BALANCE SHEET SOLUTIONS
an alloya company

WEEK OF MARCH 11, 2019

Weekly Relative Value

Deficits Surge

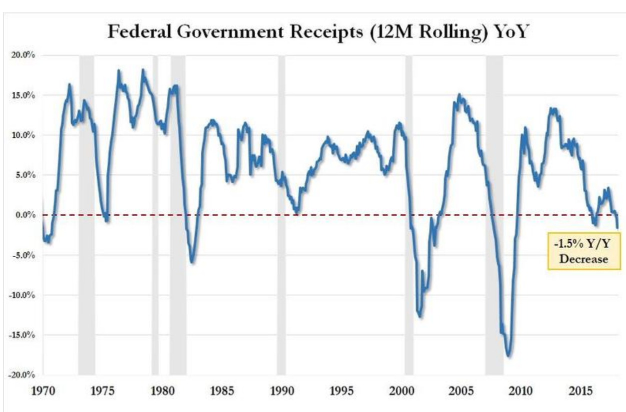
"Deficits don't matter"— Former Vice President Dick Cheney

Another month, another frightening jump in the U.S. budget deficit.

The U.S. budget surplus in January was only $9 billion, badly missing the $25 billion surplus expected. As a result, the budget deficit for the first four months of the fiscal year, widened to $310 billion, a whopping 77% higher. **Yes, a 77 percent increase in one year?**

This is largely the result of the revenue hit from President Trump's tax cuts and the increase in government spending. The deficit was the result of a 2% drop in fiscal YTD receipts to $1.1 trillion, while spending jumped 9% to $1.4 trillion.

Worse, the absolute drop in tax receipts, which declined for both corporations and individuals, was the biggest since the financial crisis; and, as shown in the chart below, every time that receipts have posted an annual decline, a recession either followed shortly or had already arrived.



Unfortunately, since receipts are set to decline even more in the coming months, the overall budget deficit is set to widen further in the coming years as the Republican tax cut package and increased spending for defense and other priorities boost government outlays.

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

SUBSCRIBE

THIS WEEK...

- Budget Deficit Soars
- Trade Deficit Soars
- Where is the Bubble?

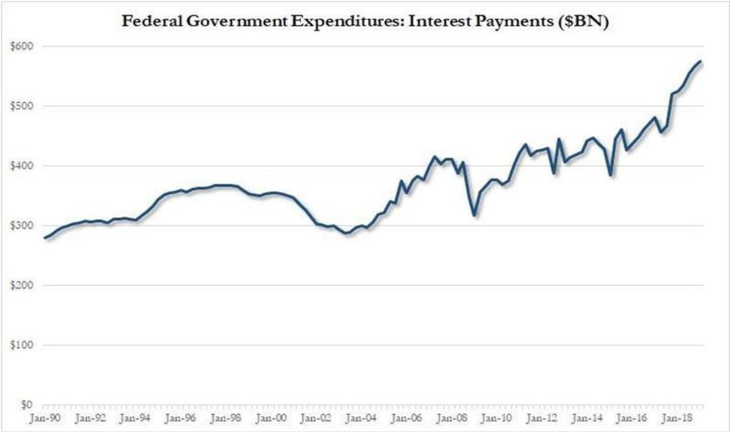
PORTFOLIO STRATEGY

According to the Congressional Budget Office on present policy, annual deficits of a trillion dollars — between 4 and 5 % of gross domestic product — will persist over the next decade.

They expect this to push government debt from 78% of GDP to 93% by 2029. the budget deficit in fiscal 2019 will widen to $897 billion, up by $118 billion from a year earlier; any economic recession will result in a far greater number.

We are on pace to add way over a trillion dollars to the national debt this year, and one of the big things fueling this horrific debt binge is our rapidly expanding interest payments. For the first four months of this fiscal year, interest payments on the U.S. national debt hit $192 billion, the most interest ever paid in the first third of the fiscal year. And since total debt, which recently surpassed $22 trillion is only set to keep rising - once the latest pesky debt ceiling issue is resolved in a few months - expect interest on the debt to keep rising and hit $1 trillion per year in a few years, making it one of the biggest spending categories, and on pace to surpass total U.S. defense spending (roughly $950 billion per year) in dollar terms in just a few years.

