BALANCE SHEET SOLUTIONS
an alloya company

WEEK OF SEPTEMBER 30, 2019

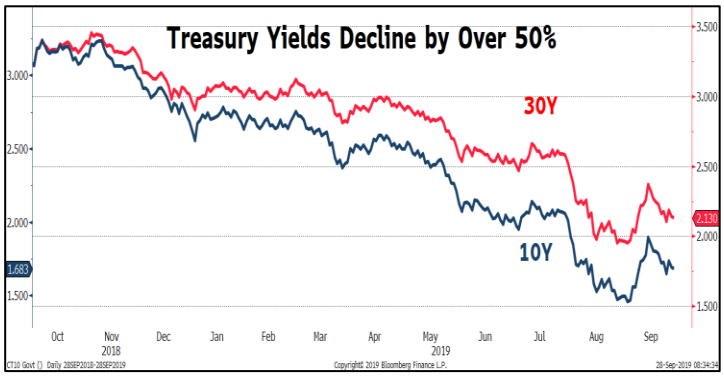
Weekly Relative Value

REAL MEN (AND WOMEN) BUY BONDS

The S&P 500 first made it above the 3,000 mark on July 12 and has crossed above it four times since. Today, it sits below that mark and is actually little changed in the past 20 months.

Source: Bloomberg

Meanwhile, in the past year, the total return on the 10-year Treasury is +15% and for the long bond (30-year) it is +27%. That compares to less than a 5% total return for the S&P 500. If I am right on where rates may be heading, the expected total return in the 30-year bond will come close to 30%. I seriously doubt that, in the context of sky-high multiples and a backdrop where earnings and earnings expectations are tracking lower, the equity market will come anywhere close to that.



Source: Bloomberg

Many people seem to be confused about how such low levels of yields can lead to huge total returns, but these folks tend to be equity pundits who don't understand bond market math notably the power of convexity at these uber-low levels of interest rates. They say,

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THIS WEEK

"Who would be stupid enough to buy a 10-year Treasury note at 1.7% or a long bond at 2.2%?" These were and are the same individuals who said the very same thing (more than 100 basis points ago).

So, who's buying? Some institutional investors have to buy duration for matching purposes insurance companies, for one. There are others, like the banks, who now are de-risking and shifting out of non-liquid assets like commercial and industrial (C&I) and real estate credit to more liquid Treasury holdings. Banks have also been extending duration because they have shed their cash assets at an epic 37.1% annualized rate in the past 13 weeks while boosting their Treasury securities at a 53% annual rate. So, if the banks are de-risking and adding duration to their fixed-income assets, shouldn't you be doing the same?

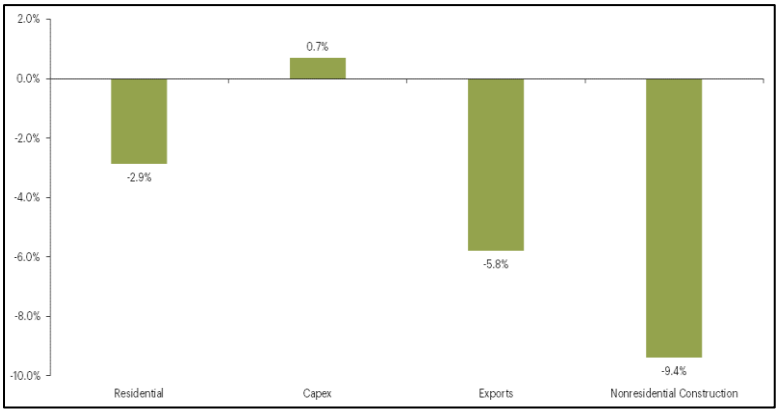
As for individual investors, there may be some who have highly deflationary expectations or who have a preference for liquidity and safety right now, and a near-2% yield is a perfectly appropriate alternative.

A year ago**,** the long bond yielded 3% and today that same bond yield is closer to 2%. And yes, something tells me that a year from now the yield will be approaching 1%. Heck, the recession hasn't even arrived, and the Fed's easing cycle is in its infancy. In a recession the fed funds rate will drop to zero in the blink of an eye.

THE ECONOMY IS LIKE THE HUMAN BODY

The economy is a complex organism like the human body. And as I can personally attest from experience, when something afflicts one part of the body, inevitably the rest of the body is affected. As an example, business capex and housing have 60% correlations to consumer spending; nonresidential construction has a 30% correlation (exports just 7%, which makes sense since outbound shipments are more sensitive to the foreign consumer).

