Weekly Relative Value

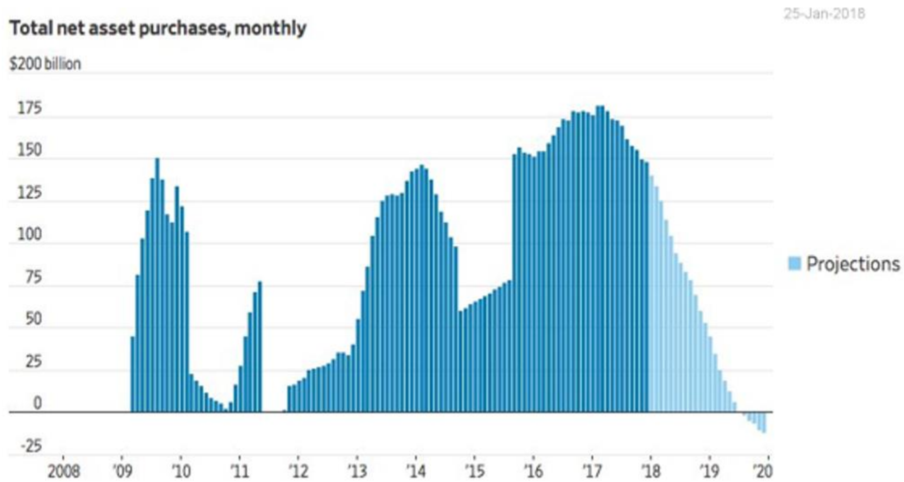
No Free Lunch

"There's no such thing as a free lunch." – Milton Friedman

The phrase "There is no such thing as a free lunch," is now so common that everyone knows what it means – even if something appears to be free, there is always a cost. In other words, you can't get something for nothing!

The phrase appears to date back to the 1930s when American bars offered a free lunch with the purchase of a beverage. The free lunch was totally legitimate. The food really was free. But there was a catch; the meals had about the same sodium concentration as an entire salt lick for a herd of cows, which left diners thirsty. So, they bought another drink. And another. Until they bought so many drinks that they had indirectly paid for their so called "free lunch."

Will the Central Banks be Successful in Deleveraging?



Note: Total purchases include the Bank of England, U.S. Federal Reserve, Bank of Japan and European Central Bank. January 2008-February 2009 and June-September 2011, amounts were between 0 and –$0.05 billion.
Source: Deutsche Bank

This sounds a lot like the latest central bank monetary maneuvers. Since the financial crisis, the central banks of the U.S., Europe, China and Japan have leveraged up their balance sheets to unprecedented levels and literally printed money round the clock. They bought not only government and mortgage debt; the European Central Bank even bought bushel baskets of corporate debt. In Japan, the Bank of Japan upped the ante by buying enough equity exchange-traded funds to become a top 10% shareholder in most companies in the Nikkei Index.

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Through their unprecedented intervention, central bankers have replaced the market mechanism of pricing interest rates to the point that short-term rates were zero in the U.S., and negative in Europe and Japan. They forced savers to become investors and speculators, thereby driving asset prices ever higher.

In doing so, the “all-knowing” central bankers created wealth out of thin air, boosted stocks, bonds, real estate and art, and catapulted government, corporate and personal debt into the stratosphere. Thus far, there have been little to no negative ramifications for what I and some others have described as radical and reckless policies on the part of the major central banks.

If the central banks manage to unwind their balance sheets (shown on previous page) and normalize rates with little or no disruption, they will have truly gifted the world the rarest of phenomena: a “free lunch.”

The problem is, as Milton Freidman stated, “There’s no such thing as a free lunch.” Someone **always** has to pay. The timeless question is – when and how much?

“There’s no such thing as a free lunch, Featherstone, and you can’t have your cake and eat it.”

In addition to the extreme monetary actions, current fiscal policy has been turned inside out too. In the past, as the economy strengthened, and the debt burden increased, Congress responded by raising taxes and cutting spending. This time around, the opposite has occurred.

