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INVESTMENT SERVICES

Weekly Relative Value

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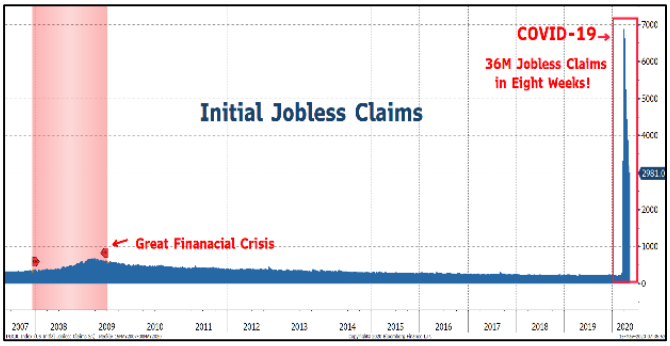
WEEK OF MAY 18, 2020

Repeat After Me: The Stock Market is Not the Economy

"A healthy person has a hundred wishes, but a sick person has only one."
– A.G. Riddle, Pandemic

Last week, initial claims for unemployment for the week ending May 9 rose by 2.98 million. There have now been over 36 million jobless claims filed in the last eight weeks. And as we noted last week, the so-called "officially unemployed" Americans now exceed 20 million (26x worse than the largest decline during the Great Financial Recession) and is expected to increase significantly. By final count, 20% to 25% of the U.S. labor force may be impacted. Unemployment at 14.7% is heading towards 25%. Let us not forget the humanitarian loss from COVID-19 with the U.S. death toll approaching 90,000 and expected to breach 100,000 by June.



Source: Bloomberg

And once again, the stock market chose to rally big on a horrible jobless claims report. It would be funny if it weren't so sad to hear the talking heads scream about the Nasdaq 100 rising 30% in April and just 5% off the peak at a time when the U.S. economy shed all of the jobs added in the past decade.

Source: Cagle

THIS WEEK

- CONSUMERS IN A FUNK
- AS THE CONSUMER GOES…
- WORST IN 101 YEARS!
- WORST SINCE 1706

PORTFOLIO STRATEGY

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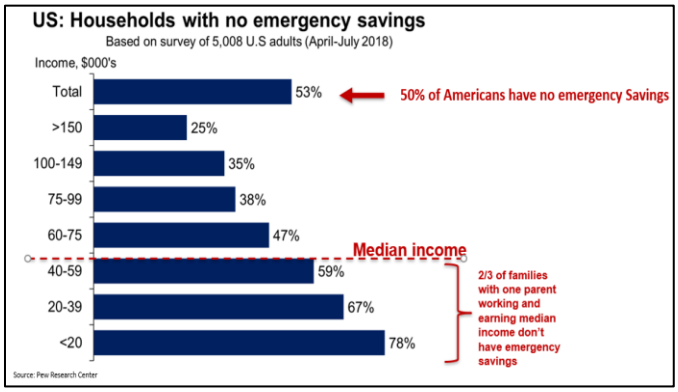
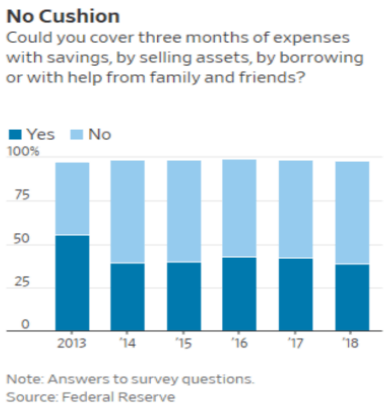
Imagine that the worst month for employment in recorded history and thousands of deaths coincided with the best stock market performance in 33 years. It is a rather sad commentary that Wall Street can manage to rejoice this much with Main Street in so much pain. It is akin to someone wearing a red dress to a funeral.

Last week, the Fed published a report on how the pandemic and lockdowns have disproportionately affected the fortunes of low-income households (almost 40% of households earning less than $40,000 experienced at least one job loss in March — that compares to 19% for those making between $40,000 and $100,000; and 13% for those in the $100,000-and-up cohort). At eight million in job losses, those with a high school diploma or less represented roughly 46% of total job losses. Also keep in mind how the jobs crisis morphs into a health crisis since close to half of all Americans receive their insurance through their jobs. Let them eat cake, right!

