BALANCE SHEET SOLUTIONS
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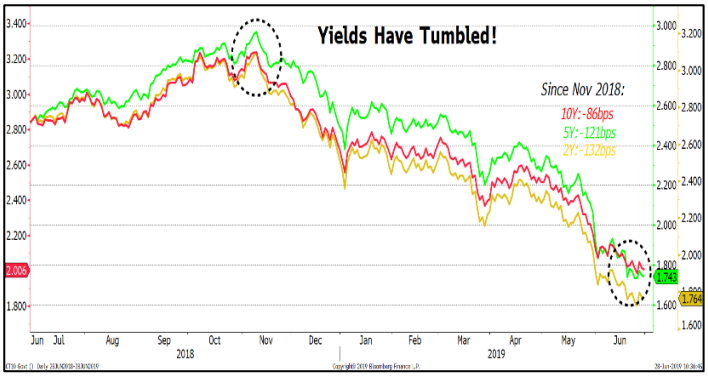
WEEK OF JULY 1, 2019

Weekly Relative Value

Bonds are from Mars, Stocks are from Venus

Unquestionably, the biggest story in financial markets in 2019 is the breath-taking decline in global rates. The benchmark 10-year U.S. Treasury has fallen 86 basis points since November 2018. Likewise, the two-year and five-year Treasury yields have dropped 132 basis points and 121 basis points, respectively. Austria issued its second 100-year bond at 1% and ever-larger parts of the world's bond markets keep sliding into "negative" yield territory. Last week, the yield on Swiss 45-year bonds due in 2064 fell below zero percent!

Yields Have Plunged by 45%



Source: Bloomberg

Given the magnitude of the rate declines, it may seem as if bond markets are "irrationally exuberant." For now, however, there are no black or even gray swans in sight, as the world continues to slow down. And, as I have harped on for years in this space, the biggest reason for this slowdown is because the world has too much debt to grow at historical rates. In fact, the more debt there is, the lower the interest rates have to be. And that's exactly what we have been seeing.

Central bank rhetoric has also affirmed yield declines, with the Federal Open Market Committee (FOMC) strongly hinting that rate cuts are coming and European Central Bank (ECB) President Mario Draghi stating that "in the absence of improvement" in inflation data, "additional stimulus will be required."

And institutional money managers have finally moved into the "lower for longer" camp. The most recent Bank of America Fund Manager Survey found a near-record of fixed income investors expect short-term interest rates to fall over the next 12-months. **Just 10% expect long-term interest rates to rise.** In November 2018, 89% expected higher short-term yields and 63% expected higher long-term yields.

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

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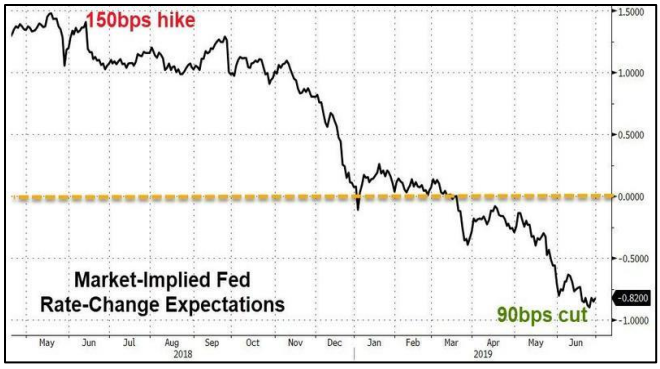
- "BACK ON TRACK"

PORTFOLIO STRATEGY

The chart below shows that four rate cuts over the next 12 months are now effectively priced in.

