BALANCE SHEET SOLUTIONS
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WEEK OF DECEMBER 9, 2019

Weekly Relative Value

Why I Remain Bullish on Bonds

"Bonds despite their ridiculous yields will not easily be threatened with a new bear market." – Bill Gross

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

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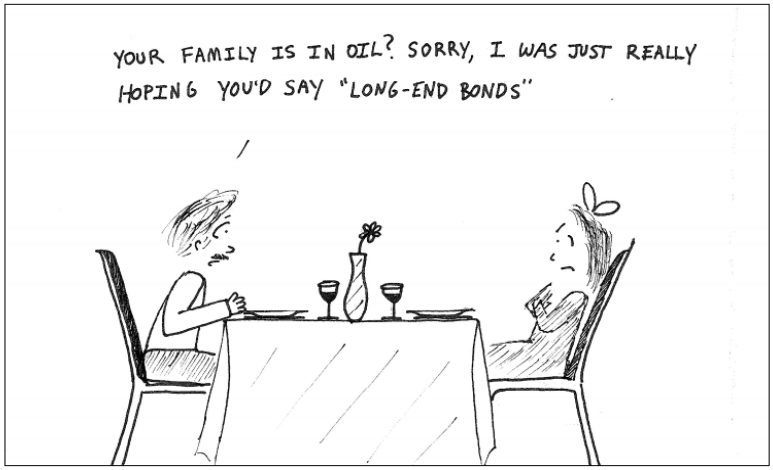
If you are a long-time reader of the Weekly Relative Value, you are well aware of my steadfast bullishness on the bond market. While others have been quick (and very wrong) to call the end of the greatest bull market ever, I have consistently argued that the bull market in bonds remains intact. And even though long-term 10-year Treasury yields have plunged from 5% to 1.8% over the past decade-plus, to this day I remain bullish on bonds. In this week's edition of the Weekly Relative Value, I will review the bullish case for bonds.



Source: Morgan Stanley

Let's first start with the "big theme."

Virtually a week does not go by when I do not discuss the four-letter word D-E-B-T. We simply have far too much of it with the world awash in $250 trillion of outstanding IOUs at the household, business and government levels. That is about 3x the level of income to support this albatross.

For perspective, in 2000 the debt level was less than $100 trillion. By 2009 it had doubled to nearly $200 trillion and today it sits at $250 trillion. And the solution by the bright lights in government is to add more fuel to this fire. While in the Chinese Zodiac this is the "year of

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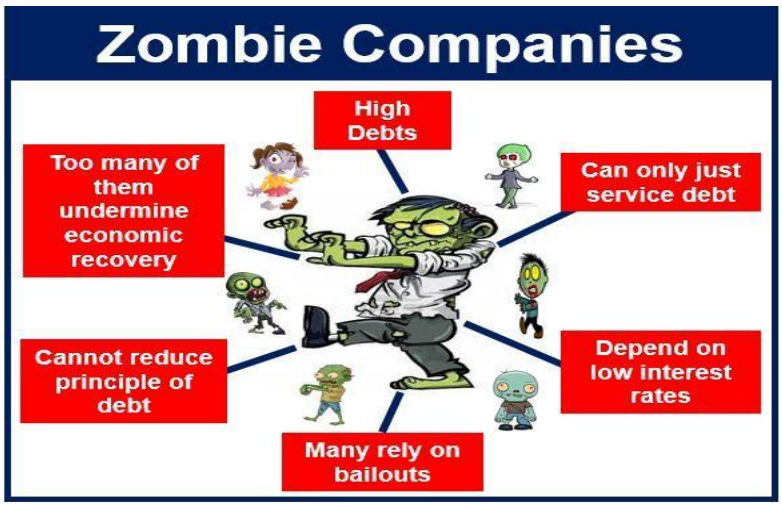
the pig" you can only paint lipstick on it for so long. Papering over a debt problem is not the same as resolving it.

Rising government debt from record peacetime levels (whether through tax cuts, spending increases, or both) are not a panacea for anything. What we have to do for the entire global economy is find a way to bring debt-to-income ratios back down to levels that will allow for sustainable economic growth. Yet, this seems lost on practically everybody. Throwing even more debt on top of the mountain of debt is very unproductive, and because central bankers are scared out of their collective wit, they are forced into cutting interest rates or restarting quantitative easing (QE) programs to avoid a destabilizing global debt default.

Further, by maintaining an extremely accommodative monetary policy these central bankers keep "zombie" companies alive. This, in turn, only serves to exacerbate the excess capacity and deflationary pressures around the globe. And as a result, the current miniscule inflation rates trend lower and further and further away from the official policy targets.



Source: Market News

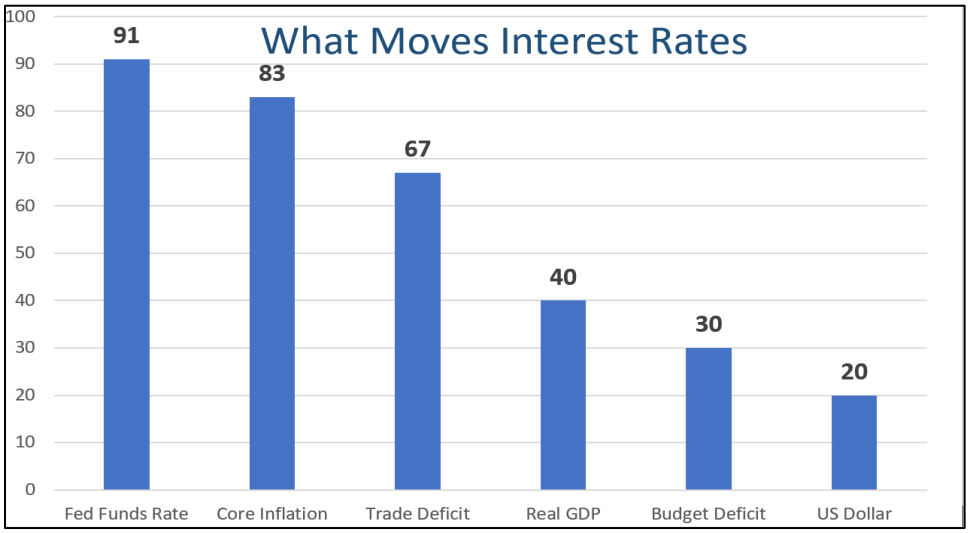
Thus, the largest constraint on the U.S. and global economy, and the primary reason for heightened deflationary risks, is this unsustainable debt burden, which is more pronounced today than at any time in modern history. And while you may be giddy over what is happening in equity markets today, do not let the manipulated and distorted equity markets endorsed by central banks lead you to any other conclusion

