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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF FEBRUARY 18, 2020

Food for Thought

"If you really think that the environment is less important than the economy, try holding your breath while you count your money." – Guy McPherson

January 2020 was the fifth warmest January on record in the U.S. All 48 contiguous states experienced above average temperatures. Yes, it is indeed a welcome change from the polar vortexes of past winters, but it's also a blunt reminder that climate change is for real and is impacting the world.

Consider the following:

- In 2019, there were 820 major events such as droughts, floods, hurricanes and forest fires, costing $150 billion in damages and causing over 9,000 deaths worldwide. This vastly surpasses the 30-year average of 520 annual disasters estimated by Munich Re and poses a significant drag to global growth.
- Global temperatures are forecasted to rise by around 3°C by 2100 unless there is a concerted effort by world leaders to get emissions down by 45% (from 2010 levels) over the next 10 years – and then go entirely carbon-neutral by 2050. No small feat.

Source: Cagle Cartoons

And no place on Earth is immune. In 2019 alone, the U.S. saw several historic climate events including flooding in the Midwest in May, Hurricane Dorian in August, and the "Bomb

THIS WEEK

PORTFOLIO STRATEGY

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Cyclone" that hit the Northeast in October. Australia is dealing with massive bushfires while countries like Kenya are dealing with the biggest locust infestation in 70 years.

This isn't a "tree-huggers" concern. It's economic.

And the greatest long-term impact could be on food supply and prices.

According to the National Research Council, a rise of just 1°C in global temperatures can lead to a 5-15% reduction in crop yields. Such destruction would eliminate millions of small-scale farmers. And the United Nation's Food and Agriculture Organization estimates that about 88% of the world's agricultural land belongs to small-scale or family-owned farms. Regional disasters can wreak havoc on global food supply chains, which leads to increased transportation costs and food price inflation. And regardless of income, spending power across is depleted as a result (everyone needs to eat).

The U.S. is a net food importer. But over 30% of the U.S.'s food imports come from Canada and Mexico, which have both seen weather-related supply disruptions in recent years.

- In 2019, the price of Canadian vegetables increased by almost 20% due to weather disruptions and infections (E. coli in lettuce was a major problem). Prices for Canadian vegetable and meat products could increase by 4-6% according to a study by Dalhousie and the University of Guelph (which, by the way, lists climate change as the "elephant in the room" for 2020).
- In Mexico and the southern U.S., depleted groundwater, leading to natural disasters such as aridification, drought and fires, is threatening food supply. Domestically, California's wildfires are getting more severe, and since a third of the country's vegetables and 66% of the U.S.'s fruits and nuts are produced in the state, the risk of disruptions to the country's food supply are mounting.

The bottom line is that the household impact of these kinds of food price disruptions is essentially a tax on consumption. Lowest-income families will be harmed the most, exacerbating existing inequalities and limiting funds available for discretionary spending.

DOES ANYONE REALLY KNOW?

"China cannot be trusted on any statistic. We have suspected that for years, with plenty of evidence. Now we have absolute proof." – David Kotok of Cumberland Advisors

China yet again reported a huge wave of coronavirus cases. The new figures bring the totals for Hubei to 58,182 cases, and 1,696 deaths in the province. Around the globe there are north of 73,000 cases, while the death toll rapidly approaches 2,000. And nearly everyone questions the data we do have. As economists morph into infectious disease specialists, let's just admit that nobody truly understands the true trajectory of this virus. We still don't even have an accurate estimate of the total number of infected people even as markets respond in knee-jerk fashion to every press headline.

The things that we do know: 1) There is an elevated death rate with this virus. 2) The virus is virulent – it spreads like oil on water. 3) Quarantines have slowed but not stopped the spread.

I highly recommend you listen to **this interview with Dr. Neil Ferguson**, founding director of the MRC's Centre for Outbreak Analysis and Modelling. According to this interview (on February 5):

- Dr. Ferguson estimates that every infected person is on average infecting 2.6 others. If the average time from infection to transmission is under two weeks, this is consistent with his estimate that the nCoV numbers are roughly doubling every five days.
- His best estimate of current new infections per day is 50,000, nearly 20X higher than the official count. This implies a total infected number of roughly one million today.
- The Covid-19 is very transmissible, more like a classic influenza than like SARS. And with influenza, standard quarantine measures are seldom effective. For this reason, Ferguson sees "only limited evidence" that the spread of Covid-19 may be slowing down.
- On its current growth path, he expects infections to peak in Hubei in about a month's time. And in the rest of China about a month later.

