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INVESTMENT SERVICES

Weekly Relative Value

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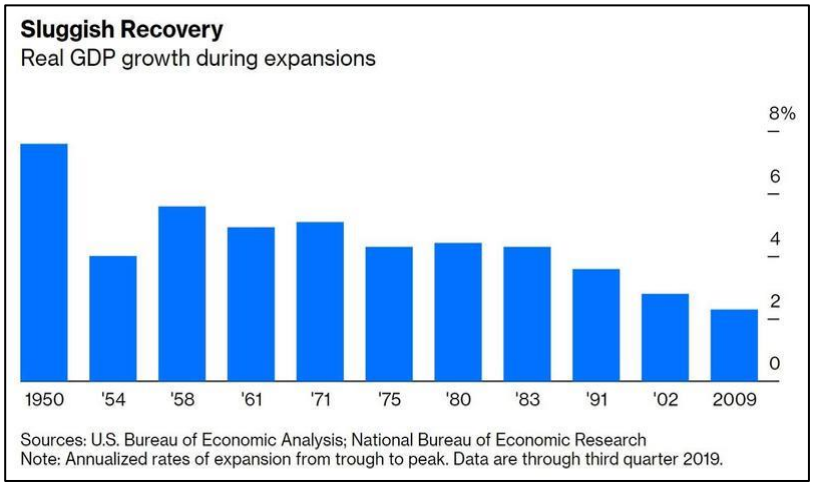
WEEK OF JANUARY 6, 2020

Welcome to the New Decade

Welcome to 2020 – a new year and a new decade.

"Who cares what it is called, the result is an explosive increase in the money supply!! And it's not bank lending that's behind that, because bank lending growth continues to slow down. So, the economic effect is exactly the same as with "QE". It walks like a duck, quacks like a duck, guess what: it's a duck! - Peter Tenenbaum

The U.S. economic recovery that began in June 2009 is now in its 127th month, which is a record. And for the first time ever, the U.S. economy finished the first calendar decade without a recession.



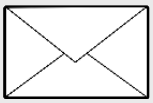
But while the recovery is the longest in duration, it has also been the farthest from a recession in the post-World War II era.

And arguably, the reason the economy has avoided a recession is the Fed Reserve. But this source of strength also doubles as its biggest risk for the economy and markets.

As of November, the collective balance-sheet assets of the Federal Reserve, European Central Bank, Bank of Japan and Bank of England stood at 35.9% of their countries' total gross domestic product (up from about 10% in 2008), according to data compiled by Bloomberg.

THIS WEEK

PORTFOLIO STRATEGY



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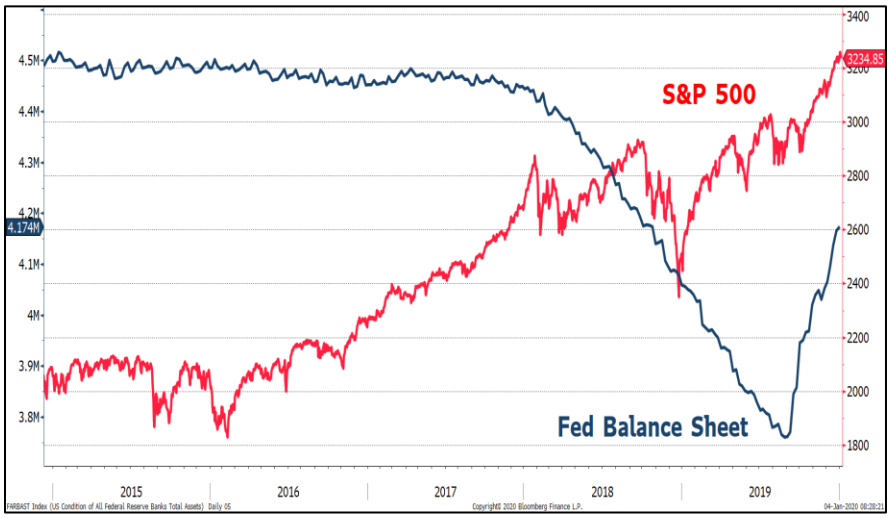
At the same time, according to the World Bank, developed country GDP expanded to $54.2 trillion at the end of 2018 from $46.1 trillion a decade earlier. All the while, the world's major central banks have rebuilt their balance sheets to nearly $15 trillion of assets, or 4x larger than they were prior to the 2008 financial crisis. And in fact, even with booming equity markets and uber-tight credit spreads, these entities obviously are still so consumed with fear over economic fragility that the assets they hold are about as high today, almost eleven years into the expansion, as they were at the peak.This kind of intervention is totally unprecedented. It's hard to quantify exactly how much of this combined "money printing" by central banks contributed to GDP growth, but most would agree that it ranges anywhere from "some" to "much." As trillions of dollars were created out of thin air and pumped that money into the financial markets, it is no mystery that asset prices levitated higher.

