BALANCE SHEET SOLUTIONS
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WEEK OF DECEMBER 16, 2019

Weekly Relative Value

The Greatest Fed Chairman Ever!

"It was the biggest inflation and the most sustained inflation that the United States had ever had."
– Paul Volcker, former Chairman of the Federal Reserve

President Richard Nixon created inflation by ending the gold standard in 1973. The dollar's value plummeted, making import prices higher and creating inflation. Nixon tried to stop it with wage-price controls in 1971. That restricted business activity, slowed growth and created stagflation (slow growth/high inflation).

Source: Cagle Cartoons

I was just starting in the business in 1980, and at that time, consumer price inflation had risen from 4% to over 14%. The Fed had lost all credibility, and no one believed inflation could be stopped. Enter Paul Volcker. Known as "Tall Paul" for his height of 6 feet 7 inches, Volcker vowed to end "stagflation." And he did. In 1980 he gave investors the "Volcker Shock" treatment, courageously putting the Fed's key rate at 20%.

"He wanted everyone to think we would keep interest rates low to support the depreciation of the dollar." – Paul Volcker

That's how Paul Volcker, described his non-politicized relationship with then U.S. Treasury Secretary James Baker after the Plaza Accord in 1985.

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

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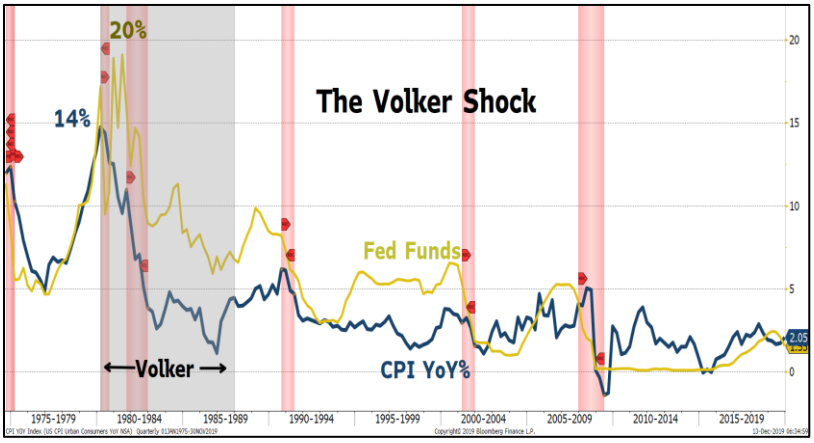
THIS WEEK

And Volcker was attacked by Democrats and Republicans alike. His effigy was burned on the Capitol steps. Former U.S. Senator Ted Kennedy proposed abolishing the Fed. But then President Ronald Reagan backed Volcker. And Volcker didn't flinch. He stood firm on his policy convictions in the face of so much criticism. He said what he thought. He did what he said he would do.

History has proven him prescient. Inflation (per the Consumer Price Index (CPI)), was over 14% in 1980. Three years later, it was under 3%. Unfortunately, it also created the 1981 recession. But had Volker not had the courage to do what he did, the economy would have been much worse off.

Volcker's monetary policy led to a "Strong Dollar, Strong America." Average real GDP growth was well over +4% between 1983 and 1989. The dollar was strong. His tough medicine set the stage for the long-term secular bull market in bonds and equities. In my judgement, the Reagan miracle was really the Volcker miracle.

Short-Term Pain… Long-Term Gain



Source: Bloomberg

On a personal level, I once had the distinct honor of having lunch with Paul Volker in New York City after he left the Federal Reserve in 1987. Despite being one of the most powerful and influential men in the world, I was struck by how unassuming he was. He could have been the guy next door.

And by all accounts, he was an honest man of unwavering character. Volker – not lobbying for a high paid job on Wall Street – put working in the service of our country above all else, always putting doing the right and difficult things ahead of the expedient and partisan things. In other words, he could not be "bought" by Wall Street or Washington. He sacrificed his personal well-being for the well-being of our country and those who served it. He was one of the greatest public servants ever. A true patriot and American hero.

Sometimes, in this hopelessly toxic political environment, it is too easy to forget that there are such spectacularly good people still.

Paul Volcker passed away on December 8, 2019. Rest in peace, Mr. Volcker.

