BALANCE SHEET SOLUTIONS
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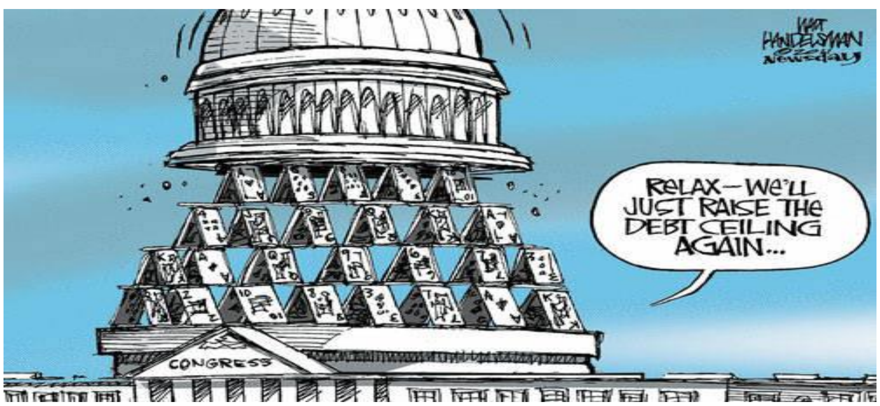
WEEK OF NOVEMBER 19, 2018

Weekly Relative Value

Does Money Grow on Trees?

"The power of compound interest is the eighth wonder of the world." – Albert Einstein

Growth has popped in the last year primarily because of the increase in deficit spending. Normally, countries try to moderate fiscal policies late in the cycle so they can keep some powder dry for the next recession. Today, debt and deficits are soaring. As interest rates rise, the interest payments on the massive federal debt soar and become an ever-rising share of fiscal resources and the economy. To wit, interest payments alone have soared 20% in the past year, by far the fastest-growing part of the spending pie.



The problem is that rising inflationary pressures are compelling the Fed to raise short-term borrowing costs further. The other problem is that the level of debt is on a destabilizing path. In the coming year, **$2.7 billion of national debt will be added every single day.** Think about that! As it stands, the net public debt has already more than tripled in the past decade to nearly $16 trillion. It has soared to 78% relative to GDP, and on track to top 96% in the coming decade.

As I have highlighted in this space, we will all suffer from the hangover from the ill-timed and ill-advised fiscal stimulus boost earlier this year. Last year, U.S. federal government debt service charges took up 6.6% of all spending. That was then. The future is much bleaker as the Congressional Budget Office estimates that in a decade, interest expense on the public debt will represent 13% of spending.

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

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By 2020, Washington will be spending more on debt service than on Medicaid; by 2023, interest costs will surpass the Pentagon budget; and by 2025, debt servicing will exceed all non-defense discretionary outlays.

It is almost surreal that the GOP was talking before the election about a "middle income" tax cut and now are talking about the need for an infrastructure boondoggle. Or the thought of making the last round of tax cuts permanent with no plan to rein in spending. For these politicians, it's as if money grows on trees.

THE RACE TO 6%

The average 30-year fixed rate on conforming mortgages (loan balances $453,100 or less and 20% down payment) has now risen to 5.17%. This is the highest average rate since September 2009. It should be noted that borrowers with smaller down payments and/or lower credit ratings are already paying quite a bit more.

Is 6% the Line in the Sand?

Mortgage rates, which are still historically low, are only 90 basis points away from 6%. This is where they were in December 2008. But as you will recall, at that point the Fed was unleashing zero interest-rate policy (ZIRP) and quantitative easing (QE) to purchase mortgages in an attempt to lower rates.

Now the Fed is unwinding its balance sheet and reducing mortgage-backed securities, which, in turn, is negatively impacting mortgage rates.

