Weekly Relative Value

The Magic Wand

At a campaign rally last week, Trump bragged that his administration had "**found the magic wand"** for manufacturing in the U.S. Just a few hours later, GM announced it will be closing eight plants, four of which are in the U.S., and shedding close to 15,000 workers. That's a lot of folks.

Why the cutbacks?

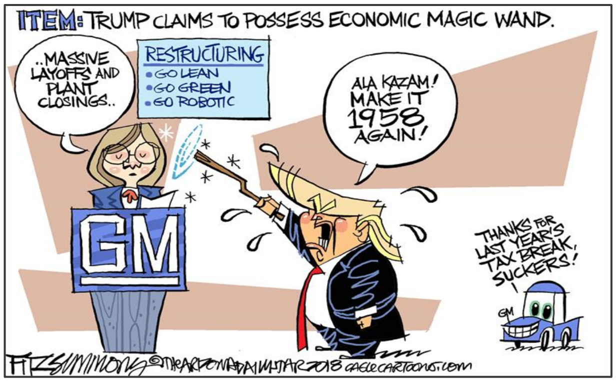
GM's new-vehicle deliveries in the U.S. plunged 11% in the third quarter. GM apparently expects these "market conditions" to worsen further, and it's getting ready for it. Additionally, GM "will double" resources allocated to its electric and autonomous vehicle programs over the next two years. This is a massive shift that other automakers are also undertaking.

In response to the GM announcement, Trump told GM CEO Mary Barra she had "**better"** reopen plants in the U.S. soon.

Or what?

Donald Trump says in his attack against GM that he wants to "protect" workers. But "protection" from what? Capitalism?

Meanwhile, Mary Barra isn't a public servant; she's only there to "protect" shareholders.



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

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THIS WEEK…

And frankly, Trump's own trade policies have hurt the auto industry by layering on higher costs of steel and aluminum products for the auto sector and hastened the restructuring.

"President Trump believes he can command markets like King Canute thought he could the tides. But General Motors has again exposed the inability of any politician to arrest changes in technology and consumer tastes roiling the auto industry… Mr. Trump thinks his trade machinations can overrule the realities of the marketplace, but he's wrong as Barack Obama was about climate and regulation. Fine with us if he wants to end subsidies for all companies. But if he intervenes to make GM less competitive, Mr. Trump will merely hurt more workers." – Wall Street Journal Editorial, "Trump's GM Collusion"

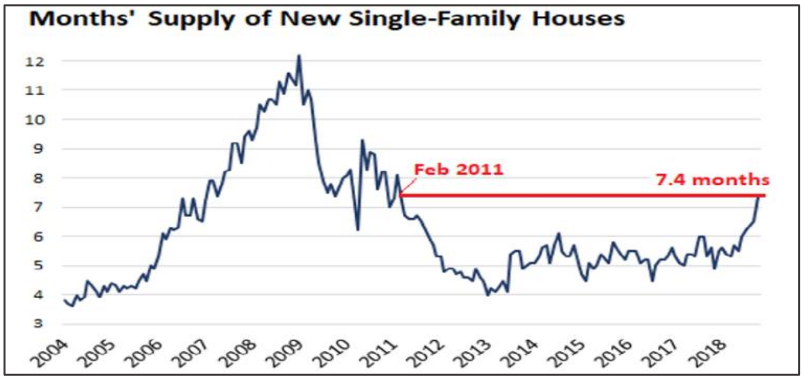
The U.S. needs free market capitalism; free of government subsidies and government interference. Trump is the ultimate in government interference. Talking up some companies one day and deriding them the next. Putting in tariffs which raise their costs of production. Threatening companies if they don't do what he wants.

We are about to find out how little "magic" there is in Trump's wand.

HOUSING IN THE BASEMENT

The long list of weak housing data continued in October with the release of the new home sales. Sales collapsed 9% month-over-month in the worst monthly setback of the year. Year-over-year new single-family houses plunged 12%, while the six-month trend is down 26% annualized and the three-month pace is -35% annualized. In other words, the contractionary trend in housing is accelerating. And the trend is now broad based: Northeast (-18.5% month-over-month), Midwest (-22%), South (-8%) and West (3%).