However, when the Federal Reserve suggested that they were going to increase interest rates three times in 2019 and Federal Reserve Chair Jerome Powell said the balance sheet was on "automatic pilot," stocks plunged by 20%. Then came the 180-degree turn (aka the "Powell Put") as the Fed cut rates thrice and the Fed's reversal prompted other central banks around the world to follow suit in what was supposed to be the year of quantitative tightening (QT), which turned into widespread global policy easing.

There is no such thing as a one-factor model to explain the stock market. Metrics such as the Fed's balance sheet, repo, etc. cannot explain the stock market's movements in isolation. That said, when the Fed injects money, funds generally flow to the best-returning market. During the financial crisis, it was the bond market. Today, as was the case in 1999, it is the stock market. The Fed insists that their repo support operations are "not QE (quantitative easing)" and therefore are not influencing financial markets. "Mr. Market" doesn't see it that way. As the old saying goes, "if it looks, walks and quacks like a duck… it's a duck."

When the repo markets ran into turmoil, the Fed started re-padding its balance sheet, bringing it back above $4 trillion. A move that coincided with the strong fourth-quarter rally in risk assets. In fact, approximately 10% of the stock market's gains came when the Fed announced its "non-QE" QE program. So, during a big part of the year, nearly 30% of the stock market gain came on the heels of Fed moves; much like last year's 20% decline, which was coincident with the Fed's hawkish rhetoric.

The Fed's "Non-QE" QE Program



Source: Bloomberg

2019 was another "rung" in the ongoing bull market. The trifecta of a resumption – QE, interest rate cuts and a flood of federal debt – coupled with ongoing stock buybacks and corporate tax cuts, all fueled an asset explosion.

2019 was truly unprecedented. The S&P 500 was up nearly 30% and every sector, whether defensive or cyclical, was in the green. Best year since 2013. The Nasdaq 100 soared 38%, its best performance since 2009. Gold was up 18% in its best year since 2010. The Treasury market had its best year since 2011 even as corporate bond spreads tightened towards their lows for the cycle. We have never seen this before. Ever. Quite the feat. No country for fundamental investors, that much is for sure.

S&P 500 by Decade

	Annual Return (including Dividends)	Number of Record highs	Number of Corrections
1950's	19.3%	141	6
1960's	7.8%	224	5
1970's	5.9%	35	7
1980's	17.5%	190	9
1990's	18.2%	310	5
2000's	-0.9%	13	11
2010's	13.5%	242	6

Source: Bloomberg

So, chalk up a win for the bulls. But the big question is, what happens when the Fed ends their "non-QE" QE program in the second quarter (the current projected end date)? Will asset prices plunge? As shown below, the market has never, ever been more highly priced. The last time that the S&P 500's price-to-sales (far harder to manipulate than price-to-earnings) was March 2000 (right before the dot-com collapse)

No One Can Say Stocks are Cheap

Source: Bloomberg

And the stock market has never, ever been more decoupled from actual (un-faked) earnings. But as has been often discussed in this space, this equity rally has virtually nothing to do with economics or company fundamentals. It's a 100% Fed liquidity driven market. End of story.