Going forward, the deficit-financed tax cuts and expansionary fiscal policy, combined with the escalating growth of entitlements, will likely result in trillion-dollar deficits for years. And, as has been highlighted more than a few times in this space, excessive debt lowers economic growth in the long run as debt service consumes capital that could be used constructively to grow the economy.

To believe the current Trump administration that growth will ramp up and stay elevated for years to come (paying for the debt), you need to believe that something fundamental has changed to produce higher economic growth. You would also need to believe the administration found cures to reverse the two secular constraints that are primarily responsible for the slow-growth, low-inflation environment, which are:

- High and increasing indebtedness
- Rapidly-aging populations

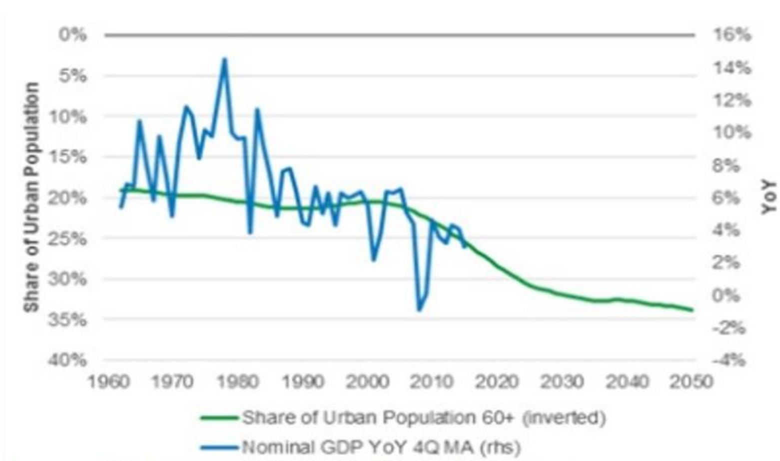
The first bullet point was documented in a 2012 study by Rienhart and Rogoff in which they observed an association between a government with high debt-to-GDP ratios (90%+) and subsequent periods of slower GDP growth. Most people can grasp the idea that excessive debt constrains their ability to spend in the future. It is no different for a government in the long run. Yes, growth may get a short-term bump from the tax cuts and fiscal largess, but after that, the boost will fade without further stimulus.

The second bullet point is intuitive; spending patterns will naturally decline as people age. The concept is most clearly demonstrated by the economic performance of Japan over the past 20 years. In the past, I've discussed – just on demographics alone – how the odds are greatly stacked against returning to growth rates of the past.

To that end, short-term blips aside, the economy will revert to the anemic growth of the past eight, or so, years.

As Canadian economist David Foot stated, "Demographics is two-thirds of everything."

As America Ages, Growth Will Slow



Sources: World Bank, Bureau of Economic Analysis
Data as of December 31, 2015

As shown in the following graph, asset prices can increase faster than economic growth over short periods of time. Eventually, however, assets prices revert to the long-term growth trend line. One can also see that asset prices today have far exceeded economic growth. As I and others have discussed, the Fed and its European, Chinese and Japanese counterparts appear to have created the greatest asset bubble of the modern era.