In such a debt-saturated, leveraged environment, it will be quite challenging if not impossible to return to pre-2008 interest rate normalcy until we have a global debt default. Call it a "debt jubilee" if you are religious or call it "helicopter money" if you are Ben Bernanke or, dare I say "Modern Monetary Theory" if you are a left-leaning Democrat.

This is why interest rates cannot go up and why yield hiccups are classic buying opportunities for the bond bulls (the few who are out there).

WHY RATES ARE LIKELY TO REMAIN LOW

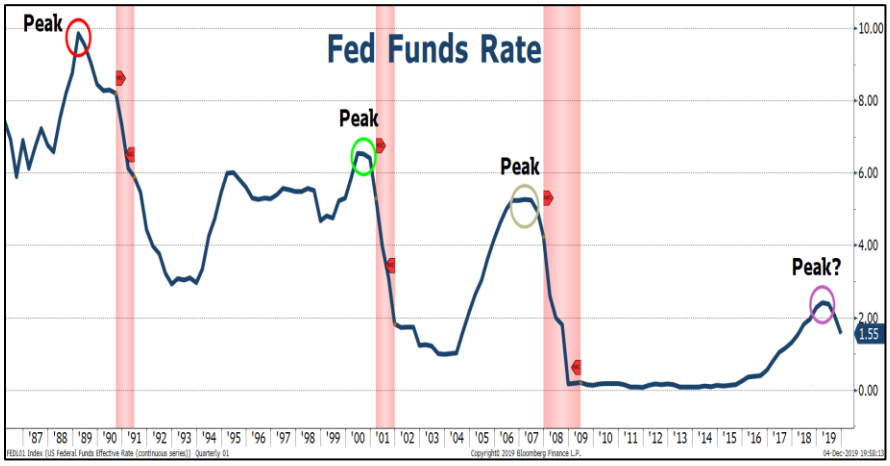
As one can glean from the following graph, the two factors that have the highest positive correlation to interest rates are the the federal funds rate and core inflation.



Source: Bloomberg

On the former, I believe that the federal funds rate has peaked for the cycle, and historically that has meant the peak of the economic expansion (with a lag).

Have Fed Funds Peaked?



Source: Bloomberg

When the recession does eventually arrive (and it will, the business cycle is not dead) the Fed will cut rates aggressively.

In fact, as shown in the following table, the average reduction has been about 470 basis points.

However, this time around the starting point in the funds rate was so low to begin with (2.375%) that it all but assures we will arrive at the zero-lower bound (and possibly go even lower!) in the next downturn.

At the very least, we should expect the Fed to create a synthetic negative policy rate via balance sheet expansion, as they did in the last recession.

What Happens When the Fed Cuts Rate?

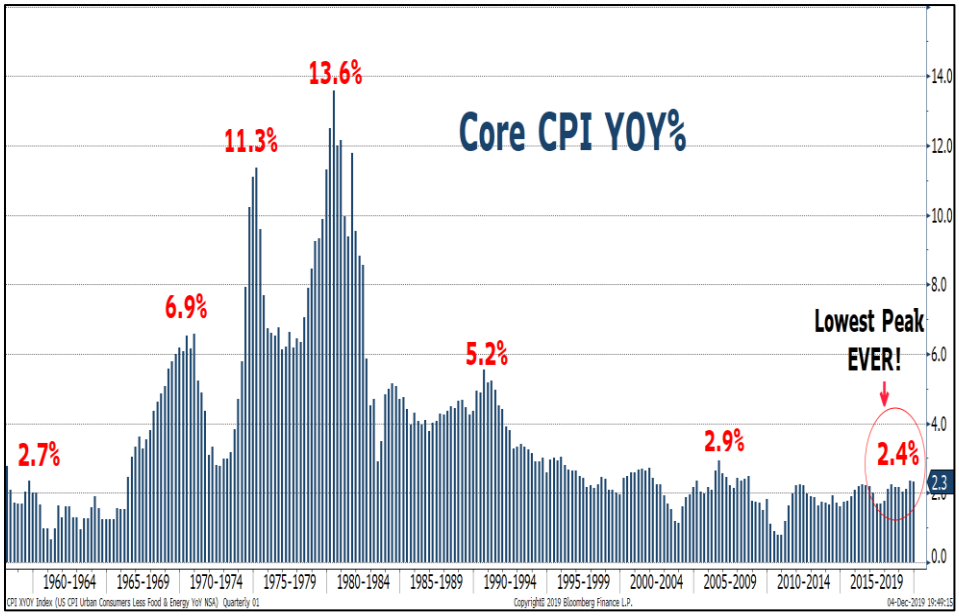
		Federal Funds Rate %		
Start	**End**	**Start Level**	**End Level**	**Delta**
Oct-57	May-58	3.50	0.57	-2.93
May-60	Jul-61	3.83	1.18	-2.65
Nov-66	Jul-67	5.74	3.79	-1.95
Feb-70	Feb-71	8.95	6.03	-2.92
Sep-71	Feb-72	5.53	3.30	-2.23
Jul-74	May-75	12.91	5.22	-7.69
Apr-80	Jul-80	17.43	9.01	-8.42
Jul-81	Dec-81	19.10	12.44	-6.66
Aug-84	Dec-84	11.50	8.13	-3.38
May-89	Sep-92	9.81	3.00	-6.81
Dec-00	Jun-03	6.50	1.00	-5.50
Aug-07	Dec-08	5.25	0.13	-5.13
Average		**9.17**	**4.48**	**-4.69**

Source: Bloomberg

The second most important determinate of bond yields is "core" inflation.

