Weekly Relative Value

The Real National Emergency

"We see no indications whatsoever of a recession on the horizon. The administration's efforts to cut taxes, slash regulations and overhaul trade deals have had a very strong impact on the U.S. economy." – U.S. Treasury Secretary Steve Mnuchin

I am not the Treasury Secretary of the United States, so who am I to argue. But for a number of months, I have highlighted the steady flattening of the yield curve. And with good reason, the spread between 2s and 10s is now 15 basis points away from turning negative or inverting. And an inversion of the 2s/10s Treasury yield curve has predicted "every" recession over the last 40 years. Clearly, while no signal is fool proof, one should keep a close eye on this metric.

Source: Cagle Cartoons

Some investors take solace in the fact that the odds of a recession are currently increasing but a recession is not a foregone conclusion. Furthermore, on average it takes about 12 months after an inversion before the recession occurs. In other words, we have time before we need to worry.

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

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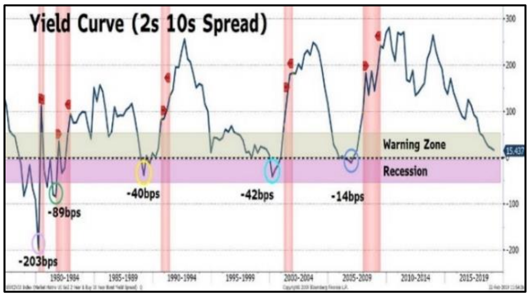
PORTFOLIO STRATEGY

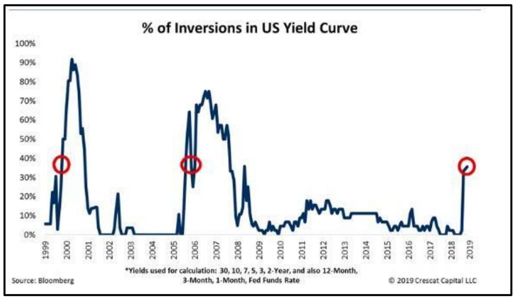
Warning Zone



Source: Bloomberg

While the world watches the 2s/10s spread, it's important to note that other portions of the yield curve are already inverted. In fact, the yield curve from six-month Treasury bills to seven-years is now inverted. The graph below, courtesy of Crescent Capital, calculates that 40% of yield curves are inverted. And, as indicated by the red circles, whenever the percentage of yield inversions have reached today's levels, a recession has followed. Maybe the market has already sounded the recession alarm?

Yield Inversions are at Recession Levels



Source: Crescent Capital

Here is another point that has not been widely discussed. As you can see below (and in the 2s/10s graph above), the magnitude of the last five yield curve inversions has been getting progressively smaller before a recession. If that trend were to continue, a yield curve inversion may not be necessary to signal recession. Think Japan, which has numerous recessions without the curve inverting.

Date	Yield Curve (Max Inversion)
May 1980	-2.03
August 1981	-0.89
March 1989	-0.40
April 2000	-0.42
November 2006	-0.14

So, why might we enter a recession without the 2s/10s spread inverting?

In a word: D-E-B-T.

As debt swells it requires lower interest rates to service the existing debt as well as generate new economic activity. And as the yield curve flattens, lenders have less economic incentive to lend money. As I discussed two weeks ago, the latest Senior Loan Officer Survey indicates that banks are less willing to lend credit. Thus, economic activity dependent on lending activity slows. Extending this argument, it should be obvious: economies with larger debt burdens are more sensitive to a tightening of financial conditions. Thus, the amount of inversion required to generate a recession in such a scenario also declines. Once again, think Japan.

The U.S. is now the most leveraged economy of all time. Given the massive debt at all levels of the economy – national, state, corporate and individual – could it be that the Fed has already overtightened, as it has done so often in the past? So, as financial conditions have already tightened, is the U.S. now at a point where inversion is not required to slow borrowing and stymie economic activity?