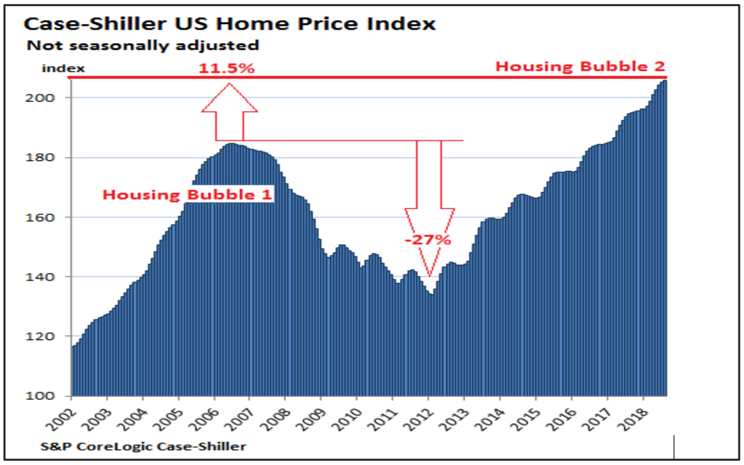
Since the beginning of the year, the 30-year mortgage interest rate has risen 95 basis points (from 4.22% to 5.17%) while the 10-year Treasury yield has risen 71 basis points (from 2.46% to 3.17%). Thus, the spread between the two has widened from 176 basis points at the beginning of January to 200 basis points now. In other words, mortgage rates are climbing faster than the 10-year Treasury yield, now that the Fed has begun the shed of mortgage-backed securities. This is hardly shocking as the Fed exits the mortgage market.

But, from a longer-term perspective, 6% is still low. However, while rates appear somewhat harmless over the long-run, home prices across the U.S. have surged 11.5% above the peak of the first housing bubble. In many local markets, prices have far exceeded levels seen in 2008/2009. (Think: Denver, Boston, San Francisco, L.A.)

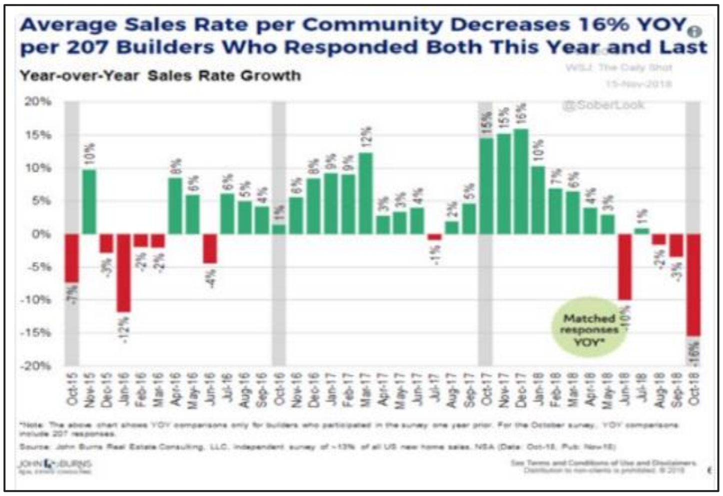
Thus, current mortgage rates – as low as they still are, historically speaking – are having an impact on the housing market. Some potential buyers are being priced out and others are skeptical that today's inflated home prices will not fare well with higher mortgage rates. To many, what was marginally affordable, with a good amount of stretching, has become unaffordable.

And the slowdown in housing is already becoming visible. For a few months now, we have seen the first indications in some of the hot local housing markets that fundamentals are deteriorating: declining sales, rising inventories, increasing number of days on the market even though their prices have not declined.

Housing Bubble 2?



Weak Home Sale Everywhere Except Florida



The real pain will likely occur when mortgage rates approach 6%. At that rate, many prospective home buyers will be priced out of the markets at current prices.

The solution will be lower prices – even if it means rising defaults and problems among mortgage lenders, particularly the non-bank lenders (the “shadow banks”). To wit, Quicken Loans has now become the largest mortgage lender in the U.S. Quicken Loans and other shadow banks are not regulated by the Fed and most have taken on more risk than conventional banks to gain market share. The Fed can only worry because it does not regulate these institutions.

THE STOCK MARKET ECONOMY

The stock market was not nearly as important to the economy then as it has become today.

Back in 1966, when the market had hit a peak (after a bull run that began in the early 1950s), the Wilshire 5000 (the broadest measure of the U.S. stock market) would have had a collective market cap of approximately 42% of GDP, meaning that stocks were worth less than half of the whole U.S. economy.

