Balance Sheet Solutions
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WEEK OF NOVEMBER 26, 2018

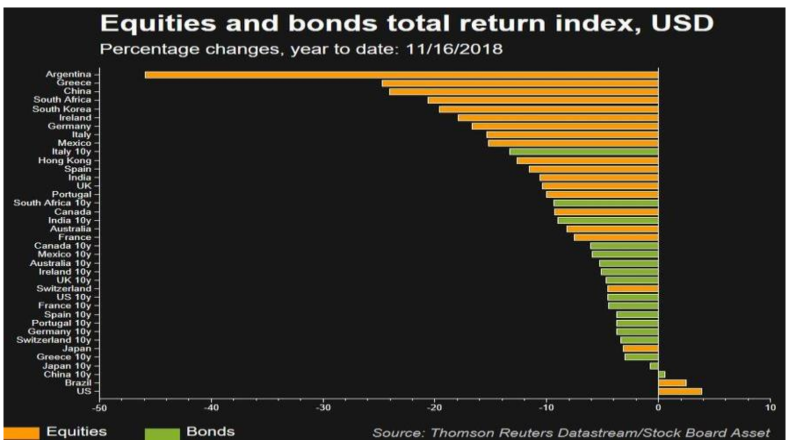
# Weekly Relative Value

## Swimming Naked

*"Only when the tide goes out do you discover who's been swimming naked."* – Warren Buffett

You can talk about valuations and fundamentals all you want, but liquidity is the oxygen for risk assets. And it is drying up.

The table below shows that both bonds and stocks around the world have suffered this year with almost no financial asset class posting positive returns. Brazilian and U.S. stocks, along with Chinese 10-year bonds, were the only assets that could muster a return with a plus at the front. And even those returns were anemic.




So why the terrible year for financial markets?

That's easy. It's the Fed.

The Federal Reserve – the world's central bank – has caused both a global economic slowdown along with a bear market in most financial assets.

Although many argue the Federal Reserve's rate tightening campaign has been modest, the opposite was true as the Fed approached the zero bound. Instead of sending rates to negative levels, they engaged in massive quantitative easing. This was monetary accommodation, and although it didn't send rates below zero, academics have created a method of measuring the "equivalent" rate. **This is known as the Wu-Xia Shadow Rate**.

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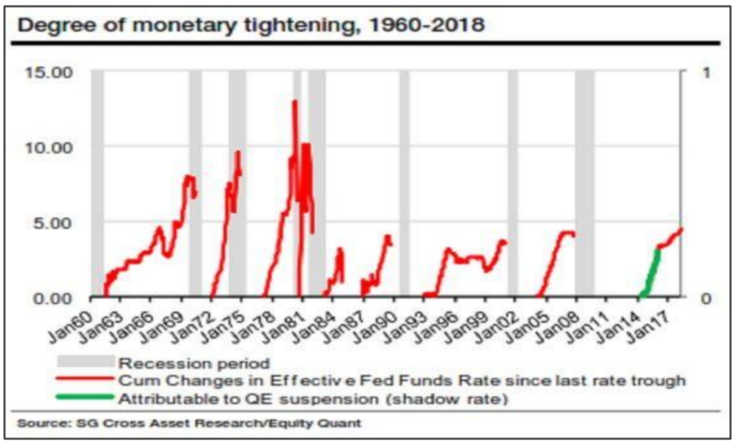
**THIS WEEK…**

As shown below, when you incorporate the quantitative easing suspension, this tightening cycle is much longer in the tooth and is now approaching a level of monetary tightening where the Federal Reserve has paused in the past.

The Fed has contended that its balance-sheet “normalization” is neutral for policy. Yet, in the past 12 months, the Fed effectively has drained more than a half-trillion dollars from the financial system. The central bank has reduced its assets by over $300 billion by running down its holdings of Treasuries and agency mortgage-backed securities. If the Fed continues to reduce its holdings by $50 billion a month, as it has been doing, monetary conditions would tighten by the equivalent of 220 basis points by the end of 2019. While markets focus on the fed funds rate, the unwinding of the Fed’s balance sheet is equally important as it serves to lower liquidity.