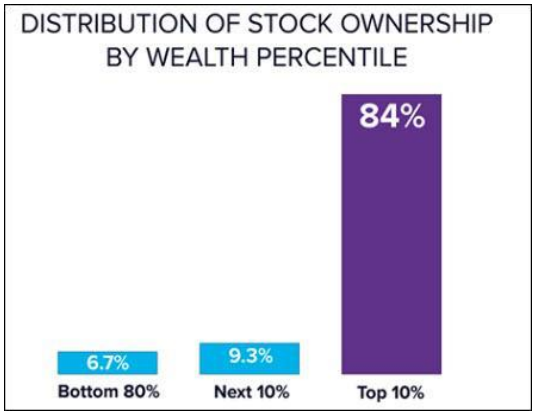


"Roughly half of U.S households have no emergency savings, according to a Federal Reserve survey released last year. Those that do may not have enough. Almost 60% said they couldn't tap into rainy-day funds, borrow form family and friends or sell something to cover three months of living expenses." – The Wall Street Journal



The Fed's ongoing moves to backstop the investment community ensured that the stock market soared. Again, that is the bitter irony, in a Marie Antoinette sort of way, to have seen two-thirds of the 20.5 million job loss in lower-paying positions yet the Fed's focus is on inflating asset prices for the top 10% of Americans. But this does nothing for the little guy who has minimal exposure to the stock market. As a reminder, 84% of all stock market wealth is owned by the wealthiest 10% of all Americans. The top 1% of the income strata own 40% of the stock market.

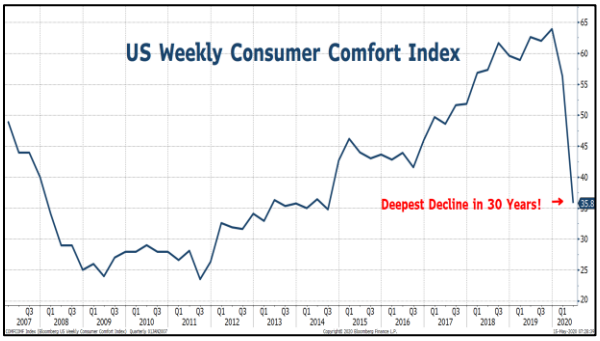
Yet the Fed continues to believe in the "trickle down" theory. Sure thing. While the Federal Reserve had hoped inflating asset prices would boost consumer confidence, consumption and ultimately economic growth, it didn't occur. Again, the benefit of the Federal Reserve's interventions was clearly concentrated in the top 10%. So not only are we moving through this crisis with already record-wide income disparities expanding further, the same is happening to wealth disparities.



Source: Federal Reserve

CONSUMERS IN A FUNK

Consumer confidence continues to fall with the Bloomberg Consumer Index down 14 out of 15 weeks and the sharpest decline in 30 years.

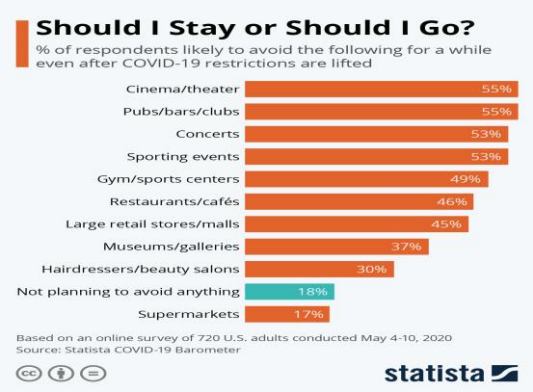


Source: Bloomberg

And it is easy to understand why. According to the New York Fed's Survey of Consumer Expectations, the mean expectation of job-loss over the next year rose to 20.9% in April from 18.5% in March. So, we have more than 1-in-5 saying they are fearful of their job. Fully 40% say their financial condition is worse now than a year ago (was 30% in March) and the share believing it will erode further in the coming year expanded to 31.6% from 27.8%. And 22% of households believe their incomes will decline outright in the coming year. Do you really think Americans are embarking on a spending spree? If this becomes a case of perception becoming reality, we can rule out not just a V-shaped recovery but also one that is U-shaped. We could be talking L-shaped, and that is nowhere close to being priced in.