Okay, here are some (admittedly) back-of-envelope calculations. If the infected number is now one million, that alone will eventually generate in the next 2-4 weeks roughly 10,000 deaths.

If the infection total is doubling every five days, then we will be up to 2 million infected by February 18, generating 20,000 eventual deaths. As for further doublings over the rest of February and into March – well, you can keep doubling these numbers just as easily as I can.

If the mild-mannered Professor Ferguson is correct, the outlook for the coronavirus is indeed worse than expected.

This what Dr. Robert Redfield, Director of the Centers for Disease Control and Prevention had to say about coronavirus:

"Right now we're in an aggressive containment mode… We don't know a lot about this virus…This virus is probably with us beyond this season, beyond this year, and I think eventually the virus will find a foothold and we will get community-based transmission." – Dr. Robert Redfield

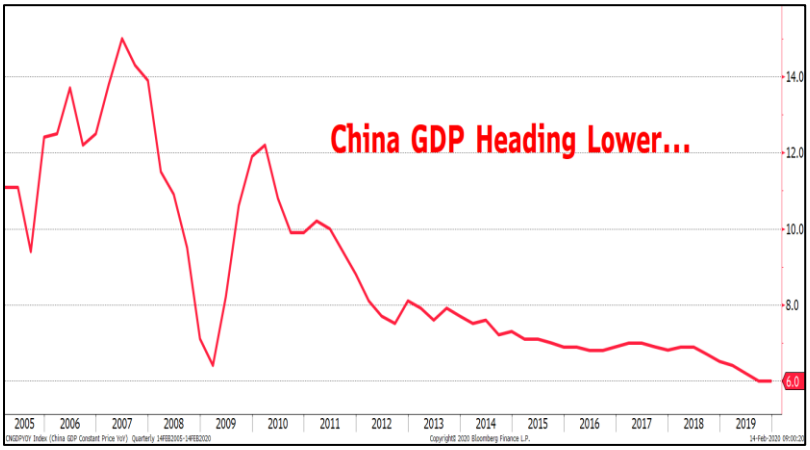
Hopefully, modern medicine will come up with a vaccine quickly. There is reason to be hopeful on that front. Possible vaccines are already in animal trials in both the U.S. and China.

Source: Cagle

But the economic impact won't wait and it's going to be big. China is four times more important to the world macro scene today than it was 17 years ago (amid the SARS epidemic) and the consumer's share of Chinese GDP has doubled since that time. Note, 15% of U.S. foreign trade is with China. Europe and others are also being impacted, which will affect our exports to them.

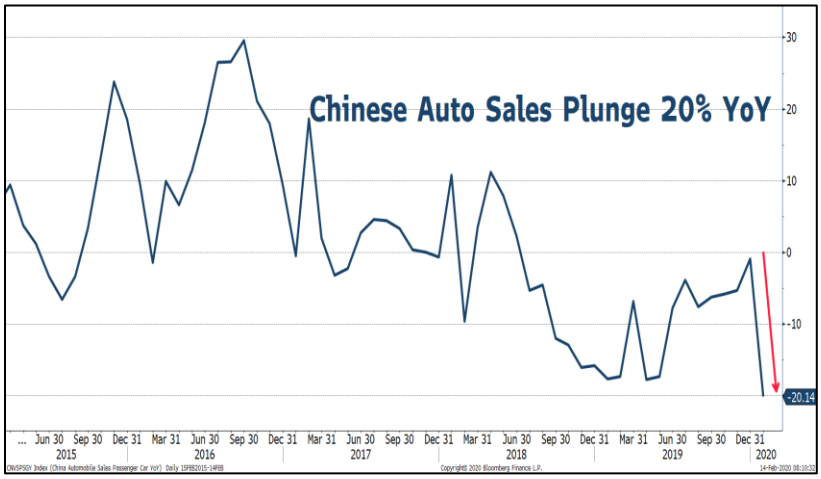
To be sure, sales of iPhones will come back, but services spending won't – those 86,000 cancelled domestic and international flights in and out of China since January 23 are not going to be recouped. This is a permanent loss of earnings for a whole lot of businesses.

