BALANCE SHEET SOLUTIONS
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WEEK OF AUGUST 13, 2018

Weekly Relative Value

Fiscal Follies

"By passing much-needed tax reform, we will finally unleash the economic growth engine which will more than pay for these tax cuts in the future." – President Donald Trump

There are those who say "**Trumponomics"** is the second coming of **"Reagonomics."** Undoubtedly, "the Gipper" accomplished many great things and "supply-side economics" did propel the economy in the 1980s. Cutting taxes and increasing spending were the right prescription. However, back then, times were different.

Under former President Ronald Reagan, national debt to GDP did double from 30% to 60%. But, as this table shows, when Reagan went on a spending spree, the country could afford it. Debt was low, interest rates were declining, the population was young, productivity was rising, and trade barriers were collapsing.

	Reagan (1982)	Trump (2018)
Household Debt to Income	62%	130%
US Government Debt to GDP	30%	105%
Total Debt to GDP	0.90X	3.60X
Productivity Growth	2.0%	0.25%
Labor Force Growth	2.0%	0.5%
Median Age Baby Boomer	26	60
Global Trade Barriers	Falling	Rising

As one can glean from the table above, the situation is quite different today. The ratio of U.S. government debt to GDP is 105% – 70% higher than when the Gipper occupied the Oval Office. The labor force is declining and ageing rapidly. Productivity has plummeted and, as we all know, trade barriers are rising, not falling, under the Trump administration.

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

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THIS WEEK…

- To a Trillion and Beyond
- Making Matters Worse
- Housing Soft Patch
- Double Whammy
- Three Important Questions

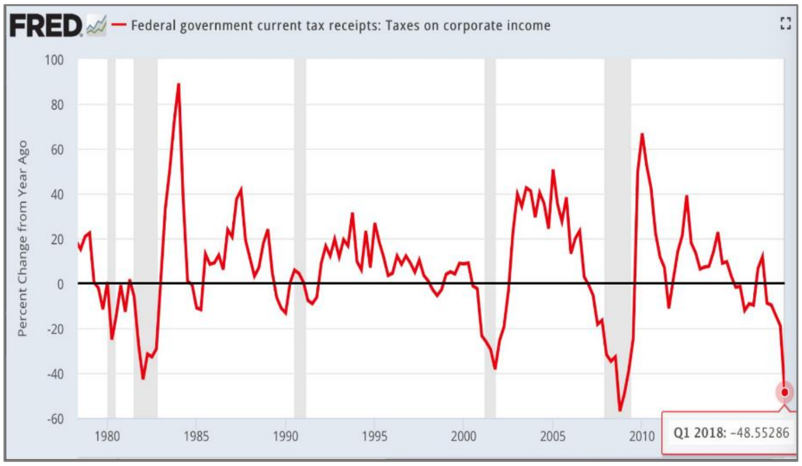
PORTFOLIO STRATEGY

In other words, when Reagan was in office, we could afford to leverage up. Today, not so much. We are at peak debt levels and pushing the envelope into uncharted waters.

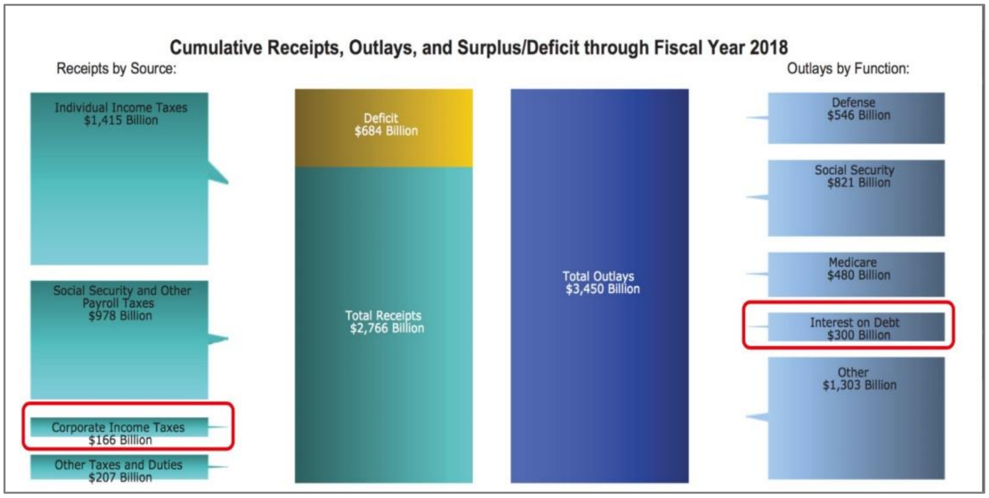
The theory behind the recently enacted tax cuts is that U.S. economic growth will ramp higher, and higher growth will lead to higher tax receipts. So, in other words, the tax cuts should pay for themselves. While admittedly early, that has not been happening so far. To wit, year-over-year total government revenue is down 7% and corporate tax receipts have plunged 48%.

