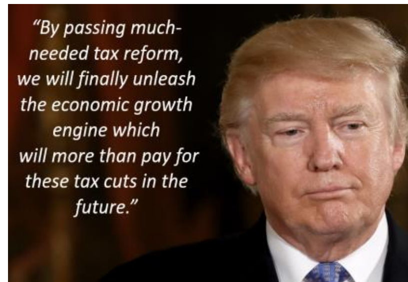
Weekly Relative Value

It's the Demography, Stupid!

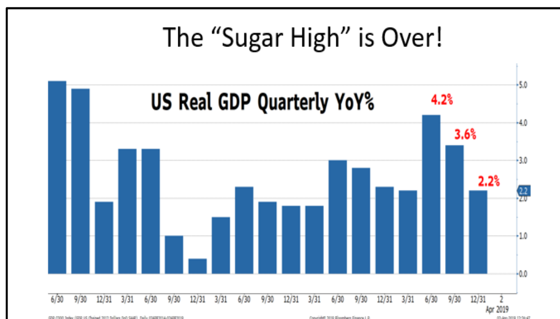
"The U.S. is facing a 'brutal reality' of nearly ***zero-percent growth in its working-age population for at least a decade****."* – Neil Howe

President Trump has gone on record that his pro-cyclical stimulus policy of tax cuts and fiscal spending (Tax Cuts and Jobs Act enacted in late 2017) would deliver 3, 4 or even 5% growth. Higher growth would create more revenue that would more than pay for the tax cuts and additional spending. Do you really believe that?



Since the Trumpian tax cuts and increased fiscal spending, the U.S. economy has accelerated. As shown in the following graph, growth accelerated to 4.2% in the second quarter of 2018. But heck, if you spend a couple trillion dollars, of course growth will pick up. And remember when Obama was President, there were four quarters of at least 4% growth, and one of 5.2%. But here's the key point: there was never much follow-through. Under the Obama Administration, the economic expansion muddled through at an annual pace of roughly 2%. Today, the same pattern appears to be unfolding again. After the recent acceleration in GDP, the "sugar high" is now fading and growth is yet again trending towards 2%.

The "Sugar High" is Over!



Source: Bloomberg

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

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THIS WEEK…

- Synchronized Slowdown
- Peak Inflation
- History Repeats!
- Probably Nothin'!
- What a Jolt!
- Happy Tax Day!

PORTFOLIO STRATEGY

And it's not just an American story. Economic growth forecasts have been downgraded across the globe from Asia to Europe. Europe has struggled to sustain growth faster than 1.5% and appears to be nearing contraction yet again. Japan has rarely grown faster than 1% over the past two decades. And it is safe to say that China's glory days of rapid economic growth are coming to an end.

So, why can't the U.S. and global economy grow at a faster and sustainable growth rate? What has changed?

As James Carville might say, "It's the demography, stupid!"

The world is aging rapidly, birth rates are declining, and the working age population is falling… everywhere.

To understand how demography impacts the economy, you need to understand the iron law of economics. Put simply, real GDP growth over the long run is equal to the sum of productivity growth (output/employed worker) + labor force. Every economist of every persuasion believes in this tenet.

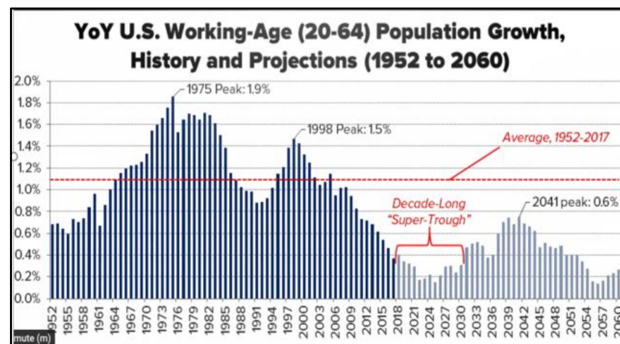
The Iron Law of Economics

Δ Productivity
+ Δ Labor Force
GDP Growth

Yet, for whatever reason, central bankers and politicians tend to ignore or underplay the influence of demographic factors over the short- and medium-term. Worse, they keep living in the past and basing forecasts on the post-war miracle years, when growth was boosted by the post-World War II baby boom and the rapidly expanding labor force combined with rising productivity.