Incredibly, despite endless rounds of QE, expansionary fiscal policy, a record stock market and the lowest unemployment rate in 50 years, the best we could muster this cycle was a measly 2.4% peak in the core Consumer Price Index (CPI). Think about that!

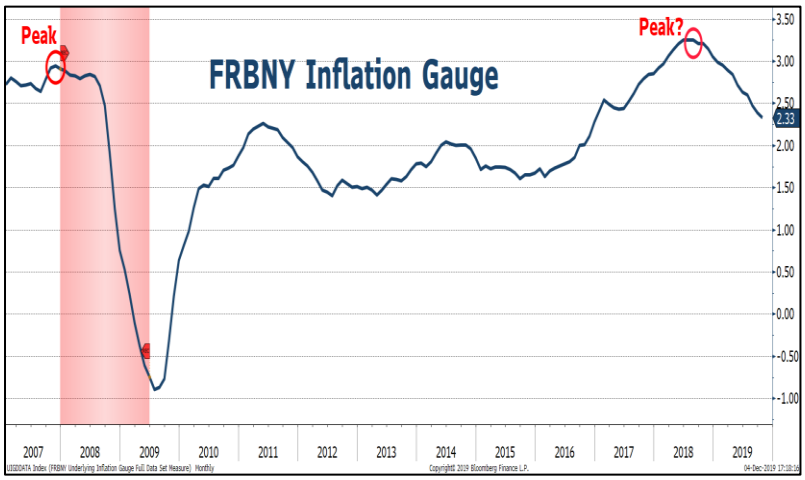
Inflation Peaks at Lowest Level Ever



Source: Bloomberg

This is the lowest peak ever. So just imagine where inflation goes in the next downturn. In fact, the New York Fed Underlying Inflation Gauge, which is a leading indicator for core CPI, has been flagging a meaningful slowdown for some time after peaking in July 2018 (three months ahead of the peak in yields). It has been lower in 14 of the past 15 months.

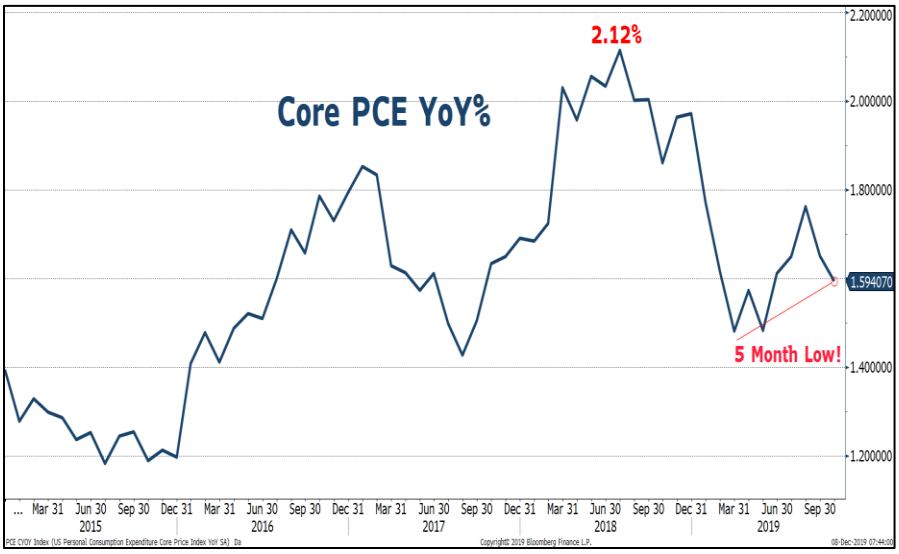
Inflation Heading Lower



Source: Bloomberg

Perhaps the most important recent piece of data was the core personal consumptions expenditures (PCE) consumer price deflator (the Fed's preferred inflation gauge) slowing to a five-month low of 1.6% in October. Core inflation wouldn't be receding if demand was robust.

Core Inflation is Headed Lower

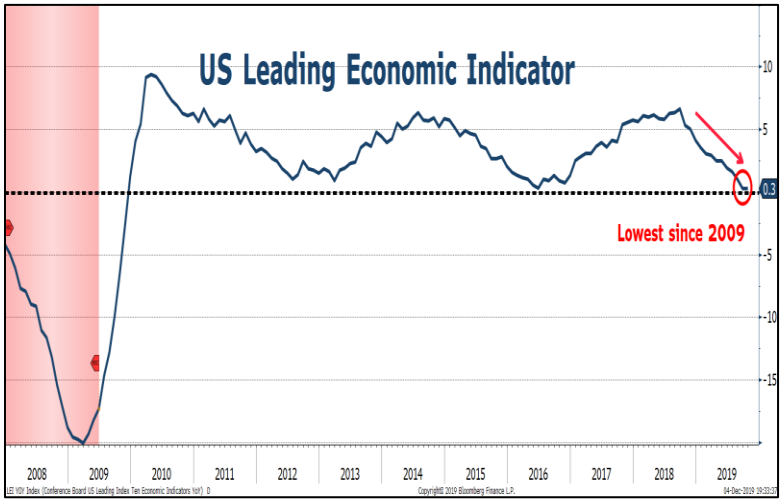


Source: Bloomberg

Just in case there was any doubt that inflation is heading lower, the Conference Board's Leading Economic Index, a leading indicator of economic activity, has yet to show any signs of stabilization and is down to 2009 levels.

This tells us that not only has growth softened to near-recessionary levels, but it will remain soft.