Going forward, until an effective vaccine is available, consumer spending will change as people focus on needs rather than wants, and the savings rate will rise as they prepare for the unknown. Statista released results from a recent survey, and it shows how consumer behavior attitudes have changed since COVID-19. Clearly many Americans remain scarred by the health shock and will be slow in returning to their old routines.

Most things are clustered around the 45-55% level. This is higher than I expected, especially for pubs and bars. Even still, the survey was a blunt financial forecast. Even if half of those responding (20-25% of all respondents) said they would avoid an activity or place, we are talking about 25-40% permanent revenue loss. Even if 90% of businesses reopen and some semblance of normalcy returns, it will be a disaster relative to the recent past and even compared to the last recession. Millions of small businesses will not survive.



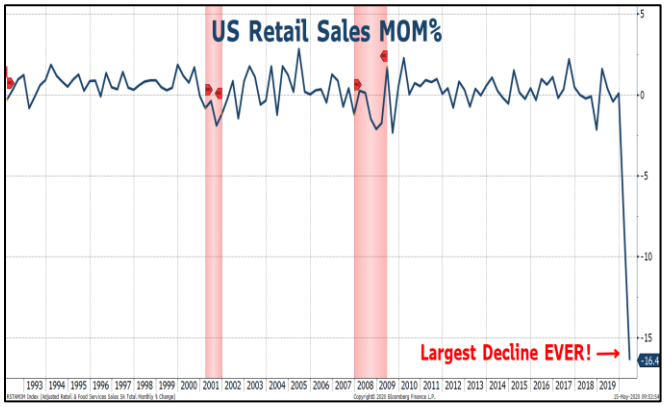
Fear is an incredibly strong emotion and that graph above shows that you cannot dismiss people's fears.

Heaven help us if there is a second major wave and other panic.

Here is some commonsense advice. If everyone would simply wear masks and practice reasonable social distancing, consumers might regain enough confidence to spend. But that does not seem to be happening and will get no easier as the weather warms up.

AS THE CONSUMER GOES…

After March's collapse in headline retail sales, April was expected to be a bloodbath, but it was much worse than expected with a 16.4% month-over-month collapse (the most ever), considerably worse than the 12% drop expected.



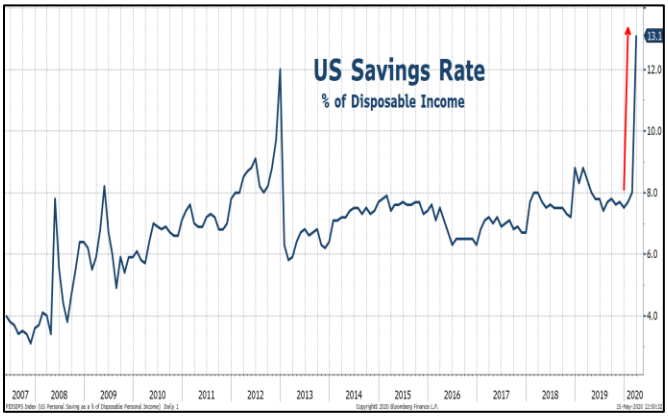
Source: Bloomberg

Under the surface, it was quite ugly. Clothing was down a whopping 79%. This followed a 49% decline in February. Hopefully, everyone has a sewing machine. Furniture sales plummeted 59%, to a record low. Appliance and Electronics dropped 60%. Even grocery store sales were down. Let's face it, how much canned soup can you possibly fill in the pantry?

The one bright spot was non-store retailers up 8.4%: the second-best month ever. Over the past three months, the online share of total retail sales has gone from 13.1% in February, to 15.0% in March to 19.4% in April (just a decade ago, this share was less than 8%).

Consumers do not appear to be using savings from deferred spending at restaurants and gas stations to splurge on online purchases to any material, offsetting degree. Worryingly, the National Retail Federation says the road to recovery for American stores will be a bumpy one of "fits and starts." Some estimates show that there is a 50% chance that 19 retailers tracked by S&P Global Ratings will default on their debt.

