BALANCE SHEET SOLUTIONS
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WEEK OF JUNE 24, 2019

Weekly Relative Value

How Low Will Rates Go?

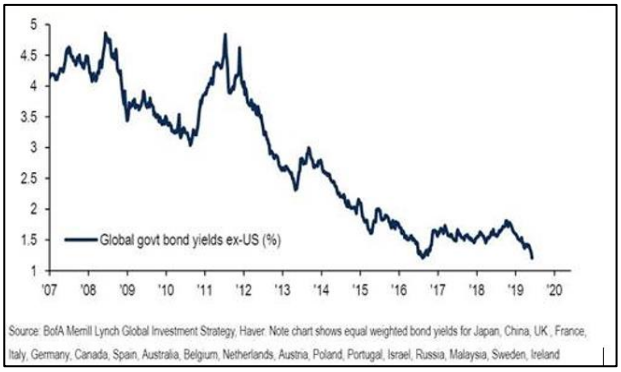
"I think rates should be 4% today… You better be prepared to deal with rates 5% or higher."
– Jamie Dimon, CEO, JPMorgan Chase, August 2018

Last week, all-time lows in 10-year bonds were seen in Germany, Denmark, the Netherlands, Austria, Finland, Sweden, France, Belgium, Slovakia, Ireland, Slovenia, Latvia, Spain, Portugal, Cyprus and Croatia. The benchmark government bond in Europe – 10-year German bunds – traded at an eye-wateringly low level of -0.32%. Oh, and the German bund curve is now negative out to 18 years! Think about that: 'negative yields' with a 'negative yield curve.' Amazing times.

Elsewhere in Europe, French Government bonds (OATS) hit a low of -0.004% – the first time they have been below 0% – while yields in Sweden and Austria closed at -0.02% and -0.05%, both below 0% for the first time too.

Here's another tidbit. The amount of negative yielding debt in the world rose by $700 billion this past week and is now around $13 trillion (the most ever). And yields, as shown below, are now at an ALL-TIME LOW!

Global Government Yields (Excluding U.S.) at All-Time Lows!



Consider the following: Austria's **100-year bond** (yes, that is correct – 100 years) is now yielding a microscopic 1.14%. Oh, and it has a duration of 53 years!

And you thought yields were low here.

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

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THIS WEEK…

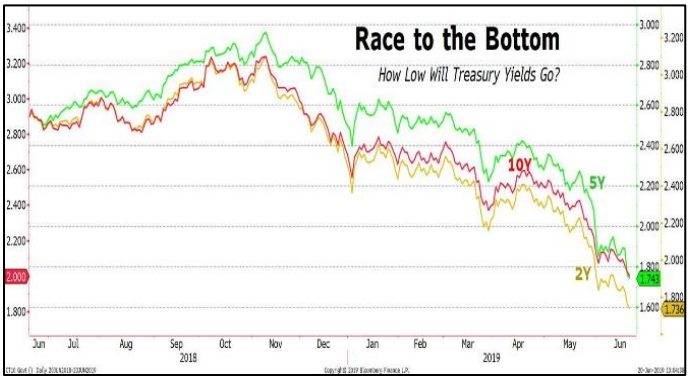
- THE EMPIRE STRIKES OUT!
- ARE MORTGAGE RATES OR HOME PRICES TOO HIGH?
- WHATEVER IT TAKES 2.0
- GOLD AT SIX-YEAR HIGH

PORTFOLIO STRATEGY

But, isn't it quite telling that there are investors who are willing to lock in a 1.14% yield for a CENTURY? What does that tell us?

Source: Bloomberg

Back in the USA yields rallied throughout most of the week. The yield on the benchmark 10-year Treasury note – which surpassed 3% last year amid warnings from the nation's pre-eminent banker that it was headed to 4%, if not as high as 5% – slid briefly under 2%, its lowest level since 2016. The two-year note, the maturity most sensitive to Fed expectations, ended at 1.73%, the lowest since November 2017, and more than 50 basis points below the bottom of the Fed's current 2.25% to 2.50% target range for federal funds.



