BALANCE SHEET SOLUTIONS
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WEEK OF JULY 22, 2019

Weekly Relative Value

"All the Way Down to Zero"

Let's start this week's edition with a few quotes from Bob Michele, Chief Investment Officer and Head of Global Fixed Income at JP Morgan Asset Management.

*"10-year Treasury yields are heading **all the way down to zero**. I think that's where we're headed over the next couple of years. The rally in bonds hasn't even begun yet…We've had the recovery; it's coming to an end and now the central banks one after another are falling into line and cutting rates. At this point in the cycle you need some shock and awe…The only thing they have left to do is cut rates as far as they can and probably expand balance sheets."*

Adding to the discussion about low rates, New York Fed President John Williams – in a speech titled *Living Life Near the ZLB (Zero Lower Bound)* – stated that the neutral rate (the rate that neither stimulates or slows the economy) is around 0.5% and long-term forces will force the neutral rate to say lower for longer and finally he sees low inflation readings as the "New Normal".

*"**You don't need to wait until things get so bad to have a dramatic series of rate cuts**. We need to make a decision based on where we think the economy may be heading and, importantly, whether the risks to the economy are lined up...we've had mixed data, but I do think the global data has been disappointing on the downside...**disinflationary pressures, if anything, are more intense** than I thought six weeks ago."*

He further outlined the necessity of the Fed being aggressive early when the policy rate is so close to the floor, and there was a sense of urgency in his message:

A bank spokesman later walked that back, saying Mr. Williams didn't intend to suggest the central bank might make a large cut this month. But how do you walk back a speech?

Frankly, it is very difficult after reading Williams' speech to not draw the conclusion that he would vote for a 50 basis point rate cut at the end-of-July Federal Open Market Committee (FOMC) meeting.

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

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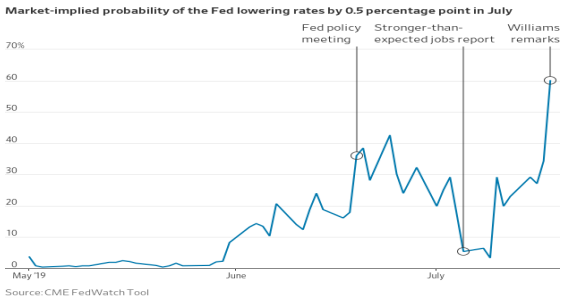
THIS WEEK…

- JAPANIFICATION
- THE BIG PICTURE
- HELL OF A WAY TO RUN A COUNTRY
- INFLATION BEE HAS NO STING
- RECESSION ALARM BELLS ARE RINGING
- THE EARNIGS RECESSION IS HERE
- NEWS ON HOUSING ISN'T GOOD
- A COMMENT ON THE POLITICAL ENVIRONMENT
- PORTFOLIO STRATEGY

And as you can see below, the odds for a 50 basis point rate cut in July surged from the low 20s to 65%!

Odds of a 50 Basis Point Hike Surge



Source: CME FedWatch Tool

But the big surprise wasn't what Williams said – after all he is a well-known 'dove'. The shocker was what Fed Vice Chair, Richard Clarida – a well-known policy 'centrist' – said. Ignoring for a minute that the Fed's track record at predicting the future is far worse than even that of Wall Street (abysmal in its own right), Clarida said the Fed should not respond to data, but to what the Fed believes the data will be. In other words, "you don't want to wait" for the economy to turn down, adding that "when interest rates are close to zero, it's important to act preemptively."

This also follows the mea culpa by Jay Powell in last week's testimony that he had overtightened this cycle (as if this has never happened before). Jay Powell may have one single vote, but it is the most important vote. He sounded very dovish at his last post-meeting press statement and again during his most recent semi-annual congressional testimony.

