Balance Sheet Solutions, LLC
Member FINRA/SIPC

Weekly Relative Value

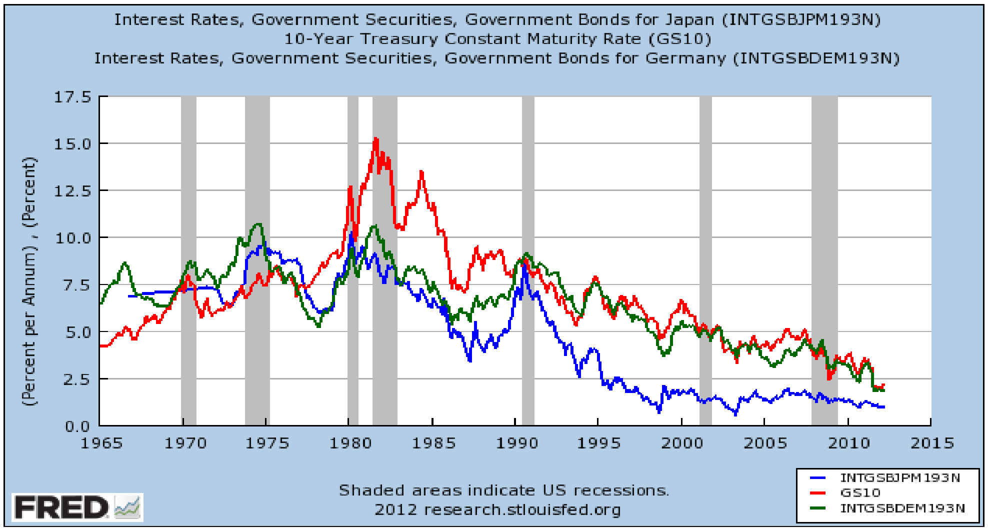
Week of May 14, 2012

Safety at Any Cost

U.S. Treasury yields extended their descent for the eighth straight week to within a few basis points of record lows. Meanwhile, yields on other safe-haven governments (Germany and Japan) have reached new record lows as well.

The 10-year U.S. Treasury note ended Friday at 1.84%, down four basis points on the week and about 20 basis points closer to the all-time low touched last September. The 30-year bond flirted with 3% and ended the week at 3.01 %, down five basis points on the week. This proved fortuitous for Uncle Sam as the Treasury was able to auction 10-year notes with a record-low 1.75% coupon and 30-year bonds with a record-tying 3.125% coupon.

The Rally Continues



U.S. Slow Growth Ahead

Growth over the 12 calendar quarters has averaged a bit less than an annual 2.4%, assuming the current economy grows at 2.1% in the second quarter. How sickly is that? So sickly, in fact, that since 1950 there has never been a 12-quarter period of expansion that ran as slow as 2.4%.

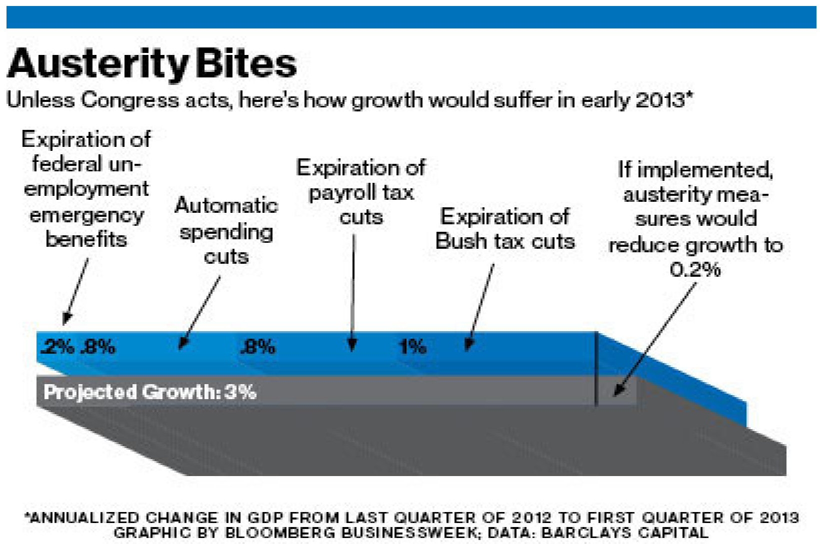
Add the fact that growth usually runs much faster following a deep recession, and this three-year period's economic performance looks much worse. In a “normal” recovery, the economy should be growing at 5-6% at this same point. Following the deep recessions of 1974-75 and 1981-82, the first 12 quarters of growth averaged 4.5% and 5.8%, respectively.

