BALANCE SHEET SOLUTIONS
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WEEK OF AUGUST 5, 2019

Weekly Relative Value

The Trade War Heats Up

"I am a Tariff Man… We are right now taking in $billions in Tariffs.
MAKE AMERICA RICH AGAIN." – President Donald Trump, December 4, 2018 via Twitter

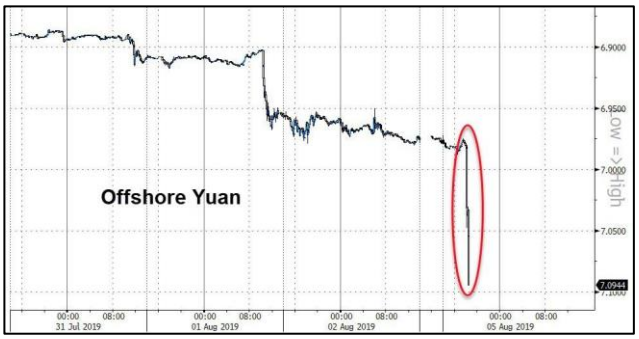
"Trade talks are continuing, and during the talks the U.S. will start, on September 1st, putting a small additional Tariff of 10% on the remaining 300 Billion Dollars of goods and products coming from China into our Country."
– President Donald Trump, August 1, 2019 via Twitter

So much for heading to the beach.

President Trump has changed the market tone for August by tweeting he will implement new tariffs of 10% on the remaining $300 billion of imports from China, effective September 1. As a reminder, that's on top of the 25% tariff on around $250 billion of other Chinese imports.

The U.S. accused China of backtracking on a trade deal as Beijing insisted on some of its own demands. This time, the U.S. faulted China for not stepping up to buy more U.S. farm products. Trump specifically said that Chinese President Xi has not followed through on his promises by not increasing purchases of U.S. agricultural goods nor stopping the flow of Fentanyl, a synthetic opioid, into the U.S. He also said, "Until such time that there is a deal, we will be taxing the hell out of China."

And to no one's surprise, China countered. For the first time since 2008, the People's Bank of China (PBOC) has lowered the value of the offshore yuan below 7.



Source: Bloomberg

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

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THIS WEEK

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PORTFOLIO STRATEGY

The PBOC has said that the moves are due to tariff expectations and protectionism. The question for the market now is what the response of the U.S. administration will be.

It's worth noting that this morning China also asked state-owned companies to suspend imports of U.S. agricultural products, which is clearly adding to the negative circle of news flow.

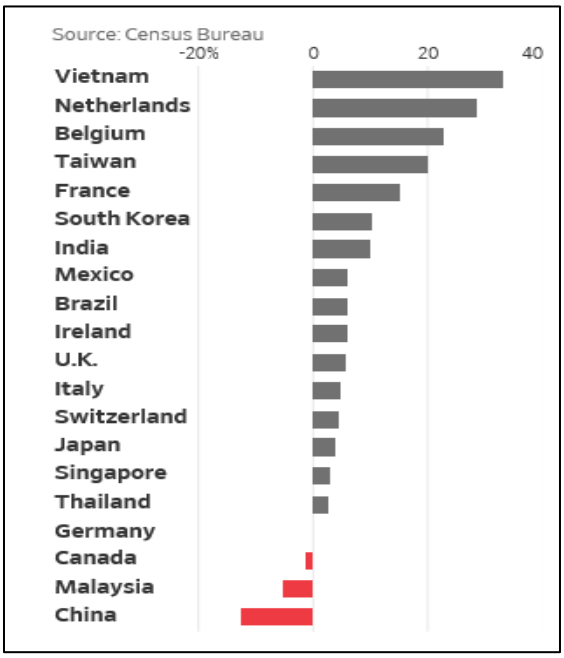
And sure enough, President Trump this morning has escalated his rhetoric: "China dropped the price of their currency to an almost historic low. It's called 'currency manipulation'…"

Then Trump added the following, clearly pushing Fed Chair Jerome Powell to do more: "…Are you listening Federal Reserve? This is a major violation which will greatly weaken China over time!"

And there you have it. One thing is safe to say: Trade wars are not easy to win!

