Balance Sheet Solutions
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Weekly Relative Value

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THIS WEEK…

- Searching for Answers
- Recession Coming
- Buy (Bonds) When There's Blood in the Street

PORTFOLIO STRATEGY

The Blame Game

"We are in a big, fat, ugly bubble. And we better be awfully careful."
– President Donald Trump, September 26, 2016

The major averages ended the week with their steepest losses since the week ended March 23. The Dow ended down 4.2%, the S&P 500 fell 4.1% and the Nasdaq lost 3.7%. Is this a correction (or worse) in what had been a steady, nearly unstoppable ascent in the U.S. stock market?

This past week's sharp drop in stocks followed Treasury yields' breakout above their previous highs for the year, with the benchmark 10-year note surging as high as 3.23% on October 5 and the 30-year bond also hitting 3.40%.

The last time stock and bond prices moved in tandem was from the late 1960s through much of the 1990s. The inflationary 1970s saw simultaneous bear markets in stocks and bonds, as interest rates soared. The great bull markets of the 1980s and 1990s saw bond yields decline from record highs, which lifted stocks.

Who's to blame for the sell-off?

President Trump—who blasted the Fed several times for keeping interest rates too low to allegedly help Hillary Clinton—now claims the Fed is hiking too fast given the apparent lack of inflationary pressures in the economy. "Crazy," "loco," and "out of control" are among the terms he used to describe the central bank's policy of raising its short-term interest rates. Trump added that he wouldn't "fire" Fed Chairman Jerome Powell, but declared, "I think I know about it better than they do," regarding the assessing of monetary policy. Anyone else having flashbacks to Trump's 2016 campaign boast in which he said, "I know more about ISIS than the generals do."?

I'll let readers decide who knows more between Chair Powell or President Trump. But I don't recall President Reagan going ape about former Fed Chair Alan Greenspan on October 19, 1987 when the market collapsed 24% (not 3%). Furthermore, if Trump wanted a "low rates person," then he should have stuck with Janet Yellen. But, alas, she is a democrat (and was appointed by Obama… gasp!).

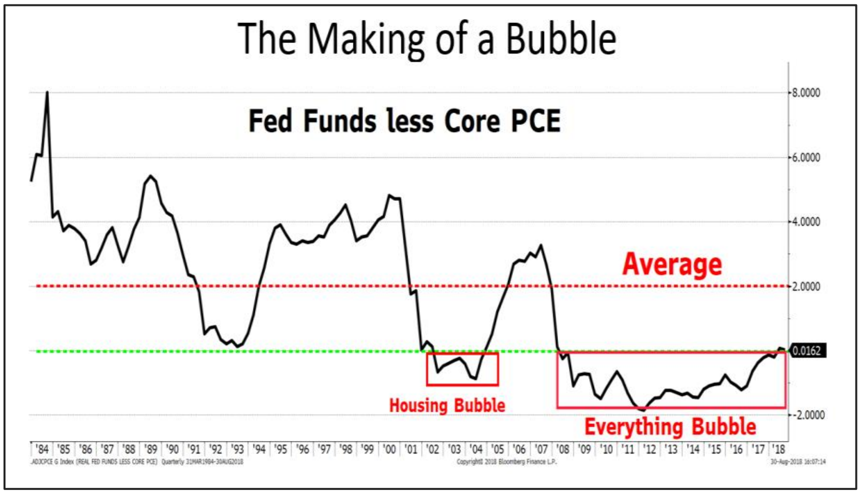
I've said it before and I'll say it again. Leadership means you accept the blame and share the credit. We have a President that takes all the credit when things are going well and plays the blame game when they are not.

More to the point. Is Trump right regarding the Fed?

In a word: no.

In reality, Fed policy is still "accommodative," even though that descriptor was omitted from the latest Federal Open Market Committee (FOMC) policy statement. "Accommodative" aptly describes the recently raised federal funds rate target range of 2% to 2.25%, which is still negative in real terms after deducting the 2.7% year-over-year increase in the Consumer Price Index. In other words, it's "money for less than nothing" in an economy that is far from being in dire straits. Further, the FOMC's "dot plots" project four more quarter-point increases by the end of 2019, which is hardly Draconian. How come this "greatest economy of all time" (according to Trump) can't withstand a move in the funds rate to 3%?

Meanwhile, America's "low interest man" chided the Fed for its baby steps toward quasi-honest interest rates. Self-evidently, the Donald thinks the route to MAGA is via thoroughly crooked money rates—the kind that don't even cover the cost of inflation, and help developers and speculators pay back their debts in depreciated money.



