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INVESTMENT SERVICES

Weekly Relative Value

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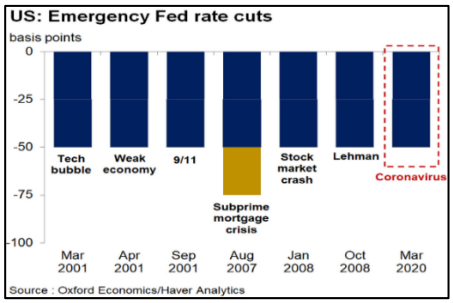
WEEK OF MARCH 9, 2020

Hurtling Towards Zero

"A rate cut will not reduce the rate of infection. It won't fix a broken supply chain. We get that."
– Fed Chair Jerome Powell

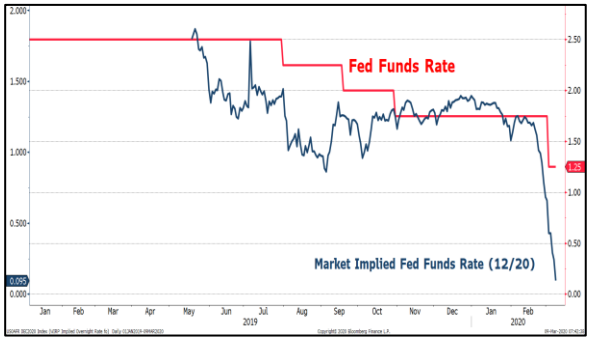
Last week's emergency rate cut was the seventh time that the Fed cut rates intermeeting in the past two decades. It did so three times in 2001 and another three times in 2007-08.



Traditionally, when the Fed engages in such an unexpected move, it means that the economy (or markets, or both) are already in freefall, and the Fed is far behind the curve.

And a 50-basis-point move so close to the next meeting (March 18) suggests that the information at the Fed's hands is pointing in the direction of recession (though they will never say it publicly). So, brace yourselves for what could be some horrible incoming economic data ahead.

More Rate Cuts to Come



Source: Bloomberg

THIS WEEK

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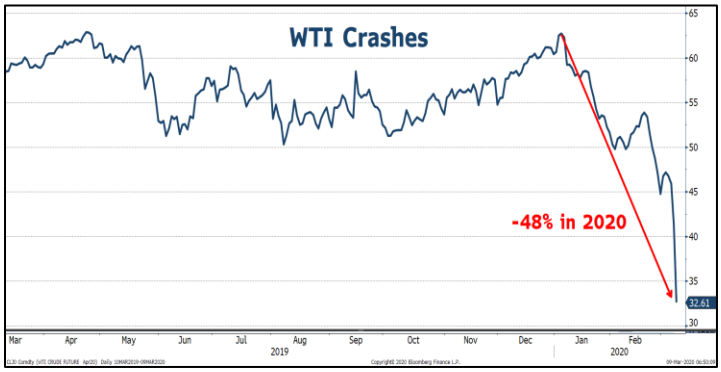
And despite the surprise 50-basis-point cut, investors have responded by saying "fifty's fine, but a hundred's divine." Futures are currently pricing in an additional 50-basis-point cut in March. That's right. In 16 days (if not sooner), the Fed will have cut by 100 basis points, all within a month from the U.S. stock market's all-time highs… Then what?

OIL PRICE WAR

Following what may have been the most drama-filled weekend since "Lehman Sunday," in which we saw not only another major spike in COVID-19 cases around Europe and the U.S., we have now seen the total collapse of the Organization of Petroleum Exporting Countries (OPEC) after Saudi Arabia unilaterally decided to flood the market with deeply discounted oil in a desperate attempt to crush the competition. Saudi Arabia kicked off an all-out oil war on Saturday, slashing official pricing for its crude and making the deepest cuts in at least 20 years on its main grades, in a bid to push as many barrels into the market as possible.



Source: Bloomberg

What's going on?

Saudi Arabia and Russia want to kill the U.S. oil industry and frackers. A lot of leveraged drillers and crude suppliers are dependent on prices above $50. For comparison, the Saudi cost of oil production is in the single digits. With the price of oil well below the breakeven cost, many high-yield, junk energy companies could witness a credit implosion.

Markets are reacting appropriately and just like during Lehman Sunday, equity and commodity prices are crashing. And yields on junk corporate debt has widened dramatically.

