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INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

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Cognitive Dissonance

Remember the old joke about a child who was such an extreme optimist that his concerned parents took him to a psychiatrist? The doctor decided to try to temper the young boy's optimism by ushering him into a room full of horse manure. Promptly, the boy waded enthusiastically into the middle of the room saying, "I know there's a pony in here somewhere!"

Cognitive dissonance is holding opposing views in your head and trying to make sense of it while maintaining your sanity.

Source: Free Press

Such as it is with markets these days.

Thanks to massive and unprecedented central bank intervention, financial markets are caught up in the "Everything Bubble." Stocks are overvalued. Trillions of sovereign debt trade with negative interest rates. Corporate credit trade with far more risk than return. In essence, markets are totally distorted and mispriced. As such, Central Banks (aka Central Planners) have effectively destroyed "free markets" and "price discovery." And making matters worse, no one knows when this intervention and manipulation will end.

Consider This: In March 2013, the S&P 500 was trading at 16 times earnings and today it is 20 times!! Please don't say to me that "interest rates are low." The fed funds rate was near-0% and the 10-year Treasury note was less than 2% in 2013. As I have explained many times over, the current bull market has hinged on liquidity and unprecedented debt-financed share buybacks. There is virtually correlation to the economy. Yet, When I explain this to folks, all I hear is "so what?" and a shrug of the shoulders.

THIS WEEK

PORTFOLIO STRATEGY

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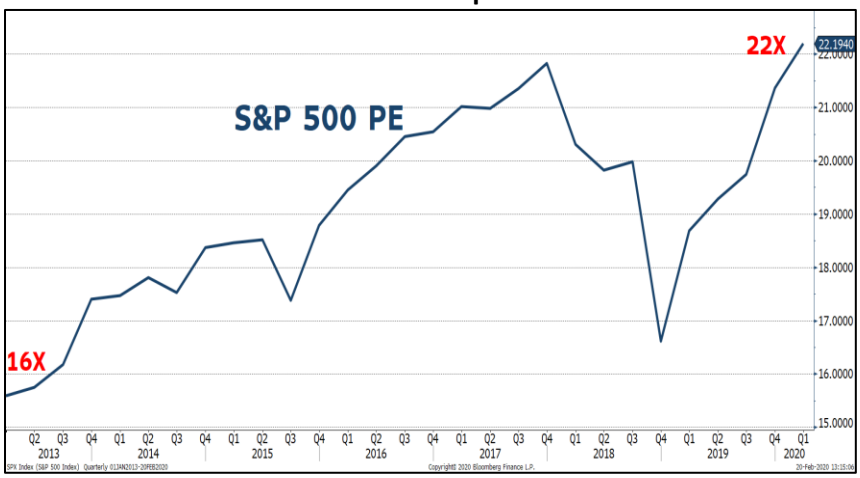
Meanwhile, there are three bulls for every bear at the highest market valuations in two decades and practically no earnings growth over the past four quarters. Interesting. And disturbing. The fact that the market's real worry is a lack of worry, is a worry all on its own.