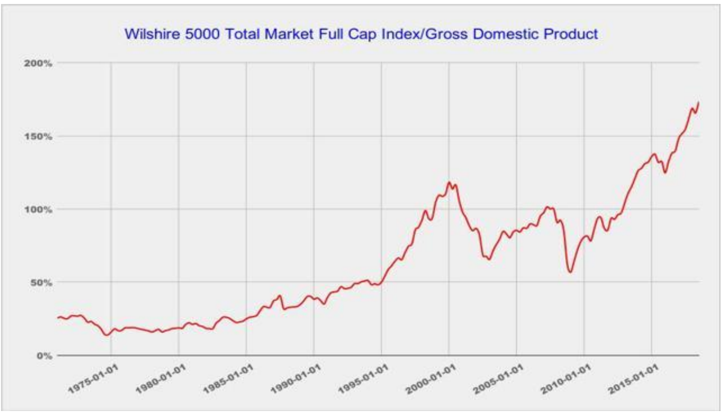
After a brutal bear market that lasted 16 years between January 1966 and August 1982, the valuation of the stock market was only 18% of GDP.

How different the world looks today. After more than 35 years of nearly steady gains, the Wilshire 5000 is now worth 173% of the overall economy, more than four times as big, in relative terms, to where it was in 1966.

This did not happen by accident. The principal driver of this has been the Fed's overly accommodating monetary policy that can fuel inflation, divert investment into "risk" assets, and lessen the fear of losses due to a belief that the Fed will be there to pick up the pieces after a possible crash. Tax policy, corporate accounting rules and financial technology have also added to the trend, but the big factor has always been the Fed.

The trillions of dollars created by the Fed need to go somewhere… and wherever it went, it would tend to push up prices.

Equity Market Cap to GDP



The stock market and house prices rising at double the pace of income growth gives consumers an artificial sense of how great they are doing. In other words, the "wealth effect" makes the economy appear healthier than it actually is.

The reality is, the U.S. economy has never been so dependent on asset inflation for its success. Yet, we know that cycles whose success are more hitched to asset inflation don't typically end very well, once the gas runs out on the "wealth effect."

The Oxford Global Economic Model suggests a 25% equity correction would potentially cut U.S. growth to around 1% by 2019.

But what would happen to the economy if the stock market entered into a protracted bear market like it did in the 1970s, a grinding downward move lasting more than a decade? Given the size of the stock market, and the way in which our economy has adapted to it, such declines could be devastating.

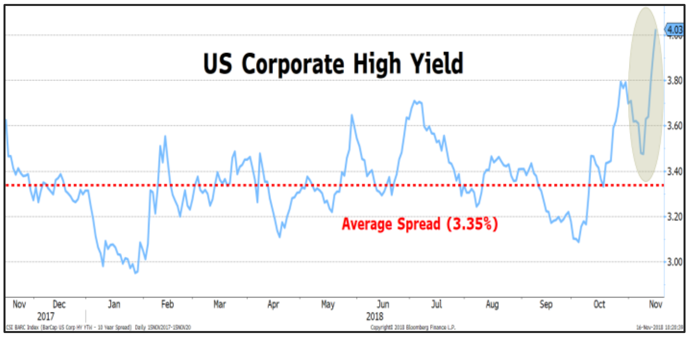
KEEP YOUR EYES ON CREDIT

"Liquidity is an elusive quality at the best of times. In a bear market, it can disappear in a moment. Rest assured that not all of today's trading strategies are predicated on that reality."

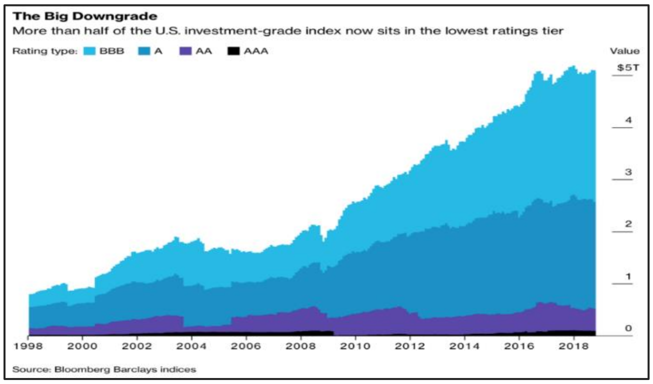
Everyone has been focused on what the equity market is doing. But the big action has been in the bond market. Specifically, the high yield corporate bond market where average interest rates have jumped 50 basis points in the past month and by nearly 80 basis points since the end of August. At just under 7%, the yield is at its highest level since July 2016. Recall, they got as wide as 887 basis points in February 2016 when they really hit attractive levels – without a recession!

