Balance Sheet Solutions
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WEEK OF APRIL 29, 2019

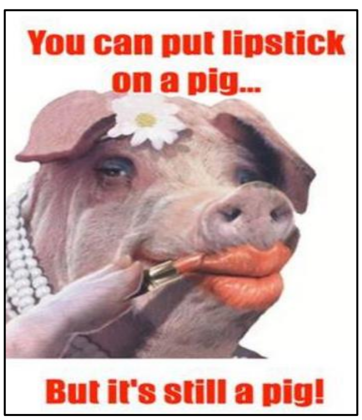
Weekly Relative Value

Removing Lipstick from the Pig

CNN: *"U.S. economy posts strong first quarter, but consumer spending slows"*
CNBC: *"U.S. economy grows by 3.2% in the first quarter, topping estimates"*
Wall Street Journal: *"Boom Goes U.S. GDP!"*

Investors received virtually no help from the mainstream media contextualizing the big surprise in the GDP report last Friday.

Here's the deal: The first "estimate" of real GDP growth did indeed surprise to the upside, coming in at a +3.2% annual rate in the first quarter, beating the +2.3% consensus view and up from +2.2% in the fourth quarter. The good news started and ended with the headline.



Source: Google Images

The most obvious contribution to the true but fake news was the U.S. government using a GDP deflator (for inflation) of 0.64% (understating inflation overstates real GDP). If nominal GDP was deflated using the government's own Consumer Price Index (CPI) inflation number, the headline GDP print would have been HALVED to around +1.6%!

In addition, the GDP acceleration was driven almost exclusively by net exports and inventory accumulation. Government spending provided an additional boost. Exports added 1.03% to the headline and inventories contributed +0.7% (so 1.73% or 54% of total). The government sector managed to add 0.41% to GDP growth, helped mostly by the expanded military budget.

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

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THIS WEEK...

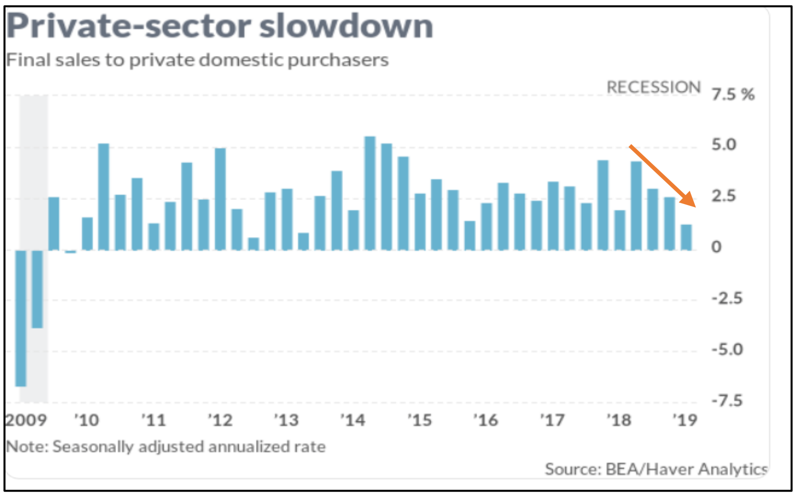
- Housing Remains in a Funk
- Speaking of Millennials
- Black Swan

PORTFOLIO STRATEGY

Stripping out the government, trade and inventory swings, real private domestic final sales — the heart of the economy — grew at only a 1.3% annual rate, half the pace of the fourth quarter. To put this in perspective, the last time the private economy was this weak was the fourth quarter of 2009, when we were emerging from the worst recession since the 1930s.

The main takeaway from this report is what's happening with the all-important consumer. Personal consumption expenditures — which account for more than two-thirds of the U.S. economy — slowed sharply in the second quarter, to a microscopic 1.2% annual rate from 2.5% in the fourth quarter of 2018 and 3.5% in the third quarter. Spending on big-ticket consumer items plunged 5.3%, the weakest since the fourth quarter of 2009! Even spending on services weakened to a 2% annualized pace from 2.4% in the fourth quarter and 3.2% in the third quarter of last year.