This represents the largest year-over-year decline in corporate tax revenue ever – and it's larger than any revenue decline during a recession to boot. I hate to imagine what will happen when the stock market declines and the U.S. does hit a recession.

Corporate Tax Revenue Plunges

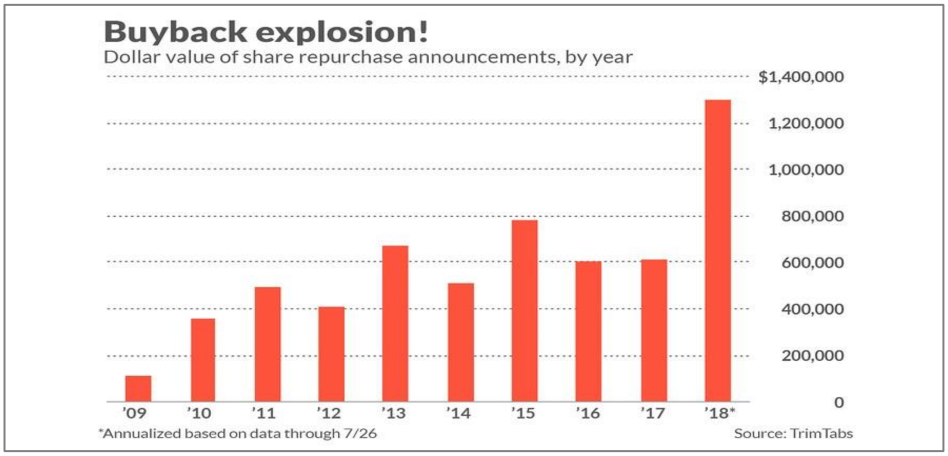


Cutting top marginal corporate taxes from 35% to 20% to level the playing field does have some merit, but there has been no effort to reduce corporate loopholes. As such, corporate tax cuts have amounted to a whopping $150 billion gift from Uncle Sam – which was financed through a huge increase in Treasury borrowings. The U.S. is now spending nearly twice the amount of money on debt interest than it is collecting from corporate revenue. For reference, in 2017, the U.S. collected $232 billion in corporate tax revenue and spent $249 billion on interest on debt.