Finally, as readers of the Weekly Relative Value can attest, the above view is consistent with my long-held conviction that the U.S. and global economy remains in a period of 'secular stagnation' in which economic growth, interest rates and inflation remain lower for longer. And while I personally do not see 10-year Treasury yields reaching zero, I do believe that yields along the curve will eventually melt away. Thus, there will continue to be, a lot of money to be made in the fixed-income market.

'JAPANIFICATION'

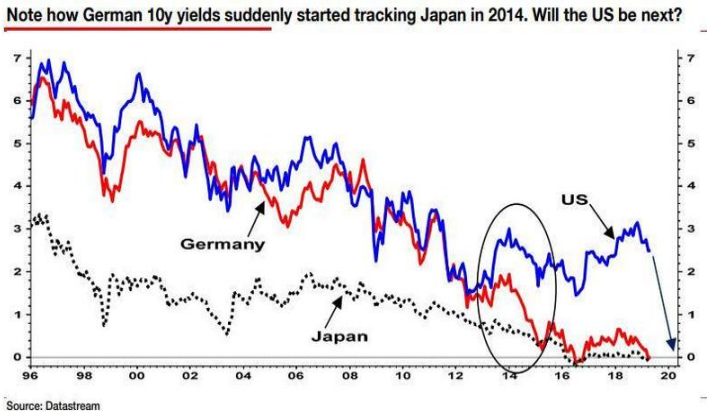
"As we have all learned, once an economy falls into the tractor beam of zero rates, it's almost impossible to escape them…In the long run the U.S. is heading the same way…Growth numbers are going to come down and real growth might go to zero. We're probably never going to go away from zero rates." – Kyle Bass

And outside 'Fedville,' many believe we are on the road to Tokyo. Kyle Bass – the venerable hedge fund manager who made his name through timely and prescient bets against the U.S. housing market – sees a global recession coming and is betting that the Fed will slash interest rates to just above zero next year and force the Fed to restart quantitative easing (QE) and possibly even consider more radical alternatives like buying equities.

To be more precise, Bass believes the longest economic expansion in U.S. history will come to an end next year. And to be fair, this isn't exactly a radical view: a recent survey asking CFOs for their outlook on the economy found that two-thirds of them believe the next recession will begin by the first quarter of 2021.

However, here's the key point: Bass believes that once the Fed re-launches QE and cuts rates this time, the U.S. economy will become stuck in the "tractor beam" of low rates and QE and remain stuck in easing mode – much like the Bank of Japan (BOJ) – forever**.**

Will U.S. Rates Converge to Japan



Source: Datastream

THE BIG PICTURE

Let's review what's happened over the past decade. During this record long expansion, global debt has surged from $116 trillion at the 2007 to $246 trillion currently. That's an epic increase of $130 trillion. Over this same period, global gross domestic product (GDP) has only risen from $58 trillion to $85 trillion (for a $27 trillion increase). In other words, the increase in debt has outstripped the income required to support that debt by a factor of five!

This grotesque amount of leverage has provided the illusion of growth and prosperity, but only a vulnerable and fake environment that would make the likes of Grigory Potemkin very proud (look him up from Russia in the 18th century — one of Catherine the Greats favorites).

Just How Strong is the U.S. Economy?

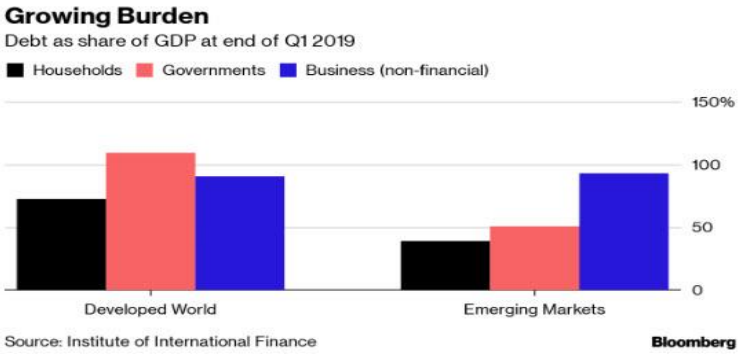
Source: YouTube, *Potemkin Village*

It's as clear as night and day that higher debt is NOT creating higher growth. All we have done is pull growth forward. Remember, debt that is not self-funding reduces economic growth as the "debt service" diverts income from investment leading to a "diminishing rate of return" for each new dollar of debt. The gap widens by the day! And extra debt is only going to make this worse. It's akin to throwing fuel on the flames.

