BALANCE SHEET SOLUTIONS
an alloya company

WEEK OF JUNE 10, 2019

Weekly Relative Value

Could Rates Go to Zero?

*"**They're going to do the works.** Stuff that I thought was brilliant in 2009 and should be used once every 50 years is now being discussed as part of the toolkit even for like a recession. **I can easily see 2 Years easily going to zero,** and I would say **the odds are very high they would cut 50 to a 100 bps in the next year**. Everything I see out of central banks globally **is radical policies ahead." –** Legendary investor Stanley Druckenmiller*

Before the financial crisis in 2008, no one, and I mean no one, thought the Federal Reserve would take rates to zero and stay there for almost eight years. No one fathomed that the European Central Bank (ECB) and Swiss National Bank would go to even more extreme levels and cuts rates BELOW zero. Quantitative easing (QE) was nowhere on the radar just months before it happened. If I had told you back in 2006 that central banks would purchase over $20 trillion in assets by 2019 and over $11 trillion of government bonds would trade with a negative yield, you would have first questioned my sanity, and then said, "No way!" Yet here we are today!

Source: Cartoon Stock

Today, the Federal Reserve has been trying to unwind its extraordinary stimulus policies by simultaneously raising short-term interest rates and reversing the QE program. In doing so, the Fed has raised the federal funds rate nine times from zero depths to 2.5% today. At the same time, the Fed has been reducing its balance sheet. Including QE tapering, the has Fed tightened by over 350 basis points! Despite the fact that rates are still very low by historical standards, this tightening cycle ranks as one of the most aggressive moves of all time.

But it now appears the tightening cycle has ended abruptly.

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

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THIS WEEK…

- ARE WE TURNING JAPANESE?
- LOWER FOR LONGER
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- PEAK JOBS
- BONDS ARE FROM MARS, STOCKS ARE FROM VENUS

PORTFOLIO STRATEGY

As we all know, President Trump and Wall Street had a fit as rates rose and the yield curve flattened. (Let's face it, politicians and Wall Street always wants lower rates.) But the straw that broke the camel's back was the stock market tumble in late 2018. While stocks were tumbling, the credit markets came to a screeching halt.

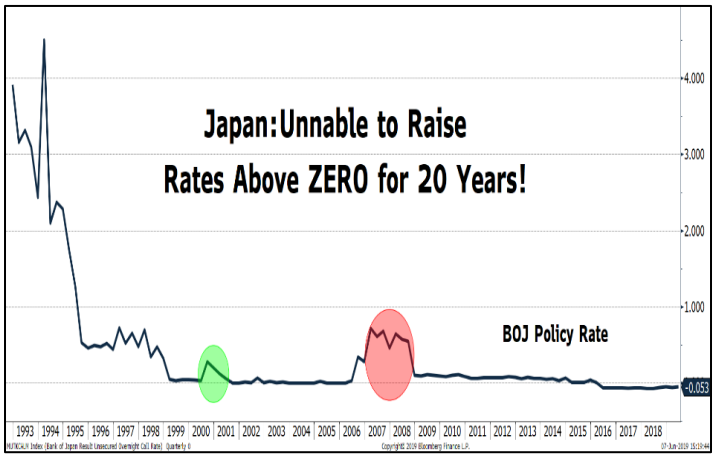
Meanwhile, across the pond, the ECB's plans to tighten are now out the door. Overall, the ECB's message last week was that they are prepared to do more in the form of rate cuts and QE. Following on, the Bank of Japan joined the worrywarts when Governor Haruhiko Kuroda stated the central bank can deliver bigger monetary stimulus if necessary. But it also seems pretty clear that central banks are getting twitchy as the U.S.-China trade war drags on.

So, on both sides of the pond, plans to exit from unprecedented and extraordinarily easy money have been thwarted by economic and markets forces.

ARE WE TURNING JAPANESE?

