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WEEK OF July 24, 2017

Weekly Relative Value

The Art of the Deal

"We're going to have insurance for everybody… we're going to have a healthcare that is far less expensive and far better… I am going to take care of everybody. Everybody's going to be taken care of much better than they're taken care of now." – **Donald J. Trump**

It appears to be all over (except the shouting) for Obamacare Repeal and Replace as another flagship policy ends up in the dustbin. This is a HUGE blow to the Trump agenda. Keep in mind, before and after the election this was the issue that Trump emphatically stated that he would tackle first. And let's face it, with no repeal and replace of Obamacare the odds of any meaningful tax reform are low. In other words, the defeat of the Obamacare Repeal and Replace pushes all his grand visions of economic stimulus, tax reform and fiscal policy back, possibly way back!

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

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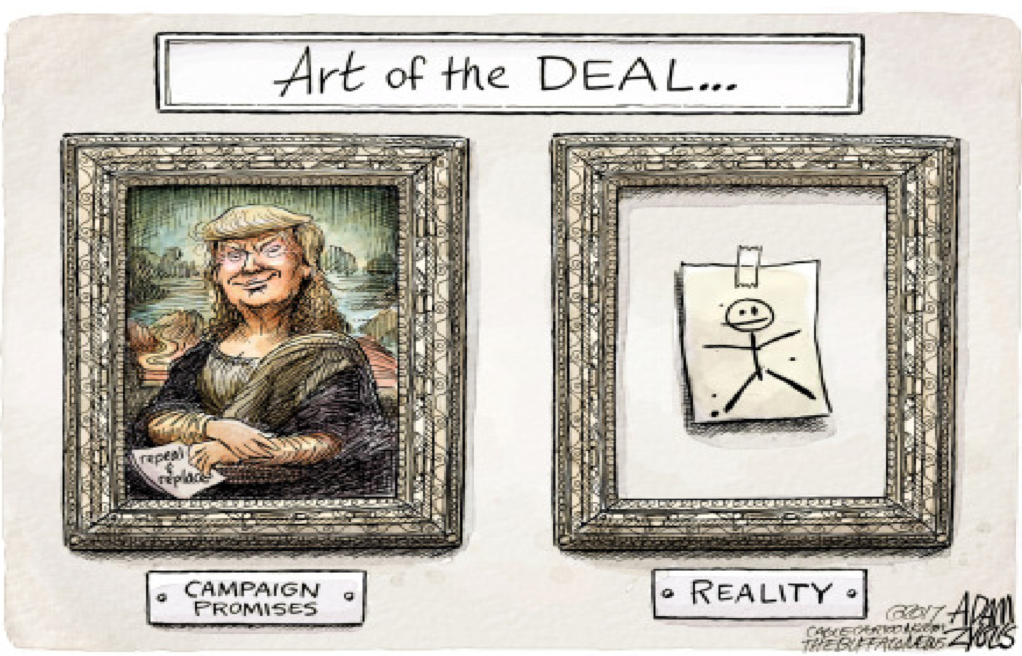
THIS WEEK…

PORTFOLIO STRATEGY



It should be remembered that even the most effective Presidents rarely get half of their campaign promises legislated and that includes periods of "one party power." Thus, in terms of politics, this is hardly shocking. Remember, it took the "Gipper" himself almost five years (and who knows how many drinks with Tip) to get tax reform done.

That said, Trump campaigned with his never-ending bravado that the deal-making skills he employed as a businessman would "Make America Great Again."

So, one question that needs to be addressed here is what ever happened to the "Art of the Deal?"