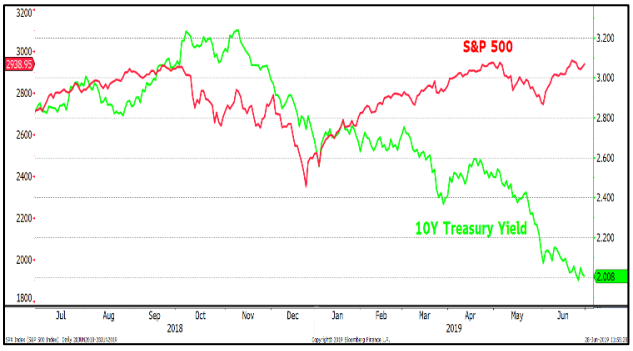
Four Rate Cuts Coming?



Source: Bloomberg

Yet, what is fascinating is that while bond market yields melt away day by day, equities continue to levitate in a world of their own. U.S. equities have risen 17% in the best half since 1997. What gives? How does one reconcile the gloom in bond markets with the Pollyanna disposition of equity investors?

The Everything Bull Market



Source: Bloomberg

In a nutshell, equity investors have convinced themselves that Fed rate cuts will be more than sufficient to offset the economic slowdown that a recession will usher in (i.e. "the worse the news, the better for stocks"). But that argument assigns to central banks an almost magical ability to fine-tune policy and assumes that any cuts will immediately support economies. This is not supported by history: when business cycles turn, equities decline, even as central banks are easing aggressively.

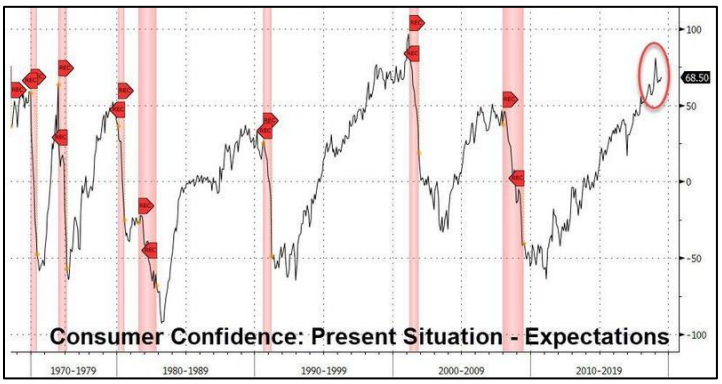
CONSUMER CONFIDENCE PLUNGES

Amazingly, the Conference Board's version of consumer confidence sagged badly in June — to 121 from 131 in May (the lowest since September 2017). There weren't many positives to find elsewhere in the data. Only 37% of respondents see the economy as being "good." An even lower 18% believe things will get better in the next six months. Just 17% see more jobs coming, and a mere 19% expect to see a higher paycheck.

Finally, the present situation fell to 162, the lowest since June last year while the expectations reading fell to 94, the lowest since January.

Note that the gap between current and future confidence (DoubleLine's Jeff Gundlach's (aka Bond King) favorite recession indicator) is flashing big red recessionary signals.

Flashing Red?



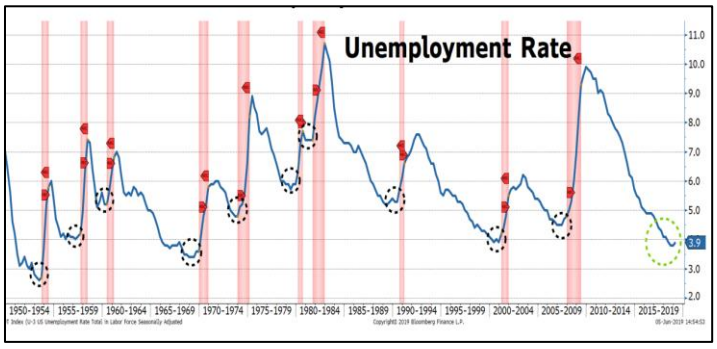
Source: Bloomberg

HAVE WE REACHED PEAK JOBS?