Below I show the official policy rate of the Bank of Japan (BOJ). After their real estate and stock bubble burst in the 1990s, the BOJ slashed rates to zero. Since then they have tried to raise rates twice (noted in the red and green circles), but each time the economy and markets forced a reversal. There have not been any additional rate hikes since. Today, 20 years later, the BOJ is still at ZERO! Amazing indeed.

The BOJ has resorted to increasingly large QE-like programs, buying every bond it can, stocks not just in Japan but in the U.S. too, and other private assets. Various fiscal policies (i.e., infrastructure projects, deregulation, tax cuts, etc.) have been implemented as well. Yet, Japan's growth has been stuck near zero with virtually no inflation. Despite the policy failure, Japan continues to do more of the same.



Source: Bloomberg

Do more of what's failed in increasingly extreme doses is also a good description of Federal Reserve policy from 2008 through 2016. Clearly, QE worked well in lifting asset prices, but not so much for the economy. In other words, QE was ultimately a massive *"wealth transfer"* from the middle class to the rich, which has created one of the greatest wealth gaps in the history of the U.S., not to mention an asset bubble of historic proportions. The European Central Bank did the same, in even larger amounts than the Federal Reserve, also with little effect on the real economy.

Let's face it, it has taken a massive amount of interventions by central banks just to keep economies afloat globally over the last decade, and now that growth is beginning to decelerate.

Question: Can the U.S., Europe and Japan grow at a sustainable and healthy rate without continued "emergency measures?"

And where would the asset markets be without the Fed's largess?

So, inquiring minds are wondering what will happen if we have another crisis or, for that matter, just a "plain ole" recession.

As noted at the beginning, legendary hedge fund investor Stanley Druckenmiller believes that central banks and governments, in an effort to be seen to be doing something, will again resort to heretofore unprecedented and possibly even more extreme monetary experiments. This is why. When you don't have a better answer, the default is to do more of the same.

Last Tuesday, Federal Reserve Chairman Jerome Powell made the following opening remarks at a monetary policy conference in Chicago:

> *"We are closely monitoring the implications of these developments for the U.S. economic outlook and, as always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective… As always, we will act as appropriate to sustain the expansion, with a strong labor market and inflation near our symmetric 2 percent objective….* ***Perhaps it is time to retire the term 'unconventional' when referring to tools that were used in the crisis. We know that tools like these are likely to be needed in some form in future ELB (effective lower band) spells,*** *which we hope will be rare."*
> *– Fed Chair Jay Powell*

To translate that statement, Powell essentially came right out and said that **going back down to zero on the funds rate is a "when," not an "if."** It may take "**unconventional"** tools during the next recession (i.e., negative interest rate policy and even more QE).

This is a very interesting statement considering that these tools, which were indeed unconventional "emergency" measures at the time, have now become standard operating procedure for the Fed. While Powell is also hinting at round four of QE, it likely will only be employed when rate reductions aren't enough.

LOWER FOR LONGER

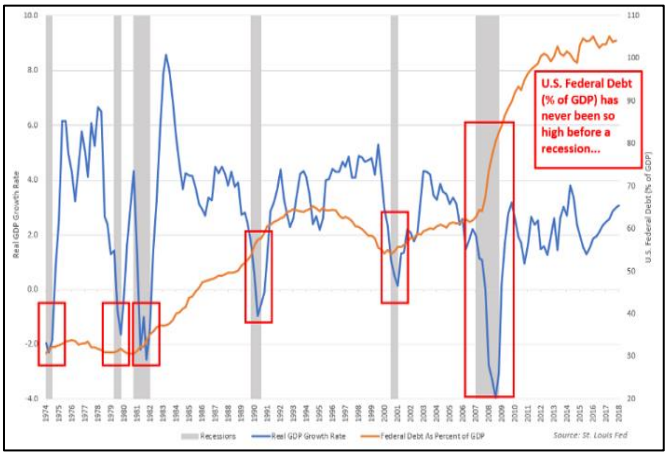
I have been unwavering in my view that the death of the bond market has been greatly exaggerated. Many pundits and strategists have believed that the historically low rates today are an aberration and must rise and that the bond bull market has come to its inevitable conclusion. This has been the mainstream narrative for years.