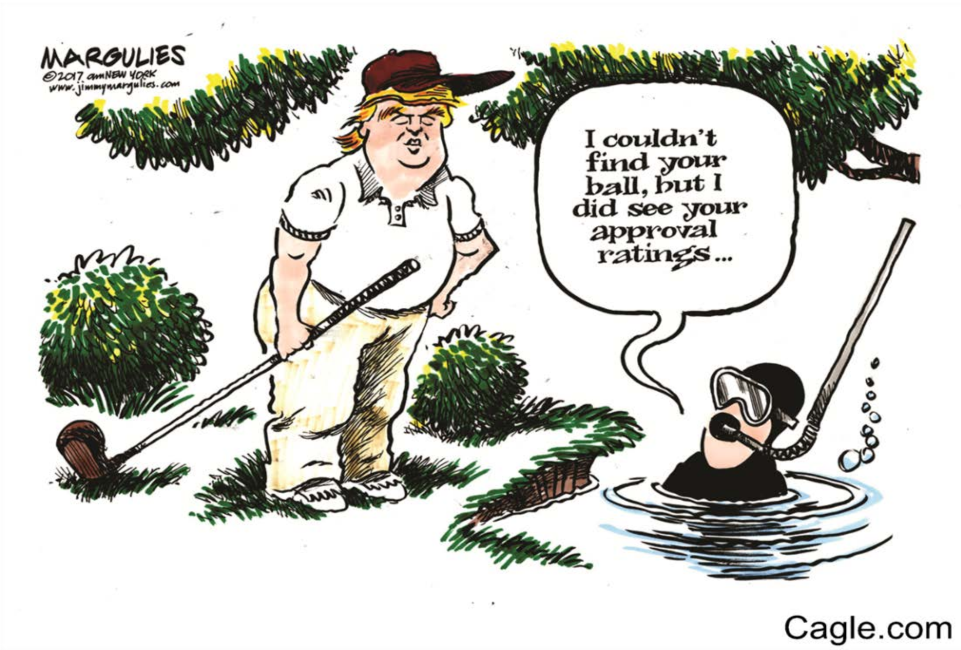
6 MONTHS, 900 TWEETS AND 0 MAJOR LEGISLATION

***"We're gonna win so much, you may even get tired of winning."* – Donald Trump**

Mr. Trump has been sending self-congratulatory tweets about his economic stewardship. Yet, he has little to brag about. The economy continues to grow at the same rate it was plodding along under President Obama. Likewise, employment gains have not accelerated.

In his interview with the New York Times last week, Trump took note (and, by implication, credit) for the records set by the stock market since his election. But a look around the globe shows the surge of the U.S. market to new peaks to be anything but unique. It is implausible that anticipation of "Make America Great Again" policies could have lifted all those markets.

Meanwhile, Trump voters appear to be increasingly frustrated with everything from the new administration's failure to enact significant legislation (health care reform, tax reform infrastructure spending) to the President's never-ending tweets. Indeed, Trump has quickly discovered that being the President is a "hard" job. He is learning that what worked for him leading his own business is not the skill-set needed to govern the country.



And its showing up in the "non-fake" polls. Per Gallup, Trump's approval rating has dropped to 36%, the lowest ever for a residing President. While Trump retains support with his base, he has lost support from Independents (the folks at the end who put him in the Oval Office). And should his ratings not improve soon, he will have difficulty accomplishing anything. And I mean anything.

Consider the opening paragraph from a recent Wall Street Journal editorial:

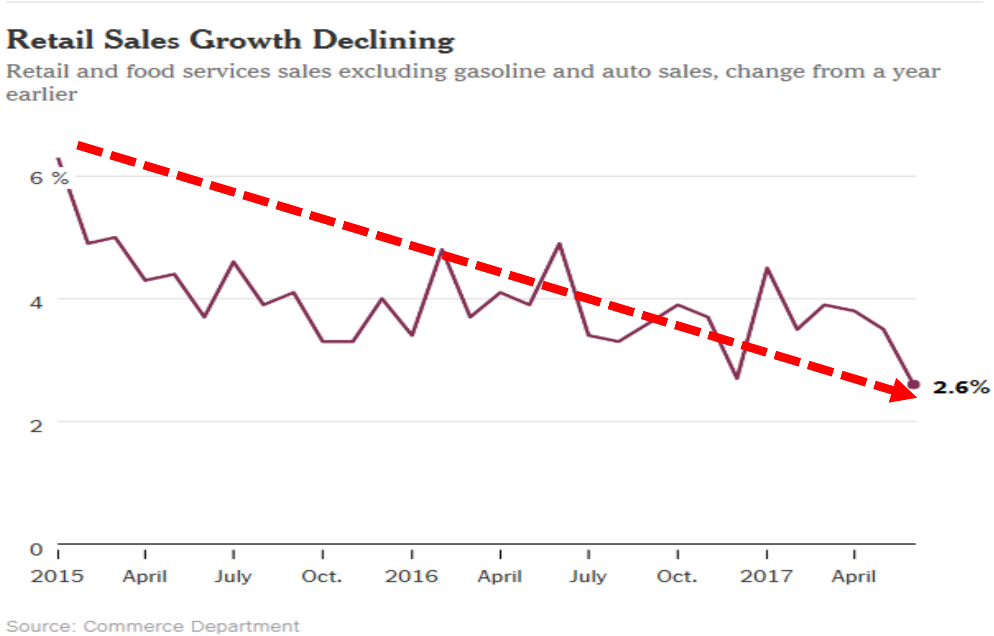
"If Mr. Trumps approval ratings stay under 40% into next year, Republicans will begin to separate themselves from an unpopular President in a (probably forlorn) attempt to save their majorities in Congress. If Democrats win the House, the investigation into every aspect of the Trump business empire, the 2016 campaign and the Administration will multiply. Impeachment will be a constant undercurrent if not an active threat. His supporters will become demoralized."