Interest Charged have Skyrocketed



Remember that the U.S. is late in the economic cycle and we are at full employment. Debt and deficits should be small and declining. Instead, they are large and rising. Note as well that the CBO's numbers assume that automatic corrective measures built into current legislation will be allowed to take effect. On the alternative and up-to-now reliable assumption that they'll be blocked, the debt would rise to 105% after 10 years. Beyond the end of the decade, even on the more favorable projection, debt would keep on going up — passing 150% of GDP by 2049.

Is there anyone left who believes that Republicans (or Democrats) ever really cared about debt and deficits?

And according to the proponents of Modern Monetary Theory (MMT), we can spend as much money as we want because "deficits almost never matter" According to MMT economists, the only possible danger from the resultant government debt would be inflation, which can usually be controlled with tools other than raising taxes. In other words, deficits almost never matter. So confident are they of their theory's universal applicability that MMT proponents often respond to their critics with scorn.

If you can believe it, there are actually members of Congress that believe this stuff. Of course, the truth is that our national debt is an existential threat to our nation, and this is a point that I have made repeatedly.

Maybe I'm old fashioned, but I don't even have the words to describe how foolish this is. It's simply impossible to borrow your way to prosperity.

Intelligent fiscal discipline isn't passé: It needs to make a comeback.

" You saw trade deficits went down last month and everyone's trying to figure out why. Well, we're taking a lot of tariff money. And it has reduced the trade deficit."- President Donald Trump

---

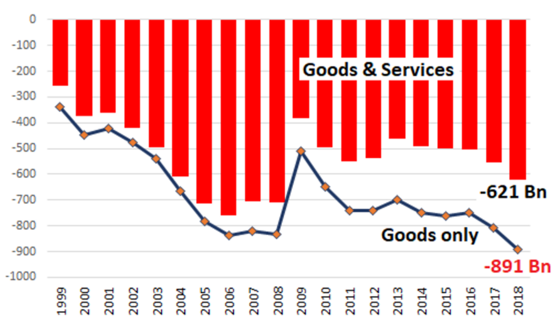
TRADE DEFICIT SOARS

You can't make this stuff up!

It isn't just the budget deficit that is ballooning. The U.S. trade deficit soared to a 10-year high of $621 billion in 2018, jumping by $68.8 billion, or 12.5%, and crushing President Trump's pledges to reduce it.

How did the deficit soar so much in one month? Simple: **less exports, more imports,** as tax cuts boosted domestic demand for imports while the strong dollar and retaliatory tariffs weighed its highest level since 2008.

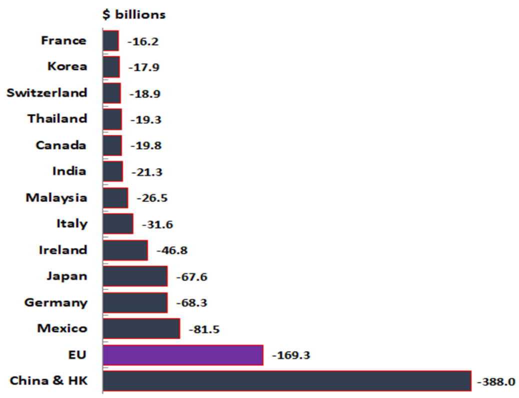
Trade Deficit Soars



Source: Commerce Department

Exports increase economic activity as measured by GDP; and imports do the opposite, they reduce GDP. So, a trade deficit is a net negative for the economy. As such, it looks very likely that the next GDP release for the fourth quarter will come in under the 2.6% that was first thought.

US Goods Trade Deficits



Source: Commerce Department

The widening of the deficit to end the year was the second largest on record. The move was driven primarily by goods, which made up 95% of the increase in the overall short fall. The goods deficit surged to a record $891.3 billion in 2018 from $807.5 billion the prior year.