While many people gaze at the 3.6% unemployment rate and use this as their economic yardstick, they fail to recognize that the unemployment rate is a **'lagging' economic indicator**. The labor market is the LAST thing to turn in a cycle as employees are slow to hire and slow to fire. While a low unemployment rate looks good on the surface, it should be a cause of concern as it typically signals the end of the economic cycle. Look at the graph below and note how very low unemployment rates are quickly followed by a recession (red shaded bar).

The last time the U-3 jobless rate was as low as it is today was in December 1969. Guess when the recession started? Try January 1970. And why? Because the economy finally started to feel the lagged effects of the Fed tightening cycle. Forewarned is forearmed, as Grandma used to say.

The Unemployment Rate is a Lagging Market Indicator



Source: Bloomberg

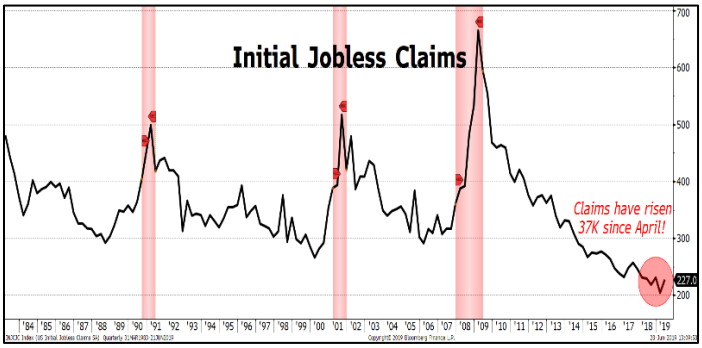
Furthermore, the employment number from the Bureau of Labor Statistics is adjusted, tweaked and mathematically abused. Think of the birth-death model where jobs are literally created out of thin air.

Finally, as an indicator, the U-3 jobless rate is often subject to very large negative revisions in the future.

If you want a roadmap of where we are going versus where we have been, the focus needs to be on '**leading' labor market indicators** such as initial jobless claims and hours worked.

And don't look now, but initial jobless claims are hooking up. Claims tallied 227,000 last week, a 10,000 run-up and above the consensus estimate by 7,000. So far, claims are up 34,000 from the cycle lows. Historically, once they increase 83,000 the recession has already started. So, on this basis, we are more than 40% there.

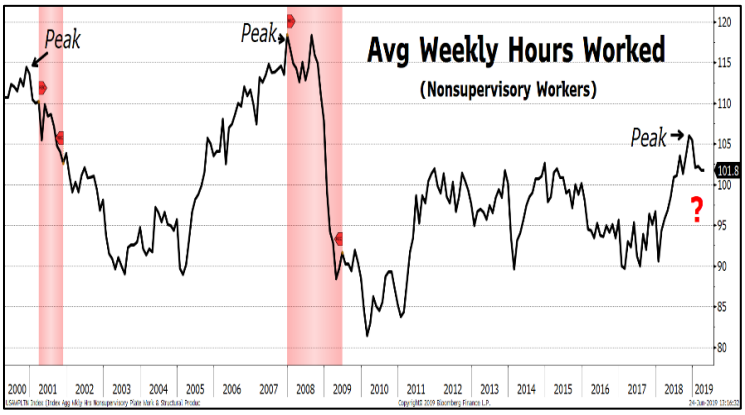
Trouble on the Job Front?



Source: Bloomberg

Another leading labor market indicator is **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. Maybe this is why the 10-year Treasury yield is pinned near 2%.

Have Hours Peaked?



Source: Bloomberg

PUSHING ON A STRING

At his press conference following the Federal Reserve's monetary policy meeting, Fed Chair Jerome Powell spent the bulk of his time talking trade wars and risks to the global economic outlook. What didn't get any attention was the state of the all-important housing market. Too bad. Because housing is a critical sector of the US economy.