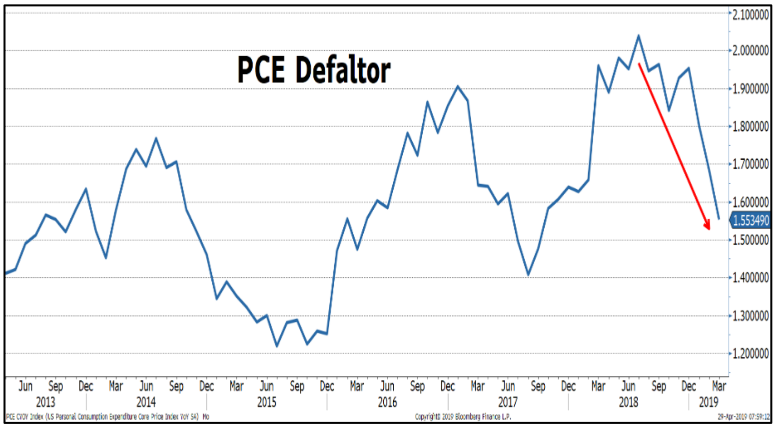
The Heart of the Economy Slows



Source: BEA/Haver Analytics

Furthermore, if the headline GDP tally was the real deal, in terms of being anywhere close to depicting above-potential growth, then the price data would reflect this alleged boom in demand. As shown below, the personal consumption expenditures deflator (which excludes food and energy prices) has receded from 2% in the third quarter to 1.9% in the fourth quarter and now down to 1.5% — increasingly moving away from the Fed's target.

No Inflation Here



Source: Bloomberg

In the forty years I've been in this business, this was one of the weakest "three % handles" on a headline GDP growth figure I've seen. Everything that created the top-line number in the first quarter borrowed from the future. Next quarter is almost certain to be worse, and unless something surprising happens, the quarter after that will be worse still. Remember: This is the Chinese Year of the Pig, and the lipstick on this pig of a report isn't going to help very much.

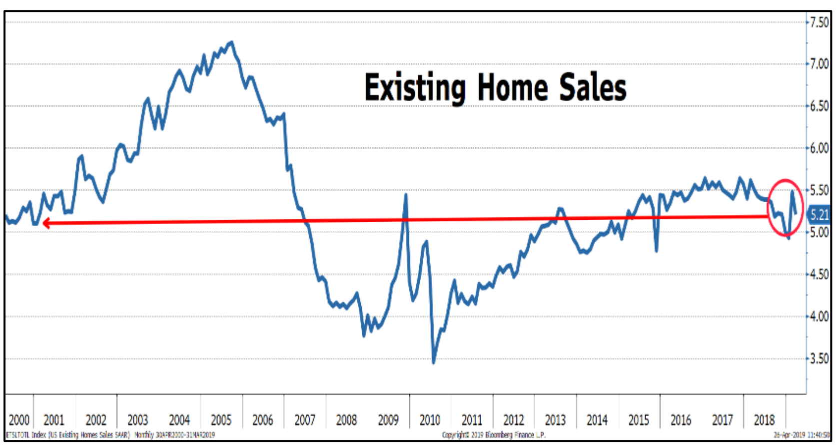
HOUSING REMAINS IN A FUNK

Can we really have a healthy economy without a vibrant housing market? U.S. housing starts were down 0.3% in March after the 12% collapse in February. We have now seen negative readings for six of the past seven months. Single-family activity slipped to levels we have not seen since 2016. Total building permits, which are not affected by rains, storms or flooding, sagged 1.7% and have contracted now for three consecutive months. Over the three months to March, single-family housing starts have fallen at a 13.5% annual rate and permits have declined at nearly a 10% pace. In the first quarter as a whole, single-family starts are down 4.6% year-over-year and building permits by 6.2%. And this is with lower mortgage rates! More to the point — how does this dovetail exactly with the broader "solid economy" narrative?

Existing home sales fell 4.9% in March to a 5.21-million-unit annualized rate. We have seen declines now in three of the past four months and in four of the past six — which has left the year-over-year trend depressed at -5.4%. In fact, at 5.21 million units, existing home sales are below (-1.1%) where they were in July 2013!

It would be one thing to say that this was all lousy weather, but all regions were down: West -6.0%, South -3.4%, Midwest -7.9%, and Northeast -2.9%. And affordability isn't the problem seeing as it's at its best level in a year and mortgage rates are down 40 basis points since November. Supply is making its way back too, with the inventory backlogs rising to 3.9 months' supply of product, up from 3.6 months in February.

Existing Home Sales Rebound... To January 2000 level!