In the previous graph are the 14 countries with which the U.S. has the largest trade deficits in goods (services not included). Ironically, the biggest culprit was China, as the deficit with Beijing - the target of President Trump's trade war - soared 13.5%, or by $45 billion, to a phenomenal $388 billion, after having jumped 7% in 2017.

President Donald Trump focused his ire mainly on trade deficits, insisting that "our jobs and wealth are being given to other countries that have taken advantage of us."

But that is simply not the truth.

Corporate America is largely responsible for the trade deficit. No one forces companies to run their supply chains through China and around the world. Yet, incentives in the U.S. tax code and cheap labor overseas make it very profitable to shift production to other countries. Corporate America has routed its supply chain so deeply into China that today 3.5 times as many goods are imported from China to the U.S. than are exported from the U.S. to China.

While the systems in China, Japan, and Germany coddle their local exporters, and impede imports, the U.S. system does the opposite: It coddles U.S. importers, and they range across the spectrum, from Walmart and GM to Apple and Pfizer. And these importers ruthlessly take advantage of what the system offers them.

Source: Cagle

Further, as RDQ Economics' John Ryding and Conrad DeQuadros explain, the only ways to shrink the deficit would be to boost domestic savings, cut investment, or reduce the budget shortfall. Tariffs, which are paid by U.S. consumers, would lower savings and might shrink the budget gap; that merely would transfer money from consumers to the government, and have no net impact on the trade gap.

In any case, Ryding and DeQuadros write that the fixation on trade balances was debunked by Adam Smith in 1776. "Trade policy is important to improve supply-chain efficiency and global economic growth," they write.

Ironically Trump has repeatedly cited the deficit as evidence of the failure of his predecessors' trade policies. The gap has surged by $119 billion during his two years as president. Even if he completes an accord to end the tariff war with China, substantially shrinking the deficit may prove tough as cooling global growth weighs on exports while domestic demand keeps driving shipments from abroad.

And so, President Trump is trapped: if he concedes the trade war to China just to keep his precious stock market higher, the deficit will continue rising; if on the other hand, President Trump pushes for a hard line on trade, the S&P - which has now priced in the end of the trade war - will tumble. The ball is now in President Trump's court regarding which option to choose.

WHERE IS THE BUBBLE?

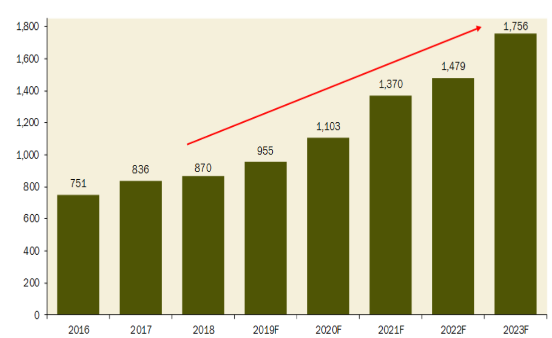
Last week the BIS sounded the alarm on corporate debt. The BIS reported that mutual funds that invest in investment grade corporate credit now have 45% exposure to BBB debt, up from 20% in 2010. A downgrade cycle would risk a forced sale of this debt that could end up spiraling, with knock on effects in general with respect to tightening financial conditions.

Dallas Fed President Robert Kaplan in a speech devoted the entire sermon on this topic (*Corporate Debt as a Potential Amplifier in a Slowdown*). To wit:

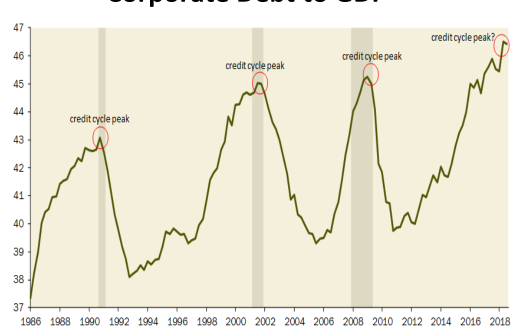
> *"Vigilance is warranted as these issues have the potential to impact corporate investment and spending plans. In the event of an economic downturn, these issues could also contribute to a deterioration in financial conditions, which could in turn, amplify the severity of a growth slowdown in the US economy".*

