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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF MARCH 16, 2020

One-Two Punch

"Everybody knows that pestilences have a way of recurring in the world, yet somehow we find it hard to believe in ones that crash down on our heads from a blue sky. There have been as many plagues as wars in history, yet always plagues and wars take people equally by surprise." – La Peste by Albert Camus

Only a few weeks ago we were enjoying the bright light of a benevolent world. Federal Reserve Chair Jay Powell told the world that the U.S. economy was "in a good place." President Donald Trump told us that the stock market was at the highest level ever and the economy had never been better.

And look at it now.

Source: Cagle

COVID-19 has swept into at least 114 countries (166,000 cases) and killed 6,400 people, was declared a pandemic by the World Heath Organization (WHO) last week. The U.S. has reported 3,125 cases and 61 deaths. Thirty-nine states in the U.S. have declared states of emergency. Ohio and Illinois have ordered all restaurants and bars closed. New York's mayor is considering a city-wide shut down.

The NBA, NHL, NCAA and PGA suspended their seasons. School closures and other disruptions are far too numerous to mention. Trump initiated travel bans from Europe including the U.K. and Ireland. On Friday, Trump declared a national emergency.

THIS WEEK

- OIL BUST
- BOND SCHIZOPHRENIA
- THE BUBBLE BURST
- WELCOME BACK TO ZIRP

PORTFOLIO STRATEGY

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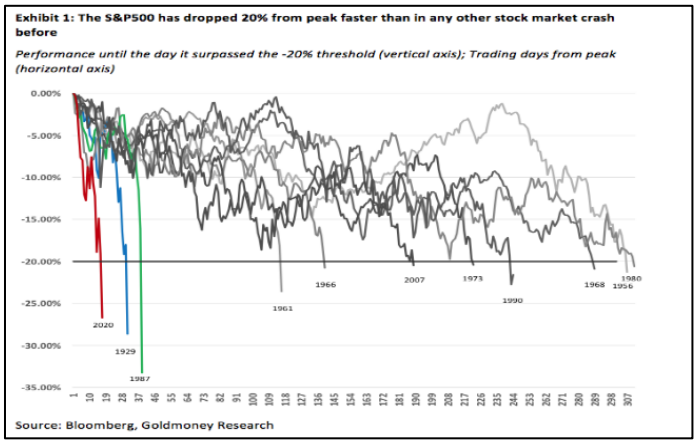
Fear and panic have gripped Wall Street. The COVID-19 pandemic has derailed the global markets, with the S&P 500 now down 27% from the highs; we have morphed from correction to outright bear market. That is true for all the major averages, including the MSCI All-Country World Index. As you can graphically see, all gains since 2016 have been wiped off the slate.

Source: Bloomberg

As shown below, this was the **fastest ever collapse in the S&P 500 from peak to bear market.**



Overall, volatility, as measured by the Volatility Index (aka the fear index), saw its biggest weekly jump ever and is near the 2008 highs.

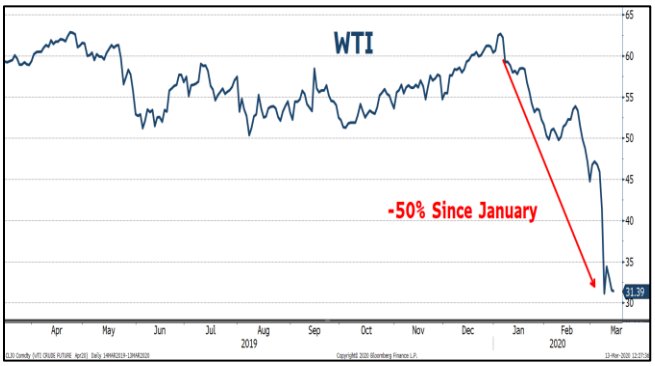
Source: Bloomberg

OIL BUST

"It's a one-two punch." – Warren Buffet

But it wasn't just the virus.

Oil prices got clocked last week. West Texas Intermediate (WTI) oil dropped 23% on the week to $31 per barrel – the worst week since December 2008.

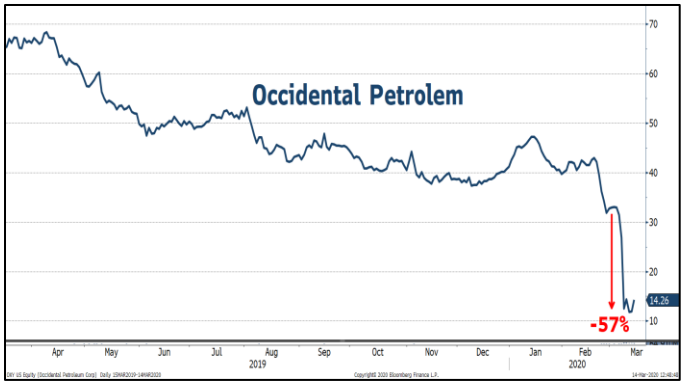


Source: Bloomberg

Over the past three weeks, WTI is down 40%, which is its biggest three-week drop ever. Besides a collapse in demand to the lowest levels since 2009 due to the coronavirus, Saudi Arabia launched an all-out oil price war by slashing pricing for its crude in an effort to push as many barrels into the market as possible. It was in response to a face slap from Russia, which refused to cut output further and insisted that U.S. shale producers should be made to share the pain.