And suddenly gone is the previously hyped "shortage" of inventory. Over the past three months, unsold supply has expanded at a surreal 33% annualized rate at a time when sales have plunged by even more than that amount. This has pushed the unsold inventory backlog up to 7.4 months of supply, the highest since February 2011, during, the first housing bust in this millennium.



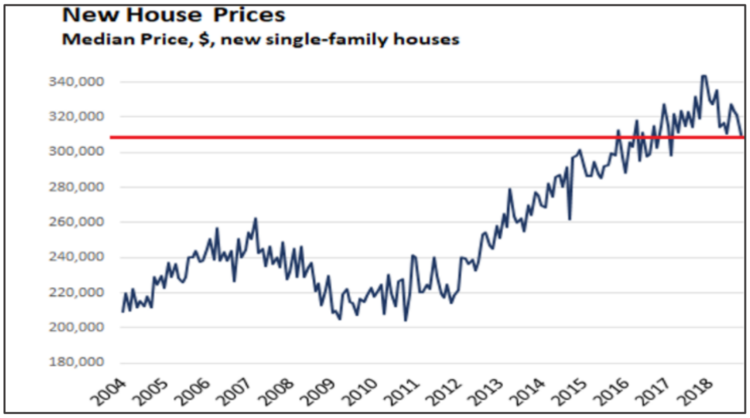
Less demand and more supply have combined to drag median new home prices down for the third decline in a row and the fourth in the past five months. Prices are down nearly 10% from the peak of nearly a year ago. At $309,700 the median new home price is actually lower now than they were three years ago. Wealth effect on spending — we hardly knew ya!

As I have been saying for some time, the woes in housing have morphed into a demand story as the pace of price gains, coupled with the rise in mortgage rates, eroded already poor affordability, especially for first-time buyers.

Adding to the gloom in the housing sector, pending home sales, which lead future activity, dropped 2.6% month-over-month in October. The year-over-year trend is -4.6% and on a clear bearish trend – now down to its lowest level in more than four years.

Also, worth noting, the weekly bank lending data shows that mortgage growth has slowed to a crawl. This reflects reduced demand but also some growing caution among the lending community, which has been hunkering down and shedding assets in recent months.

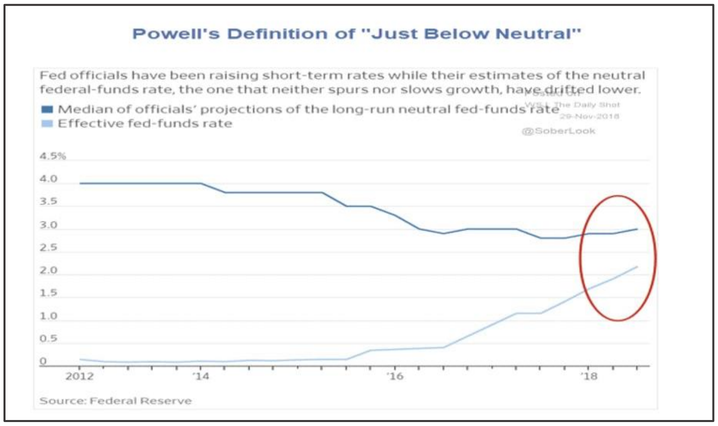
The question is how a sector with such powerful multiplier impacts, not to mention reliable leading economic properties, was not mentioned at all in Fed Chair Jay Powell's rosy speech last Wednesday.



"JUST BELOW NEUTRAL"

On October 3, the Fed Chairman said we were "a long way from neutral." And indeed, we are.

Last week, the junky monkeys that populate the stock market thought they heard something different. They thought he turned dovish. They are wrong.



Powell didn't say that the Fed is close to neutral.

He was more specific. He said, for the record, *"Interest rates are still low by historical standards, and they remain just below the broad range of estimates of the level that would be neutral for the economy — that is, neither speeding up nor slowing down growth."*

He said that rates are slightly below the low end of the range of estimates. That range is estimated to be between 2.5% and 3.5% — so at a 2% to 2.25% band right now, rates are between 25 and 50 basis points below that low end. And rates are still about 75 or 100 basis points shy of the midpoint.