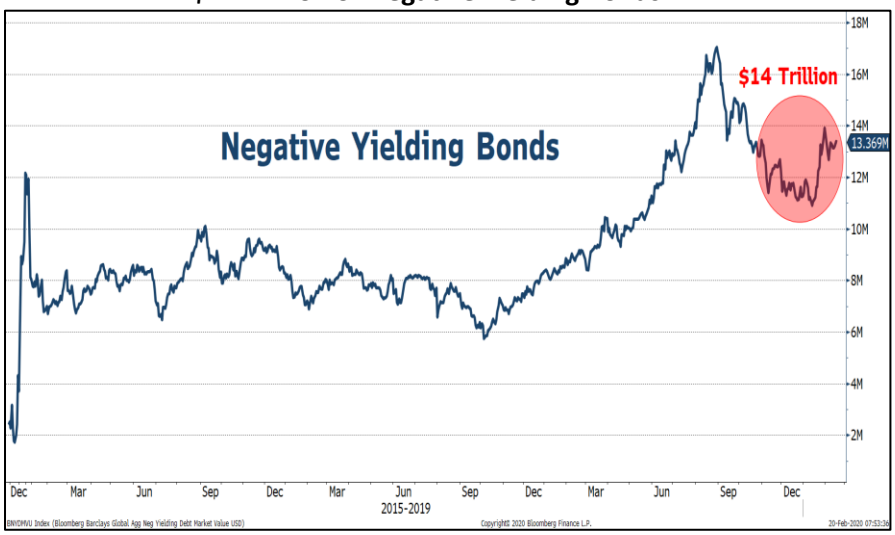
S&P 500 PE has Expanded 40%



Source:Bloomberg

Moving on. Let's face it, anything is possible in a world where some $14 trillion in bonds sport negative yields. Who in the world would buy negative yielding bonds that guarantee a loss? Yet, "investors" seemingly have no problem in doing exactly that.

$14 Trillion of Negative Yielding Bonds



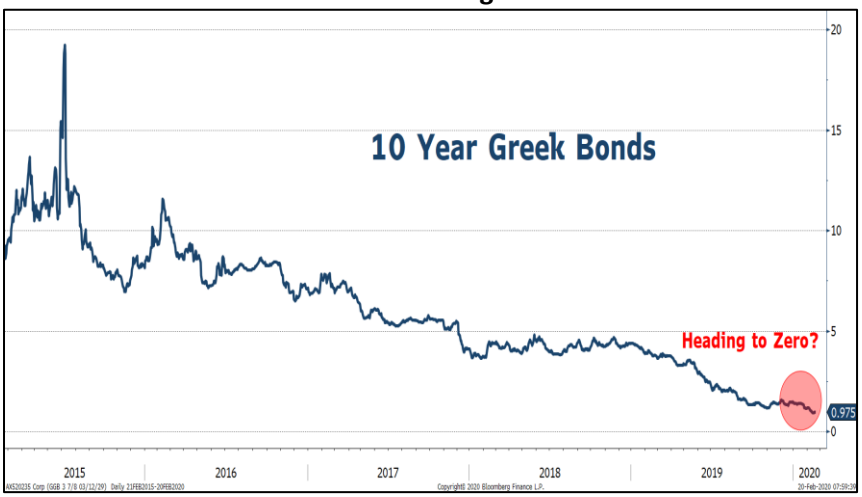
Source: Bloomberg

In Germany, five and 10-year Sovereign debt trades at -.66% and -.45%, respectively. In Switzerland, yields are even lower. If you were to put your hard-earned money to work to buy a 10-year Swiss government debt issue, you would lock yourself into a negative yield of -.78%. In Japan, the story is the same as 10-year Japanese debt trades at -.065%.

But perhaps there is no better encapsulation of this than once radioactive 10-year Greek yields below 1%. Although, this is something of a tired joke for those in the markets. It's a hit at parties, so to speak.

Ten-year Greek yields once touched 45% during the worst days of the debt crisis. Today, Greek government bonds now are trading almost 60 basis points lower than comparable 10-year U.S. Treasury yields. And now it appears that Greek bond yields could fall to 0%. Yes, ZERO!

Greek Yields Heading to Zero?



Source: Bloomberg

"The cognitive dissonance in the credit market is stunning. I recently have had the feeling that I'm living peaceably in Britain during the 1930s while on the continent the Germans were building weapons, expanding their army and navy, and opportunistically grabbing land. I know this comparison may seem excessive, yet market participants seem to be indulging in a cognitive dissonance akin to when British Prime Minister Neville Chamberlain in 1938 confidently assured not just Britain but the world that there would be "peace for our time." He told them to ignore all the red flags and assured them that two decades after the end of the Great War there would be no repeat of the global carnage. Two years later the Nazis were bombing Britain." – Scott Minerd, Chief Investment Officer at Guggenheim Partner

In the corporate investment debt arena, yields are in a range between 2.10% for double-A (AA) credits and 2.85% for triple-B (BBB) credits. That means you pick up 0.75% to move down in credit from AA to BBB. In other words, if you swapped $1 million from AA and into BBB securities, you would receive an extra $7,500 per year for taking on significantly more risk.