ZERO SUM GAME

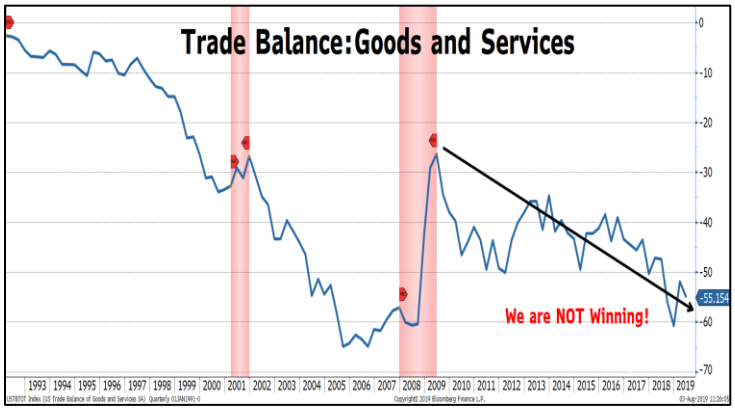
Last week it was reported that imports from China fell 12% in the first six months of 2019 from a year earlier, while exports fell 19%. Meanwhile, combined imports from South Korea, Taiwan and Vietnam were up 9.2%, suggesting some substitution away from China. As a result, Canada and Mexico are now the U.S.'s top trading partners.



Source: Wall Street Journal

In effect, Mr. Trump has succeeded in shifting imports from China to Vietnam, Taiwan, South Korea and various European countries. It's called a zero-sum game. As shown in the following graph, despite the decrease in trade with China, the trade deficit has widened since the initial tariffs went into effect.

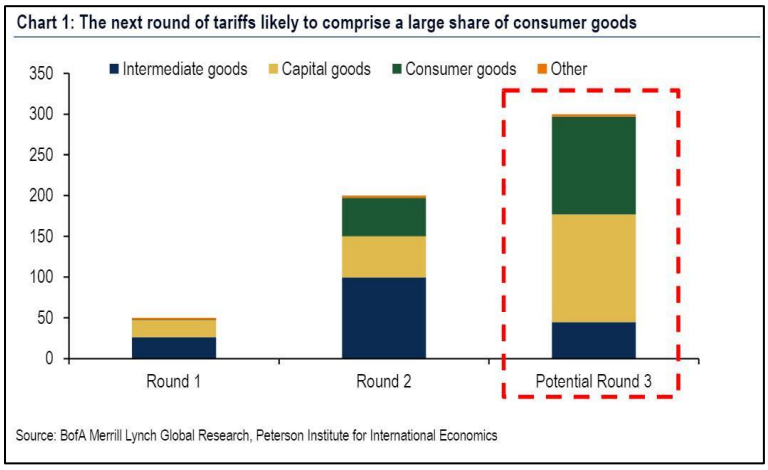
Furthermore, according to the Bank of America, this latest proposed round is a "game changer." It will hit consumer goods, which mostly had been excluded from the previous levies. Notwithstanding Trump's oft repeated, but baseless, claim that China pays the tariffs. Tariffs are levied on U.S. businesses and consumers.



Source: Bloomberg

This means that the consumer – which has been the bright spot in the recovery – could be hit. The consumer has otherwise been fairly insulated from the global pain, supported by steady job growth, strong stock market returns and falling borrowing costs. Going forward, watch if consumers actually change their spending behavior. If consumers cut back, growth will decelerate**.**

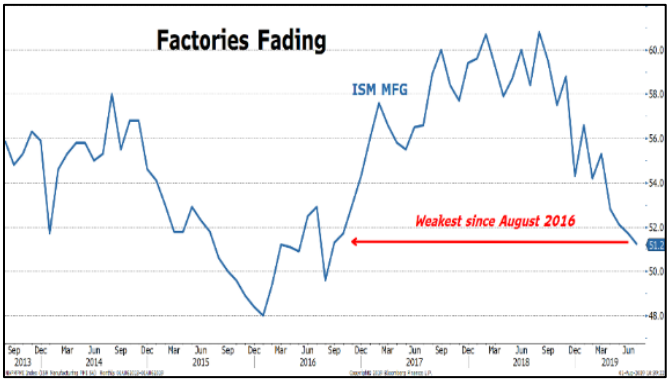
And Strategas Research Partners notes, the dollar amount extracted by the tariffs will exceed the incremental benefits in 2019 from the tax reductions enacted last year. The additional $30 billion from the proposed 10% tariff on $300 billion of Chinese imports, due to take effect next month, would bring the total take from the duties to $138 billion this year — more than the $122 billion of additional benefits from the tax cuts. The government gives and then takes away.



The additional tariffs came as markets were already trying to digest more evidence of a further slowdown in manufacturing activity. As shown in the graph on the following page, manufacturing has been steadily weakening as the impact of trade policy has affected business decisions.