And it's not just Trump. Congress has a well-deserved approval rate of ONLY 19%! After six months in office, Republicans, who control both houses of Congress, and the White House have not made progress on any of the administration's policies-health-care reform, tax reform or infrastructure investment. And mid-term elections are just around the corner.

Are investors prepared for a shift to Democrats next year?

TRUMP BUMP HAS FADED

President Trump may have gotten a post-election bump, but declining confidence in the Trump agenda may be part of why retail sales growth has recently been slowing. Core retail sales growth has dropped to 2.6%, the lowest in more than three years.

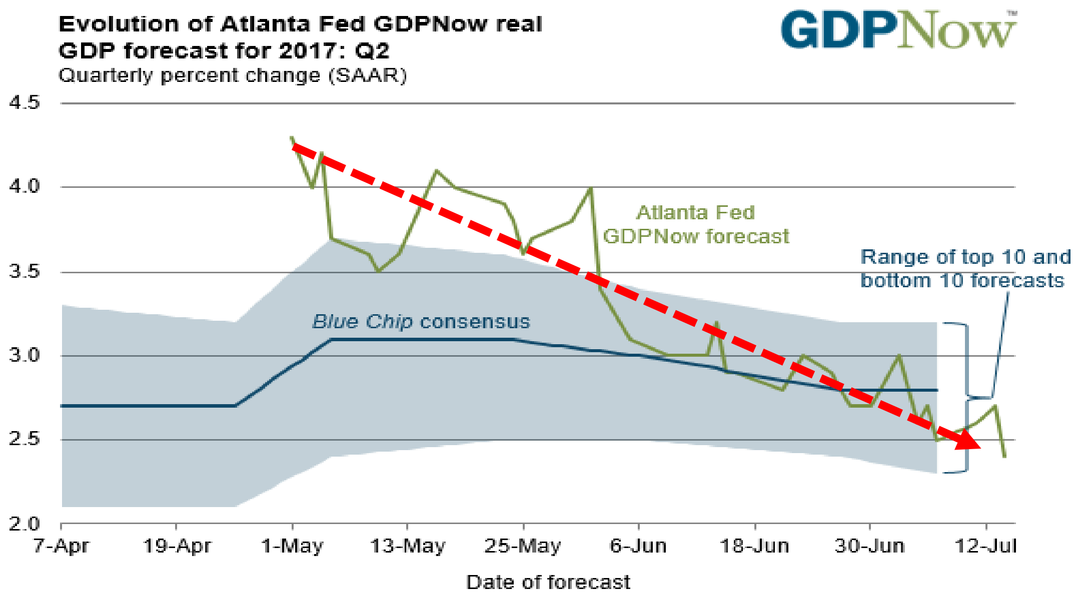


And an overall loss of confidence was on full display last Friday via the preliminary reading of the University of Michigan consumer sentiment index. The headline fell to 93.1 in July from 95.1 in June, and 97.1 in May to the lowest level since October. Fully half of the post-election run-up has now been unwound.

Other indicators, like the second-quarter forecast for GDP (reported this week), have been steadily revised downward because of the lack of progress on policy priorities and continued Washington dysfunction. To wit, the Atlanta Fed has sliced its Q2 real GDP growth estimate down to a 2.4% annual rate. It should probably be mentioned that ten weeks ago, the Atlanta Fed was sitting pretty at a 4.1% Q2 growth forecast.

Thus, while there is no recession, growth is weak and there is no sign of improvement. And looking ahead, things don't look too good for the economy, even if recession is averted over the near-term.

We are no longer talking about a 2% or 2%+ growth trajectory. More likely we are looking at 1.5%.

