BALANCE SHEET SOLUTIONS
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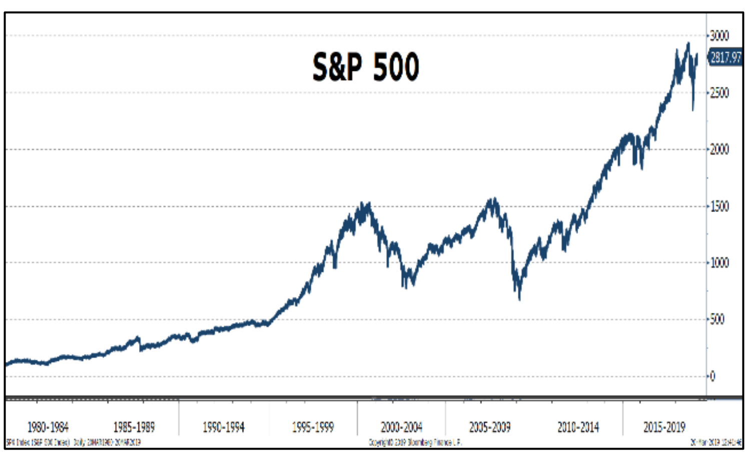
WEEK OF APRIL 1, 2019

Weekly Relative Value

Work Til You Drop

"Although the average American household has saved roughly $175,000 in various types of savings accounts, only the top 10% to 20% of earners will likely have savings levels approaching or exceeding that amount. 29% of households have less than $1,000 in savings."
– Magnify Money

The baby boomer generation (individuals born between the years of 1946 and 1964) is some 76 million strong and one of the largest demographic cohorts in American history. Most boomers entered the work force between 1966 and 1984. As shown below, since the 1980s – with the exception of the burst of the dot.com and housing bubbles – boomers have enjoyed two massive bull markets over the last four decades. From 2008 to present, the S&P 500 has more than tripled in value. With such strong equity performance, one would think that boomers would be sitting pretty as they enter their "golden years."



Source: Bloomberg

Sadly, that is not the case.

Savings levels of working age Americans remain deeply inadequate. From now until 2030, 10,000 baby boomers each day will hit retirement age. While some will begin to officially retire, collect social security checks and go on Medicare, over 40% of boomers plan to "work until they drop."

So, what went wrong?

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

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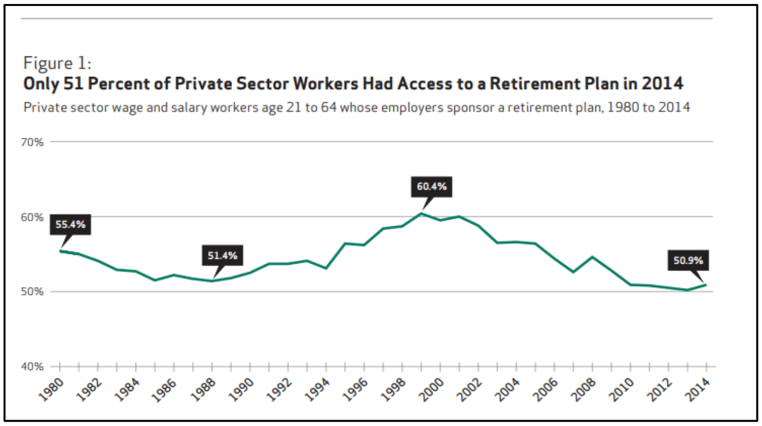
THIS WEEK…

- Social Security Won't Give You Security
- Housing Slump Continues
- Lower for longer
- Bonds Have More Fun