How Low Will China Go?



Source: Bloomberg

China very likely is heading into a consumer recession, as auto sales plunged 20% year-over-year in January to their lowest level in eight years.

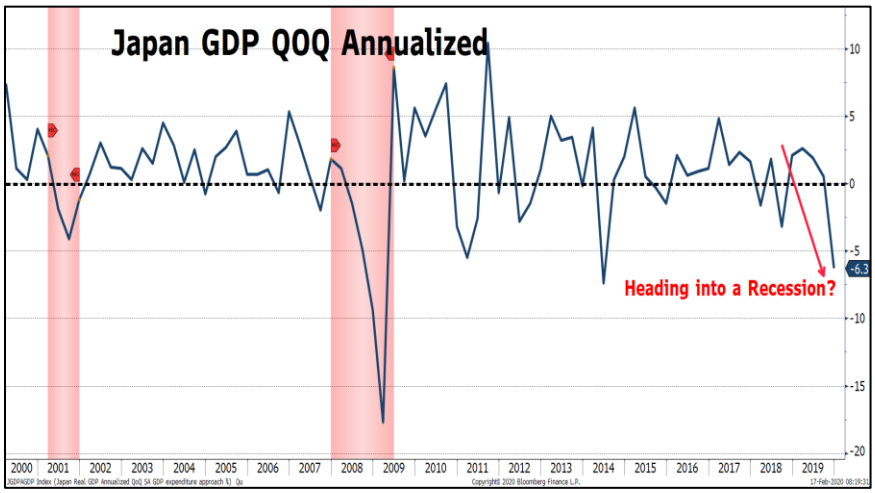


Source: Bloomberg

Elsewhere in Asia, Japan – the third largest economy in the world – saw its GDP fall by a much-steeper-than-expected 6.3% in October-December. Japan's economy has been staggered by a devastating typhoon and a wallet-shutting tax increase. Now, the coronavirus, which has brought business in neighboring China to a virtual standstill, threatens to knock Japan into a full-blown recession. Note: Guess the #1 nation Japan exports to. It's not the U.S. but China.

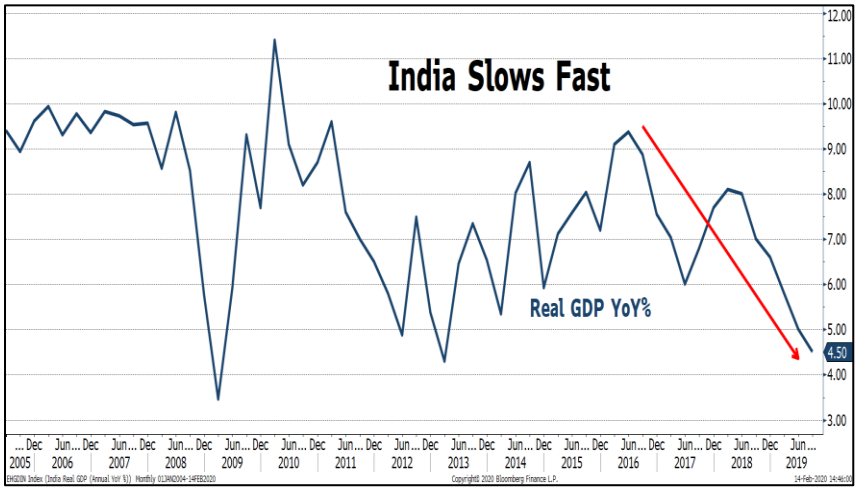
If Japan's economy shrinks again in the first quarter of 2020, the country will officially fall into recession – two straight quarterly contractions – for the first time since a brief dip in 2015 and its fourth recession since 2010. And this one rates to be severe. The coronavirus is certain to amplify an already weakening economy.

