

Weekly Relative Value

Monetary Madness

"If it were possible to take interest rates into negative territory, I would be voting for that."

– Former Fed Chair Janet Yellen

The term **"financial repression"** explains how interest rates are manipulated lower by the central banks. It's the difference between what the rate of interest would be under free-market conditions and what the interest rate is under the manipulation of central banks.

Unthinkable before 2008, and for the first time in 4,000 years of interest rate history, the idea is to jolt lending, spur inflation and reinvigorate the economy. By keeping interest rate levels below that of inflation, financial repression punishes savers with the goal of forcing individuals to stop saving and spend, spend, spend. Likewise, the policymakers believe that corporations will capitalize on the "cheap" money, issue more debt, and invest and grow their businesses.



Source: Hedgeye

The proponents of financial repression believe that you need to essentially force individuals to spend and invest. God forbid Americans save for a rainy day. By pricing the cost of money artificially lower than where it would be in a free open-market, consumers will save less and spend more.

Central bankers misjudged the human animal. When central planners implement more repression, individuals and companies become more cautious, due to the fact that the price of money is being artificially manipulated by the central banks. The reality they see differs from the sugar-coated central bank-created narrative. The thinking goes: If money is priced artificially low something is wrong! **And when something is wrong, you save more, not less.** Thus, financial repression achieves the opposite of what it intends.



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THIS WEEK...

- WHO BUYS NEGATIVE YIELDING BONDS?
- HAPPY ANNIVERSARY!
- BEYOND THE YIELD CURVE
- BONDS HAVE MORE FUN!
- PUSHING ON A STRING

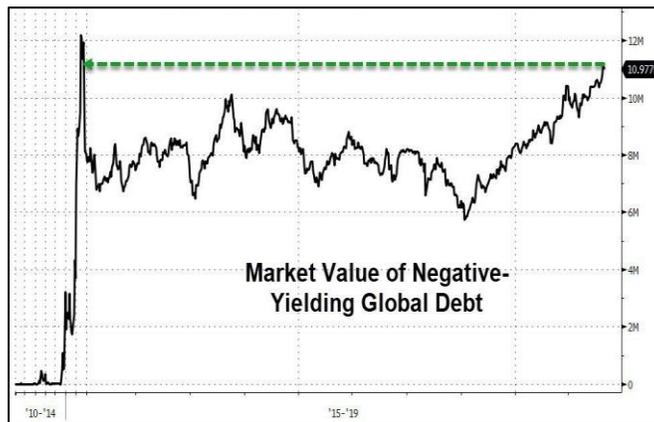
PORTFOLIO STRATEGY



“Extreme” financial repression is taking rates below zero and providing major liquidity injections via quantitative easing. And that’s where Europe and Japan are today. In this upside-down world, borrowers get paid and savers penalized. Crazy as it sounds, the European Central Bank (ECB) cut rates below zero in 2014, and then Japan followed. There are now some 500 million people in a quarter of the world’s economies living with rates in the red.

The amount of bonds with a negative yield is \$11 trillion, or almost 20% of the Global Government Bond Index. How crazy is that? You can as easily imagine a five-pawed St. Bernard or a suitable candidate for public office as you can the situation of a lender paying a borrower for the privilege of extending a loan.

\$11 Trillion of Negative Yielding Bonds



Source: Bloomberg

Below I show a table of yields around the world. What you will clearly note is yields, with the exception of those made in the Good Ole U.S. of A., are **NEGATIVE** in most of the major bond markets. Ten-year Treasuries may not yield much, but they deliver something like 213 basis points more than nothing. It’s all about relative value.

The Land of Negative Yields

	2-year	5 Year	10 Year
Germany	-0.69%	-0.59%	-0.20%
Japan	-0.18%	-0.20%	-0.10%
Switzerland	-0.88%	-0.84%	-0.51%
US	1.99%	1.97%	2.13%



Source: Hegeye

And things are even more bizarre in Germany.

The table shows that German bonds are inverted in 19 places despite the fact that the German bonds have a negative yield for 13 years. On the three-year bond, the ECB pays you 0.667% per year to borrow. If you borrow money for three months, you collect an annualized 0.514% for borrowing.

Getting paid to borrow money could not possibly happen in a free market. Yet, it's now so extreme, the longer the borrow, the more you get paid.