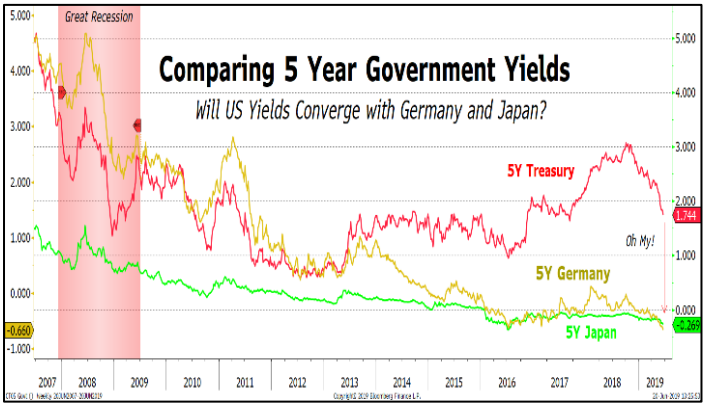
Source: Bloomberg

Nevertheless, even with U.S. yields 40-50% lower since last November, they still look very attractive versus the rest of the world…

U.S. Yields vs. World		
	2-Year	5-Year
U.S.	**1.79%**	**1.80%**
Germany	-0.75	-0.63
France	-0.66	-0.46
Italy	-0.09	1.40
Spain	-0.42	-0.11
Switzerland	-0.95	-0.86
Japan	-0.24	-0.27

Source: Bloomberg

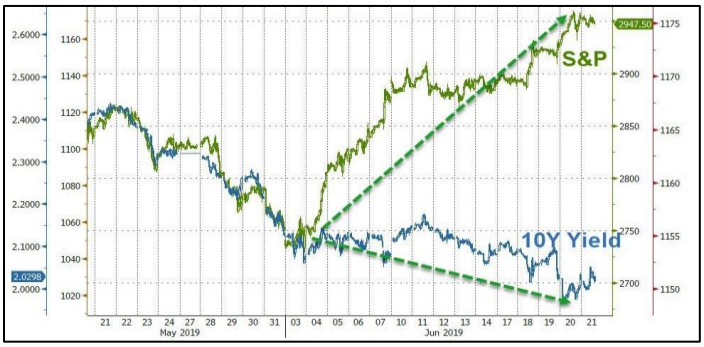
Imagine how low yields could go if the U.S. converges with Japan or Germany…



Source: Bloomberg

Yet the S&P 500 Index closed at a record on Thursday, up over 25% from its Christmas Eve nadir. That capped a three-week winning streak in which the major averages scored gains in the mid-7% range. The bond market is, in fact, telling us the Fed's fear of an economic slowdown will push into aggressive preemptive action, bolstering stock investors' confidence that the central bank will do whatever is needed to sustain the expansion at its 10th anniversary.

Stocks are from Venus and Bonds are from Mars



Source: Bloomberg

Yet, as the bulls crow about how great the stock market has done, the reality is that the 10-year Treasury note has generated a total return of 10.5% in the past 12 months versus +7.8% for the S&P 500. In other words, bonds have outperformed stocks by 270 basis points. FYI, the last time bonds outperformed stocks to this extent, at a time of a flat-to-inverted yield curve, was back in January 2008. Need I say more?

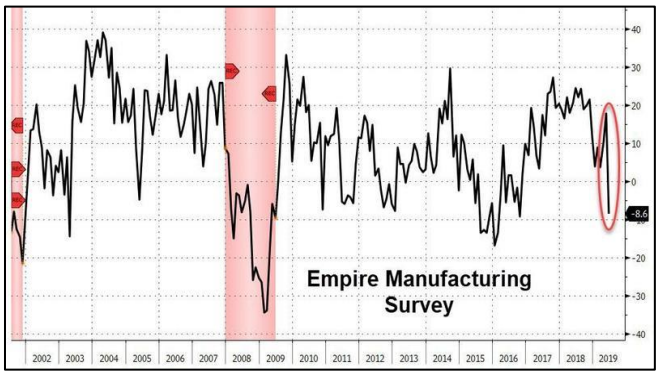
THE EMPIRE STRIKES OUT!

Against expectations of a small drop to 11.0, the Empire State Manufacturing Survey collapsed – by the most on record – from +17.8 to -8.6 in June. This is the first negative print since October 2016. And actually, the decline of 26.4 points relative to May's level was the largest on record!