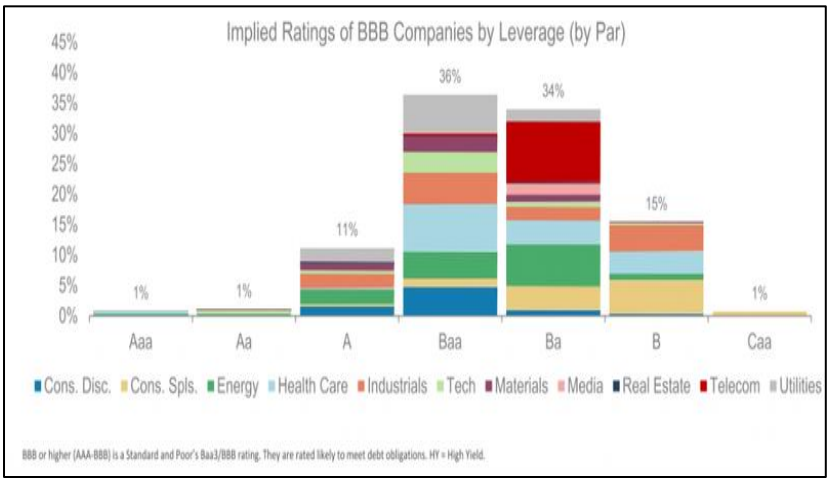
As if the poor risk premium to own BBB over AA is not enough, one must also consider the unusually high concentration of BBB bonds as a percentage of the total amount of bonds in the investment-grade universe. Currently, BBB bonds represent 40% of the corporate debt market. And more bonds than ever rest one step away from losing their investment-grade credit status. Furthermore, there is evidence that many of those companies are not even worthy of the BBB rating, having debt ratios that are incompatible with investment-grade categories. That too is troubling. And yet, BBBs yield is just 2.85% (despite "fallen angel" risk).

To wit: Kraft Heinz became the largest fallen angel last week, losing two investment-grade ratings. Macy's and Renault also just received their first high-yield ratings, reigniting fears that a slowing economy could tip more companies over the edge. UBS Group strategists predict there could be as much as $90 billion of investment-grade debt downgraded to high yield this year, dwarfing a two-decade low set last year at just under $22 billion.

That said, investors appear to be indiscriminately plowing money into the corporate credit market without giving much thought to the minimal returns. Needless to say, in the previous quote, Mr. Minerd is having a difficult time coping with what he perceives to be extreme cognitive dissonance. What is cognitive dissonance? Well, it's like when people smoke, and they know that smoking causes cancer – they are in a state of cognitive dissonance. The same is true for asset prices today. Investors know the markets are nonsensical, but they throw caution to the wind and continue to buy with both hands.

"What do you do with your cash where he helps run a number of bond funds… Leaving it standing there makes no sense and the experience over the last 10 years is that there is no pain in buying bonds… learnt behavior is that it is safe. Inflation is nowhere and central banks start buying every time yields go higher." – Luke Hickmore, Investment Director at Aberdeen Standard Investments

BBB is Not a BBB



Source: Real Investment Advice

Central bank verbal intervention has perpetuated this cognitive dissonance. The interaction of market-distorting policies and reality makes for a mind-numbing exercise that's eroded the market's capacity to function as a price discovery mechanism. Again, what is the anything worth? As far as trading and investing goes, fundamental analysis has, to a certain extent been antiquated by the central banks. Let's call it what it is: Central Planning.

To be clear, the disconnect between risk asset pricing and the risks, has been going on for a long, long time. It's truly bizarre. This is why I continually remind investors that it really isn't possible to understand today's markets relative to the economics and finance textbooks. I assure you they don't teach this in the CFA course.

"Things are frothy right now… risk assets are definitely priced at the tight end. In what world would you lend money to some of the profiles in high yield at 4%? That doesn't make any sense to me from a historical basis. People are getting in because they don't want to miss out." – Jude Driscoll, Head of Public Fixed Income at MetLife Investment Management

In 2020, central banks perseverance and intervention is being tested anew, as the coronavirus developments collide with headlines about record high asset prices. Even if the virus itself has peaked, the economic impact most assuredly has not.