Further, it is simply impossible to grow out of this debt morass. So, the only way out is debt default, a debt jubilee, debt forgiveness and debt retirement — call it whatever you want.

This is the cold hard reality: until this extraordinary and excessive debt is reduced, traditional policy stimulus will not be effective. It's called pushing on a string.

Global Debt Hits $246 Trillion: 320% of GDP



Source: Bloomberg

In addition, we have the aging demographics to deal with. Perhaps a turnaround in birth and fertility rates will help, but there is no sign of any revival. In fact, the fertility rates continue lower. The share of adult males living with their parents is at a level we haven't seen since the Great Depression. Let's face it, this is not an environment conducive to procreation.

HELL OF A WAY TO RUN A COUNTRY

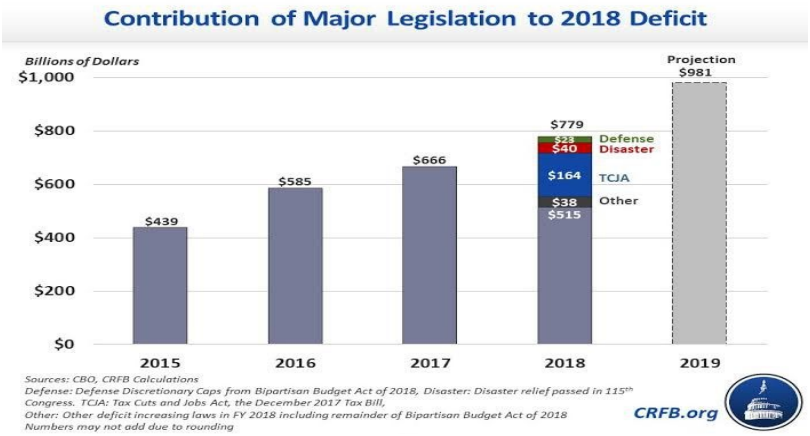
"You can make a case that it seems to be a little hypocritical because we ranted and raged during the eight years of Obama about the national debt,"... If it's truly our core principle, it should be equal whoever is in the White House.
– Republican Rep. Mark Walker of North Carolina (Tea Party)

For the first time in more than four decades, neither the Senate nor House took the trouble to vote on a budget. And the House Budget Committee hasn't released a budget for next year. So, 2020 will be another year sans budget. Apparently, the plan in is to borrow another trillion without a plan because no one wants to be held accountable for the plan. Amazing and sad!

Meanwhile our deficits are exploding with no end in sight. Today our public debt to GDP is 77%. Total Debt to GDP is 106%. The only time we have seen such high debt levels was during WWII. One understands why deficits are high during wars and recessions. However today we are in the 120th month of a peace time expansion.

So where is the deficit coming from? The majority of this year's deficit comes from the tax cut (no, the tax cut is *not* paying for itself). And it will get worse. According to the Congressional Budget Office (CBO), if the current tax code remains in place budget deficits will reach 100% of GDP by the end of the next decade and 152% by 2048. Whatever happened to the Tea Party?

Tax Cuts Cause Deficits to Explode



Source: CRFB

This is the key point: at this point in the economic cycle, debt should be small and declining. Instead our debt is high and rising. And when the next recession hits, our debt to GDP will be twice as large as when the recession of 2008 hit.

Even still with so much at risk, our so-called political leaders favor short-term over the long-term and political wins with the ultimate goal of delegitimizing the other side rather than acknowledging we are a country of diverse perspectives.