As far as the underlying details are concerned, they very much ratified the soft headline reading. New orders slumped 21.7 points to -12.0, the lowest since January 2016. Only three other months in the 19-year history of the survey saw declines of a similar magnitude, of 20 points or more. Two of those three instances – October 2001 and October 2008 – occurred during recession.

It was a similar story in the case of unfilled orders — crashing 17.9 points to -15.8, the worst showing here since December 2015. Not just that, but the six-month outlook also fell 4.9 points to +25.7. Keep in mind these are leading indicators, suggesting the weakness this month will be extended.

Record Drop in New York

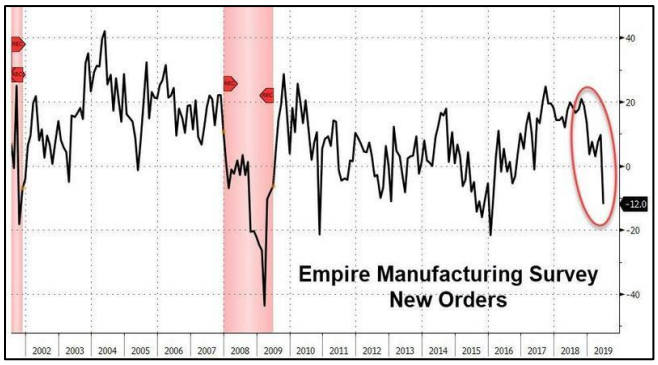


Source: Bloomberg

In addition, shipments (-6.6 points to +9.7) softened and employment (- 8.2 points to -3.5) moved into contraction for the first time in two-and-a-half years. And as expected, inventories (-1.2 points to -5.3) were once again drawn down, adding to evidence that they will take a big bite out of GDP growth during the second quarter.

Empire Manufacturing is always the first regional monthly snapshot into the U.S. industrial complex. It also has a Rodney Dangerfield "get-no-respect" reputation of not being the best guide for the U.S. manufacturing sector. How many times have sell-side salespeople or traders barked the phrase, "What does New York manufacture anyway?" While true, there's a flaw in this thought process. The supply chain is global. Signals can be gleaned from any locale, no matter how small. The largest monthly decline on record and some of the weakest internals in history in June's Empire Manufacturing Index should not be dismissed.

New Orders Plunge!

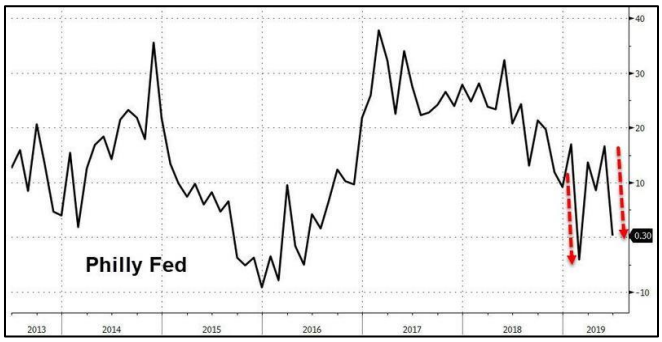


Source: Bloomberg

Confirming the collapse in Empire Manufacturing, the Philly Fed Business Outlook plunged from 16.6 to just 0.3 in June (well below the 10.4 expectation). While not as big a drop as in February, the slump from the dead-cat-bounce hopes of the last few months is very telling. New orders fell to a three-month low and prices-received fell significantly more than prices-paid, indicating a margin squeeze for manufacturers while the workweek sunk to a four-month low.

Also, worth noting from the Philly Fed report, fully 26% of the companies surveyed said output was declining in the second quarter; 42% say flat or down. In addition, over half are planning for slowdown or contraction for the third quarter. And for the firms planning to lift production, only 35% stated that they intend to accomplish this by expanding their payrolls (this speaks to the lack of skills left in the depleted pool of available labor, which has shrunk to an 18-year low).