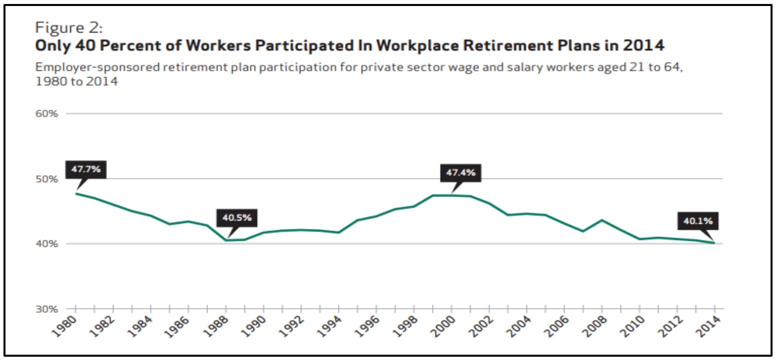
PORTFOLIO STRATEGY

According to the National Institute of Retirement Security, 57% (more than 100 million) of working age individuals do not own any retirement account assets in an employer-sponsored 401(k)-type plan, individual account or pension. Only 51% of Americans have access to a 401(k) plan.



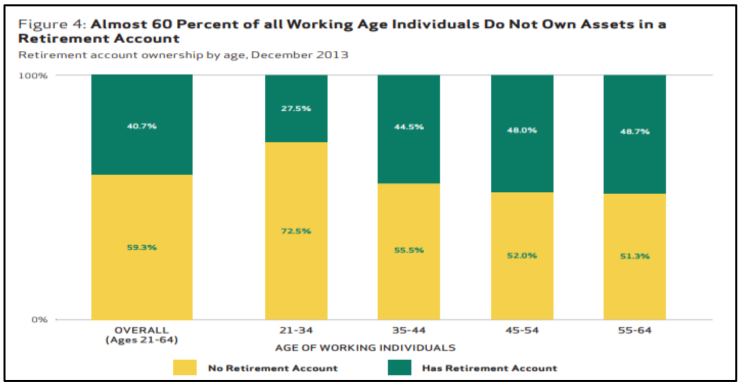
Source: National Institute for Retirement Security

More importantly, only 40% of individuals actually contribute to one.



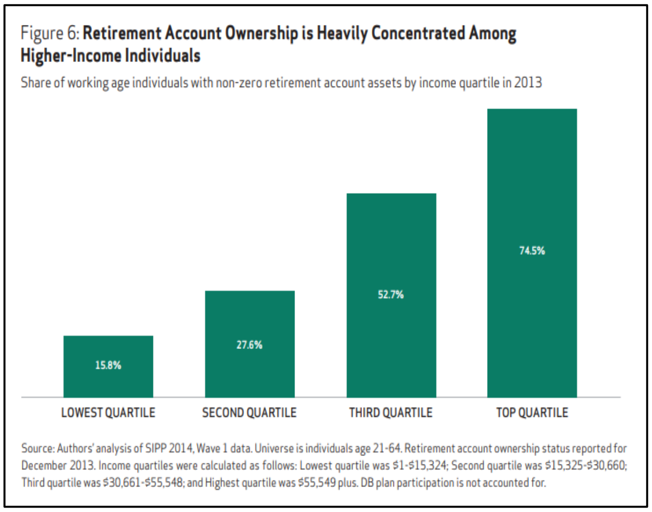
Source: National Institute for Retirement Security

Almost 60% of all working age individuals do NOT own assets in a retirement account. Four out of five working Americans have less than one year's income saved in retirement accounts.



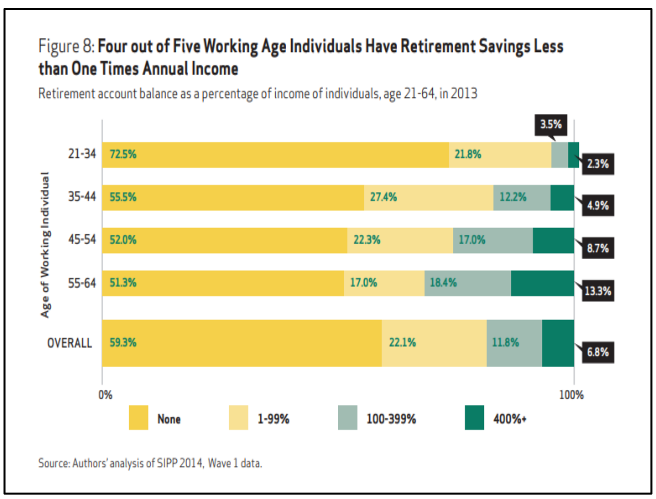
Source: National Institute for Retirement Security

And of those that do own retirement accounts, the majority of the wealth, unsurprisingly, is owned by those with the highest incomes.