Moving on. The stock market is still up 30% since the November 2016 election, and over 300% from the March 2009 bottom. People should just recognize that volatility is part and parcel of the landscape, and that markets move in both directions.

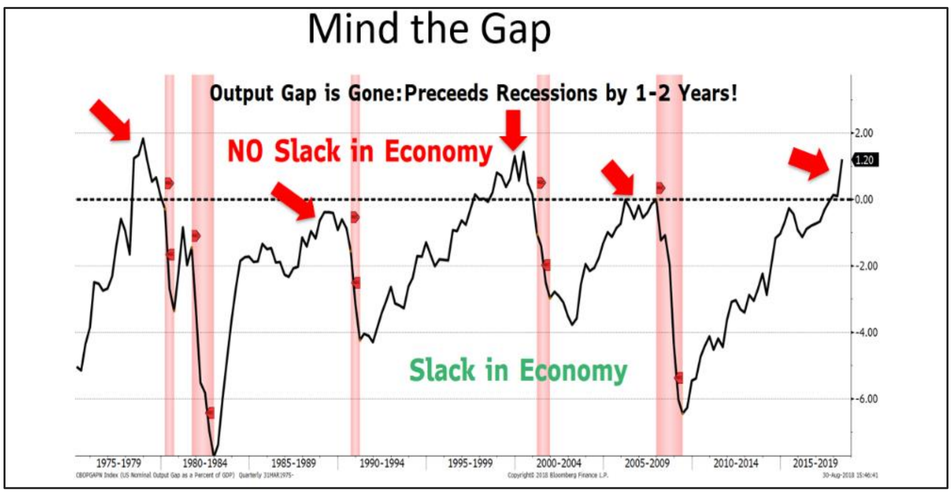
And I believe what is happening is actually a good thing. The central bank, which has remained too easy for too long, (Trump, himself, said this before the election) is gradually moving the markets away from a "liquidity" cycle to a more "fundamentally-based" cycle. That's healthy.

In addition, what roiled the stock market this past week wasn't the federal funds rate, but the longer-term yields set by the bond market. Treasury yields in particular have been on an upward march the past month for both fundamental and technical reasons.

If Trump really wants to know why interest rates have risen and equity markets have sold off, I suggest he look at the man in the mirror. While he blames the Fed for higher interest rates, he is conveniently avoiding ownership or responsibility for his own policies. The "buck does not stop here" with this President, which has been the catalyst for the sell-off in the bond market.

Let's review some of the Trump policy agenda:

- Breaking down global supply chains is inflationary. The expansion of the global supply chain over the last three decades has been a tremendous deflationary force as well as a force for global growth. With Trump lobbing grenades in his attempt to disrupt the global supply chain, the result will be higher inflation and slower growth.
- Limiting immigration, at a time when the supply of available labor is down to a 12-year low, is inflationary.
- Easing fiscal policy, at a time when the output gap has closed, is inflationary.



While the President has described himself as the "king of debt" I have to wonder if he has bothered to look at the size of the Treasury auctions. Is it possible that he is unaware that the recently imposed tax cuts have drained the revenue base as government spending has risen by 30% over the same period? You read that right. A Republican-led White House, House of Representatives and Senate have been behind government spending exploding by 30%! And nobody talks about this. If Obama was overseeing this sort of fiscal largesse, Fox News and the Tea Party (remember them?) would be apoplectic.

The federal government's interest expense is climbing rapidly and will accelerate over the next few years. The government already pays $1.5 billion in interest per day.

Here is the bottom line: Washington created a massive fiscal deficit to the tune of $214 billion in August, double what it was a year ago. Not once—even in recessions—has such a gargantuan deficit occurred in August. Late last week, the

Congressional Budget Office (CBO) released its estimate of the final deficit for Fiscal Year 2018. The CBO estimates that the deficit increased to $782 billion this year, an increase of $116 billion or 17% from Fiscal Year 2017. Recent legislation plays a big role in the deficit increase. Is it any wonder that interest rates have risen when the Treasury announced a massive $759 billion borrowing requirement for the second half of the year alone ("only" up 63% from the comparable 2017 period)?

Finally, taunting the largest buyers of Treasuries is not helpful. The Chinese have ceased activity at the Treasury auctions. Perhaps this is Beijing's plan to retaliate. But it's not just China. Japan, the other country in the trillion-dollar club for U.S. creditors, has also decided to run down its Treasury holdings.

It would seem to me that there is plenty of blame to go around.