Duration	Level May 30, 2019	Spread to Next Lower
30-Year	0.471	0.647
10-Year	-0.176	0.269
7-year	-0.445	0.115
5-year	-0.560	0.107
3-Year	-0.667	-0.024
2-Year	-0.643	-0.073
1-Year	-0.570	-0.047
6-month	-0.523	-0.009
3-Month	-0.514	0.016
1-Month	-0.530	

Germany's negative yielding yield curve inverted in 19 places

Source: Bloomberg

This is a central bank perversion. Negative interest rates are illogical and cannot happen without direct central bank manipulation.

Yes, it is crazy.

And no, this monetary madness did not spur lending, stimulate growth or raise inflation.

You would think that central planners would recognize the error of their ways. Their grand experiment is not working. If they were on the right course, Germany and Japan would now be booming. Instead, they are on the precipice of another recession.

WHO BUYS NEGATIVE YIELDING BONDS?

Why would "well-heeled investment professionals" effectively buy five-year bonds to be issued in 2024 at yields below the current, risk-free overnight interest rate? Or better still, why in the world would any sane investor buy a negative yielding bond? If you hold to maturity, you are guaranteed a loss. Below I list a few reasons why investors still buy bonds with yields below zero.

- **Asset Bubbles:** Some believe that stocks and other risk assets are grossly inflated due to the extreme and artificial low rate policies and massive liquidity injections. Sooner or later, they expect these bubbles to burst due to high valuations. Thus, rather than lose 30-50% in the stock market, they are faced with the possibility of losing 1% in a bond compared to losing 20-30% in other asset classes. Their preference is obvious.
- **Safe Assets:** Some are betting that bond prices will rise despite the negative yield, compensating the coupon loss.
- **Central Bank Policy Error:** There are many (including myself) who believe that governments and central banks have no idea how to get out of quantitative easing. As such, investors expect central banks to reduce rates further and engage in more quantitative easing, which will strengthen demand for low-risk bonds.
- **Deflation:** Overcapacity and debt will drive inflation lower and lower making bonds more attractive on a real inflation adjusted basis.
- **Passive Mutual Funds or ETFs:** Anyone who might now own a passive exchange-traded fund (ETF) tied to a global bond index. Or anyone who owns a popular target-date fund that has passive exposure to global bond indexes. In other words, millions of Americans.

This is the bottom line: Financial repression results in malinvestment, the mispricing of risk, and the lack of price discovery. But it does not stimulate the real economy. It achieves the opposite of what it seeks to achieve. All it creates are short-term bubbles in risky assets.

With that said, expect more of the same from the central banks going forward. That's all they know how to do. And, as Janet Yellen stated at the top of this article, if things really begin to unravel, don't be surprised to see the Fed test the land on negativity. Monetary madness indeed!

HAPPY ANNIVERSARY

"It's never different this time... I don't know how or when it will resolve, but the yield curve has inverted in a half-dozen places, and eventually this ends in tears." – Harley Bassman, Chairman and President of Merrill Lynch

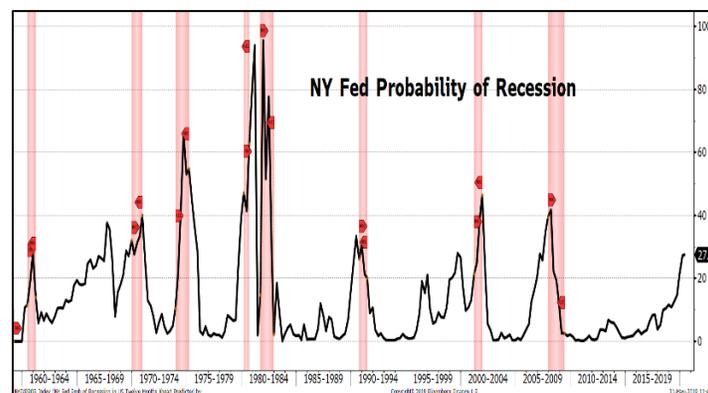
Saturday was very special because it not only marks the onset of summer, it marks the 120th month of this elongated economic expansion. Yes, indeed the expansion is now tied with the record-breaking internet (Al Gore?) cycle of the 1990s.

As we break out the champagne, let's remember that the prior record expansion came to a sudden end, to almost everyone's surprise and chagrin (as usual), in the aftermath of a Fed tightening cycle as the lags kicked in.

And cracks are now appearing. Beneath the veneer of the revised first quarter GDP report (+3.1% from +3.2%) was the same feel as before — real private final sales coming in at a punky +1.3% annual rate. Consumer spending on big-ticket durable goods, business capex, nonresidential construction and housing — the key cyclical guts of the economy — they collectively contracted 0.5%.