Source: National Institute for Retirement Security

Lastly, four out of five working age households have retirement savings of less than one times their annual income. This does not bode well for the sustainability of living standards in the "golden years."

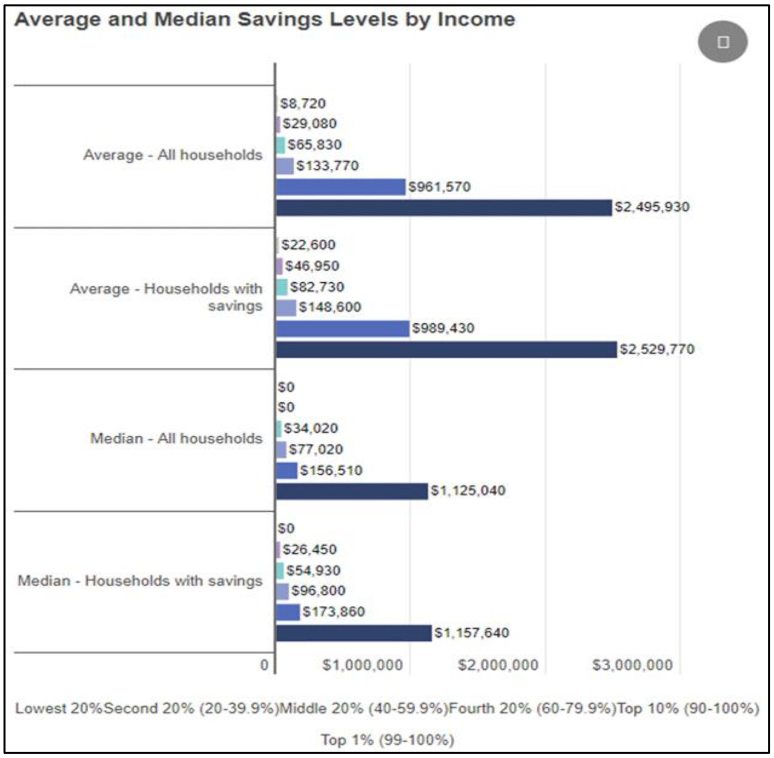


Source: National Institute for Retirement Security

Average household savings for the bottom 40% are under $30,000. Median household savings for the bottom 40% are zero dollars. Clearly the top percentiles and especially the top 1% skew the average. Note the navy-blue bars in the following chart do not represent the top 20%, but the top 1%. And the top 1/10 of 1%?

The point is that the 80% of households have less than $100,000 in savings. That is not enough for even a minimal retirement. Importantly, baby boomers who are nearing retirement had an average of just $40,000 saved for their "golden years." Let's make the very aggressive assumption that you can take 5% a year from your savings plan. If you have $100,000, that's $5,000 yearly or about $417 a month—on top of your Social Security. And if you don't have your house paid off?

The following chart sums up the mess.



Source: cnbc.com

SOCIAL SECURITY WON'T GIVE YOU SECURITY

A solid majority of Social Security recipients receive $2,000 a month or less, and many less than $1,000. The average benefit is $1,413. If that's all you have, your retirement lifestyle is not going to include many cruises and golf tournaments.

"But these are not really our focus this morning; our focus is that the average balance in 401(k)s, 403(b)s or IRAs fell to $95,600 at the end of last year from $104,300 at the end of the third quarter for 401(k)s, to $78,700 from $85,100 for 403(b)s and to $98,400 from $106,300 for IRA balances. It was not the drops in value that caught our attention; it is the fact that the averages are only at or near $100,000, forcing us to wonder what sort of retirement can the average retiree look forward to with this minimal sum of money set aside? Is that all there is? Really? Is that really all there is? If so, we are in very real trouble." – Dennis Gartman

Social Security was never intended to be a retirement plan. It was designed to keep retired workers out of poverty at a time when lower life expectancies kept retirement much shorter for most — if they lived to 65 at all. Now we live longer, and we have higher expectations. In a country of 330+ million people, shockingly few have enough retirement savings to support the stereotypical leisurely golden years.

