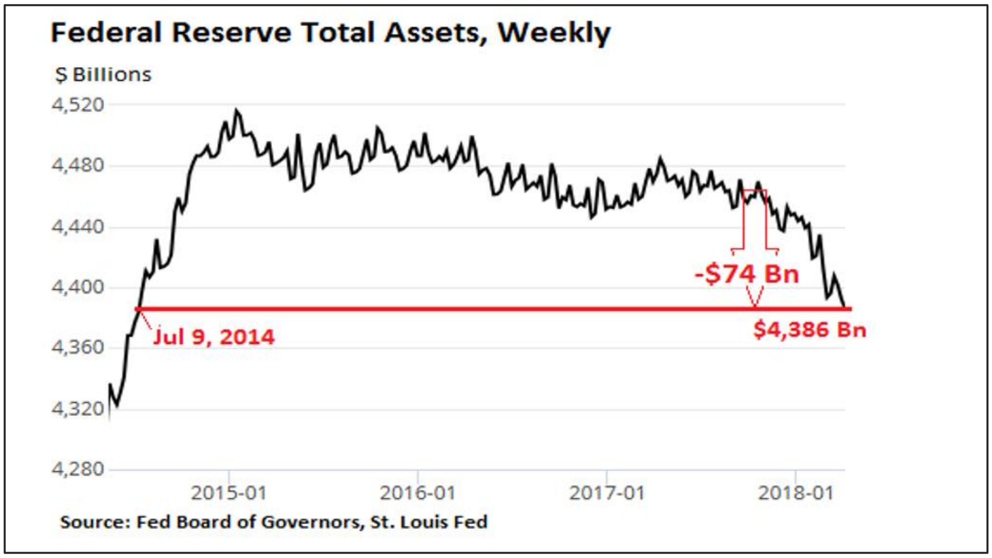
Weekly Relative Value

There's A New Sheriff in Town

*"If growth in America is accelerating, which it seems to be, and any remaining slack in the labor markets is disappearing – and wages start going up, as do commodity prices – then it is **not** an unreasonable possibility that inflation could go higher than people might expect. As a result, the Federal Reserve will also need to raise rates faster and higher than people might expect. In this case, markets will get more volatile as all asset prices adjust to a new and maybe not-so-positive environment… [There's] a risk that volatile and declining markets can lead to market panic."* – Jamie Dimon, CEO of JPMorgan Chase

Global interest rates have been cut 712 times, and central banks have purchased $12.2 trillion of assets since 2009. During the years of quantitative easing (QE), the Fed acquired a total of $3.4 trillion in Treasury securities and mortgage-backed securities (MBS). But that is changing fast as the regime shifts from quantitative easing to quantitative tightening.

Total assets on the Fed's balance sheet dropped by $74 billion, from $4,460 billion at the outset of the QE-unwind, to $4,386 billion on today's balance sheet. The Fed is shedding those securities at a rate that accelerates every quarter until it reaches its maximum pace of up to $50 billion per month in fourth quarter 2018.



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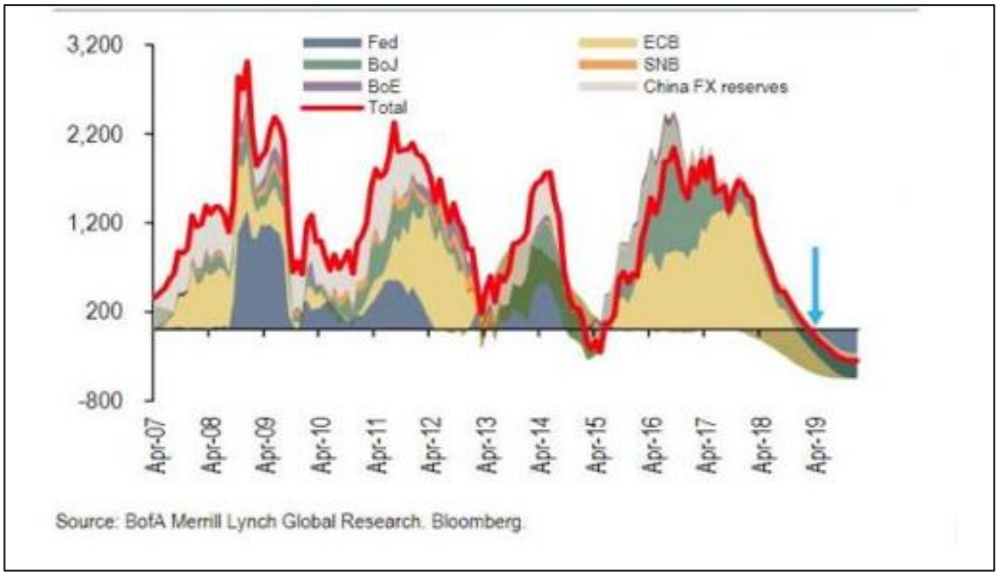
By the end of the year, this plan would shrink the balances of Treasuries and MBS by up to $420 billion. The Fed is draining its balance sheet – all while raising short-term rates up to eight more times in the next two years. This will continue until the Fed deems the balance sheet and rates to be sufficiently “normalized” – or until something big falls apart, whichever comes first.

