for lower rates. We advocate buying into markets weakness while maintaining a disciplined ladder strategy of high-quality investments.

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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.

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