No Joy in Philly



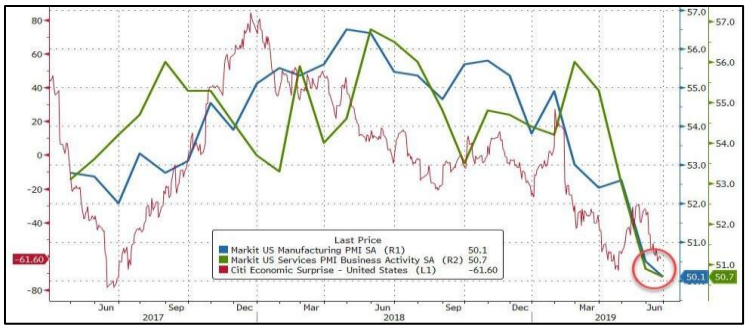
Source: Bloomberg

To end the week, the preliminary Manufacturing and Services Purchasing Mangers' Indices (PMIs) for June dropped to a 10-year low and continued edging closer to contraction.

Here are the highlights:

- Flash U.S. Composite Output Index at 50.6 (50.9 in May). 40-month low.
- Flash U.S. Services Business Activity Index at 50.7 (50.9 in May). 40-month low.
- Flash U.S. Services PMI Business expectations fell to 57.8. The lowest reading on record.
- Flash U.S. Manufacturing PMI at 50.1 (50.5 in May). 117-month low.
- Flash U.S. Manufacturing Output Index at 50.2 (50.7 in May). 37-month low.

PMI at 10-Year Low



Source: Bloomberg

ARE MORTGAGE RATES OR HOME PRICES TOO HIGH?

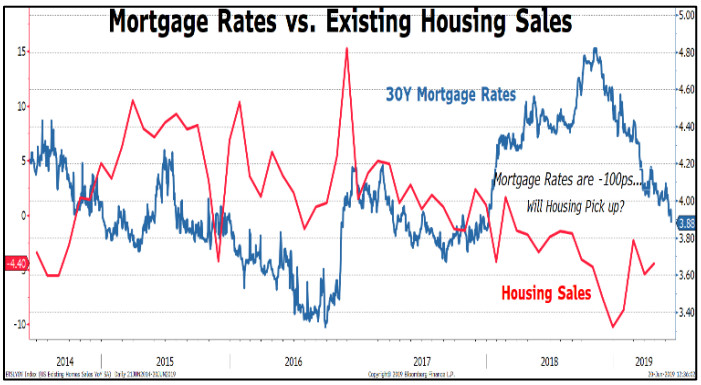
On the surface, the May housing starts report looked stellar. A spring in its step. The good news was all on the surface, with the 1.269 million annualized U.S. housing start data handily beating the consensus view of 1.239 million; and April

was revised higher to 1.281 million units from the initial reading of 1.235 million. This would have been a 2.8% burst of activity off the unrevised April data. Instead, starts dipped 0.9%.

But here is the rub:

1. The entire bounce was in multi-family, which has a far lower GDP impact than is the case with the single-family space.

2. Single-family starts give you a much better appreciation as to what is happening to the underlying residential real estate sector, and activity here retreated 6.4% to a three-month low of 820 thousand units at an annualized rate. Starts here are off a whopping 12.5% on a year-over-year basis.

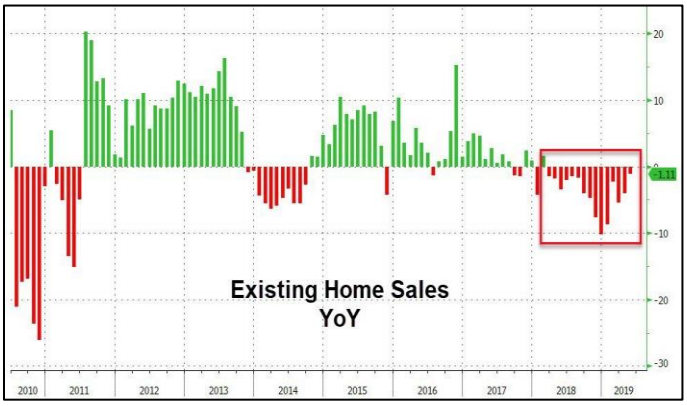


Source: Bloomberg

This is a sign that, even with mortgage rates having declined over 100 basis points since their nearby peak in November, they have thus far been unable to incite a meaningful pick-up in demand. It's tough to spin this as positive news. Does this suggest rates still are too high or home prices need to decline?