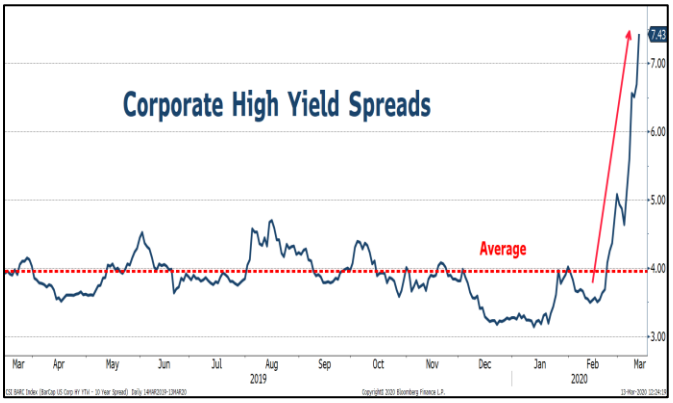
The goal of the price war is to send some big shale oil exploration and production companies into bankruptcy. The financial system has been funding these highly levered, cash-burning shale oil operations, which need a high price of oil. And even when WTI was still over $100 a barrel, shale oil producers were still burning cash.

And sure enough, shale oil drillers collapsed by 25-50% as oil plunged. Their bonds got massacred. Shares of Occidental Petroleum, which is heavily involved in U.S. shale oil and gas, collapsed by 57%. They're down 85% since October 2018.



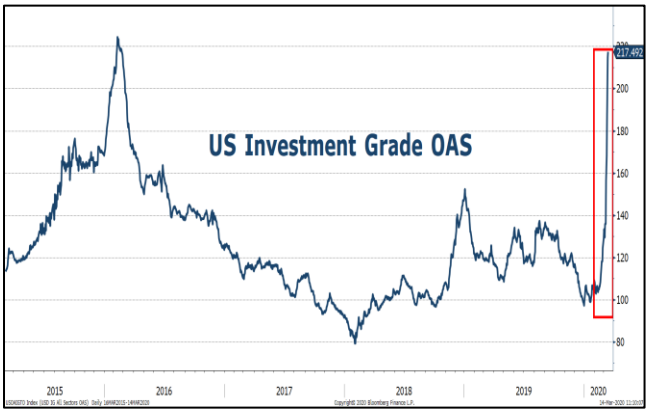
Source: Bloomberg

The plunge in oil prices and escalating recession risk is wreaking havoc on the credit markets. Overall, corporate credit suffered its worst week since the financial crisis. The average yield in the non-investment grade (aka junk) bond market skyrocketed to 7.43%. The rate has soared 360 basis points from the lows less than a month ago. CD spreads (that measure default risk) have jumped at a pace last seen nine years ago.



Source: Bloomberg

The contagion spread to investment grade credit as spreads gapped wider and crashed last week. In fact, this was the biggest weekly spread decompression in history!



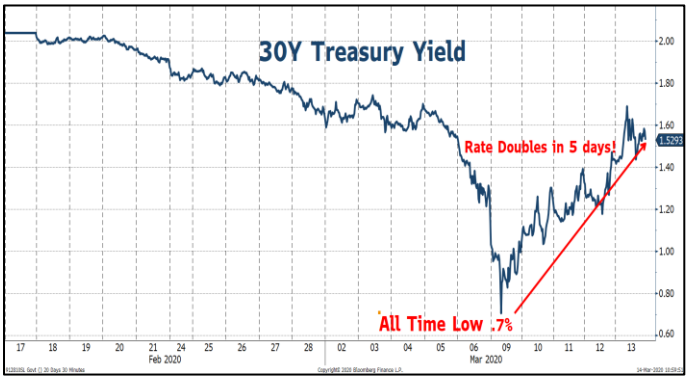
Source: Bloomberg

BOND SCHIZOPHRENIA

"Pension plans, nonprofit corporations, leveraged hedge funds and others are selling what they have a profit on, not what they need to," – Lacy Hunt at Hoisington Management