"By saying it is 'Not QE' they are arguing it is not impacting financial markets. By detailing the Y2K 'Not QE' episode, I'm arguing that not only is it QE, but we also have a historical example of how it has worked previously." – Jim Bianco, Bianco Research

Central bank support is the only reason to favor the equity market. The one source of comfort for investors is the knowledge that the Fed will come running with rate cuts and balance sheet expansion at the first sign of trouble. Count on it. The takeaway here is that it will be extremely hard for central banks to reverse "money printing." But as we saw throughout the bursting of the tech bubble and the onset of the financial crisis, there is only so much the Fed can do if and when the snowball gets rolling downhill. This is the reality. All bubbles pop… all booms end… and all bull markets eventually turn into bear markets.

It's All About Liquidity

Source: Bloomberg

But valuations don't seem to matter anymore, either. For example: An RBC survey of U.S. fund managers finds that just 11% of them see the stock market as being priced inexpensively. Yet 51% describe themselves as 'bullish'. The reason is quite simple– the central banks, in their role as blackjack dealers at the casino, have convinced the investment community that they "have your back" at all times. As Powell showed exactly a year ago, when he slips up, he will reshuffle the deck, just as Greenspan and Bernanke did before him.

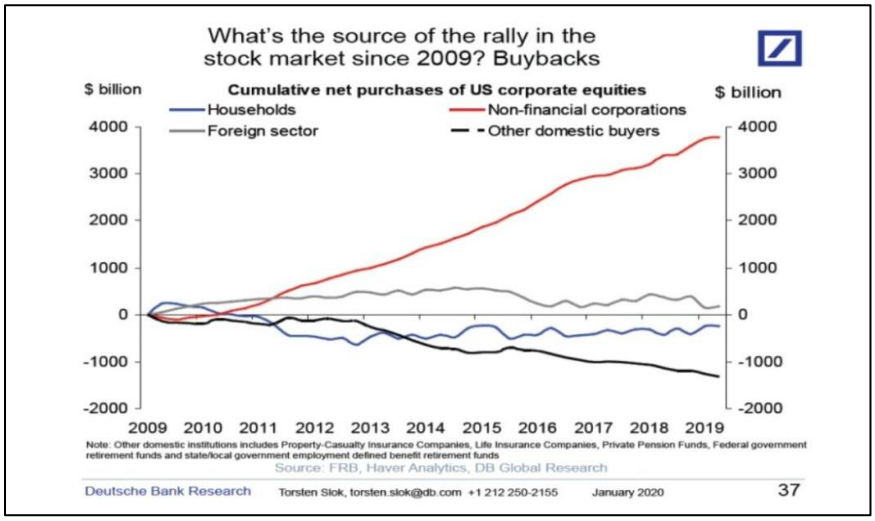
BOOM-BUST

"So, look, the stock market had a terrific decade. The S&P 500 rose nine out of 10 years. The S&P 500 is up nearly 30 percent this year, just this year alone. And half the stock market wealth in America is held by the top 1 percent of people." – David Wessel, Brookings Institution

Unquestionably, the Federal Reserve is needed to provide liquidity during a financial crisis. The Federal Reserve came about as a theoretical antidote to even-worse occasional panics and bank failures. However, by keeping rates too low for too long in the current cycle, the Fed kept its policy rate at the recessionary low of essentially zero until December 2015, 78 months into the recovery. This has led to massive capital misallocation and tremendous wealth inequality.

It also resulted in the financialization of a significant part of Corporate America. The rules now reward management, not for generating revenue, but to drive up the price of the share price. All you need is buybacks and an easy Fed, and the charade can be maintained for years. However, if the U.S. economy starts edging toward recession, stock buybacks will be at risk.

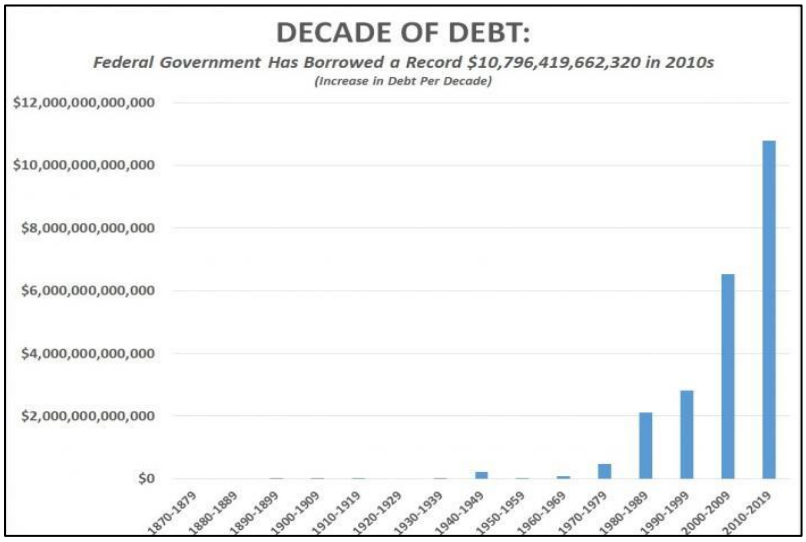
And if stock buybacks start to decelerate, watch out below in the U.S. stock market.