In the meantime, the growing mountain of debt creates substantial risks to our economic future. Yet our political leaders are either doing absolutely nothing or making it worse.

Yes indeed, it's a hell of a way to run a country.

INFLATION BEE HAS NO STING

To be bullish on bonds, one has to believe that inflation is a non-threat. While there are many pundits calling for inflation to bottom out, in the real world all anyone needs to do is look at what happened to Netflix. In an attempt to raise prices, it lost 126,000 domestic paid subscribers.

This was the first decline in customers since it began offering its digital services over a decade ago. It's called competition (Disney, AT&T, and Apple) and a consumer disinflation psychology that is the mirror image of the 1970s deeply embedded inflation expectation.

What the bond bears have to realize is that inflation is what people pay, not what businesses think they can charge. Inflation has to be a process where price increases recur, and they stick. That ain't happening. Even with unemployment at 50-year lows, the stock market near record highs and a record expansion inflation is extremely low.

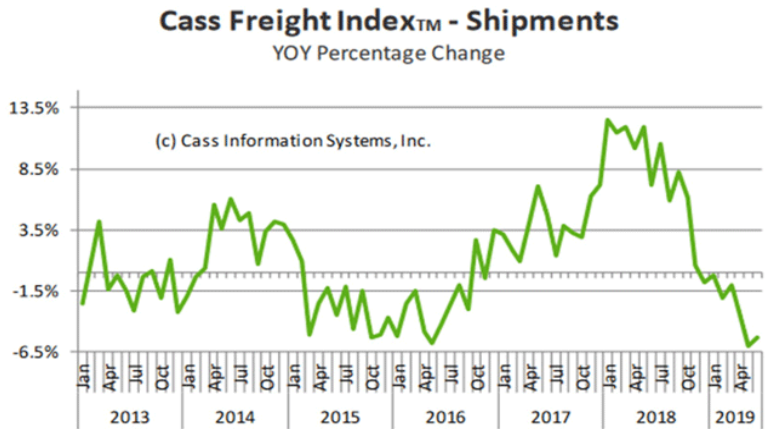
In the next economic downturn look for inflation to turn into deflation. Imagine where long-term bond yields will be residing at that time.

RECESSION ALARM BELLS ARE RINGING

The physical goods we buy – food, clothing, furniture, houses, and most everything else – have one thing in common. They travel long distances to reach us. Sometimes it's from overseas and sometimes its domestic. The Cass Freight Index measures shipment volume across the economy: truck, rail, air, ship, everything. The chart below shows its year-over-year percentage change.

As one can glean from the graph, shipment growth picked up in 2016 following an extended weak stretch. This continued into early 2018 then a steep slide ensued. (Note that this coincides with the first Trump tariffs.) Annual growth went below zero in December 2018 and has been there ever since – now seven consecutive months.

Shipping Plunges



Source: Cass Information Systems, Inc.

In addition, the Conference Board's Leading Economic Index (LEI) turned negative in June.

"The U.S. LEI fell in June, the first decline since last December, primarily driven by weaknesses in new orders for manufacturing, housing permits, and unemployment insurance claims. For the first time since late 2007, the yield spread made a small negative contribution."
– Ataman Ozyildirim, Senior Director of Economic Research at The Conference Board

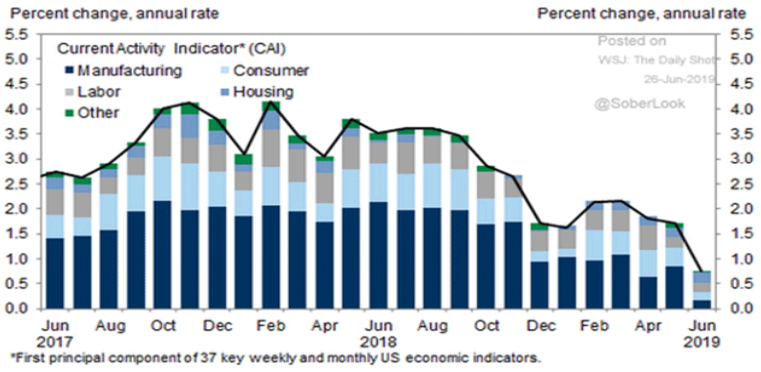
The consensus estimate was for LEI of +0.1, the read was a -0.3. Hard data indicators in the LEI have declined now in each of the past three months, and five of the past six. And there is a high correlation between the LEI and GDP, economic activity and corporate profits. As such, the LEI index is suggesting a sharp slowdown is just ahead.