Here are three reasons to question the conventional wisdom:

1. The U.S. has the highest yield in town. With more than $11 trillion in global debt trading below zero, it will be quite a challenge for U.S. rates to rise in a sustained manner. Money is fungible and money seeks the highest returns. Higher yields in U.S. debt attract capital from countries with negative yields, which in turn pressure U.S. rates lower. And at this point, there is no sign whatsoever that central banks will stop suppressing interest rates to keep nascent economic growth going.

2. Debt and Deficits. Many empirical studies have shown that too much debt slows growth. Given the lack of fiscal policy discipline in Washington, and promises of continued largesse in the future, the budget deficit is set to swell. The U.S. deficit as a percentage of GDP is currently 5%. In a recovery, debt/deficits should be small and declining. Instead, during the longest recovery of all time, we find debt/deficits high and rising. U.S. federal debt as a percent of GDP has never been so high before a recession (it's currently at 100% of the GDP vs. 62% before the Great Recession), so we are truly in unprecedented times. The only time deficits in the past have been this high has been during wars and recessions. And given the ever-widening unfunded liabilities gap, the U.S. deficit will grow even larger in the future. Imagine what happens during the next recession as tax revenue falls.

U.S. Federal Debt (% of GDP) vs. Real GDP



Source: St Louis Fed

3. Central Banks will have to Buy. U.S. government debt is currently approaching $23 trillion and will be north of $30 trillion in no time at all. On top of that, in the next five years, the credit markets have to fund $5 trillion of corporate debt rollovers, plus new debt, plus state and local debt. Who will fund this debt? It won't be coming from outside the U.S. and there is only so much that banks and big pension funds and individuals can do. Unless the Federal Reserve steps in, interest rates will soar, and the crisis will become much worse. It will have little choice but to step in and buy U.S. government debt.

This is exactly the prescription that Jerome Powell laid out suggesting the Fed is already factoring in a scenario in **which a shock to the economy leads to additional QE of either $2 trillion, or in a worst case scenario, $4 trillion,** effectively doubling the current size of the Fed's balance sheet. Other central banks will respond with lower rates and ever-larger rounds of quantitative easing.

But would doing more of the same result in stronger economic growth and higher inflation?

YOU CAN'T ELIMINATE THE BUSINESS CYCLE

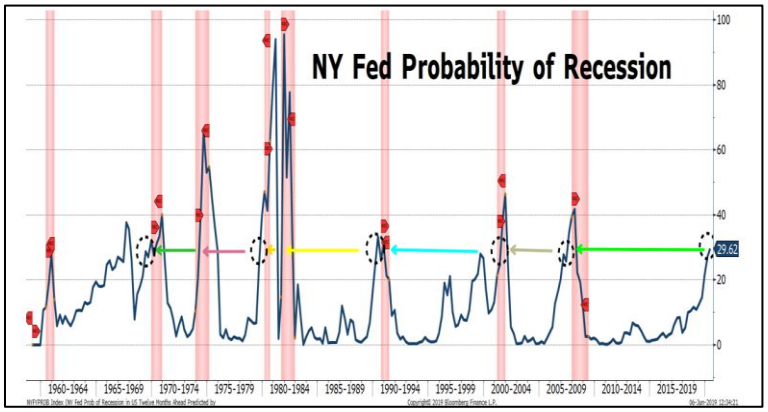
"The problem remains that you can't eliminate the economic cycle. While it's nice to imagine PE Powell and the Vice Chair of the Fed coming out every single day, ringing the cowbell and saving you from the cycle—that damn cycle won't go away." – Keith McCullough, CEO of Hedgeye

First off, Let's not assume that recessions don't happen if that's all right – we have seen 10 of them since 1950. They are not dinosaurs.