After April's disappointing drop in home sales data, existing home sales rose 2.5% month-over-month to 5.34 million in May (and saw a modest upward revision in April). This was a good report. The term good is relative. Sales are still down year-over-year as well as year-to-date and have declined on a year-over-year basis for 15 straight months... even with rates collapsing.

Housing Languishes



Source: Bloomberg

WHATEVER IT TAKES 2.0

"Within our mandate, the European Central Bank (ECB) is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." – Mario Draghi, President, European Central Bank, July 2012

Since President Trump first discussed firing Federal Reserve Chair Jerome Powell, out of a sense of frustration that his pick was not dovish enough, he has regularly expressed his displeasure at Powell's lack of willingness to do whatever it takes to keep the economy booming beyond its potential. Last week, Trump continued a fresh broadside against the Fed saying, "they don't have a clue," and that rates are too high. The newswires have reported that the White House legal office had considered the potential for Trump to demote Fed Chair Jerome Powell, to take his chairmanship away but not fire him. It is not clear if that would be legal.

Last week, Mario Draghi, Jerome Powell's counterpart in the ECB, commented that he was open to lowering interest rates and expanding quantitative easing measures if economic growth in the E.U. didn't start to pick up soon. It should be noted that most of the world's other central banks also are indicating a readiness to ease policy to counter any incipient slowdown.

This led to the following Trump tweet:

"Mario Draghi just announced more stimulus could come, which immediately dropped the Euro against the Dollar, making it unfairly easier for them to compete against the USA. They have been getting away with this for years, along with China and others." – Donald J. Trump (@realDonaldTrump), June 18, 2019

I personally find it a just a tad unusual and hypocritical that Trump openly criticizes the Fed for not cutting rates and then screams at the ECB over merely suggesting that it may ease.

At any rate, we now have the President of the United States complaining about the ECB's President. I don't know if that's a first or not and I don't particularly care. Trump says this is unfair because Draghi is devaluing the currency and makes the Europeans more competitive. No, no, no. He's devaluing the currency but that's what they all do. It's not just the Europeans or the Chinese. It's the U.S. We're the ones who taught them how to do this. All of those central bankers went to U.S. schools. It's everybody.

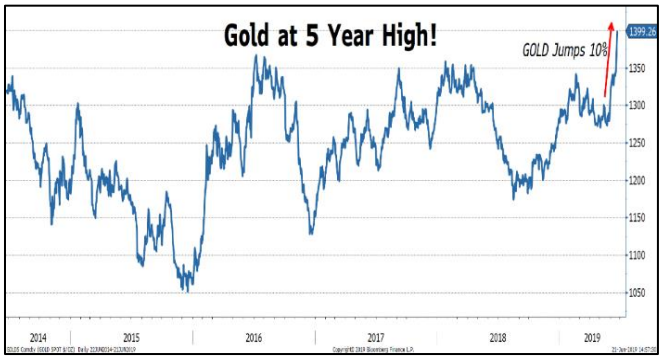
The bottom line is that the ECB and other central banks will push Trump harder to lean on the Fed to be more aggressive with lower rates and quantitative easing. Trump's urgency for Fed action also increases the odds that Powell could be replaced or demoted.

GOLD AT SIX-YEAR HIGH

"Money is gold, nothing else." – JPMorgan

Bonds were not the only safe haven. Gold was up 5% on the week and has quietly climbed more than 15% since September.

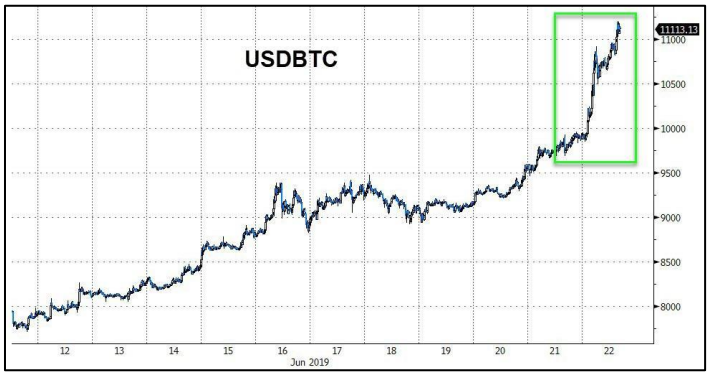
Gold closed at $1,403, past the $1,380 that previously marked not only a five-year high, but also a formidable resistance level.