Indeed, while that recession probability level looks benign (currently 14% per the New York Fed's model), it is on the rise. When it hit 14% back in 2007, spreads were closer to 700 basis points than the 400-basis-point gap that exists today. And it does not take a recession for spreads to widen. Should liquidity evaporate, the corporate market could be under serious stress with no buyers found. Yes, liquidity can disappear that quickly.

High Yield Spreads Gap Higher



The average spread of investment grade corporate bond yields over Treasuries has widened from 90 basis points in early February to 134 basis points today (they got as wide as 221 basis points in early 2016, as a yardstick). Making matters worse, at present, the triple-B market, one level above junk, is twice the size of the actual junk bond market. Consequently, it wouldn't take a huge percentage of triple-B downgrades to cause the junk bond market to balloon. In fact, if the bond rating agencies used their old-fashioned leverage ratios, as much as 45% of the investment-grade bond market could be downgraded to junk. Then consider what happens if the two giants teetering at the brink — GE and Citigroup — ever end up being downgraded from BBB status to junk.

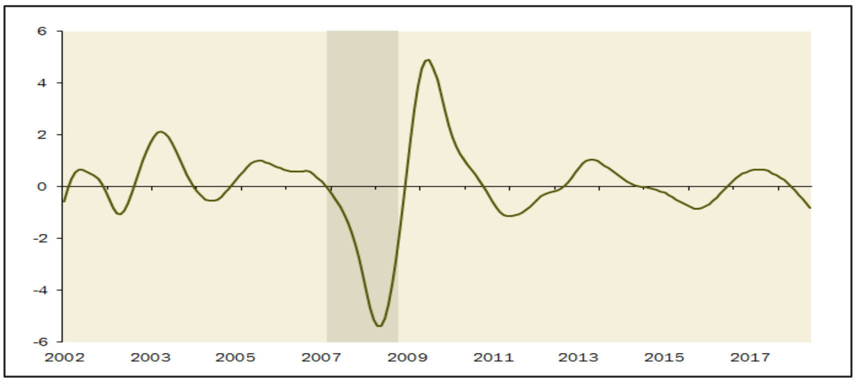


While the Fed may not yet react to what is happening in the S&P 500, the 50-basis-point run-up in the equity cost of capital in the past two months cannot simply be dismissed out of hand. The debt cost of capital rising more than 50 basis points has aggravated what has been a notable tightening in overall financial market conditions. Unless the inflation backdrop really begins to take off, the Fed may well end up pausing for a while beyond the December meeting.

GROWTH SLOWDOWN AHEAD

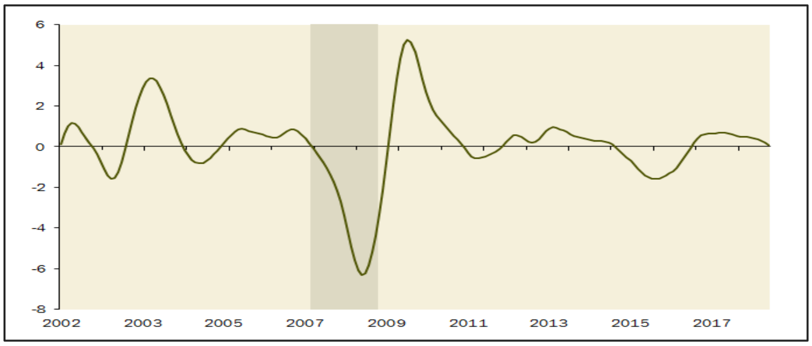
The Organisation for Economic Co-operation and Development's composite of leading indicators was released for September and showed the tenth straight month of sequential decline. We haven't seen a similar period of weakness in over two years. The year-over-year rate, which started the year at +0.45%, now stands at -0.82%, the weakest trend since April 2016. And the level, at 99.5, is actually the lowest since December 2012!

OECD: Composite Leading Indicators
(Year-Over-Year Percent Change)



Even the U.S., in a sign of the fading bump provided by the fiscal stimulus, has seen its growth momentum slow discernibly.

OECD: U.S. Composite of Leading Indicators
(Year-Over-Year Percent Change)



This message was reinforced by Economic Cycle and Research Institute's Weekly Leading Index, where the growth rate slipped to -2.6% in the week ended November 2. This marked the worst pace since March 2016 and is a massive haircut from the near -9% trend back in February.

Don't say you weren't warned ahead of time.