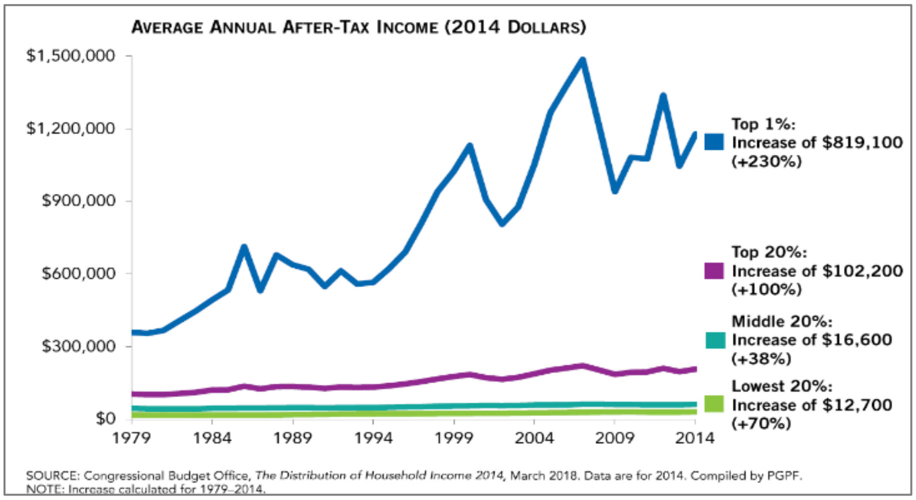


The argument for corporate tax cuts was that businesses would invest in the future, hire more people and raise wages – fueling an economic boom. But the corporate sector, prior to the tax relief, was flush with cash and cheap financing. Today, capex growth – outside of commercial construction, oil and gas spending – remains quite weak. In fact, business outlays on industrial equipment actually contracted in the second quarter. Meanwhile, wages have risen only modestly. As you can clearly see below, the true beneficiaries of these tax cuts are those in the C-Suite. The only real boom is in share buybacks. In essence, fiscal policy was used as a tool to make equities even more expensive than they already were.

Stock Buybacks are Expected to Double in 2018



Likewise, the move to cut personal taxes, likely the most regressive package ever, has only widened already-record levels of income inequality in the country. But who's going to complain, right?



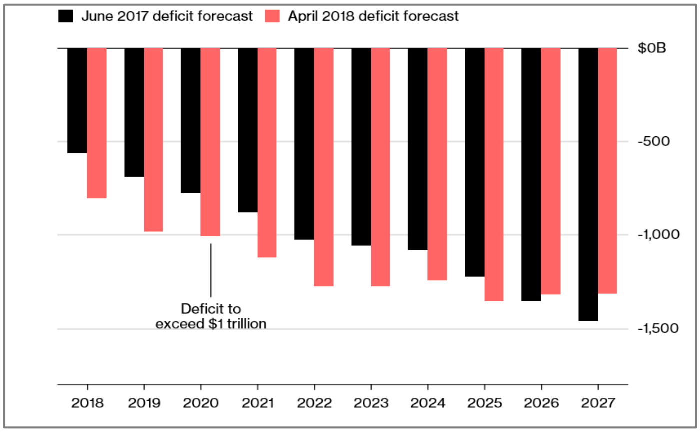
Supply-siders will argue that spending is the real culprit. And I would agree. But there was no effort, even by the alleged "fiscal conservatives" of the GOP, to attack spending as they went on this tax-cutting spree.

"In the last three years, Congress has passed bills that raised the discretionary spending caps, completely undermined the spending caps, reversed Medicare cost controls and reduced revenues without cutting spending."
– Paul Winfree, former budget advisor to President Trump, current fellow at The Heritage Foundation

TO A TRILLION AND BEYOND

"What you are getting is a stimulus at the very wrong moment. The stimulus is going to hit the economy in a big way this year and next year, and then in 2020 Wile E. Coyote is going to go off the cliff and it's going to look down."
– Former Fed Chair Ben Bernanke

According to the Congressional Budget Office (CBO), the deficit/GDP ratio – which already was at a crazy-high level for this stage of the cycle at 3.5% – will now average 5% (or $1 trillion plus) over the next decade. Only on two other occasions in the post-World War II era have we seen fiscal deficits at 5% of GDP or higher, and these occurred during recessions in 1983 and 2009. Now such deficits will become the norm. **At this late stage of the cycle at full employment, deficits should be small and declining – not large and rising. To a trillion and beyond.**



To make matters worse, the CBO thinks total federal debt will be 152% of GDP by 2048, and that by 2041 it will take all federal tax revenue just to support Social Security and the various healthcare programs and pay interest. That's before defense spending or anything else the government does. And that's assuming eternal relatively high growth, NO recessions and a rising stock market as we ride off into the sunset. And nobody seems to care.