Simply put, a tightening cycle is well underway. This tightening cycle, which the European Central Bank and the Bank of Japan are set to join in coming quarters, follows nine years of unprecedented global monetary easing and asset price returns. It’s very hard to imagine you can get out of a scenario of prolonged extraordinary measures without some kind of “trauma.” But, for now, with the S&P still just a few percentage points from its all-time highs, no one seems to care.

Global QE Turns Negative in 2019



A NEW SHERIFF IN TOWN

Trade and geopolitical issues have created many headlines of late, but I believe the primary reason that risk assets are struggling in 2018 is the Fed. The markets are all about the Fed – they have always been about the Fed – and now, we have a new sheriff in town.

The minutes from the Federal Open Market Committee meeting are important because they are the first of the post-Yellen era. They were different in many respects and revealed a growing support for a slightly more hawkish policy stance. It was unanimous, as in “all” see the economic outlook as having strengthened, and “all” expect inflation to move up too. That is not my view, but I don’t control the monetary levers.

Here’s my two cents: The Fed is playing with fire with this excessive bullishness in the economy. The risk, as always, is that it raises rates too far and too fast when the economy is peaking, not strengthening. But then again, we have seen this movie many times before.

One thing is for sure – the Fed made it clear that it is not at all concerned by what is happening in the financial markets. The volatility and weakness in equities is not derailing their bullish macro forecast just yet.

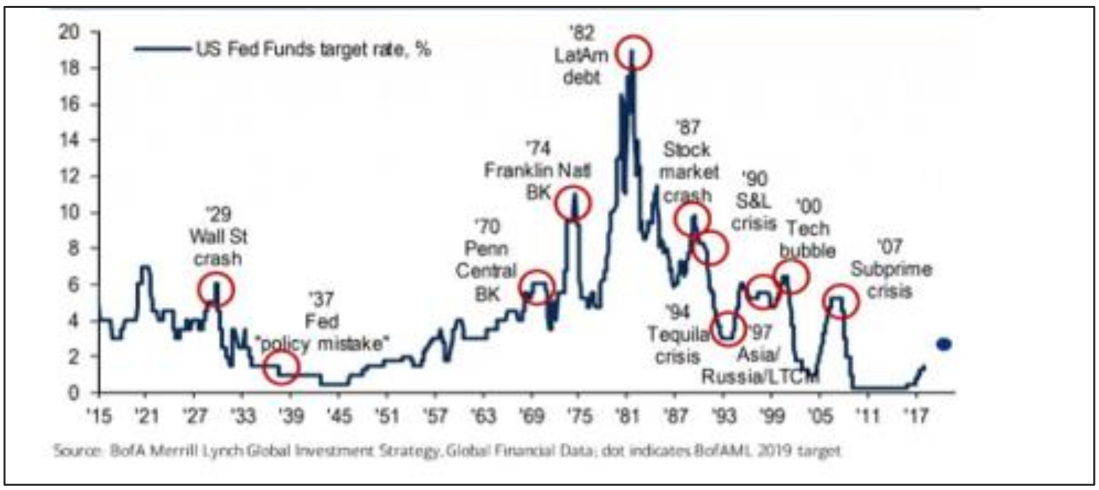
Thus, from a market perspective, despite the recent sell-offs in the stock market, the QE-unwind plan will likely continue unabated.

But remember, the stock market never should have been a mandate for the Fed, and this is the key change with the new sheriff at the Fed. A "Powell put" for the stock market? Don't even think about it. Fed Chair Jay Powell will not be cutting rates if the market goes down another 10% from here, or more.

However, if credit freezes up as it did during the financial crisis, all bets will be off, and the Fed will step in as lender of last resort. But that scenario is not yet on the horizon. So, the QE-unwind will be allowed to work its magic to undo part of what years of QE have wrought.

As depicted below, history shows that once the Fed starts to tighten financial conditions, it requires a major "event" to reverse course.