The New York Fed Probability of Recession is at an 11-year high — at nearly 28%, is far above the 11% level a year ago and 7% two years ago. If you're bullish on this old expansion, the data suggest to us that there aren't that many grains of sand left in the hourglass.

Recession Odds Spike Higher



Source: Bloomberg

Long live the recovery. The recovery is dead.

I keep hearing from the so-called experts at the Fed and on Wall Street that the economy is going to “muddle through.”

Economists and strategists dare not mention the “R” word. Why?

They are paid not to! Economists have morphed into marketeers for Wall Street “asset-gathering” firms. Let’s face it. And any bad news is bad for “asset-gathering.”

Furthermore, it goes against the “full employment” theory. The reason why pundits and economists never call for a recession is because if you’re wrong, it could end your career. But, if you miss it, along with everyone else, you are forgiven. Let’s chalk it up as safety in numbers. Look at all the economists and strategists out there who completely missed the Great Recession who are still gainfully employed. It is the human condition and the innate need to be bullish at all times. But the cycle is the cycle, and it has not been repealed.

The Yield Curve: Most Inverted Since July 2007



Source: Bloomberg

Meanwhile, the Fed (and Larry Kudlow’s) favorite recession indicator is flashing “redder.” The benchmark 10-year Treasury yield (2.15%) is trading below that of the three-month bill (2.35%). This has spooked the stock market because this flip from the typical configuration historically has been a portent of recession. Indeed, on six occasions over the past 50 years when the three-month yield exceeded that of the 10-year, economic recession invariably followed, commencing an average of 311 days after the initial signal. And as longer-term Treasury yields have declined steadily in recent weeks, the disquieting question of “what does the bond market know” has rattled the stock market, leaving the Dow Jones Industrial Average lower for the sixth straight week.

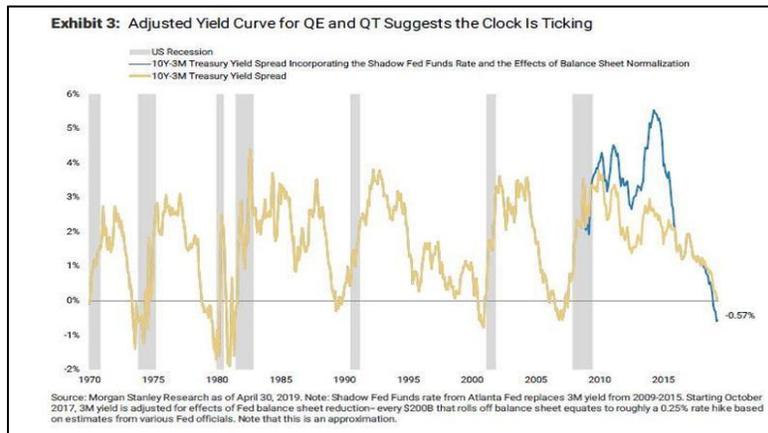
But the yield curve inversion might be worse than meets the eyes. Economists at Morgan Stanley have adjusted the yield curve for both QE and QT and have found that it has actually been inverted for the past six months. Ouch! They therefore concluded that **“we think this means the U.S. economic slowdown and rising recession risk is happening regardless of the trade outcome.”** Welcome to the club!

In the following graph, the yellow line is the unadjusted 10-year/three-month yield curve, and the dark blue line shows what it would look like fully adjusted for quantitative easing (QE) and quantitative tightening (QT).

Unlike the unadjusted curve, which only flipped negative in March, the adjusted yield curve inverted last November and has remained in negative territory ever since, surpassing the minimum time required for a valid meaningful economic

slowdown signal. It also suggests the “shot clock” started six months ago, putting us “in the zone” for a recession watch. Hardly a surprise Morgan Stanley is chopping its second quarter forecast for GDP nearly in half, to 0.6% from 1%.