Real GDP Components (Quarter-Over-Quarter % Annualized)



Source: Arbor Research

As shown above, the economy has been experiencing a series of rolling recessions. Housing has been in a contraction mode for six consecutive quarters (-2.9% at an annual rate in the second quarter). Even if housing does pick up in the third quarter, the damage has already been done because a string like this of negative readings has only happened for a recession-bound economy. Capex growth has basically been stagnant for the past two quarters (+0.7% in the second quarter and -0.1% in first quarter). These are at annual rates. Export volumes cratered at a 5.8% annualized pace in the second quarter. And both export orders and capex intentions show no near-term turnaround. Non-residential business spending collapsed at a 9.4% annual rate in the second quarter and has contracted now in three of the past four quarters.

The U.S. consumer, being 70% of GDP, has been the glue keeping the global economy together. And it would be a stretch to believe that the negative shocks to exports and business capital spending wouldn't exert some influence on the household sector with a lag. Meanwhile, nobody talks about the fact that the GM strike has already shuttered more than 30 plants and all I hear is how autos, like housing, don't really matter anymore. Sure, as if we all somehow sleep under the stars and walk to work every day. This will only compound the recession, which is already under way in the industrial sector.

Once cutbacks in capital and construction spending morph into reduced hirings and sluggish employment readings, the impact on the consumer will be that much more evident. At that point, everyone will be throwing in the towel and calling for recession, the S&P 500 will be down 30%, as is typical in a bear market, and the yield on the 10-year Treasury note will have converged below 1%. Once these events happen, it will probably be time to turn bullish on the economy.

CONFIDENCE SINKS

The bulls may say, "watch what they do, not what they say they will do." Maybe so, but how consumers feel can best be described as in a deep funk. The Conference Board's headline confidence index plunged to a three-month low of 125.1 in September from 134.2 in August – the steepest decline for the year to date. The key was the expectations component, which plunged 10.6 points to an eight-month low of 95.8, the sharpest slide for 2019. This metric is a leading indicator for consumer spending.

Source: Bloomberg

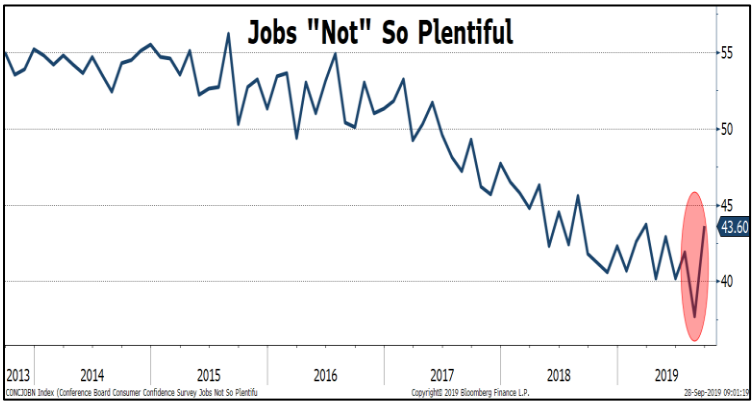
Digging deeper into the survey, buying plans were a tale of woe. Homebuying intentions declined to 5.2 and now stand at a five-month low. Plans to purchase an appliance sagged to 48.5 from 51.8, and down to a 14-month low. And as for autos, buying plans slid to 11.5 from 13.0, also a 14-month low.

And the employment picture has turned for the worse. The "jobs-are-plentiful sub-index" within the Conference Board's Consumer Confidence Survey crashed 5.5 points to a three-month low of 44.8 from 50.3 in August. Such a sharp decline has historically been reserved for recessions. This was the largest drop since October 2001 and calls for a rise in the unemployment rate when the data come out next week.

On this theme (weaker employment growth), Markits Flash Purchasing Managers' Index (PMI) composite showed the first sub-50 reading for its employment sub-index in nearly 10 years. And the weakness wasn't confined to manufacturing as employment in services fell to a level last seen in December 2009.

Finally, there have been five straight months of negative revisions to the payroll data. This is a canary in the coal mine. Keep an eye on the workweek, manufacturing hours worked and factory overtime, which all appear to have rolled over.