Many of our parents and grandparents had defined benefit plans and others guaranteed retirement benefits from the corporations they worked for. Those are an increasingly endangered species in the private sector while 401(k)s, IRAs and Social Security aren't giving the average person enough to retire on anything close to a comfortable lifestyle.

Many individuals are further away from retirement than they ever imagined. Furthermore, all investors lost something far more valuable than money – the time that was needed to reach their retirement goals. Now imagine what would happen if we have a nasty bear market?

I realize this is not a happy story, but I call it as I see it.

HOUSING SLUMP CONTINUES

Housing starts plunged 8.7% in February. The -9.9% year-over-year trend is the worst since September 2016, and dare I say just before the President got elected. The headline would have been an even greater disaster if the hyper-volatile multi-family sector hadn't surged 17.8%. The more important (from a GDP contribution standpoint) single-family area collapsed 17.0% and has been flat or down in five of the past six months. And the 805k unit level (annualized) is down 10.6% from year-ago levels. The sharp decline in single-family starts was geographically broad based – the Midwest (-8.3%), the South (-12.1%), the West (-24.4%) and the Northeast (-42.0%). Building permits, which are a leading indicator, fell 1.6% in February on top of a 0.7% dip in January. Permits have been flat or lower in four of the last five months.

Source: CartoonStock

Of course, Wall Street will notify us that the number is noise and not to worry. From my lens, this has a Japan feel to it – where interest rate relief exerts little impact on the sectors that should benefit the most from lower market rates.

In addition, there are clearly structural issues at play. Principally the shifting view among millennials about homeownership. Think about the "gig" economy and the record length of time it is taking millennials to get married, let alone begin a family (my wife is waiting for one of my three sons to deliver us a grandchild). In addition, the millennials desire to retain maximum flexibility and avoid being tied down, which is a priority among today's young adults. And let's not forget the mountain of student debt that is a ball and chain on first-time homebuyer demand.

LOWER FOR LONGER

Regular readers of this piece can attest to the fact that I have remained a staunch bull on the bond market. While other economists and strategists have repeatedly called the end to the great bull market in bonds, I have argued that rates will remain lower and for longer. Yes, rates can/will back up as they periodically have, but rates cannot rise to substantially higher levels for a sustained amount of time without driving the highly leveraged economy into a recession.

Lance Roberts from Real Investment Advice does an excellent job of explaining why interest rates are likely to remain lower for longer than the conventional wisdom suggests:

"*Rising interest rates are a function of strong, organic, economic growth that leads to a rising demand for capital over time.* *There have been two previous periods in history that have had the necessary ingredients to support rising interest rates.* ***The first was during the turn of the previous century as the country became more accessible via railroads and automobiles, production ramped up for World War I, and America began the shift from an agricultural to industrial economy.***

The second period occurred post-World War II as America became the '*last man standing'* ***as France, England, Russia, Germany, Poland, Japan and others were left devastated.*** *It was here that America found its strongest run of economic growth in its history as the* ***"boys of war"*** *returned home to start rebuilding the countries that they had just destroyed. But that was just the start of it.*

Beginning in the late 1950s, America embarked upon its greatest quest in history as man took his first steps into space. The space race that lasted nearly twenty years led to leaps in innovation and technology that paved the wave for the future of America. ***Combined with the industrial and manufacturing backdrop, America experienced high levels of economic growth and increased savings rates, which fostered the required backdrop for higher interest rates.***

Today, the ingredients to create that kind of economic growth no longer exist…

…The U.S. is no longer the manufacturing powerhouse it once was.

…Globalization has sent jobs to the cheapest sources of labor. Technological advances reduce the need for human labor and suppress wages as productivity increases.

…Labor force participation rates remain mired near their lowest levels since the 1970s.

…Demographic trends in the U.S. continue to weigh on the sustainability of pension benefits and long-term economic growth.