THE GREATEST ASSET BUBBLE IN HISTORY

"I'm intrigued the Fed says, 'Maybe we can let inflation run a little hot.' I'm like, if you actually counted inflation correctly then you'd find out that we're already on fire. If you were to bring into account, oh, I don't know, apartment rent and home prices and stocks and bonds, but no, no, no. no, no."

"Well, in theory, Jay Powell's resume was what we wanted it to be. This is the guy who in October 2012 said that 'the Fed's [quantitative easing] policy was creating a fixed income duration bubble across the entire credit cetera spectrum.' So, he knows what he's talking about and he knows what the Fed's policy has done…

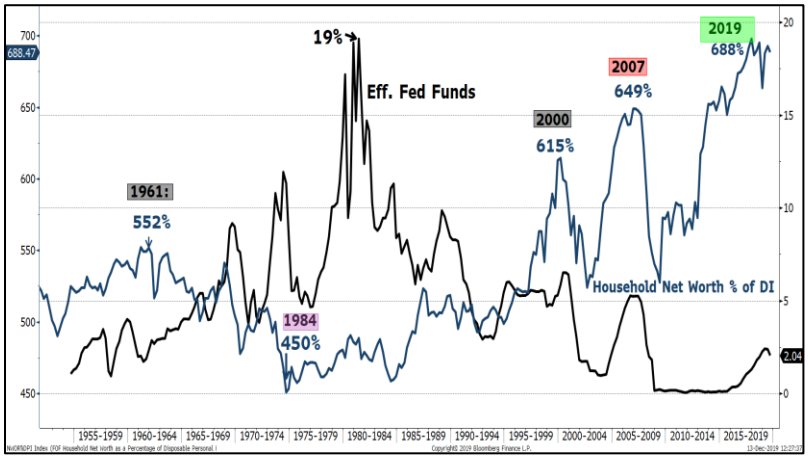
The Powell we have today is clearly not comfortable in his skin. He knows what he's doing is wrong. I think unlike Volcker, Powell got to the edge of the abyss. He had a choice to make between two really bad outcomes and he chose to make neither." – Former Fed advisor Danielle DiMartino Booth

Powell is not Paul Volcker. He was a successful lawyer. He knows where his post government gig bread is going to be buttered.

It is what it is.

Today- at any sign of economic weakness- "the Street" begs for an easy Fed, a weaker dollar, and lower interest rates. The chart shows the market value of all household assets (stocks, bonds, real estate, etc.) as a percentage of disposable personal income. As the chart below details, as rates go up, asset valuations go down... and vice versa. And never have asset valuations been so far beyond underlying incomes to support those valuations as they are now.

Household Net Worth at All Time Highs



Source: Bloomberg

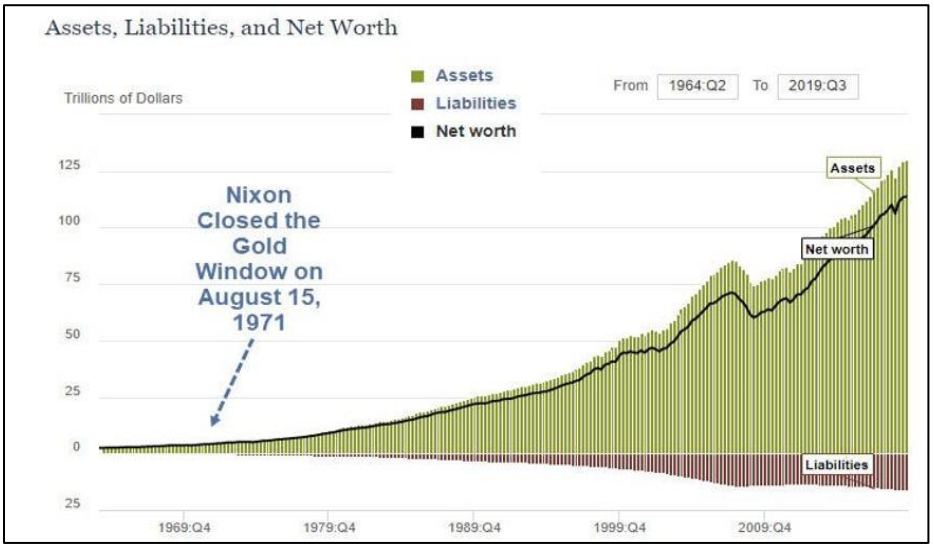
And it's not just stocks, bonds and real estate.