And when those cracks appear, the lags from the cutbacks in capital spending, exports and construction will hit the consumer. This is a particularly concerning since consumer spending has been the one source of support in an economy that is otherwise contracting.



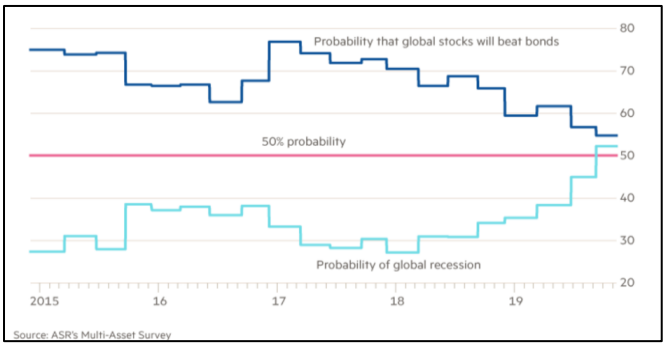
Source: Bloomberg

Keep your eyes on the employment data released on Friday. The Wall Street consensus survey is a gain of 134,000 jobs in September. Any number much weaker than this could create another leg down in yield across the curve

SURVEY SAYS…

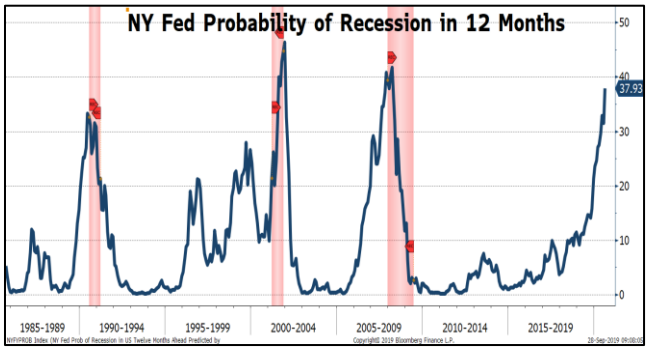
Absolute Strategy Research released their September survey of 206 professional money managers representing $4.1 trillion of assets under management. The results showed that for the first time in the history of the survey, the probability of a global recession within the coming year has exceeded 50%. And fewer than half see equity prices being higher in the next year. No wonder the President has ceased tweeting about 401k plans. Then again, what can be said? After all, corporate insiders ($19 billion) are on pace to sell more stock this year than any other since 2000 (oh, and a recession started the very next year).

Global Recession Odds Exceed 50%



Source: Financial Times

Also, in the same line of thinking, a Bank of America Merrill Lynch Fund Manager Survey has followed the New York Fed model in predicting a recession to occur in the coming year for the first time since 2009. The blinders have finally come off.



Source: Bloomberg

MUST-READ ARTICLE OF THE WEEK

The Coming Currency War: Digital Money vs. the Dollar is a must-read from the Wall Street Journal.

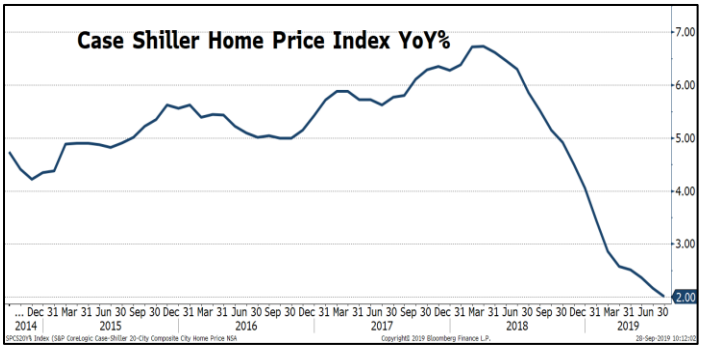
The competition the U.S. dollar is likely to have in the not-too-distant future, in terms of reserve currency status, from digital cash is likely going to be very intense. In fact, this will be a challenge to all fiat currencies and guess who is in the lead on this file and expected to launch a digital version of its currency by early next year? China. Around 40% of world trade is invoiced in U.S. dollars and 88% of all foreign exchange transactions are conducted in greenbacks, even though the U.S. represents just 9% of global exports. This transition promises to usher in more global market volatility even if it promises a quicker, more efficient and less costly global payments system. The biggest losers from this emerging shift to national digital currencies could end up being the central banks.

