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WEEK OF SEPTEMBER 23, 2019

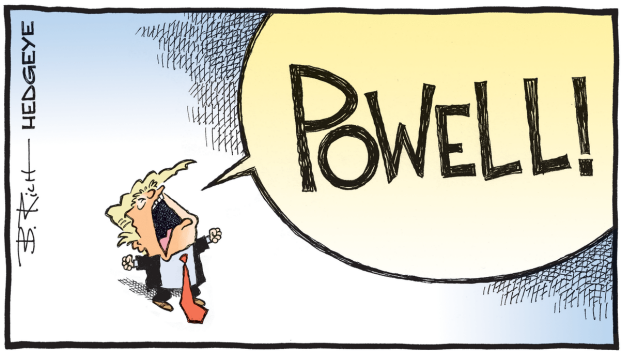
Weekly Relative Value

Ignore the Dots

"Jay Powell and the Federal Reserve Fail Again. No 'guts,' no sense, no vision! A terrible communicator!" – President Donald J. Trump, September 18, 2019

To no one's surprise the Fed cut the funds rate by 25 basis points last week to a 1.75%-2.00% range. There was very little in the way of forward guidance and this remains an extremely divided central bank. Voting against the action, St. Louis Fed President James Bullard preferred to lower the target range for the federal funds rate to 1.50% to 1.75%. He must be lobbying with the President for the Chairman's seat. Kansas City Fed President Esther George and Boston Fed President Eric Rosengren both preferred to maintain the target range at 2.00% to 2.25%.

Tantrum



Source: Hedgeye

This bifurcation is unusual. It is likely that the decision to lower rates by 25 basis points this past week represented a compromise between the two camps, which would explain why there were dissents both from officials who wanted sharper reductions, as well as officials who wanted not to cut at all. The question is, which group has the better grasp of what the economy needs?

With regards to the economy, the Fed did state that household spending has been rising at a strong pace, however, the Fed downgraded its assessment of both business investment and exports, mentioning how both have weakened. The Fed invoked the export sector as being a source of downside economic pressure.

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

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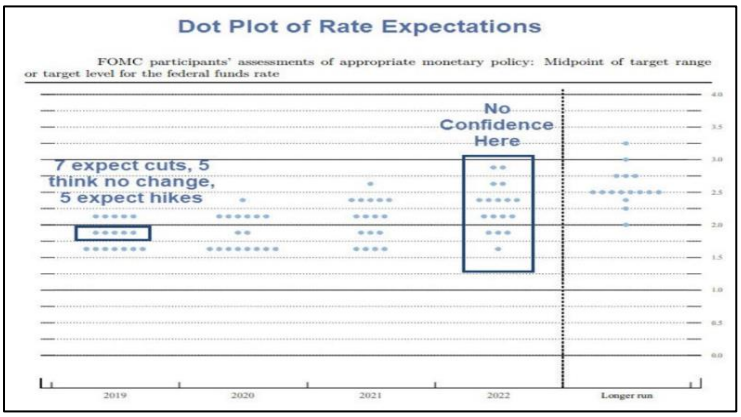
THIS WEEK

- SYNCHRONIZED GLOBAL SLOWDOWN
- THE DEAL
- CFOs TURN GLOOMY

PORTFOLIO STRATEGY

Finally, the Fed emphasized, yet again, that the rate cut was warranted by the "*implications of global developments for the economic outlook as well as muted inflation pressures.*"

The dot-plot contained a lot of information. Incredibly, five Federal Open Market Committee (FOMC) members want to raise rates between now and the end of the year. That's not going to happen. Another five want to now go on hold. And seven of the 17 FOMC officials want to ease again, but nobody sees having to go more than one more time.