A banana duct-taped to a wall was bought for $120,000. The proud owners say it'll be an "iconic historical object." You just can't make this stuff up.

Duct-Taped Banana… Probably Nothin'!

The chart below paints a rosy picture. Assets are at all-time highs and liabilities are relatively small on a percentage basis. But what the chart does not say is where the wealth is and where the liabilities are.

Is Everything Fine?



Source: TheBurningPlatform.com

The assets are concentrated in the hands of the top 0.1% and the top 10%. The liabilities are concentrated in the bottom 90%.

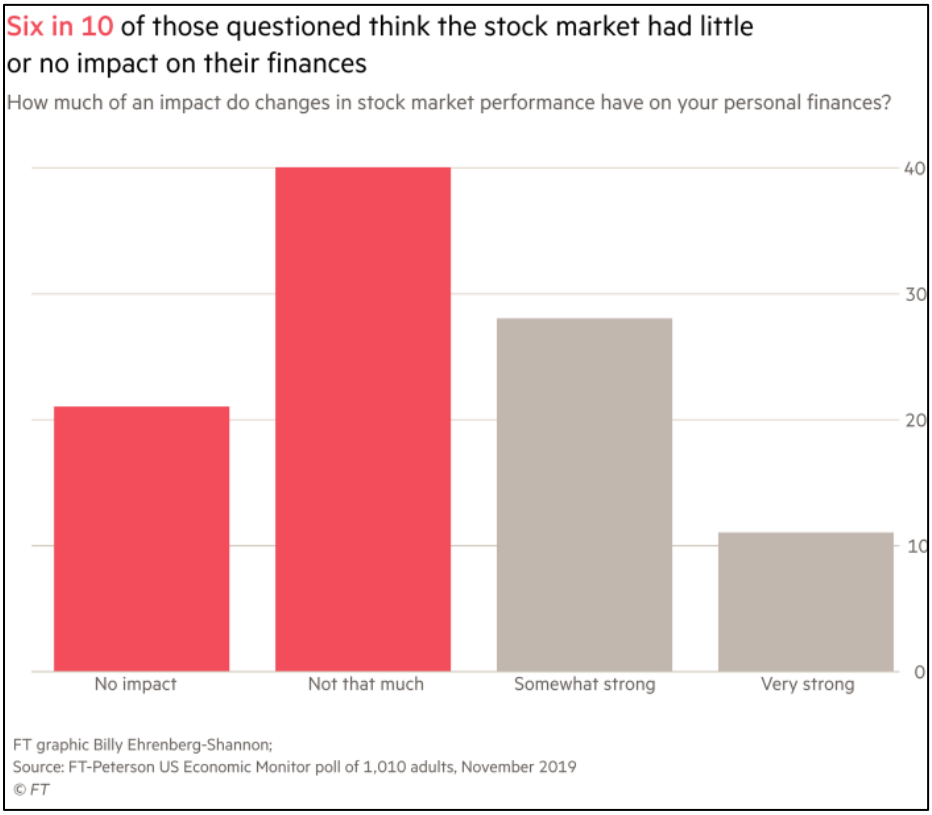
That's a big reason why we have "inequality" running at generational highs.

Most of the country isn't prepared for retirement. And many who think they are prepared do so only because of inflated asset prices, are unlikely to last. This is a result of bubble-blowing tactics ongoing for decades.

Meanwhile, if you do not feel wealthy, then most likely it's because you aren't.

There was an interesting piece in the Financial Times that reported only one-third of Americans feel the benefits of the great bull market. Amazingly, only 40 % of the population realizes stocks are up for the year.