Source: Bloomberg

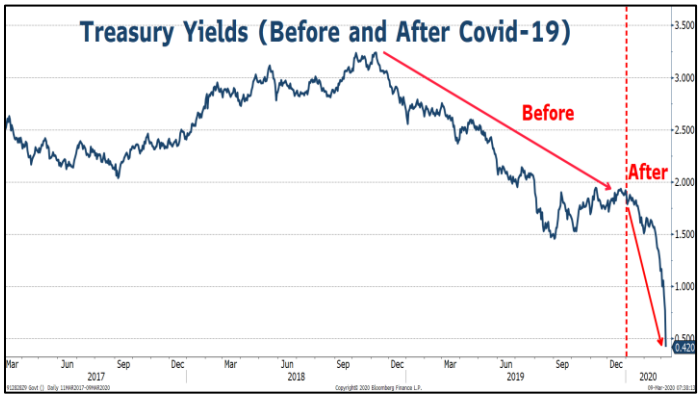
LAYING DOWN THEIR CARDS

This has been the longest economic recovery of all time. But, as economic recoveries mature (now month 128), pent-up demand becomes exhausted. As such, the economy becomes extremely vulnerable to an exogenous event. That exogenous event, of course, is COVID-19. Now all markets are fast coming to grips that the coronavirus is proving to be a global shock that may not be contained. And U.S. Treasuries – more than other asset class – understand the implications of the supply and demand shock to the global economy created from coronavirus. Disrupted supply chains impair production schedules and fears of getting the virus cause households to avoid large crowds and to revise travel plans and work arrangements.

Source: Hedgeye

I have always maintained that the Treasury market is the single best metric of where the economy is heading. And long before the coronavirus, Treasury yields had been telegraphing lower growth, inflation and earnings. As one can glean from the graph below, 10-year Treasury yields had already declined over 100 basis points before the coronavirus outbreak.

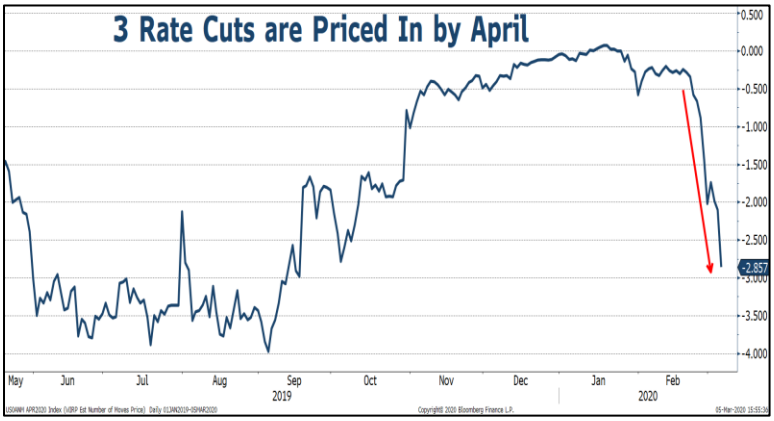
Over the past month, Treasuries have laid down their cards as the yield on the 10-year Treasury note has slid to 0.45%. The "long bond" (the 30-year Treasury) has seen its yield slide to 0.87%. Incredible. The two-year Treasury note yield has dropped to 0.28%. The three-month Treasury bill's yield has plunged, absolutely plunged**.** It was 1.45% last Thursday. Today? All of 39 basis points. A drop of 100+ basis points in six trading sessions. One hundred plus. Six days.



Source: Bloomberg

The front end is screaming that the Fed is behind the curve even after last week's bold 50-basis-point easing. Maybe it wasn't bold enough. That is the message from the market. Or maybe it's this gnawing feeling that the Fed is basically

powerless to deal with this situation. The fed funds rate is now in the 1-1.25% range and just a handful of moves away from running out of conventional bullets, and we see market expectations of another 75 basis points. That would put the fed funds rate at 25-50 basis points. Wow.



Source: Bloomberg

JOINING THE CLUB?

Treasury yields are "catching down" to the rest of the world, the rest of the world is not "catching up" to the U.S.

And it's not over.

Will the U.S. Join the Negative Yield Club?