Japan Is Heading for Trouble …Again



Source: Bloomberg

And India, once the really hot spot for the global economy, has seen its economic growth cool off to a decade-low of 4.5%. Former Indian Finance Minister Yashwant Sinha warned several months ago that the country is in a "very deep crisis," witnessing "death of demand," and the government is "befooling people" with its economic distortions of how growth is around the corner. Meanwhile, Singapore's Prime Minister was ringing some recession alarm bells. The Bank of Korea issued a similar warning.



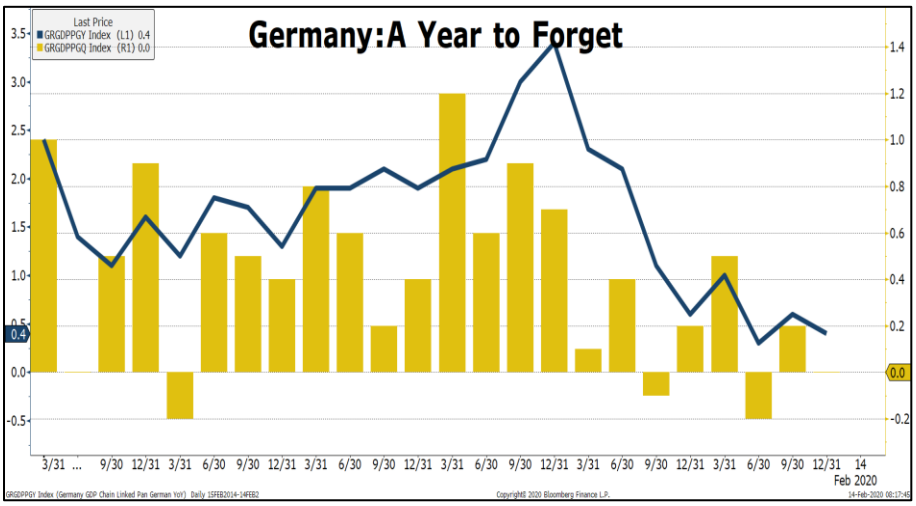
Source: Bloomberg

It's not just Asia slipping into flat or negative GDP growth.

In Germany – the fourth largest economy in the world – real GDP growth came in at just +0.1% for the second consecutive quarter. There is jubilation in some circles that Germany and the U.K. managed to escape a technical recession (wow, "flat" never felt so "up"), but a small consolation, really, as both countries barely expanded at all in the

fourth quarter. At any rate, this is not an inspiring development. It's like being on a diet and being proud that you're putting on less weight. Give me a break.

Germany's Growth Engine Has become a 0.5% Caboose



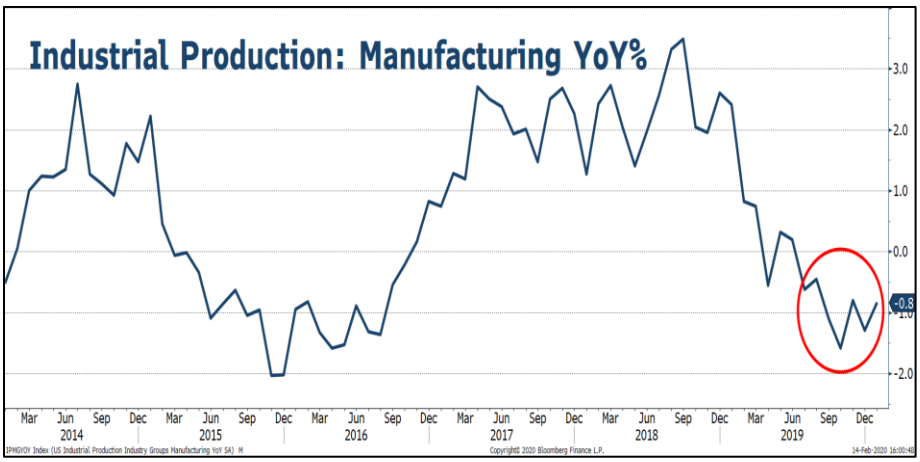
Source: Bloomberg

In North America, Canada's economy has already stalled out. Mexico seems worried enough about the global outlook that its central bank just cut rates by 25 basis points to 7% (125 basis points of cumulative easing since last August).

Yet, all I hear about are "green shoots" and re-acceleration.