Many pundits have believed the U.S. economy would be impervious to this monetary tightening. Well, I did not buy that for one second. The reality is that the U.S. and the world have never been so indebted. Reducing liquidity through tighter monetary policy was bound to have an outsized economic and market impact due to this massive debt overhang.

Liquidity overrides everything else. Unless there is a reversal in central bank policy, which for now looks highly unlikely, it is becoming painfully obvious that once the monetary training wheels are taken away, this market bicycle is having to do the pedaling all on its own.

## LIQUIDITY AND THE STOCK MARKET

The S&P 500 has quadrupled this cycle. Yet panicked pundits are screaming at the Fed for taking the real fed funds rate to zero. If this is the “healthiest economy of all time,” can’t the markets stand on their own without ongoing life support?

I’m guessing if this was just about the economic fundamentals, the S&P 500 would have peaked a thousand points ago. I can hear the gasps. But the reality is, without the excess central bank liquidity from nearly a decade of repeated quantitative easing and interest rate suppression, the stock market would have “only” tripled instead of quadrupled. Even in the last credit-bubble-induced bull market of 2002-07, the stock market doubled – it didn’t even triple let alone quadruple.

What is truly amazing is Donald Trump’s comment: “*I’d like to see the Fed with a lower interest rate.*” As I have noted in the past, higher long-term rates are a byproduct of his administration’s fiscal and trade policies.

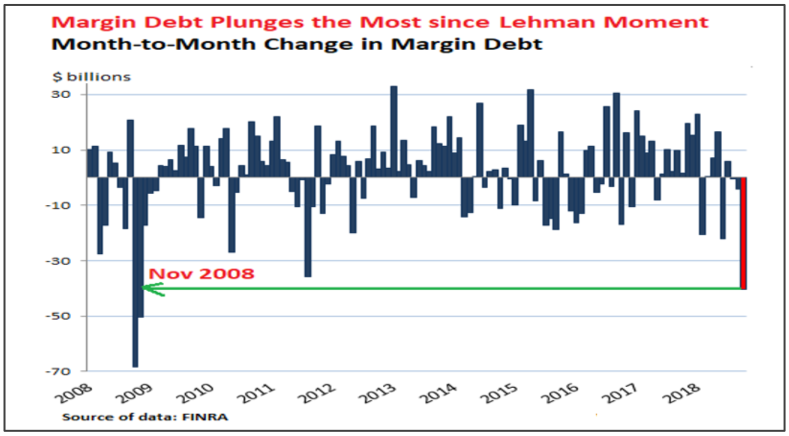
Let’s look at the facts. The economy is growing at 2-3%, inflation is 2%, unemployment is at a 50-year low and the fed funds rate is 2%. Against that backdrop, the real inflation adjusted fed funds rate is zero. What exactly is the President talking about? The Fed should not lower the fed funds rate back into negative terrain, in real terms, just to juice up what is still an over inflated stock market.

Regardless, the mean-reversion process seems to be underway and neither the White House nor the Fed can change the course.

## MARGIN DEBT PLUNGES

*"In the Chinese year of the dog, the canine's bite proved to be worse than his bark. In the coming year of the pig, no amount of lipstick is going to improve its looks."* – David Rosenberg

Since the financial crisis, margin debt has surged to a record high. In turn, that massive margin debt has fueled the stock run-up. But what goes up must come down. During the October meltdown, margin debt – the amount individual and institutional investors borrow from their brokers against their portfolios – plunged by $40.5 billion. As shown below, this is the largest decline in margin debt since November 2008.




And make no mistake, there is a strong correlation between the stock market and margin debt.

Rising margin debt creates stock market liquidity out of nothing. Thus, an increase in margin debt drives stocks higher. But when stock prices drop sharply, investors with margin debt get margin calls. Investors are forced to sell stocks to pay down margin debt. This creates a vicious circle whereby selling pressures intensify, which leads to increased margin calls, which leads to more forced selling. Thus, a high level of margin debt exacerbates the move down in stock prices.

The important point is that ballooning margin debt accelerates the run-up of stock prices and declining debt accelerates the subsequent sell-off. When the stocks are sold, the proceeds are used to pay down margin debt. Thus, the liquidity created from margin debt just evaporates without a trace.