SEARCHING FOR ANSWERS

Everybody is always searching for answers and playing the blame game, but when it comes to financial markets, there isn't always rhyme or reason. When markets surge for no apparent reason, I don't typically see anyone asking "why?" The stock market has radically outpaced the economy over this cycle. In fact, the outperformance of stocks versus real economic growth has been unprecedented. The S&P500 quadrupled from the 2009 lows in the face of the weakest economic expansion of all time. The average annual gain in the index this cycle is roughly 18%, which is actually in line with prior bull markets in the post-WWII era. But it was accomplished with real and nominal GDP growth half what the historical average was. And one quarter of 4% growth has not changed the underlying trend.

The dramatic outperformance of stocks versus the real economy is attributable to the Fed's extreme and unprecedented monetary policies of maintaining unnaturally low interest rates, and the market interventions via relentless quantitative easing (QE). To wit, it is estimated that about 1,000 points (25%) in the S&P 500 were due directly, and indirectly, to the Fed's benevolence.

"On the subject of Federal Reserve policy, the current back-slapping about the success of extraordinary monetary policy is a lot like declaring victory in a football game at halftime, just before a flock of fire-breathing dragons swoops onto the field and eats the leading team. As we saw in the collapse of the mortgage bubble (another product of yield-seeking speculation brought to you by your friends at the Federal Reserve), we have to allow for the possibility that the second half of the game will be violently unrecognizable.

"I describe recent Fed policies with the word 'deranged' intentionally—not just because those policies took interest rates and the monetary base far outside of their historical range, but also because doing so has encouraged an even more grotesque round of yield-seeking speculation than the preceding mortgage bubble, which ended in global financial collapse. In the interest of protecting the jobs of bank executives, and protecting bank bondholders from perhaps a few hundred billion dollars in losses (depositors were never at risk, which should be immediately obvious from studying any bank balance sheet), the Fed created yet another yield-seeking bubble that has encouraged vastly expanded indebtedness in every sector of the economy, and has set U.S. equity market investors up for a likely loss in excess of $20 trillion in market capitalization in the coming years." – John Hussmann, Ph.D.

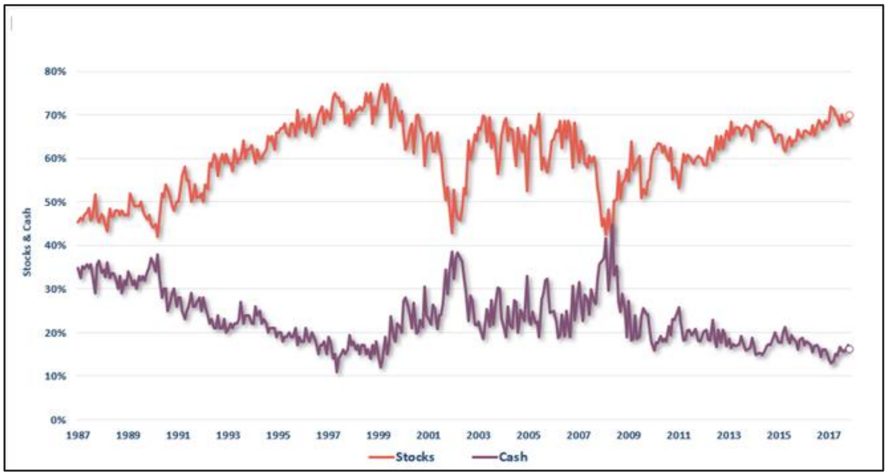
And therein lies the problem. After $20 trillion of reckless monetary expansion, risk assets—from the safest to the most volatile, from the most liquid to the unquoted—have skyrocketed with disproportionate valuations. Price discovery has all but disappeared. The Central Banks have created the "bubble of everything."

The declines last week are a footnote in the stock market's appreciation over the past 10 years. Yet, the central banks via so-called "financial repression" have brainwashed investors into believing stocks are a "protected" asset class and "there is no alternative to stocks." As shown below, individuals are now carrying the highest levels of equities and carrying very low levels of cash. In other words, investment complacency has been running high, risk has been dismissed for chasing returns, and value has been displaced by momentum. All signs of a late market cycle.

With that all said, what investors are wondering is: with the recent plunge in the S&P 500 of over 5%, has the long-anticipated (and long-overdue) market correction finally begun?

No one knows. Last week's performance may have been yet another warning. The markets may bounce back as they did in February. However, the bottom line is, asset prices have been artificially inflated and remain so. Sooner or later, the bubble will burst. It is no different than previous bubbles. And the bigger the bubble the bigger the eventual hangover.