Ever heard of the term "pushing on a string?" It was invented for times like these. While zero rates and another $2-4 trillion in QE might indeed be successful in further inflating the third bubble in asset prices since the turn of the century, 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. For example, whatever happened to the spring thaw we were supposed to be seeing in the U.S. housing sector? Even with mortgage rates diving a further 20 basis points in the past month to 4.0% (for the 30-year fixed), mortgage applications for home purchases have declined in each of the past four weeks and in six of the past seven. The slide in May was epic – for the month as a whole, down at a whopping 23% annual rate. This goes to show how little interest rates can help an economy so laden with debt. Think Japan.

Moving on. The New York Fed just published its May estimate for recession risks, rising to 29.6% from 27.5% in April, the highest they have been since May 2007 – just seven months ahead of the last recession. For the first time in thirteen years, these recession probabilities have increased for seven months in a row. Note what the chart below illustrates – there is no turning back once this metric touches 30% and we are pretty well there. As further validation, the St. Louis companion model pegs recession odds at the highest level in six years, and the second highest level since the recovery began a decade ago.

Recession Odds Have Doubled in Past Year



Source: Bloomberg

So, once again, if the U.S. heads into a recession or if there is another unknown financial calamity around the corner, rates will go lower. The only question is how low.

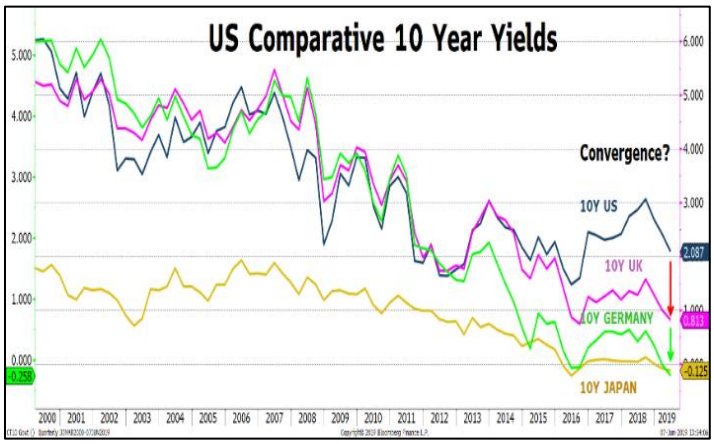
Will the U.S. follow in the footsteps of Japan and Europe?

Take a look at the following graph.

In Germany and Japan, 10-year yields are solidly in negative territory. So, U.S. yields are quite attractive on a relative basis. If U.S. rates fell to where rates are in the U.K. (0.81%), we are looking at over a 120-basis-point decline from current levels.

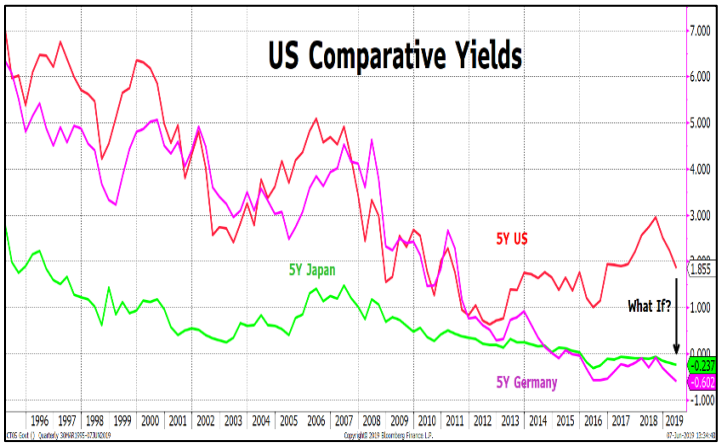
Even still, they would be more attractive than most of the developed bond markets, which are already negative. In a global recessionary environment, global yields would continue to decline further into negative territory. In such an environment, U.S. yields could drop to zero.

Crazy as it sounds, U.S. yields at zero would still be attractive to foreign investors.



Source: Bloomberg

The chart below compares five-year U.S. rates to Germany and Japan. At 1.85%, five-year U.S. rates look downright juicy relative to Germany and Japan. Even though rates have declined significantly since last November, in a global recession, U.S. rates could tumble much, much further.



