BALANCE SHEET SOLUTIONS
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WEEK OF AUGUST 12, 2019

Weekly Relative Value

Troubled Times

"Some say the world will end in fire,
Some say in ice.
From what I've tasted of desire
I hold with those who favor fire.
But if it had to perish twice,
I think I know enough of hate
To say that for destruction ice
Is also great
And would suffice."
– Robert Frost, Fire and Ice

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

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THIS WEEK

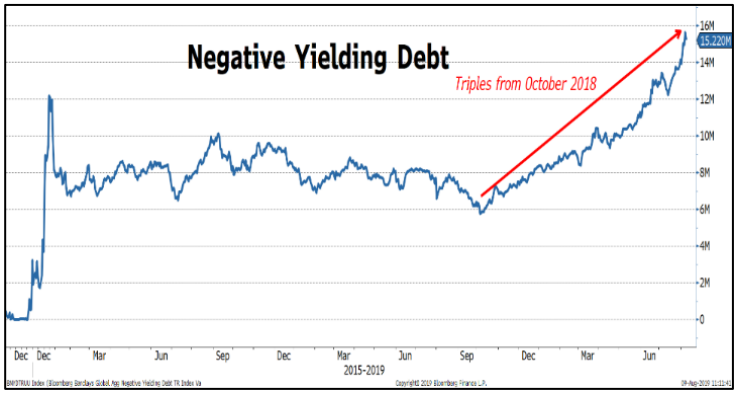
- AWASH IN DEBT
- TRADE AND CURRENY WAR
- THE FED AND GOLD
- THE WORLD IS SPLINTERING
- SOCIAL AND POLITICAL DIVIDE
- NATIONALISM AND PROTECTIONISM

PORTFOLIO STRATEGY

- LOWER FOR LONGER

I believe we are living through a period of history that may well be discussed and written about for decades to come. Today, the total amount of bonds outstanding globally trading with a negative yield exceeds $15 trillion. Think about that: 25% of the global bond market now sports a yield less than ZERO! This includes government and corporate debt, and also some euro junk bonds that have joined the elite group of chasing each other further and further into the negative-yield absurdity. Yet, no yield seems too low as investor demand shows no sign of abating.

Negative Yielding Debt Exceeds $15 Trillion



Source: Bloomberg

In Europe, bond yields continue to amaze. Joining Switzerland and the Netherlands, all maturities of German bunds—the benchmark for euro-denominated bonds—sank below

zero percent. So, investors who held a 10-year bund would realize an annual loss of 0.56% if held to maturity.

It's akin to paying a bank for a safety deposit box.

And Denmark's third largest bank – Jyske Bank – is now offering borrowers mortgages at a negative interest rate, effectively paying its customers to borrow money for a house purchase. Borrowers can now take out a 10-year fixed-rate mortgage with an interest rate of -0.5%, meaning customers will pay back less than the amount they borrowed.

What this means is that if you buy a house for $1 million and pay off your mortgage in full in 10 years, you would pay the bank back only $995,000. No mortgage payments would be due between the purchase and payoff date, so effectively a borrower only has to repay principal, with a small discount, guaranteeing that the bank loses money on the loan. In a nutshell, banks are now paying borrowers while crushing savers who have to suffer negative interest rates on their deposits.

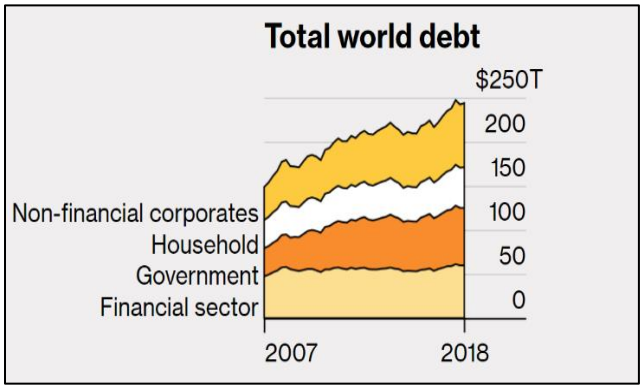
And back at home, with the 30-year Treasury bond pushing yields toward modern-day lows, Pimco has declared it's no longer "absurd" to think about negative yields reaching the Treasury market too.