"Nearly two-thirds of Americans say this year's record-setting Wall Street rally has had little or no impact on their personal finances… Thirty-nine percent said stock market performance had a 'very strong' or 'somewhat strong' impact. The survey suggested most Americans are not aware of market movements, with just 40 percent of respondents correctly saying the stock market had increased in value in 2019. Forty-two percent of likely voters said the market was at 'about the same' levels as at the start of the year, while 18 percent believed it had decreased."
– The Financial Times

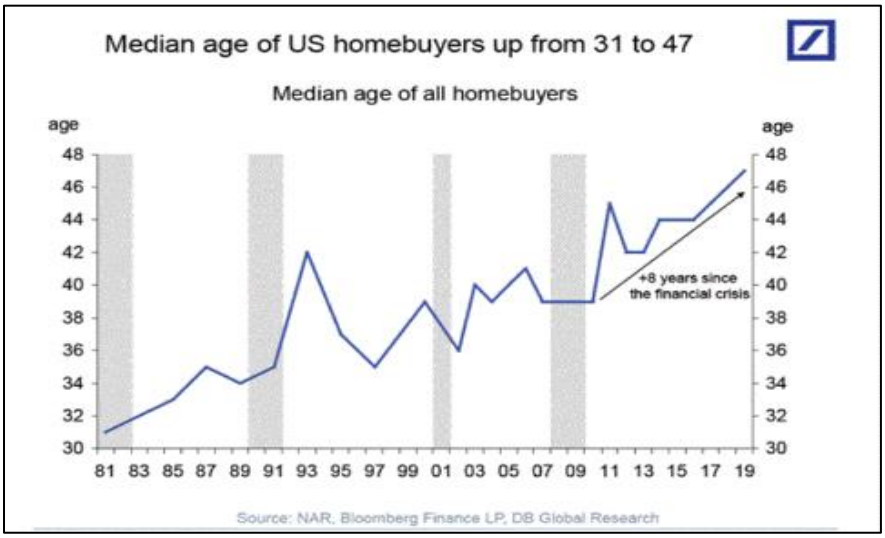


The extreme level of asset inflation we are witnessing is a matter of Fed policy and an absolute necessity, given the nature of our debt-based, fiat monetary system. These over-valued assets provide the collateral that permits the additional borrowing required to keep the "system" going.

Obviously, this cannot go on indefinitely.

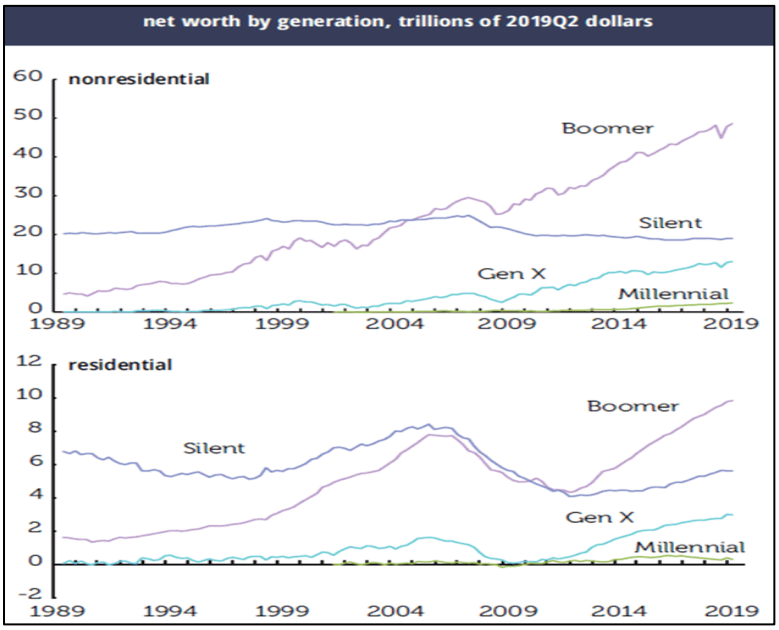
And the remarkable chart that follows from chief economist of Deutsche Bank Securities, Torsten Slok, shows that Americans are having to wait much longer until they buy a house. In the decade since the financial crisis hit, the average age of homebuyers has increased by eight years – which means that a generation that thought they were about to own their home as the crisis began has only recently managed to do so.

There are plenty of measures of economic pain for Americans who don't feel included in the current "capitalist economy." This is one of them.



And even though the poverty level in the U.S. is well above international average incomes, people compare their situation to what they see. Philippa Dunne at The Liscio Report showed two charts demonstrating older generations (read baby boomers) are doing much better than Gen-Xers and especially millennials.

Millennials only hold 3% of total U.S. wealth, and that's a shockingly small sliver of what baby boomers had at their age. When boomers were roughly the same age as millennials are now, they owned about 21% of America's wealth, compared to millennials' 3%…" – Hillary Hoffower, Business Insider



Source: The Liscio Report

And look at the table below. Notice that 49% of Millennials favored socialism.