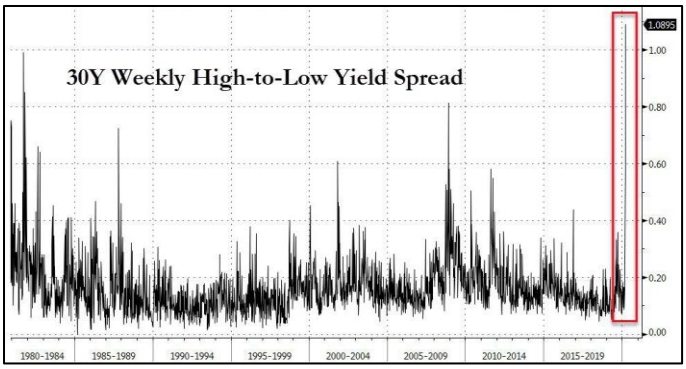
Fears last week sent the benchmark 10-year and 30-year Treasury yields below 0.4% and 0.69% for the first time ever, touching an all-time low of 0.34%. (No, that's not a typo!) In fact, yields on all maturities (including the 30-year and two-year) stumbled below 1%. Yet by the end of the week - despite the collapse in stocks, 30-year Treasury yields spiked to 1.52% on Friday. In other words, the yield doubled in what has been the biggest weekly move ever.

Given that a deflationary crash is underway, with the Fed about to slash rates to zero, the yield on the long bond ought to be dropping. Instead, yields on the 30-year and 10-year Treasuries soared. And bid-ask spreads on Treasuries were at the widest level in history.



Source: Bloomberg

The bond market's range this week was the largest ever.

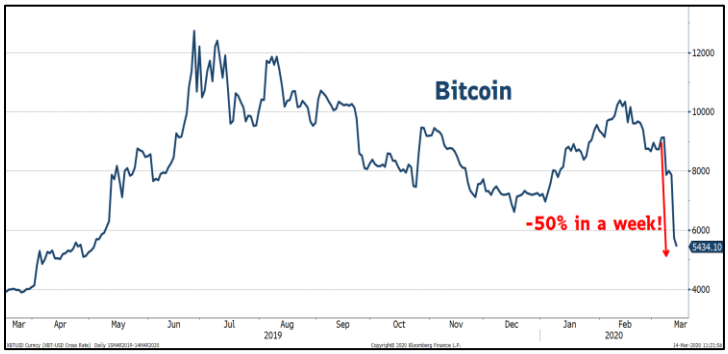


Source: Bloomberg

Gold, normally a safe haven, followed the bond market. Higher Treasury yields are generally seen as bad for gold.

Source: Bloomberg

Moving on. Last week was the worst for cryptocurrencies since April 2013 – a total bloodbath. Bitcoin crashed 50% in a 24-hour period on March 12-13.



Source: Bloomberg

To sum up: In the unprecedented chaos last week, EVERY MARKET – from equities to bonds to cryptocurrencies – BROKE!

THE BUBBLE BURST

I've said more than a few times but the biggest bubble of all is the bubble in central bank hubris. They think they can fix any problem or crisis that comes along in the economy.

Here's the brutal reality. A grotesque amount of leverage created the illusion of a bull market. Because of "fake money" and zero percent financing, every asset had become overvalued. Let's call it the "Everything Bubble." Investor complacency reached a fever pitch. Euphoria reigned and everyone was drinking the Kool-Aid.

That's the anatomy of a bubble.

Guess what?

Bubbles burst.

Even though the economy was slowing to stall speed, corporate profits had been declining and labor markets were too tight, the Wall Street narrative was that the U.S. economy had somehow become recession-proof. The business cycle was dead. Caution was thrown to the wind. In other words, the investment community had come to believe in fairy tales. But they've now turned into goblins.

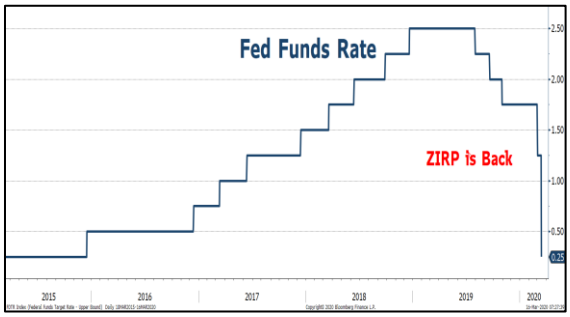
In a nutshell, the system was vulnerable (economically, structurally and behaviorally) and the COVID-19 shock dramatically exposed these vulnerabilities.

Frankly, when you think about it, it's really nuts what the Fed has done since 2009 to create the Everything Bubble. And what it is trying to do now to contain the implosion of the Everything Bubble is even nuttier.