MAKING MATTERS WORSE

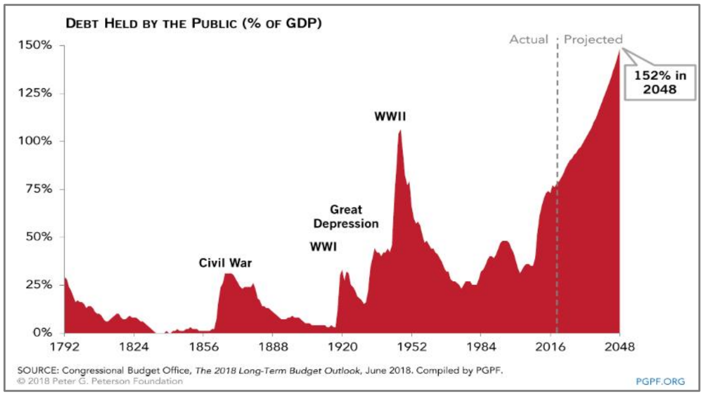
What happens to not only the U.S. debt, which recently hit $21.3 trillion, **but to the interest on that debt in a time of rising interest rates.**

U.S. government interest payments are already rising rapidly, and just hit an all-time high of $538 billion in the second quarter of 2018.

Interest costs are increasing due to three factors: an increase in the amount of outstanding debt, higher interest rates and higher inflation. Needless to say, all three are increasing.

The bigger question is, with short-term rates still just around 2%, what happens when they reach the mid-3% range as the Fed's dot plots suggest they will?

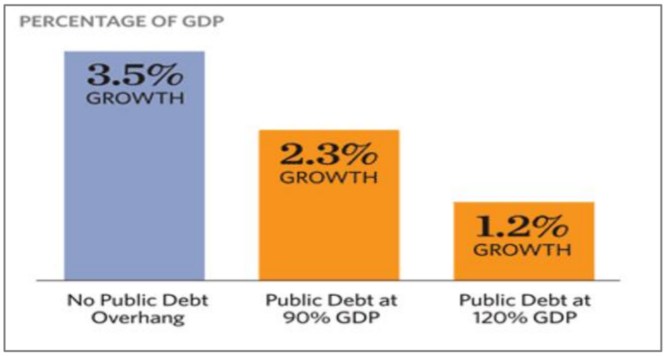
At the end of the day, the entire tax relief package is on borrowed money, and there will be a price to pay. We are left with a mountain of debt that still needs to be serviced. And once the sugar-high is over, the debt will put a stranglehold on economic growth.



Let's face it, if deficit-financing at a time of record public debts were such a bright idea, I'm sure every country in the world would do it. The only modern-day example is Japan, and it hasn't exactly worked out well over there.

An extensive economic analysis of 22 countries over 110 years, completed by Carmen Reinhart, Vincent Reinhart and Kenneth Rogoff, indicates that higher levels of debt result in lower levels of economic growth. On average, real annual GDP growth for the countries belonging to the Organization for Economic Co-operation and Development with a debt ratio of more than 90% came to 2.3%. Since crossing that threshold, growth has averaged just 1.2%. The fact is, higher debt does NOT create higher growth.

Debt Does Not Equal Growth



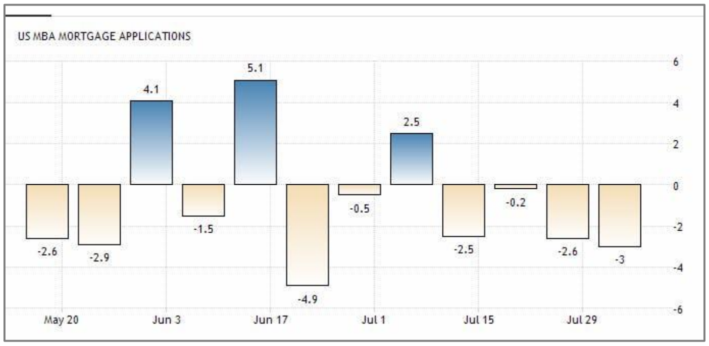
I will go on record that these deficits and debts are simply unsustainable. There is little chance, if any, that we can erode the balance sheet to such an extreme without a debt crisis. Debt does not matter until it does. Timing is the only issue.

HOUSING SOFT PATCH

I find it odd that nobody is talking about the sharp downturn we are now seeing in the housing market – which is the best leading indicator for the broad economy. Residential construction spending has retreated now in four of the past five quarters. We have not seen this decline since the overall economy was knee-deep in a recession in the stretch that lasted from the fourth quarter of 2008 through the first quarter of 2010. Building permits and new and existing home sales have declined over the past few months. Meanwhile, inventories have begun to rise. Adding angst to the housing market, mortgage applications sank 3% in the week of August 3 – the fourth decline in a row, taking the year-over-year trend further into negative terrain at -17.3%.