And back at home I'm being told that the U.S. economy is just fine.

Let's review. The U.S. is experiencing a capital spending recession, and declining factory payrolls. U.S. industrial production has contracted year-over-year for five straight months. In the manufacturing segment, production is down year-over-year for the seventh straight month**.** Let's be clear. We are in a manufacturing recession. And this is before the impact of the virus had fully hit global supply chains.

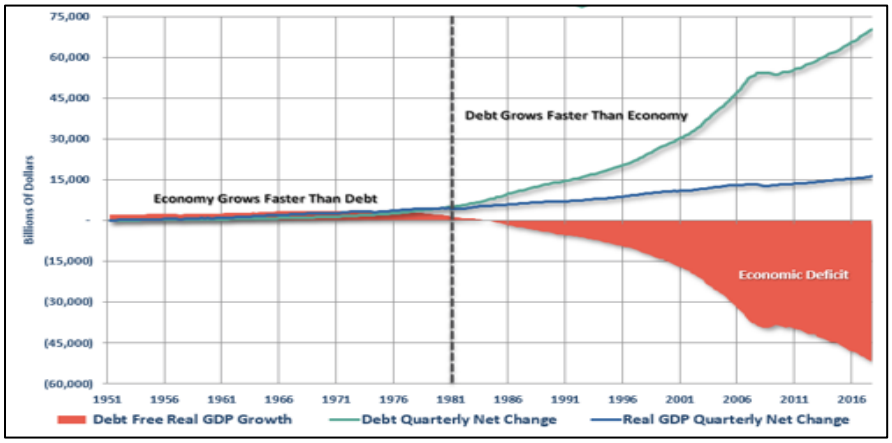


Source: Bloomberg

Has the U.S. economy managed to escape an official NBER-defined recession (two consecutive quarters of negative growth)? Absolutely. What's holding the glue together? The government. The reality is that if it wasn't for the government running a massive trillion-dollar fiscal deficit, economic growth would actually be recessionary. In other words, if you subtract the debt, there has not been any organic economic growth since 1990. "Fake Economy?"

All I can say is if this is "the strongest economy ever," God help us when things really turn bad.

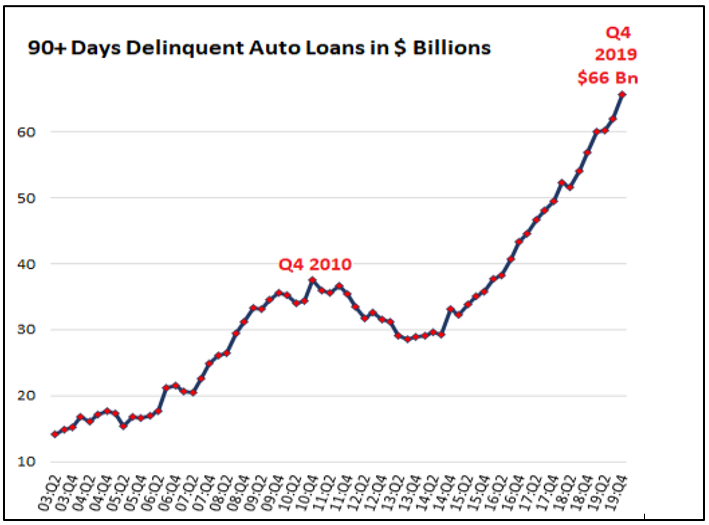
GDP Less Government Spending



Source: Lance Roberts

GRAPH OF THE WEEK

Subprime loans (borrowers with a credit score below 620) are exploding at a breath-taking rate, and they're driving up the overall delinquency rates to levels last seen in the Great Recession. Nearly a quarter of all subprime auto loans are 90+ days delinquent. About 22% of the $1.33 trillion in auto loans outstanding are subprime, so about $293 billion are subprime. Of them, $68 billion are 90+ days delinquent. This means that about 23% of all subprime auto loans are seriously delinquent. Nearly a quarter!