	CAPITALISM	SOCIALISM
MILLENNIALS	51%	49%
GEN X	61%	39%
BABY BOOMERS	68%	32%

GALLUP

I understand the economic theories that GDP growth will eventually spread widely enough to ease the angst. But I am not sure we can wait that long. People are hurting now, and they are increasingly willing to embrace radical solutions. "Just wait for better times" is not cutting it as technology eats into higher-paying jobs and aggravates the stress of lower-income jobs.

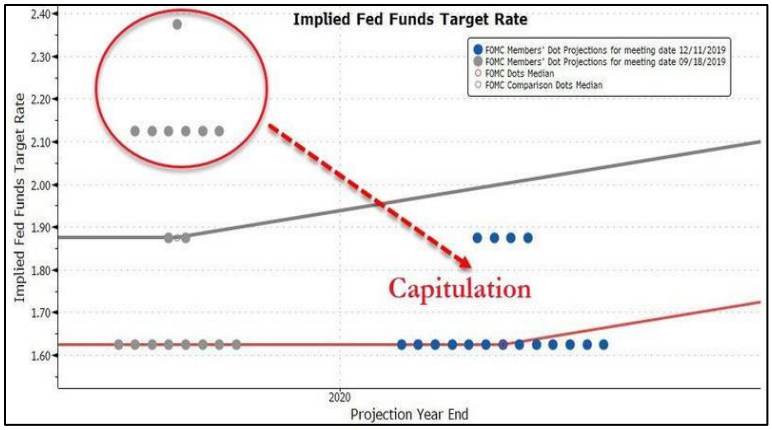
Getting everyone connected to the economy and sharing in our prosperity is a big challenge. So was sending men to the moon. When JFK called on Americans to set that goal, he said we do such things **because** they are hard. The nation went to work and, a remarkably short time later, Neil Armstrong took that one small step, representing us all and indeed, all mankind.

We can do hard things.

STATUS QUO

The Federal Reserve officially capitulated as the federal funds target range was left unchanged at 1.5%-1.75%, as expected, **f**ollowing three straight cuts There were no dissents (a unanimous 10-0 decision) for the first time since May 1. A clear indication that policymakers uniformly view the policy stance as appropriate.

Status Quo for Now



Source: Bloomberg

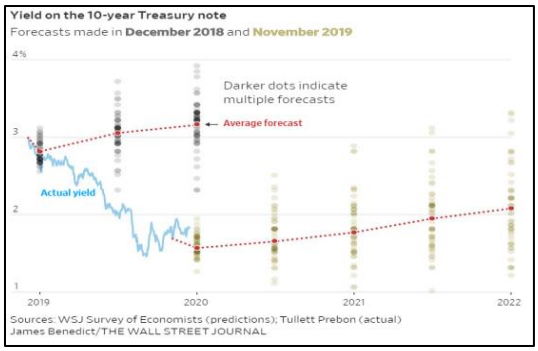
The Federal Open Market Committee (FOMC) says rates are currently "appropriate" to support growth, jobs and inflation, while officials omit prior language that said, "uncertainties about this outlook remain." The FOMC said the labor market and household spending were strong, while business investment and exports were weak. The Fed said it will continue to monitor information, "including global developments and muted inflation pressures."

The dot plot shows 13 of 17 officials expect no change in the funds rate through the end of 2020; most see higher rates as likely in 2021, with a further increase expected in 2022. There was little change in forecasts for economic growth, unemployment and inflation.

Bottom line: The Fed is on hold for the foreseeable future and it will take a material change in the data for this stance to change.

WHERE ARE YIELDS GOING?

In 2019 most economists had predicted yields to climb. Instead, economic growth cooled, trade tensions intensified, and bond yields reversed, falling to near all-time lows. This is nothing new for the Wall Street crowd. In fact, in eight of the past 10 years, economists surveyed by the Journal predicted the 10-year yield would rise higher than it did.



So, as everyone brings out their crystal balls, a recent Wall Street Journal survey showed that economists expected the yield on the benchmark 10-year Treasury note to end next year above 3%, or just slightly higher than 1%. The average forecast of 1.97% was only modestly higher than where the yield settled at 1.86%. Most expect the Federal Reserve will keep interest rates steady after cutting them three times this year.