And by keeping rates artificially low, the Fed has fostered and promoted massive debt growth. Over the last 10 years, we have added more than $10 trillion to the national debt; state and local government debt has soared to record highs all over the nation; corporate debt has risen more than 50%; student loan debt has more than doubled; and the total amount of U.S. household debt is now nearing $14 trillion. The total federal debt accumulated during the decade has equaled approximately $83,967 per household. (The Census Bureau estimates there are approximately 128,579,000 households in the country currently.)

Making matters worse, the $12+ trillion in net additional public debt issued since 2007 is only set to pick up pace as federal spending rises, taxation continues declining, and unfunded liabilities metastasize. The economy simply cannot grow fast enough to pay for this massive debt. Imagine what happens when the recession occurs?

I have referred to U.S. fiscal policy as "generational theft." By stealing from the future, we have been able to stabilize the present, but the long-term cost to be borne by the next generation is going to be quite painful. Is this prudent? Is it right? Do we care? Regardless, please don't try to tell me that the U.S. economy is in the best shape ever.



Source: National Bureau of Economic Research

In summary, the past 10 years of unprecedented monetary intervention has ushered in a decade where the U.S. officially prints money to drive growth and creating the illusion of prosperity. The problem is, you simply can't print your way to prosperity; pretending that everything is "booming" won't come close to paying the bills.

Will the monetary magic wear out this year? It is impossible to say with certainty, but we do know that we are closer to the end of the road this year than last year. So, if investors want to join the stock rally, they should do so with the full knowledge of what they are doing.

Source: Hedgeye

BACK IN THE REAL WORLD

The Wall Street narrative for buying long stocks throughout the year was that Trump's trade deal would finally be signed and global growth (i.e., Purchasing Managers' Index (PMI) readings) was bottoming. Count me skeptical.

Yes, China agreed to some helpful changes. The U.S. dropped some (not all) of its current and planned tariffs. But those aren't the real problem. The real problem is that businesses still can't be confident policy will remain stable, and thus are unable to make growth plans. I think we will keep seeing this in capital investment numbers. The trade war genie is out of the bottle.

Worse, this trade war may be producing the opposite of its intent. Last week, Tesla delivered the first vehicles made in its new Shanghai factory, built specifically to avoid trade barriers. Instead of incentivizing U.S. export production, tariffs are making U.S. companies shift what would have been export production to other countries. We will see more of this. It may be good for those companies but not for American workers.

As you will glean from the graphs below, the "Great Soybean Bean Deal of 2019" and NAFTA 1.2.0 were not panaceas for U.S. or global industrial demand. After a modest recovery over the past four months, PMI manufacturing reports in the U.S. and from around the world almost all worsened in December, showing that the sector continues to face global challenges.

Note: PMIs reflects how a panel of manufacturing executives representing 18 manufacturing industries – names are not disclosed – see new orders, production, employment, etc. at their own companies. PMIs are the timeliest measure of what is happening in the manufacturing sector.

The overall Purchasing Managers' Index dropped to 47.2% in December 2019, the fifth month in a row of contraction, and the fastest contraction since June 2009. And while the declines were very broad, affecting 15 out of 18 industries, December also saw some big special items: Boeing suspended production of the 737 Max and GM's strike bled into the beginning of December.