Source: New York Fed

"Seriously delinquent" auto loans (prime and subprime) that are 90-plus days delinquent have now surged 15% year-over-year to 4.94% (or $66 billion) of the $1.33 trillion in total loans and leases outstanding. This surpasses where the delinquency rate had been in the third quarter of 2010 as the auto industry was collapsing, with GM and Chrysler already in bankruptcy, and with the worst unemployment crisis since the Great Depression approaching its peak. **But this time, there is no unemployment crisis. These are the good times.**

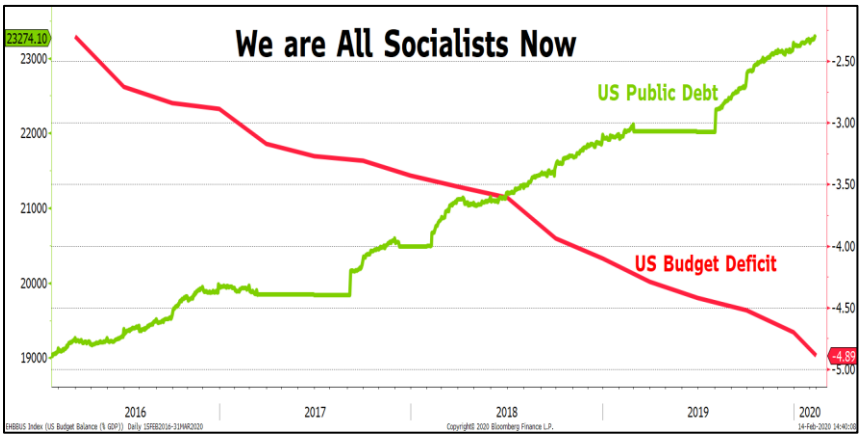
WE'RE ALL SOCIALISTS NOW

"He that goes a borrowing goes a sorrowing." – Benjamin Franklin

Let me also say this. It's hilarious to hear the free market types criticize Bernie Sanders. Please, we're all socialists now.

Let's face it, who exactly is a so called "conservative" anymore when it comes to the role of government. Government spending has increased by $800 billion under the Trump Administration.

In the first four months of the new fiscal year, the budget deficit has soared 25% year-on-year. That's a cool $389 billion deficit, or over $1.2 trillion annualized. The budget deficit/GDP ratio is now at 4.9%, up from 4.3% a year ago, unheard of at this stage of the cycle. The last time we were at these levels was 2013 when the unemployment rate was 4% higher, sitting at 7.5%.



Source: Bloomberg

Federal government spending, with a Republican Party (once known as the "fiscally responsible" party) in office no less, has ballooned 10% in the past year. And we are lamenting about socialism? It's here! Government spending already totals a huge $1.6 trillion.

As shown above, there is a long-standing addiction in Washington to debt. Every year, we continue to pile on more debt with the expectation that economic growth will soon follow. Yet the reality is the opposite.

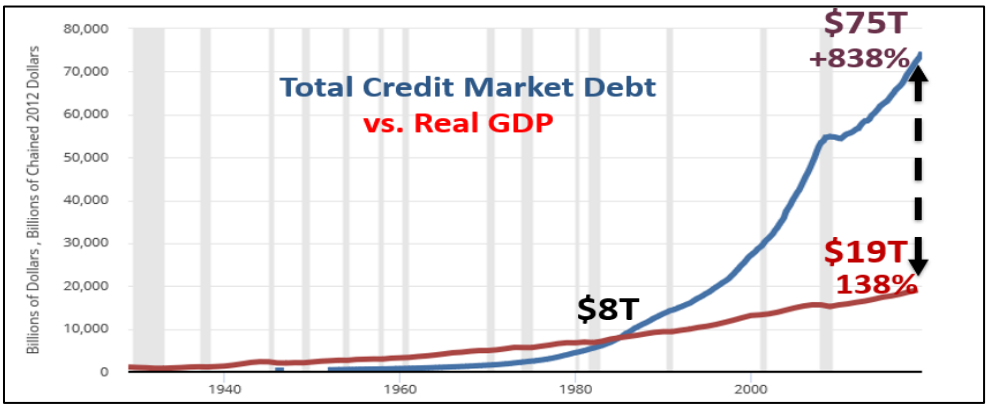
- U.S. government debt is now over $23 trillion or 106% of GDP. The U.S. deficit has doubled to $1 trillion and at roughly 5% of U.S. GDP. Throw in a recession, and you are quickly at total debt of $40 trillion… with an economy of only $26 trillion and a debt-to-GDP ratio closer to 150% than 100%.