WELCOME BACK TO ZIRP

""The coronavirus outbreak has harmed communities and disrupted economic activity in many countries, including the United States... The Federal Reserve is prepared to use its full range of tools to support the flow of credit to households and businesses." — FOMC Statement

Yesterday, the Fed opted for its second emergency rate cut in less than a month since the U.S. stock market made an ALL-TIME HIGH. In an emergency meeting, the Federal Reserve on Sunday cut its benchmark interest rate to almost zero and launched round four of quantitative easing (QE4) consisting of $700 billion ($500 billion in Treasury purchases and $200 billion in mortgage-backed securities).



Source: Bloomberg

In addition:

- **The interest rate at the discount window** — the rate at which banks borrow money directly from the Fed — has been slashed by 150 basis points to just 0.25%. The intention is "to help meet demands for credit from households and businesses."
- **Banks are being encouraged** to lend out their capital rather than hold onto it for regulatory reasons. There is now no reserve requirement for banks.
- **America's largest banks** agreed not to spend any capital, buying back their shares, at least until the end of June.
- **International capital flows** are also being buttressed with coordinated action between the Fed and the Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank and the Swiss National Bank.

My thoughts on the move:

The Fed's moves, while necessary, are akin to bringing a knife to a gun fight. The Fed may well be cutting rates at the short end and doing so at the longer end via QE, but the U.S. economy was never suffering from higher interest rates. These policy steps will not induce people to go out and borrow money to spend since they are stuck at home. In the Q&A that followed, even Powell basically admitted that the Fed is fitting a square block into a round peg. But it's the only game in town and fiscal policy stimulus will be slow to surface because of this wide partisan divide in an election year.

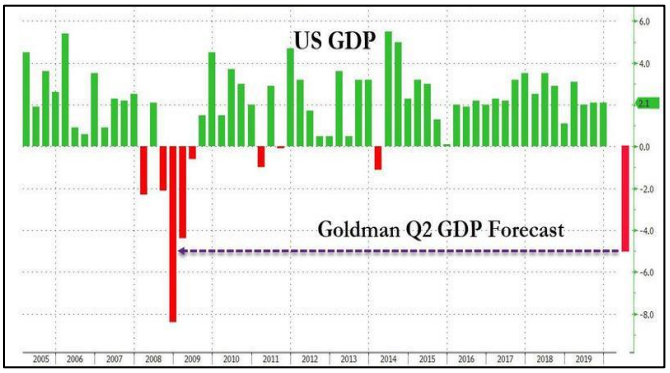
The aggressiveness of the move ahead of the FOMC meeting (which is no longer taking place) suggests that the Fed has become panicky and seems to have garnered some pretty awful economic data points in recent days. The fact that Jay Powell said the FOMC would not be releasing updated economic projections has raised the concern that uncertainty has become extremely elevated. And there is this gnawing realization that the Fed is now out of bullets and there's nothing left just when the recession is starting (as is now the case).

Furthermore, there is a growing view that no matter how aggressive the central banks have been, they are still behind the rapid spread of the coronavirus.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"We expect U.S. economic activity to contract sharply in the remainder of March and throughout April as virus fears lead consumers and businesses to continue to cut back on spending such as travel, entertainment, and restaurant meals… Emerging supply-chain disruptions and the recent tightening in financial conditions will likely add to the growth hit." – Jan Hatzius, chief economist at Goldman Sachs

As a result, Goldman Sachs is now expecting second quarter GDP to crater -5%, down from its prior forecast of 0%, and the biggest quarterly GDP contraction since the peak of the financial crisis when GDP cratered by 8.4%.



Source: Bloomberg

We'd been in a historic run-up through February, amid historic stock market euphoria, reaching historic bubble highs during a period of languid global growth and declining corporate profits. And now we're facing the bit-by-bit shutdown of parts of the economy not just in the U.S. but globally. Many sectors are now facing a crunch, and we are talking about airlines, energy, retail, restaurants, leisure/hospitality and entertainment. This will hit 40 million workers or nearly one-third of the private sector staff loads. With consumer spending about to come under the knife, any recovery will be muted even with policy stimulus. That's how bad it is – unprecedented really.

On top of all of that, there is that sharp drop in the equity markets that has wiped out over $7 trillion in household wealth in a span of a month or more, which will weigh heavily on consumer confidence.

With the sudden economic stop, and with many states shutting down by closing schools, bars and restaurants – combined with the sluggish government response, both on testing and fiscal stimulus – it appears the U.S. economy is now entering a recession. The length of the recession will depend on the course of the pandemic, and that is unknown at this time. And even if all this blows over by summer, the consequences due to the dual impacts of the virus and oil price shock will linger for a long time. The fall out will be spread out in the months ahead.

I am of the view that we finish the cycle with the entire U.S. Treasury yield curve below 1%, with the 10-year yield getting as low as 0.25%.

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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

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.

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