	Jan	Feb	Mar	Apr	May	Jun
Leading Economic Indicators	0.0	0.2	0.1	0.1	0.0	-0.3
Coincident Economic Indicators	0.0	-0.1	0.1	0.1	0.2	0.2
Lagging Economic Indicators	0.5	0.3	0.2	-0.1	-0.2	-0.2
coincident-lagging ratio	98.9	98.5	98.4	98.6	99.0	99.0

Source: The Conference Board

In addition to the Leading Economic Index, economic growth deceleration is visible via the Goldman Sachs Current Activity Indicator. It peaked in early 2018 (not coincidentally about the time President Donald Trump started imposing tariffs on China) and slid further this year. Much of it is due to a manufacturing slowdown, but the consumer and housing segments contributed as well.

The Greatest Economy Ever?



Source: Wall Street Journal

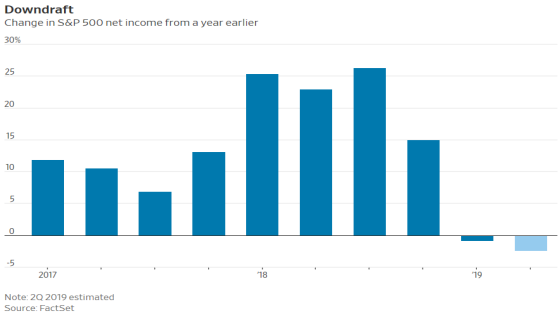
The Fed understands that the economic cycle does not last forever. And after eight years of a debt driven expansion it is highly likely we are closer to the next recession than not. I think the Fed is beginning to panic as they were never able to get yields up to high enough levels to be effective in the next recession. Being caught at the 'zero bound' at the onset of a recession leaves few options for the Federal Reserve to stabilize an economic decline. This is why the Fed may act sooner and more decisively.

THE EARNINGS RECESSION IS HERE

Ever notice how the news agencies always report "earnings per share" and what they did versus "street estimates"? They never discuss what profits are in dollar terms, and rarely mention how they are trending on a year-over-year basis. Well, it's early days yet, with just 13% of the S&P 500 universe reporting thus far, but earnings are running -2.4% on a year-over-year basis. This compares to the +4.1% estimate the consensus had at the end of 2018. Yet even as the

earnings picture has deteriorated, stocks have been pushing higher in a rally that has sent them into record territory. Nothing like a 6.70% miss to the downside to ignite investor 'animal spirits', don't you think?

Earnings Decline



Source: FactSet

Keep in mind this expected decline in second quarter earnings per share (EPS) is distorted by the share buyback craze. In straight-dollar terms, net income is poised to decline by an additional 2% on a year-over-year basis (see *Bleak Earnings Could Rain on Fed's Parade* in the Wall Street Journal). This week 133 S&P 500 companies will be reporting their earnings results — guidance will be most important.

As for the third quarter, the consensus has lowered the numbers down to -0.5% year-over-year from the EPS forecast of +4.6% at the end of last year.

That said, we have the stock market reaching new highs even amidst three quarterly profit declines in a row. This doesn't happen every day, I can assure you of that. But hey – whoever said investing had to make sense?