Business confidence is being affected by tariffs and is falling markedly. Fed Chairman Powell says the biggest threat from trade dispute is the impact on business confidence: "*The mechanical effects of the tariffs are quite small... as it relates to U.S. economy. The real question is what are the effects on the economy through the confidence channel, business confidence channel, and again very, very hard to tease that out… You have to look at a range of estimates, and I think*

businesses will tell you that it's a factor, particularly manufacturing businesses that have supply chains that cross international borders will all tell you that it's been a challenge."



Source: Bloomberg

In essence, trade policy uncertainty makes it more difficult for business leaders to make decisions about capex and hiring. Business confidence peaked in early 2018, coincident with the imposition of tariffs on Chinese-made solar panels and washing machines. Confidence has since fallen sharply. More tariffs are likely to exacerbate this negative trend in business confidence. This in turn will negatively impact manufacturing in the U.S.

JOB GROWTH SLOWING

The U.S. economy generated 164,000 jobs in July. However, the two preceding months' total was revised downward by 41,000.

And while the headline employment data met expectations, the shrinkage in the workweek is a disturbing sign, because companies cut hours first and bodies later. This is why the manufacturing workweek, and NOT headline employment (lagging indicator), is one of the 10 components that make up the Conference Board's Index of Leading Economic Indicators.

Also, keep in mind the birth-death model added 67,000 to that 164,000 number despite new business creation stagnating. So, the birth-death model continues to skew the headline in a deceptive upward fashion. The headline without the "plug factor" was actually +97,000. Then, take into account the 41,000 net downward revisions to the prior two months, and we get 56,000. In other words, this report, holistically, was a dud.

Finally consider this: The past three payroll reports have shown downward revisions. This typically happens in an economy that is losing momentum. It should also be pointed out that temp agency employment – a great leading indicator – has stalled out since February. What does that tell you about the strength of the labor market?

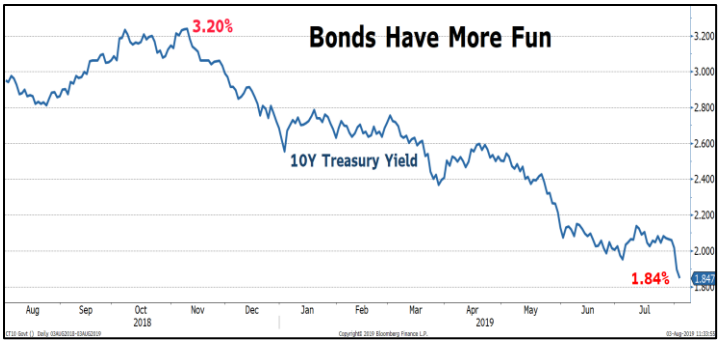
Market Implication: This report is bullish for bonds and keeps the Fed in play, with or without the renewed trade turmoil.

BONDS HAVE MORE FUN

When watching business news or reading the Wall Street narrative, all I ever hear from the stock market crowd is: "Who would buy Treasuries at these levels?" The funny thing is, they are saying it now as they were a year ago when yields were 100 basis points higher. Obviously, those equity geeks need a refresher in bond math. At any rate, the 10-year Treasury note has generated a total return of 13% in the past year, and the long bond ("the bond") has triggered a net

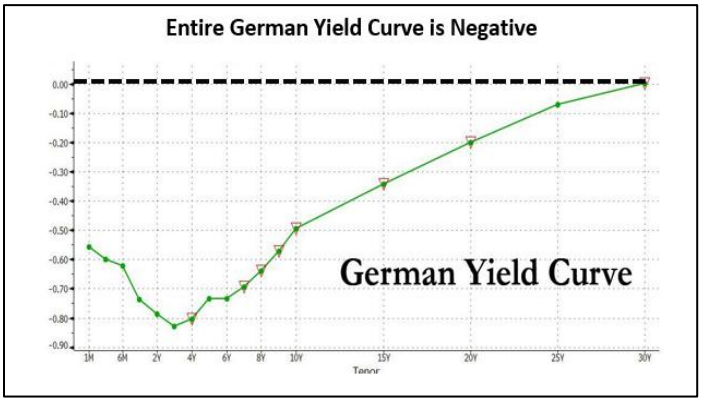
total return of 18%! Oh yes — the total return in the U.S. stock market is +6.6% over the past 12 months. So yes, there are times when bonds do have more fun.

10-Year Treasuries Generate a 13% Total Return



Source: Bloomberg

Meanwhile, on the back of horrific economic data and expectations of further rate reductions, eurozone bond yields tumbled, with German 10-year government bond yields dropping more to an all-time low of -0.53% while the 30-year dropped below zero for the first time ever.



