

Weekly Relative Value

Stagflation?

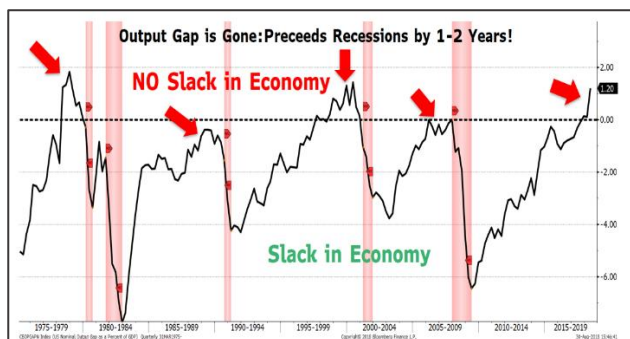
*“We may go past neutral, but we’re a long way from neutral at this point, probably.”
– Fed Chairman Jay Powell*

Nobody expected the Fed to raise rates last week and they didn’t.

Based on the official release, the Fed, at the margin, seems less ebullient over the business spending back-drop, but the central bank remains very bullish on the labor market as well as the consumer.

The Fed also stuck to the same “ole mantra” on the guidance — calling for “**further gradual increases**” in the funds rate. Indeed, it is going to take an awful lot to push Fed Chairman Jerome Powell off course from normalizing rates. Expect another rate hike next month and three more next year. Even still, that would only bring the funds rate to the so-called neutral rate of 3%.

The Fed may well have to go beyond neutral because the U.S. economy is currently thought to be expanding beyond its full potential as measured by the **output gap**. The output gap measures the difference between the actual output of an economy and its potential output. Potential output is the maximum amount of goods and services an economy can turn out when it is most efficient — that is, at full capacity. If the economy grows above its potential, it overheats – leading to excessive inflation, asset bubbles and tighter monetary policy in response. As shown below, the output gap is now negative.



Now that the economy is operating with a negative output gap, we are seeing a cyclical build-up of inflation pressures. It will transcend the strong dollar and weak commodity



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complex since 60% of the consumer price pie is in services, not goods, and services are inherently domestic in nature and very labor-intensive.

In an article in the Wall Street Journal – [Finding Stocks to Buy in an Era of Rising Prices](#) – it’s become increasingly clear that inflationary pressures are boiling underneath the surface:

“...under the surface, there are worrying signs both that cost increases are starting to bite into profits and that investors are growing more concerned about inflation... costs are rising, with low unemployment pushing up wages at the same time that Donald Trump’s import tariffs feed through into higher input prices. Companies that can pass on higher costs to their customers will thrive and help to push up wider inflation. Those that cannot will face squeezed profit margins, and an unpleasant outlook.”

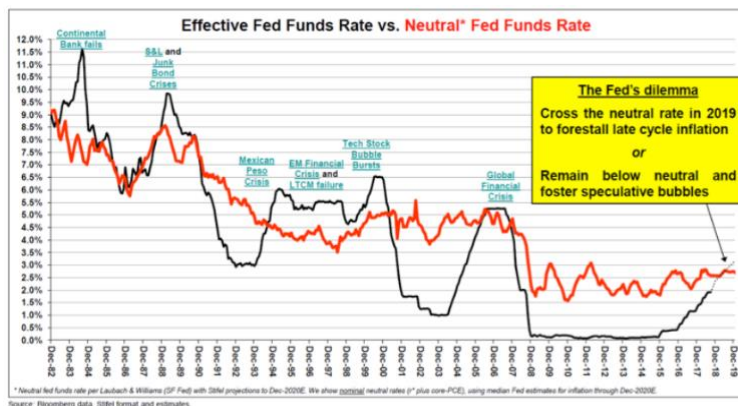
I should add that two White House policies are aggravating this escalation in cost-push inflationary pressures: one is the tariff and trade actions being taken and the other is immigration.

Of course, everyone wants strong border security, but the blanket measures being taken have resulted in a decrease of 6.5% on a year-over-year basis for the official immigration count in the U.S., now rolled back to 2015 levels. This is happening when the domestic pool of available labor is flirting with a 12-year low and businesses are saying their top constraint is a lack of qualified applications for job openings. Remember, when push comes to shove, the economy is largely made of people.