Lowest Since 2009

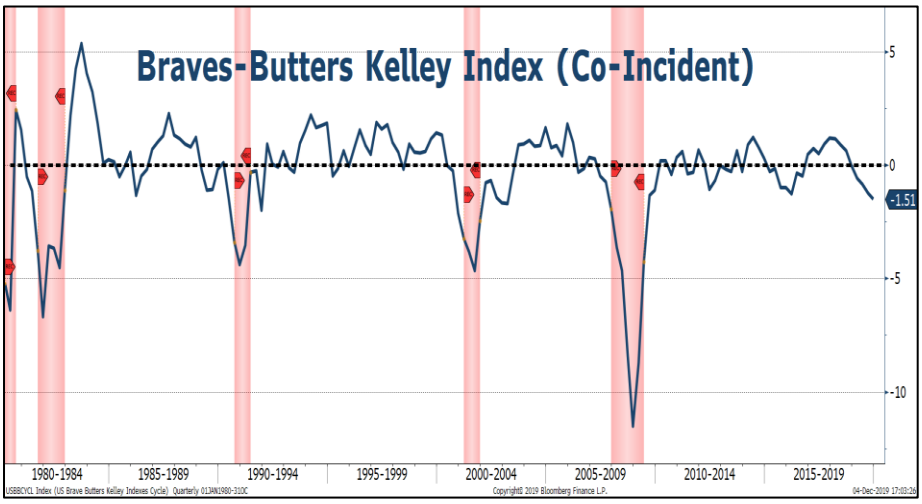


Source: Bloomberg

Likewise, the Brave-Butters-Kelley Monthly Coincident Index, a relatively new metric from the Chicago Fed, is flagging a further deterioration in U.S. economic growth. To provide some brief context, it is designed to summarize the information in 500 monthly macroeconomic time series relevant to GDP growth. Good luck finding a more all-encompassing measure of economic activity than the Brave-Butters-Kelley Index.

But as the chart below shows, you only see an index value of -1 when the economy is already in recession. Mind you, there have been a few false positives (such as 2002/2003). In any event, the current level of this index is signaling non-trivial recession risks. It is also flagging a further build-up in deflationary pressures, since that is what goes hand-in-hand with prolonged periods of below-potential growth.

In Recessionary Territory

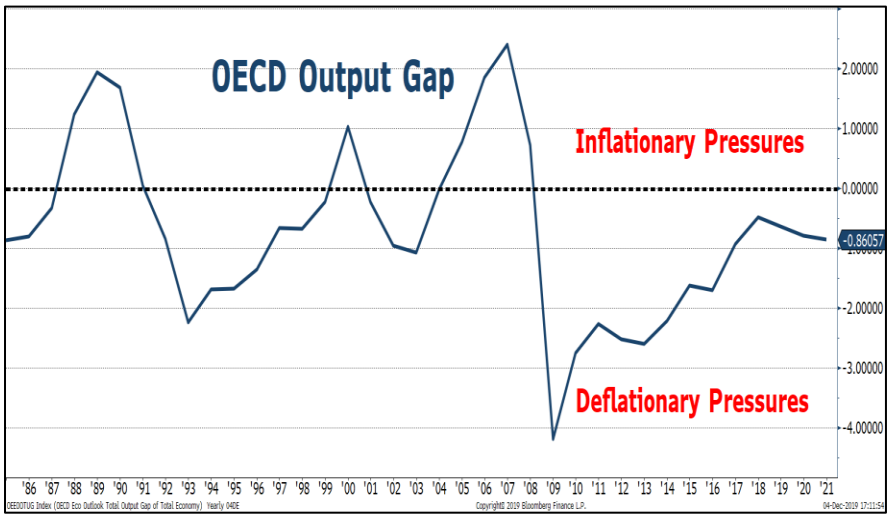


Source: Bloomberg

Also, on a global basis, the global output gap (measures aggregate demand versus aggregate supply) has failed to close for the first time ever during an economic expansion.

This means there remains more supply than demand, which is the primary reason why we have been in a slow growth, low inflationary environment for the past 10 years. This is quite amazing when you think of all the central bank machinations. At any rate, this too supports a downward trajectory of inflation rates going forward.

The Output Gap Did Not Close

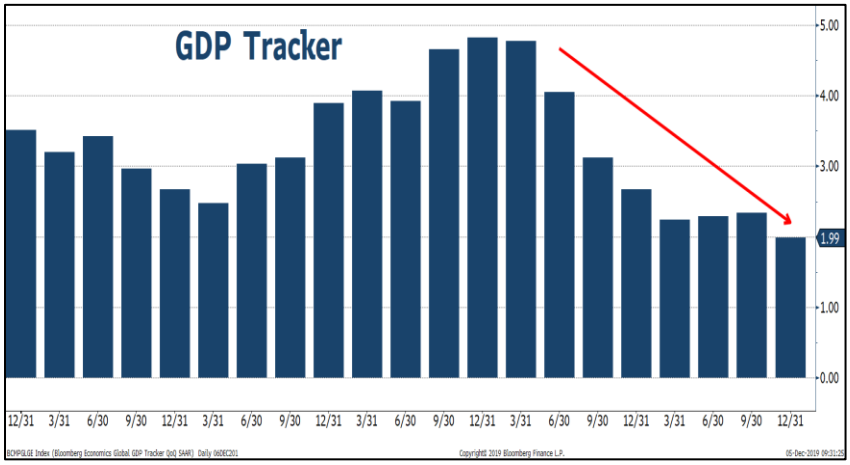


Source: Bloomberg

My view on the economy is that it is anything but the "Greatest Ever." I saw this headline on my handy Bloomberg terminal last week *Global Insight: Economy Turning a Corner: GDP Tracker Says No*. Needless to say, I would agree.

In fact, it looks like global real GDP growth in the fourth quarter is coming in at a paltry, and below-potential, 2% annual rate. A year ago, the estimate was for 4% and now it is half that pace. This marks a deceleration from 2.3% in the third quarter and would tie us for the most sluggish backdrop for the 10-year cycle.