RECESSIONS: CAUSE AND EFFECT

History shows that we have had 13 Fed rate hiking cycles in the post-World War II era, and ten of these landed the economy in recessions. In the three “soft landings,” GDP growth slowed sharply even if there was no contraction. Simply put, each recession was caused by excessive Fed tightening, or at least the Fed not seeing the tea leaves and easing policy in time.

Every single Fed GDP model — New York, Atlanta and St. Louis — is suggesting that real GDP growth is slowing down to a two-something pace this quarter. From there, we may get an even softer pace into 2019.

Fed Hikes and Recessions

First Hike	Last Hike	Result
October -50	May-53	Recession
Oct-55	Aug-57	Recession
Sep-58	Sep-59	Recession
Dec-65	Sep-66	Soft Landing
Nov-67	Jun-69	Recession
Apr-72	Sep-73	Recession
May-77	Mar-80	Recession
Aug-80	Dec-80	Recession
Mar-83	Aug-84	Recession
Jan-87	May-89	Soft Landing
Feb -94	Feb-95	Soft Landing
Jun-99	May-00	Recession
Jun-04	Jun-06	Recession
Dec-15	???	???

The Powell Fed’s next move is going to be a rate hike. Now you know why the stock market has the jitters — it’s not typically bullish for risk assets when the central bank is busy raising rates into a slower growth profile.

Based on a recent survey, 66% of economists now forecast a recession in 2019 or 2020. Assuming economists actually get it right this time, and we see a downturn, the charts and tables below show how stocks and bonds are likely to perform.

What if We Get A Recession: S&P 500

Expansion Date		Peak to Recession Start		Recession Start to Recession Trough		Peak to Recession Trough	
		Months	Decline (%)	Months	Decline (%)	Months	Decline (%)
Oct-49	Jul-53	6	-7.2	2	-8.2	8	-14.8
May 54-	Aug -57	12	-9.1	2	-13.8	14	-21.6
Apr-58	Apr -60	8	-10.4	6	-3.8	14	-13.9
Feb-61	Dec-69	13	-15.1	5	-24.7	18	-36.1
Nov-70	Nov-73	10	-20.2	11	-35.1	21	-48.2

Mar-75	Jan-80	0	-0.9	2	-14.0	2	-14.7
Jul-80	Jul-81	8	-6.8	13	-21.8	21	-27.1
Nov-82	Jul-90	0	-0.9	3	-17.0	3	-19.9
Mar-91	Mar-01	12	-24.0	6	-16.8	18	-36.8
Nov-01	Dec-07	2	-6.2	15	-53.9	17	-56.8
Average		**7.1**	**-10.3**	**6.5**	**-20.9**	**13.6**	**-29.0**

As one can glean from the table above, stocks always decline during recessions. On average, the bear market (from peak to trough) lasted 13 months and the average decline is 29%. It should be noted that the past two equity debacles saw losses of 36.8% and 56.8%.

Meanwhile bonds are an investor's best friend in times of troubles. As shown below, 10-year Treasury yields have declined during every recession. On average the yield on the benchmark 10-year Treasury has fallen 160 basis points. So, maybe the long-term secular bull market in bonds is alive and well.

What If We Get a Recession: 10-Year Treasury Note Yield

Expansion Date		Peak Before Recession%	Recession Start	Low in Recession	End of Recession
Feb-61	Dec-69	8.1	7.9	6.3	6.5
Nov-70	Nov-73	7.6	6.7	6.7	8.1
Mar-75	Jan-80	11.2	11.3	9.5	10.8
Jul-80	Jul-81	14.7	15.0	10.4	10.7
Nov-82	Jul-90	9.1	8.3	7.8	8.1
Mar-91	Mar-01	6.8	5.0	4.2	4.8
Nov-01	Dec-07	5.3	4.0	2.1	3.6