The Fed understands all of this, which is why Jay Powell said on October 3 that the funds rate would likely need to be pushed above the 3% estimate of “neutral,” which means four or more hikes coming our way (on top of the shrinking balance sheet).

Thus, barring a severe financial market setback, or an event that causes the Fed to curb its current rosy economic forecast, it would be hardly shocking to see four or five more rate hikes before the Fed presses the pause button.

And you don’t need a degree in history to recognize that such late-cycle inflationary build-up has brought every expansion and bull market to its knees. Even the record-long expansion of the Internet-led 1990s (that many thought would last forever) was thwarted by the Fed. As shown in the graph below, whenever the Fed has hiked above the neutral rate, bubbles tend to burst.



The issue to focus on will be the ongoing impact of rising interest rates on major drivers of debt-driven consumption, such as housing and auto sales. Combine that with a late stage economic cycle colliding with a central bank bent on

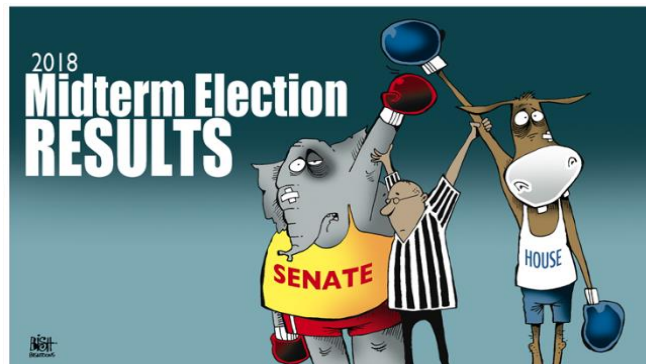
removing accommodation, and you have a potentially toxic brew for a much weaker economic outcome than currently expected.

Slower growth, tighter policy and a steady, persistent rise in inflation all lie ahead in the coming year. This is what stagflation is all about.

ELECTION 2018

“As societies grow decadent, the language grows decadent, too. Words are used to disguise, not to illuminate, action: you liberate a city by destroying it. Words are to confuse, so at election time people will solemnly vote against their own interests.” – Gore Vidal

The U.S. midterms went as the consensus predicted with the Senate staying in GOP hands, and the Dems taking control of the House for the first time in eight years. Yes, believe it or not, the pollsters got it right this time. The surprise would have been if the GOP kept the House. It should be noted that since World War II, the party of the president has lost an average of 26 seats in the midterm elections. This is the way “checks and balances” are supposed to play out.



The ugliness of the political scene over the last two years is likely to get even more ugly. The President no longer has a subservient Republican House to deal with anymore. The new Democratic-controlled House is in marked opposition to his agenda. The President will continue to argue that he is at the epicenter of power – but he no longer is.

In the lame duck session, there will be plenty of fighting over the border wall and other Trump initiatives – and it will get messy. I suspect little administratively will be achieved over the next 12-18 months, as the end of one man’s rule (the President) is over.

The President now faces hostile judicial and intelligence committees, which will have subpoena power over the President. We may also see no end to investigations, subpoenas and possibly impeachment talk, and a hard push for POTUS to cough up those tax returns.

Bottom line: After last week’s election, the political sands are likely shifting.

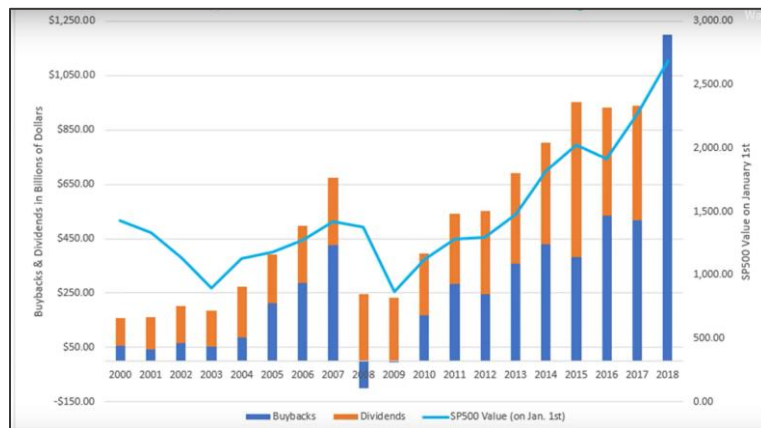
One thing that hasn’t changed with the midterm election is the blatant untruths that come out of Donald Trump’s mouth. The President said, **“The economy is booming like never before.”**