It may not make sense, but it points to an unusually high degree of risk aversion. But, it's also definitely a hallmark of an investor psyche of a "return of capital" as opposed to a "return on capital." But let me be clear, this is totally abnormal because it reflects an abnormal economic, financial and political backdrop.

AWASH IN DEBT

As the central banks have cut interest rates to 5,000-year lows, it has made it much cheaper to borrow. So, governments, corporations and households have been throwing a giant debt party for the past decade, which has created artificial economic activity. In other words, without the massive debt increase, there would be no growth. And this is why I believe our economic recovery (both U.S. and global) isn't a genuine recovery because it's driven by debt and new economic bubbles.

Global Debt Has Risen $100 Trillion Since the Great Recession



Source: IFF

Since the Great Financial Crisis, global debt has increased by $100 trillion and is now $244 trillion or 320% of global GDP. As the saying goes, insanity is defined as "doing the same thing over and over and expecting different results." We are doing exactly that by continuing to lever up the global economy and expecting sustainable economic growth. There is simply no way this debt will or can be paid. The only way forward is through a grand reset, one which inevitably involves hyperinflating the debt away. Thus, anyone who thinks that another crisis is far-fetched is incredibly naive.

Unfortunately, I believe the next one will be even worse simply due to the fact that we have an additional $100 trillion worth of debt to deal with now.

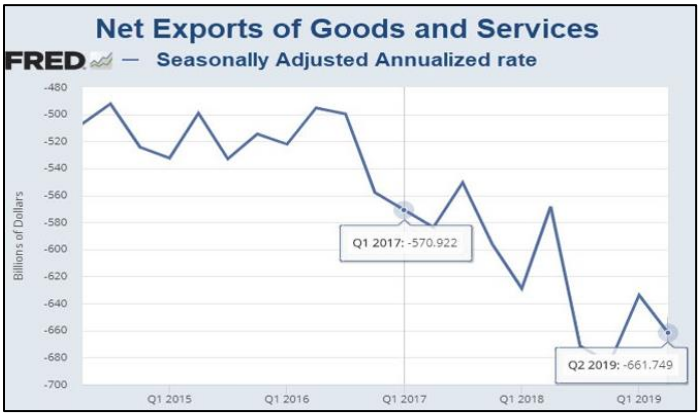
TRADE AND CURRECY WAR

And of course, we have a trade, currency and economic war between the U.S. and China – with no side willing, or perhaps able, to back down at this point. While some may say this is "4-D" chess, I believe the administration is rolling-the-dice. Trump's trade war is looking more and more like a classic policy quagmire. The trade war is failing in its goals, at least as Trump sees them: the Chinese aren't crying uncle, and the trade deficit is rising, not falling.

"Billions of Dollars are pouring into the coffers of the U.S.A. because of the Tariffs being charged to China, and there is a long way to go. If companies don't want to pay Tariffs, build in the U.S.A. Otherwise, let's just make our Country richer than ever before!" – President Donald J. Trump, November 29, 2018

Let's review: Since Trump launched his ever-escalating trade war, net exports have fallen by $90.8 billion.

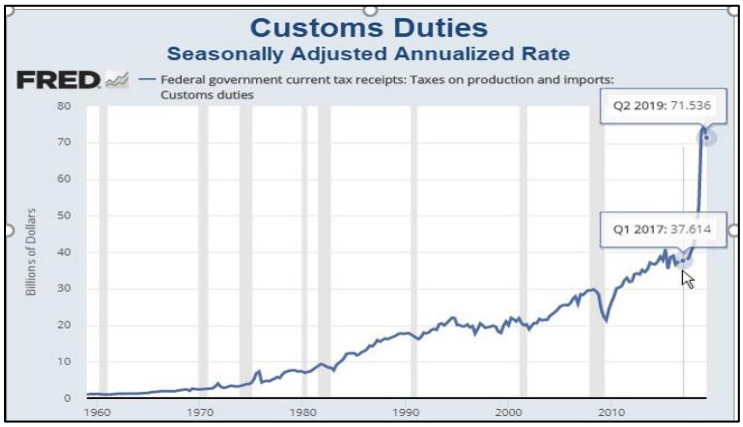
Exports Plunge



Source: St. Louis Federal Reserve

Customs duties (tariffs) have risen by $33.9 billion.