And while there has been hope that lower mortgage rates would spark a renaissance in the U.S. housing market new home sales in May have blown that narrative out of the water. New home sales were simply dreadful in May, sliding

7.8% to a five-month low of a 626,000 annualized unit rate. The consensus had penned in a 684,000 tally. Adding insult to injury was that this followed a 3.7% decline in April dragging the year-over-year trend down to -3.7% from +8.0% in April.

Pushing on a String!

Source: Bloomberg

That would be concerning under most circumstances, but it's particularly worrisome now given that mortgage rates are down by over 100 basis points and we have the lowest unemployment rates in half a century. These ingredients should be supportive for the market. Could this be a classic case of "pushing on a string?" In other words, you can bring the horse to water, but will it drink? So far, homebuyers aren't drinking. It's also worth considering because demand for homeownership is obviously in some sort of secular decline, for a whole host of fundamental and behavioral shifts.

The bottom line: Housing has a big impact on economic growth and is a leading indicator of the overall economy. Housing tends to lead the economy into and out of recessions. If lower rates fail to resuscitate the most rates-sensitive sector there is, that does not augur well for the future and tells me that the central bank may have no choice but to go (and go big). The big story in the coming year is a return trip to the zero bound. Maybe even lower than that.

LILLEVILLA

"Despite falling mortgage rates and rising wages, the cost of owning the typical home remains out of reach or a significant financial stretch for the nation's average wage earners,"
– Todd Teta, Chief Product Officer at ATTOM Data Solutions

ATTOM Data Solutions published its second quarter 2019 *U.S. Home Affordability Report*, which reveals median home prices last quarter weren't affordable for the average American in 74% (353 of 480 counties) of the counties analyzed. The affordability of each county was calculated by examining the amount of income needed to make monthly house payments (assume a 3% down payment and a 28% maximum "front-end" debt-to-income ratio) — including mortgage, property taxes and insurance.

Thus, for many Americans, purchasing a home is "financially out of reach."

Enter Amazon.

Amazon is now selling entire houses ("Lillevilla" log cabins) for less than $20,000 — with free shipping. This Lillevilla is 292 square feet.

Want more room? Amazon offers the Altwood Timberline | 483 SQF Cabin Kit for $34,900.

Still want even more room?

Try the Allwood Eagle Point | 1108 SQF Cabin Kit for $46,900.

The above links are active, so feel free to buy a house today on Amazon.

Amazing.

Sears used to sell houses in its catalog. We have now come full circle.

CHICAGO PMI PLUNGES

On the heels of dismal weakness in all regional Fed outlook surveys, the Chicago Purchasing Managers' Index (PMI) just collapsed from 54.2 to 49.7 (drastically missing the 53.5 expectation) and back into contraction for the first time since 2015.

The components also left much to be desired. The growth rate of new orders swung to -6.7 from 1.1 in May and 5.2 in April. Shipments throttled back from 7.6 to 1.7. Hiring plans retreated from 28.9 to 20.2 and half the 41.4 reading in

November. The wage component weakened to a 19-month low and we have come off the lowest successive readings in pricing power in nearly three years.

Capex tanked from 18.3 to 6.9 while plans to raise capex have fallen from 36.0 in March to 26.2 in April to 22.8 in May and now down to 22.5 for June, a 22-month low.

The forward-looking six-month-ahead "business activity" headline has gone from 18.4 in both March and April to 9.1 in May to -2.7 as of June, the first swing into contraction mode since May 2016.

If this is the best economy ever, I'd love to know what a recession looks like (oh, but that will be Powell's fault).

Chicago Contracts

Source: Bloomberg

2,373 SQUIRELLS

Needless to say, I am hardly bullish on U.S. economic data. And while I question whether or not we should be spending our tax dollars on counting rodents, it's hard not to be bullish on U.S. data collection. How can you not be, when census workers are able to calculate the exact number of squirrels running around Central Park (the exact number — 2,373). Just as the U.S. Census records a wide array of demographic information, Squirrel Census provides a trove of details about where each squirrel was spotted, what color its fur was and whether clusters of the same type were noted throughout the park. For the evidence, take a look at *Why Count All the Squirrels in Central Park? Why the Heck Not* in the New York Times.