Seriously? Let's look at the facts.

The best economy ever would go to Harry Truman (two years of 8%+ growth). Next in line would be Dwight D. Eisenhower and Ronald Reagan, who both presided over at least one year each of 7%+ plus real growth. Lyndon B. Johnson enjoyed two years of 6%+ growth. Yet, according to Donald Trump, somehow, real GDP growth at 3% over the past year classifies as "the best economy ever," and nobody (except me, perhaps?), calls out Mr. Trump on this. It doesn't matter to me who the president is, there is no room anywhere for such overt misleading statements.

WHERE'S THE CAPEX BOOM?

It lasted a good two quarters but is now in the rearview mirror. The Duke University Fuqua School of Business quarterly survey now shows an average capex spending growth plan for the coming year at +5.7%, which is down from +11% in the first quarter.



So where has the money gone? Guess. Try stock buybacks and dividend payouts, which totaled \$600 billion in just the first half of this year alone — up \$142 billion from the comparable period in 2017.

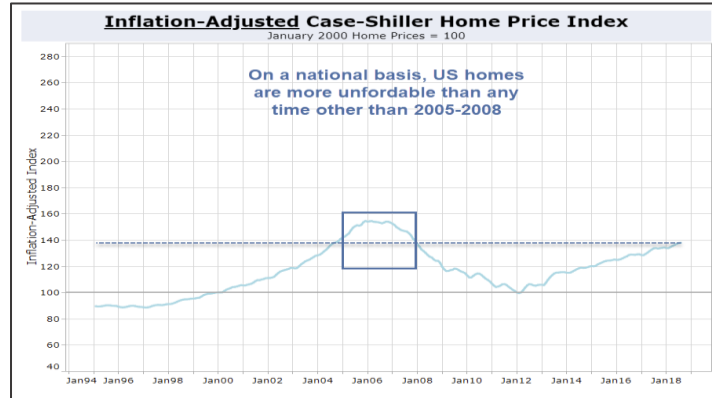
Unlike prior cycles — when corporations favored long-term business investments and expansions — corporations have largely focused on juicing their stock prices via share buybacks, dividends and mergers & acquisitions. S&P 500 companies are on target to hit an insane annual stock buyback rate of \$1.3 trillion — rising at 3-4x the pace of capex growth.

U.S. HOUSING AFFORDABILITY LOWEST IN A DECADE

To understand affordability, one needs to look at real median household income versus home prices of repeat sales of the same house. Real median household incomes have been stagnant. Real home prices haven't. It's the net of rising real incomes versus price on the same house that determines whether or not homes are more affordable.

This lack of affordability is definitely impacting the housing market. Despite consumer sentiment near multi-year highs, consumers' assessment of buying conditions for houses (and cars) continues to trend down.

The housing market is unlikely to cause another crisis as it did in 2007. But the slowdown in housing activity is a clear sign that the Fed’s interest rate hikes are starting to take their toll on the real economy. As housing goes, so goes the economy.



MEANWHILE IN CHINA

“There’s no other single country with such a high vacancy rate... Should any crack emerge in the property market, the homes to be offloaded will hit China like a flood.” – Li Gan, Ph.D. of Southwestern University of Finance and Economics in Chengdu, China

Home-buying speculation is rampant in China. Over a fifth of China’s homes are empty. That’s 50 million empty apartments. This is the highest home vacancy in the world.



An amazing 69% of recent home purchases have been second or third homes. In total, a quarter of China’s housing is empty, and only serves to amplify speculation.