Source: Bloomberg

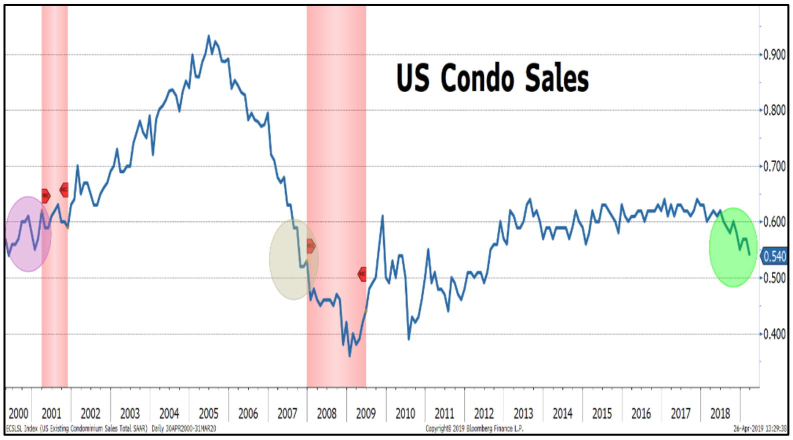
The problem remains one of student debt and the impact it continues to have on housing, as the share of sales from first-time buyers, while recovering some to 33% in March, is still far below the 40%-50% number that typifies a normal housing market.

As a side-note, it is interesting to note that the prime area of weakness was in the condo/co-op market where sales dropped 5.3% month-over-month in March and by 11.5% on a year-over-year basis to 540,000 units at an annual rate.

This level is comparable to what we experienced prior to the last two recessions where condos/co-op markets saw year-over-year declines at the onset of the downturn.

If the condo market is a leading economic indicator, then *caveat emptor* is all I can say.

As Condos Go… So Goes the Economy?

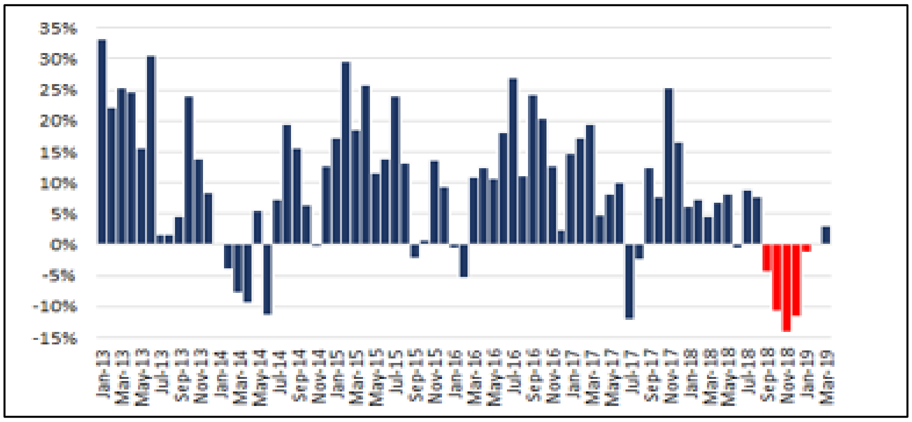


Source: Bloomberg

Finally, on the housing front, at first blush, the 4.5% surge in U.S. new home sales looks very bullish, the third straight increase and up now in four of the past five months. Quite a different tale than the soft resale numbers. However, there are a few caveats worth mentioning:

1. Sales are still lower today than they were in November 2017. In fact, they are half of their prior peak levels, for some perspective.

New Single-Family Home Sales (Percent Change Year-Over-Year)