What Will the Next Financial Crisis Be?



13 MILLION!

Chief Economist and Strategist David Rosenberg is repeatedly asked: "**What statistic troubles you most?"**

His answer is simple: ***13 million!***

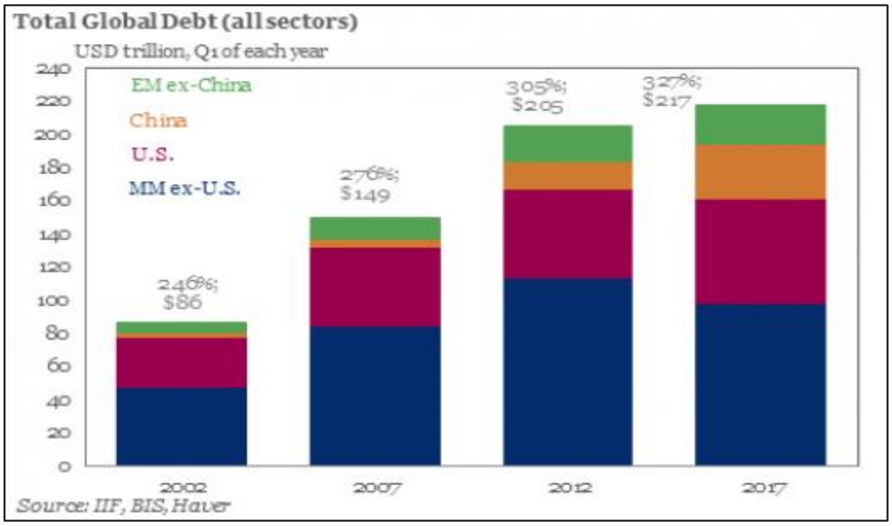
As Rosenberg explains, "***That's the number of people who have joined the financial services industry since the last credit collapse ended."***

Why is that so troubling?

"These youngsters have only known bull markets in everything from weed to FANGs to Picassos to Crypto... to uber-low interest-rates, endless QE, and economic expansion... And are they in for the surprise of their lives!!"

GLOBAL DEBT REACHES NEW RECORDS

According to the Institute of International Finance (IIF) latest quarterly update, global debt rose another $4 trillion in the past quarter to a record $237 trillion in the fourth quarter of 2017, and more than $70 trillion higher from a decade earlier, and up roughly $20 trillion in 2017 alone. The IIF data report that the share of global debt remains well above 300% of global GDP.



And, of course, the U.S. has made a solid contribution to the burgeoning debt pile. We are just five months into the fiscal year, and already the budget deficit has mushroomed 14% to $600 billion (or a run rate of a $100 billion/month) – and there are still seven months to go!

Due to the large, irresponsible, unpaid-for tax cuts and a government spending binge, the U.S. is expected to record a $1 trillion budget deficit by 2020 – two years sooner than previously expected. Annual budget deficits are projected to reach $2 trillion by 2028. Federal budget deficits are now projected to be $12.4 trillion over the next 10 years – an increase of $2.3 trillion since 10 months ago.

Amazingly, these Congressional Budget Office projections assume that the economy will grow 3.3% this year, up from the 2% previously expected, and that unemployment will average 3.8% in the current fiscal year and 3.3% in fiscal year 2019. Those predictions are more optimistic than those of most private-sector forecasters or the Federal Reserve, and pose the risk of wider deficits if the economy falls short of those wonderful numbers.

In just a little over a decade, our debt could be the highest it has even been compared to the overall economy. The current record was set just after World War II. The difference here is that there is no world war, no recession, no depression, and unemployment is low.

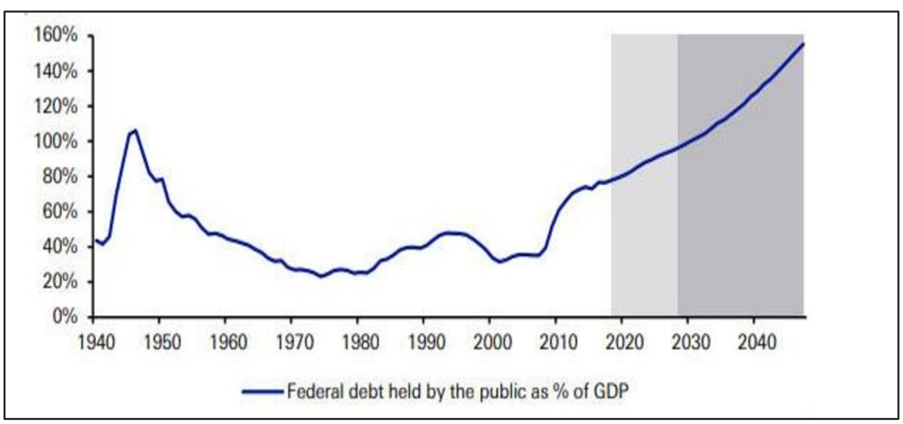
Imagine what would happen to the deficits if we fall back into a recession. Fiscal deficits would surge! If the U.S. didn't have the strongest army in the world, no way no how it would be rated AAA by any credit agency.