It's pretty clear what's happening: home prices are unaffordable, yet the Fed is hiking.

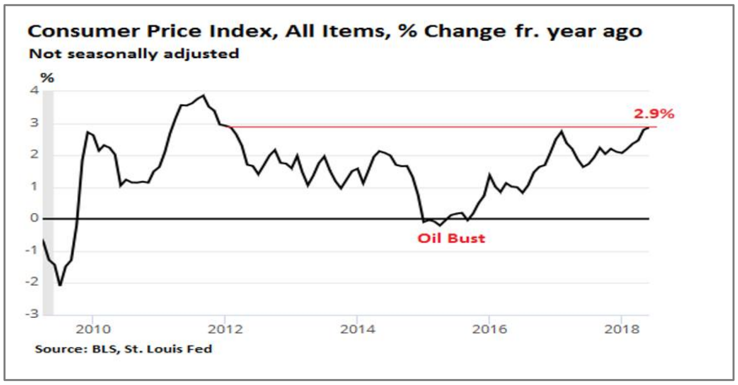
Mortgage Purchase Applications Decline for a Fourth Week



DOUBLE WHAMMY

Inflation, as measured by the Consumer Price Index, rose 2.9% in July from a year ago – the fastest rate since February 2012.

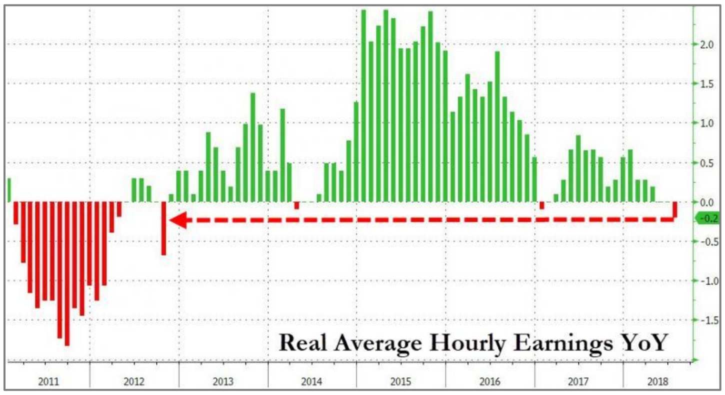
Inflation: Highest in Six Years



And the core measure of the Consumer Price Index (CPI), which excludes food and fuel, rose 2.4% from a year earlier – the biggest advance since September 2008. The core CPI reading brought the three-month annualized gain to 2.3% after rising 1.7% in June.

In terms of the Fed, this CPI reading – particularly the core CPI reading – is another paving stone on its well-defined path to becoming increasingly hawkish, as even the doves are becoming less dovish and, in some cases, outright hawkish.

Rising inflation is squeezing consumers. Through July 2018, consumer prices are up 2.9% year-over-year, while wages for non-managerial workers are up 2.7%. Thus, real average hourly earnings shrank. Inflation-adjusted wages were unchanged in July from the previous month and dropped 0.2% from a year earlier. Therefore, wages are not keeping up with consumer price inflation and the average worker is worse off than a year ago.



THREE IMPORTANT QUESTIONS

1. **Does the yield curve still matter or is it different this time?** The San Francisco Fed published "Economic Forecasts with the Yield Curve" containing research on the yield curve debate on March 5, 2018. Their conclusion is as follows:

   "Forecasting future economic developments is a tricky business, but the term spread has a strikingly accurate record for forecasting recessions. Periods with an inverted yield curve are reliably followed by economic slowdowns and almost always by a recession. While the current environment appears unique compared with recent economic history, statistical evidence suggests that the signal in the term spread is not diminished. These findings indicate concerns about the scenario of an inverting yield curve. Any forecasts that include such a scenario as the most likely outcome carry the risk that an economic slowdown might follow soon thereafter."