U.S. nonfinancial corporate debt has more than doubled since the last financial crisis, and that is one of the reasons why our financial system is far more vulnerable today than it was just before the last financial crisis. As shown below as a percentage of gross domestic product, **corporate debt is now higher than in the prior peak reached at the end of 2008**.

Corporate Debt Outstanding



Corporate Debt to GDP



Making matters worse the quality of corporate debt has declined. The lowest level of investment-grade debt, BBB bonds, has grown from $800 million to $2.7 trillion by year-end 2018. High-yield debt has grown from $700 million to $1.1 trillion over the same period. This trend has been accompanied by more relaxed bond and loan covenants.

This is where the leverage (bubble) is. BBB corporate bonds outstanding have increased from a 30% share of the investment grade market, to over 50% today, which is unprecedented. In 2007, we had the junkiest mortgage market ever. Today we have the junkiest corporate bond market on record. Not to mention an epic $7 trillion of this debt will be refinanced in the coming half-decade, bumping against the competition from massive gross new Treasury borrowings.

So, pay close attention to the corporate debt arena going forward. Any major deleveraging cycle could be the catalyst to drive the U.S. economy into a recession.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Over the last six months, the decline in the Leading Economic Indicators (LEI) has been sharper than originally anticipated. Importantly, there is a strong historical correlation between the 6-month rate of change in the LEI... The downturn in the LEI predicted the current economic weakness and suggests the data is likely to continue to weaken in the months ahead."

In mid-2018, the Federal Reserve was adamant a strong economy, and rising inflationary pressures, required tighter monetary conditions. At that time, they were discussing additional rate hikes and a continued reduction of their $4 trillion balance sheet.

All it took was a rough December, pressure from Wall Street's banks, and a disgruntled White House to completely flip their thinking. And sure enough, as the Fed hit the pause button.

But this is the point. It has taken a massive amount of interventions by Central Banks to keep economies afloat globally over the last decade and there is rising evidence that growth is beginning to decelerate. Can the economy and markets function without life support from the central bankers?

The Fed has de facto tightened 340 basis points this cycle, which already comes close to matching what it did ahead of the 1990-91 recession and is more than what it did ahead of the 2001 downturn. Half of the recessions of the post-WWII era were followed by the degree of tightening the Fed has implemented this cycle. Understanding that there is no such thing as a sure thing, I have said it once and I will say it again, the Fed has embarked on a tightening cycle 13 times since 1950 and we had a recession occur, with a lag, on 10 occasions.

Not every economic indicator has been poor, but the vast majority sure have been. Investors have this nasty habit of living in the moment, whereas I am constantly urging them to look at the forest past the trees. History says we have roughly an 80% chance of a recession in the coming quarters. Timing it is very difficult, but it is out there.

The NY Fed recession probability model is up to 24% from 10.4% a year ago and 4.1% two years ago (the last time we were at 24% recession odds was back in July 2008 — when we were already eight months into one!).

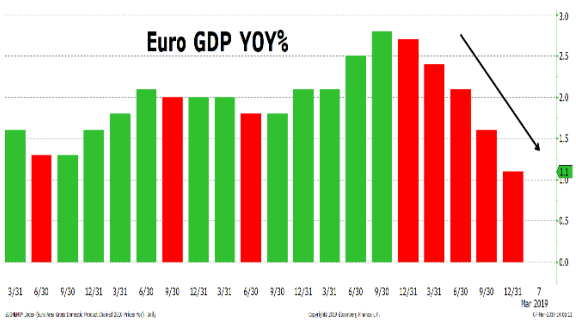
As I discussed previously, China and the ECB are signaling their concerns about **"economic reality."**

China's economy just turned chaotically south with Chinese exports plunging 21% in February. It should be noted that China has been the largest growth engine of the global economy since the Global Financial Crisis, but it would appear despite the less than trustworthy official data China already may have entered a recession in Q42018 or will soon. Authoritarian countries such as China routinely and systemically overstate their GDP. One such study by SpaceKnow monitors 6,000 industrial sites in China and shows that China's manufacturing sector entered a contraction last year. Furthermore, the median Chinese stock was down 40% in the fourth quarter from its highs a year ago, strong evidence of recession.