As I have stated previously, there was no need for stimulus and no rationale to rack up these insane deficits (that the GOP at one point cared about) during stable times and already historic levels of debt. Instead, at this point in the business cycle, we should be running surpluses (remember that quaint concept?) to be prepared for the next emergency. But there is zero talk of changing course.

Meanwhile, talk of paying for these budget-busting policies has just about disappeared. We have been hearing, “Don’t worry, this will pay for itself.” The powers that be say the tax reform will generate 3% plus growth to infinity.

I believe a substantial extended growth of over 3% in GDP – even once the effect of tax cuts is factored in – is a pipe dream. Seriously, does anyone believe that the GOP-sponsored tax cut will result in sustainable stronger growth, lower deficits and less borrowing?

Debt to GDP Projected to be Above 150% by 2046



Former Vice President Dick Cheney asserted that Ronald Reagan proved that deficits don’t matter, but that might not hold under Donald Trump, who has dubbed himself the “King of Debt,” and has the defaults and bankruptcies to prove it.

Policymakers have dug themselves into a deeper and deeper hole. Our historic and unsustainable debt cannot be fixed with more tweaks (or tweets) and gimmicks. This is a time bomb. Our short-sighted, politically-motivated approach will harm our kids and weaken our country.

I, and others of a similar persuasion, have said for years that excessive debt slows growth as increasing resources are consumed by debt service. It's the law of diminishing returns as Lacy Hunt, economist and Executive Vice President of Hoisington Investment Management Company, describes below. More debt leads to slower growth and eventually lower inflation and then lower interest rates.

Lacy Hunt Ph.D. discusses the law of diminishing returns from debt below:

"The law of diminishing returns is already evident in all major economies as well as on a global scale. Global GDP-generated per dollar of total global public and private debt dropped from 36 cents in 2007 to just 31 cents in 2017.

Diminishing returns is even more apparent in the case of China's public and private debt, largely internally owned. In terms of each dollar of debt, China generated 61 cents of GDP growth in 2007 and only 33 cents last year. In other words, in the past ten years the efficiency of China's debt fell 45%.

The most advanced sign of diminishing returns is in Japan, the most heavily indebted major country, where a dollar of debt in the last year produced only 22 cents of GDP growth. This economic principle applies equally to businesses.

In 1952, $3.42 of GDP was generated for every dollar of business debt, compared with only $1.39 in 2017. In the corporate sector, where capital as well as technology is most readily available, GDP generated per dollar of debt fell from $4.50 in 1952 to $2.50 in 2007 to $2.21 last year."

You have heard it before, but I'll say it again. More debt is not the answer.

BE CAREFUL

There is a raging debate on Wall Street as to whether the recent setback in the equity markets is a mere pause in the 109-month bull market, or whether we are in a topping formation and transitioning away from said bull market. Of course, time will be the ultimate judge.

But one thing the bears and the bulls universally agree upon is that we have entered a new paradigm of heightened volatility. Welcome to the world in which the Dow Jones Industrial Average swings hundreds of points, not only from day to day, but also from hour to hour.

In terms of volatility, the Volatility Index average has soared 60% and averaged 18 throughout the first five months of 2018. The only other time this happened in the past was in 2008. If you recall, for most of 2008 the Wall Street consensus was for a soft landing until September when Lehman Brothers, AIG and Merrill Lynch collapsed.

In fact, in the April 29-30, 2008 FOMC minutes, the conclusion the central bank made at that time is shocking knowing what we know now: **“The Committee felt that it was no longer appropriate for the statement to emphasize the downside risks to growth.”** Seriously? Think about that assessment. These comments from the Fed were made just months before the great financial crisis.

In 2008, the S&P 500 experienced 32 days of 2% or better, and 42 sessions in which the S&P 500 declined 2% or more. And as an ugly reminder, the market retrenched 38% for the year. Year-to-date, the S&P has experienced seven days of 2% or worse, and just one day (despite the euphoria of how great everything is) of a 2% gain or better. Heightened volatility tends to be associated with the onset of bear markets as opposed to bull markets.