	2-Year	5-Year	10-Year
U.S.	**.31%**	**.38%**	**.46%**
Germany	-.96%	-.95%	-1.02%
Switzerland	-1.07%	-1.04%	-.88%
France	-.76%	-.63%	-.39%
Japan	-.33%	-.32%	-.19%
Netherlands	-.89%	-.86%	-.66
Portugal	-.37%	-.00%	.35%
Spain	-.47%	-.18%	.24%
Sweden	-.42	-.67	-.50
UK	-.01%	.02%	.10%
Australia	.41%	.38%	.60%
Canada	.70%	.67%	.72%
New Zealand	.41%	.60%	.81%

Source: Bloomberg

The Fed's emergency cut suggests that U.S. yields will continue to converge with the rest of the world. Here as a reminder, all of Germany's and Switzerland's sovereign debt now trades in negative yield territory. The same is true for France out to the 15-year sector and Japan out to 10 years. The U.K. is the latest member to join the club. Will the U.S. join this crowd?

Of course, negative rates seem bizarre. But then again, if we experience price deflation, interest rates may well be positive in "real terms." Anyways, all you need to know is that nearly 80% of the world now has negative real yields at the front end of the curve.

In any event, what's important to understand is that negative rates are not a myth as nonsensical as they may seem to be. They do exist. Even the usually hawkish Cleveland Fed President Loretta Mester indicated last week that the central bank's policy review is keeping an open mind when it turns to the topic of "negative rates." In other words, nothing is off the table.

While this doesn't suggest that U.S. official policy (fed funds) rates are poised to dip below the zero-bound level near term , yields in the two- and three-year sector of the U.S. Treasury curve have a much higher chance of turning negative, which is as disturbing to write as it surely is to read.

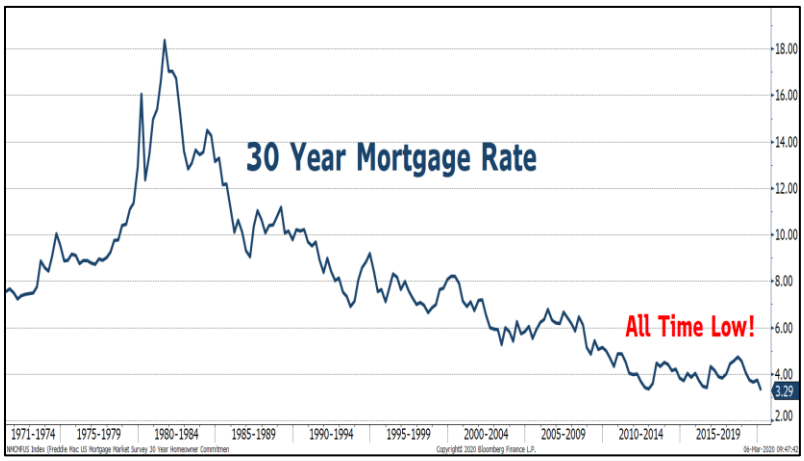
And this is why. Once policy rates are near zero, investors will begin to think that there's a chance (no matter how remote) that the currently unthinkable is the only course of action. At that point it becomes a self-fulfilling prophecy, and as we have observed so often, whatever the market demands of the Fed, the Fed ends up doing. Even if it means negative interest rate policy (NIRP).

To be clear, NIRP in the U.S. won't come tomorrow. Nonetheless, given the global rates backdrop, it is well within the realm of conceivable outcomes to have negative front-end yields. The question of when that could happen will depend on stocks: another crash and we may wake up in late March or early April in a whole new monetary twilight zone.

ON THE POSITIVE SIDE

The drop in bond yields has dragged mortgage rates down to all-time lows of 3.29% from 3.45% last week. This is good news for homebuilders, and what is unique about the house search process is that it doesn't involve having to be in crowds. Just you, your partner and your real estate agent.

Record-Low Mortgage Rates



Source: Bloomberg

SOCIAL DISTANCING

"Social distancing is the technical term now used to describe one of the primary prevention methods. It means: stay at home, don't mix with crowds, don't get on mass transit, don't stand in a security line at the airport, don't stand in line at the Costco panic-buying toilet paper."

Global COVID-19 cases have topped 110,000 and the death toll is at 3,800. The virus has now spread to 97 countries. Of note, Italian cases have risen to 7,377 – the death toll to 366 – and the government has closed all schools and universities. Approximately 17 million people are being quarantined. In the U.S., 30 U.S. states have reported 545 cases of coronavirus confirmed by lab tests, and 22 deaths. That number is likely understated due to the lack of testing kits. Many people in the United States are infected despite having no known connection to previous cases, which suggests local, person-to-person spread of the virus is occurring. Officials from the Center for Disease Control and Prevention (CDC) have warned that future outbreaks are almost inevitable, given the number of cases around the world.