Looking forward, Blue Chip economists are forecasting growth of 2.0-2.5% next year

Yes indeed, this time is different!

Fiscal Cliff

Under status quo through the end of 2012, there will be record drag (roughly 4%) on GDP from reduction of those tax benefits to spending. Currently, since the economy is barely growing at 2% – do the math – a negative 2% economic growth rate is a very large recession. Try as they may, Ben Bernanke and the Fed have NO ability to offset the impact of the “fiscal cliff.”



Update on Greece

Greece is heading for a second election at breakneck speed and support is skyrocketing for anti-austerity. This situation is untenable and must be resolved soon. If not, Greece’s lenders (the EU and the IMF) could withhold future money infusions in response to the rejection of the austerity program. Faced with the prospect of running out of money, estimated to occur in July if there are no further disbursements, the Greek government may have to print its own currency (the drachma), leading to an EMU/EU exit. An exit would most likely go hand-in-hand with the Greek government’s defaulting on its debt. But the bigger problem might be the contagion. A Greek exit could raise concerns that other peripheral countries might follow suit. This, in turn, would have major implications for national banking systems.

In a sign that Germany is coming to terms with a possible Greek departure, business and political leaders stated last week that the euro zone could survive without Greece. This is because the Euro bloc is better able to withstand shocks. Der Spiegel, one of Germany's most respected news sources, went one step further and argued that a Greek exit was the only way forward now.

Per Der Speigel, "The Greeks were never ripe for the currency union and they still are not today. The attempt to make the country sustainable(y) healthy through reforms has failed… In the meantime, it is clear that the exit is in their own interest... Only an exit of Greece from the euro zone gives the country a chance in the long term to get back on its feet."

Its front cover depicted a splintered euro coin strewn across ancient Greek ruins.

While European politicians try to convince themselves and the world that a Greek exit from the euro would not really be the apocalypse imagined, any such move is fraught with many unknown and unintended consequences and could result in a Lehman like moment. As a side note last week the Greek10-year bond yield reached nearly 25% from 20% a week earlier.

BRICs Falling One by One

Last week, we focused on Brazil’s weakening growth prospects. This week, our focus turns to China's fab economy which is showing serious signs of strain. Exports, the engine of that nation's remarkable growth, are lagging. In April, they edged up a mere 4.9%, roughly half as much as economists had predicted. Imports, meanwhile, managed to eke out a miserable 0.3% rise, far below the 11% anticipated. Industrial output was reported at +9.3% versus an estimate of +12.2%, the smallest increase since May 2009. And residential real estate has hit the skids.

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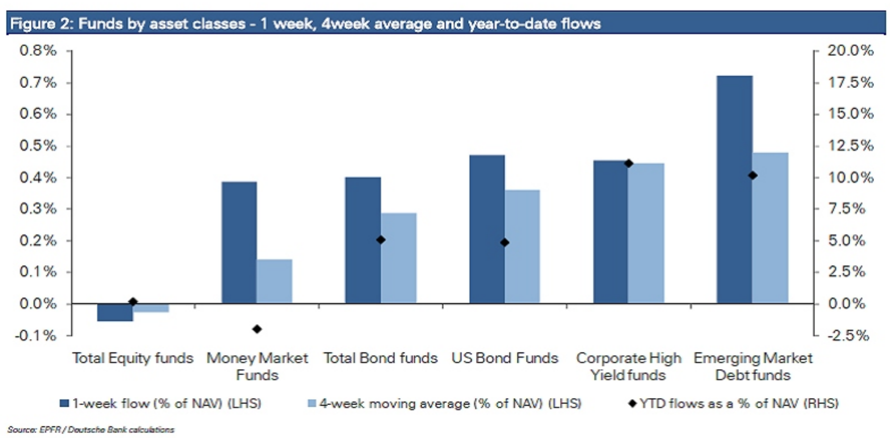
Bonds: Yes, Stocks: No

In a world of hurt, ranging from the continuing European debt crisis, floundering U.S. growth and teetering emerging markets, the refuge appeal of U.S. government debt remains extremely robust, despite record low yields. Last week, bonds enjoyed record inflows, the highest weekly inflows since July 2010 (see chart below). Equity funds, as they have since the beginning of the year, continue to show steady outflows. It appears that debt, deleveraging and aging population (read: aging Baby Boomers) are driving the demand for income and safety over capital appreciation. The case for safety has been reinforced by the dismal and volatile performance of the equities. *Over the past 13 years, and including the recent market advance, the S&P 500 has underperformed even the minuscule return on risk-free Treasury bills, while experiencing two market plunges in excess of 50%.* For the time being and possibly for many months to come, safety and capital preservation – at any cost – remains the dominant investment theme.