“‘Be careful’! All you can tell me is ‘be careful’?”
CartoonStock.com

As Mark Twain taught us, history may not repeat itself, but it often rhymes.

One should not quickly dismiss the message from the market. The major equity averages are only down fractionally year-to-date, but the overriding story is one of acute volatility.

And that folks, is not bullish.

If you’re already experiencing distress at the rather minimal market loss we’ve seen in recent weeks, you’re probably taking more risk than is appropriate.

The main message is to be careful.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Important to the long-term investor is the pernicious impact of exploding debt levels. This condition will slow economic growth, and the resulting poor economic conditions will lead to lower inflation and thereby lower long-term interest rates. This suggests that high quality yields may be difficult to obtain within the next decade. In the shorter run, in accordance with Friedman's established theory, the current monetary deceleration, or restrictive monetary policy, will bring about lower long-term interest rates." – Lacy Hunt Ph.D.

Cracks are showing in the global growth story.

Last year's synchronized strength now seems to be in the rear-view mirror. The U.S. seems to be posting little better than 1.5% real GDP growth rates for the first quarter.

For the past three months, retail sales have fallen, something that has happened only five times outside recessions. This is a very noisy series, but any way you look at the trends, they are weakening. "Joe and Jane Six-Pack" are largely tapped out, and not from spending on fun stuff either, but on necessities such as food, energy, healthcare and housing. Thus, despite the tax cuts, consumers' situations are more uncertain than the consensus belief. All of which makes today's release of March retail sales data key for investors. The consensus forecast is that retail sales will rise 0.4%.

And there are strong signs that the once-hot euro-area economy is cooling down in response to last year's huge appreciation in the euro and the negative knock-on effects on exports and manufacturing activity. Asia is broadly stable, but no longer accelerating, and the continent is highly vulnerable to any possible trade skirmish between the U.S. and China.

At the same time, the Federal Reserve sees the economy chugging along, with inflation reaching its 2% goal. The monetary authorities are on track to raise interest rates twice more this year after last month's 25-basis-point increase in the federal funds rate range to 1.5%-1.75%. At this point, the central bank expects this tightening cycle to last into 2020. The latest forecasts contained in the Fed's Summary of Economic Projections indicate that the federal funds rate will rise to 3.4%, which is restrictive by the central bank's own definition of a longer-run policy rate of 2.9%.

Meanwhile, as the Fed tightens, the flattening yield curve implies monetary and fiscal stimulus is maxed out and raises ominous concerns about a looming recession. To wit, the spread between the 10-year Treasury note yield and the two-year yield is down to a mere 45 basis points.

This is the tightest spread for the cycle and precisely matches the shape of the curve that we had in October 2007 – and the recession that nobody saw happening was just two months away.

Further, we are just two rate hikes away from the yield curve inverting. It is an inverted curve – when short-term interest rates exceed long-term ones – that has foreshadowed ***every*** U.S. recession!

According to the Fed's own dot plots, the third rate hike of the year is expected by the end of the third quarter. If longer term rates remain range-bound, you may want to circle early 2019 as the possible timing of the next, indeed inevitable, recession.

In terms of the market, the front end of the curve is held completely captive to what the Fed is doing. The back end of the Treasury curve may well continue trading in a range as bearish cyclical forces (i.e. increased Treasury supply, cyclical inflationary pressures, etc.) bump against bullish secular forces (i.e. excessive debt, aging demographics and declining productivity). The inability of the 10-year yield to rise above 3% suggests that the Fed will be hard-pressed to raise short-term policy rates above that level without risking a downturn. Remember, there has never been a time when Treasury yields rose during a recession. On average, the 10-year Treasury note yield declines 160 basis points.

45 Basis Points Away from Recession?

In terms of portfolio strategy, we continue to advocate that credit unions maintain a risk appropriate diversified ladder strategy. In terms of sectors, high quality bank notes offer the most attractive yield and risk return trade-off relative to other investment alternatives across the maturity spectrum. (See below table.)

Bank Notes Yield Comparison

	1-Year	2-Year	3-Year	4-Year	5-Year
Bank Notes	**2.66%**	**2.88%**	**3.08%**	**3.20%**	**3.45%**
CDs	1.80%	2.45%	2.60%	2.70%	2.85%
Agency	2.21%	2.30%	2.46%	2.58%	2.63%
Alloya Certs	2.30%	2.48%	2.56%	2.67%	2.70%

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.