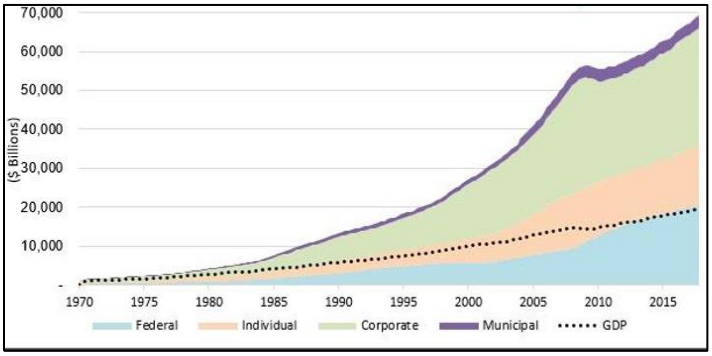
The Trump Administration, Federal Reserve and Wall Street say, “it’s different this time.” No worries for as far as the eyes can see. The prevailing narrative is the economy is healthy and yield curve signals have been distorted by quantitative easing and low interest rates abroad.

THE REAL NATIONAL EMERGENCY

“The real national emergency isn’t at the border. It's the national debt!”
– Peter Schiff, CEO and chief global strategist of Euro Pacific Capital, Inc.

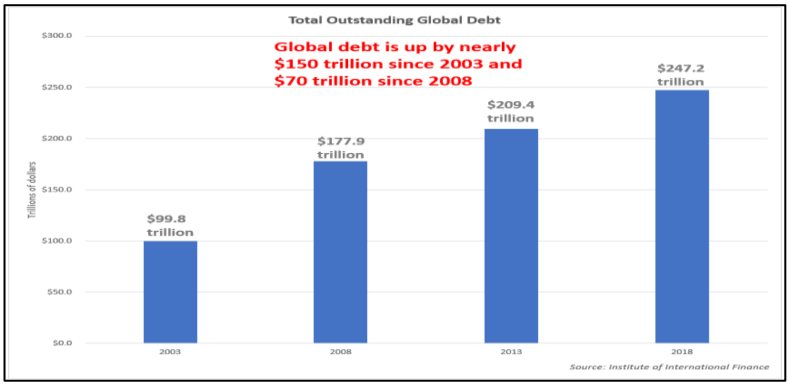
The graph below compares total domestic debt and GDP. One can quickly glean from the graph that debt is growing faster than GDP. In simple terms, GDP represents our collective ability to service and repay our debt.

Total Debt Outstanding



And clearly, it’s not just the U.S. The Institute of International Finance reported that global debt has surged by nearly $150 trillion since 2003 and $70 trillion or 43% since 2008. Debt has been growing at a faster rate than the underlying GDP as global debt as a percentage of GDP to reach an all-time high of 225%.

Unfortunately, the global economy is heading toward a point of total debt saturation, which is the inevitable result of debt growing faster than the underlying economy. Growing debt burdens will stifle economic growth and lower inflation, which will make it even harder to grow out from under the debt.

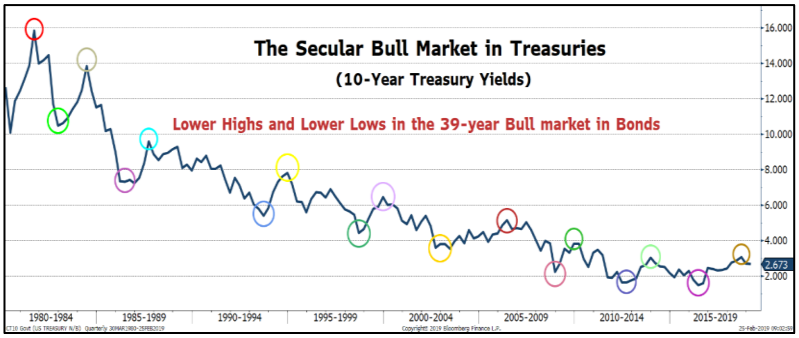


Source: Institute of International Finance

This in turn will lower long-term interest rates.

The consensus continues to believe each rise in interest rates is the end of the bond bull market. Au contraire. Any increases in interest rates are simply "head fakes" within a continued downtrend in rates as higher levels of debt act as a truncating force on economic activity.