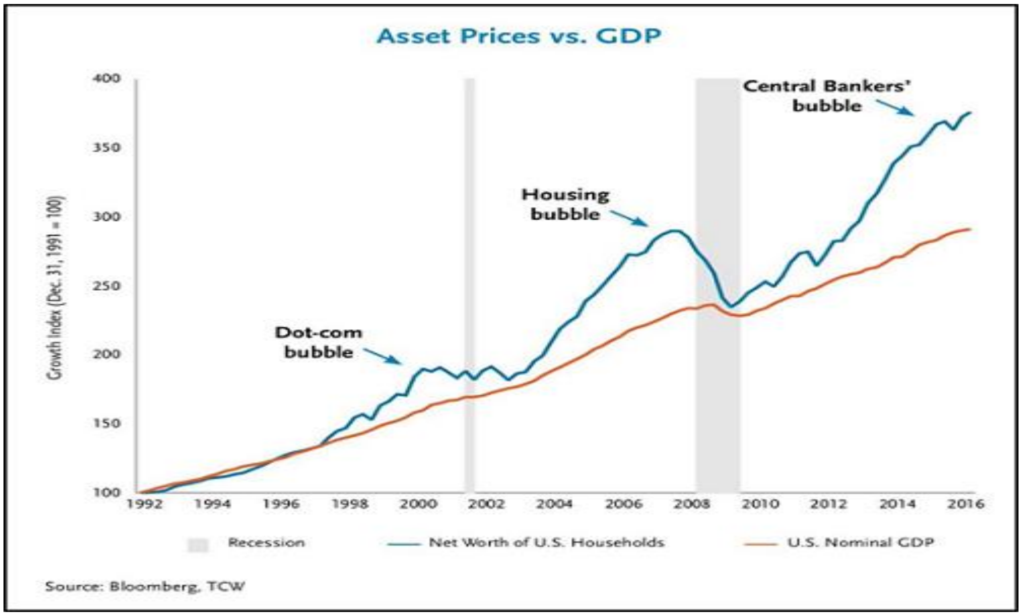
Is this sustainable?

Thinking that the central bankers can create sustainable wealth by printing money is a flimsy argument. Yes, they cause prices to rise, as was the case with the dot-com and housing bubbles. But, as is the case with all bubbles, they eventually burst.

Market participants have become accustomed to an implicit "free lunch," thanks to central banks and governments. Investors and speculators will earn consistently positive returns on their capital as central banks and governments continue to exercise their power to "save" participants from losses and generate phantom wealth "gains."

How much will risk assets have to decline for "wealth" to return to the production of real-world wealth in the real-world economy? Clearly, the answer is "a lot."

Asset Prices Have Deviated from the Real Economy



RISK MANAGEMENT IS KEY

I suspect few investors have a strategy for a permanently riskier environment going forward.

Let's review the shifting landscape:

- Treasury Secretary Steve Mnuchin openly declared his preference for a weak dollar policy at a time when the greenback was sagging sharply.
- In his State of the Union address, the President unveiled his strategy to fiscally reflate the economy via large-scale deficits.
- The new Fed Chairman Jermone Powell stated in clear-cut fashion that rates had to be normalized.
- Finally, the White House slapped hefty tariffs on aluminum and steel.

We have entered an entirely new environment: more aggressive Fed tightening, massive budget deficits, protectionist trade policies and an overt weak-dollar policy. The step-up in volatility this year is the market's way of telling us we are in a new regime.

So what are investors to do?

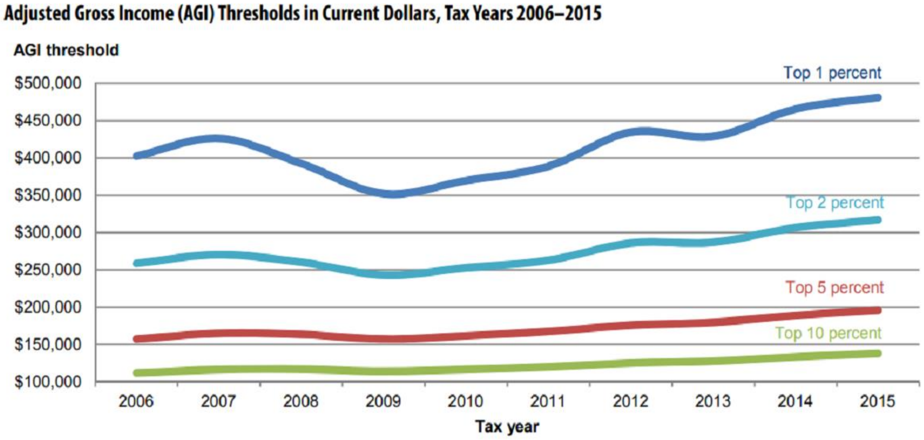
Our job is to navigate the waters we currently sail, not the waters we think we will sail in the future.