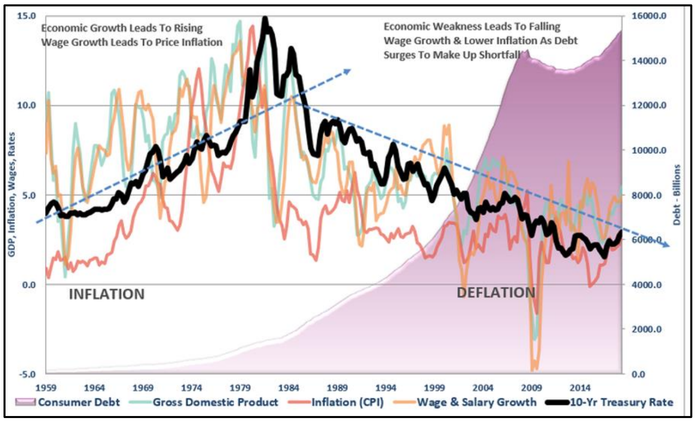
…Massive debt levels divert capital from productive investment to debt service.

…Productivity growth, the engine for economic growth, has ground to a halt.

*Interest rates are not just a function of the investment market, but rather the level of '****demand'*** *for capital in the economy. When the economy is expanding organically, the demand for capital rises as businesses expand production to meet rising demand.* ***Increased production leads to higher wages which in turn fosters more aggregate demand. As consumption increases, so does the ability for producers to charge higher prices*** *(inflation)* ***and for lenders to increase borrowing costs. (Currently, we do not have the type of inflation that leads to stronger economic growth, just inflation in the costs of living that saps consumer spending – Rent, Insurance, Health Care, Energy.)***

This is shown in the following graph. The rise in rates during the 1960-70s was combined with rising inflationary pressures driven by a rising trend in economic growth and wages. Extremely low levels of household indebtedness allowed rates to rise without severely negative consequences.

Interest Rates: A Function of GDP Growth, Inflation and Wages



Source: Real Investment Advice

With households, corporations, the government and investors more leveraged today than ever before in history, the rise in rates will have a more immediate and widespread economic consequence.

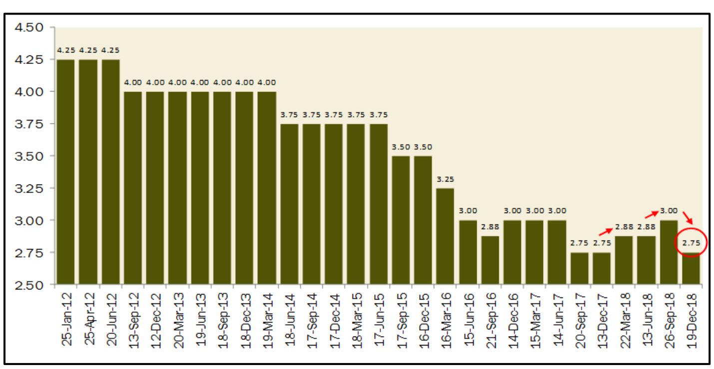
When rates start to increase, there is NOT an immediate negative consequence on economic growth, employment or inflation. As the increase continues, early warning signs are dismissed as just a "lull" or "soft landing." However, those early warning signs have previously been just that.

BONDS HAVE MORE FUN

"First of all, to say, 'We're getting a recession' to me that's dumb. I don't know why that is seen as such a bombastic view. That's what happens at the end of a cycle."
– Liz Ann Sonders, Charles Schwab Chief Investment Strategist

Because of powerful secular constraints on growth and inflation from aging demographics, accelerating technological improvements and excessive debt loads, the Fed's estimates of the "long run" funds rate has been declining steadily over time — it was pegged at 4.25% just seven years ago. By September 2017, it had been trimmed to 2.75%, near where it is today.

Where is Neutral?



Source: Haver Analytics, Gluskin Sheff

Meanwhile, core inflation is not at the Fed's target, the leading inflation indicators are turning lower, and the forward-looking wage data are as well, indicating that slack is returning to the U.S. economy.