But population and productivity growth has stagnated in the U.S. (as well as China, Japan and Europe). The miracle is over. The American baby boom has faded out and the growth in the working age population slowed to a mere 0.2% last year from 1.2 % in the early 2000s. As shown in the following graph, we are entering a decade-long "super trough" of working age population growth. And it looks like, for the rest of our lives, we will never again see the working age population growth we experienced as recently as 2011.

U.S. Labor Force is Down… And Not Getting Back Up

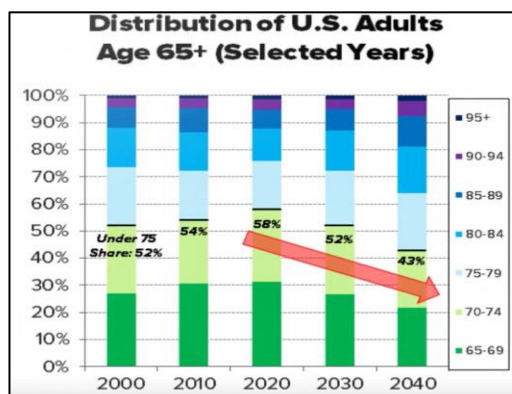


Source: Hedgeye

People want to bring back the Reagan economy. But back in the early 1980s, we had a huge wind of 1.7% free GDP growth at our backs, just from warm bodies. Even with a sudden change in fertility and immigration, the U.S. is unlikely to see the kind of growth in working age population the U.S. saw from the mid-1970s to the mid-80s and again in the 90s. Thus, based on the declining population of working age Americans, economic growth would be expected to slow – and it has. This is the new normal for the American economy. The effect from demography is here and present.

The chart below shows how the American population is aging, and the workforce is shrinking. From 2020 through 2040 the percentage of Americans under the age of 75 will decline from 58% of the population to 43%. Meanwhile, those over the age of 75 will rise to 57% of the population.

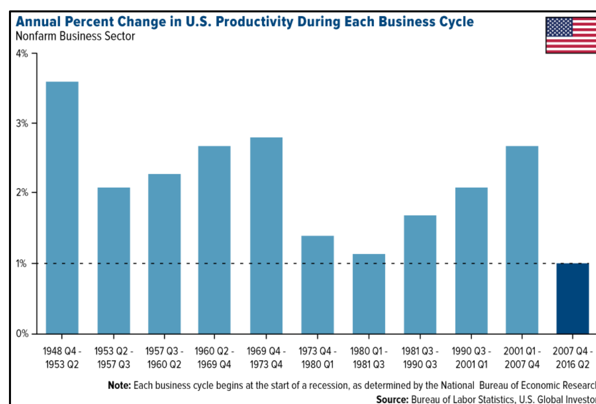
The Working Age Population is Declining Fast



Source: Hedgeye

It's nice to imagine that productivity will jump enough to add to growth, but we would have to see a near-tripling of trend productivity, to the highest level observed in the post-war era, to bring structural real GDP growth prospects to even 3% annually. As shown below, since the post-war surges of the 1950s and 60s, productivity growth has slowed dramatically.

Wither Productivity

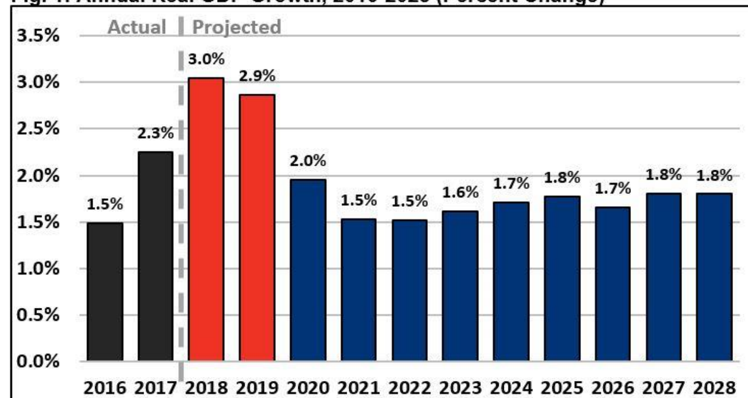


Source: BLS

Not surprisingly, the Congressional Budget Office (CBO) estimates of potential GDP growth imply structural growth of less than 2% annually over the coming years. After the initial bump from the Trump stimulus program (red bars),

growth slows down and is expected to remain in the 1-2% range. This is due to the iron law of demographics. **It's baked in the cake.**

Growth to Slow Over Next Decade



Source: Congressional Budget Office.