Source: Bloomberg

The rap against gold has always been that it yields nothing. But in a world with over $13 trillion of bonds with negative yields, the yellow metal no longer is at a disadvantage. The 'old' money also appears to have caught a bid with the 'new' money -Bitcoin and other cryptocurrencies- highlighted by last week's announcement by Facebook of its own crypto coin.

Bitcoin Soars Above $11,000



Source: Bloomberg

Make no mistake, the combination of: 1) easier monetary policy everywhere underscored by the fact that, in just a month, we have seen the futures market go from pricing in 20% odds of a Fed rate cut at the end of July to 100% (in fact, the futures market is now discounting 69% odds of three 25-basis-point cuts by year-end); 2) the nail-biting geopolitical environment (Iran, Korea China); and 3) the fact that President Trump has been looking to demote Jay Powell, are all powerfully bullish factors for bullion.

Regardless, as gold hovers near a six-year high, one has to wonder what the message is.
What are these investors protecting themselves from?

Could it be that gold's resurgence may reflect the massive global debt build-up, which induces the world's central bankers to keep interest rates low?

Could it be that gold and cryptocurrencies are expressions of distrust in government-issued paper currencies?

Or could it be a worsening global growth outlook and the instability that comes with that?

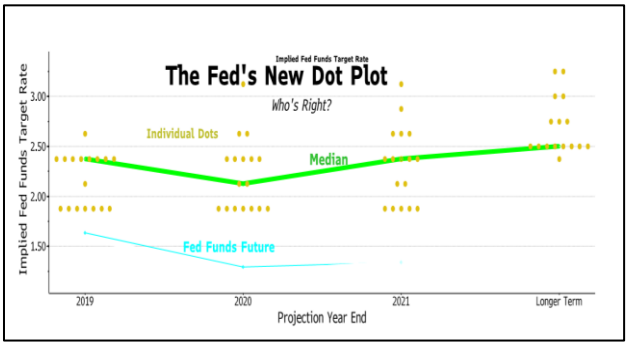
MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Fed did largely what was expected – not panicking or succumbing to political pressure by cutting rates (the market was only priced 25% of the way for a move so quickly). Besides, what's the risk of waiting six weeks- by then, we will be through the G-20 Summit and the Fed will have an extra set of data to glean, especially as to whether the May weakness in payrolls will be repeated or refuted in June. But the trail is being blazed for rate cuts coming in the near- and intermediate-term. The statement, as anticipated, dropped the term *"patient"* and acknowledged the following trends:

- slower economic growth
- weaker business investment
- falling market-based inflation expectations
- higher uncertainty around inflation hitting the 2% target

We now have eight Federal Open Market Committee (FOMC) officials calling for at least one cut this year (seven predicting two rate moves), eight are on hold and one has his/her head in the sand and is calling for one hike. St. Louis Fed President James Bullard dissented, and was in favor of an immediate 25-basis-point rate cut. And Minneapolis Fed President Neel Kashkari (non-voter) supported a 50-basis-point rate cut to 1.75% to 2.00% and a commitment not to raise rates again until core inflation reaches the 2% target on a sustained basis. I sympathize with Bullard and Kashkari, yet I can understand the desire to wait given sky-high equity valuations and the possible appearance of succumbing to White House pressure.

Take a look at the following graph. **The Dot Plot vs. the Market**



Source: Bloomberg

The green line represents the median fed funds forecast. Individual forecasts are expressed through the yellow dots. But most importantly, look at the blue line. This line indicates where the futures market believes the fed funds rate will be. Needless to say, the market believes the Fed is way too high and wrong again by a wide margin. But, what does it mean when the real yield – their margin over inflation – on the five-year Treasury note is down to around 20 basis points from 1% at the end of 2018 and the real yield on the 10-year maturity a mere 40 basis points? It's the bond market's way of foreshadowing the weak economy that lies ahead.

What does it mean when the fed funds/three-month bill and three-month/10s curves are inverted as much, and for as long, as they have been? You know trouble somewhere is brewing. The near-50-basis-point negative spread between the two-year Treasury note and fed funds rate accurately predicted the past two recessions.