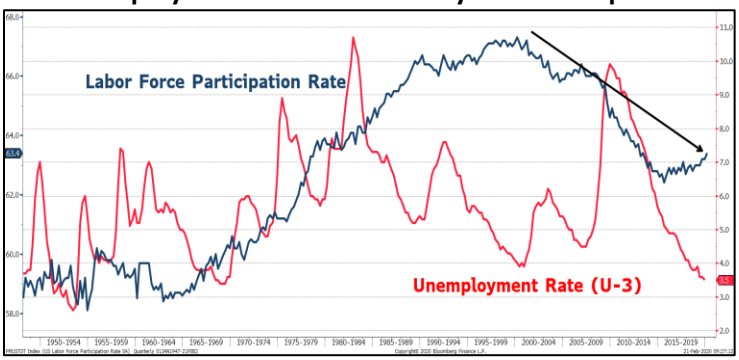
Then again, in the world of fake markets, I suppose it doesn't matter.

HOW STRONG IS THE US ECONOMY?

Many people believe that the U.S. economy is doing great because the unemployment rate is 3.6%. Yet, that single number is meaningless in the context of a 63.2% labor force participation rate (lowest peak in 47 years). If we had experienced the same participation rate this cycle as we did into the 2000 peak, when it peaked at 67.3%, the jobless rate today at the current level of employment would be higher than 9%.

So, the "jobless rate" in its own is only meaningful if you're a politician. Otherwise, the exercise above tells you there may be just a bit more slack in the labor market than commonly recognized,

Low Unemployment Rate Distorted by Low Participation Rate



Source: Bloomberg

Possibly, this helps explain why real (inflation adjusted) earnings have gone nowhere for a full year. If the labor markets were booming, wage pressures should be building. Yet, companies in the real world seem to see things differently.

Earnings are Barely Keeping Pace with Inflation

Source: Bloomberg

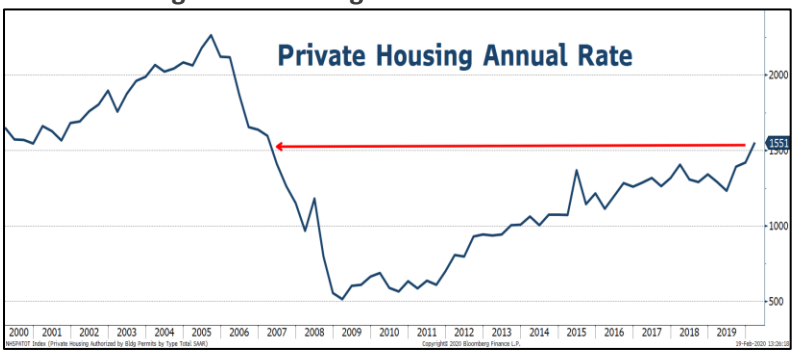
Meanwhile, towards the end of 2019, all we heard was how terrific the holiday shopping season was.

Last week, Walmart reported that same-store sales disappointed in fourth quarter with a 1.9% year-over-over increase or less than half the 4.2% pace a year earlier. This was in the context of all those "wealth effects" the Fed helped generate in fourth quarter of 2019. This followed dismal results from Target and Macy's. And yet, the narrative of a "resilient consumer" is hard to break. Is everyone shopping on Amazon?

UNDERSTANDING SEASONAL ADJUSTMENTS

So far, incoming economic data needs to be treated with a giant grain of salt. And the reason why… the climate is clearly changing. Based on the first two months of the year this is going to be the among the warmest 10 winters ever recorded, and according to the National Oceanic and Atmospheric Administration, there's a 50% chance of being the balmiest of all time.