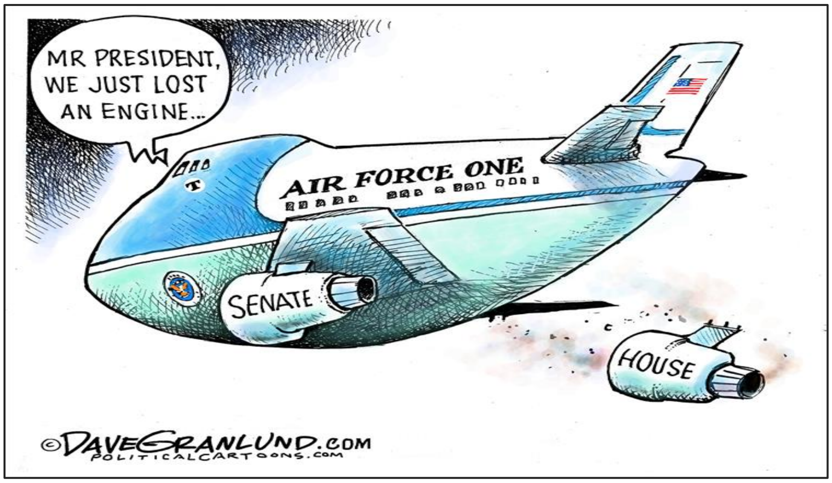
The 10-Year Yield Declines
160bps in recessions

ON THE POLITICAL FRONT

"With his polarizing political style, Mr. Trump, even more than most Presidents, will succeed or fail based on economic results. He should appreciate that a recession in the rest of the world is a threat to the U.S. economy and his Presidency." – Wall Street Journal: America Is Not an Island

On the political front, it looks like we had a "Blue Wave" in the midterm elections after all in the governorships and the House (now an estimated net swing of around 40 seats). Meanwhile the GOP won the Senate by a smaller margin than what was expected. There is something to be said about Arizona electing a Democrat for the first time since 1988. That is big and would have been unforecastable just two years ago. This is what happens when there is a huge voter turnout (largest in 50 years) and when women and millennials get more active.

This is the wonderful thing about America — egos and power-hungry king wanabees only end up with two years to wield their power. Then the Independents step in — nobody's "base" is bigger than theirs — and ensure that the system of checks and balances are reasserted. Of course, this means policy gridlock.



"INSANITY"

Speaking at New York University, the "Maestro" himself – former Federal Reserve Chairman Alan Greenspan – called Trump's tariffs "insane."

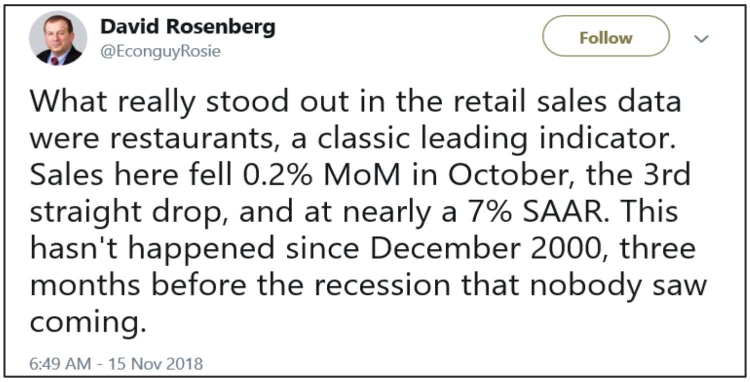
> Former Federal Reserve Chairman Alan Greenspan called President Donald Trump's tariff policies "insane" and said, "why we're doing it probably is very deep in the psyche of somebody."
>
> Responding to a question about China, he said both sides lose out in such a clash.
>
> "It's an excise tax, and people think of tariffs other than what it is, it's a tax and everybody engaged in warfare of this type, it would mean that you're withdrawing credit or purchasing power from a whole series of countries… **There are victors and there are losers in a tariff fight, but that doesn't say that a more important issue is both are losing, it's just the winner loses less."**

Greenspan is correct.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Mainstream money managers and Wall Street economists expect that growth should significantly moderate in 2019. Already there are signs that the interest-rate-sensitive part of the economy is starting to suffer. As discussed above, higher mortgages and declining housing affordability are becoming an issue as the inventory of homes is piling up in many parts of the country.

Also, the most recent October retail sales data from last week had a worrying omen.



So, will the Fed continue to raise rates?

In October, Fed Chair Powell stated in a Q&A at the Dallas Fed, **"We are far away from the neutral rate,"** and was quite upbeat overall. Most importantly, he said that while "stock market turmoil is something that affects the real economy and that financial conditions matter for the outlook," he defied hopes for a Fed intervention to halt the market slump, saying that the Fed is "looking mainly at the real economy." In fact, one could say that Powell brushed aside the recent market volatility, saying the October episode is just "one of many factors in a very large pod" and that "financial conditions and financial market activity matter a lot for that, and it's not just the equity market."