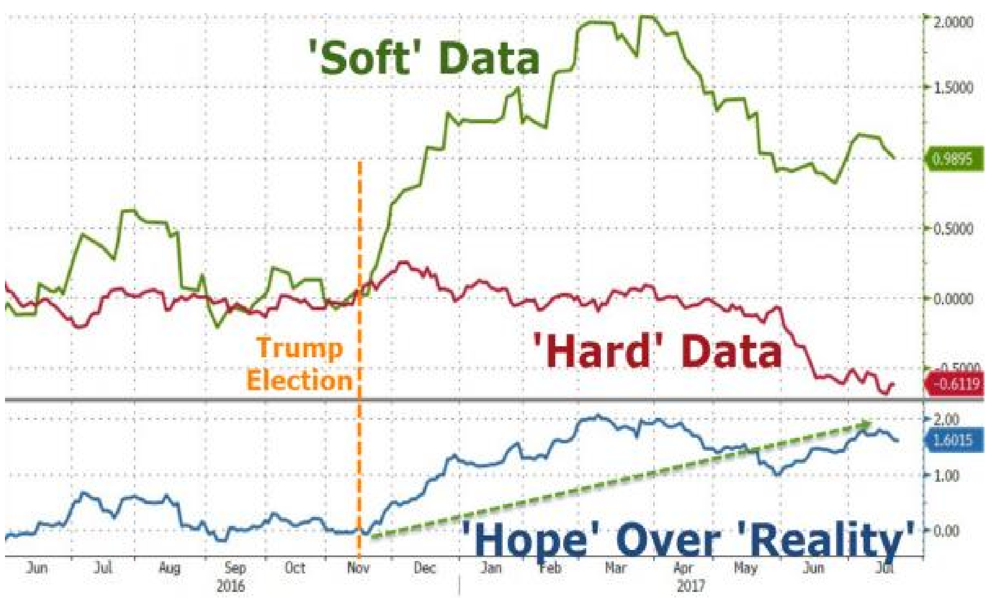


Sources: *Blue Chip Economic Indicators* and *Blue Chip Financial Forecasts*

Note: The top (bottom) 10 forecast is an average of the highest (lowest) 10 forecasts in the *Blue Chip* survey.

What's interesting is since the election of Donald Trump, "hope" has triumphed over reality. The narrative is Trump is a business genius. He will cut taxes, deregulate and invest in America. Yes, he will "Make America Great Again!" Yet, very little has been achieved. As shown below, **hard data – real actual economic output – has collapsed to two-year lows** as surveys of economic activity reached record levels of delusion.

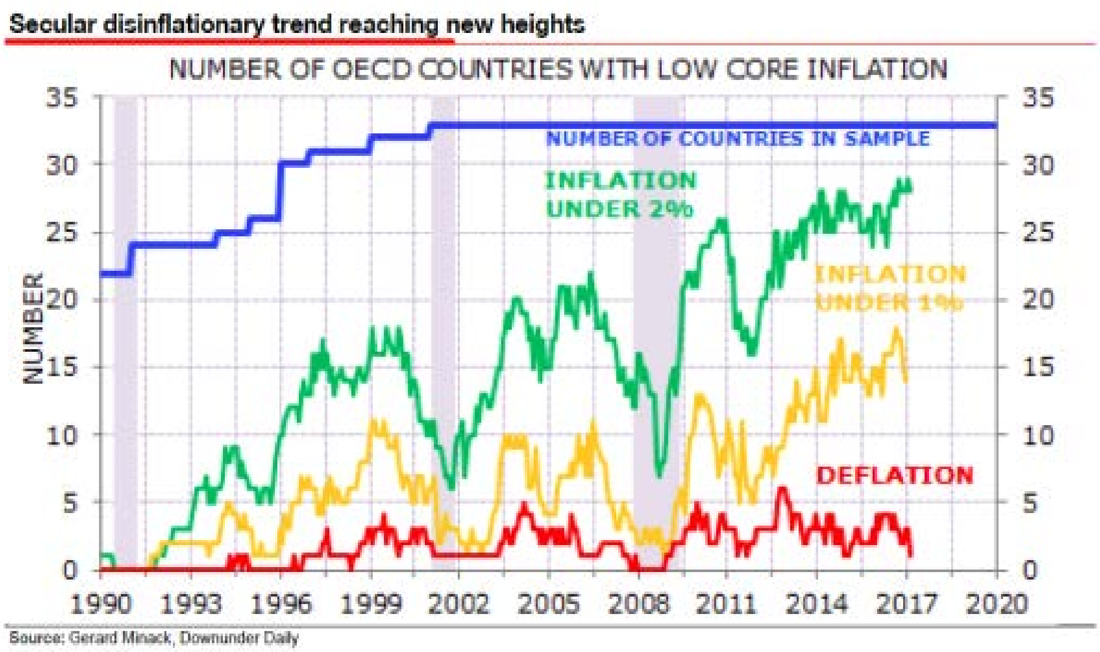
So, the question is - **will "hope" continue to triumph over reality?** And for how long?