Lower Highs and Lower Lows



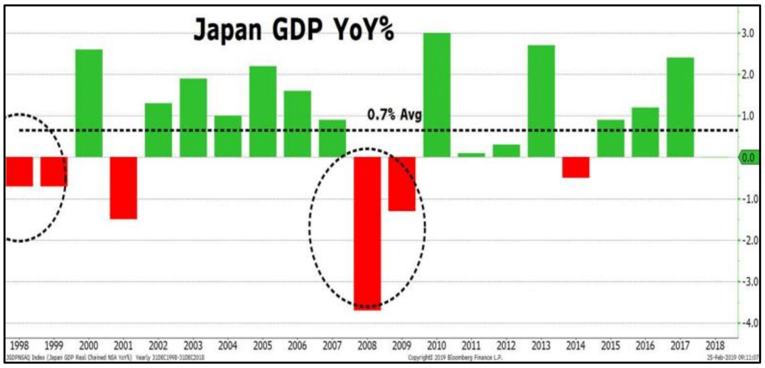
Source: Bloomberg

We have to look no further than Japan, Europe, and the U.S.

"Japan has done unprecedented amounts of monetary stimulus and the result is still constant contractions in economic growth. Europe has not been able to grow its economy and the third recession since 2007 is unfolding. The U.S. economy had the weakest recovery since the 1940s with record stimulus. As velocity crashes, monetary policy becomes increasingly ineffective."
– Eric Basmajian, Founder & Editor at EPB Research

Japan is the poster child for being the most over-indebted economy, followed by Europe, China, and the United States. As you will see below, the higher the debt the lower the growth and inflation.

Japan's Lost Decade



Source: Bloomberg

In the past 10 years, Japan has done unprecedented amounts of monetary stimulus – quantitative easing negative policy rates – and the result is still constant contractions in economic growth. Over the past decade, Japan has experienced four economic contractions. Each time the economy is met with a small spurt in growth, negative growth follows.

Europe has not been able to grow its economy and the third recession since 2007 is unfolding. Italy is in a recession and Germany is literally one basis point away from joining the recession club.

The U.S. economy had the weakest recovery since the 1940s with record stimulus. Each time the economy experiences a short-term spurt in growth, interest rates rise as a result of the increase in economic activity. But because of the massive debt, the rise in interest rates leads to a sharp deceleration in growth, similar to the decline we are experiencing today.

For example: The economy accelerated strongly from 2016-2018 due to tax cuts and more fiscal stimulus. Interest rates rose sharply across the curve. Then, with a lag, higher interest rates acted as a truncating force on growth. And since then, rates have declined significantly across the curve.

Wash, rinse, repeat.

Interest rates have tried to breakout several times in this economic cycle, only to be met with a future decline in growth and inflation, bringing the long rate back down.

And don't use quantitative easing to explain why rates are so low. Further, the notion that international bond yields are suppressing U.S. bond yields is a weak argument; once you hedge the currency, U.S. bond yields are lower than international bond yields.

The evidence is becoming more compelling by the day. Growth is the consequence of over-indebted economies. As governments around the world try and solve a debt problem with more debt, the result is more of the same. Trying the same solution over and over and expecting a different result is not likely to work well.

So, the first order of business, from a macro perspective, is to bring debt levels down. In the meantime, expect lower rates of growth, lower rates of inflation, and lower long-term interest rates over the long run. In the short term, cyclical forces can cause transitory spurts in growth, inflation and interest rates, but the rise is unlikely to be sustained.

SUBPRIME DELINQUENCIES AT GREAT RECESSION LEVELS

"The substantial and growing number of distressed borrowers suggests that not all Americans have benefitted from the strong labor market… A development that is surprising during a strong economy and labor market." – New York Fed

Subprime auto loan delinquencies – loans that are 90 days or more past due – surged to 4.47% of total auto loan balances in the fourth quarter 2018. This put the auto loan delinquency rate at the same level it was in the second quarter of 2008. But, unlike in second quarter 2008, the labor market is still strong. What happens when the economy stumbles and unemployment rises?

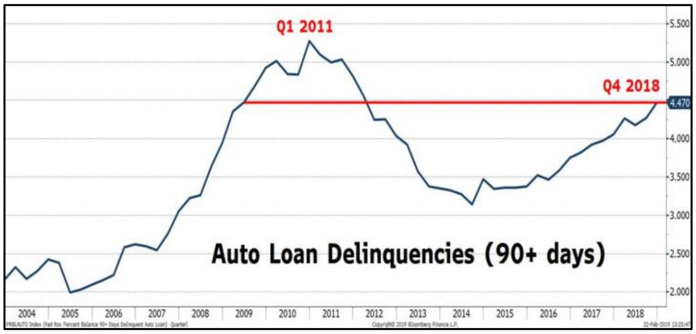
There are about $273 billion in subprime auto loans outstanding. At the end of 2018, there were over seven million Americans with auto loans that were 90+ days past due, one million more than at the end of 2010, at the peak of the overall delinquency rates.