Greater returns are generated from the management of "risks" rather than the attempt to create returns by chasing markets.

THE TOP 1%

What does it take to get into the top 1%?

The price of admission is an adjusted gross income of $480,930 – basically, what one might make before deductions.



NOTES: AGI threshold is the minimum amount of adjusted gross income needed for inclusion in each percentile. Figure is based on all individual income tax returns, excluding dependents.
SOURCE: IRS, Statistics of Income Division, Individual Income Tax Shares, November 2017.

That's according to the latest edition of the [Internal Revenue Service's Statistics of Income Bulletin], which shows the elite group tallied about 1.4 million in 2015, continuing its steady growth since 2009. Back then, you could have joined this bunch with an adjusted gross income of $350,000 – its Great Recession low – but it's been climbing ever since.

Note: This is looking at salary (aka adjusted gross income; not holdings, real property, portfolio, etc.). Many within the top 1%, and especially the top 0.01%, have no salary at all.

FIGHTING THE NEXT RECESSION

Of course, we should try to avoid falling into another one. Unfortunately, that is easier said than done. Fighting the business cycle is akin to fighting Mother Nature. In other words, they are part of life and cannot be avoided.

In the past, the Fed reduced the federal funds rates by over 400 basis points, on average, before they defeated the recession monster. The least the Fed has had to cut to squash a recession was 200 basis points.

With fed funds currently at 1.5%, what would the Fed do if the recession appeared sooner than expected?

The only option would be to take rates negative. Imagine the implications that would have on the banking system.

What about another round of quantitative easing? With the Fed's balance sheet currently at $4 trillion (rather than $800 billion when this experiment began), the likely impact at the margin would be small. It's called the law of diminishing returns. Further, based on earlier comments, the Powell-led Fed does not seem to have a very strong appetite for unleashing renewed rounds of quantitative easing.

Of course, the Fed could go even more "radical" and monetize the debt. That could lead to a burst of inflation, which would crush the millions of baby boomers living on fixed income. And of course, the implications for the Fed's credibility and the U.S. dollar could be considerable.

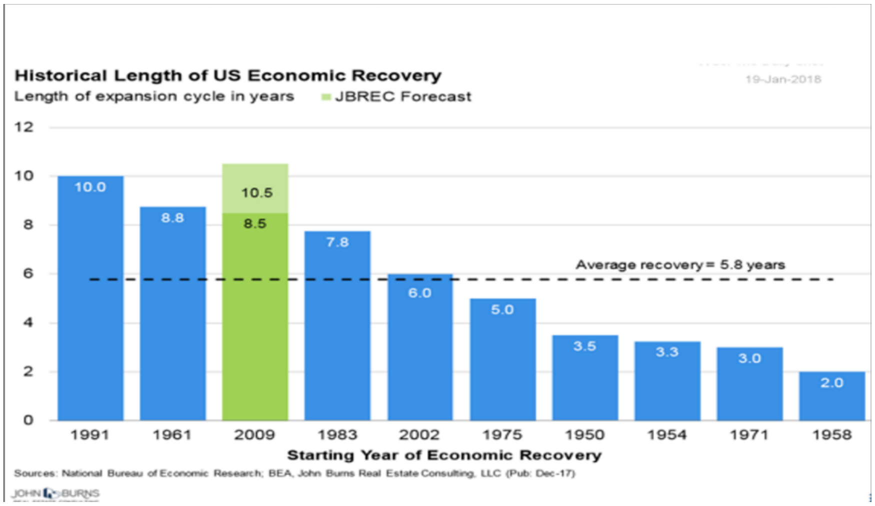
The bottom line is, the Fed has limited options. It has overstayed accommodation and been too slow to recalibrate interest rates, thus leaving no monetary policy bullets left.