So, the post-war miracle is over. Economic growth is weighed down by the baby bust and the debt hangover (which has been discussed in this space quite often). Whatever politicians tell the public, their attempts to bring back the miracle years are ill advised. Growth in the economy is driven by growth in the number of workers and in output per worker, or productivity. Stimulus measures like the Trump tax cuts can lift growth above this path, but at best temporarily, at the risk of higher deficits and debt. (And God forbid should Modern Monetary crowd take control of the monetary and fiscal levers.)

"Low interest rates are usually attributed to low inflation, weak economic growth and super easy monetary policy. But there's another, deep-seated factor that doesn't get much attention: demographics." – Greg Ip

The Bottom Line: Presently, and for at least the next decade, there is no clear impetus for further growth in employment except participation rates moving well above historical norms or elderly remaining in the labor force far beyond expected levels. Without the growth in employment, there is no impetus for growth in consumption, new housing creation, or economic growth.

Furthermore, in trying to generate artificially higher growth over the short-run, our policy makers and politicians run the risk of doing more damage to the economy in the long-run. The world does not need more debt and more inflation to counter trends of declining population growth and high indebtedness. Instead, economists need to adjust their forecasts and politicians need to rethink their policies to match this reality. Because trying to recreate a bygone golden age is a shaky way to build the future.

Demographics – along with excessive debt – explain the downward trajectory of rates in the U.S. and around the world. Because these demographic forces are unlikely to reverse direction very rapidly, actual interest rates will stay lower for longer than the Fed has previously recognized. Of course, the market has already reached this conclusion, but it is important that the Fed is no longer fighting the market. This considerably reduces the risk of a sudden hawkish shift in Fed policy settings in coming years.

SYNCHRONIZED SLOWDOWN

The IMF made news last week by announcing its latest updates to 2019 GDP growth around the world. Overall global growth was downgraded to 3.3%, which still doesn't look so bad but would actually be tied for the worst showing since the Great Recession ended a decade ago. No region was left untouched as the global synchronized expansion of two years ago continues to morph into an ongoing global synchronized slowdown. U.S. real growth for this year was sliced to 2.3% from 2.5% —wave bye-bye to that three-handle of 2018, Larry! The Fund is calling for a further moderation to 1.9% for 2020.

The euro area and the U.K. were both revised three-tenths lower — 1.3% for the former, and 1.2% for the latter. That is heading towards Japan-like numbers, whose GDP growth projection was trimmed to 1.0% from 1.1%. China goes to 6.3% from the January forecast of 6.4% — even with all that stimulus! India also was shaved down to 7.3% from 7.5%. Canada's real growth was taken down hard to 1.5% from 1.9%.

Slow-Down Coming

PEAK INFLATION

Inflation is telling us quite a bit about demand growth and business pricing power. The headline Consumer Price Index (CPI) rose 0.4% in March (in line with consensus) but was skewed by a 3.5% run-up in energy prices, which has yet to run its course. The fact that the core CPI only managed to eke out a 0.1% gain attests to the view that there is so far very little spillover to other sectors. The key here is that the core inflation rate is running at 2.0% and this puts the 2.4% cycle peak last July further into the rear-view mirror. This was the lowest peak in the core inflation rate for any cycle in the post-WWII era.

Peak Inflation

Source: Bloomberg

Of course, there are folks out there who look at the bounce in commodity prices this year as a signal that inflation has returned. The rebound has been dominated by a supply squeeze as opposed to booming global demand. As a sign of true secular deflation in the goods sector, consider that oil prices are still down -44% from the cycle highs, the Commodity Research Bureau is down 49%. Copper and aluminum are both down more than 30% and lumber by almost 50%!

Scholarly research pegs the real neutral funds rate between 0.6% and 0.8%. Thus, the Fed overtightened this cycle by two to three hikes. This may be the only source of agreement I will ever share with the likes of Larry Kudlow and Stephen Moore. That said, it may be too late to unwind this excess tightening as recessionary pressures are building and likely to become more visible later this year.

Big picture —just know that 10 of the last 13 Fed hiking cycles have ended in recession. And the three where they were averted (1965/66,1983/84 and 1994/95) only happened because the Fed actually responded by cutting rates (they didn't just walk back their pledged hikes!). This time, we have yet to see this occur, and most recent set of Federal Open Market Committee (FOMC) minutes suggests this is not on officials' radar any time soon. They want to see how the economy progresses over the next couple of quarters. Thus, it could be year-end before they have a definitive answer. So, ultimately, any action the Fed takes will be too late.