Last week, the ECB sharply downgraded Eurozone growth and inflation forecasts. As for the new ECB economic forecasts, markets reacted most to the news that 2019 inflation was being revised down to 1.2% from 1.6%. Growth is now expected to be 1.1% in 2019 compared to 1.7% previously. I still believe these forecasts are wishful thinking. Apparently, others do as well. Headlines came out after the close suggesting some ECB officials were worried they hadn't cut growth forecasts enough. And according ECB head honcho Mario Draghi " a weakening in the economic data points to a sizable reduction in the pace of economic expansion that will extend into the current year" So, the ECB will not raise rates in 2019 and will extend the TLTRO program, which is the Targeted Longer-Term Refinancing Operations which gives cheap loans to struggling Eurozone banks**,** into 2021.

But there is nothing to worry about, right?

Europe is Heading Towards Recession



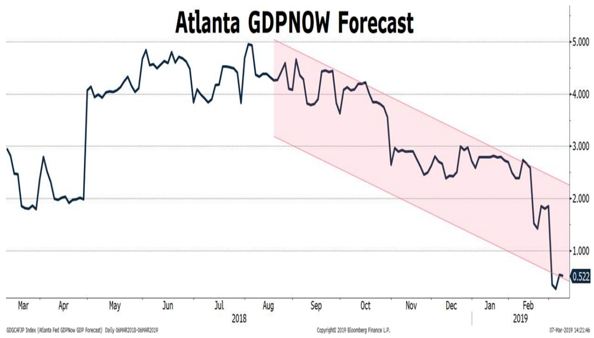
Source: Bloomberg

Last Friday, the U.S. jobs report came in much weaker than expected:

> *"Wall Street's main index's fell after data showed U.S. job growth almost stalled in February, adding to the concerns of a slowdown in China and global growth sparked by weak Chinese export data and a prolonged slowdown in the eurozone"*

The U.S. is not an island and there is no "economic immunity" once the global economy is in tatters. And as shown below economic growth has taken a decided turn for the worse. According to the Atlanta Fed's GDPNow model, the economy is growing at a 0.5% annualized rate in the first quarter. This would make the third consecutive quarter of declining growth. If incoming data continue to show weakness Q1 could fall into negative territory. If so, the U.S. would be only one quarter away from being in a "technical" recession.

Will the US Follow Europe?



Source: Bloomberg

Meanwhile, so many pundits and commentators are saying "I can't see a recession!". I hear this every day. It's like saying "I can't smell the carbon monoxide". By the time you "see the recession", your head is sliced off.

The bottom line?

Growth is slowing in China, Europe and the U.S.

And that is what the market is forecasting. Odds of a lower federal-funds target range this year have climbed to a 19.8% chance of a cut of 25 basis points or more at the FOMC's Dec. 11 meeting. But don't be surprised if economic weakness becomes more widespread if the Fed 'cuts' policy rates by 25 basis points by summer or early fall.

HOW WILL THE FED RESPOND TO A RECESSION?