Tariffs Rise



Source: St. Louis Federal Reserve

And last, but not least, tariffs – which are taxes on consumers and business – are up by about $100 billion.

The alleged "massive" amount of money is an additional $33.9 billion while net exports are down by $90.8 billion and taxes on consumers are up.

Question: Is this making "America richer?"

China, in turn, is threatening retaliatory measures of its own — and delivered by ceasing purchases of U.S. soybeans and is engaging in a round of currency devaluation for the first time since August 2015. Last week, the yuan pierced 7 to the dollar — the first time it has touched this threshold since 2008. The People's Bank of China (PBOC) made it very clear that this was a response to "unilateralism trade protectionism measures and the imposition of the increased tariffs on China."

While we are told China has much more to lose in this trade war, people are missing the big picture. Beijing could ban the export of rare earths that are used for things like consumer electronics to military equipment. America needs this. Or how about discontinued purchase of Boeing airplanes in addition to soybeans? Think it through. China also can step up what it's already doing to American companies — surprise inspections, shipment delays, license rejections and the big bomb, which is a boycott of American goods. Simply put: There is no winner from a global trade war.

The Chinese Yuan Depreciates

Source: Bloomberg

Here we have a trade and currency war going on between the world's two dominant powers — and with no endgame in sight. Tariffs on Chinese goods are back to levels we associate with pre-1930s protectionism.

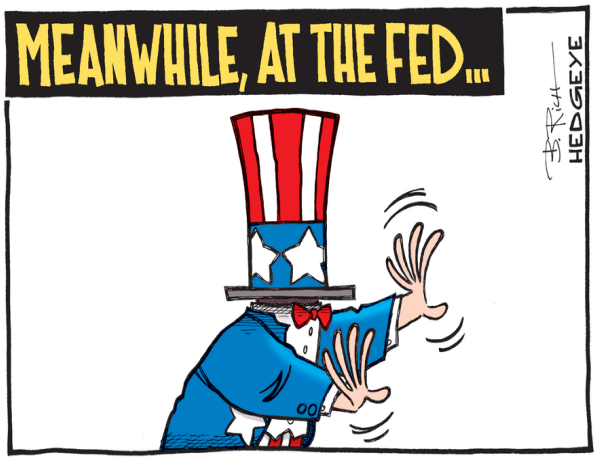
The trade war is reaching the point where it becomes a significant drag on the U.S. economy. The economics team at Goldman Sachs uttered the "R-word" in a report overnight, concluding that, "Fears that the trade war will trigger a recession are growing." Welcome to the club, fellas. Larry Summers also has weighed in and made it clear that the global economy is at its riskiest turning point since the 2008/09 financial crisis.

THE FED AND GOLD

Moving on. The Federal Reserve has done little but sow confusion. The Fed has constantly bungled its communications with the market and has flip-flopped in a manner I have not seen in four decades in the business.

Chairman Powell did a "pivot" in January but didn't act until July. And after sounding very dovish at his semi-annual congressional testimony, he walked that sentiment back at the following meeting saying this wasn't going to be an

easing cycle. Why on earth would he say that? Meanwhile, there has been at least one dissent at each of the past two Federal Open Market Committee (FOMC) meetings, and half of the central bank is dovish, and half is hawkish.