To read the full article visit: www.wsj.com/articles/the-coming-currency-war-digital-money-vs-the-dollar-11569204540

HOMES DEFLATE

There has been a positive vibe from last week's U.S. new home sales data as new home sales surprised to the upside in August, up +7.1% to a 713,000 annualized unit pace (consensus: 659,000). Undoubtedly, looking just at the headline, this is a strong report.

Home Prices are Deflating



Source: Bloomberg

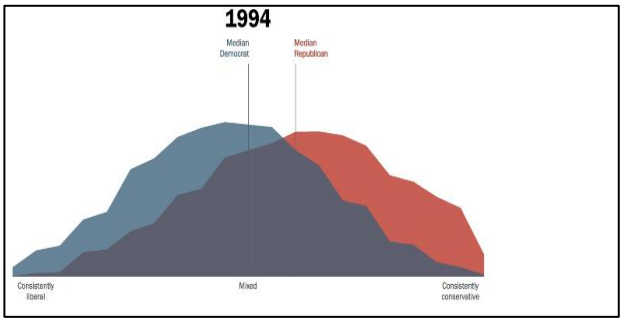
However, when looking underneath the hood, the strength was in "spec" buying. And buying activity was actually down for homes priced at less than $400,000. Sales above $400,000 soared 46% while homes priced below $400,000 slumped 12%. As discussed in this space numerous times over the years without greater participation from the critical first-time

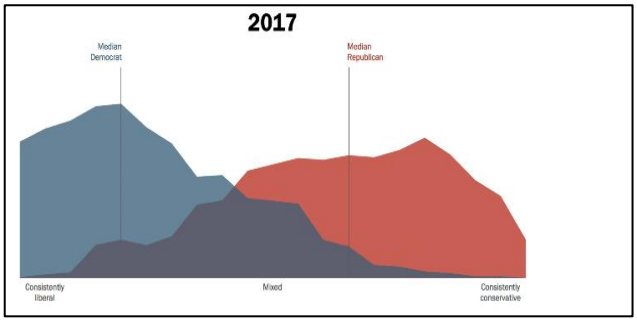
home buyer (aka millennials) there will not be any prolonged improvement on the housing front. Not to mention the fact that if home demand were truly strong, prices as per the Case-Shiller Home Price Index never would have posted the weakest year-over-year pace in seven years. As they say, the truth is always in the price. According to the S&P/Case-Shiller 20-City Composite, home prices continued to decelerate in July printing a flat reading sequentially (weakest since August 2018), which took the year-over-year trend to a mere +2.0%. This is the slowest pace of price gains in nearly seven years, a reflection of the prolonged weakness in the housing market (declining for six quarters in a row and eight of the last nine).

Keep in mind that housing is a quintessential leading indicator and we have already seen six consecutive quarterly declines (and eight of the last nine) in residential investment. At no point in history have we seen this occur without either being in the midst of recession, or one following shortly thereafter. So, you're either playing the odds or for one reason or another expecting this time will be different.

CAN WE COME TOGETHER?

Is bipartisanship dead? The two charts below come from the independent think tank Pew Research on the partisan divide between the Democrats and Republicans. The charts demonstrate how the political divide by party has grown significantly and consistently over 23 years. In 1994, the general public was more mixed in their allegiances, but a significant divergence started to occur from 2011 onward.





By 2017, the divide had significantly shifted towards the two extremes of the consistently liberal/conservative scale. Median Democrat and Republican sentiment also moved further apart, especially for politically engaged Americans.

While the above data on group polarization ends in 2017, it's clear that the repercussions continue to have ripple effects into today and the future. These differences mean there is no consensus on the nation's key priorities.

In 2019, Republicans believe that terrorism, the economy, social security, immigration and the military should be top-of-mind, while Democrats refer to healthcare, education, environment, Medicare, and the poor and needy as their leads.

With Trump's presidential term up for contest in 2020, the lack of common ground on pressing issues will continue to cause a stir among both Democratic and Republican bases.