Source: Bloomberg

Yes, I know all of this sounds insane but if we were all honest with ourselves, no one would have expected us to be where we are today. While many believe that rates "have" to go higher, don't be surprised if the path of resistance is lower (not higher) rates.

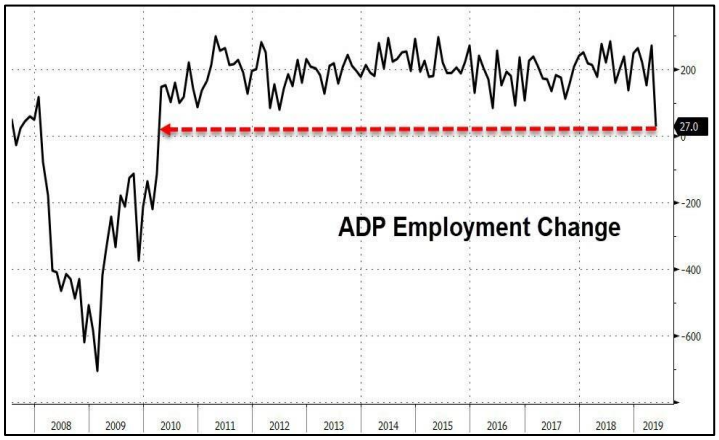
PEAK JOBS

Last week, the ADP jobs report was a real shocker to the downside. Only 27,000 net new jobs were added in the private sector, which was far off the consensus view of +185,000 and was light years from the April tally of +271,000 (and the twelve-month average of +223,000 going into the month). In fact, this was the weakest print since the labor market was

emerging from the grips of the Great Recession in March 2010. The declines were too widespread to simply write off as a transitory event.

Go back to December 2007, and ADP flashed a soft +47,000 payroll reading. What we just saw was even lower than that. And what makes December 2007 special is that this was the first month of the last recession. Remember, precious few saw that recession coming, and the consensus remained bullish right into late summer of that year. Word to the wise.

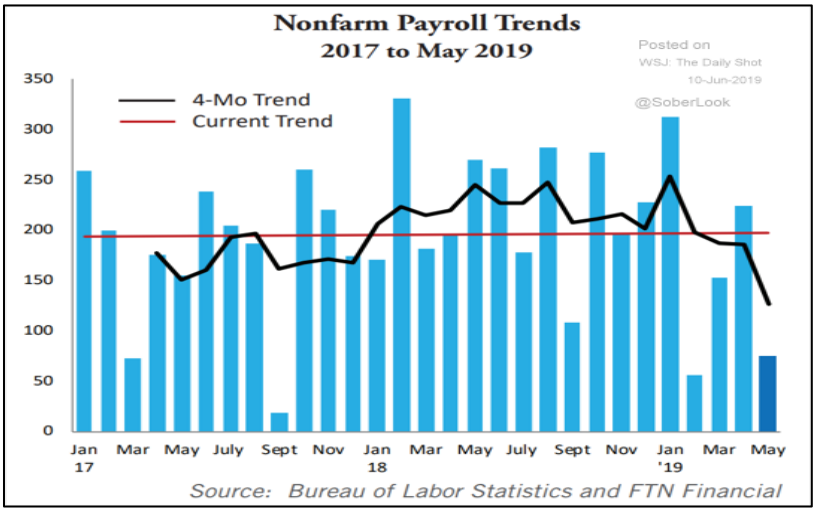
Private Payrolls Crash!



Source: Bloomberg

The ADP report was followed by the May non-farm payroll report. Shockingly, the economy generated ONLY 75,000 jobs in May. This was the fifth weakest report in more than five years but also 100,000 below the consensus number of 175,000. The two-month revision subtracted a total of 75,000 jobs, as March was revised down from +189,000 to +153,000, and the change for April was revised down from +263,000 to +224,000, making it a net-zero for the month and suggesting some serious deceleration in the labor market.