"BACK ON TRACK"

"We're right back on track… We're holding back on tariffs and they're going to buy farm products," President Trump told reporters after meeting with Chinese President Xi Jinping at the G20 Summit of major economies.

And so, it has come to pass: The much-anticipated meeting between the U.S. and China is over. While I await further details, here is my initial reaction.

We have an uncertain pause with no immediate escalation. However, there is still no clear path towards a comprehensive deal. The U.S. administration has indicated that it will hold off on 25% tariffs on the remaining U.S. $300

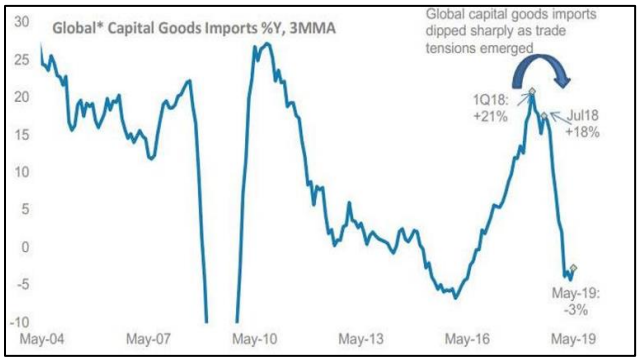
billion imports from China. There was also an agreement that both parties will roll back restrictions on high-tech exports by U.S. companies and that China would continue to purchase agricultural products from the U.S.

Both Trump and Xi were playing for time. Trump's demands about opening up China to U.S. agricultural products is simple play for an electoral boost. Xi needed the promise of no further tariffs and a Huawei. That said, the fact that Trump was willing to trade Huawei for an agreement was fascinating. A few weeks ago, he was parading advice on the danger Huawei presents to long-term communications systems and therefore the whole economy. The neo-cons will be furious.

However, as things stand, it's unclear on whether real progress was achieved on the sticking points that caused talks to break down in the first place. The U.S. and China remain on collision course.

Regardless, with the current cloud of uncertainty, strong companies are having difficulties making sound business decisions. And uncertainty is the enemy of the business cycle. As shown below, heading into the G20 meeting, it was clear that the global capex cycle had ground to a halt.

Global Trade Plunges



Source: Haver Analytics

Is it any wonder that corporate sentiment has also declined to multi-year lows? Global PMIs for May fell in unison. The Morgan Stanley Business Conditions Index recorded its largest one-month decline ever, plunging to a level not seen since June 2008. Other business sentiment gauges, such as the regional Fed and German Ifo and ZEW surveys for the month of June, paint a fairly bleak picture too. What's more, as noted above, consumer sentiment is also starting to sour with the Conference Board's Consumer Confidence Index for June falling to the lowest point since September 2017.

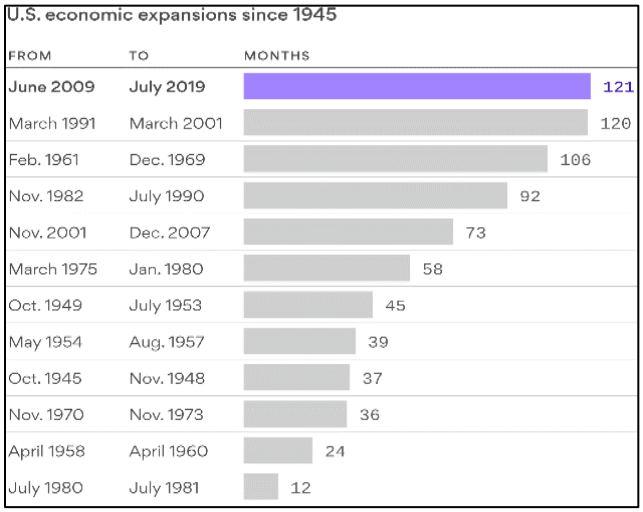
Tracking how the talks evolve from here and will be key. Should we see re-escalation it would increase the risks of a global recession.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Today marks the longest period the U.S. economy has gone without a recession, edging past the economic cycle that ended when the dot-com bubble burst.