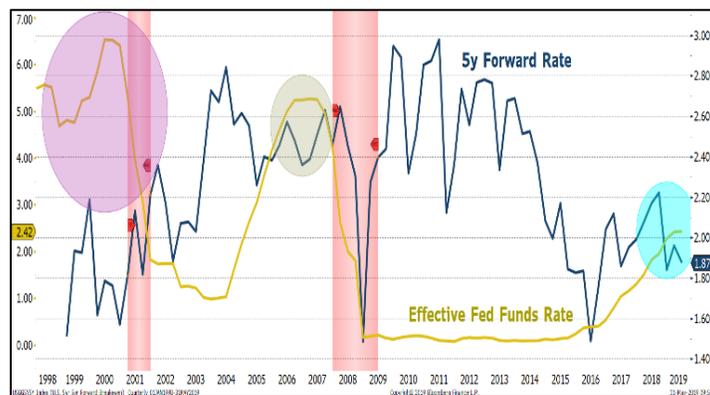
Yield Curve Adjusted for QE and QT



Source: Morgan Stanley

Here’s another less-widely-watched yield curve graph that plots the five-year forward rate versus fed funds. Once again, every time this yield curve has inverted, a recession has followed.

Fed Funds Rate vs. Five-Year Forward Rates



Source: Bloomberg

BEYOND THE YIELD CURVE

While most eyes are focused on the collapse of the U.S. yield curve and its recessionary predictions, there are many other critical indicators flashing red “recession-imminent” flags.

Lumber: One of the most important factors in construction is at its lowest level since April 2016.



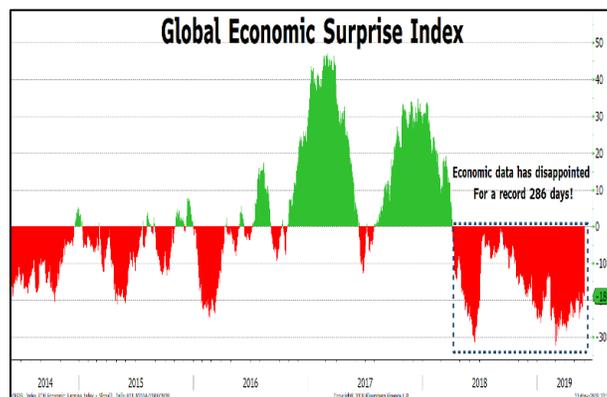
Source: Bloomberg

Copper: The commodity with the PhD in economics has rolled over and has now declined 22% since November 2018.



Source: Bloomberg

Global Economic Data: This economic composite has suffered the longest negative streak – 286 days – on record. The global economy is fragile and getting weaker.



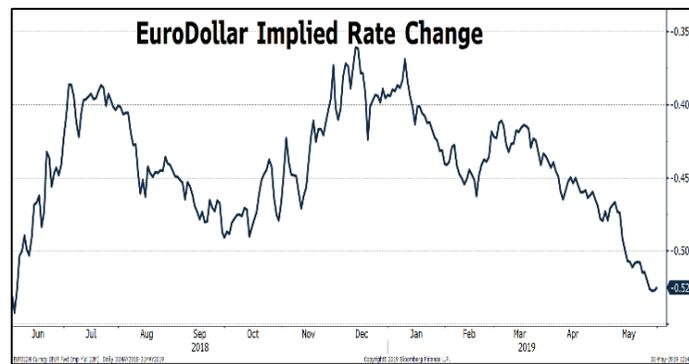
Source: Bloomberg

And finally, if everything is awesome, why is the market screaming for almost two full rate cuts by the end of 2019? Yes, siree Bob! Investors believe the Fed is so far behind the curve, that the futures market, for the first time this year, is pricing more than a 40% chance that the central bank will be dragged, kicking and screaming, into two rate cuts by the end of 2019, not just one!

As an aside, I should remind readers that just last December the Fed’s Jay Powell said the Fed was on “autopilot.” The majority at the Fed said the federal funds rate would be hiked two times in 2019. Six of the esteemed members on the Federal Open Market Committee (FOMC) forecasted three rate hikes.

What a hoot. Once again, the Fed overestimated (nothing new here) the strength of the economy and its resolve to hike.

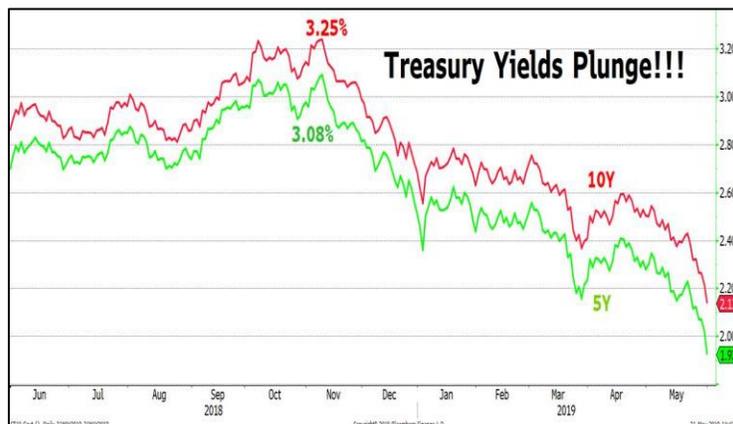
Two Rate Cuts Coming?