10 of 13 Rate Hike Cycles Have Led to Recession

First Hike	Last Hike	Result
Oct-50	May-53	Recession
Oct-55	Aug-57	Recession
Sep-58	Sep-59	Recession
Dec-65	Sep-66	Soft Landing
Nov-67	Jun-69	Recession
Apr-72	Sep-73	Recession
May-77	Mar-80	Recession
Aug-80	Dec-80	Recession
Mar-83	Aug-84	Recession
Jan-87	May-89	Soft Landing
Feb-94	Feb-95	Soft Landing
Jun-99	May-00	Recession
Jun-04	Jun-06	Recession
Dec-15	???	???

Source: Bloomberg

HISTORY REPEATS!

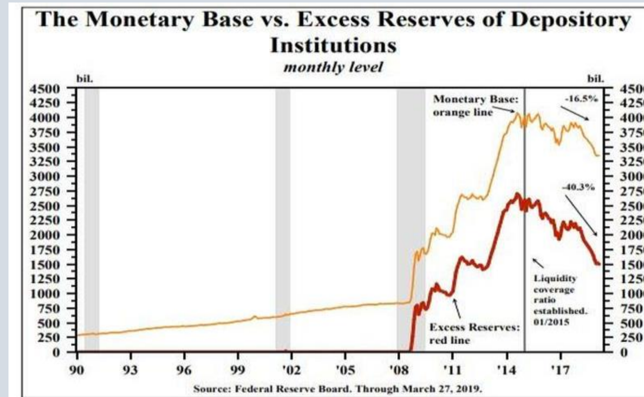
"The Fatal Similarities to The Past Are Remarkable." – Lacy Hunt, Ph.D.

The following was excerpted from Hoisington Investment Management's Latest Quarterly Review:

"The parallels to the past are remarkable, but there appears to be one fatal similarity – the Fed appears to have a high sensitivity to coincident or contemporaneous indicators of economic activity*, however the economic variables (i.e. money and interest rates) over which they have influence are slow-moving and have enormous lags.*

In the most recent episode, in the last half of 2018, the Federal Reserve raised rates two times, by a total of 50 basis points, in reaction to the strong mid-year GDP numbers. ***These actions were done despite the fact that the results of their previous rate hikes and monetary deceleration were beginning to show their impact of actually slowing economic growth.***

*The M2 (money) growth rate was half of what it was two years earlier, **signs of diminished liquidity were appearing and there had been a multi-quarter deterioration in the interest rate sensitive sectors of autos, housing and capital spending.***



***Presently, the Treasury market, by establishing its rate inversion**, is suggesting that the Fed's present interest rate policy is nearly 50 basis points too high and getting wider by the day. A quick reversal could reverse the slide in economic growth, but the lags are long.*

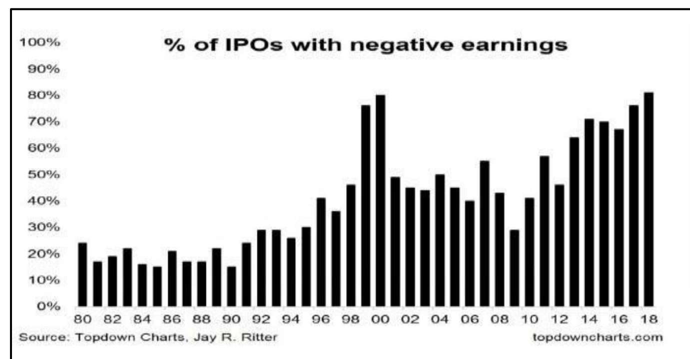
***It appears that history is being repeated – too tight for too long, slower growth, lower rates."** – Lacy Hunt, Ph.D.*

In Summary: Lacy Hunt says interest rates are 50 basis points too high. In relation to the Fed's mandate, I believe Hunt is correct. Alternatively, the Fed should have started hiking in 2010 or 2011 and be cutting rates now.

The Fed is constantly chasing its own tail. I believe that is what Lacy means when he speaks of lags.

PROBABLY NOTHIN'!

Shades of 1999



WHAT A JOLT!

The Job Openings and Labor Turnover Survey (JOLTS) came out for February, and the widespread weakness strongly suggests that the household survey has the correct story on the jobs market this year – not the establishment survey that has become increasingly influenced by the fabled Bureau of Labor Statistics birth-death model. What makes the

JOLTS special is that it opens the hood on the labor market car so you can see the "churning" that is going on beneath the surface.