Corporate and individual debt have risen to all-time-high levels. The system is choking on debt.

But the higher debt is NOT creating higher growth. The gap widens by the day! Such has been a consistent source of frustration for Obama, Trump and the Fed, who keep expecting higher rates of economic growth, only to be disappointed.

And this is why… Debt that is not self-funding reduces economic growth as the "debt service" diverts income from investment leading to a "diminishing rate of return" for each new dollar of debt.It now takes almost $5 in debt to generate $1 of GDP. In 1970 it took $1.5 of debt to generate $1 GDP.

Choking on Debt

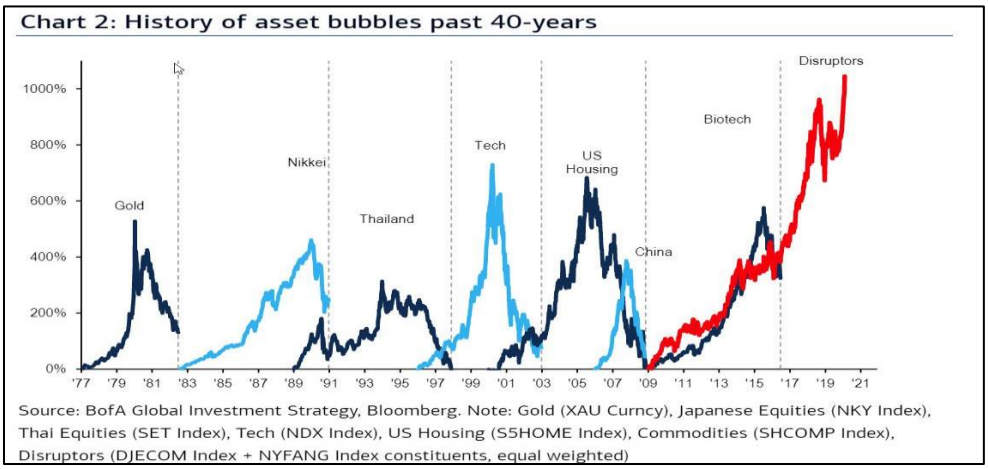


Source: St Louis Fed

In such a debt-saturated, leveraged environment, it will be very difficult if not impossible to normalize rates until we have a global debt default. Call it a "debt jubilee" if you are religious, "helicopter money" if you are Ben Bernanke, or "Modern Monetary Theory" if you are a left-leaning Democrat.

BIGGEST BUBBLE IN 40 YEARS

As it happens, every time the Fed has tried to manage asset prices, it had blown another bubble. The lowest interest rates in 5,000 years coupled with endless money printing has all but guaranteed a melt-up in risk assets.



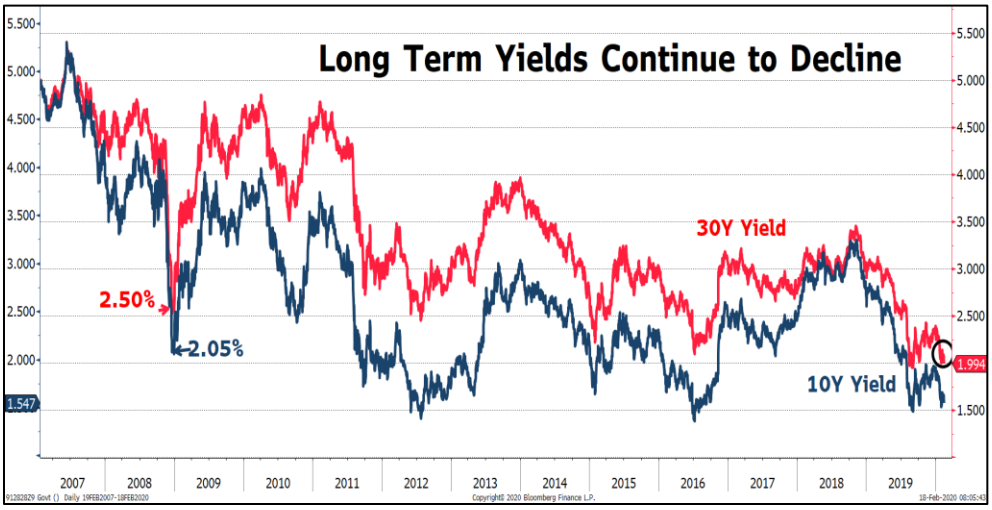
Thanks to 800 rate cuts by central banks since the Lehman Brothers Bankruptcy, ecommerce + FANG Index (aka the disruptors), after rising more than 1,000% from the crisis lows, has become the single biggest asset bubble of all time.