All-In: Cash Levels at All Time Lows



RECESSION COMING

"We think the major economies are on the cusp of this turning into the worst recession we have seen in 10 years… Should the U.S. economy start to shrink, and our analysis suggests that it will, the high nominal levels of debt will instantly become a very big issue." – Murray Gunn, Head of Global Research at Elliott Wave International

All booms end in recession.

Two-thirds of business economists in the U.S. expect a recession to begin by the end of 2020*.* According to a poll of 51 forecasters, issued by the National Association for Business Economics from August 28 to September 17, about 10% see the next contraction starting in 2019, 56% say 2020 and 33% say 2021 or later.

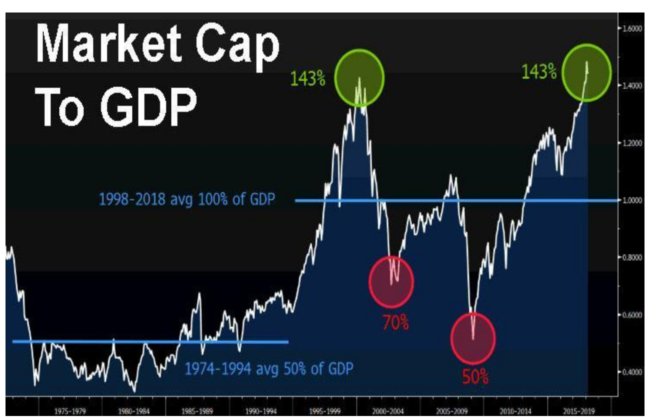
In other words, 66% of mainstream economists believe that the next recession will strike in either 2019 or 2020.

Of course, those that follow my weekly missives on a regular basis already know that there are a multitude of signs that indicate that the U.S. economy is already slowing down. Cheap financing for autos is now drying up, and bank profit margins are shrinking from rising rates. And it's not just autos and bank credit growth that are slowing down, but the U.S. housing market really is in a state of disarray. Housing is a perennial leading indicator of the economy.

So, the majority of economists see that the next recession will arrive within the next two years, and many are suggesting that it will be even more painful than the last one. I agree. The next recession will be much larger and deeper than most currently expect due to the massive amount of leverage built up during the current cycle. A loss of 40-50% will not be surprising as a mean-reverting event wipes out a big chunk of the gains made over the last decade. You say, "That's preposterous!" In the dot-com bubble, tech stocks declined 83%. During the housing bubble, the S&P declined about 50%. When you're pushing $40 trillion in U.S. equity market capitalization, the highest multiple of U.S. GDP in history, a loss of half of that capitalization over the completion of the cycle is a conservative estimate.

There is little risk in managing risk. The end of bull markets can only be verified well after the fact, but therein lies the biggest problem: waiting for verification requires a greater destruction of capital than we are willing to endure.

Are Stock Prices Sustainable?



BUY (BONDS) WHEN THERE'S BLOOD IN THE STREET

"The time to buy is when there's blood in the street." – Baron Rothschild

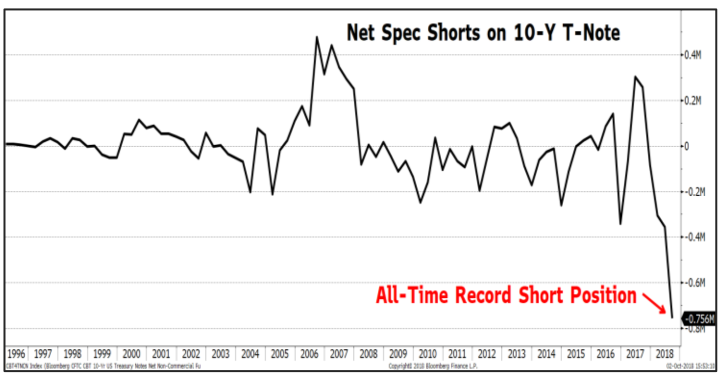
In other words, going against the crowd often yields the most successful outcomes. This is the essence of contrarian investing. But being a contrarian is both lonely and difficult.

So, what's the next big contrarian call that no one is willing to believe? **Treasury bonds.**

"With the economic expansion nine months from being the longest in U.S. history, the yield curve nearly flat and housing market indicators peaking earlier this year, it doesn't take much imagination to see what's next: a recession and falling interest rate cycle – i.e., a U.S. Treasury bull market." – Eric Hickman

The consensus is the great bull market in bonds that began in 1981 has ended, and a new bear market has begun. The "old" and "new" bond kings Bill Gross and Jeff Gundlach have joined the consensus declaring that the bear has finally arrived.