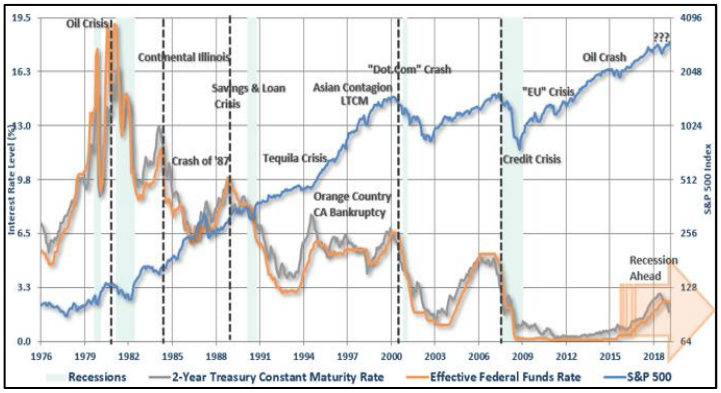


Source: Federal Reserve

The Fed seems completely unconcerned of any recessionary impact in the near-term. **However, such has always been the case, historically speaking, just before the onset of a recession.** This is because the Fed, and economists in general, make predictions based on lagging data which are subject to large future revisions. Regardless, the outcome of the Fed's monetary policies has always been, without exception, either poor or disastrous.

"In the U.S., the Federal Reserve has been the catalyst behind every preceding financial event since they became 'active,' monetarily policy-wise, in the late 70's. As shown in the chart below, when the Fed has lifted the short-term lending rates to a level higher than the two-year rate, bad 'stuff' has historically followed." – Lance Roberts, Seeking Alpha

The Federal Reserve and Financial Crisis



Source: Real Investment Advice

Here's some advice: ignore the dot-plots, which now show that the Fed is done cutting rates. These are the same folks that produced dot-plots in December 2018 calling for repeated policy tightening that clearly never materialized. Shamefully, 15 of the 17 FOMC members last December actually believed that the funds rate was going to be raised in

2019, and instead we have seen two cuts. The mantra now is that the Fed is either going to the sidelines or just one move away from completing the classic mid-cycle policy adjustment. The main point I want to make is that the dot-plots typically reflect what the Fed wants, not what it gets.

Fed vs Market Interest Rate Expectations for 2019

	1 Hike	Neutral	Neutral+hike	1 Cut	2 Cuts	1 Cut+2 Cuts
Fed	29.40%	29.40%	58.80%	41.20%	0.00%	41.20%
Market	0%	40.50%	40.50%	47.60%	11.90%	59.50%

Source: Bloomberg

The Fed's view of where interest rates are headed in 2019 is quite different from market expectations. I believe the market is far closer, especially after Fed Chair Jerome Powell admitted to Congress in July that it overtightened this cycle. If there is the closest thing to a sure thing out there, it is that the futures contracts priced just about 50% of the way for another year-end rate cut, but those odds are far too low, in my view. And as they rise, the bond market will rally.

And for next year, market pricing suggests that the Fed's policy interest rate band at the end of 2020 will be 1-1.25%, which is a bit lower than anything penciled in by the central bankers. Traders seem to be betting that the economy will require lower interest rates than Fed officials currently deem necessary. If that assessment turns out to be right, expect further reductions in the rate outlook when the Fed publishes its next set of forecasts in December.

My view: This rate cycle eventually ends at the zero-bound... and beyond.

SYNCRONIZED GLOBAL SLOWDOWN

"Escalating trade policy tensions are taking an increasing toll on confidence and investment, adding to policy uncertainty, weighing on risk sentiment in financial markets, and endangering future growth prospects."
– The Organisation for Economic Co-operation and Development (OECD)

In one of the most downbeat forecasts on the global economy that we've seen so far this year, the Paris-based organization of wealthy nations known as the OECD – the Organisation for Economic Co-operation and Development – warned that the global economy is heading toward a recession, and that governments aren't doing enough in terms of fiscal stimulus to try and boost the economy.

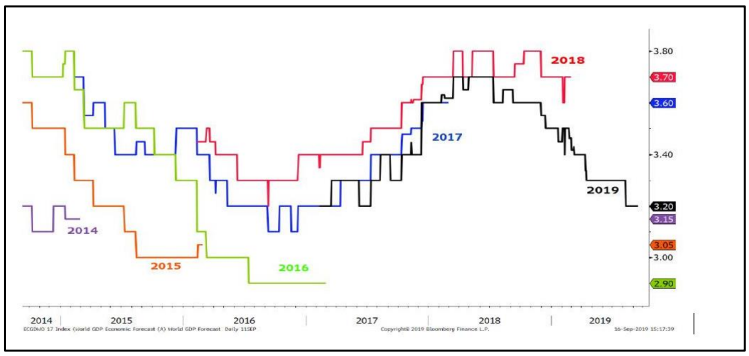
The OECD once again trimmed its GDP growth outlook for 2019 to 2.9% from the 3.2% forecast four months ago, the slowest in a decade. You heard that right. This is the lowest since crawling out of the Great Recession. And world growth is now seen at 3.0% next year, down from the prior 3.4% call.