Source: Bloomberg

BONDS HAVE MORE FUN!

Bond markets have been proactive in discounting future growth and inflation expectations. Last week, yields on the 10-year Treasury note fell to a fresh 20-month low of 2.13%. Bond yields are now down a steep 37 basis points for the month alone and decisively below the overnight funds rate. As can be gleaned from the graph below, 10-year yields have declined 112 basis points from 3.25% in November 2018 to 2.13% as of Friday’s close. Amazingly, all Treasury tenors from two-year to five-year are now trading below 2.0%. Five-year Treasury yields have declined 116 basis points from 3.08% to 1.92%. Welcome back, One-Handle... We missed you!



Source: Bloomberg

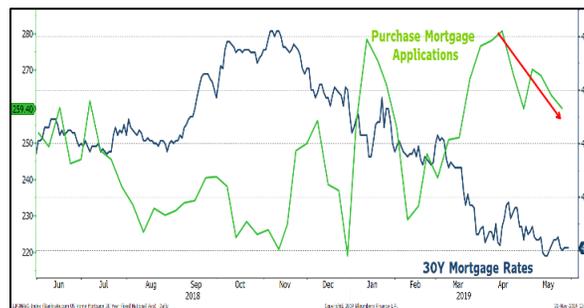
PUSHING ON A STRING

We are seeing early signs of what is going to happen once the Fed begins to cut rates. The answer is nothing. There will be no initial positive effect on spending. This means the central bank is going to end up going super-aggressive on its non-conventional policies. Think zero-interest-rate policy (ZIRP) and QE.

I say this because the bond market has been doing so much of the leg work for the Fed as it is, and with no apparent positive influence on the most rates-sensitive sectors. It is incredible that we could see the yield on the 10-year T-note plunge more than 110 basis points since last fall to a 20-month low of 2.2%, and yet mortgage applications are going down, not up. This means that bond yields will have to go down even more to bring mortgage rates down to levels that will finally spark a housing turnaround.

Last week, mortgage applications fell 3.3% and have slipped in two of the past three weeks. The key purchase index sagged 1.4% and has declined in each of the past three weeks and in five of the past six to stand at the lowest level since mid-March when mortgage rates were 30 basis points higher than they are today! That indeed is pushing on a string. This only tells me that as low as market interest rates are, they have to go lower and won't stop until we start to see a response in the credit-sensitive data.

Mortgages are NOT Responding to LOWER Rates



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

“If this is implemented it will be a serious downside risk to the U.S. economy. Looking carefully at the trade data between the U.S. and Mexico shows that 67% of all imports from Mexico are related-party trade which is another way of saying intra-company trade. What this means is that U.S. companies are using Mexico for production. Put differently, most of the trade between Mexico and the U.S. is the global supply chain. And the trade data further shows that the biggest import categories from Mexico to the U.S. are cars and car parts and trucks and buses.”

– Torsten Slok, Economist at Deutsche Bank AG

“Trump is broadening the trade war to multiple fronts and tariffs have become his favorite weapon... American consumers will bear an increasing proportion of the cost from tariff hikes, as the coverage spreads to consumer goods. Both tariffs and export controls are disrupting and wreaking havoc to supply chains.”

– Chua Hak Bin, Economist, Maybank Kim Eng Research Ltd.

The U.S. economy bought some time last year with the tax stimulus, but that has now run its course and it's now fiscal-hangover time. All the while, the lags from the prior Fed tightening are kicking in. Everyone seemed to think we dodged a bullet and the Fed stopped hiking rates in time, and that all we would end up getting is a "soft landing." But history shows that "soft landings" occur just 15% of the time in the wake of a Fed rates cycle — it is a low-odds bet.

Meanwhile, we are into a new and uncertain chapter in this economic war between the U.S. and China. And to make matters worse, last week the "Tariff Man" imposed tariffs on Mexico. FYI, Mexico happens to be our third largest trading partner. Think about this. With 37% of imported auto parts from Mexico, tariffs would hit U.S. households with estimates of a \$1,300 price hike per new vehicle, assuming 25% imposition by October. Auto production would be cut by three million, slamming a sector buttressed by weak sales and rising layoffs. My view: To get embroiled in one major trade war might be considered a misfortune; to find oneself in two of them looks like carelessness. Trump can't end global trade. But by making it much less predictable, he can cripple a key driver of American — and global — economic vitality.