The New York Fed pointed out as auto loans have surged:

1. "There are now more subprime auto loan borrowers than ever, and thus a larger group of borrowers at high risk of delinquency."
2. "The overall performance of auto loans has been slowly worsening, despite an increasing share of prime loans in the stock."

And the trend is picking up. Among subprime auto loans, loans that transitioned into serious delinquency rose to over 8%.

Subprime Auto Delinquencies Spike to Great Recession Levels

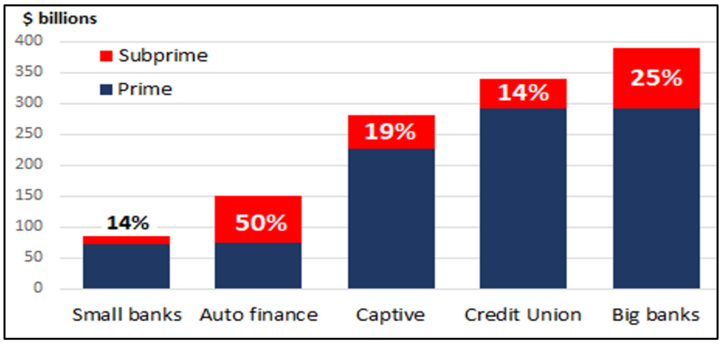


Source: Bloomberg

The good news is that credit unions have largely avoided this trend thus far. Credit unions are the second largest auto lender after big banks, but their risk profile is very low. Credit unions have only 14% of their loans rated subprime and only 0.7% of credit union auto loans are 90+ days past due.

As you can glean from the table below, the "big banks" – banks with over $500 billion in assets – originated the most auto loans ($389 billion), and 25% ($97 billion) are subprime auto loans. Specialized auto finance lenders – "shadow banks" – have piled into this sector most aggressively. While they originated only about $150 billion of all outstanding auto loans, 50% of their loans ($75 billion) are subprime. "Captive" auto lenders, such as Ford Motor Credit, originated $281 billion in auto loans, but only 19% of them were subprime.

Subprime vs. Prime Auto Loans



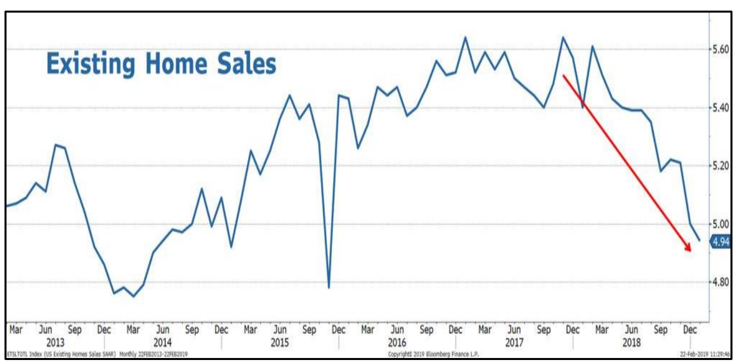
HOUSING REMAINS IN THE BASEMENT

With existing home sales accounting for about 90% of U.S. housing, it would seem Fed Chair Jay Powell's dovish tilt just got more support.

Sales of existing homes in January dropped 8.5% from a year earlier, to a seasonally adjusted annual rate of 4.94 million homes, after having dropped 10.1% year-over-year in December and 8.9% in November. All three were the biggest year-over-year drops since May 2011, during the final throes of housing bust.

The only region to post a sales gain was in the Northeast. Somehow this belies the notion that this is about the Polar Vortex. And you can't blame financing costs. This decline in sales is occurring despite the large drop in mortgage rates since early November.