We are now in the ninth year of the economic cycle, and the White House and Congress are heading down a reckless path of accelerating deficits and debts. Remember: There is no such thing as a free lunch. The massive deficits already have caused a shift higher in the interest rate structure. Roughly one-fifth of the massive near-$20 trillion U.S. debt load rolls over every year – and the debt rolling over now is doing so at an average interest rate that is 50 basis points higher than when it was first taken. That puts the incremental cost of servicing that debt in the neighborhood of $100 billion.

Think about that for a minute. Between the tax cuts and spending increases, the "add" to growth this year comes to little more than $120 billion. So, guess what? Over 80% of this wonderful "tax relief" ends up getting eaten by the run-up in interest charges on the debt! Newton taught that every action has an equal and opposite reaction.

Suppose the national debt runs up from $20 trillion to $25 trillion while as interest rates rise from 3% to 4%. In that situation, annual interest due on the debt goes from $600 Billion to $1 trillion – an increase of $400 billion a year. That's $400 billion that can't be spent on infrastructure, nor social or insurance programs. What would happen if/when we fall back into recession? The budget deficit in the next downturn will approach close to $2 trillion! It is high time we disabuse ourselves of Dick Cheney's "wise" comment that "Deficits don't matter."

How Long Will this Recovery Last?



In coming months and years, the U.S. government will test its ability to issue additional debt in ways it didn't in the 1980s or 2003 because its debt-to-GDP ratio is greater than 100%, which is three times what it was in 1980 and roughly twice what it was in 2003. This will layer even more uncertainty on the supply/demand imbalances as the Fed reduces its balance sheet. Thus, we are simultaneously witnessing the unwind of an unparalleled monetary experiment and an unprecedented borrowing experiment with a high debt-to-GDP ratio.

Possibly, we will experience a failed Treasury auction at some point, or a dollar crisis – while will not matter until it does. Maybe this is what the originators of the cryptocurrencies see coming down the pike.

This heightened uncertainty can only lead to ongoing heightened volatility.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

It is possible that the mainstream narrative is correct, and that the recent rise in rates is foreshadowing a future of higher GDP growth and inflation. If so, the market is discounting the future expectations. Sometimes markets work that way. Sometimes they don't.

So far, neither U.S. growth nor U.S. inflation are systematically higher than where they have been over the past eight years. To believe they will rise sharply out of the range of the past 10 years, you would have to believe that GDP growth and inflation will overcome the two main constraints on economic growth: a high and rising debt burden, and an aging population. These are the primary reasons that interest rates have persistently declined over the past several decades.

Predicting a regime change to much higher GDP growth – and hence higher inflation – could simply be a case of looking for, and then seeing, something that isn't there.

In fact, if the incoming economic data continues to disappoint, GDP growth could slow significantly in the first quarter. (I see those eyebrows raising and eyes rolling!) Everyone thinks the U.S. economy is doing just fine even though 60% of the incoming data have come in below expectations in the past month.

Consider these recent data releases (January over fourth quarter expressed annualized):

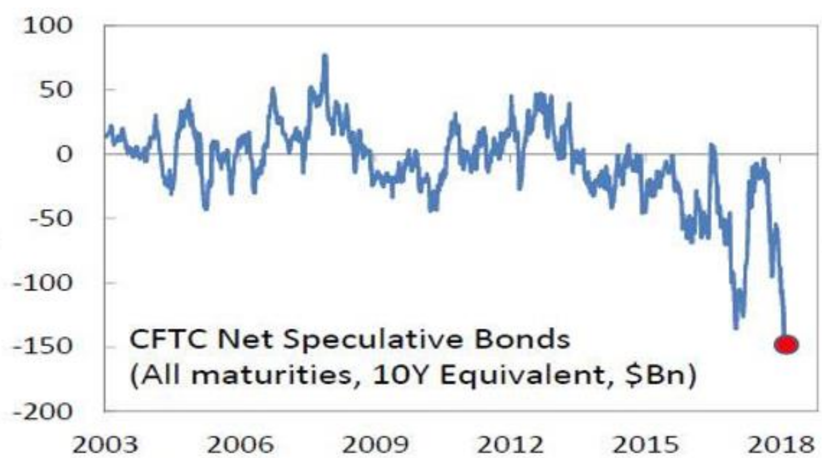
- Existing home sales: -14.4%
- Single-family housing starts: -7.0%
- Real retail sales: -3.1% (This will impact both fourth quarter and first quarter GDP estimates.)
- Real weekly earnings: -2.3%
- Aggregate hours worked: -0.7%
- Manufacturing output: +0.4%