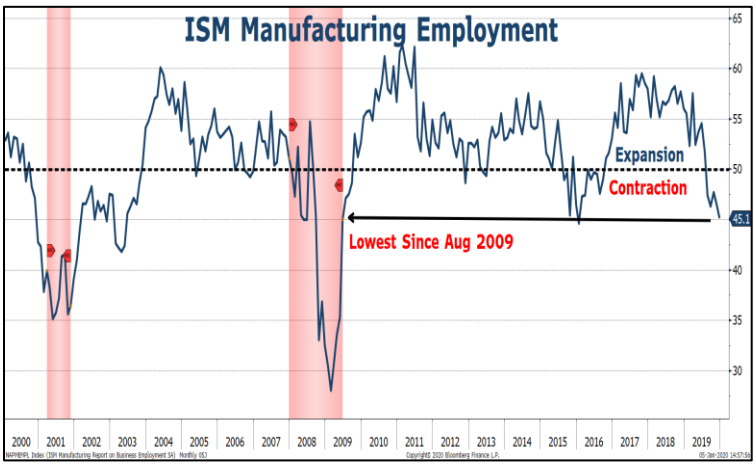
As shown below, year-over-year Institute for Supply Management (ISM) Manufacturing is at levels that have historically lined up perfectly with U.S. recessions.

U.S. Manufacturing Slows to the Lowest Since 2009

**Red Shaded Area Indicate Recession / Source: Bloomberg*

The Employment Index fell to 45.1, the fifth month in a row of contraction, and the fastest contraction since August 2009.

U.S. Manufacturing Employment Slows the Fastest Since 2009



**Red Shaded Area Indicate Recession / Source: Bloomberg*

To complete the picture, the preceding graph displays the total number of employees in the manufacturing sector. I marked roughly Barack Obama's and Donald Trump's reigns. Note the curve has now turned down. And note what happened under George Bush and prior presidents. In other words, there has been no manufacturing.

Here's the key point. Services-producing industries amount to the equivalent of 70% of U.S. GDP, and to 80% of the private sector economy. At this point, there are no indications that there was a sharp deterioration in the service sector in the fourth quarter. But with manufacturing deteriorating at this pace and based on the historical relationship between manufacturing and the rest of the economy, the ISM report suggests that real GDP in December could be lowered significantly.

JOBS AND THE CONSUMER

Challenger, Gray & Christmas, Inc. reported that job losses tied to bankruptcies soared to levels not seen since 2005. Sixty-two thousand one hundred thirty-six job losses were a result of firms going bankrupt and laying off employees in 2019. There were more job cuts related to bankruptcy in 2019 than in both 2008 and 2009, during the Great Recession.

One of the drivers behind the cuts has been the implosion of retailers. 2019 was the year the oft-invoked healthy American consumer carried the economy, but U.S. retailers announced 9,302 store closings, a 59% increase from 2018 and the highest number since Coresight Research began tracking the data in 2012.

Despite the latest jobs report showing the unemployment rate near a 50-year low, 2019 saw the third highest number of total layoffs in the decade, with nearly 600,000 people losing their jobs, a 10% increase over 2018.

The report also said one of the leading causes of job losses last year were "trade concerns, emerging technologies, and shifts in consumer behavior."

While the U.S. added an average of 180,000 jobs a month in 2019, the retail, mining and utilities sectors all saw net job losses for the year. The lion's share of new jobs has been in health care, leisure and hospitality, and professional and business services.

Corporate Layoffs Rising

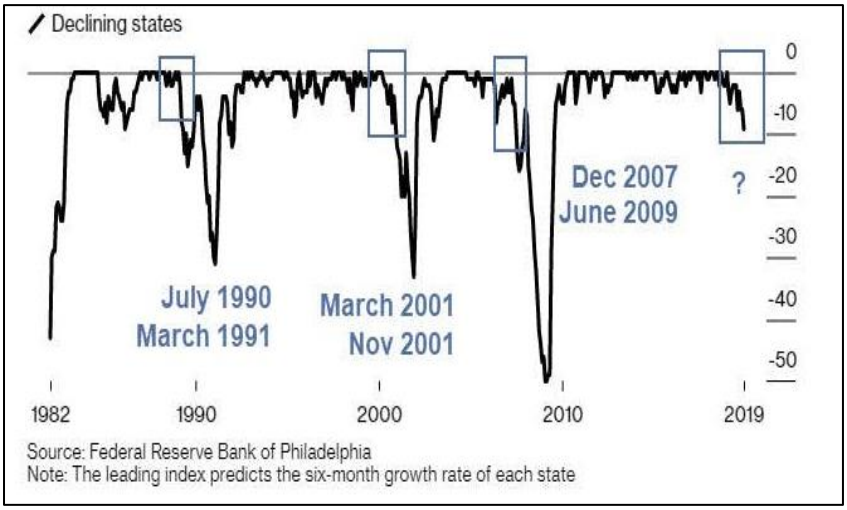
Year	Annual Total
2009	1,288,030
2011	606,082
2015	598,510
2019	**592,556**
2018	538,659
2010	529,973
2016	526,915
2012	523,362
2013	509,051
2014	483,171
2017	418,770