Furthermore, Powell seemed pretty bullish on the economy. He is "forecasting continued solid growth." So why pause? In terms of the financial sector, "the system is now much stronger... financial institutions and markets are substantially more resilient than they were before the crisis." So why pause? He added, "Household debt would not present a systemic stability threat if the economy sours." So why pause? He isn't worried about weakness in equities barring some systemic risks being generated. He mentioned that "large, sustained declines in equity prices can put downward pressure on spending and confidence." But so far, we haven't really seen anything "large" or "sustained." So why would he pause? He specifically said, "It is important to distinguish between market volatility and events that threaten financial stability."

History shows that the Fed has never, not once, completed a tightening cycle without taking the funds rate above neutral. Even during the "soft landing" episodes in the mid-1960s, mid-80s and mid-90s. Don't ever bet against history rhyming.

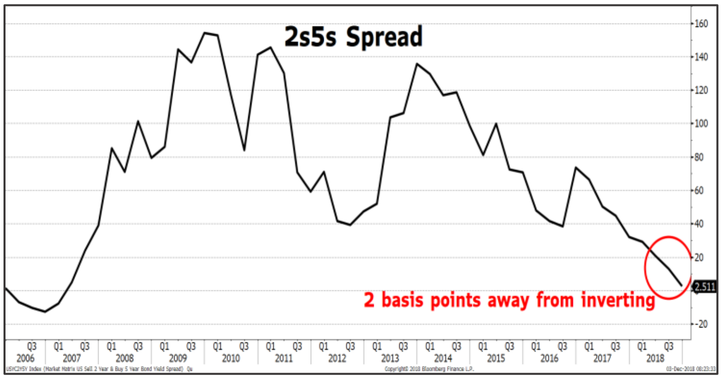
Nothing has really changed.

THE LAG EFFECT

The most important thing that Jay Powell said last week was:

> *"We also know that the economic effects of our gradual rate increases are uncertain and may take a year or more to be fully realized." – Fed Chair Jerome Powell*

The Fed has already de facto tightened the equivalent of over 300 basis points this cycle. Even if the Fed pauses after the December hike, the $600 billion of quantitative tightening in 2019 would be equivalent to Powell raising rates 130 basis points. Thus, the aggregate tightening will approach 550 basis points. No expansion ever survived that degree of policy restraint.



We are nearing the peak of the expansion and credit cycle; all bets are off that there is anything the Fed can do to prevent the downturn from taking hold. Recessions are inevitable facts of life. Will this be another case where the Fed stayed too loose for too long and then Fed has to overtighten? Brace for it, especially since so few expect any real meaningful economic slowdown next year.

Meanwhile, the Treasury market is starting to sniff out a recession as the spread between 2s and 5s is within three basis points of inverting. As an aside, the yield curve does not have to invert — the flattening trend on its own is also flashing a notable cooling off in growth in 2019.

REASONS FOR CONCERNS

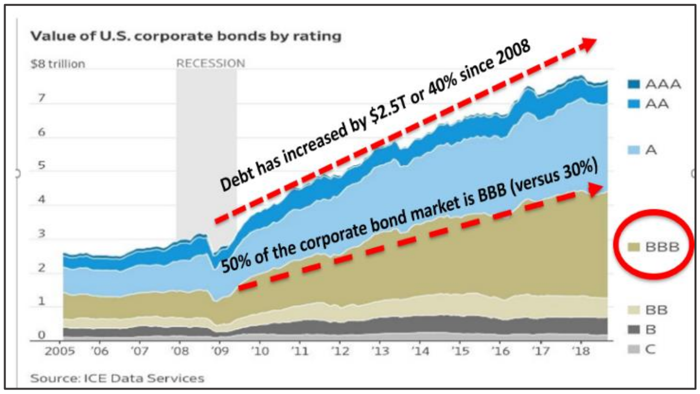
While Chairman Powell was upbeat on most aspects of the economy, he did highlight concerns about high levels of debt among non-financial businesses (banks excluded), and especially the high level of leveraged loans. This makes the economy more vulnerable to a sharp pullback in credit availability, which could exacerbate the effects of a negative shock on economic activity.