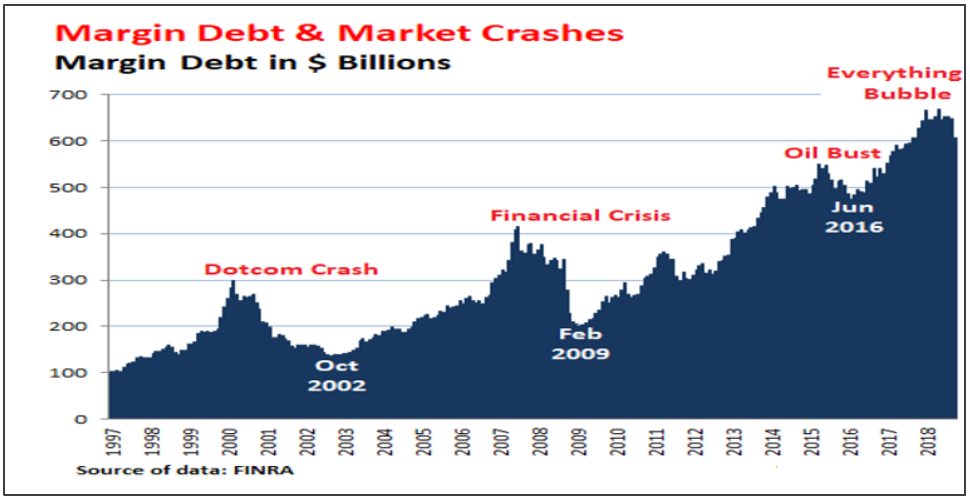
When the dot-com bubble burst, the Nasdaq had plunged 78%. Over the same period, margin debt plunged 54%. A similar scenario played out during the financial crisis crash. And now we have the "Everything Bubble."

If history is any guide, October's plunge in margin debt may just be the beginning.

With a Fed bent on continuing to lift interest rates, earnings showing real signs of deterioration, ongoing trade wars and tariffs, continued reductions in central bank liquidity, and corporations curtailing share buybacks – the market finally appears to be starting to *run on empty.*

To the extent that you believe that the Federal Reserve is not ready to become dovish, then the risk to equity markets remains to the downside despite the recent sell-off — perhaps meaningfully so.

Forewarned is forearmed.




## THEME FOR 2019

*"The sell-off in GE is not an isolated event. More investment grade credits to follow. The slide and collapse in investment grade debt has begun… Don't be fooled by bond prices holding up, because trading volumes are down. There are fewer bids in the market, and the dispersion of bids is wider. It is time to jog—not walk—to the exits of credit and liquidity risk." – Scott Minerd, Guggenheim Partners Chief Investment Officer*

The pullback in liquidity and overall tightening in financial conditions is readily apparent in the credit markets, which have seen some rapid erosion. Corporate credit took a pounding in October, which extended into November (especially in the debt-heavy BBB space). U.S. average corporate bond yields at 4.4% have jumped to the highest level in 8+ years. Credit default spreads (CDS), which measure the risk of default, have climbed back to 18-month highs in the U.S.

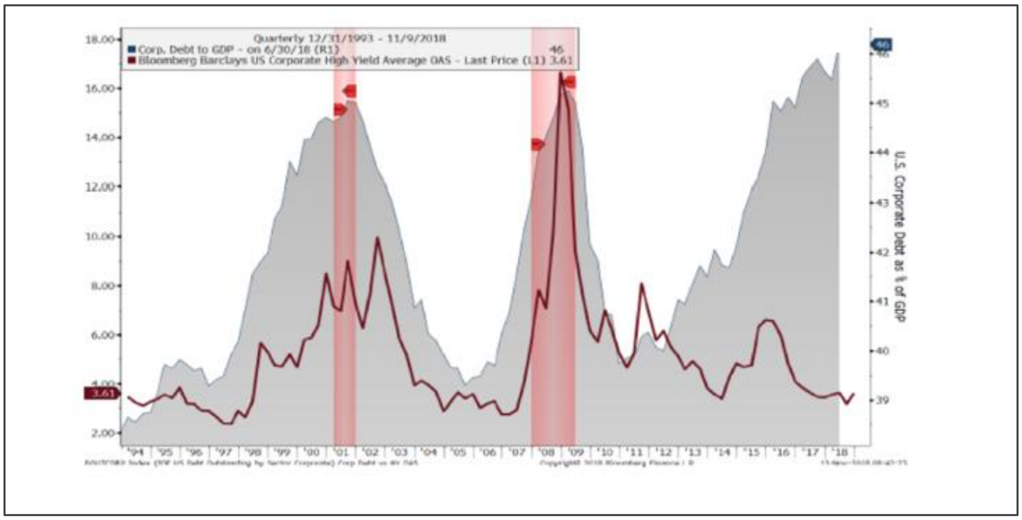
The problem facing the corporate bond market is excessive debt and an oversupply of bonds. There is a lot of leverage among corporations, which can be seen in "massive increases" in the size of the investment-grade market and a deterioration in the quality of debt. Spreads are tight – even tighter than you think – because quality has been systematically going down in the covenants that are offered by corporate issuers. In other words, despite the recent widening spreads and debt, levels are out of sync with one another.