Fast forward to last Friday, Fed Vice Chairman Richard Clarida underscored the Fed's rising concerns with the global economy, warning that there is "some evidence of global slowing" while implicitly contradicting Powell's comment in September by saying that policy – currently 2% to 2.25% – is "getting closer to the vicinity of neutral and being at neutral would make sense." "Neutral" is that elusive rate that neither boosts nor retards the economy.

All of a sudden, we are told the central bank isn't far off from neutral as it turns out, and Clarida mentioned 2.5% as being at the lower end of the band — which technically would mean just one more hike! The futures market has moved from pricing in a one-in-three chance of the Fed fulfilling the median dot-plot projections of three hikes next year to one-in-ten odds currently. That implies that the peaks in short-term rates could come sooner and be lower than feared. It also indicates that the four quarter-point hikes by 2019's end, implied by the Fed's "dot plot" of rate projections, might not all materialize. That said, another quarter-point hike still seems highly likely, if only not to give the appearance of buckling to pressure from the White House, although the probability has slid to 68.9% from 78.5% a month ago.

Whatever the case, the bond market viewed Clarida's comments as dovish as yields dropped 3-5 basis points post-comments.

Bond Market Level and Reaction

Duration	Level	Change	Spread to Next
30-Year	3.333	-0.033	0.256
10-Year	3.077	-0.041	0.092
7-year	2.985	-0.450	0.093
5-year	2.892	-0.053	$\boxed{0.036}$
3-Year	2.856	-0.570	$\boxed{0.044}$
2-Year	2.812	-0.050	0.137
1-Year	2.675	-0.024	0.322
3-Month	2.353	-0.013	0.153
Fed Funds Rate	2.200		

Yield curve likely to invert here first

With all the volatility of the last month and midterms, less focus has been on one of the most ominous of economic signs: the yield curve. Well, Goldman Sachs weighed in last week, warning investors that a yield curve inversion is looming. Goldman went further than that to say two-years might be flat or overtake 10-years. The investment bank said that spreads between two- and 30-year bonds would fall to zero. To put that call into perspective, it would be a narrowing of 50 basis points versus now. Goldman highlighted the move in its **top themes to watch for 2019**.

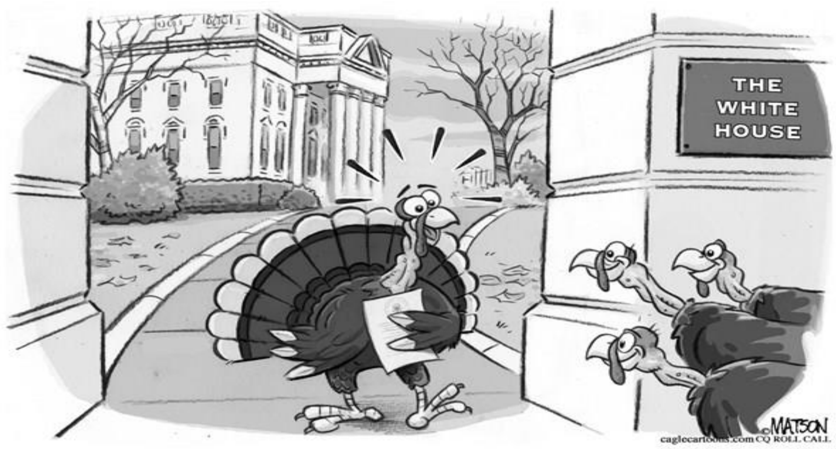
Remember: every time the yield curve has inverted, a recession has followed shortly thereafter. As shown above, only 3.6 basis points separate the five- and three-year maturities. Only 4.4 basis points separate the three- and two-year maturities. That's where yield curve inversion will likely begin.

In terms of strategy, credit unions should raise the overall liquidity and quality of their loan and investment portfolios. In terms of portfolio strategy, if the U.S. is on the cusp of slowing into the fourth quarter and into 2020, interest rates may be closer to peaking than widely believed. As such, we continue to advocate a fully invested, diversified, risk appropriate ladder strategy for credit unions.

HAPPY THANKSGIVING!

I want to take this opportunity to wish everyone a Happy Thanksgiving. We are all so fortunate to live in this great country. Please take some time to reflect on our many blessings with family and friends over the next week.

Enjoy!



"BETTER THAN A PARDON! THE PRESIDENT FIRED ME!!"

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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.

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.

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