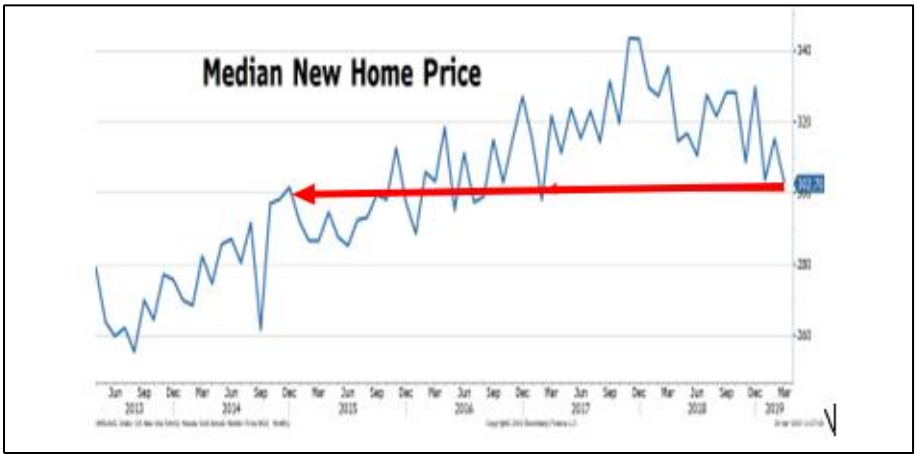
Source: Bloomberg

2. Home builders, the ultimate pros in the housing market, have figured something out: Cut prices and build homes with lower price points. The median selling price of new houses dropped 9.7% in March from March last year to $302,700 and basically no higher now than back in December 2014. Imagine that over four years of no home price appreciation. The median home price plunged 4% sequentially and has deflated now in two of the past

three months. The year-over-year trend is now -9.8% — very nearly the weakest since coming out of the Great Recession.

In addition, they're building homes at lower price points. House sales at the lower end gained market share while houses at the higher end lost market share. The big sales burst is in cheap starter homes because those units priced under $150,000 soared to the highest level since August 2013. Those priced in the next rung ($150,000 to $199,999) jumped to the highest since May 2018. On the other end, houses that were sold at prices of $400,000 or higher in March made up 29% of the mix, down from 32% in March 2018.

New Home Prices Back to 2014 Levels



Source: Bloomberg

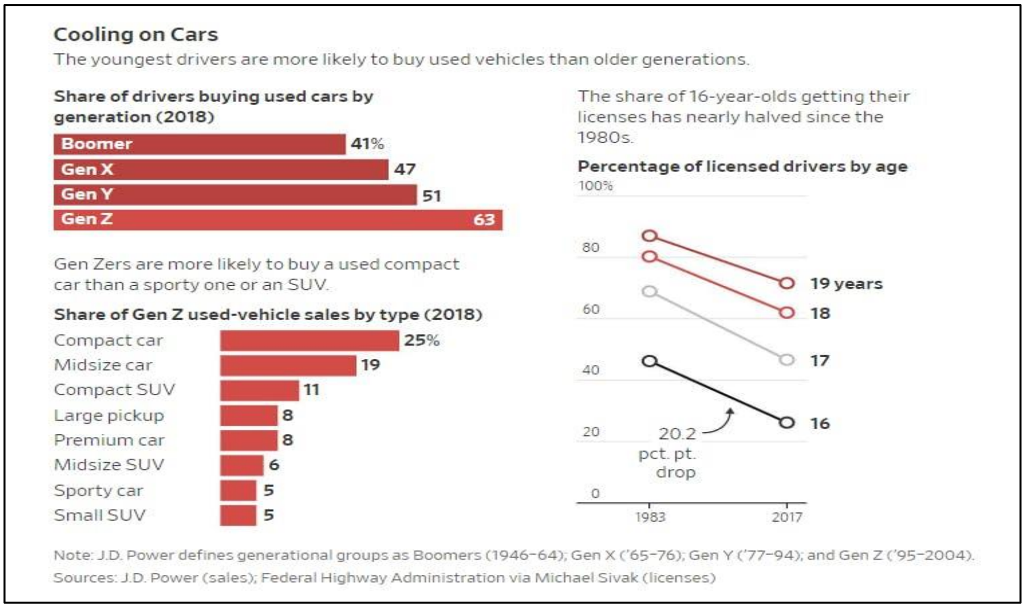
All this makes basic sense. Homebuilders are in the business of building and selling houses, and unlike homeowners, they cannot just not sell their houses when the market isn't with them. So, they sharpened their pencils and made deals at prices where the buyers were, and as prices dropped, sales ticked up and high inventories started to shrink a little. Price can fix a lot of problems. This is something homeowners haven't figured out yet. There is plenty of supply of existing homes, but it's the wrong supply, priced too high, so sales fall.