"The Greatest Economy Ever!"



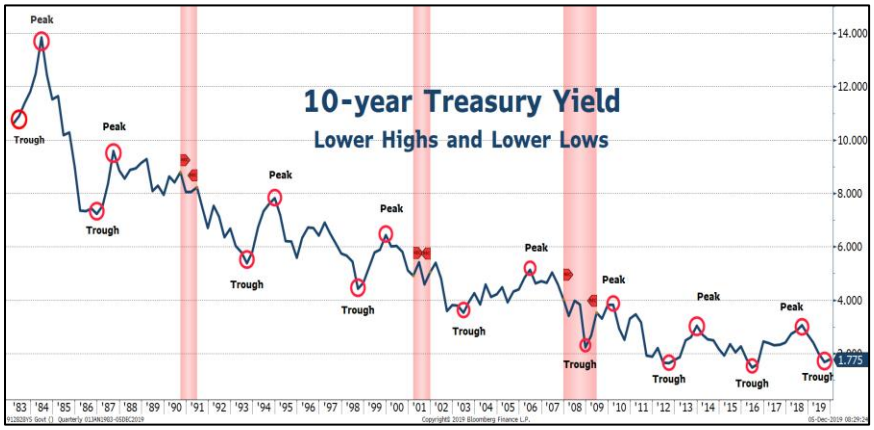
Source: Bloomberg

So, while I hope for better days ahead, the prevailing evidence suggests the long-term path for bond yields remains lower.

Obviously, rates will not move in a straight line. There will be many short-term "zigs and zags" as there have been since this amazing bull market began in 1980. But the trend remains unmistakable. Take a look at the long-term chart (charts don't lie) below, plotting the path of 10-year Treasury yields over the past 37 years. Over this period of time we have seen the 10-year Treasury benchmark yield rise a remarkable 2,000 basis points (20%). But every time rates have risen, the economy has slowed and rates have reversed with the peaks and troughs of yields going lower and lower. Simply put: We have seen lower highs and lower lows for over three decades. That folks, is what defines a secular bull market and it does not appear to be ending anytime soon. Frankly, it would not be a stretch to see the 10-year Treasury benchmark fall below 1% when the next slowdown occurs.

This is why we have consistently recommended that credit unions remain fully invested while taking advantage of temporary sell-offs in the bond market to deploy excess cash reserves. Over the past decade, this discipline has served credit unions well.

The Bull Continues

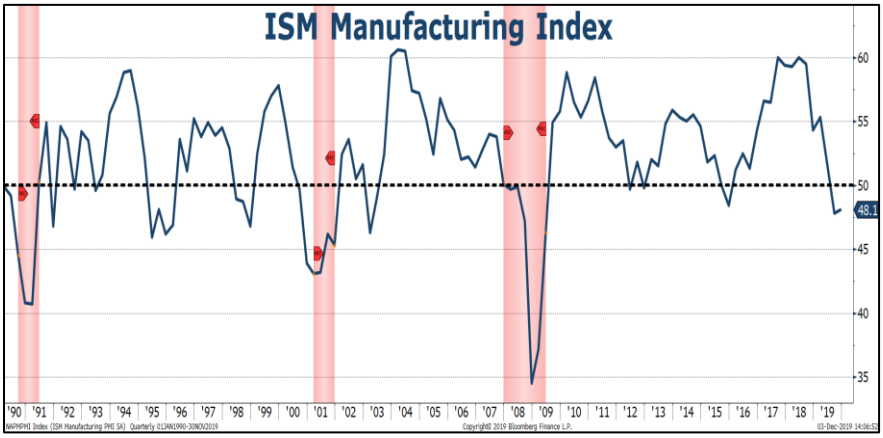


Source: Bloomberg

SLO-MO

Practically every piece of economic data last week disappointed. First, projections of a bottoming out in manufacturing activity were blown out of the water by the November Institute for Supply Management (ISM) report. The headline came in at 48.1 in October and a decent-size miss from what the economics community had penned in, which was a 49.2 print. The index has now fallen in seven of the past eight months. More importantly, it has been below the 50 cut off for growth in each of the past four.

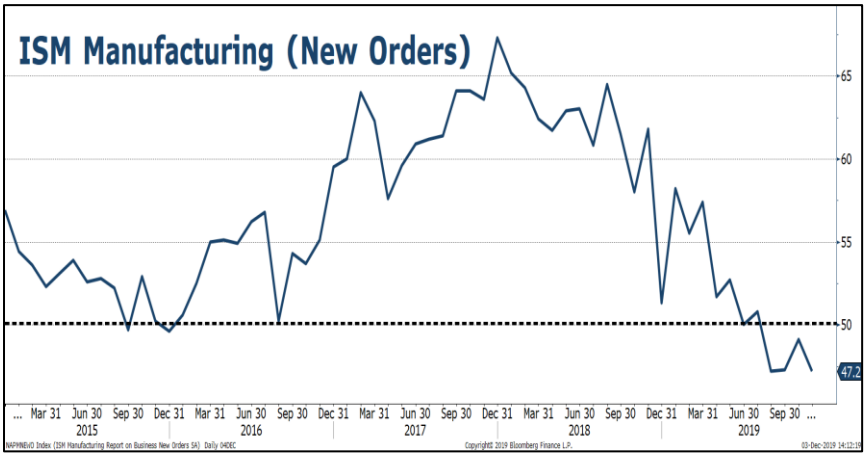
Manufacturing is in the Dumps



Source: Bloomberg

The new orders index was disturbingly weak, slipping from 49.1 in October to 47.2. This is tied for the weakest number since August of this year, June 2012 and, before that, April 2009 when we were at the depths of despair at the worst part of the credit collapse a decade ago.