Where do you think bond yields will go in 2020?

Send your comments or forecasts to editor@balancesheetsolutions.org or to me personally and please make sure to include your name and credit union.

SIGNING OFF

The year is coming to an end and there is a 100% probability that we will not have a classic recession (two consecutive quarters of negative GDP) in 2019, the Chinese Year of the Pig – one that had a whole cosmetic bag of lipstick applied to it.

This is because the consumer never gave in, and the reality is that half of household spending, or 35% of GDP, are essentials like rent, utilities, health care, education and food, which have never declined (collectively) in any recession in the post-World War II era. So, the bar is always set very high for an outright recession, because the other 65% of the economy has to go down a lot. This time, even though we have seen rolling downturns in housing, nonresidential construction, capital spending and exports, the hit to employment and consumption never did materialize.

That said, the economy is far from out of the woods. Excluding the consumer and government spending, real GDP has actually contracted fractionally in the past two quarters.

And for equity investors, it is earnings that count most. This will be the fourth quarter in a row in which S&P 500 operating earnings per share have contracted. If not for a dramatic P/E multiple expansion this year, the stock market would have declined instead of soaring 25%.

The reality is, this market is momentum and liquidity-based, dominated by machines instead of man.

Delusional

Source: Hedgeye

Face it, if things were really anywhere close to being normal, then surely after a 10-year-plus economic expansion and bull market, with the unemployment rate at a five-decade low of 3.5%, we would not be seeing the funds rate negative in real terms, the Fed's balance sheet sitting at an epic 20% of GDP, and the U.S. federal government racking up $1 trillion (or near 5% of GDP) in fiscal deficits at this stage of the cycle.

Strip out this massive degree of fiscal and monetary policy support, and we are, in fact, in a recession. That truly is how precarious the situation is when monetary and fiscal policy together are in a place that in the past were only used to fight a severe economic downturn. But now we are told by the Fed that this economy is in a supposedly good place. The President tweets that this is the best economy of all time. Come again? If that's the case, then why all the life support?

We finish 2019 with investors complacent and sharply higher valuations, but with the economy in much softer shape and the political outlook much more clouded while the yield curve is still flat as a pancake.

All I can say is that if 2019 is the Year of the Pig, 2020 could be the Year of the Rat!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Agreements on the U.S.-China trade deal and the USMCA, as well as the U.K. elections results, have provided more clarity for the outlook, at least in the short-term. The Fed and European Central Bank (ECB) signaled polices will remain accommodative for an extended time. The Bank of Japan is expected to leave policies unchanged next week, especially after the Japanese government's recent plans for a larger-than-expected fiscal package.

The prospect of seeing tariff hikes unwind (merely avoiding December 15th tariffs) surely is a positive development for the near-term. And this follows the news of the updated version of NAFTA finally moving through Congress. But I'm not convinced that investors fully understand just how limited this Phase One deal is, the tiny portion of issues it really addresses, and how the much more important issues (such as subsidies and technology transfers) have been left for another date.

Moreover, with the Fed now signaling that they are effectively done lowering rates through next year, and President Trump concluding a "trade deal," what will be the next driver of the markets? What will the "algos" do without daily **"**trade tweets" to push stock markets higher?

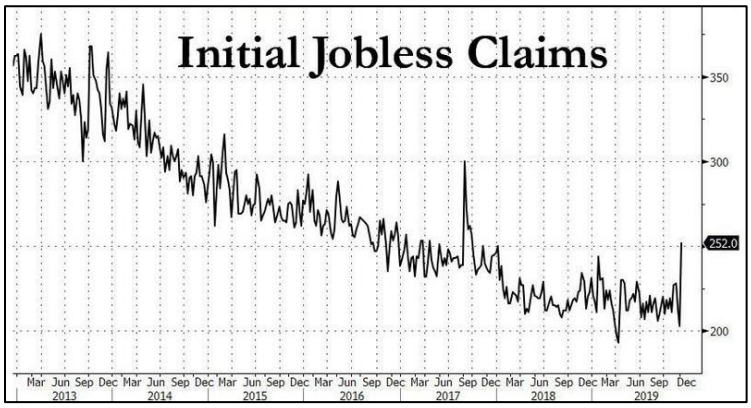
Stocks and Tweets

Source: Bloomberg

My suspicion is that the conclusion of the **"**trade deal" could well be a "buy the rumor, sell the news" type event as details are likely to be disappointing.