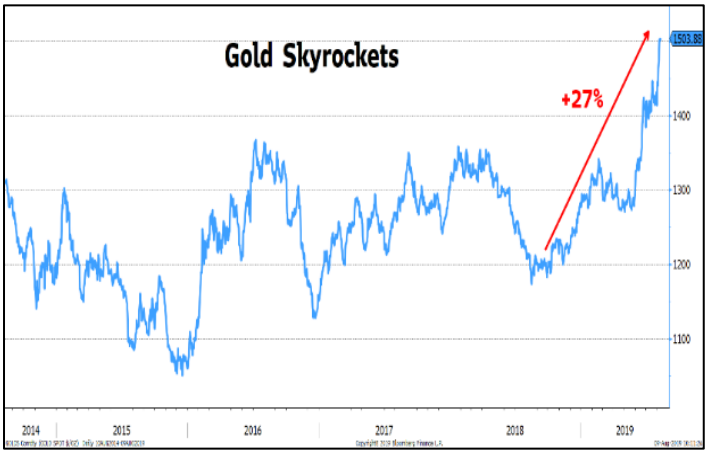


Source: Hedgeye

All the while, gold prices have broken out in recent months. In fact, **gold is at all-time highs in 73 different countries** and central banks are adding bullion to their reserves. Cryptocurrencies have made a big comeback as well (the usage is becoming increasingly commonplace). This is a complete reflection of the lack of faith in the system.

"It's interesting, people say it's the low interest rates [driving the price up]. We had low interest rates years ago, but all these things have not mattered. ***Now, they are talking about low interest rates, negative interest rates and debt levels, and it's all coming to the forefront at once, and they don't have the physical gold to do what they did for so long****..."*
– Bill Murphy, Chairman of the Gold Anti-Trust Action Committee (GATA)

The Gold Rush is On!

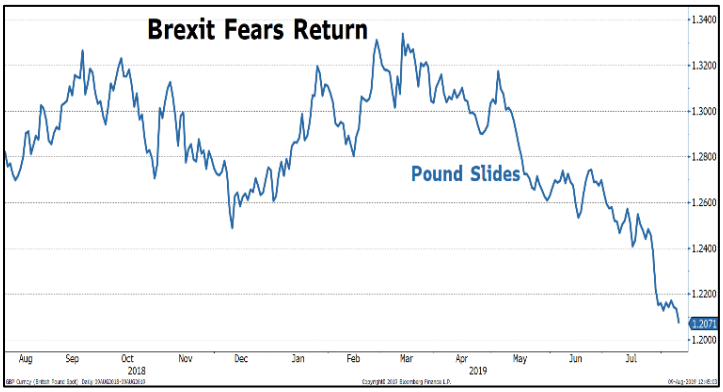


Source: Bloomberg

THE WORLD IS SPLINTERING

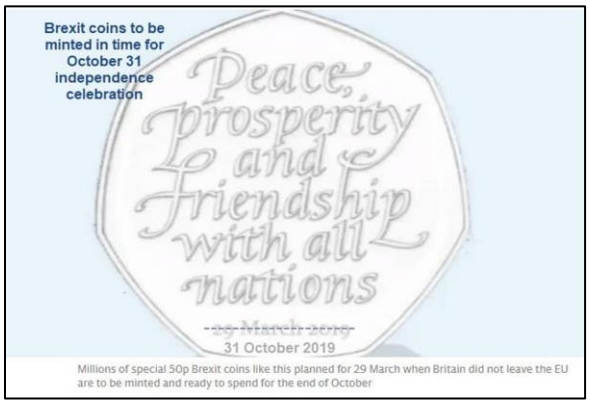
Meanwhile, the world is splintering. The odds of a "no deal" exit on Brexit come October 31. As shown below, the British pound is at a level that it has seen in just 16 sessions since 1975.

Will Britain Stay or Go?



Source: Bloomberg

Plans for "Peace, Prosperity and Friendship" coin are underway in the U.K. They will be minted in time for Brexit Day.



And there are other deep divisions within the EU. Italy may be the next country to opt out. North Korea and Iran remain wild cards. Japan and South Korea are having a trade war. Out of nowhere we also have these renewed tensions between India and Pakistan. And the situation in Hong Kong bears watching – especially if the peg with the dollar is broken.