2. **Can we have a recession even if the curve doesn't invert?** The short answer is yes. In periods of ultra-low rates, the curve does NOT have to invert to generate a recession. To wit, Japan endured three recessions in just the past eight years without the curve inverting. Likewise, the euro region was in a recession from the third quarter of 2011 to the first quarter of 2013. Again, the curve did not invert! The key variable is the general change in rates across the curve at a time of record-high indebtedness and the associated drag from rising interest costs.

3. **How good are economists at predicting turning points?** The International Monetary Fund published an analysis by Zidong An, João Tovar Jalles and Prakash Loungani, titled "How Well Do Economists Forecast Recessions?" They concluded that only 3% of the time, the consensus among the economics community accurately predicted the coming recession the April before it began. How much confidence should one have when people say nobody else is calling for recession? Read the conclusion below:

   "This paper describes the evolution of private and public sector forecasts in the run up to recessions. <u>We find that the ability to predict turning points is limited.</u> While forecasts in recession year are revised each month, they do not capture the onset of recessions in a timely way and the extent of output decline during recessions is missed

by a wide margin. This holds true for both private sector and official sector forecasts. Our work does not provide an explanation for why recessions are not forecasted ahead of time. We suggest three classes of theories, which are not mutually exclusive, which could explain our findings. One class says that forecasters do not have enough information to reliably call a recession. Economic models are not reliable enough to predict recessions, or recessions occur because of shocks (e.g. political crises) that are difficult to anticipate. <u>A second class of theories says that forecasters do not have the incentive to predict a recession. Included in this class are explanations that rely on asymmetric loss functions: there may be greater loss — reputational and other kinds — for incorrectly calling a recession than benefits from correctly calling one.</u> The third-class stresses behavioral reasons for why forecasters hold on to their priors and only revise them slowly and insufficiently in response to incoming information…"

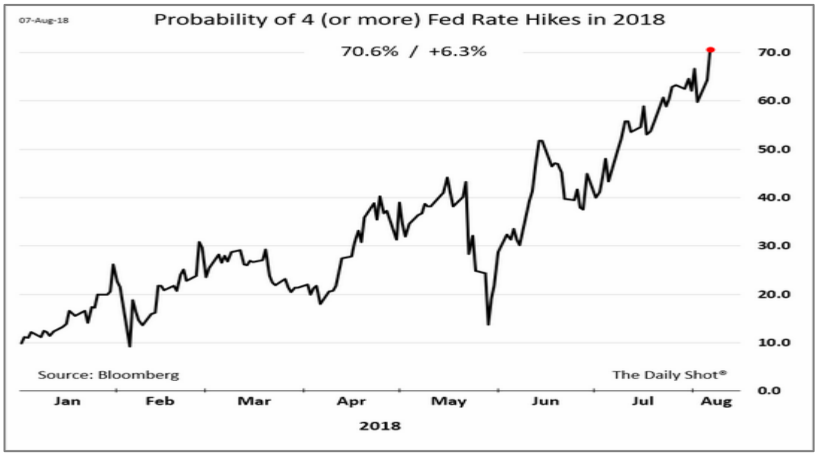
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"While the global economic growth rebounded in the second quarter, it will probably slow again in the second half of this year and in 2019, the U.S. will not be able to sustain annualized GDP growth of 4%, China's economy is slowing steadily, and any pick-up in the euro zone from a lackluster first half is likely to be modest." – Capital Economics, July 2018

Let's start with the Fed. The reality of Fed tightening is beyond dispute. The Fed is on course to raise interest rates 1% per year in four separate 0.25% hikes each March, June, September and December. The Fed is also slashing its balance sheet about $600 billion per year at its current tempo.

The equivalent rate hike impact of this balance sheet reduction is uncertain because this kind of shrinkage has never been done before in the 105-year history of the Fed. However, the best estimates are that the impact is roughly equivalent to another 1% rate hike per year.

Combining the actual rate hikes with the implied rate hikes of balance sheet reduction means the Fed is raising nominal rates about 2% per year starting from a zero-rate level in late 2015.