"There are reasons for concern, however. Information on individual firms reveals that, over the past year, firms with high leverage and interest burdens have been increasing their debt loads the most. In addition, other measures of underwriting quality have deteriorated, and leverage multiples have moved up. Some of these highly leveraged borrowers would surely face distress if the economy turned down, leading investors to take higher-than-expected losses-developments that could exacerbate the downturn. The question for financial stability is whether elevated business bankruptcies and outsized losses would risk undermining the ability of the financial system to perform its critical functions on behalf of households and businesses."

"Looking across the landscape of major asset classes, we see some classes for which valuations seem high relative to history. For example, even after standard adjustments for economic conditions, valuations on riskier forms of corporate debt and commercial properties are in the upper ends of their post-crisis distributions, although they are short of the levels, they hit in the pre-crisis credit boom." – Chairman Jerome Powell

Over the past few weeks this point has been highlighted in this space. The market value of the investment grade corporate market is $6 trillion. Approximately 50% of this debt is rated BBB, or one notch above junk. Almost 30% of the companies in this huge BBB tranche have debt-to-EBITDA ratios in line with the average in the non-investment credit arena.

To avoid a wave of "fallen angels" (BBBs that get pushed into "junk") corporates need to repair their balance sheets. Next year's focus will be on debt servicing and debt retirement, likely at the expense of shareholders. Either that or we see a raft of credit downgrades that force corporate bond spreads wider, with the increased debt cost of capital impairing economic growth.



HAVE JOBS PEAKED?

Since hitting a 49-year low back at the beginning of September, the trend in unemployment claims has risen for three consecutive weeks. While the numbers are still low by historical standards, the rise in claims suggests it will be harder for the economy to continue to post the large employment numbers we have been seeing (absent a rise in the number of hires, which seems unlikely given the depleted labor pool). As a result, expect a slower pace of payroll growth going forward.

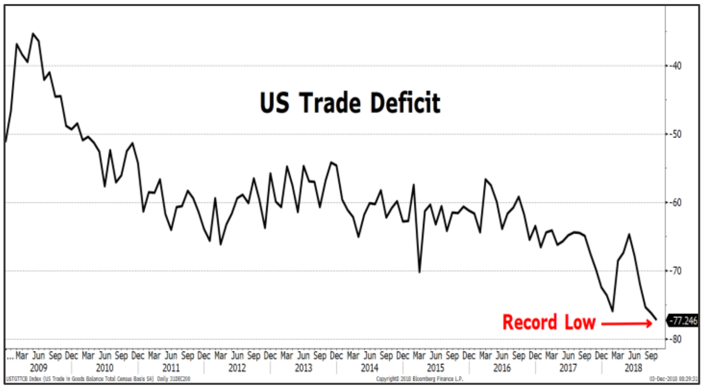
"Trumponomics" may be partly to blame. Legal immigration is down 6.5% over the past year because of the restrictive, or "protection," policies being pursued by the populist administration. This is curtailing the inflow of skilled labor that businesses critically need at the current time.

President Trump has also been successful in driving down the number of undocumented immigrants living in the U.S. While deterring illegal immigration has some merit, these policies have reduced a source of cheap labor for the economy. And remember these individuals who were gainfully employed were contributing to economic activity.

The latest National Federation of Independent Business (NFIB) survey showed that a near-record 53% of small businesses cannot fill their open job positions because of a lack of qualified applicants. "Labor quality" was their biggest concern. A mere 2% say Fed policy is their chief dilemma and yet the President spends his time tweeting about the central bank, in a clear attempt to divert people's attention from the wide array of other factors impeding economic growth: restrictive immigration policy, cost-push inflation from tariffs, and high and rising structural fiscal deficits.

U.S. TRADE DEFICIT SPIKES HIGHER

It's noteworthy that Donald Trump has made reducing trade deficits a pillar of his economic policy and yet net exports made their largest negative contribution to GDP since 1984! The trade balance widened to $77.2 billion in October, a fresh record. Exports, due to waning global demand and a stronger U.S. dollar, fell 0.6%, their fourth decline of the past five months. Meanwhile imports, driven by comparably firm domestic demand (on account of the reckless fiscal stimulus package), inched up +0.1%, the sixth straight increase.