IS DEFLATION ON DECK?

The core personal consumption expenditures deflator has been below 2% for 61 months in a row and in 100 of the last 104 months. For the last four successive months, U.S. core consumer price index (CPI) and wage inflation have surprised on the downside. While one data point is not a trend, four data points surely provide clear evidence of the decisive re-emergence of a deflationary trend.

And the U.S. is not alone. In the Eurozone, core inflation has been below 2% for 101 months in a row. And in Japan, core inflation has been below 2% in 229 of the last 232 months.



As shown in the chart above, although the number of Organization of Economic Cooperation and Development countries in absolute deflation at the core CPI level has receded, those undershooting a typical core CPI target of 2% are at an all-time high. This is quite amazing given where we are in the global economic cycle. The bottom line is that global deflationary pressures are still very much intact.

In the U.S., we are somewhere between the seventh and eighth inning of this elongated economic cycle. Yet, inflationary pressures are indeed ebbing in the U.S. economy. Of course, this begs the question that if the third-longest cycle in U.S. history cannot produce a cyclical uplift in wages and prices, what on earth will happen in the next recession?

The cold hard reality is we are now just one recession away from Japanese-style outright deflation!

LOWER FOR LONGER

When markets suddenly change their short-term direction, pundits and prognosticators are pushed in front of cameras to explain the most recent gyrations. Such has been the case over the past few weeks. With the sudden rise of rates around the world, the pundits argue that sell-off is long over-due. The bull market in bonds is over and long-term rates are bound to skyrocket. They cite a host of reasons, including the reduction of the Federal Reserve balance sheet, tapering of quantitative easing, lurking inflation and fiscal stimulus from Washington DC, and so on.

But let's face it. This is not the first time we have heard from the Cassandras. In fact, virtually every year whenever the bond market sells off, the bears come out of the closet with their prophesies.

As regular readers of this piece are all too aware, I have been **in the "lower for longer" camp – lower growth, lower inflation and lower bond yields** for quite some time. I have argued for years that excess debt, ageing demographics and declining productivity would effectively tamp any rise in long term rates.

And frankly, nothing has changed. Debt across all segments (government, corporate and individual) of the economy have risen. Productivity continues to languish at 40-year lows. And the demographic tail continues to wag the economic dog.

"The first of the boomers turned 70 this past year, that 80 million proverbial pig-in-the-python in North America, and 1.5 million will be doing so each year for the next fifteen years." – David Rosenberg

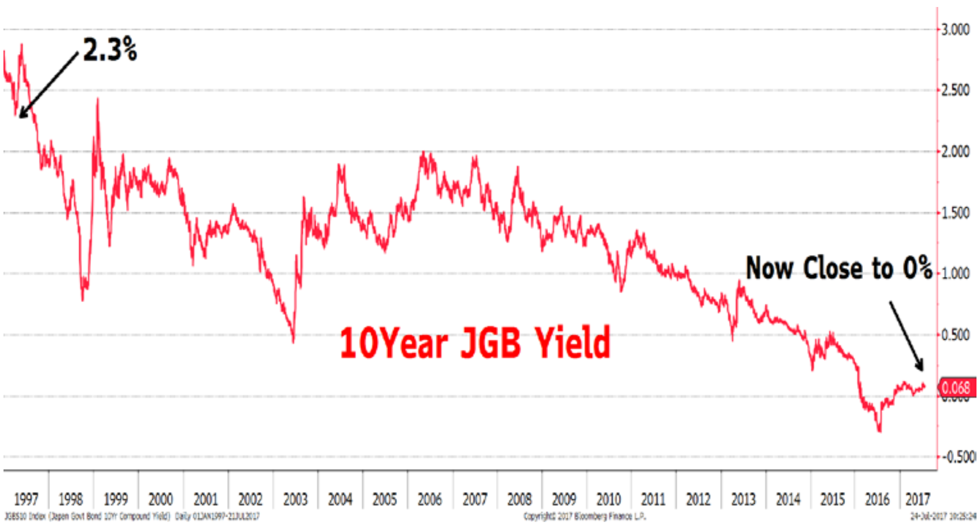
This baby-boomer trend will fundamentally influence the economy for the next decade. The boomers drove consumption and the economy while in their 20s and 30s (from 1960 through the 1980). That trend is over. Boomers are no longer driving the economy. And it appears that Millennials are not in position to accept the baton and run with it.