Source: Houston Chronicle

But the stock market never needed earnings anyway. All it needed was higher EPS. And we know that the higher EPS has not been driven by top line revenue growth. Rather, the higher EPS has been engineered by the debt-financed stock buyback and M&A wave which lowered the S&P 500 share count to a two-decade low. This is what we called 'manufactured' earnings. In no way, does the stock market resemble organic growth or the economy. The stock market today is little more than any commodity that is driven by machines and algos.

NEWS ON HOUSING ISN'T GOOD

U.S. housing starts fell 0.9% in June to 1.253 million units at an annual rate. This followed the 0.4% retreat in May and starts are now down at nearly a 7% annual rate since January. Building permits did not offer much hope of a turnaround, as they slid 6.1%.

Adding insult to injury, the most recent mortgage applications data was down 1.1% and losing ground now in each of the past three weeks. The new purchase sub index slumped 3.8%, in the worst showing in nearly three months, to hit its lowest level in six weeks.

That this has happened in an environment where mortgage rates have come down substantially attests to the view that the debt-burdened economy has lost some of its responsiveness to lower borrowing costs. You will be hearing a lot about 'pushing on a string' once the Fed starts to cut rates at the end of the month. This week, New and Existing Home sales data for June will be released.

A COMMENT ON THE POLITICAL ENVIRONMENT

The level of hatred, polarization, xenophobia, nationalism and the loss not just of the middle class but the lack of anything close to the middle in the political realm has reached extreme levels. If this wide divide in society is what we have on our hands at the peak of the stock market cycle, the peak of the economic expansion and the lows in unemployment, what on earth are things going to look like on the other side? I shudder to think.

It's a good thing the Fed is waking up. Preventing a destabilizing recession at a time of such acute societal tensions worldwide should be front and center on the minds of today's central bankers.

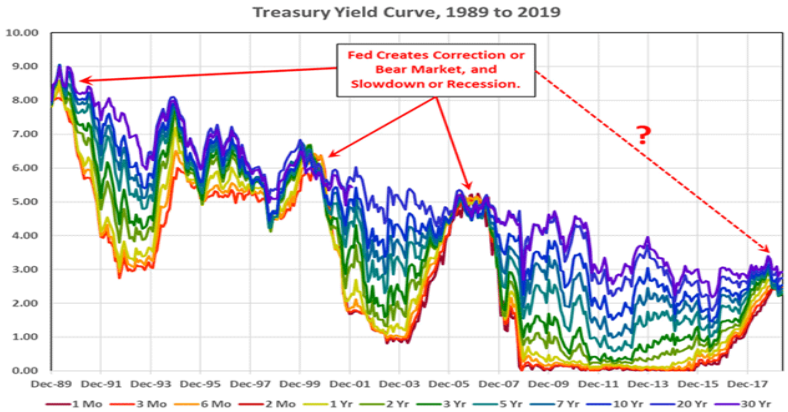
MARKET OUTLOOK AND PORTFOLIO STRATEGY

As we move forward, the risk asymmetry is pretty obvious to me. There is an elevated and rising risk of recession, but there is little risk of sustained inflation coming back any time soon. The litmus test was seven years of free money, endless QE, two huge fiscal stimulus packages and even this bizarre move to raise costs via tariffs and global supply chain disruptions. And still no inflation!

In conjunction with the balance sheet reduction, and the nine rate hikes, it is estimated that the Fed tightened the equivalent of 400 basis points this cycle. If you assume, as Morgan Stanley does, every reduction in the balance sheet reduction is equivalent to a rate increase, then the yield curve (3-month – 10-year) effectively inverted months earlier than most now think. Worse, the tightening from peak QE back in 2015 was far more aggressive and faster than realized.

Furthermore, with regards to the yield curve, long-term yields are high when inflation and/or growth expectations are strong, and low when inflation/growth expectations are low. When the long end falls below the short end (or the short end rises above the long end), the long end is telling us that people are happy to lend long-term at rates lower than the short-term cost of capital and are disinclined to borrow at rates at or above the short-term cost of capital. This probably means some blend of risk aversion and pessimism. On the other hand, the Fed waits until it sees signs of weakness, so it's always behind the curve.