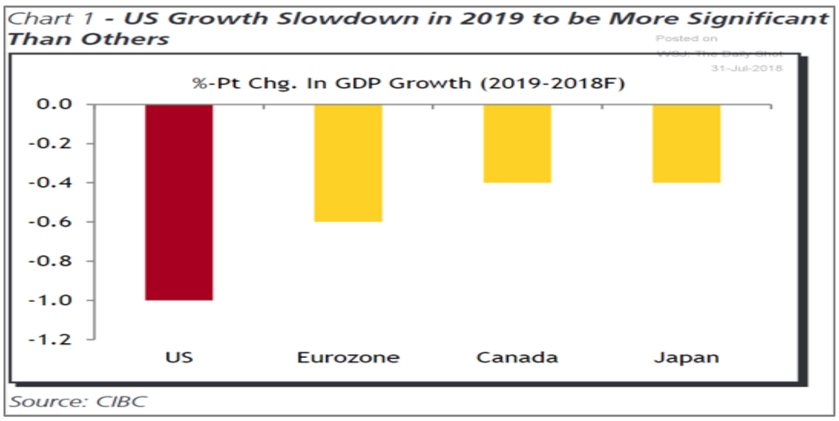


And the Fed may be hiking rates just as U.S. growth has peaked. Real growth in the second quarter of 2018 was 4.1%, and artificially boosted by non-recurring events.

Lower growth and leveling-out seem likely in the quarters ahead. Real annualized U.S. GDP growth exceeded 4% four times in the past nine years, only to head for near-zero or negative real growth in the months that followed. There's no compelling reason to conclude that the second quarter of 2018 will be any different.

Furthermore, the U.S. does not exist in a vacuum. The real growth quarterly rise in eurozone GDP was a disappointment the second quarter. Likewise, China's economic-related reports revealed a distinct slowdown.

Slower Growth Ahead

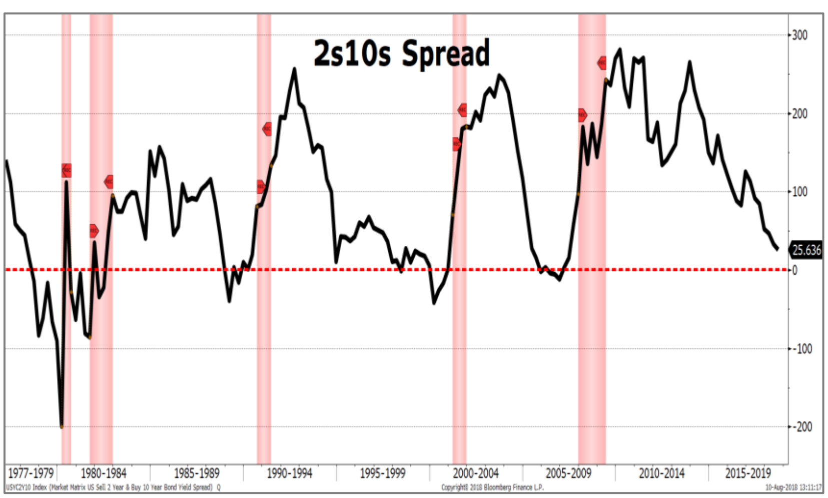


By the end of the year, the full extent of a global slowdown will be apparent. The U.S. is headed to lower growth and inflation by the fourth quarter of this year.

With all due respect to those positioning much higher yields as a real risk given the hunky-dory view of the world, last week we saw the highest Treasury bond issuance on a weekly basis, and bond yields were down on the week. And the all-important yield curve continued its flattening bias with the 2s/10s spread narrowing to 25 basis points.

Do you think the bond market is starting to discount the growth and inflation cycle?

Or do you think it's all about Trump, tweets and turkey?



Can't Miss Opportunity: The ALM Workshop – Registration is Now Open!

The Asset-Liability Management (ALM) Workshop is coming to West Covina, CA on Thursday, September 27, 2018. This one-day event will provide ALM insight and analysis from our team of experts, helping you gain a better understanding of interest rate risk, net economic value, net interest income and more! Plus, take advantage of up to 7 CPE credits.

View the agenda and register at www.balancesheetsolutions.org/almworkshop2018.

MORE INFORMATION

In terms of relative value, please see the Relative Value Analysis.

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.