Source: Challenger, Gray & Christmas, Inc. ©

Also, remember that the unemployment rate is a lagging indicator. A better metric for the direction of the labor market is actual unemployment claims. And it is worth mentioning is that in December, nearly two-thirds of states had rising initial claims year-over-year**.**

Meanwhile, a new report from the Philadelphia Fed shows nine states are expected to see their economies shrink this year, even as the central bank and most economists expect the U.S. as a whole will avoid recession. The number of *states projected* to see contracting economies is the highest since July 2009.

Trouble Brewing? Nine States Projected to Contract in 2020



Source: Federal Reserve Bank of Philadelphia
Note: The leading index predicts the six-month growth rate of each state

With employment and the U.S. economy continuing to decelerate into 2020, it's likely that more job losses tied to bankruptcies will be seen, and overall job cuts could keep moving higher.

All this means is that the employment slowdown will persist well into the new year. As has been discussed quite often it has been the U.S. consumer who has prevented the U.S. economy from sliding into a recession. Should job losses continue, the all-mighty consumer may become more frugal very quickly. As the consumer goes… so goes the economy.

The U.S. jobs report will be released this Friday, January 10, which is expected to show a gain of around 160,000 jobs – after last month's surprisingly large increase of 266,000. Also please keep your eye on annual payroll revisions which will be released in February. That data could make the past look less shiny.

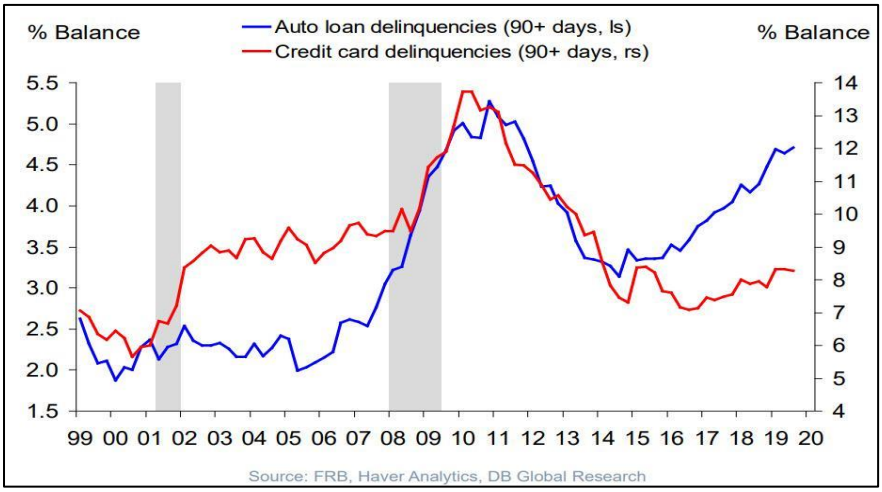
MARKET OUTLOOK AND PORTFOLIO STRATEGY

With the first full trading week of the year on deck, investors are sketching their market predictions for 2020. Will the decade-long bull run continue? What's next in the Fed's rate cycle? Will inflation rise and drive rates higher? Or will the long-term secular forces of secular stagnation prevail with growth slowing and interest rates and inflation declining? Will the labor market remain strong? Or have we reached "peak" employment? How about upcoming phases of the U.S.-China trade deal? Is it truly the greatest trade deal ever or just another smokescreen? How will the 2020 presidential election affect the market?