Nobody mentions that fourth quarter real GDP, which was "supposed to" come in north of 3% or even 4%, came in well below at 2.6% growth. This would be in line with the average for what has been the weakest economic recovery on record.

So, how would the markets react if first quarter GDP printed with a low 2% or 1% handle?

SHORT SQUEEZE?

As the old saying goes, "More money has been lost trying to predict the change/rate of change in interest rates than in any other speculation."



Source: J.P. Morgan QDS, CFTC.

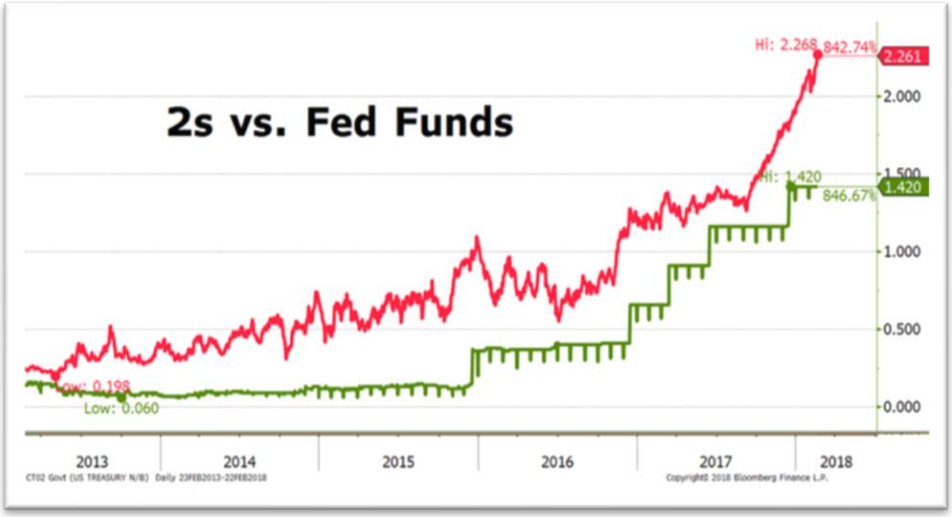
As shown in the graph, speculators (aka hedge funds and traders) have the largest 10-year Treasury short position in the history of bond trading. When there is such a large short position, what often happens is a "short squeeze."

If the U.S. economy is truly peaking and the inflation scare is overdone, the stage may be set for a sharp rebound in bond prices and declining yields.

Meanwhile, on the front end of the yield curve, the two-year Treasury yield has experienced a sharp sell-off since September 2017 with yields rising by almost 100 basis points.