Here is the breakdown by region:

- Euro area growth has been revised lower to 1.1% from 1.2% for this year and to 1.0% from 1.4% in 2020. At best, that's a growth recession.
- U.K. growth was lowered to 1.0% in 2019 from 1.2% and to 0.9% from 1.0% for next year.

- Japan is expected to grow 1.0% this year and 0.6% 2020. One can legitimately wonder what sort of shape the global economy is in when we see that Japanese exports of autos to the rest of the world deflated 7.2% year-over-year in August and parts shipments plunged 13.6%. The same folks who tell you today not to worry because manufacturing is a small share of the economy are the same pranksters who said the exact same thing about the housing sector exactly 12 years ago.
- And back at home, the U.S. economy is now expected to grow at 2.4% for 2019 from 2.8% and to 2.0% next year from 2.3%. Remember: Change is always at the margin and it is the direction of growth, not the level, that investors should be focused on. As discussed in this space, many segments of the U.S. economy are hurting including capex, housing, non-residential construction, transports and export orders. The trucking and RV businesses are in a downturn. And so is the lodging industry, which is rather sensitive to the economy.

World GDP Forecast by Year



Source: OECD

"Our fear is that we are entering an era where growth is stuck at a very low level… Governments should absolutely take advantage of low rates to invest in the future now so that this sluggish growth doesn't become the new normal." – OECD Chief Economist Laurence Boone

In addition, the OECD's overall composite of leading indicators fell for a 19th straight month in July, which is the longest negative streak since the financial crisis. And for some added food for thought, the six previous occasions of similar negative streaks all coincided with recession.

Unlike the financial crisis when China saved the world with massive stimulus, no region of the world appears to be on solid enough economic footing to be the engine that pulls the global economy upward. With rates at zero and below, there is no catalyst for reaccelerating global growth. Trade wars and broad economic uncertainty are hurting economic outlooks worldwide.

THE DEAL

We have been told virtually every day for the past year and half that a "deal with China" is imminent. The mantra on CNBC is the President will pull a rabbit out of the hat and concoct some sort of interim deal with China before recession risks impair his run for a second term. Of course, he will deem this to be a resounding success. Maybe the stock market rallies and Treasuries sell off for a day or two. However, beyond the trading community, nobody should end up surprised by a toothless deal that means little but garners a couple of photo opportunities.

"I don't think there will be an agreement of any type until it's a matter of substance… I don't think we're going to see tariffs going away and people feeling that we've made a great accomplishment until we have a real agreement and a real agreement in my opinion will not be buying more crops and doing small things."
– Tom Donohue, President of the U.S. Chamber of Commerce

Please see the above quote. I would agree completely.

This is a broader economic war and it's not about toys, clothing or soybeans but rather American alarm at how China is emerging as the world's technological superpower especially when it comes to 5G. And when it comes down to the thieving ways China obtains its intelligence, well, I don't see the politburo caving in on this even if the U.S. placed an entire embargo on Chinese-made goods. China looks at its strategy of stealing technology as being akin to the American land grab of the 1800s. No time for a history lesson here, except to say the Chinese know more about American history than Americans do.

Source: Hedgeye

CFOs TURN GLOOMY

And in the business world, CFOs have started to prepare themselves for a recession. For the first time in several years, **economic uncertainty is now their lead concern,** replacing worries about the difficulty of hiring and retaining talented workers.

According to Duke University/CFO Global Business Outlook Survey released last week **53% of CFOs expect a recession prior to the 2020 presidential election.** And two-thirds predict a downturn by the end of next year. While a downturn may not amount to a recession, it certainly means CFOs are taking the initiative to prepare for the worst. In fact, business spending is expected to inch just 0.6% higher over the next 12 months. That's a sharp deceleration from 8% growth projected in March and the second-lowest growth since December 2009. Only 12% of CFOs in the U.S. indicated they have become more optimistic about the domestic economy, down from 44% a year ago. The CFOs' views are consistent with other important indicators, such as the inversion of the yield curve.