SPEAKING OF MILLENNIALS

"That freedom of getting your own wheels and a license — and that being the most important thing in life — is gone… It used to be the day they turned 14 years and eight months, everybody was lining up at the door. Now I'm starting to see more 15- and 16-year-olds in class." He frequently hears from parents that they're the ones pushing their children to enroll. – Brent Wall, Owner of All Star Driver Education in Michigan

The Wall Street Journal has an interesting article that strikes right at the heart of the auto industry: *Driving? The Kids Are So Over It*. At increasing rates, millennials and generation Z see no need to get a driver's license. About a quarter of 16-year-olds had a driver's license in 2017, a sharp decline from nearly 50% in 1983. Even among those in their early 20s, fewer are getting their licenses. About 80% of 20- to 24-year-olds were licensed drivers in 2017, compared with 92% in 1983, according to transportation researcher Michael Sivak.

At the heart of this shift is a huge change in attitude about cars and housing coupled with amazing technological advances. Whereas a driver's license once was a symbol of freedom when boomers were growing up, teenagers are reaching their driving age at a time when most have access to ride-hailing services such as Uber and Lyft to shuttle them around town. At the same time, social media and video chat let them hang out with friends without actually leaving the house. When they reach their 20s, more are moving to big cities with mass transit, where owning a car is neither necessary nor practical. And of those who do buy a car, many more than in older generations opt for a used one.



Source: Wall Street Journal

Boomers did not have social media outlets when we were in high school and college. Nor did we have cell phones. If you wanted to do something you had to drive or get your parents to take you. I remember driving around my little town for hours with nowhere to go. Driving was an activity and gas was 20 cents a gallon.

Obviously, cost is an issue. Detroit is busy churning out SUVs that cost well over $30,000. The average price paid for a new vehicle was $32,544 in 2018, up from $25,490 a decade ago, according to J.D. Power. The average monthly payment on a new-car loan reached $535 a month last year, or more than 10% of the median household income, a level most Americans can't afford.

The cost of insurance is rising. One can forgo a car but not a place to live. Housing costs have risen far more than the stated rate of inflation.

J.D. Power estimates that Gen-Zers will purchase about 120,000 fewer new vehicles this year compared with millennials in 2004, when they were the new generation of drivers—or 488,198 vehicles versus 607,329 then.

Boomers are the primary force keeping the current auto trends alive. Demographically-speaking, it won't last. If teenagers are any guide, Americans' love affair with the automobile may no longer be something car makers can bank on. The auto industry will soon not look as it does today. Cars will be smaller, lighter, electric and self-driving. Boomers will be gone. Those living in big cities will not need to own a car at all, and most won't.

BLACK SWAN

"A black swan is an event or occurrence that deviates beyond what is normally expected of a situation and is extremely difficult to predict. Black swan events are typically random and unexpected." – Wikipedia

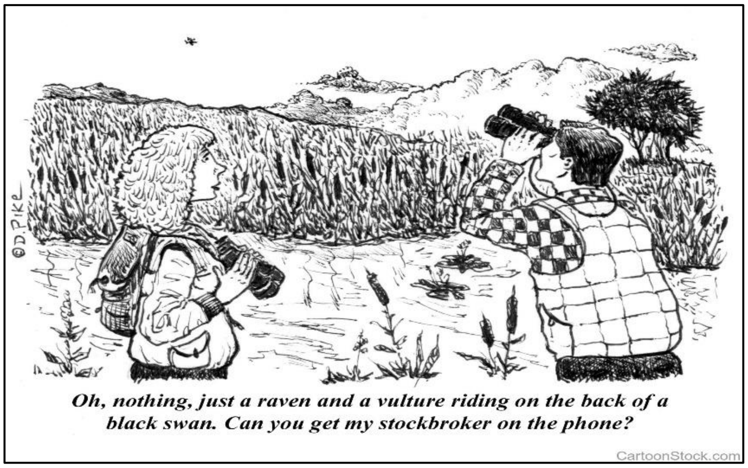
I am often asked what the next "black swan" event will be. Most folks assume it will be an economic or financial event. But what if it is a political event? Let's face it. Very few thought Donald Trump would win in 2016. Talk about a black swan!

What if we end up seeing a clean sweep by the Democrats? The Dems would keep the House and take the Senate (where more Republicans face re-election than Democrats next time around). Many might say, "no way!" However, again, very few predicted that Trump would win in 2016. Furthermore, if a recession occurs, which is an elevated risk, let alone the fallout from the Mueller report, then President Trump's re-election prospects will be dimmed substantially. Frankly, the President may have difficulty getting his base out as he did last time, since there will not be Hillary Clinton to be demonized.

While Joe Biden is a centrist, unquestionably, the Democratic party as a whole has moved radically to the left on practically every issue. Please consider the "promises" — whether health, education or the environment (all key issues with millennials, who will be a force to be reckoned with in 2020).