Building Permits at Highest Level Since March 2007



Source: Bloomberg

Why it matters: You have to keep in mind that all the seasonal adjustments the government statisticians use for the high-frequency data, from employment to industrial production to housing starts, are smoothing to "raw" numbers to help make the monthly numbers comparable to each other. Hence the "seasonal adjustments." But when January and February now feel like April weather-wise, these figures are receiving seasonal-adjustment support that are nothing more than distortions and illusions (it can work in both directions – a crazy plunge in January clothing sales and utilities output. Then again, an equally nutty-low number of people who missed work because of inclement weather conditions in the latest payroll data.

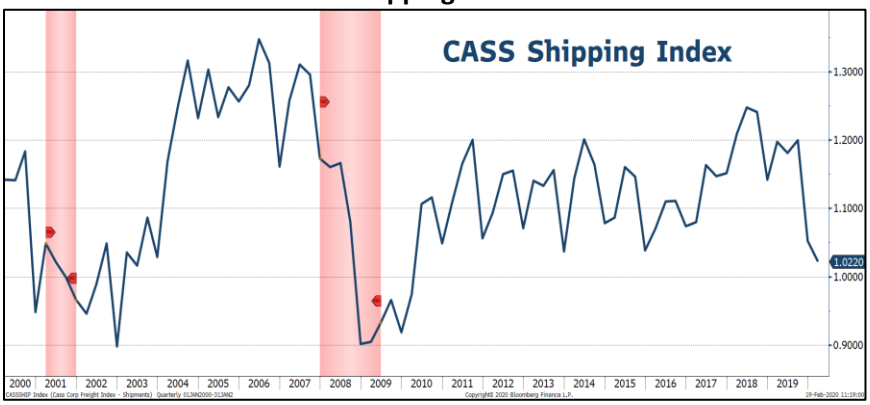
Consider the housing starts data released last week. It was noted by many that housing starts on a seasonally adjusted basis increased in the Northeast to the highest since June 2015. I hate to be the one to disappoint you, but the recent spurt in the starts data is a weather story more than anything else. Warmer temperatures supported construction in months that typically slow, and voila you have a real estate boom. How else do $4 thousand "raw" single-family housing starts in the Northeast translate into a "seasonally adjusted annual rate" of $66 thousand?

SHIPPING SINKS!

The January Cass Freight Shipping Index is more bad news for the global economy. The Cass Freight Shipping Index deflated for the fourteenth month in a row in January, and the -9.4% year-over-year reading is the most negative since the economy was crawling out of the Great Recession in October 2009.

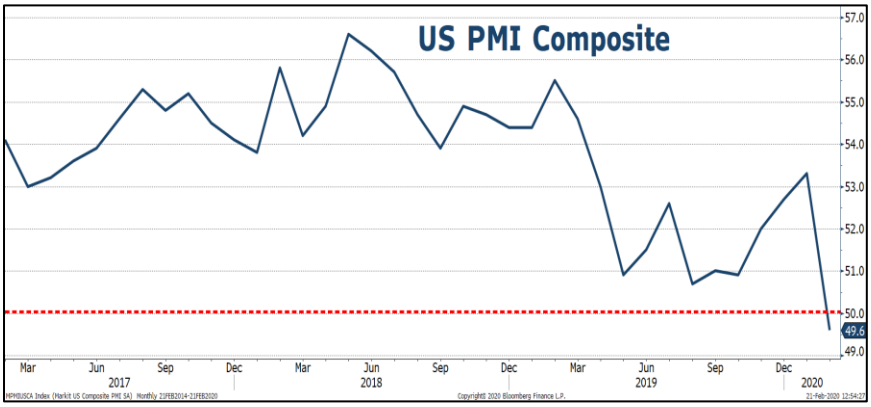
Some Chinese factories resumed operation this past week, but they are still not close to 100% production levels. Others have pushed re-opening back to March 1. The most important aspect of this report is that coronavirus implications are not yet reflected in the charts.

Shipping Sinks!