Job openings plunged to 7.087 million in February, from 7.625 million in January, to sit at the lowest levels since March of last year. Note too that the decline in job openings (538 thousand) was the largest since August 2015 and the second largest of the cycle.

The weakness was very broad based. The decline in education and health (105 thousand), as well as leisure and hospitality (105 thousand) are noteworthy because these have been the areas of the labor market that have been providing the greatest support. That support now looks to be waning. Adding insult to injury, new hirings were pared by 133 thousand in February, the third decline in the past four months. The decline again was widespread.

From my perch, this was the weakest JOLTS report in five years — when Fed policy easing was in full throttle. Not to mention, ranking in the top five of the very worst readings since the jobs cycle began nine years ago. Green shoots, indeed.

RATES WILL NEVER RISE

"I Don't See Rates Rising Again in My Lifetime." – Larry Kudlow, Director of the National Economic Council under President Donald Trump

Almost five years ago, former Fed Chairman Ben Bernanke uttered **he does not expect the Fed's interest rate to rise back to its 4% average during his lifetime.**

In retrospect, he was right because just a few years later, with the fed funds rate at 2.50%, the Fed realized that any further hikes would crash the market, which was already on the verge of a bear market, and as a result Fed Chair Powell put the Fed's rate hike strategy on hold.

Now, five years after Bernanke's infamous statement, Trump's top economic advisor Larry Kudlow has done Bernanke one better said that he does not think that rates will go up ever again, **"maybe never again in my lifetime,"** effectively admitting that the U.S. economy is on the verge, if not in, a recession (either that, or giving a pretty dire prognosis of his own health).

Source: Hedgeye

Kudlow also said that Powell is doing a good job, despite disagreements. Ah yes, it got to the point where Trump even had to call Powell, and while the full conversation shall remain a mystery, Trump told the Fed chair that he is "stuck" with him (for now).

And in an effort to confuse the hell out of everyone, Kudlow added that the economy is so strong that the Fed should cut rates immediate by 50 basis points. Because obviously that makes sense.

Last, but not least, less than six months ago, the "smartest men in the room" at Goldman Sachs' prestigious economics department were in full hawk mode – forecasting four rate hikes in 2019.

Now even the mighty Goldman has folded to the market's view, proclaiming with no smile on their face that growth will be better than they expected in 2019 and 2020. BUT... pushing back their forecast for the next hike from first quarter 2020 to fourth quarter 2020. In other words, no rate hikes until after the elections.

The ***"excuse"*** – despite rosier growth forecasts – is simple: ***no inflation.***

HAPPY TAX DAY!

Although the Tax Cuts and Jobs Act enacted in late 2017 increased take-home pay somewhat last year, millions of households nevertheless treat tax refund season as a built-in component of their annual budget. Whether it's that summer vacation, the family room face lift, or yes, that down payment on a new set of wheels – the tax refund proceeds are the planned funding source. And consider that at the same time refunds are down, gasoline prices are up by about 50 cents a gallon from their 2019 lows, equating to a $65 billion de facto tax on households.

It's no exaggeration to say that there are few risks to the global economy more daunting than a persistent slowdown in U.S. consumer spending. At 17 percent, U.S. consumption's contribution to global gross domestic product eclipses that of the 16 percent attributable to the entire Chinese economy.

Don't forget to file your taxes…

Many Unhappy Returns

Source: Cagle Cartoons

MARKET OUTLOOK AND PORTFOLIO STRATEGY

In just two months, or June, the U.S. expansion will become the longest economic up-cycle in history. Yet and despite the recovery's duration, the growth rate during this expansion has been the lowest ever.

Last December's Federal Reserve rate hike may have been the last rate increase for this cycle. Over the past several months, the Fed repeatedly signaled that it is done raising rates and, as stated in its latest FOMC statement, "will be patient as it determines what future adjustments to the target range for the federal funds rate may be appropriate." The Fed's latest forecast shows no further hikes this year and only one hike in 2020. And even the Trump administration demands a rate cut of 50 basis points. What does it mean when, nearly a decade after the end of the recession, the U.S. economy can't stand short-term interest rates of more than 2.5%?

As discussed above, my view is that the Fed has already overtightened and, as the lag from higher rates impacts the real economy, the risk of a recession is rising. As such, do not be surprised if the Fed begins to ease later this year. Given this backdrop, we continue to advocate a fully invested, well diversified ladder strategy.

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- Dueling Market Views featuring Tom Slefinger and Steven Rick
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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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