SOCIAL AND POLITICAL DIVIDE

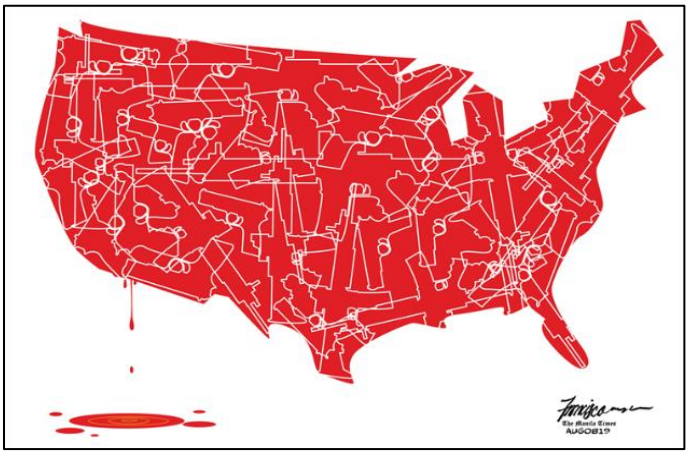
On a social and political perspective, there is growing frustration that no matter who is in power, politicians aren't working for the masses. There is a disturbingly high level of acrimony and divisiveness in this country. We have a backlash against the inequality trifecta (of income, wealth and opportunity), the politics of anger, the growth of anti-establishment movements, the loss of trust in governments, the growing risk of financial instability.

As of August 5, which was the 217th day of the year, there have been 255 mass shootings in the U.S., according the nonprofit Gun Violence Archive (GVA), which tracks every mass shooting in the country. The GVA defines a mass

shooting as any incident in which at least four people were shot, excluding the shooter. The toll of 255 mass shootings include five high-profile massacres in the past eight days, in which more than 100 people have been shot.

Are the horrific mass killings a signpost of a society starting to come apart at the seams? Is it a sickness related to social media? Or maybe it's from the ability to spread "alternative facts" so easily on the Internet, to the point where people can't discern what is fact and what is fiction? Is it a reflection of the huge gap between the "haves" and "have nots?"

Violent Gun Country



Source: Cagle Cartoons

NATIONALISM AND PROTECTIONISM

Beyond the deep social and political divisions at home, we have the rising tide of nationalism and protectionism that is reminiscent of the 1930s. Post the Marshall Plan, the world experienced a high degree of world coordination and integration. It has not been perfect, but it has led to an unprecedented period of global stability. And unless the political leadership vacuum is filled, we are on a slippery slope. The past 70 years in which the world became smaller and worked together to make it a better place are at risk. The ugliness of hate, blame, mistruths, nationalism and populism have staged a revival.

In summary: Gold prices surging. Bond yields plunging. Central banks in a confused state. Social and political fissions. The breakdown of the world order.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

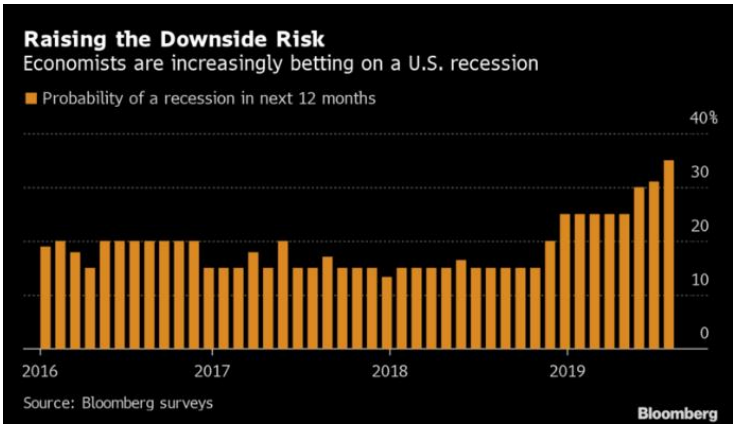
The Inevitables | Seeking Alpha
https://seekingalpha.com/article/4137086-inevitables
Jan 12, 2018 - Jeffrey Gundlach said the 10-year **Treasury yield** topping 3 percent ... "The last **line in the sand** is 3 percent on the 10-year," Gundlach said.