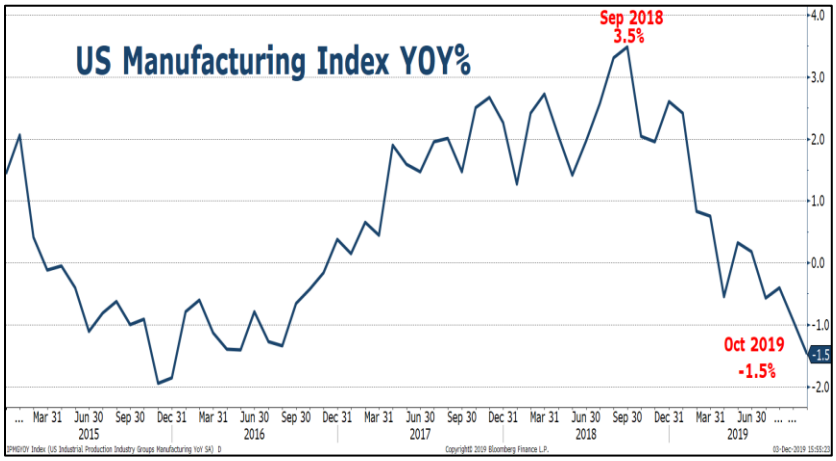
New Orders Crash



Source: Bloomberg

***Sidebar**: Purchasing Managers Indices (PMIs) are private-sector measures, based on how a panel of manufacturing executives – names are not disclosed – see new orders, production, employment, etc. for their own businesses in the current month (November). Official data for manufacturing in November will be released in two weeks.*

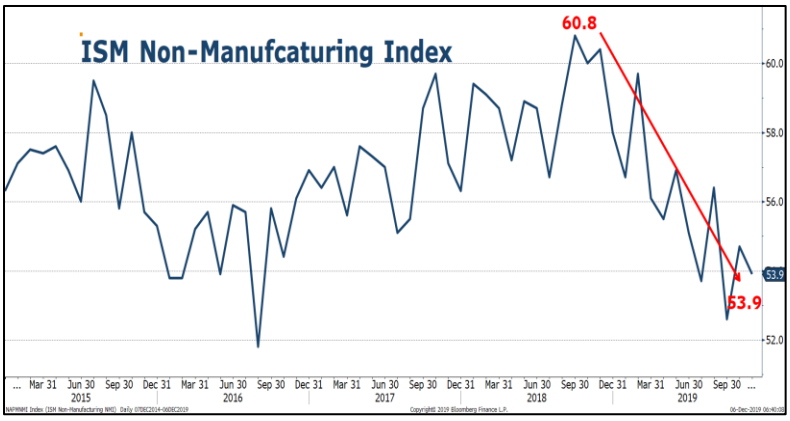
PMIs have proven to be good predictors of where official manufacturing data will end up months later. They're a real time view into manufacturing conditions. So, the PMI data we're looking at today gives us a preview of what the official manufacturing data might look like over the next month or two. And it's not pretty. The official manufacturing index peaked in December, with year-over-year growth rates peaking at 4.0% in September last year. Since then it has declined 1.5% year-over-year. The PMIs suggest the trend will accelerate in the wrong direction.



Source: Bloomberg

The non-manufacturing ISM, like its manufacturing counterpart, came in below consensus views in November slipping to 53.9 from 54.7 in October. Since last September, this index has cascaded lower from 60.8. Needless to say, for a service driven economy, this trend looks ominous.

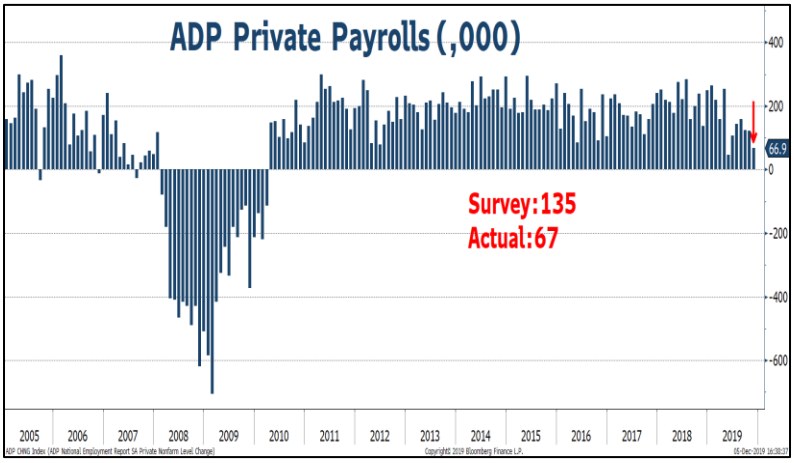
The Service Sector is Weakening



Source: Bloomberg

If the ISM reports weren't bad enough, the ADP private sector payroll data fell well short of consensus expectations in November with a mere 67,000 increase, which is negligible; October was revised down a touch to 121,000 from 125,000. The data also showed that small businesses hiring has stalled. Small "ma and pa" shops are leading indicators, because of their flexibility, and it is these entities that can adapt the best to shifting economic conditions. These businesses (1-19 workers) shed 15,000 employees on top of the 13,000 net job loss in October. This brings the decline to five of the past seven months, during which the total retrenchment has been 79,000. It's been nine years since we last saw such weakness.

Private Payrolls Disappoint



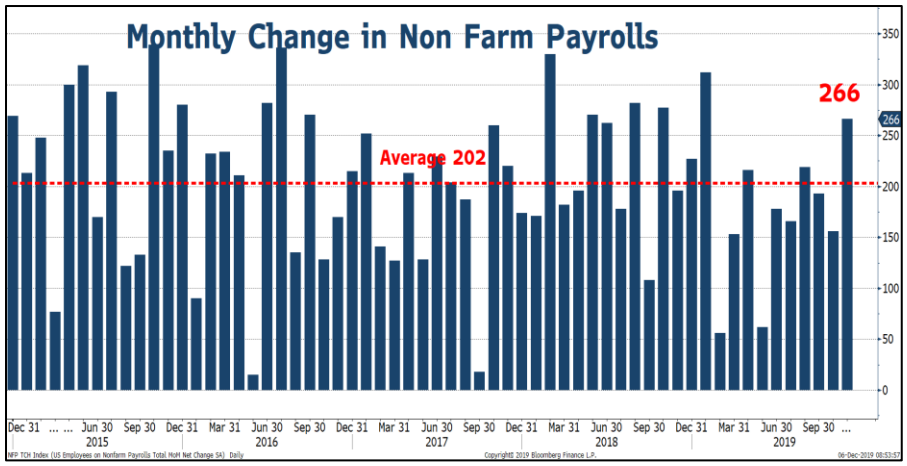
Source: Bloomberg

Yet, on Friday the headline non-farm payroll report smashed through expectations in November, coming in at +266,000 versus the consensus estimate of +180,000. In fact, the highest number on the range of forecasts was +237,000, so consider this somewhat of a blowout. And there were upward revisions of 41,000 for the prior two months.