"Executives don't want to be caught unprepared for the next recession like they were in the global financial crisis. There are plenty of warning signs and now is the time to be prudent. Who wants to put their firm at risk by increasing borrowing to fund a major new project when a recession could be on the horizon? It is no surprise that capital expenditures have dried up." – Campbell Harvey, a founding director of the Duke CFO Survey

*"I do think this could become a self-fulfilling recession… **If we are teetering on the edge of recession and companies are already worried, it's going to make it more likely we tip into a recession."***
– John Graham, a finance professor at Duke University's Fuqua School of Business

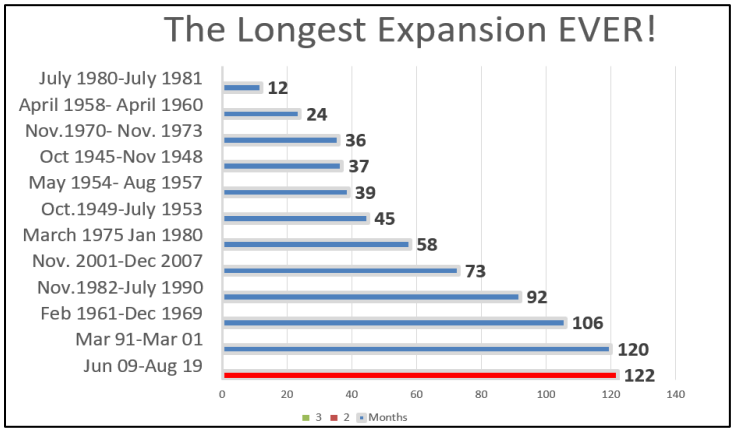
Just look at **FedEx** or **U.S. Steel.** These companies were certifiable train wrecks. Notably, FedEx dropped 13% (losing $6.2 billion of its market value in a day). This was the biggest hit the company stock has taken since the depths of recession in December 2008. And now that we're through the Fed meeting what really matters is earning season. How many more train wrecks will we see over the next month?

MARKET OUTLOOK AND PORTFOLIO

"What we call the beginning is often the end. And to make an end is to make a beginning. The end is where we start from." – T.S. Eliot

The point here is that *"all things do come to an end."*

The U.S. economic expansion is the longest ever. And while it's true that recoveries don't die of old age, as the expansion matures, pent up demand is exhausted and the economy is more susceptible to some sort of catalyst that causes investment and spending to slow… Hmmm. What could that be?



Source: Bloomberg

If there was an article that spoke to me, it was *The Recession Is Here* of the current Bloomberg Businessweek. The recession may not have hit the consumer yet, but that will happen. In this domino game where housing, capex and non-residential construction are in the doldrums, the sagging foreign orders data are showing that exports are next in line.

The industrial sector – the bottom of the economic pyramid – has already suffered back-to-back quarters of negative quarterly readings.

Soon companies will be announcing layoffs. And as unemployment rises, consumption falls. We are now up to 22 states in which factory jobs have contracted year-to-date and the list is growing.

At the same time, we have to take note that we are in the midst of a three-quarter recession in U.S. corporate profits. There is no denying that third quarter earnings-per-share estimates have been wound down to a -3.6% year-over-year pace from they were at the turn of the year (+3%).

In summary: Don't lose sight of where the economy is heading. In addition to trade frictions, disrupted global supply chains, slowdowns or looming recessions overseas, and corporate deleveraging at home (which is one reason why capital spending and spending plans are in retrenchment), commercial and residential real estate are in a funk, capex has collapsed, global trade is plunging, and employment has peaked. The New York Fed model pegs recession odds now at 84%, the highest it has been since we were actually in an official National Bureau of Economic Research (NBER)-defined economic downturn just over a decade ago. All of this points to one thing, and one thing only, which is a declining interest rate path. As we have seen in recent weeks, this isn't going to be a straight line.

In any event, even if recession risks do subside, we are still going to be in a low-growth environment for a long time – as well as an environment of miniscule interest rates. These fundamental forces are not changing over the near or intermediate term. As such, any selloffs provide an attractive entry point to deploy excess cash reserves.

In terms of portfolio strategy, credit unions should maintain a fully invested, risk appropriate laddered portfolio. In terms of value, we believe the five-year part of the yield curve offers an attractive risk-reward at current levels.

PREMIER PORTFOLIO

Since its launch in September 2018, Balance Sheet Solutions' online trading platform – Premier Portfolio – has been making a positive impact at credit unions across the corporate's membership.

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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.