It has been said that demographics explain 70% of what is happening and what is to come. I agree. But the bond bears just don't get it. They believe rates are too low and must go higher.

SHADES OF JAPAN

While the U.S. is not Japan, we appear to be heading down a Japanese-like path. Asset bubble bursts, bad policy choices and the 3-Ds (debt, demographics and deflation) make America look eerily like Japan.

The Long Decline in Japanese Yields

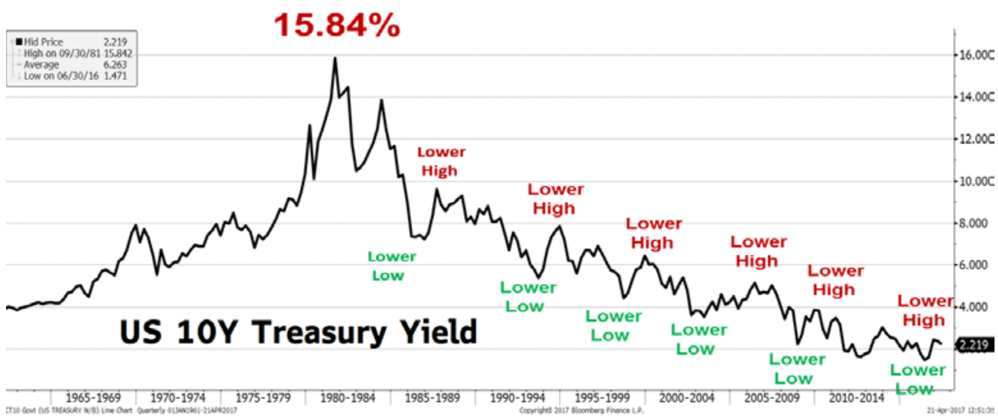


For perspective, in April 1997, the 10-year Japanese government bond (JGB) yield first hit 2.3% (where the U.S. 10-year yield is today). And two decades later, 10-year JGBs are barely above zero%. One thing that investors have learned over the past two decades was that "shorting" JGBs was a widow making trade. However, if there was something that did work consistently in Japan over the past 20 years, it was to buy the price dips in the JGB space. The same may hold true for U.S. Treasuries.

TECHNICALLY SPEAKING

From a technical aspect, the downtrend in long-term rates that began in the early 1980s is firmly intact. To break out of the current 35-year bull market trend, the 10-year note yield would need break through 3% for an extended period. Even if the downtrend is broken, history shows that rates will tend to move in a sideways consolidation for several years, often retesting the lows more than once.

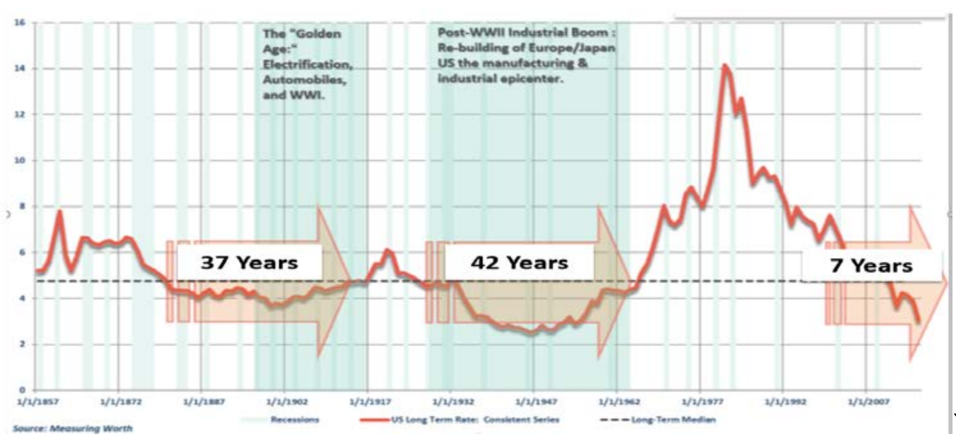
While rates may trend higher in the near term, we have not reached the point where the U.S. economy can sustain persistently higher rates. A secular bear market in bonds remains a low probability event. If anything, political, military and market uncertainties would more likely lead to another sudden decline in rates rather than a massive spike upward.