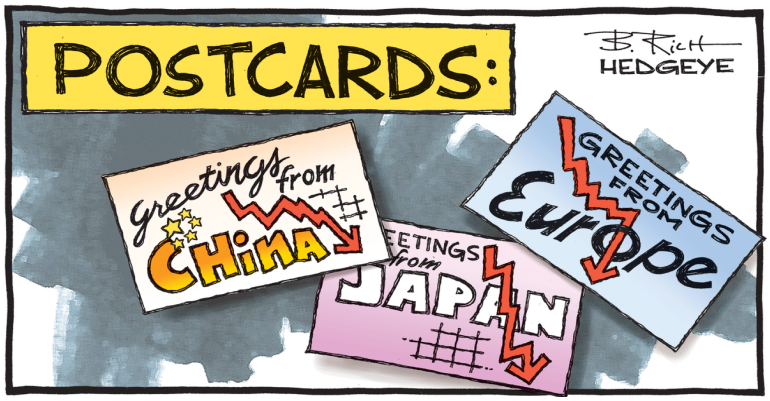
Source: Bloomberg

And last Friday, it was reported that the U.S. February Flash Composite PMI dropped to 49.6 vs 53.3. The last time PMI crashed GDP went negative in first quarter 2014 (-1.1%).



Source: Bloomberg

Meanwhile… here are a few postcards from around the world. Suffice it to say, the global economy is not humming these days.



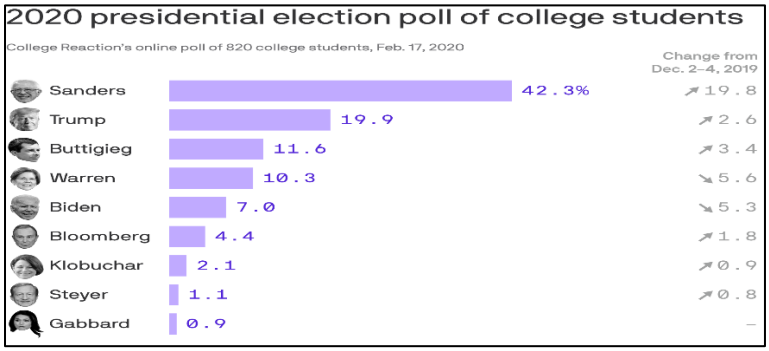
Source: Hedgeye

BERNIE… THE MAN TO BEAT?

On the political front, Elizabeth Warren may well have shone in Wednesday's primary debate, and Bloomberg received body blows of his own making. But the reality is Bernie Sanders is the candidate to beat for the Democratic nomination. Have a look at *Why Sanders Will Probably Win the Nomination* by the venerable David Brooks in the New York Times.

People who say he can never beat Trump remind me of the consensus four years ago who said Hillary had it in the bag. I am constantly reminded by Republicans of how delighted Hillary Clinton and the Democrats were when Trump was nominated. Do you remember that? They thought the election was going to be a cake walk. 'Trump believes in protectionism and isolationism. He couldn't possibly win in a modern day and age.' I see all these Republicans saying similar things like, 'Who's going to vote for a Socialist?' And then you look at head-to-head polls where Sanders is beating Trump. The latest Quinnipiac survey shows Sanders well ahead of Mr. Trump in both Michigan and Pennsylvania (and the election will be won or lost in the electoral college votes in battleground states such as these).

And according to a new College Reaction/Axios poll, over the past two months Bernie Sanders has surged 20 points among college students to become the group's clear 2020 favorite.



Source: Axios

Likewise, an NPR/PBS NewsHour/Marist poll this past week showed the weak support for moderate candidates among Democrats and Democratic-leaning independents 45 and under:

1. Bernie Sanders: 54%
2. Elizabeth Warren: 16%
3. Mike Bloomberg: 8%
4. Joe Biden: 6%
5. Pete Buttigieg, Amy Klobuchar: 5%

Why it matters: The numbers reflect the extent of which young Democratic voters are embracing socialism and rejecting moderate choices. In fact, Recent polling shows that 70% of millennials would vote for a socialist, compared to 36% of baby boomers and 33% of the silent generation.

The good news for the market is that President Trump's approval rating out of the latest Gallup poll is 49%, a high since he took the keys to the White House.