Core Personal Consumption Expenditures Year-Over-Year (%)

Source: St. Louis Fed

The market is priced largely for a Fed easing in the months ahead, but not nearly enough because the central bank never ever stops at one – recession or not. And I have a keen sense that if the New York Fed's model is prescient (in that recession odds are nontrivial and on the rise), then the yield on the 10-year Treasury note will be revisiting the cycle lows of 1.3%. And if that happens within the next 12 months (the yield already has collapsed nearly 100 basis points from last year's peak), then the total net return will be roughly 15%. This is what they mean when they say that bonds have more fun.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I'd need to see an inversion of some magnitude and/or duration, and right now we don't have either. If you see an inversion that goes on for several months... that's a different kettle of fish. We're not there yet."
– Robert Kaplan, Dallas Federal Reserve President

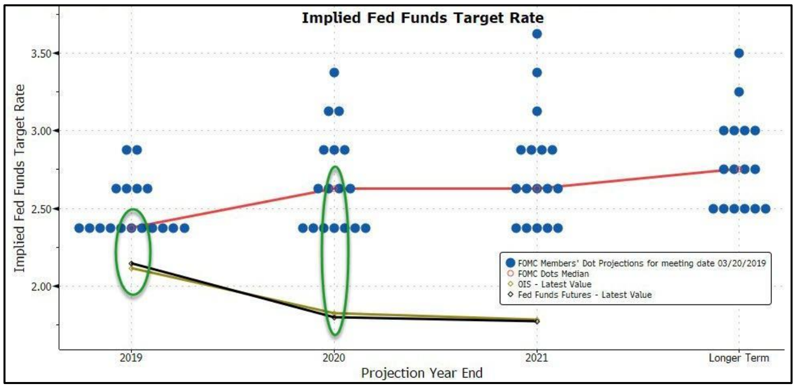
"I'm not freaked out." – Mary Daly, San Francisco Federal Reserve President

The final release of fourth quarter GDP revealed that the economic slowdown to end the year was even worse than expected. Indeed, real GDP growth came in at a 2.2% annual rate, which was much slower than the 2.6% growth rate that was first reported. Given that it is now March, this release holds less weight, but it does mean that the economic momentum into first quarter was worse than first thought.

But while the U.S. economic data have been soft overall, the numbers in Europe and Asia still look pretty atrocious. And the outlook isn't much better. Investors should be wary.

As it stands now, 72% of investors see the Fed lowering rates at least once in 2019, according to the CME Group, up from 34% a week ago. The market itself is pricing in almost 40 basis points of rate cuts in 2019 while the Fed remains stuck at no rate change in 2019.

Speaking of calls for lower rates, the Wall Street Journal editorial board lends their support for the nomination of Stephen Moore for the Fed. And just weeks ago, President Trump's top economic advisor Larry Kudlow was bloviating about the strength and sustainability of the U.S. economy. Something appears to have scared him. **E**choing Trump's latest Fed pick Stephen Moore, Kudlow is calling for the Fed to "immediately" cut rates by 50 basis point. Kudlow "would love to see" such a downward move, adding that the central bank shouldn't have ever set overnight interest rates past 2%.



Source: Bloomberg

So the Fed is clearly willing to let itself fall behind the curve, in the name of taking out an insurance policy. By the time Mr. Kaplan sees what he wants to see in order to make a move, it will be too late... assuming it isn't already too late.

I say, never mind the inversion and for how long? The Fed should come back to us and explain what it means to have the yield on the 10-year Treasury note collapse nearly 100 basis points in a six-month time span. And what does it mean to have the yield fall below the policy rate? Surely this is a message that deserves something better than just *"I'm not freaked out."* The bond market is challenging the Fed's forecast head-on. And the bond market may not be infallible, but it is right far more than it is wrong.

In terms of portfolio strategy, we continue to advocate that credit unions maintain a well-diversified and risk-appropriate ladder strategy as we move forward. Any significant back-up in yields provides an attractive entry point to invest excess cash reserves.

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> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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> – Shawn Nikkel, Finance Director of Denver Fire Department FCU

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> – Darin Higgins, President of Western Illinois Credit Union

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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.

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