Source: Bloomberg

Amazingly, as shown in the preceding graph, the German yield curve from one-month to 30-years has a negative yield. As such, Germany joined Denmark and Switzerland in offering negative returns across all maturities and assuring losses to all investors should notes be held to maturity, taking the total stock of investment-grade debt yielding less than 0% above $14 trillion globally.

Guess where Treasuries, the world's "high yield" investment grade market, are heading?

SHOCK AND AWE

The Financial Times column ***"'Shock and Awe' Must Be Response to Threat of Zero Yields,"*** by Bob Michele, Global Head of Fixed Income at JPMorgan Asset Management, should be on everyone's must-read list.

Here are some of his insights below. Bolded text are my insertions for emphasis.

"Ten-year US Treasury yields could be headed to zero*. This is not a forecast. This is not a bold prediction. This is not something that we hope happens.* ***This is an observation of what is unfolding in the markets right in front us."***

*"**Today, about one-third of the global government bond market and one quarter of the global aggregate bond market have negative yields**. We should consider it a warning — that this is the path the US market is on unless there is an adequate policy response."*

"The US economy could be characterized as 'OK.' So, what is driving the flows into government bonds and where is money coming from? More importantly, where so yields go now?"

"There is also the very real risk that inflation expectations have become unanchored and central banks are gradually becoming powerless**. New York Fed President John Williams captured that risk nicely this month by saying that, **"Investors are increasingly viewing these low inflation readings not as an aberration but rather a new normal."

MARKET OUTLOOK AND PORTFOLIO STRATEGY

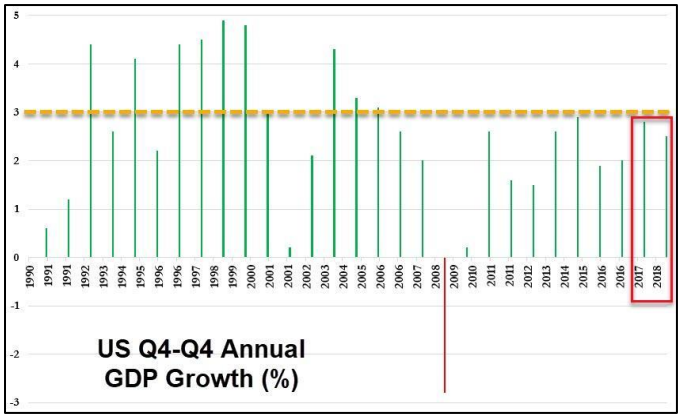
Fed Chairman Powell delivered the widely expected quarter-point cut. Powell said the modest cut was to protect the economic expansion in a time when uncertainty around trade policy has been "more elevated than we anticipated." He characterized the move as "a mid-cycle adjustment to policy" and said it was not "the beginning of a lengthy cutting cycle."

"Mid-cycle adjustment to policy." Huh...?

- The current U.S. expansion is now the longest in history at **122 months.**
- The second longest expansion (from the early 1990s to the dot-com bust) was 120 months.
- The average expansion? Around 60 months.

"Mid Cycle" infers we will now double the longest expansion in history. That's not happening.

And for those paying attention, there was a hefty downward revision for 2018 GDP to 2.5% from 3.0%. As shown below, 2.5% growth is hardly anything to brag about, especially in the context of massive fiscal stimulus and tax cuts. The growth rate is comparable to the prior administration's record. It surely is not the greatest economy of all time.

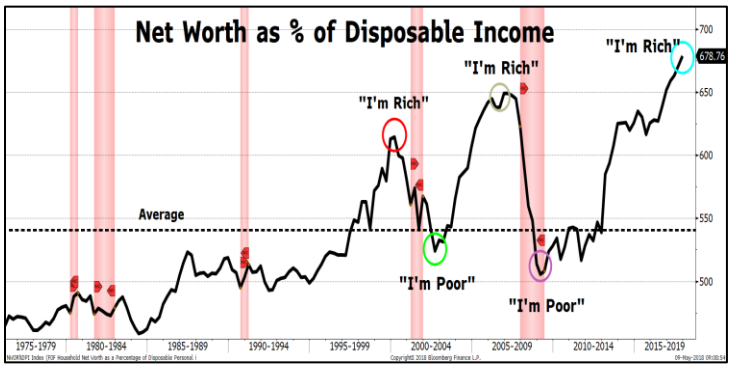


Source: Bloomberg

As an aside, according to the pundits, the recession-odds are now zero because GDP printed 2.1% in the second quarter. However, prior to every recession since 1948, real GDP growth had a plus sign in front of it the quarter preceding of the quarter of the downturn's onset — the average is 3.2% and median is 2.4%. In other words, it is 100% normal for GDP to print positive the quarter before the recession or, in fact, the quarter in which it begins. The last downturn was not

when Lehman or Bear Stearns collapsed; it was in December 2007. The financial shock doesn't cause the recession. The recession causes the financial shock. This also happened in 2001 and 1990.