WHY?

Nobody ever asks the question, "Why is the yield on the 30-year Treasury bond the lowest ever and the 10-year Treasury note 51 basis points BELOW the lowest point reached in the 2008-09 Great Recession?" The low in the worst recession since the 1930s was 2.05%, and here we are today, sitting at 1.54% in the 11th year of this expansion built on unprecedented leverage, the Fed's repeated interventions, years of free money, the "wealth effect" on spending, and massive doses of fiscal stimulus.

If this is truly the strongest economy of all time, rates should be rising. But the bond market understands what's really going on and is not being fooled by the "artificial" economy and "manipulated" stock market. While the statistical relationship between the S&P 500 and GDP has broken down, the long end of the Treasury market remains the best leading indicator of where the economy is going.

Treasury Yields Tell the True Story



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"If the U.S. economy entered a recession soon and interest rates fell in line with levels seen during the moderate recessions of 1990 and 2001, yields on even longer-dated Treasury securities could fall to or below zero." – Senior Fed Economist Michael Kiley, January 20, 2020

My role at Alloya Investment Services, week in and week out, is to provide an independent, objective and realistic assessment of the economy and markets. As readers will attest, I take strong positions against consensus thinking when backed by hard evidence. In a business where most economists present what they believe will be most well-received, I form my views without fear and without favor.

In other words, I call it the way I see it. It may not be what you want to hear. I get it. Everyone wants the good news. But as I often say; hope is not a good investment strategy. By providing a "dose of thought-provoking reality," I believe credit

unions will be better informed to see around the corner and hopefully make better investment decisions regarding their investment portfolios and overall balance sheet.

If you have been following my work – reading the Weekly Relative Value or hearing me speak at a CFO roundtable – you know that I have vehemently argued (for the past 10 years) that economic growth and inflation would be below trend. As a result, interest rates would remain "lower for longer."

And the reason we remain in a low-rate environment is because we are in a period of secular stagnation (too much supply and not enough demand) as a result of excessive debt, aging demographics and declining productivity. These long-term secular trends are not easily or quickly reversed. As such, the rate backdrop is unlikely to change anytime soon.

Here are my latest thoughts on the U.S. economy:

1. **GROWTH:** No recession yet, but growth remains subdued.
2. **INFLATION:** Low… and likely to decelerate meaningfully from here
3. **POLICY:** The Fed is not dovish enough to prevent recession risk from accumulating. Hence lower rates.

In essence, we continue to live in a low-rate world and that is not unlikely to change anytime soon. In fact, I believe lower rates are heading our way.

Our ongoing advice is to minimize excess cash reserves and maintain a fully diversified ladder portfolio. Any back-up in yield provides an attractive entry point.

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.

"Premier Portfolio is user-friendly and modern. It allows us to browse current offerings and make immediate purchases at any point throughout the day. The tracking mechanism in Premier Portfolio is very hand. Since the system knows what dollar amount is currently owned in a financial institution, there is no room for error. We love the ability to check term and rate on a single summary. Premier Portfolio takes the guessing out of the equation. It is a highly useful tool and would recommend to anyone using Balance Sheet Solutions (now Alloya Investment Services)."
– 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

"Premier Portfolio's online services allows me to access statements and overall market analyses, review a list of available security offerings, as well as purchase SimpliCD's and Alloya's certificates. Premier Portfolio is convenient, easy, secure, and has become my go-to place for investing!"
– Rhonda Schroeder, CEO of Blackhawk Area Credit Union

Visit **www.alloyacorp.org/premierportfolio** to learn more about Premier Portfolio and how it can benefit your credit union!

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.