More importantly, the rollback of tariffs does not immediately undo the damage that has already occurred. Economic growth has weakened globally, and corporate profit growth has turned negative. Tax cuts are fully absorbed into the economy. And the "repo" market is suggesting that something is broken. All of which is leading to rising recession risk.

Also of note last week, the Bureau of Labor Statistics (BLS) reported a shocker when the latest weekly initial jobless claims soared unexpectedly by 49,000, from a near-cycle low of 203,000 to 252,000, and the highest print since 2017! There was no immediate explanation for the sudden spike, although the Labor Department did note that volatility is **"not unusual"** around the Thanksgiving holiday.



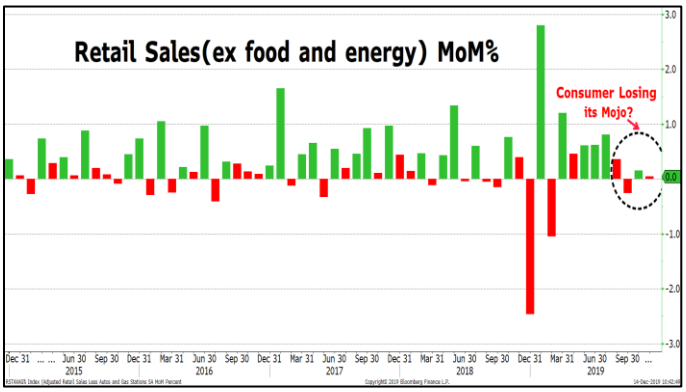
Source: Bloomberg

Even if the latest unemployment claims have been distorted by the late arrival of this year's Thanksgiving holiday, we've had 10 consecutive weeks of increasing numbers of Americans collecting unemployment insurance, validating the Duke Fuqua CFO Survey showing nearly 60% are in cost-cutting mode.

As discussed above, the consumer was the key to the economy avoiding recession in 2019. And the same holds for 2020. If jobs are lost, consumption will fall. The business cycle will end, and a recession will ensue.

And to that point, the holiday shopping season is off to a slow start as judged by the November retail sales report. Retail sales excluding cars and gasoline were unchanged from the previous month.

Is the Consumer Out of Gas?



Source: Bloomberg

Notably, sales declined sharply across categories that are closely tied with holiday gift-giving, including clothing, electronics, department and sporting goods stores. Spending at bars and restaurants also dropped 0.3% last month, the steepest monthly decline since last December.

And it's not a bricks-and-mortar story, one that can be explained away by the fact that we've become a Prime-time Amazoned nation? Note that e-commerce sales were not only revised down to 0.6% growth in October from the originally reported 0.9%, they've also fallen at a 13.6% annualized rate through the fourth quarter, more than any single category of retail sales**.**

Retail sales account for about a quarter of consumer spending. This report doesn't track spending on most services, such as health care and housing.

The weak print could just be a seasonal adjustment factor given the fact that Thanksgiving fell on November 28, the last possible date. Below is a list of friendly reminders as to why the almighty consumer buys less:

- Earning less; working less
- Anticipates earning less in the future
- Spent beyond means; too much debt
- Observes higher unemployment
- Expects higher unemployment
- Wealth shrinks; asset values shrink
- Prices decline; more discounts

No, none of these reasons are what you would characterize as "good." We have now seen 10 consecutive weeks of increased ranks of Americans receiving unemployment insurance. This means that as unemployment starts rising, (whether it's you or a neighbor) it will have a psychologically negative impact on spending.

Also note that credit card delinquencies are rising and there's a fair amount of stress in subprime autos… This could be the canary in the coal mine and a warning that the consumer is hunkering down for the winter.

Keep your eyes on the all-powerful consumer going forward…

HAPPY HOLIDAYS!

"Be always at war with your vices, at peace with your neighbors, and let next year find you a better man."
– Benjamin Franklin

Wishing everyone happy holidays and a healthy, prosperous new year!

See you in 2020!

The next edition of the Weekly Relative Value will be distributed on January 6, 2020.

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**.

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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 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

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– Shawn Nikkel, Finance Director of Denver Fire Department FCU

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– Rhonda Schroeder, CEO of Blackhawk Area 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.