No matter where one stands on these issues, the question is who will pay – higher tax rates on top personal incomes, higher capital gains taxes, dividend taxes, taxes on share buybacks, and the prospect of wealth taxes.

I'm not forecasting that this will l happen. However, if there is a move towards the left "populist" policies it is a clear risk to the stock market beyond the next 20 months. Take note that this is not the Clinton/Rubin team that had your back — this current group of Democrats seeking office will be aiming to stab you in the back. This should have every equity investor concerned.



Source: Cartoon Stock

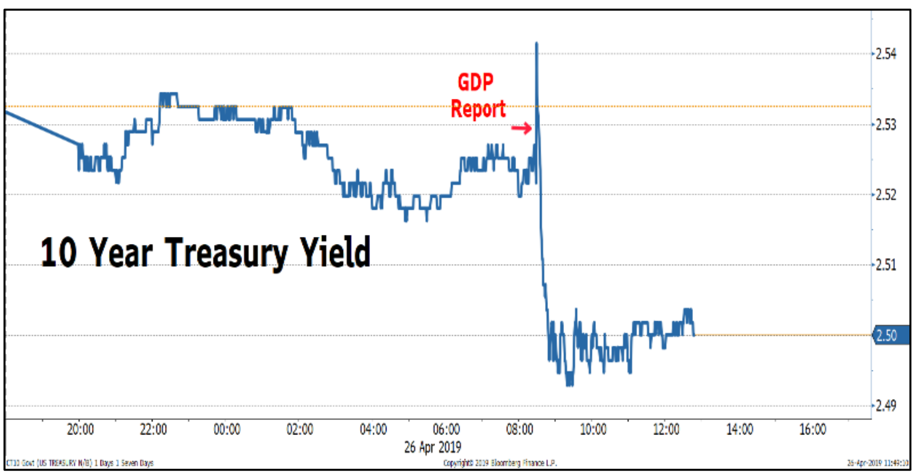
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The thought that the economy's rate of growth this year will be much slower than last is still right… I don't think we're going to see an economy that's nearly as strong as last year because the benefits of those tax cuts are gone."
– Mark Zandi, Chief Economist at Moody's Analytics Inc.

Despite last quarter's surprisingly high GDP numbers, the economy is not as strong as advertised. Underlying consumer demand is weak. The boost from the tax cuts, which juiced consumer spending, is wearing off. A long-lasting increase in business investment has failed to materialize, probably due to the uncertainty created by the ongoing trade tensions. Finally, and most importantly, the Federal Reserve has raised rates eight times since 2016 in an effort to head off inflation. That inflation never materialized, and now overall U.S. demand is weakening. In fact, a recession late this year or early next remains a live possibility.

Lastly, bonds yields should have surged on the GDP number suggesting a much stronger economic growth rate. However, yields fell on Friday signaling that investors are continuing to question both economic growth and the market rally. Last week, two-year Treasury yields dropped a big -10 basis points to 2.28% and 10-year Treasury Yield dropped -6 basis points to 2.50%. If real demand weren't #slowing, why has the 10-year U.S. Treasury yield dropped for 18 of the last 25 weeks?

10-Year Yields Plunge after Q1 GDP Report



Source: Bloomberg

Remember: It was only a few months ago that the U.S. Federal Reserve was intent on continuing to increase interest rates. But now, some policy makers are even hinting that the next move may be a rate cut. The Federal Reserve Bank of Chicago President Charles Evans was on record stating this month that if the core inflation rate held at around the 1.5% area for a few months, he "would definitely be thinking about taking insurance" by cutting rates. Robert Kaplan, President of the Federal Reserve Bank of Dallas, also indicated that if inflation persisted at low levels, he would have to take that into account in setting rates. Even if Fed Chair Jerome Powell suggests at his May 1 press conference that such a move could occur within a few months, that may not be the end of the easing cycle.

Despite the headline economic numbers, the federal funds futures market was still betting on a cut of a quarter-point or more in the Fed's 2.25%-2.5% target range. The futures market is assigning a 63.8% chance of a reduction priced in for the December policy meeting and a 68.6% probability at the January 2020 meeting. The FOMC meets this week, and no change to policy is expected at this meeting.

In terms of portfolio strategy, we continue to advocate a fully invested, diversified ladder strategy.

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– Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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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.