The Trend is Not Your Friend



Monthly job gains have now averaged 164,000 in 2019, compared with an average gain of 223,000 per month in 2018. As a sign of how rapidly the once-hot labor market is cooling off, the 75,000 tally in May represents a major slowing

from the three-month moving average of 151,000, the six-month average of 175,000 and the twelve-month pace of 196,000. To me it sure looks like a classic end-of-cycle pattern.

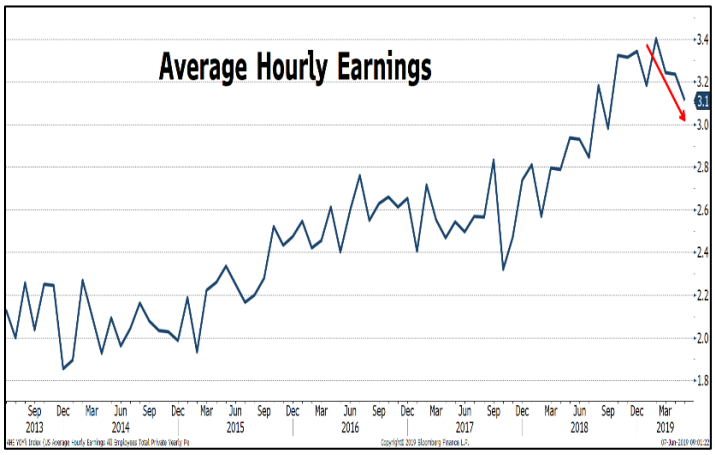
Let's take that one step further. Note that the "birth death" model added a fictitious 65 thousand to the headline number. This is the Bureau of Labor Statistics' (BLS) guestimate for jobs created by net new business creation — even though other data sources now show that the number of new firms being created has actually started to flatten out. So, adjust May's result for the revisions and for the birth-death skew, and it can certainly be argued that the underlying payroll figure last month was -65,000.

In terms of where the jobs were or were not, manufacturing employment has all but stagnated in the past three months (just +3,000 in May). At the same time, the transports (air, truck and rail) dipped 1,000 in May and have posted net job losses of more than 5,000 over the past three months. Is this another canary in the coal mine telling us that we are at the tail-end of this business cycle?

And if that isn't bad enough, according to the BLS, in May the number of full-time jobs declined to 129,695, a drop of 83,000 for the month and the third consecutive decline. In fact, **for the first five months of 2019, a total of 218 thousand full-time jobs have been lost, with May's number the lowest since October's 129,225**. Meanwhile, "offsetting" this decline in high-paying, full-time jobs is the increase in part-time jobs, which in May rose by 66,000 to 26,981 which brings the total to the highest level since December. The last time we had full-time employment down 218,000 in the first five months was 2008. Is it any wonder that bond yields are melting?

Confirming that when it rains it pours, wage growth also slowed down. Average hourly earnings have continued to decline, which has taken the year-over-year trend down to an eight-month low of 3.1%. The labor market may seem tight, but if there still wasn't some slack then, wage growth wouldn't be decelerating. On top of that, average weekly hours remained unchanged at 34.4, missing expectations of a rebound to the average recent print of 34.5.

Wages Turn South



Source: Bloomberg

What about the household survey?

While jobs on this score did rebound 113,000, this barely dented the prior losses, and leaves employment down 187,000 year-to-date, which last happened in 2009. I should add that the full-time/part-time split was hardly favorable, with full-time positions shrinking 83,000 in May — down a whopping 464,000 in the past three months, which is a losing streak

we have not seen in nearly nine years. In fact, you again have to go back to the recession year of 2009, 2001 and 1991 — for those who don't "see" the recession.

Finally, on the jobs front, Challenger, Gray and Christmas layoffs continue to march upwards. May marked the eleventh month that Challenger, Gray & Christmas layoffs have risen over prior year. In the event you missed the headline, at 289,010, job cuts are 39% higher than those announced through the first five months of 2018. May's 58,577 job cut announcements are also up 46% from April's 40,023.