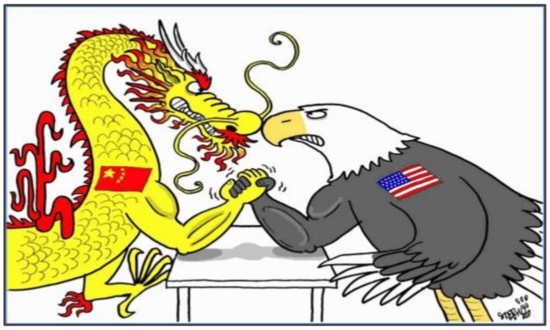


A TRUCE?

"U.S. President Donald Trump and Chinese President Xi Jinping agreed to keep their trade war from escalating with a promise to temporarily halt the imposition of new tariffs as the world's two largest economies negotiate a lasting agreement." – Investor's Business Daily

Who knew all it would take was a dinner and a handshake over a 90-day trade truce to unleash such a powerful rally in risk assets? The Chinese agreed to buy more U.S. products and lower some of its import duties on autos, and the U.S. agree to hold off on raising tariffs to 25% from 10%. A 90-day truce! To negotiate over negotiations.

Imagine what would have happened if the trade war with China had actually ended! This postponement alone has triggered a huge rally today. So, the Grinch may have stolen Thanksgiving profits, but Christmas came early for markets with world stocks rising over 1% as S&P futures jumped as much as 2% and the Shanghai Composite soared 2.9%.



That said, aside from preserving the status quo on the current state of the trade war, which means no additional tariffs and no hikes to the tariffs rates, nothing has really changed besides a few vague promises from both sides to reach trade utopia – something both sides know will never happen.

China gets a delay. So, does Trump amidst rising complaints from the automotive and farm sectors.

Hooray!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Risk assets, like equities, are showing signs of relief that the trade tensions have been reduced for now. The halt to trade hostilities and tariffs for a while is probably good enough for a relief rally in both the U.S. and Chinese markets, but not enough to change the current outlook for next year and stop the global economy from slowing down. The slowdown in trade already is slowing economies that depend on capital-goods exports. Japan's economy, the world's third largest, contracted at a 0.3% annual rate in the third quarter, while Germany, No. 4, contracted at a 0.2% pace.

On the domestic front, Powell is due to testify on Wednesday before the Joint Economic Committee of Congress, where he's sure to be grilled further on the outlook for rates and the economy. While the markets remain priced at 74% of the way for a December rate hike, it is the 2019 policy path that is up for debate. The odds of the Fed going three times for next year, as they pledged, have collapsed from 26% just one month ago to 10% currently. The futures market is discounting just one rate hike for 2019 and that one hike is in the second half of the year. That said, with two more Fed rate hikes (at least) on the cards, yield curve inversion is still in play for early next year.

More clues are due on Friday in the employment report for November; the consensus forecast calls for a 200,000 rise in non-farm payrolls and an unchanged jobless rate of 3.7%. As noted previously, there has been a slight upward drift in unemployment claims in recent weeks. Given the weakness in trade and housing, it's something to be watched.

Meanwhile, last week in the bond market the yield on the 10-year Treasury note declined four basis points to 3.02% and is just above the 100-day moving average. The 200-day trendline isn't far off now at 2.96% and a break would open the door to a 2.80% test. We haven't seen a two-handle grip on the 10-year Treasury note yield since last September and we are just a couple basis points away. Where are all those bond bears who, just a few months ago, were calling for the end to the secular bull market?

Frankly, yields could have been significantly lower, but the supply curve has shifted out dramatically. Treasury borrowing is so out of control that the borrowings last week totaled $129 billion, a 28% expansion from the same time a year ago. All else equal, a shifting of the supply curve out and to the right generates lower prices and, in this case, higher yields (or higher than they otherwise would be).

In terms of portfolio strategy, credit unions should continue to maximize liquidity while overweighting quality assets in the overall balance sheet and investment portfolio.

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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.