The current belief is that rates will be slashed to zero and QE4 will be implemented at the first hint of a more protracted downturn in the economy and market. However, QE will likely only be employed when rate reductions aren't enough. This was noted in 2016 by David Reifschneider, deputy director of the division of research and statistics for the Federal Reserve Board in Washington, D.C., released a staff working paper entitled *"Gauging The Ability Of The FOMC To Respond To Future Recessions."*

The conclusion was simply this:

> *"Simulations of the FRB/U.S. model of a severe recession suggest that large-scale asset purchases and forward guidance about the future path of the federal funds rate should be able to provide enough additional accommodation to fully compensate for a more limited [ability] to cut short-term interest rates in most, but probably not all, circumstances."*

But there is a problem**.** In 2008, when the Fed launched into their "accommodative policy" emergency strategy to bail out the financial markets, the Fed's balance sheet was only about $915 Billion. The Fed Funds rate was at 4.2%.

If the market fell into a recession tomorrow, the Fed would be starting with roughly a *$4 Trillion* balance sheet with interest rates 2% lower than they were in 2009. In other words, the ability of the Fed to stimulate the economy and 'bail out' the markets today, is much more limited than it was in 2008.

But there is more to the story than just the Fed's balance sheet and funds rate. The entire backdrop is completely reversed. The table below compares a variety of financial and economic factors from 2009 to present.

This suggests that the Fed's ability to stem the decline of the next recession or offset a financial shock to the economy from falling asset prices, may be much more limited than the Fed, and most investors, currently believe.

There is a finite ability to continue to pull forward future consumption to stimulate economic activity. **In** other words, there are only so many autos, houses, etc., which can be purchased within a given cycle. There is evidence the cycle peak has been reached.

Times Have Changed: Will ZIRP and QE Work Today?

	Then: 01/2009	Now: 01/19	Difference
Fed Funds	.15%	2.4%	2.25%
10-Year Treasury	2.52%	2.68%	0.16
Nominal GDP	-1.75%	5.34%	7.09%
Inflation	-0.12%	1.5%	1.64%
Unemployment	7.80%	4.0%	-3.80%
Jobless Claims	543500	229,900	-314,500
Shiller-CAPE 10	19	28	9
Government Debt ($tn)	$11.00	22.00	11.00
Existing Home Sales	3,8200,00	4,370,000	550,000
New Home Sales	336,000	657000	321,000
Consumer Sentiment	61.2	91.2	30
NFIB Survey	83.9	101.2	17.3
PCE	-1.47%	3.98%	5.45%
Retail Sales	-11.48	4.01%	15.49%
Leading Economic Indicators	76	111	35
Vehicle Sales (millions)	9.76	17.13	7.34
Fed Balance Sheet	$915bn	$4Trillion	$3.85 Trillion

In terms of portfolio strategy, we continue to emphasize that credit unions remain fully invested in a well-diversified, high quality, and duration appropriate ladder strategy.

In terms of sectors, traditional agency debt spreads have collapsed to comparable duration Treasury securities. Going forward, these tight spreads are likely to persist due to shrinking new issuance. As such, we recommend that credit unions consider investment alternatives that offer better value. Of note, we continue to advocate well structured CMBS products (FNMA DUS and Freddie K's) that provide bullet like characteristics of agency debt while offering higher yields and income.

We also favor well-structured CMOs that limit prepayment and extension risk. In addition to the added yield, credit unions benefit from monthly cash flows and broader diversification.

Finally, in the credit arena, high quality bank notes are recommended as a means of diversifying and adding income.

Please do not hesitate to contact your Fixed Income Representative for additional information.

CREDIT UNION EXECUTIVE LEADERSHIP SYMPOSIUM

Join us for our fifth annual Credit Union Executive Leadership Symposium from September 4-6, 2019 in Chicago, Illinois!

Highlights of this year's event include:

- Keynote speaker Suze Orman
- Dinner at Smith & Wollensky Restaurant
- Leadership & Motivational Speakers
- Football Night with Alloya – NFL Opener
- Economic Outlook
- Dueling Market Views featuring Tom Slefinger and Steven Rick
- Multiple Networking Opportunities
- 9.5 CPE Credits Available

Register now for early bird pricing and a chance to win free symposium registration with hotel accommodations included – a value of more than $1,500! Runner-up prize will be a $500 Visa gift card.

Visit **www.alloyacorp.org/symposium2019** to view the agenda and register today!

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.