As is shown below, **this is the most extreme short position in markets today.** They're betting that the Trump economic changes and tax cuts have produced sustainable trend growth, and that tight labor markets portend higher inflation.



Undoubtedly, yields on 10-year U.S. Treasury notes have risen from an all-time low of 1.38% to 3.21%—their highest level since April 2011. Yet, we've seen this movie before. Yields went from 2.4% to 3.6% between October 2010 and February 2011 before falling to 1.5% in June 2012. Yields also rose from 1.67% in April 2013 to 3.0% in December 2013 before falling again to 1.67% by January 2015. In short, numerous bond market routs have been followed by major bond market rallies in the past 10 years.

Sharp upticks in 10-year Treasury rates have historically led to financial events, recessions, market corrections or a combination of all three. For the past 10 years, U.S. Treasury yields have traded in a range of 1.4% to 3.9%. Each time yields get too high, the economy slowed, and yields collapsed.

With households, corporations, the government and investors more levered today than ever before in history, the rise in rates will spread through the entire financial ecosystem like a virus. The rise and fall of stock prices have very little to do with the average American, the vast majority of whom have no stake in the markets. Interest rates, however, are an entirely different matter and have the greatest effect on the bottom 80% of the economy. Think student loans, auto loans, credit card debt and mortgages.

But what if growth and inflation have peaked?

It takes a brave investor to go long when the rest of the market is so heavily short. *Yet, that's exactly why the opportunity to go long in Treasuries is so attractive.* With all of the big players (more short than at any point in history) it only takes a small alarm causing lower yields and higher prices to trigger a massive short-covering rally where these short investors scramble and buy bonds to cut their losses. **The ultimate "reversion to the mean" in Treasury's will drive rates towards zero.**

"It is counterintuitive, but U.S. Treasury bull markets begin when the economic weather is the sunniest. It happens when the unemployment rate is the lowest and consumer and industrial confidence the highest. By the time a recession is obvious, a good chunk of the move lower in rates will have taken place. Of course, there are no hard and fast rules to make money in finance, but to the extent that 'this time isn't different,' now is the time to get ready for a large opportunity in the U.S Treasury market."

And this is where the opportunity currently exists for a contrarian with a longer-term view:

"Bull markets began far before their accompanying recession did. The bull markets started an average of 1.8 years before. This happens because the start of a recession is marked by a decline in real economic activity, yet long-term Treasury yields start to move lower from the mere hint of a slowdown in activity. This is important because many familiar commentators and banks (Ray Dalio, Ben Bernanke, Nouriel Roubini, Mark Zandi, Societe Generale, JP Morgan) are warning of a recession in 2020. This 1.8-year average combined with a mid-2020 recession would suggest a U.S. Treasury bull market beginning around now."

MARKET OUTLOOK AND PORTFOLIO STARTEGY

Here's the scoreboard (year-to-date peak to present drawdown):

- **Russell 2000:** -11%
- **Nasdaq:** -9%
- **S&P 500:** -6%

In other words, the investing landscape is changing. While the pundits proclaim strong growth and higher inflation for as far as the eye can see, the contrarian market call is for U.S. growth and inflation to both slow in the fourth quarter of 2018.

Can the Fed continue to raise rates into a rate of change slowdown in both U.S. growth and inflation? How about into ongoing meltdowns in global stock markets? Yes. In fact, most of the time, that's what the Fed does. It reacts on a lag to lagging economic data.

As discussed above, high- quality bonds may be the biggest beneficiary once sentiment changes. It is simply impossible to know when the tide will shift. Unquestionably, short-term and long-term rates could continue higher over the next month. However, at some point higher rates will lead to slower growth (recession) and declining asset values. The economy is simply too leveraged to withstand higher rates for any period of time. Wish we could time it, but we can't! We also know that by the time you read the headlines that the economy is slowing and inflation receding the markets will have already discounted the move.

As stated above, "U.S. Treasury bull markets begin when the economic weather is the sunniest. It happens when the unemployment rate is the lowest and consumer and industrial confidence the highest. By the time a recession is obvious, a good chunk of the move lower in rates will have taken place."

Thus, if one is not prepared for this upcoming regime change, you will miss the move as the markets and economy downshift.

For this reason, as we have advocated for quite some time, credit unions should maintain a disciplined laddered portfolio of high-quality securities.

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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.