What's most intriguing is the spreading breadth of layoffs in high-paying industries. Big tech firms led the way in May with some 12,635 pink slips. The year-to-date 18,568 is an eye-catching 342% higher than 2018's low base of 4,205.

No surprise, retail continues to lead the way with 50,243 cuts thus far this year, but that's **down** 28% over last year in spite of the 18,242 store closures (and counting -- Got Gap?).

But what really caught my eye was what the report had to say about the challenges facing the auto industry.

"[So far this year] companies in the Automotive industry have cut 21,446 jobs, 211% higher than the 6,905 cuts in that sector in the first five months of 2018. It is the highest five-month total since 2009, when 111,614 cuts were announced through May. In fact, this year's total for the sector has already surpassed year-end totals for every year since 2009, with the exception of last year, when 30,587 total cuts were announced, and 2012, when 24,092 auto cuts were announced for the year."

Given how ultra-sensitive this sector is to the business cycle, there is no possible way to interpret this as anything but another clear signal that economic growth has slowed discernibly. Worth keeping an eye on this in the months ahead.

The new news is the breadth of layoffs is spreading into high-paying industries with auto layoffs at a decade high.

BONDS ARE FROM MARS, STOCKS ARE FROM VENUS

Now that the economy is looking punky, Wall Street bulls have shamelessly rewritten the script. The bulls have embarrassingly changed their reason to buy stocks from, "The U.S. economy is great," to "Fed rates are coming." The stock market is near its highs and is predicting boom times forevermore. During a downturn corporate earnings collapse, revenues fall, price-earnings ratios go to heck, and over-leveraged companies begin to default on their debts, which tends to wipe out shareholders. Economic downturns can be terrible for stocks that have been inflated and priced way beyond perfection. But there are no signs yet that the stock market, which is supposed to be forward-looking, is pricing in any of these risks. It's gallivanting around in la-la-land.

Likewise, junk bonds get hammered in a big way when the economy turns south because, in a downturn, these over-leveraged cashflow-negative companies are suddenly grappling with existential problems. But that's not happening yet.

So, neither stocks nor riskier bonds are seeing a recession. And yet those in the Treasury bond pit and fed fund future traders are betting on three or four rate cuts over the next six months.

My take: That equities are higher is just a hyper response to the growing prospect of Fed handholding before too long. Powell to the rescue! This is another classic example of how "bad news" has become good again!

But how well did that work out for former Fed Chairs Alan Greenspan in 2001 and Ben Bernanke in 2007? Remember, they cut rates fast and furious but too late to prevent the business cycle from inevitability peaking out and rolling over. Initial bursts of euphoria on the first round of rate cuts didn't exactly last too long. Ahhh...the benefits of history and hindsight.

The Market Mismatch

Source: Bloomberg

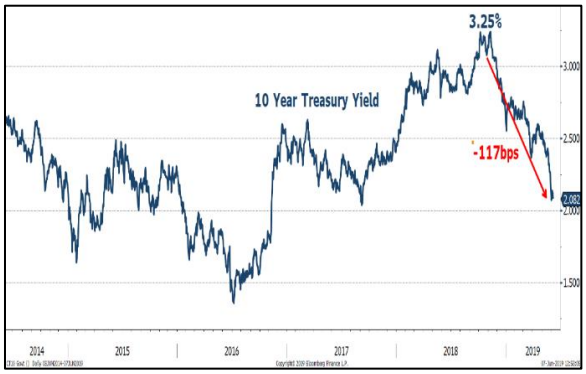
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Growth has slowed very sharply… Companies are more reticent to spend, both on hiring staff and on business equipment." – Chris Williamson, IHS Markit's Chief Business Economist

In the U.S., economic data have weakened, the outlook has worsened sharply, and Fedspeak has also turned decidedly dovish. The Atlanta Federal Reserve's GDPNow and New York Nowcast have the second quarter pegged at 14% and 1%, respectively. We have an economy this year where real private sector demand is barely averaging a 1% annual rate of growth. That is very weak. I believe by the time August rolls around, U.S. GDP will be flirting with 1%, inflation will be falling, and Corporate America will be dealing with a profit recession (two quarters of negative earnings growth). In Europe, the ECB's message was that they are prepared to do more in the form of rate cuts and QE. Likewise, in the U.K., declining growth expectations have underpinned the rally in yields.