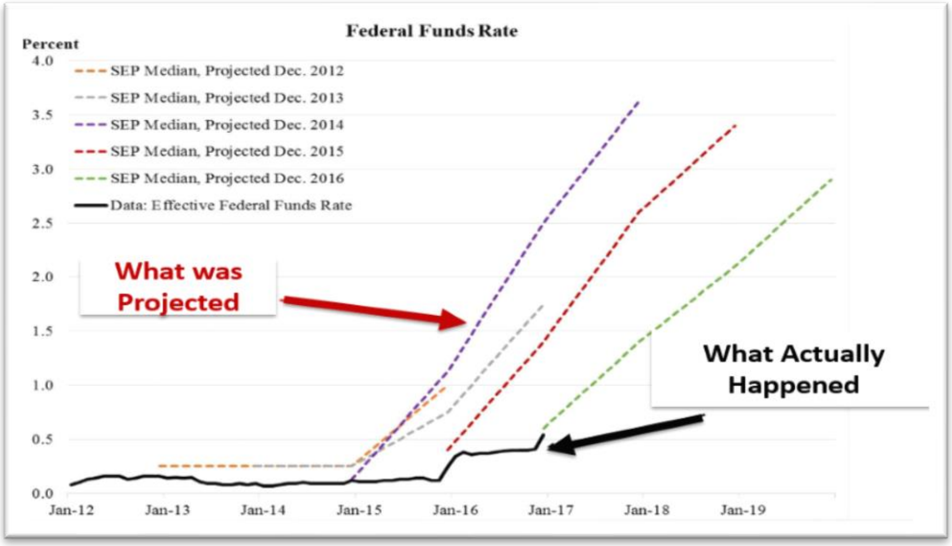
On the following chart, the two-year Treasury yield is plotted versus fed funds. Most recently, the two-year yield has spiked higher in anticipation of additional Fed rate hikes. Supply concerns have also negatively impacted the short part of the curve. Currently, the spread between two-year Treasury yields and fed funds is over 80 basis points.

Could it be that the market has over-compensated potential Fed rate hikes?



Yes, the Fed consensus is they will hike rates three times in 2018. With that said, let's not forget the Fed's forecasting record. As shown below, it has been, in a word: HORRIBLE!

How much faith do you have in the Fed's crystal ball?



So, should credit unions continue to maintain excess cash reserves in anticipation of higher rates?

The following table shows the income return for two-year Treasury, Agency and bank note securities compared to staying in fed funds over a 12-month time horizon.

Income Analysis **12-Month Time Horizon***	
	Income Return
2-Year Treasury	**$111,507**
2- Agency Bullet	**$115,727**
2-Year Bank Note	**$143,946**
Fed Funds	**$102,062**

***Assuming the following:**

- $5 million invested
- Fed Funds starting rate at 1.50%
- 25-basis-point increase in March, June and December

By purchasing the two-year Treasury today, you are, for all practical purposes, guaranteed approximately $111,000 in income over the next 12 months. If you maintain the same investment in fed funds and the Fed does hike three times in 2018, the income earned would be approximately $102,000. Thus, you would earn an additional $9,000+ of income from the Treasury position. In 12 months' time, the two-year Treasury would have a remaining term of one year.

As one can see in the table, income can be further enhanced by purchasing high-quality Agency and bank note securities. Of note, the bank note sector is one of our favored short duration sectors due to strengthening credit fundamentals and higher yields versus comparable Treasury/Agency securities.

Obviously, no one knows with certainty what the Fed will do and when. Possibly they will raise rates only one or two times. Or possibly up to four times. But we do know with certainty that the two-year Treasury will generate $111,507 if we invest today.

Does it make sense to wait, hope and pray that the Fed adjusts rates higher? Or does it make more sense to take advantage of the recent sell-off and lock in a higher income today?

As they say, "A bird in the hand is worth two in the bush."

Note: Registration is now open for the **2018 Credit Union Executive Leadership Symposium**, September 5-7 at the Westin River North in Chicago, IL! You will hear from a wide range of speakers, including NFL Legend Mike Ditka, "The Attitude Guy" Sam Glenn, as well as credit union industry experts. Plus, back by popular demand, CUNA Mutual's Steven Rick and Balance Sheet Solutions' Tom Slefinger will battle it out in another round of "Dueling Market Views."
Please visit alloyacorp.org/symposium2018 to view the agenda and to register.

More Information

In terms of relative value, please see the Relative Value Analysis.

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.