Flows by asset class funds (all including ETFs)



Portfolio Strategy

Overall, we believe that interest rates are likely to remain range-bound. When bond yields jump up for any reason, it is a buying opportunity UNTIL the Fed starts taking the punch bowl away. As everyone on this planet is well aware, the Fed has openly stated numerous times that they intend to keep rates on hold through late 2014!

Our view, given the macro environment and the status quo Fed monetary policy, is that the curve will continue to bull-flatten. Credit unions can take advantage of the flattening trade via extension trades from twos to fives. We continue to believe that the five-year part of the yield curve is the sweet spot for credit unions and short-duration investors looking to optimize yield and total return.

Continued…

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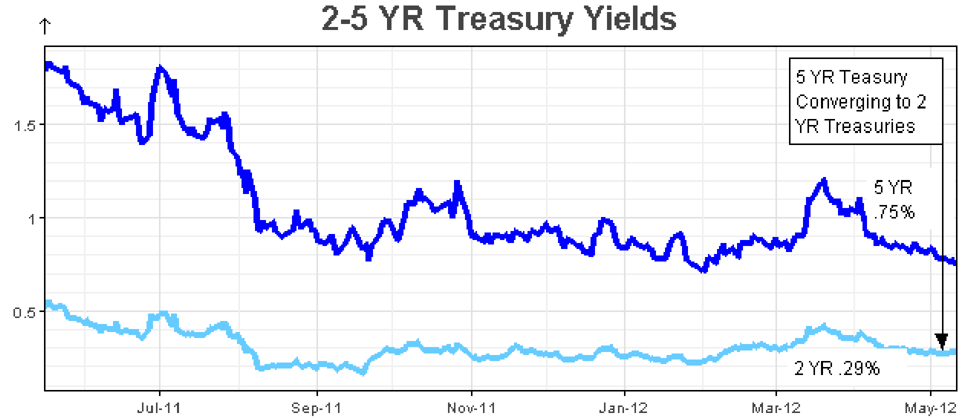
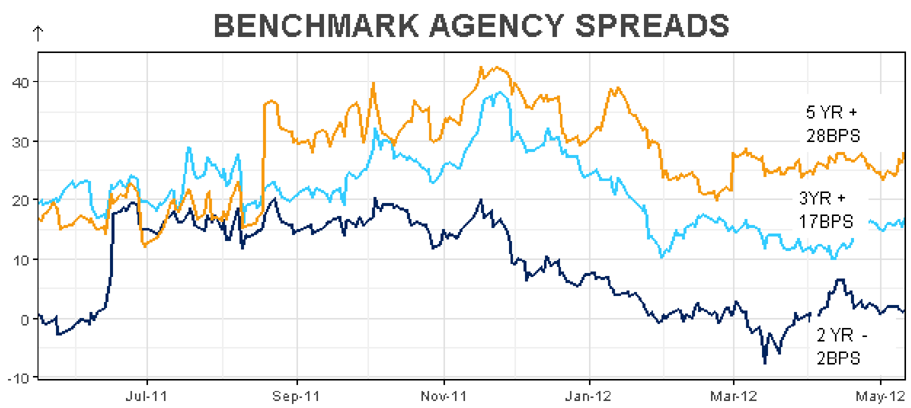


Key	Axis	Name	Last	Minimum		Maximum		Mean	SD	SD Change
	Left	USD Treasuries 2 Year	0.278	0.161	09/19/2011	0.554	05/18/2011	0.307	0.081	0.019
	Left	US Treasuries 5 Year	0.747	0.710	02/02/2012	1.841	05/18/2011	1.063	0.303	0.051

Overweight Five-Year Agency Debt

Within the five-year sector of the yield curve, Agencies continue to offer yield pick-up of +25 basis points over comparable-duration Treasuries. We believe pent-up demand for "safe" Treasury surrogates, coupled with limited new-issuance supply, should keep Agency-Treasury spreads well bid, leading to superior returns in the short end of the curve.