It's going to be a fascinating contest. We now have a mighty polarized country and you have a potential for a political upset yet again. The element of surprise is the market's enemy number-one. Consider this possibility – Sanders teaming up with Elizabeth Warren and the whole progressive movement. That would change almost everything we know today.

Much of what happens will depend on voter turnout, especially among the youth (as well as the Independents), who seem enamored by this 78-year old self-proclaimed socialist. To understand why voters under 30 years old flock to Bernie, see *Why the Young Back Bernie Sanders* in the op-ed section (by William A. Galston) in the Wall Street Journal.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

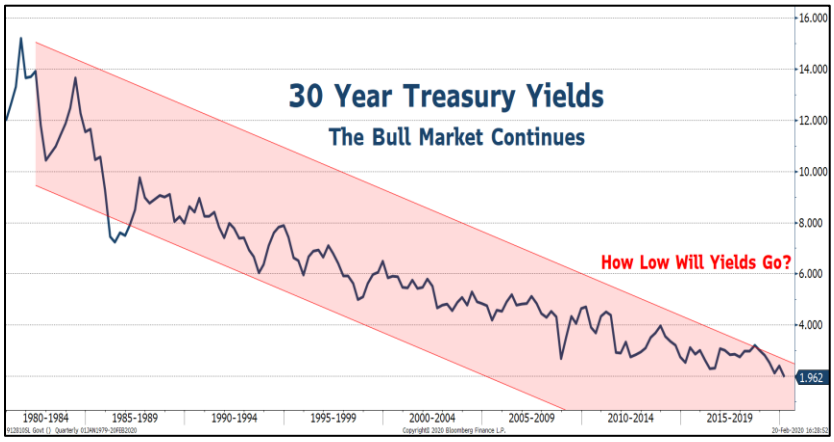
There are economies that can stand on their own two feet and those that still need crutches. The U.S., after over a decade of expansion, still needs a crutch or two via monetary and fiscal stimulus to stay afloat. Let's face reality – the surge in the fiscal deficit in 2019, three rate cuts, and the Fed's renewed expansion of its balance sheet accounts for well over 50% of the 2.3% growth the U.S. economy could manage to muster. Is that a strong economy?

This is how I see things shaping up. Recessions come from a slowdown in the business cycle, but it actually takes some catalyst. And I believe the Trump tariffs were the catalyst which broke supply chains around the world. The Coronavirus on top of that really doesn't help.

Over the next few months, there might be some euphoria around the election as both parties spend a lot of money on fiscal stimulus. That said, the business cycle is long in the tooth and looking through my crystal ball my view is that we're heading into a recession over the next 12 months. You can see this playing out in bond yields. They're falling daily. And have been for quite some time. As I often say, bonds reflect reality. Stocks reflect hopes and dreams.

The long Treasury bond is down to 1.92%. The total return in the past year in the 30-year bond is +28% versus +20% for the Wilshire 5000 index. So, the answer is yes, bonds have more fun.