Big Picture: The natural trend for an economy is to grow. A recession only occurs when something "breaks." And it's hard to time the end of the current recovery. Still, it will end, due either to Fed overtightening or a financial crisis, like the 2000 dot-com blow-off or the 2007-2009 subprime mortgage collapse.

That said, no financial crises are in sight, but there are possibilities such as excess debt in China and among U.S. businesses, a trade war escalation, consumer retrenchment resulting in widespread deflation, and disappointing corporate profits measured against sky-high stock prices.

The Consumer is Showing Signs of Stress



On the bond front, it's been a rough start to the year for the bearish bond trader. Benchmark yields tumbled Friday, driving the curve flatter, due to the potential ramifications of a U.S. airstrike that killed one of Iran's top generals.

And those expecting cheerier news on the economic front faced disappointment from the worst U.S. factories data since 2009. As discussed above, Friday's manufacturing figure was just flat out u-g-l-y.

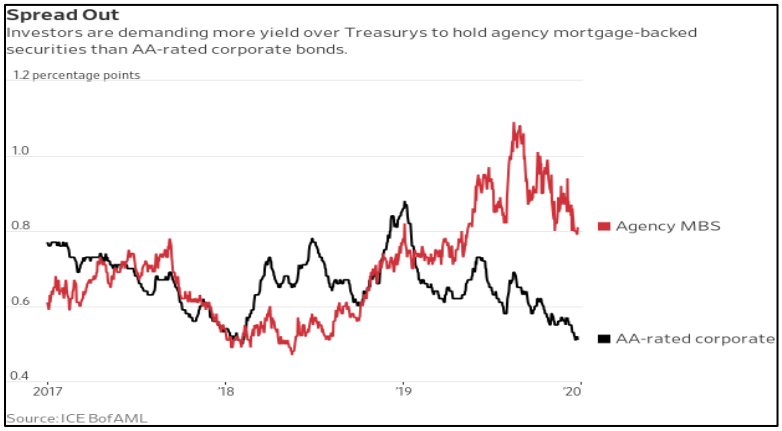
Long-term View: Low rates are going nowhere and could even fall further in the future due to negative demographic trends, massive debt loads at all levels of the economy and sluggish productivity growth. These factors are apt to prove chronic by nature and might be around for a while.

As such, I see nothing to break U.S. growth out of its below trend or move the neutral level of interest rates higher in the next five to 10 years. The trick will be in avoiding something even worse. So, we are entering the new decade, but the more things change the more they remain the same.

Near Term: As we move forward, the curve can continue to flatten, and that's predicated on two things. One is that I don't think the economic data are going to come through. And two, the trend in interest rates is lower. Look for the curve to flatten back toward zero in the first half of this year, with the 10-year approaching its 2019-low around 1.43%, compared with about 1.8% now. That may well beckon a Federal Reserve rate cut in the first half of the year.

In terms of portfolio structure, as always, we continue to advocate that credit unions maintain a fully invested risk appropriate ladder strategy. For those credit unions looking for more yield, we would encourage them to take a look at agency mortgage-backed securities (MBS) or structured mortgage products. Mortgage spreads widened in 2019 due to the Fed reducing large holdings of mortgage bonds accumulated as part of its postcrisis stimulus policies and to fears of increased prepayment activity. MBS spreads have also risen due to concerns over increased prepayment activity as interest rates have fallen. That said, in a low yield environment, MBS products offer an attractive yield pick-up over Treasury/agency debt as well as corporate debt (see the following graph).

MBS Offers Good Relative Value



PREMIER PORTFOLIO

Alloya Investment Services' online trading platform, Premier Portfolio, has been making a positive impact at credit unions across the corporate's membership since its launch in 2018.

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> – Darin Higgins, President of Western Illinois Credit Union

> *"While it's always great to connect with our Balance Sheet Solutions, (now Alloya Investment Services), Account Executive one-on-one, Premier Portfolio is an amazing and easy tool to use in purchasing investments. We have access to statements, online trading and the ability to look at all of the offering in one place. I highly recommend trying this out!"*
> – Shawn Nikkel, Finance Director of Denver Fire Department FCU

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> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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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@alloyacorp.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 Alloya Investment Services, 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.