There are distress signals in a number of U.S. indicators. Consumer spending is the only thing keeping GDP up right now. And consumption is closely linked to asset appreciation. If asset prices decline, consumers will get nervous and the GDP numbers will roll over.



Source: Bloomberg

Let's also remember the Conference Board Leading Economic Indicator slid 0.3% in June. While the initial jobless claims numbers remain extremely low, that is likely due to companies that are hoarding their skilled staff given what's left in the depleted pool of available labor. Meanwhile, the decay in the Challenger hiring announcement data of late is a tad disconcerting. Not to mention the fact that small business employment in the ADP report has shrunk now for two months running. This is the best leading indicator of all. It leads what happens at the large-company level.

On the inflation scoreboard, the year-over-year trend in the core personal consumption expenditures (PCE) deflator has decelerated to 1.5%. This is actually a touch below the 1.6% trend in the fourth quarter of 2008 when the world was falling apart. This is now month #121 of the economic expansion, a record for duration, and the jobless rate is well below 4% at the current time and the equity market at new record highs. Ever stop to think what happens to underlying inflation when the party stops?

And while the Fed was hoping to steepen the yield curve with its 25-basis-point rate cut, the inversions strengthened dramatically.

Inversions Strengthen

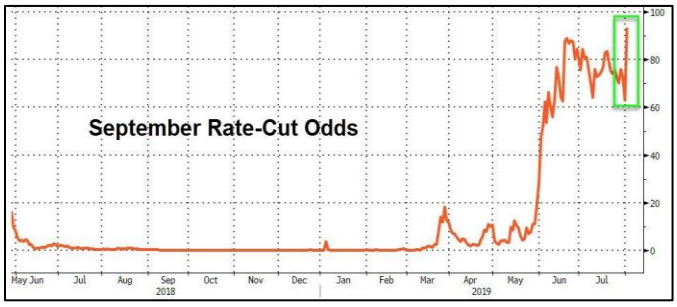
Duration	Level Aug 3, 2019	Spread to Next Lower
30-Year	2.377	0.534
10-Year	1.843	0.105
7-year	1.738	0.076
5-year	1.662	-0.009
3-Year	1.671	-0.039
2-Year	1.710	-0.152
1-Year	1.862	-0.152
6-month	2.014	-0.047
3-Month	2.061	-0.057
1-Month	2.118	-0.022
Fed Funds Rate	2.140	

Inversion 29.7 Basis Points with FF Rate, 27.5 With 1-Month

Max Inversion 47.8 Basis Points

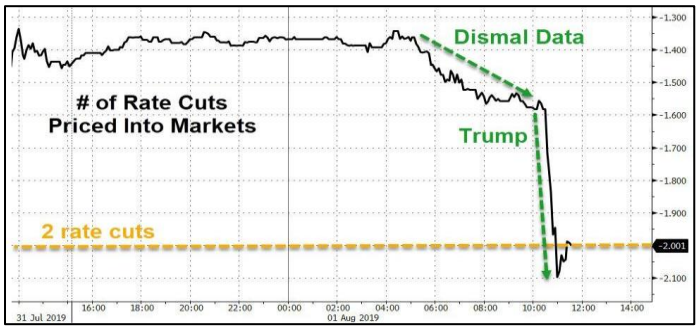
Source: Bloomberg

As the markets move past the Fed and begin to focus on weaker earnings and economic growth, the backdrop becomes more problematic for the bullish case. The futures market is now assigning a 100% probability of the Fed moving again in September.



Source: Bloomberg

And as shown below, the market now believes the Fed will cut two more times in 2019. In other words, they are not buying into Powell's "mid-cycle' theory one iota.



Source: Bloomberg

My outlook: If this is a "soft landing," the Fed likely will cut no more than three times. On the other hand, if it is a "hard landing," the historical evidence suggests we are heading back down to zero-bound on the funds rate (and expect to see this happen in the next 12 to 24 months). It could be quicker than that, but all anyone needs to know is that yield curve dynamics will end up taking the 10-year Treasury note yield to 1.0% and the 30-year below 2.0% before all is said and done.

In terms of portfolio management, credit unions should continue to remain fully invested. Excess cash will continue to negatively impact portfolio returns.

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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
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> – Darin Higgins, President of Western Illinois Credit Union

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MORE INFORMATION

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.