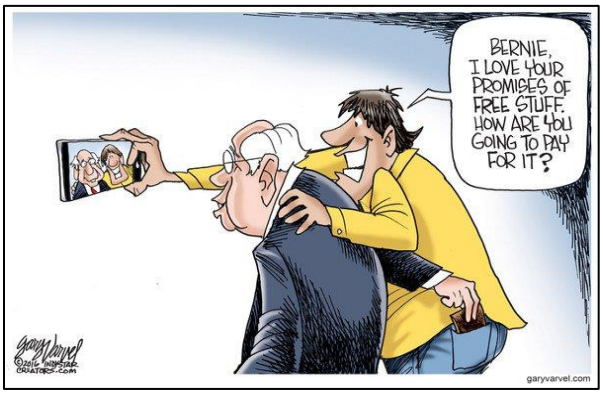
Is there anything Americans will be willing to cross the aisle for?

POLITICS HEAT UP

Thirteen months out from a presidential election, House Speaker Nancy Pelosi announced an impeachment inquiry of President Trump. At the center of the investigation is Trump's July phone call with the Ukrainian leader. The President has reacted to the decision in his usual style, hitting back at Democrats and saying the process is "bad for the country." At the same time, Trump knows that from the perspective of history, it's not good to be just the fourth American president to face impeachment. (Andrew Johnson and Bill Clinton were impeached but then acquitted by the Senate. Richard Nixon resigned in the face of impeachment.)

Meanwhile Mr. Trump's approval rating remains stuck at 40%, which is not good news for him even if he has his base and 90% support within the GOP. Trump is now facing a contest from three contenders, two who are embarrassed at a Republican leader who runs a Democrat-type fiscal superstore (Joel Walsh from Indiana, William F. Weld from Massachusetts and Mark Sanford from South Carolina).

At some point, investors are going to have to pay attention to the domestic political scene. The key issue is what happens to Joe Biden because, if he pulls a Jeb Bush, then we have Elizabeth Warren and Bernie Sanders to worry about, and their plans for higher income tax rates and wealth taxes to fund the massive expansion in government programs would represent the biggest shift in fiscal policy since the New Deal.



Source: Cagle Cartoons

Let's look at some of the specific proposals from the two candidates.

Warren is proposing a 2% wealth tax on people worth between $50 million and $1 billion; 3% on a billion-plus. Call it confiscation from the upper-upper class of $2.6 trillion over 10 years' time. Sanders wants to go even further with a gradual increase from 1% on $32-$50 million of wealth all the way up to 8% above $10 billion. Bernie (aka Robin Hood) tax-grab is $4.35 trillion over a decade. There are other countries that have similar wealth taxes but enforcing the law is really difficult. If there's a bull market out there, if this ever happens, it will be in billable hours for tax lawyers and accountants (I should add divorce lawyers).

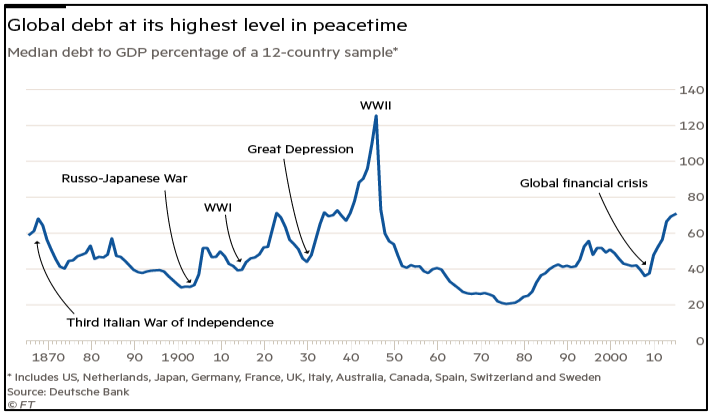
Many people think Elizabeth Warren is a crackpot and America will never elect a socialist. Don't be so sure. It's been four years since the last vote and a whole lot of teenagers who weren't old enough to cast a ballot in 2016 will be doing so and items like climate change, gun control and income/wealth inequality speak to them. If the youth turn out and vote in droves, this could be a game changer.

Warren's message is resonating among the masses and especially the younger generation. Take a look at the article- *Students Take to the Streets for Day of Action on Climate Change* in the weekend Wall Street Journal. These kids can

vote and this issue, whether you agree with it or not, has some serious traction with young people across the planet and is emerging as a critical political file. This is one reason why the youth increasingly identify with Elizabeth Warren, for one, the demon of Wall Street and capitalism.

EXCESS DEBT = LOW RATES

According to Deutsche Bank, large economies have the highest level of debt relative to GDP of the past 150 years (except for a spike around World War II). As a result, at these bloated debt loads, economic growth is likely to remain structurally depressed, ensuring interest rate levels remain low for the foreseeable future. No argument here. I have been making this point for close to 10 years.