'Bond king' Bill Gross draws line in sand for 10-year yield
https://www.ft.com/content/2d954032-d756-11e6-944b-e7eb37a6aa8e
Jan 10, 2017 - Bill Gross, known as the "**bond** king", has drawn a **line in the sand**, warning that the US **Treasury** market is close to moving into a secular bear ...

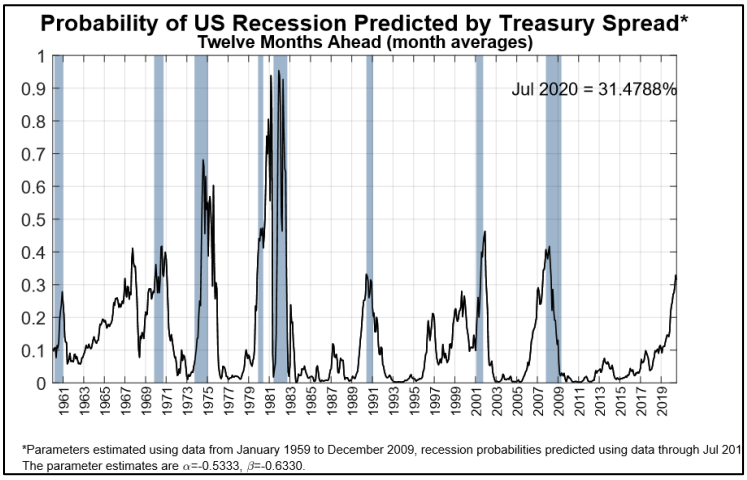
Today, the yield on the 10-year Treasury benchmark is 1.69%.

The U.S. economy is losing momentum. Gross domestic product expansion is forecasted to slow to a 1.8% annualized pace in the third quarter, from 3.1% in the first three months of the year and 2.1% in the second quarter. The July jobs report reflected an economy that is clearly slowing down into the third quarter. In the past three months, payroll gains have averaged 140,000, compared with 223,000 for all of last year. Manufacturing has averaged just 8,000 so far this year, a big haircut from 22,000 per month in 2018. Goods-producing employment in general is down to 23,000 on average so far in 2019 (15,000 in July), and that compares rather unfavorably to 58,000 last year. And as shown below, economists are raising their probability of a near-term recession. The likelihood of a U.S. recession in the next 12 months rose to 35% in August, from 31% forecast previously.

Recession Odds Increase



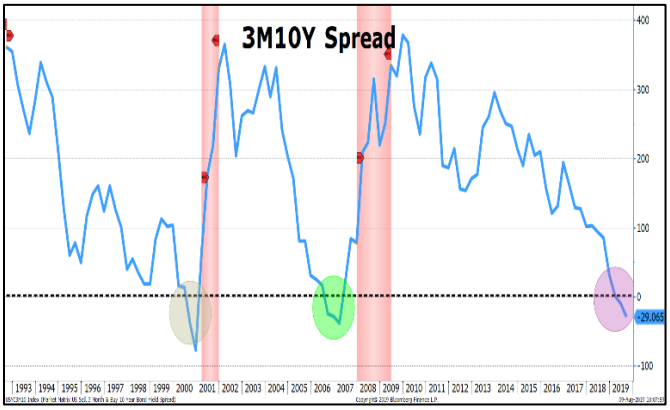
The New York Fed Recession Risk Model has now risen to a decade high of 32%. And as indicated on the graph below, anytime this model has reached 32 in the past, a recession has followed like day turns to night.