Source: Cagle Cartoons

There is no doubt that the escalating trade frictions are impeding business and consumer sentiment and spending. But the reality is that the overall decline in the pace of economic activity was already occurring. It should not be lost that the Fed pushed the envelope this cycle by tightening monetary policy a cumulative 350 basis points, considering both the nine rate hikes and the switch to quantitative tightening. Rare has been the day that such a degree of monetary tightening didn't push the U.S. economy into recession, and the lags range anywhere from six to 18 months. All of this in the context of the most overleveraged peacetime economy on record.

The political divide in the U.S. could scarcely be greater, as hopes of some big infrastructure spending plan coming to the fore and saving the cycle were kyboshed last week in that failed meeting between the President and Chuck Schumer and Nancy Pelosi.

Going Nowhere Fast!



Source: Bloomberg

Finally, keep your eyes on the stock market. Last week the S&P 500 Index declined again and is now down 6.8% from its peak in early May. The Dow Jones unceremoniously plopped through the 25,000 level and is now 7.9%. The NASDAQ is fell 8.7% in May. The Russell 2000 Index, which covers stocks with smaller market capitalization, is down 9.2% in May alone, down 15.7% from its October 2018 peak.

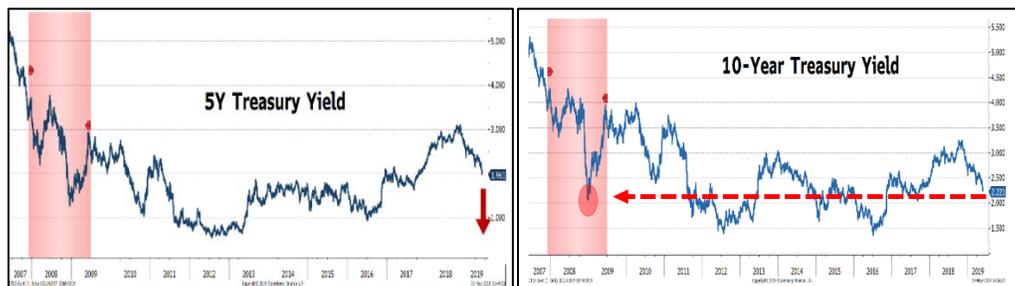
As shown in the previous graph, the equity markets have gone nowhere in 17-20 months, despite intoxicating surges and nerve-wracking drops. From a technical perspective, it's not looking pretty. From a technical perspective, it sure looks like the dreaded "triple top". That my friends is not bullish!

If the stock markets test the lows seen last December, look for the Fed to become ULTRA dovish.

As we move forward, I expect global economic and financial conditions to worsen enough to warrant at least a 50-basis-point cut from the Fed this year, beginning in the third quarter. If the economy does end up in a recession, the Fed is going to respond to this recession the same way it responds to all recessions that it causes... Look for the Fed to unwind its tightening and move back towards ZIRP... STAT!

And if you're still hoping/wishing/praying that U.S. Treasury yields fly north of 3-4% (like many Wall Street pundits were predicting last summer), I wish you well. It is unlikely investors will see these levels anytime soon, so long as global sovereign yields continue to sink.

Yields are Approaching Recessionary Levels...But Can Go Much Lower



Source: Bloomberg

But, you say, rates have already fallen by quite a lot. How much further could they really drop? Indeed, rates have fallen by a large amount. Even still, let's remember that the 10-year yield hit 1.36% in 2016 the last time we had a real growth scare, almost a full percent lower than today's level. That said, should the Fed cut rates, the front end of the yield curve (two- to five-year) will experience the largest declines in yield as the yield curve steepens.

Ditto for the front end... As noted above, the five-year part of the yield curve would be the primary beneficiary of a reversal in monetary policy.

So, what should credit unions do? When growth and inflation are slowing at the same time, the best thing you can own is high-quality bonds. As we have been harping on for months, credit unions should continue to minimize excess reserves and maintain a fully invested, diversified, risk-appropriate ladder strategy. The past six months of steadily declining market rates is the latest example of why this tried and true discipline is so effective and prudent. It may not be exciting, sexy or highly sophisticated, but it works! Sleep better. Throw away the crystal ball and fortune telling machine.

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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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