LOW FOR LONG

As shown below, during the credit and asset collapses of 1873 and 1929, long duration high quality bond yields did little more than bounce along a depressed floor for 20 to 30 years after the initial deflationary shock. We are heading into the tenth anniversary after the latest deflationary shock (Great Recession). So, if history is any guide, we are likely to remain in this lower-for-longer interest rate theme for more time than widely expected.

Interest Rates: Low for Long



MARKET OUTLOOK AND PORTFOLIO STRATEGY

The bond market's reaction to the four Fed rate hikes have surprised many pundits. After the first 100 basis points of Fed rate hikes, the 10-year Treasury note yield is right where it was when the Fed started to raise rates in December 2015.

Here is the reality. Historically, the Fed has hiked rates only when real GDP growth rate was approximately 4% and inflation was rising. So, for this cycle, the real growth rate has been a punky 1.7% and the year-over-year core inflation rate has declined from 2.1% to 1.7%.

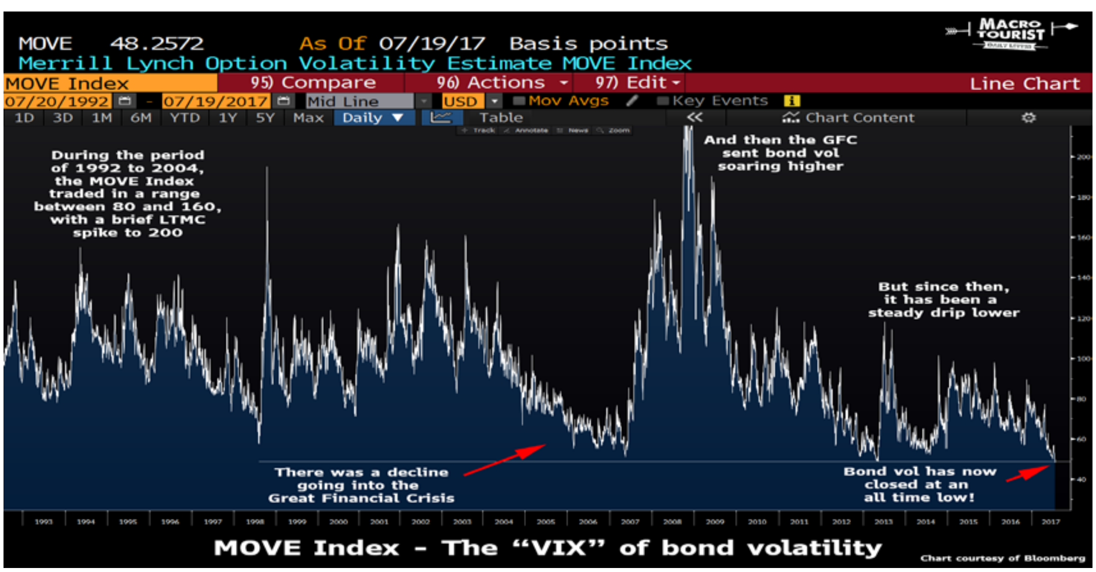
The bond market gets it! There is no mystery why long-term rates are not exploding higher. The bond market is rational. The Fed is irrational as it moves to fight an inflation ghost.

Furthermore, as discussed above the political backdrop is rife with gridlock. Unbelievably, there is still hope among investors that tax reform is coming by 2018. At the same time, evidence is mounting that the Democrats have a serious shot of taking the House next year.

Will the Fed continue to tighten? Only time will tell, but deflationary trends argue for less policy tightening by the Fed. However, if the Fed does continue to hike rates, the economy and inflation will decline further. If the Fed does not raise rates further, it is only due to weakening growth or inflation. Either way, history tells us that the yield curve will continue to flatten as it did after the last two rate hike cycles.

As they say and do in Japan, buy the dips!

Bond Volatility Now at All-Time Low



More Information

In terms of relative value, please click here for 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.