Source: Financial Times

MARKET OUTLOOK AND PORTFOLIO STRATEGY

That inflection in global growth, which so many on Wall Street are hoping for, looks increasingly unlikely to materialize.

Here are some important data points:

- *U.S. Conference Board Consumer Confidence Index: slowed -9.1 points in September to a three-month low of 125.1*
- *South Korean Exports (first 20 days): slowed -820 basis points to a fresh cycle-low of -21.8% year-over-year in September*
- *Eurozone Manufacturing Purchasing Managers' Index (PMI): slowed -1.4 points to a fresh cycle-low of 45.6 in September*
- *Germany Ifo Expectations Survey: slowed -0.5 points to a fresh cycle-low of 90.8 in September*
- *The U.S. economy is slowing (in particular the Industrials/Manufacturing economy).*
- *Late-cycle wage growth is percolating (see GM labor strikes for more details).*
- *A resurgent U.S. dollar hurts companies that earn a disproportionate amount of their revenues overseas.*
- *Recent blowups we've witnessed in companies like Micron Technology, U.S. Steel and FedEx aren't anomalies. On the contrary, they are evidence of important trends underlying a shaky U.S. economy.*

Taken together, I believe most investors are oblivious to the evolving reality of slowing U.S. and global growth. A "one-two punch" of bad earnings data and sluggish growth could catch a lot of people flatfooted in the coming weeks.

Furthermore, the mantra that the Fed is done easing is proving to be way off base. Fed Chair Jay Powell was explicit in his view on downside macro risks and the need to be proactive at his post-meeting Q&A. Consider this remark:

"The main takeaway is that this is a committee that has shifted its policy stance repeatedly, consistently through the course of the year, to support economic activity as it has felt that it's appropriate."

And then Vice Chairman Richard Clarida said the exact same thing on CNBC in a Friday interview, "It*'s important to act when you can, responsibly and pre-emptively, to try to stay away from that bad situation."*

Enough said.

This backdrop provides the reason why excess cash reserves at credit unions will continue to negatively impact the investment portfolio and overall balance sheet.

Readers of the Daily Market Commentary or Weekly Relative Value are well aware of the long-held investment advice to minimize cash, avoid forecasting and maintain a risk-appropriate, high-quality, diversified ladder strategy.

As shown below, that advice has been spot on. As one can glean form the table below, cash has significantly underperformed versus longer duration securities. For example, if an investor has maintained a 1-3-year maturity ladder portfolio over the past 10 years, they would have outperformed cash by a whopping 847 basis points!

And even though rates have declined by over 100 basis points since last year, the advice remains the same today. Throw away the crystal ball and Ouija Board and maintain the "tried and true" ladder discipline. Sleep better!

Cash is Not King!

Comparative Total Returns: 12/31/08 – 08/31/19	
Sector	Return %
Cash < 1 Year	9.15%
1-2.99 Years	17.61%
3-4.99 Years	38.86%
5.00-6.99 Years	59.85%
7.00+ Years	86.60%

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.

> *"Premier Portfolio's online services allows me to access statements and overall market analyses, review a list of available security offerings, as well as purchase SimpliCD's and Alloya's certificates. Premier Portfolio is convenient, easy, secure, and has become my go-to place for investing!"*
> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

> *"While it's always great to connect with our Balance Sheet Solutions Account Executive one-on-one, Premier Portfolio is an amazing and easy tool to use in purchasing investments. We have access to statements, online trading and the ability to look at all of the offering in one place. I highly recommend trying this out!"*
> – Shawn Nikkel, Finance Director of Denver Fire Department FCU

> *"Premier Portfolio is user-friendly and modern. It allows us to browse current offerings and make immediate purchases at any point throughout the day. The tracking mechanism in Premier Portfolio is very hand. Since the system knows what dollar amount is currently owned in a financial institution, there is no room for error. We love the ability to check term and rate on a single summary. Premier Portfolio takes the guessing out of the equation. It is a highly useful tool and would recommend to anyone using Balance Sheet Solutions."*
> – Darin Higgins, President of Western Illinois Credit Union

Visit **www.alloyacorp.org/premierportfolio** to learn more about Premier Portfolio and how it can benefit your credit union!

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.