As Americans so fondly recall, the result of chasing unaffordable homes for the purpose of price speculation has resulted in yet another unprecedented debt bubble. According to Caixin, **outstanding personal home mortgages in China have exploded sevenfold from 3 trillion yuan (\$430 billion) in 2008 to 22.9 trillion yuan in 2017.**

The nightmare scenario for China is that owners of unoccupied dwellings rush to sell if cracks start appearing in the property market, causing prices to spiral.

The importance of the housing market in China's economy should not be underestimated; this is where almost 75% of the country's household wealth is stored and it is deeply interwoven with shadow banking.



A close look at housing in China and the customs under which deals are completed will give Americans some real surprises. A housing bust is coming, and it will hit China hard.

EUROPE SLOWS: EUROPEAN CENTRAL BANK OUT OF BULLETS

Just when you thought things couldn't get worse in the eurozone, the latest GDP and consumer spending data were released and were nothing shy of awful: eurozone real GDP growth decelerated -50 basis points to 1.7% year-over-year in the third quarter of 2018 – the slowest pace since 2014.

Layer on fresh 18-month lows in the European Commission's Economic Sentiment and Business Climate Indicators in October, and you're left with undeniable evidence that economic growth in the world's second largest economy (i.e. the eurozone) is rapidly deteriorating.

Since the Great Recession, ECB President Mario Draghi and the ECB have tried to spur growth through quantitative easing (QE), to decrease rates and introduce new money into the economy. With record-low rates and hundreds of billions of new euros in the market, Keynesians would expect a rallying economy. But growth has been subdued.

A recession in Europe is inevitable. European nations are deeply in debt, running budget deficits and witnessing putrid results. Draghi and co. have only exacerbated the eurozone's problems by adopting easy-money, inflationary policies. Now that it has fired all the big guns to barely achieve 2% quarterly growth, the ECB is out of bullets, unable to do anything more unless it wants to risk rampant inflation and a currency crisis.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

I'm not going to take out my crystal ball and time the day, week or month of the next recession except to say it's coming, possibly in 2019. The markets have already voted. Because it's extremely unusual to have two periods in a given year where the S&P 500 declines 10%. Over the past five decades, this condition either presaged or occurred during a recession.

Tax reform was a good idea, but the outright tax cuts were just plain stupid. Despite strong growth and exceptional corporate profits, government receipts were flat in the last fiscal year, thanks to tax cuts. The policymakers tried to solve a debt crisis by adding more debt and thereby creating the conditions for yet another. The fiscal deficit is out of control – nearly 4% which is unprecedented for a fully-employed economy when the books should be balanced. Yet, the tax and spend policies are likely to continue, which bodes poorly for the fiscal outlook. With the loosened spending curbs,

the federal deficit may reach \$1 trillion this year. There is a big price to pay from this. Higher debt and deficits will serve as major headwinds to growth going forward.

The trade frictions are clearly impeding business activity. The shortage of skilled workers is the most acute and widespread it has been in history. The part of the workforce that consists of either high school dropouts or just a high school diploma has been responsible for half the overall job creation in the past six months. At the risk of sounding elitist, I'm not sure how many bus boys, bartenders and bell captains the U.S. needs right now, but if these people are writing code, then God help us all.

Finally, strip out the fiscal "sugar high," and productivity is running at less than a 1% annual rate. Tack on sub-1% labor force growth, and the U.S. economy remains as sclerotic as it ever was at less than 2%. The risk of a global recession in the next two years has risen.

All told, I'm not trying to sound the alarm bell here – global equity markets have done plenty of that all year. I'm merely just pointing out rising risk of the global economy flirting with recessionary levels of growth and the US economy slowing in the coming months.

With debt high and many of the structural problems that caused the great recession still in existence, a global recession could be more difficult to resolve than its predecessors. The scope for fiscal and monetary activism is limited. And there is a risk that recession could boost populist and nationalist policies that, in turn, will exacerbate the economic problems.

In terms of strategy, credit unions should raise the liquidity and quality of their loan and investment portfolios. We continue to advocate a diversified, risk appropriate ladder strategy for credit unions.

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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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