With regard to the economy, so many people gaze at the 3.6% unemployment rate and use this as their economic yardstick. And yet, we were last here back in December 1969… and guess what? The recession started the very next month. Go figure.

You want a roadmap? Focus on a leading labor market indicator. And it's not the U-3 unemployment rate. It actually is the index of aggregate hours worked for nonsupervisory production workers. It peaked in December 2007 and September 2000 – just ahead of the recessions so few saw coming. When did it peak this cycle? Try January of this year.

Here's a dose of reality. The U.S. economy is on much more fragile footing than is generally recognized or even acknowledged on bubblevision (unless I'm being interviewed). The Atlanta Fed has trimmed its estimate for second quarter real GDP growth to a 2.0% annual rate from 2.1%; and the NY Fed is at just 1.4% for the second quarter (was 2.2% at the start of May) and took the third quarter down to a 1.3% pace from its 1.7% estimate a week ago. It's otherwise known as a "stall-speed" economy.

As for the Fed, more data will need to be received before they cut rates. However, if the data continue to worsen with no resolution on the trade front, it would not be surprising if we see a 50-basis-point rate cut on July 31. Some may think this is too aggressive, yet the first easings in the last two cycles were 50-basis-point cuts. So, it's hardly out of the ordinary.

But here's the key takeaway. A recession happens (and it will sooner or later), then the Fed cuts rates an average of nearly 500 basis points and never less than 200 basis points. This means we could quickly end back at the "effective lower bound" as the Fed likes to put it. A round trip back to zero, and quite possibly lower than that. We have already seen research out of some of the Fed district banks over negative rates, a renewal of quantitative easing, and interest rate targeting out the curve. And because of the time-worn 90% correlation between the overnight rate and the 10-year Treasury note, I can easily see the 10-year Treasury note yield declining to 1% if not lower as yields melt away.

And just imagine where two-year Treasury yields will end up if Zero Interest Rate Policy (ZIRP) 2.0 comes to be…

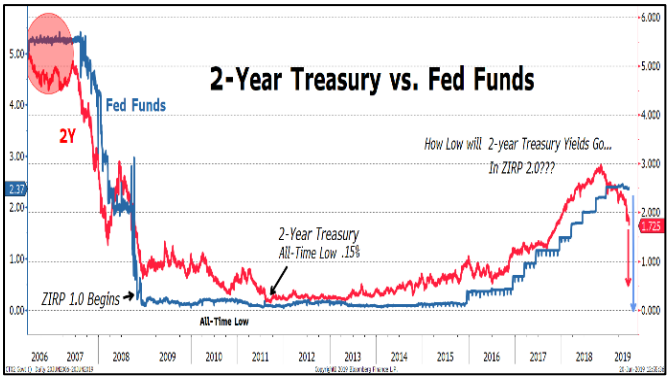
Let's just say a lot lower!

Here's a bit of history. In 2007, the two-year Treasury yield was around 5%. The Fed can cut rates to zero and the two-year yield traded as low at 0.15%. Do you remember?

So fast forward to where we stand today. The two-year Treasury yield is now 1.72% and the fed funds effective rate is over 2%.

So do the math. If the Fed cuts to zero, two-year Treasury yields could virtually disappear from the screens.

Not just that, but there is another very bullish dynamic for Treasuries evident in the Commitment of Traders reports. Two weeks ago, the net speculative short position on 10-year Treasury notes (on the Chicago Board of Trade) was 434,970 contracts. Last week, this was cut to 324,470 net short contracts. These speculators are hurting bad and being forced to cover – and there is still a way to go for this short squeeze to run its course. This alone is a very powerful source of de facto support.



Source: Bloomberg

As I wrap up, it should be noted that commercial banks have been de-risking – shift toward liquid from non-liquid assets. To wit, there has been a marked slowing in commercial real estate loans, commercial and industrial lending and residential mortgages, while the fastest-growing segment on banking sector balance sheets are Treasury securities, and by a country mile.

So, in conclusion, we continue to urge credit unions to reduce excess cash reserves, and remain fully invested via a risk-appropriate, high-quality, diversified ladder strategy.

Keep it simple.

Throw away the crystal ball!

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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.

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.