But the bond market, as usual, had already sniffed this out. Mr. Bond has not been fooled by the "greatest economy ever" and saw the problems before the politicians, economists and pundits. For virtually six straight months, bond yields have been falling and signaling a growth slowdown.

Take a look at the graph below. The 10-year Treasury yield has been cliff diving. Since November 2018, yields have plummeted 117 basis points!

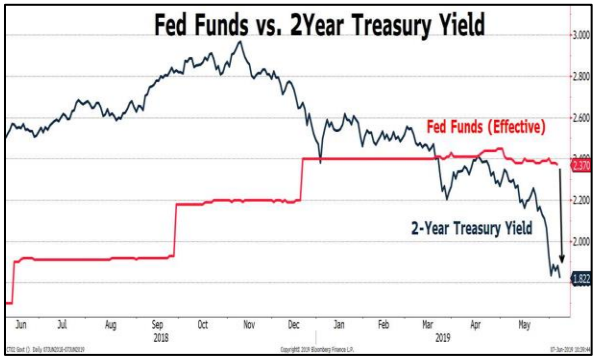


Source: Bloomberg

And look at how yields on the front end have cascaded lower. The five-year Treasury yield has melted away – declining from 3.11% to 1.85%)! In a matter of six months, yields have been cut in half. Wow!

Source: Bloomberg

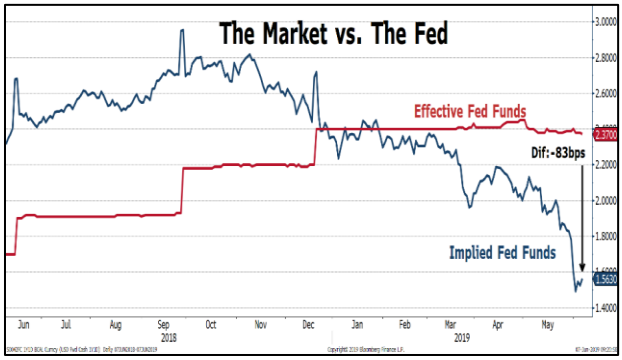
And it now appears that the Fed is behind the curve. The yield on the two-year Treasury note declined from 3% to 1.82%. The spread between the two-year Treasury yield and fed funds is now 55 basis points. When the fed funds rate/two-year Treasury note inverts more than 50 basis points, as is now the case, the Fed ended up easing in the past 100% of the time. And when the Fed cuts rates, even when recessions don't ensue, it never ever does it just once or even twice.



Source: Bloomberg

In fact, fed fund futures are pricing in three rate cuts from current levels. And if the economy contracts, the overnight rate is headed back to zero. If so, the Treasury curve will bull steepen but drift lower with the 10-year yield likely approaching say the U.K. level of sub-0.81%.

Fed is Behind the Curve!



Source: Bloomberg

If you listen to what the markets have really been saying this year, they seem to agree with our view that growth will disappoint whether there is a trade deal or not.

All of the above explains why we have been constantly pounding the table to reduce excess cash reserves and buy high quality investments via a diversified, risk appropriate ladder strategy. Credit unions that have maintained this discipline are reaping the rewards. As we move forward, we strongly encourage credit unions to stay fully invested while underweighting excess cash reserves. Throw away the crystal ball and fortune telling machine. Sleep Better!

Note: Given the magnitude of the recent rally, do not be surprised if the markets sell off and rates rise over the near-term. That said, any market weakness provides an attractive entry point for credit unions looking to invest new monies. As we have been saying for years: BUY THE DIPS!

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> – Darin Higgins, President of Western Illinois Credit Union

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