That dichotomy is illustrated in the following graph. The shaded area depicts leverage (the corporate debt-to-GDP ratio) and the red line is the option-adjusted spread between high-yield (junk) and Treasury bonds. The two moved in sync from 1994 until 2013, after which leverage increased without a similar increase in spreads.

Going forward, corporate cash flows will face tremendous competition from higher wage and interest costs in the face of challenges from a softening global economy. Highly-leveraged companies with a daunting refinancing calendar — a tsunami of $3.5 trillion of total corporate debt refinancing for the next four years begins in 2019 — are going to face a fork in the road as to whether to continue to please equity owners or to focus on bond holders and avoid the disruption of being downgraded.

If you are looking for a theme for 2019, corporate deleveraging should be near the top of the list. If the name of the game for the $3 trillion of the near-junk BBB credit space — a record high 50% of the total corporate bond market — is to stave off a downgrade to non-investment status, then the implications for stock buybacks and dividend payouts for the equity market are going to be somewhat short of supportive.

**Corporate Yields Inconsistent with Supply**




## WHERE IS CAPEX SPENDING?

We were told by the President that the corporate tax cuts, profit repatriation and accelerated depreciation allowances would unleash a CAPEX boom.

Let’s take a look.

New orders for durable goods collapsed 4.4% month-over-month in October, which followed a 0.1% dip in September. The consensus was expecting an aircraft-induced decline around -2.6%, not -4.4%. Not to mention, September was revised sharply lower to -0.1% from +0.7%.

And the critical non-defense capital goods order segment excluding aircrafts was unchanged (actually down 0.04% to the second decimal place… having declined now for three consecutive months), which again surprised a consensus looking for a 0.2% uptick. The data were all the more disappointing given that September was revised to now show a 0.5% slide instead of a 0.1% dip.

Machinery orders tumbled 0.5% in its worst month since March. Primary metals (weren’t we told that without steel, we have no industrial base?) plunged 2.3% and have seen orders slide now in five of the past six months. Autos eked out a 0.2% gain but have basically stagnated since July.

If corporate America is not willing to invest in their future now, when will it?

## HOUSING LANGUISHES

Courtesy of the existing home sales report, housing experienced a positive surprise. Existing home sales rose 1.7% in October, the first increase since March. But don't get too excited. This did little to recoup last month's 3.4% slide. And even with this month's bounce, sales are 5.1% below year-ago levels (and down 7.3% at an annual rate for the year-to-date).


Not just that, but at 5.22 million annualized units, resales are actually lower today than they were in July 2013! More than five years of nothing. The housing market is rolling over with inflated prices and higher rates. More timely data (i.e. housing starts, mortgage applications) on housing activity show absolutely no acceleration whatsoever — if anything, the trend has actually worsened further. Not too difficult to understand... unless you are a PhD economist working for the Fed.