That said, I remain guarded. First, when Thanksgiving lands late in November, the effect can be huge. David Rosenberg estimates that this timing effect could be at least 100,000 on the headline payroll number alone.

Second, let's consider that this was a five-week interval period between surveys, as opposed to the normal four-week gap, and historically this provides an upward skew.

Jobs Jump, But…



Source: Bloomberg

Then, tack on the 46,000 returning General Motors (GM) workers. After netting out these factors, the underlying payroll number was closer to 100,000. So, cool your jets!

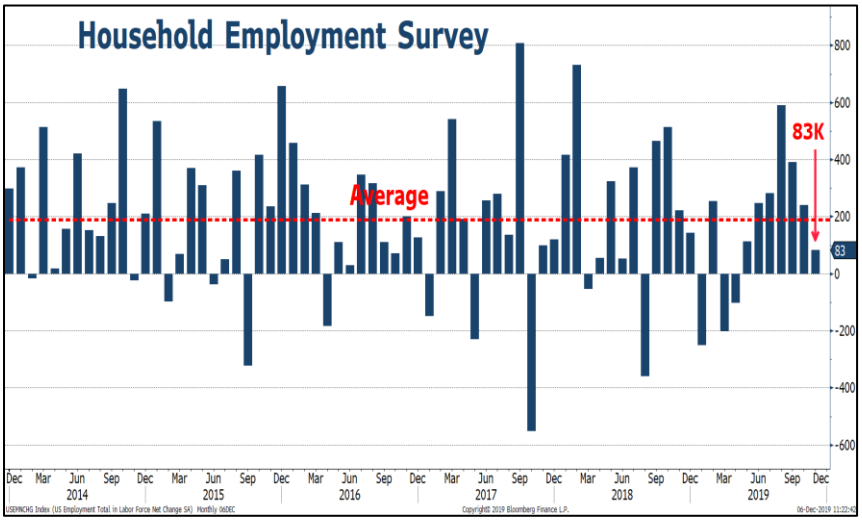
The GM Strike Ends

Source: Bloomberg

In other words, if you do an entire forensic data analysis on the November employment report instead of a knee-jerk response from the seemingly bullish headline figure, the only conclusion that can be drawn is that we are seeing a classic late cycle weakening in labor market trends. This month we can say the end of the GM strike provided a one-month or perhaps two-month lift in jobs. Seasonal adjustments on top of GM further skewed things.

The companion household survey also came in light, at +83,000 in November, which is the softest reading since last April and only one in five were in full-time jobs. It could well be that the household poll was the more revealing out of the two employment surveys that were released. But I did not hear a peep from the Wall Street crowd on this tidbit, which is interesting in its own right.

Which Survey Do You Believe?

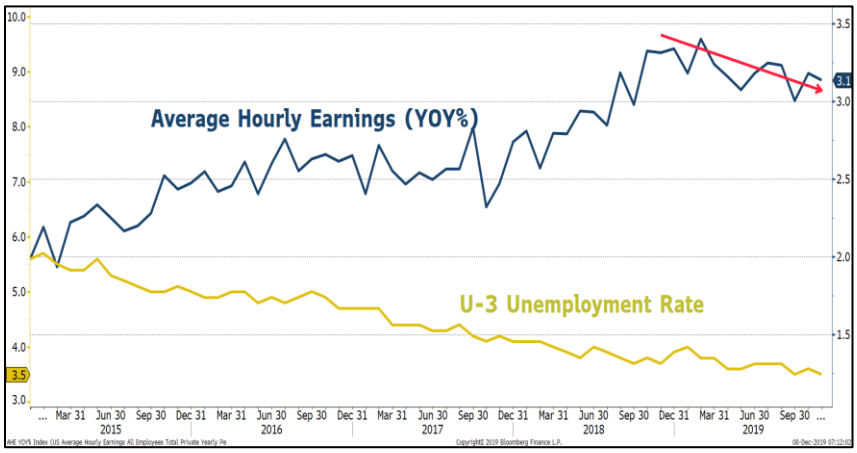


Source: Bloomberg

Despite the dip in the unemployment rate to 3.5%, average hourly earnings are down to +3.1% on a year-over-year basis. It has been 10 months now that the jobless rate has been south of 4% and over this time, the trend in wages has actually slowed. A good chunk of this reflects the fact that the U.S. economy is increasingly shifting to a low-productivity

industry composition. At the risk of sounding highbrow, the reality is that burger flippers, bartenders and bell captains don't write code and don't make that much money. This is the fastest growing segment of the employment population; running double the pace of the rest of the employment pie, yet they earn nearly 40% less than everyone else. You do the math. This is why wages are so suppressed; it's the type of jobs this economy is generating. End of story.

Wages Should be Higher



Source: Bloomberg

Final note: I'm not at all surprised by the cheerleading that went on after the release of the employment report on Friday. And that is because what grabs everyone's attention is the headline payroll data. So very few bother to delve into the details of the release to see what is actually going on, and whether the number corroborates with everything else happening in the U.S. economy.