Key	Axis	Name	Last	Minimum		Maximum		Mean	SD	SD Change
	Left	US Agency On-the-run 2 Year Spread	1.399	-7.775	03/14/2012	20.250	10/04/2011	8.465	7.622	1.527
	Left	US Agency On-the-run 3 Year Spread	17.000	9.973	04/12/2012	37.986	11/25/2011	21.097	6.126	1.635
	Left	US Agency On-the-run 5 Year Spread	28.675	12.005	06/30/2011	42.599	11/17/2011	27.117	7.473	2.066

MBS Overweight - Down in Coupon

We remain modestly overweight the mortgage sector. Supply-demand technicals remain supportive with strong demand from REITs and banks. Within the MBS sector, we continue to favor down-in-coupon trades in the coupon stack. Despite higher coupons coming off this week, they still appear rich, relative to prepayment risks.

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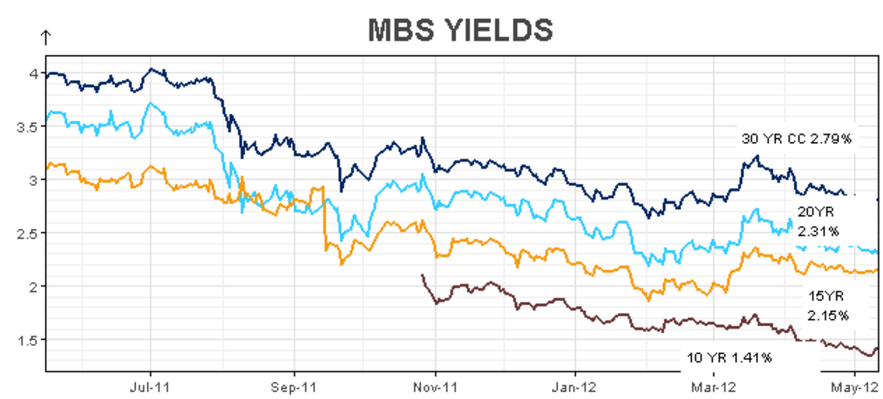
Adding to prepayment risk last week, the Responsible Homeowner Refinancing Act of 2012 was introduced by Senators Menendez and Boxer in the Senate. The provisions of the bill most relevant to agency MBS investors are:

- Expanding the HARP eligibility date by one year to May 31, 2010.
- Encouraging cross-servicer refinancing by:
  − Equalizing reps and warranties to match those of same-servicer refinancing.
  − Easing borrower qualification for cross-servicer refis by preventing GSEs from determining borrower eligibility based on LTV, employment status and income.

The expansion of the eligibility date would be a strong negative for valuations of all Make Home Affordable (MHA)/Credit Qualified (CQ) pools (LTV 105-125 %). Moving the eligibility date would mean that the cut-off date was not sacrosanct, and could be changed yet again to encompass a higher eligible population. Although we continue to think the chance of passage is limited, the introduction of the Menendez-Boxer bill in the Senate does serve to increase policy risk in higher coupons.



Key	Axis	Name	Last	Minimum		Maximum		Mean	SD	SD Change
	Left	FNCL CC CC Static Yield	2.790	2.630	02/02/2012	4.034	07/01/2011	3.235	0.401	0.057
	Left	FNCT 3.5 TBA Static Yield	2.311	2.190	02/02/2012	3.720	07/01/2011	2.812	0.421	0.069
	Left	FNCI CC CC Static Yeild	2.141	1.853	02/02/2012	3.149	05/19/2011	2.473	0.364	0.064
	Left	FNCN 3.0 TBA Static Yield	1.410	1.341	05/07/2012	2.103	10/27/2011	1.688	0.178	0.033

More Information

For specific offerings or for additional portfolio strategy guidance, please do not hesitate to contact your account executive or investment advisory representative.

Author **Tom Slefinger** has more than 30 years of fixed income portfolio management experience, and has developed and successfully managed various high-profile domestic and global fixed income mutual funds. He 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 providing advice to credit unions on investment portfolio strategies and sectors/security selection. The primary emphasis of consultations is focused on optimizing investment portfolio returns consistent with a disciplined asset-liability framework. He can be reached at tom.slefinger@balancesheetsolutions.org or 800-782-2431, ext. 2753.