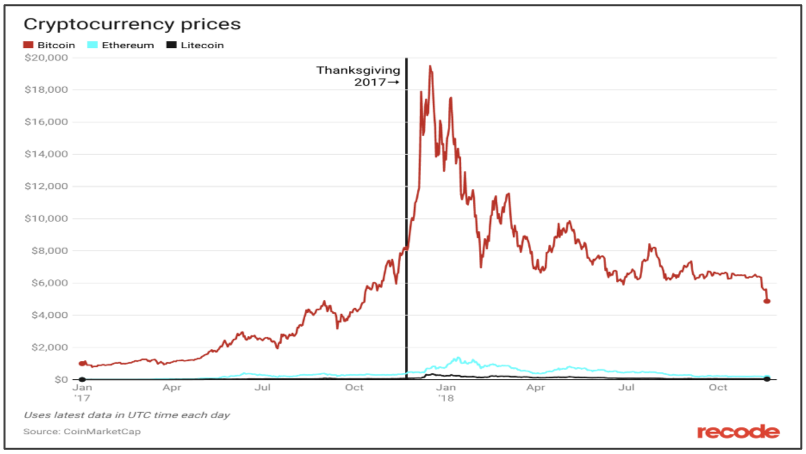
Why are existing home sales languishing? Most notably, housing has seen many years of price growth outpacing wage gains and the recent back-up in mortgage rates is making homes unaffordable. This is especially noticeable for the first-time buyer, which represented a miniscule 31% of sales during October. Normally, a healthy market would expect to see this share closer to 40% to 50%. This sheds some light on why residential real estate has underwhelmed in this nine-year-plus expansion.

## BITCOIN HAS NO PLACE AT THE TABLE

As shown in the following graph, Bitcoin and other cryptocurrencies have been on a decidedly negative trend since the beginning of 2018. In January, Bitcoin was trading at a whopping $18,000 per coin. As of last Friday, the most famous cryptocurrency had fallen to close to $4,000. Clearly the bubble in digital currencies has burst. Is this yet another victim of liquidity backdrop?

Here is some great advice from Recode:

*"So, in case the people around your table bought into crypto last year and didn't get out in time, it might be a good idea to treat the subject like politics; keep quiet and pass the gravy…" – Recode*




## CRUDE DROPS 34% IN 7 WEEKS

The chart shows how West Texas Intermediate (WTI) crude oil fell by over $26 per barrel or 34% since early October.


So why have oil prices fallen?

While supply has definitely increased, I believe the slowing global economy, is the unpreventable cause of what's going on, and will continue to go on.

Oil prices are a reflection of supply and demand. Global demand has already been falling for the last several months and oil prices are now waking up to that reality. Oil prices also tend to lead the broad economic cycle as well. Since most of the economic data we look at is trailing, and subject to heavy negative revisions, the collapse in oil prices suggests that coming economic reports will likely be materially weaker than currently expected.

But there is another enormous problem for the oil and gas sector currently at risk – the debt.

For the last few years, oil companies have been taking advantage of the extraordinarily low interest rate environment to leverage up and chase marginally productive drilling in high-depletion rate shale wells.

Since energy-related bonds make up about 15% of the high-yield index, and with a substantial number of corporate bonds on the verge of falling below BBB ratings in the months ahead, the potential impact of falling energy prices *(a reduction in revenue)* and higher borrowing costs is a potential double-whammy to an important sector of the economy.

## IT'S A MAD, MAD WORLD

The madness of the world is in full display. On the same day that the President tweets that he wants lower oil prices, he publicly supports the Crown Prince of Saudi Arabia and dismisses the CIA findings that the Prince had ordered the murder of the American journalist Jamal Khashoggi. In other words, when American values, such as defending human rights and the rule of law, collide with American interests, Trump will opt for the latter.

Meanwhile, the President gloats of how he has singlehandedly brought gasoline prices down. If I hurt anyone's sensibilities and sensitivities with this stream of consciousness, I truly apologize. After all, there is no personal advantage for the President to be cozying up to Crown Prince Mohammed Bin Salman; it's all about America First. Sure thing.


## MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"I can't overstate how important it is to understand and learn from market cycles and history."* – Howard Marks

I have heard from many Wall Street pundits that there is no recession coming. No one sees a recession. But when has the consensus ever called for a recession? The answer is NEVER. Likewise, the Fed staff, all with PhDs and the most elaborate macroeconomic model on the planet, has not called for a recession EVER, even when staring them in the face. So, Wall Street and the Fed have a PERFECT record of NEVER forecasting a recession. And yet, since 1950, the U.S. has had 10 recessions.