Last week a number of spending announcements were announced to tackle the coronavirus: $38 billion out of Asia and $8.3 billion in the U.S. The International Monetary Fund (IMF) has stepped up to the plate with $50 billion in emergency spending to help poorer countries deal with the epidemic. But there is a huge economic cost and not all of the lost spending is going to come back, which is why many economists have given up on the V-shaped post-pathogen recovery.

Source: Cagle

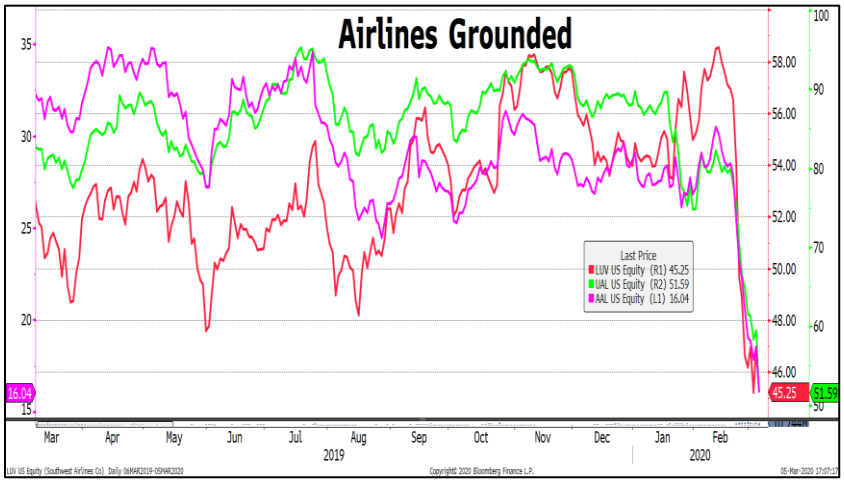
Travel. Tourism. Hospitality. Retail. These are the major areas of spending that will get hurt the most and will experience the weakest recovery.

Airlines in the U.S. have stated they're cutting international and domestic routes. Last week, the International Air Transport Association warned that the virus outbreak will cost the airline industry as much as $133 billion in foregone revenue. Stocks of the top-seven U.S. airlines plunged 30% in 15 trading days.

But it's the cutting of domestic capacity that is now cropping up in the U.S. and in other countries as well, as conferences get cancelled one after the other, thus shutting down the conference-going circus, and as companies encourage employees to eliminate unnecessary business trips and switch to online tools.

Southwest Airlines warned that "in recent days, the Company has experienced a significant decline in customer demand, as well as an increase in trip cancellations, which is assumed to be attributable to concerns relating to reported cases of

COVID-19." This is U.S. domestic demand by spooked Americans that are just now starting to practice the art of "social distancing."



Source: Bloomberg

Also, cruise cancellations are skyrocketing. Not just cancellations, but bookings for 2021 and 2022 are down a whopping 40%!

Surely, the folks at Starbucks realize this as this quarter's sales have experienced a huge 50% year-over-year plunge.

And we may not have seen the worst yet in terms of the effects on consumer spending. Remember, people who are sick or quarantined stay at home. They may watch Netflix, but they don't go out and shop – that's the problem.

Isn't it incredible that the release of the new James Bond movie is going to be postponed? Then again, let's face it, who is flocking to the movie theaters these days. Probably as many people as are lining up to see the Mona Lisa... in other words, nobody.

At some point we will have a vaccine and treatment, but not quickly enough (infectious disease experts say a vaccine could take as long as 18 months to develop) to prevent a global recession in the first half of the year.

Let's take a quick scan around the world. Data suggest that Australia is going to post its first quarterly GDP contraction in nine years. China, Italy, Japan and South Africa are already there, and so all this comes to around 30% of global GDP heading into contraction mode**.**

Now even the usually optimistic PIMCO is calling for a recession. The problem is, the Fed is about out of rates bullets, and with the 10-year note yield down to 50 basis points, there isn't much quantitative easing can do either. Remember, that yield was around 4% and had the potential to be stimulative given the room at that time for decline. No longer. This is why Boston Fed President Eric Rosengren hinted that what is needed now is for the Fed to find other assets to buy, and in fact, something like this (or a role to become a direct lender to stressed-out firms soon to face defaults) will be necessary. Thing is, the Fed is far more legally constrained than the European Central Bank (ECB) and the Bank of Japan (BoJ) – and any change will require Congress to amend the Federal Reserve Act. Good luck with that in an election year and a deep divide across the aisle. While there are reports that the White House and Treasury officials have been working on a stimulus plan over the weekend, it appears to be piecemeal, and let's face it – as is the case with monetary policy, at a 5% deficit/GDP ratio, fiscal policy also is suffering from the laws of diminishing returns.