- **Why it matters:** This milestone comes at one of the more pessimistic moments in the last decade.
- **A significant slowdown** in growth, and maybe a recession, is coming.
- **The reasons** include trade tensions and slumping growth across the globe.

The bottom line: As people worry that a recession is around the corner simply because there hasn't been a recession in a while, that could weigh on consumer and business confidence — and become a self-fulfilling prophecy.

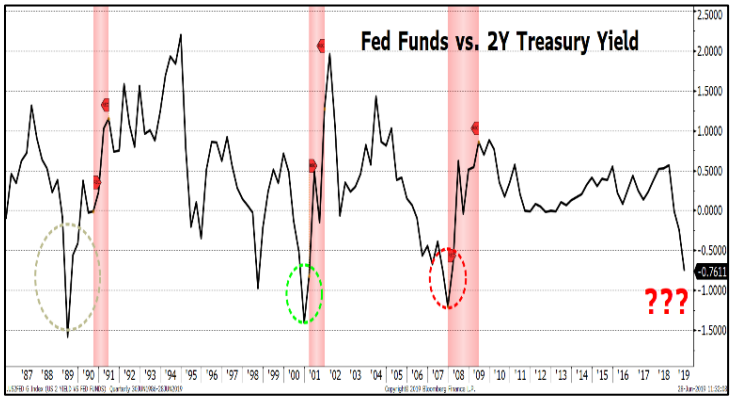


Source: National Bureau of Economic Research

So, as the economy weakens, one has to wonder if the Fed behind the curve.

Take a look at the yield spread between the two-year Treasury yield and fed funds. The current spread stands at -76 basis points. Inversions preceded recessions in 1991, 2000 and 2008. However, the rate regime is very different today than it has been at any time since the two-year bond has existed because the fed funds rate today is less than half of what it was at each of the last five inversions. So, when calculating the two-year yield to fed funds spread as a percent of the fed funds rate, only once (in 2008) was this portion of the curve more inverted. By this measure, the Fed is substantially behind the curve and should act by cutting rates by at least 25 basis points in July as a start.

Is the Fed Behind the Curve?



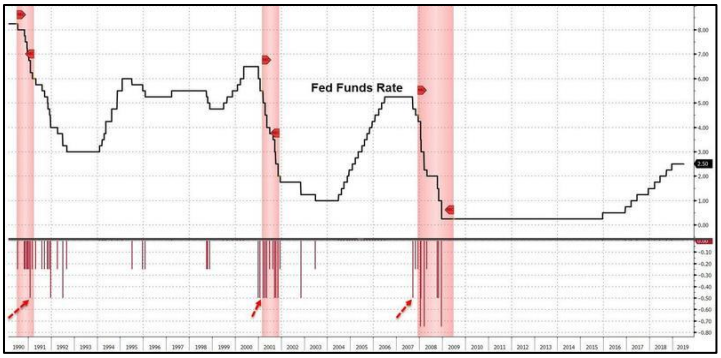
Source: Bloomberg

Meanwhile, a 50-basis-point cut, while still a low probability (unless the ISM and employment data are much worse than expected this week), could indicate the effects from the prior rate hikes.

As indicated in the following graph (red arrows on bottom half of chart), whenever the Fed has cut by 50 basis points, it's simply too late. The Fed was behind the curve and a recession was already baked in.

Will history repeat?

Will the Fed cut by 50 basis points?