Here is a dose of reality. Over the past three months, existing home sales have contracted. The cyclically sensitive segments of retail sales, from autos to building materials to appliances to sporting goods to restaurants, have all weakened significantly. And core CAPEX orders have contracted over this time frame. This covers all three major facets of the economy — housing, the consumer and the business sector. This reflects a significant change from growth to stagnation. Guess what comes after that? Recession pressures are building.

There have been 13 Fed tightening cycles in the post-World War II experience, and 10 of them landed the economy in recession. Thus, we know that there is close to an 80% chance of a recession based on this alone. The lag from the start of the tightening cycle to the recession is typically 3-4 years. The Fed started this campaign in late 2015, so do the math.

Assuming the Fed raises rates again at the December 19 meeting, together with the ongoing impact of the "quantitative tightening" from the balance sheet reduction, the cumulative tightening by the Fed will come to approximately 500 basis points. This is a massive dose of monetary policy tightening on the most leveraged peacetime economy of all time.

By the way, the "greatest economy of all time" has just seen the Atlanta Fed's GDPNow model reduce its estimate of fourth quarter real GDP growth to a 2.5% annual rate from its 3% call at the beginning of the month. The Atlanta forecast has now moved below the New York Fed's forecast of 2.6%. But, the St. Louis Fed, in less than a week, has gone to 2.3%.

Watch fourth quarter real GDP growth forecasts come down further. Sub-2% may not be a stretch, and likely a mere appetizer as we head into 2019 when the fiscal hangover begins and the peak impact of what the Fed has already done wreaks havoc on the data.

While a 25-basis-point rise in its key interest rate target is still all but certain at its December policy meeting, market participants are growing increasingly skeptical that the central bank will follow through with the three hikes in 2019 implied by its most recent "dot plot" of projections.

On Wednesday, Fed Chairman Jerome Powell addresses the Economic Club of New York and investors will be all ears looking for hints about future monetary policy. Powell's speech will likely be watched closely in light recent discussion from officials on downside risks to the outlook and softer inflation. Additionally, Vice Chair Richard Clarida speaks tomorrow and will be closely watched in light of his dovish remarks 10 days ago, which seemed to signal a notable repricing of Fed expectations. The Federal Open Market Committee (FOMC) minutes on Thursday may be a touch backward-looking but are always interesting. Watch out for Black Friday and Cyber Monday sales data as well for a barometer on the consumer.

Later this week, the G20 meet. That said the meeting is a sideshow to the meeting between U.S. President Trump and Chinese President Xi Jingping to discuss trade. Recent comments (per Bloomberg) from White House economic advisor Larry Kudlow have been mixed; however, Kudlow has said that Trump is trying to "inject a note of optimism into trade talks with China" while Trump himself has been reported as saying that "China wants to have a deal." This suggests that the President has been siding with the more pro-free trade advisers in the White House recently. Since then, news broke that China hawk Peter Navarro will not be attending the meeting, which also lends support for potential progress at the meeting. That being said, it's still extremely difficult to predict the outcome but expect plenty of headlines and hints through this week.

As we start the new trading week, we have a hope-faith rebound on our hands. Hope that the President will want to try to turn the stock market, his self-made yardstick, higher by sounding conciliatory at the G20 meeting (which kicks off this Friday). Hope that oil has bottomed. Hope that Powell now will start to sound dovish. Hope that Italy will go back to the drawing board. Hope that the border funding issue and possible government shutdown will somehow just go away. Hope that the House Democrats will not just reflexively file subpoenas. Hope that the positive seasonals will reassert themselves. Then again, hope is rarely, if ever, a very effective investing strategy.

From a risk management perspective, credit unions should focus on maintaining higher quality assets and a high level of liquidity in the investment portfolio and overall balance sheet. Now is not the time to push the envelope of risk. In terms of portfolio strategy, as noted for the past few months, credit unions should remain fully invested in a diversified, high quality, risk appropriate ladder strategy.

## PREMIER PORTFOLIO

For the first time, Balance Sheet Solutions, LLC credit union clients are now able to perform many of their daily investment activities all in one location, including…

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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.