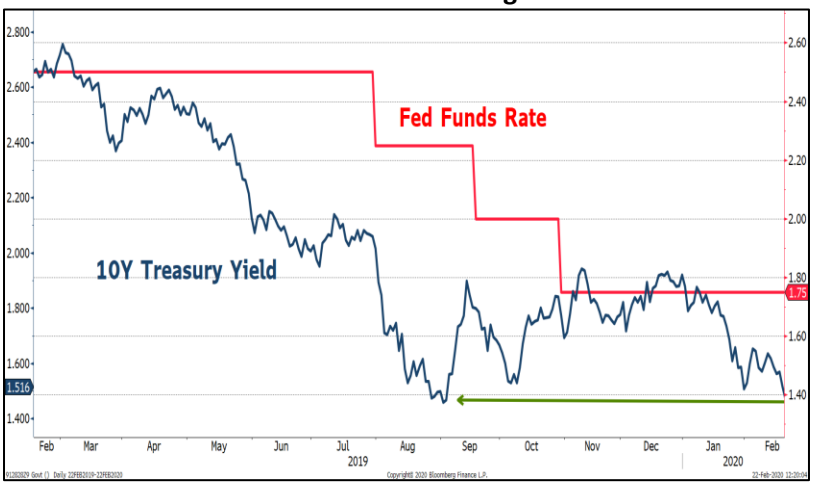
Treasury Yields Close at All Time Lows



Source: Bloomberg

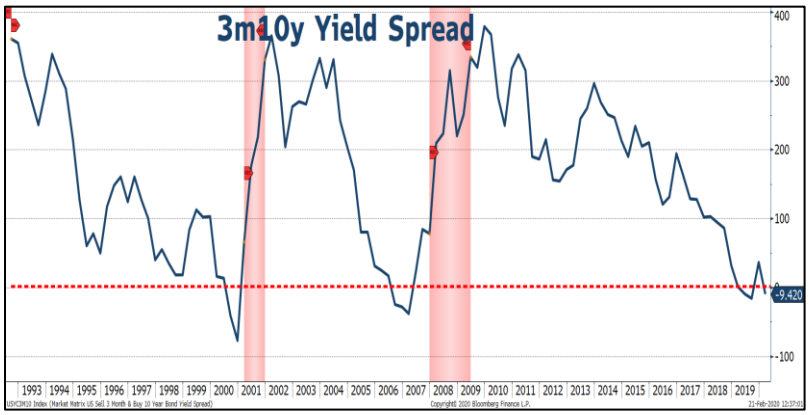
I would be hardly shocked if the Fed initiates a surprise rate cut in the not too distant future. Please note below, the U.S. Treasury yield has collapsed towards the same level that the U.S. Treasury 10-year yield was (1.45-1.48%) in the third quarter of 2019. Don't forget that move (and the commensurate re-inversion of the curve you're seeing now) forced the Fed's hand on a rate cut.

Will the Fed Move Again?



Source: Bloomberg

And the yield curve is now, once again, inverted.



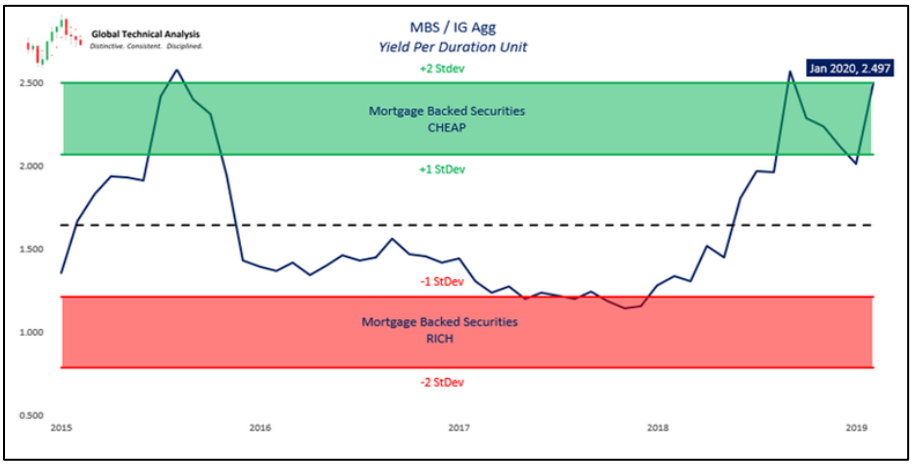
Source: Bloomberg

As such, 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.

In terms of relative value, with so many assets having historically expensive valuations, it is a difficult time to be bullish on any asset class. However, there are still a few interesting markets around. The chart below shows that the mortgage sector (MBS) yield per unit of duration ratio to the investment grade corporate sector. And the data suggests the MBS sector is the cheapest sector within the investment grade universe and the cheapest since 2015.

Yield to Duration	IG - Agg	IG - AA	IG-A	IG-BBB	MBS
Current	.32	.27	.29	.35	.86
5-Year Average	.45	.42	.41	.50	.71

If one is seeking fixed income exposure, they are better served to shift their asset allocation to a heavier weighting of MBS.



Source: Global Technical Analysis

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> – Darin Higgins, President of Western Illinois Credit Union

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> – 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

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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.

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