Source: New York Federal Reserve

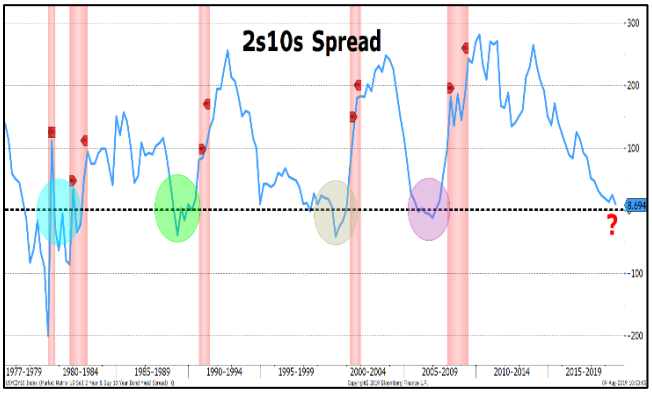
The ever-prescient yield curve is blaring the loudest recession warning since 2007.

The three-month/10-year spread has remained in negative terrain for six months. Every time this has happened historically, a recession has followed within 12 months.



Source: Bloomberg

Likewise, the two-year/10-year spread has collapsed to eight basis points. Once again, this spread is screaming that the economy is slowing, and a recession is imminent.



Source: Bloomberg

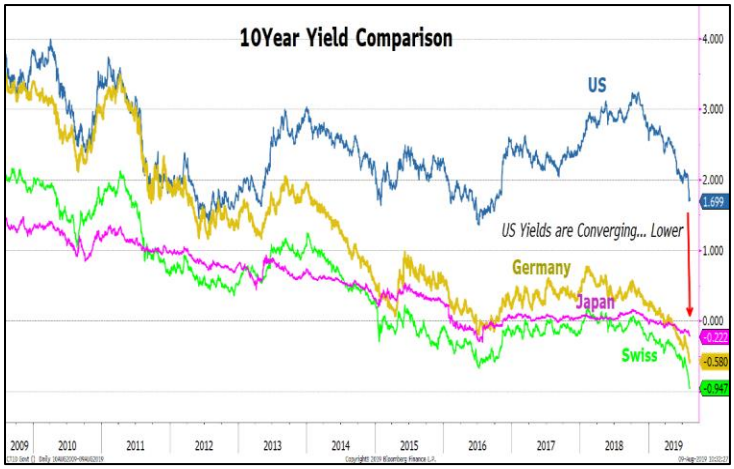
And, regardless of what the Fed says, Mr. Market is saying "sorry, but you're wrong once again" — and is now pricing in 100% odds of a September rate cut and 75% odds for two more cuts by year-end.

LOWER FOR LONGER

Historically, the only time rates were this low was back in the Great Depression of the 1930s where the country experienced a long stretch of deflation. This is the point: In periods of secular deflation, interest rates stay low and yield curves stay flat — not for years, but for decades. As in three decades or more. This past 10-year experience was likely just the first down payment. And the unprecedented level of global debt, as we saw with this entire round trip from the July 2016 yield lows in the Treasury market to the highs in November 2018, attests to the complete inability for interest rates to rise very much or very long.

And finally, please remember**:** This meltdown in global market interest rates has happened, not at the bottom of the economic and equity cycle, but at the top! Imagine where they go when the recession comes, unemployment rates rise, and equities decline. Even in the U.S., a move to negative yields out to the 10-year part of the curve is a distinct possibility. After all, who thought this could ever happen in Germany or France?

U.S. Rates are Converging Lower!



Source: Bloomberg

As stated in this space more than a few times, in periods like this, high-quality bonds are usually a very good place to be. And the U.S. bond market looks downright juicy in the big scheme of things. It is no wonder that demand for 30-year U.S. Treasuries has been so strong that yields fell as low as 2.12%, just shy of the lowest level since the Treasury began regular sales in 1977.

We continue to urge credit unions to maintain a risk-appropriate, high-quality ladder strategy.

CREDIT UNION EXECUTIVE LEADERSHIP SYMPOSIUM

Credit Union Executive Leadership SYMPOSIUM

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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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> – Shawn Nikkel, Finance Director of Denver Fire Department FCU

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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.