By the time there is evidence of weakness, it's too late for the Fed to do a thing. The point being the bond market gets it right more often than not. And the graph below suggests that the long bond is saying "we're running out of time to ease."



Source: Research Affiliates

Maybe, just maybe, the yield curve is distorted, and a recession will be avoided, but this would be the first time EVER! One thing seems certain: the yield curve isn't signaling higher growth. The *best* you can say is that the mild expansion will continue as it has. That's maybe better than the alternative, but it doesn't make me want to pop any champagne corks.

Also remember: the effects of this most recent tightening have not yet fully percolated through the real economy. As Newton taught us in his laws of motion, every action has an equal and opposite reaction. You don't come out of tightening cycle like this with a 'get out of jail free' card very often.

One more thing – after the Fed eases you will hear that this is an "insurance policy" to "extend the expansion". The same thing was said about the initial rate cuts in 1990, 2001 and 2007.

This is how it actually played out. In January 2001, the Fed cut the fed fund rate (6.5%) by 50 basis points at the first easing and by the end of the easing cycle the funds rate down was at 1%. Then again, the recession nobody saw coming did commence in March 2001, two months after the first rate cut.

In the subsequent easing cycle in September 2007 the Fed cut the fed funds rate 50 basis points. Economists would declare a "soft landing" long after the recession actually began, which was December 2007 or two months after the first reduction in the funds rate. The Fed then quickly went to a zero interest-rate policy (ZIRP) along with multiple rounds of quantitative easing and Operation Twist.

Moving forward, if the consensus is right that this is a 'soft patch' and nothing else, then I believe the Fed will ease 75-100 basis points to remove the excess policy restraint.

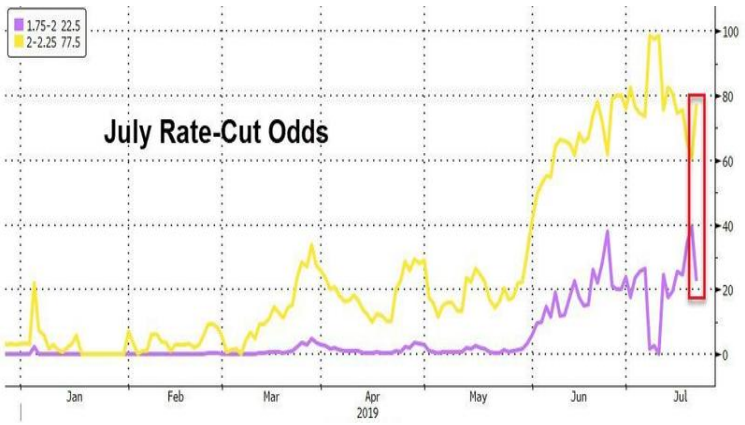
But if the weakness in the economy becomes well entrenched, and we head into recession, then history tells us the Fed ends up cutting by at least 200 basis points. The average rate reduction in a recession is 500 basis points!

Do the math. From the 2.25-2.50% starting point you can see why the Fed will have to get even more creative and aggressive once we get back to the ZLB — the Zero Lower Bound.

The consensus expectation calls for a 25 basis points cut in the target interest rate, while I expect the Fed to deliver 50 basis points. The market is pricing an outcome somewhere in between, with fed funds futures implying around 30 basis points.

Let's also not forget the European Central Bank (ECB), which is poised to cut rates further into negative terrain and revive asset purchases.

What Will the Fed Do on July 31?



Source: Bloomberg

Finally, in terms of investment performance, I believe one can make a strong case that 'excess cash' is, has been and will continue to be the worst place to be in terms of portfolio performance as we move forward.

As has been stated in this space virtually every week, the most conservative and prudent approach to managing excess cash reserves is to build a high quality, broadly diversified and duration appropriate ladder strategy. If you wait for the Fed to cut rates you may miss out on the ability to lock in higher rates today.

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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.