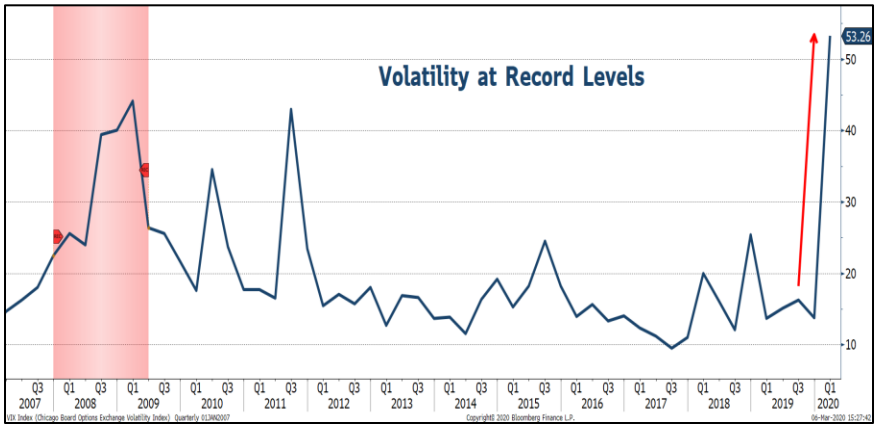
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"All of a sudden, the reality of revisiting the zero-lower bound, which the Fed now refers to as the effective lower bound (ELB), is no longer off in the distance. It could be right around the corner… And this at a time when Fed officials are still saying that the economy and monetary policy are 'in a good place' and the fundamentals are sound. So, what do policymakers do when the good place deteriorates into something mediocre, and the fundamentals turn sour?" – Caroline Baum, MarketWatch

Volatility is off the charts. We are engaged in a massive battle for control between central banks, the structural problems in the global economy and now a crisis that has popped on the scene out of the blue. It's pointless making grandiose predictions right now. Yes, anything can happen.

That said, for some time now I've been arguing that the U.S. and global economy were heading for a slowdown. Then the coronavirus outbreak served as an accelerant to an already less-than-desirable economic situation. To make matters worse, the Fed cut rates by 50 basis points last week. This emergency panic cut added more fuel to this fire of uncertainty, spooking an already jittery equity market.

I believe we are likely experiencing more than just a "soft patch." More importantly, this is no longer a domestic question, but rather a global one. Since every major central bank is now engaged in a coordinated infusion of liquidity, fighting slowing economic growth, a rising level of negative yields, and a spreading virus.



Source: Bloomberg

My advice is to read and re-read the Organization of Economic Co-operation and Development (OECD) report that was just published – the "best case" scenario is a softening in global growth this year to 2.4% from 2.9%. Think that's okay because of the "plus sign?" I have news for you – it would be the weakest since 2009. And the "worst case" is -0.5% – the bond market is leaning that way, and the stock market is still way behind. Problem is that the Treasury market generally gets the call right.

Short-term: With regards to the bond market, the moves we have seen are epic in nature. Hyperbolic moves are typically short-lived so it would hardly be surprising to see a sharp upward reversal near-term. That said, any such back-up would provide an attractive entry point to put excess cash to work.

Intermediate/Long-term: We also have to be mindful that if a recession is on the doorstep. If a recession occurs, look for 10-year Treasury yields to decline further from these already historically low levels. On average, the 10-year Treasury yield declines 100 basis points in economic downturns. The starting point is now 0.77%. Again, do the math.

As noted in the table on page 4, the trail has already been blazed. Switzerland is already at -88 basis points, Germany at -69 basis points, the Netherlands at -55 basis points, France at -35 basis points, Japan -12 basis points. The U.K. and Spain are within 20 basis points now of hitting the zero level on their 10-year rates.

In terms of portfolio strategy, last week's massive drop in yields is yet another example of why we have been so vociferous about maintaining a fully invested, duration-appropriate, high-quality ladder.

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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

> *"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.