Housing Continues its Descent



Source: Bloomberg

But hope continues:

"Existing home sales in January were weak compared to historical norms; however, they are likely to have reached a cyclical low. Moderating home prices combined with gains in household income will boost housing affordability, bringing more buyers to the market in the coming months."
– National Association of Realtors Chief Economist Larry Yun

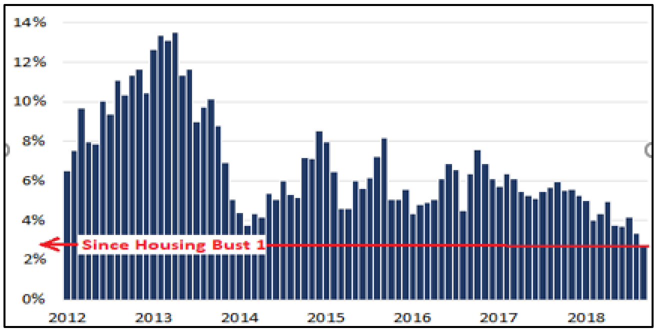
Apparently, Lawrence Yun does not expect housing numbers to decline further going forward.

And he could be right for once. We are heading into the strongest part of the housing sale cycle. Thus, housing may bounce in the near future. Nothing goes straight down.

However, I see no evidence to support a cyclical low in housing. While slower price gains and lower mortgage rates have helped affordability, many people still cannot afford houses. The first-time buyers – the proverbial bottom of the housing pyramid – have seen their share of sales fall to a one-year low of 29% from 32% in December and is still light years away from the 40%-50% share that in the past typified a normal market. First-time buyer demand remains weak due to home prices rising much faster than income levels for years. In addition, many are saddled with the albatross of massive student indebtedness and the fact that over seven million Americans are behind on their auto loan payments. In other words, potential homebuyers have more on their mind right now than jumping into the real estate market.

There are millions of millennials looking forward to buying a home, but it still appears to be a ways off. However, with sales volume dropping, and inventories rising, home price appreciation is slowing. That said, in some markets, price levels have a long way to go before they make sense, where a household with a median income can afford a median priced home.

Home Price Increases are Lowest since Housing Bust



MARKET OUTLOOK AND PORTFOLIO STRATEGY

In a classic sign of hope triumphing over experience, only 10% of the economists polled in the just-released National Association of Business Economics (NABE) survey believe a recession will occur this year; 42% say it will hit in 2020; and 25% see it in 2021. The survey did indicate that 77% of those surveyed believe the business cycle has not been repealed and see a down turn in the next three years. The 23% who see expansion as far as the eye can see are the same ones who have missed every turn in the cycle.

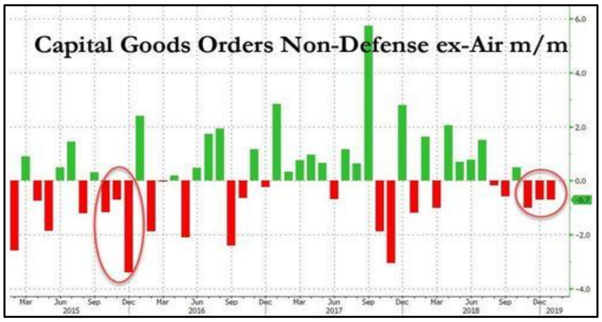
No recession in sight? Maybe. But let me once again remind everyone that the Fed has never forecasted a recession. Never! And Wall Street forecasts have been equally as abysmal in forecasting the economy and predicting recessions. Amusingly, when Wall Street economists are asked why their forecasts are so wrong, they say they listened to the Fed. And there you have it! The blind leading the blind.

But, here's the point: if you wait for the Fed or Wall Street to tell you the recession has started, it really won't matter much anyway.

What the economists know about 2020 and 2021 is beyond me. What we do know is that incoming data has been horrible. Housing is in a cyclical decline, auto sales have peaked, retail sales have tanked, and capital spending has worsened. In December, core capex orders dropped 0.7% and this followed a downwardly revised -1.0% showing in November.