We also have to ask ourselves if the payroll report was the outlier last month from everything else. ADP employment came in at +67,000, or half what the consensus was expecting. Non-farm payrolls missed to the upside by more than 80,000 while ADP disappointed to the downside by over 70,000. How does this make any sense?

MARKET OUTLOOK AND PORTFOLIO STRATEGY

***Jerry Seinfeld**: "If every instinct you have is wrong, then the **opposite** would have to be right."*
***George Costanza**: "Yes, I will **do the opposite**. I used to sit here and **do** nothing, and regret it for the rest of the day, so now I will **do the opposite**, and I will **do** something."*

In what is another bad sequel to the movie Groundhog Day, the news of the day every day last week was, again, that the Chinese are going to waive certain import tariffs and increase agricultural purchases. By my count, this is the third time in the last three months in which Trump indicated that the Chinese would begin purchasing a meaningful amount of U.S. agriculture products.

In fact, on October 12, President Trump tweeted: *"The deal I just made with China is, by far, the greatest and biggest deal ever made for our Great Patriot Farmers in the history of our Country. In fact, there is a question as to whether or not this much product can be produced? Our farmers will figure it out. Thank you, China!"*

And then he tweeted this the same day: "*Start thinking about getting bigger tractors!"*

One day later he tweeted: "*CHINA HAS ALREADY BEGUN AGRICULTURAL PURCHASES FROM OUR GREAT PATRIOT FARMERS & RANCHERS!"*

Sounds great, but it never happened.

There still could be a deal. The deadline for further Trump tariffs is December 15. That's six days away and a huge amount of time on the Trumpian Time Scale where his opinions change not day-to-day, but by the hour.

My base case scenario all along has been that Trump would produce some essentially irrelevant deal then brag about what would effectively be a return to the status quo. This is what he did with USMCA, his NAFTA replacement that is 95% the same the deal.

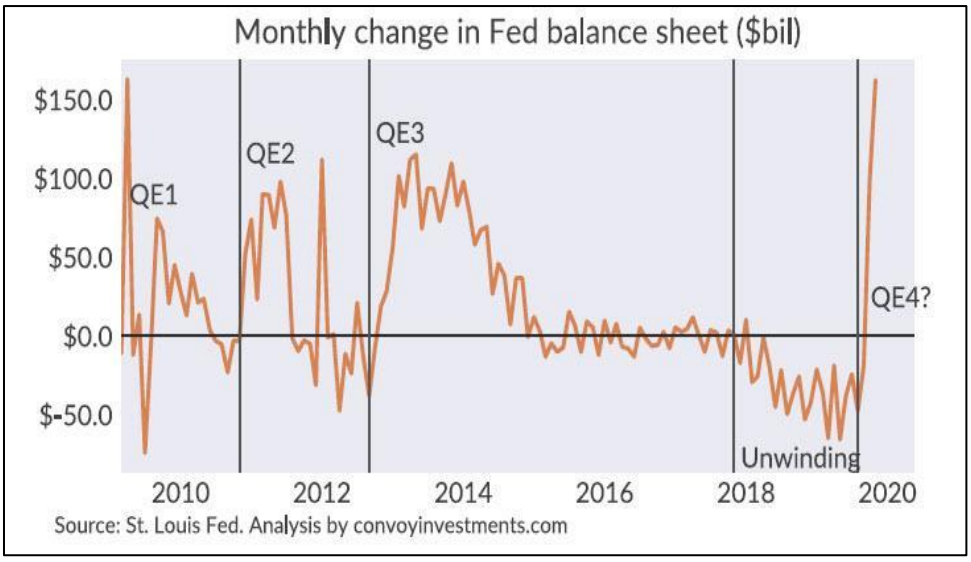
Luckily enough, politically motivated tweets aside, the data, as always, will set us free.

As the equity market bobs and weaves around every single trade nuance, the U.S. economy is slowing down visibly. U.S. corporate profits are set to decline for four quarters in a row. Let's face it, it's not every day that the stock market rallies 20% in such an environment. So, if you want any evidence of how to make money in today's environment, do the exact opposite of what your brain tells you that you should be doing. For Seinfeld fans, it's called the George Costanza Effect.

In fact, the global economy – while sputtering – is supposedly doing just fine. And yet, central banks are acting as if a global financial crisis is just around the corner.

As shown below, the planned QE unwinding has hit a brick wall and the Fed balance sheet is now expanding at a rate matched only briefly by QE1, and faster than QE2 or QE3.

Once again, there is absolutely nothing fundamental about this market. Momentum, sure. Sentiment, you bet. Liquidity, big time.



So, boil it down to uber-low interest rates and ongoing injections of Fed liquidity, but then consider why these things are happening because the central bankers know, though they don't advertise this at all, that the macro outlook is fraught with risk and fragility. They will do everything they can to prevent a recession and full-on bear market.

As I can attest, recessions are difficult to predict. While we all hope that a recession will never happen, we should always understand that one is out there. It is a matter of time, folks. But at the very least, people ought to discuss the actual data instead of pretending that all is well.

Exports are not good. Agriculture stinks. We got a boost because the GM strike got settled and housing picked up a bit from lower rates, but the consumer is once again stretched, and incomes have not matched job growth. I'm in the recession camp and for the additional reason that our economic expansion is long in the tooth.

As discussed in detail above, the most prudent course of action is for credit unions to maintain a risk-appropriate, high-quality, diversified ladder strategy. Take advantage of intermittent sell-offs. You have heard it here before (many times): **BUY THE DIPS!**

ALLOYA INVESTMENT SERVICES – COMING JANUARY 2020

We are excited to announce that the broker/dealer services provided to credit unions under the name Balance Sheet Solutions will be rebranded as Alloya Investment Services on January 1, 2020. The broker/dealer services and relationships currently provided to Balance Sheet Solutions' credit union clients will not be impacted by the name change to Alloya Investment Services. To learn more about the rebrand of Balance Sheet Solutions, visit **www.alloyacorp.org/invest/alloya-investment-services**.

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

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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.

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