Source: Bloomberg

Regardless of when and by how much, the Fed will cut rates. The U.S. economy is on much more fragile footing than is generally recognized or even acknowledged (unless I'm writing or speaking). To wit: Last week, the Atlanta Fed trimmed its estimate for second quarter real GDP growth to 2.0% and the New York Fed is at just 1.4% for the second quarter (was 2.2% at the start of May). Also, the third quarter has been revised down to a 1.3% pace from its 1.7% estimate a week ago. It's otherwise known as a "stall-speed" economy.

Inflation Remains Below Fed's Target

Source: Bloomberg

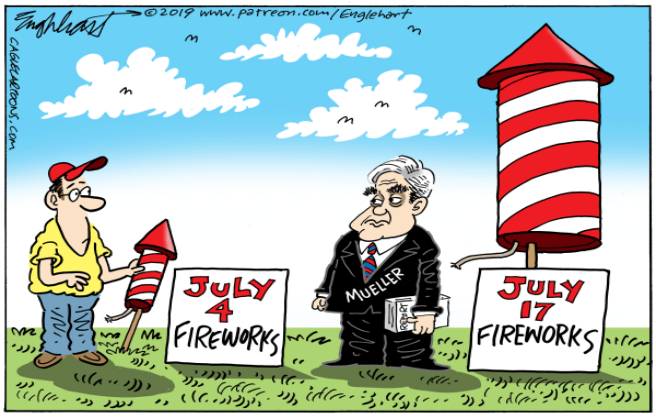
On the inflation front, the Fed's favorite inflation indicator – the core personal consumption expenditures deflator – is stagnating well below the Fed's 2% target. As for inflation expectations, the Cleveland Fed's 10-year rate cooled off to 1.68% in June from 1.80% in April, even with the surge in oil prices! This is the lowest such reading on market-based inflation expectations since 2016. And we already know that the University of Michigan's five- to 10-year median household inflation expectation measure in June receded to a record low of 2.2% from 2.6% on May 15.

In the coming week, the first major economic data for June will bring the Institute for Supply Management's closely watched manufacturing gauge, which could indicate further slowing. Then of course we have the big June employment number on Friday, July 5. The consensus is for 165,000 jobs added, and for the unemployment rate to be unchanged at 3.6%. As a reminder, there were 75,000 jobs added in May, and the unemployment rate was at 3.6%. A much-weaker-than-expected jobs report would cement a 25-basis-point cut and raise the probability of a 50-basis-point cut at the next FOMC meeting at the end of July.

In terms of portfolio strategy, we continue to advocate a fully invested, high-quality, duration-appropriate ladder strategy. Excess cash will likely continue to be a performance drag and, as such, should be minimized.

Finally, from a strategic point of view, given the magnitude of the downward shift in rates since last November, do NOT be surprised if the bond market sells off (yields rise) over the next week or two. The market may be overdone in the short run. However, any short-term weakness serves as an attractive entry point to put money to work. Capitalize on the weakness. In other words, buy the dips.

Post-July 4th Fireworks?



Source: Cagle

Finally, it's that time of the summer. You can smell the fried chicken, taste the buttery corn on the cob, marvel at the sight of the firework finales in your local area and listen to the sound of the Boston Pops. What a great country indeed. However, if the heat overwhelms, don't stop the feeling. Live stream ***Stripes***, that American classic, but maybe not with the whole family present. You may recall (if you don't, you've missed out in life) that the Bill Murray flick, strategically released just before July 4th (albeit 38 years ago), gave new meaning to breakfast fare. The Aunt Jemima Treatment may or may not have entailed a hot stove and a spatula, but let's just say the end result amounted to very few flapjacks.

Happy 4th to one and all… Enjoy!

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- Dinner at Smith & Wollensky Restaurant
- Leadership & Motivational Speakers
- Football Night with Alloya – NFL Opener
- Economic Outlook
- Dueling Market Views featuring Tom Slefinger and Steven Rick
- Multiple Networking Opportunities
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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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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.