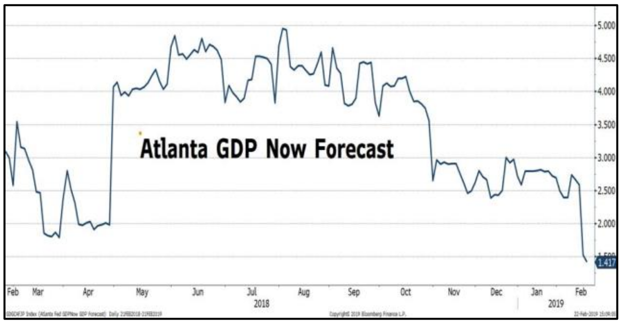
This is a leading indicator of business capital spending and it has now contracted in four of the past five months. So, capex has joined housing in the recession bin.

What Happened to the Tax Cuts?



The Atlanta Fed's model has taken fourth quarter real GDP growth down to a mere +1.4% annualized pace, and the New York Fed for this quarter is now seen to be even weaker at +1.1%.

U.S. Fourth Quarter Growth Dives



Obviously, the Fed has awoken to the fact that economic winds have shifted. After saying in November that they were a long way from "neutral," they appear to have done a classic 180 degree turn and pressed the "pause" button.

Now the 10-year Treasury note yield is just 15 basis points away from slipping below the upper end of the Fed's 2.25%-2.5% target band for the funds rate. Does the Fed really want to raise it again and invert the curve?

Going forward, the main question is whether the Fed stayed hawkish too long or is loosening up in time to keep the economy growing. The Federal Open Market Committee meets again March 19-20, so whatever they do then should tell us more. But from my lens, the Fed has already overtightened (the equivalent of over 300 basis points of rate hikes). Recession risks for this year are elevated and on the rise.

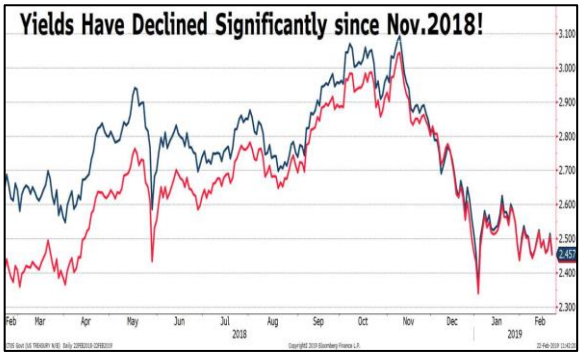
Remember: Try as it may, the Fed cannot stop economic gravity. The U.S. economic recovery is now 115 months long. Given the duration of the recovery, pent-up demand "stuff" has been fulfilled and likely exhausted. When pent-up demand has been satisfied, a cyclical downturn in the production of stuff begins, leading to a slowdown in manufacturing and a weakening of economic growth.

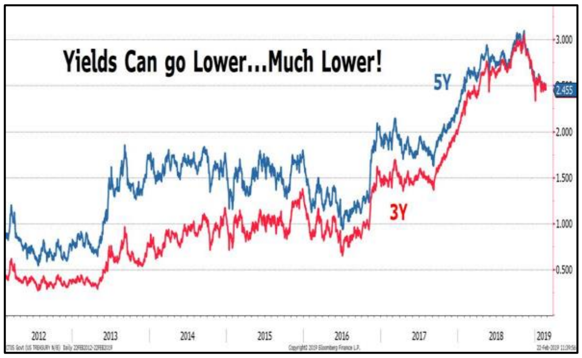
Housing and auto sales are good examples. There is a limit to the number of cars and houses an economy can demand. Once the demand for cars and houses has been fulfilled, auto production and home building slow, layoffs result, and cyclical forces push the economy lower. This does not always result in a recession, but this is the business cycle.

In conclusion, could it be that the Fed is done raising rates for the cycle with fed funds at ONLY 2.25%? Quite possibly. I believe the only way that Jay Powell would push for another hike is if inflation rose. Without higher inflation I continue to believe the next move in rates will be down, not up. If so, front-end rates and bond yields out the curve will be melting before our eyes in the next 12-24 months.

As shown in the two graphs below, three-year and five-year Treasury yields have already collapsed in anticipation of slowing growth, inflation and a kinder, gentler Fed. That said, should the U.S. economy slow and end up in recession, yields can decline much, much further (100-125 basis points).

So, the message is: stay invested in a risk-appropriate ladder strategy of high-quality securities. From a tactical perspective, any rate increase should be viewed as an opportunity to put excess cash reserves to work.





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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.

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