Eating in is in and eating out is out though with the lockdowns ending in most parts of the country, one should expect a rebound soon on this score. Open Table just reported that 25% of the restaurant industry is not going to make it. That is a permanent loss of over three million jobs, right there (or more than a typical year's worth of total payroll growth). Tack on millions more of permanent job loss once we apply this lingering hit to the likes of entertainment, retail, accommodation and air travel.



Source: Bloomberg

And when you read *McDonald's Details What Dining In Will Look Like* in the New York Times, you will come away with a view that fast-food lovers will just continue to order in from Domino's instead.

And how will a restaurant make money if state-mandates require it to operate at 50% capacity? What about the hotel/travel/airline industry? Or retail?

Also, how can you go out to eat when you don't own a car (and who exactly is going to be taking mass transit anywhere?)? The retail sector is truly in long-term disarray and was a part of the economy that had supported around 16 million jobs before the crisis hit.

Combined with a spike in the household savings rate and deteriorating confidence that the crisis will be temporary, a heightened sense of thrift among consumers bodes poorly for prospects of a vigorous, consumer-driven rebound later this year. With headline retail sales contracting at a 62% annualized rate, this implies an astoundingly negative print for overall personal consumption expenditures and GDP growth. Control group sales, which exclude food services, autos, gasoline and building materials, are down 44% so far in the current quarter.

A sharp drop-off in consumer spending is one of the main drivers behind estimates for GDP to post the sharpest drop in records dating back to 1947. The Atlanta Fed's GDPNow model is forecasting a record 42% drop in the second quarter!

The New York Fed Nowcast is -31.1%. Below I show the forecasts of economists surveyed by Bloomberg. The baseline is -36.6% with some forecasting a -50% decline.

Amid the flurry of data, those corresponding to the health of consumers, such as retail sales, remain most important to watch going forward. Consumers were the most important economic engine prior to the crisis, and they will similarly prove to be the main catalyst of the recovery, as well.

INDICATOR	4Q19	1Q20	2Q20	3Q20	4Q20	1Q21	2Q21	3Q21	4Q21	2019	2020	2021
GDP (Percent QoQ AR)												
Baseline	2.1	-4.8	-36.6	16.2	6.9	3.0	8.0	5.5	4.5	2.5	-6.9	5.2
Downside	2.1	-4.8	-50.0	15.0	-2.5	2.5	5.0	5.0	4.5	2.5	-14.5	4.2
Unemployment Rate	3.5	3.8	18.0	12.0	10.0	9.0	7.5	7.0	6.5	3.5	10.0	6.5
CPI (Percent YoY)	2.0	2.1	-0.5	-1.0	-0.5	-0.5	3.0	3.5	2.5	2.0	-0.5	2.5
Fed Funds Rate	1.75	0.25	0.25	0.25	0.25	0.25	0.25	0.25	0.25	1.75	0.25	0.25

As of April 29, 2020
Full-year GDP growth rates are 4Q/4Q.
Unemployment and inflation rates annual forecasts are 4Q averages.
Fed Funds values are upper bound of target range.

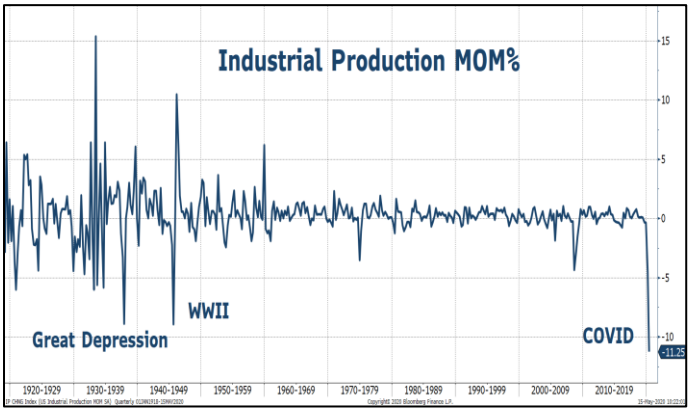
Actual
Forecast / Forecast

Source: Bloomberg

WORST IN 101 YEARS!

On the heels of miserable retail sales numbers comes the worst-ever industrial production numbers. The report provides another grim look at the COVID-19 wrecked economy.

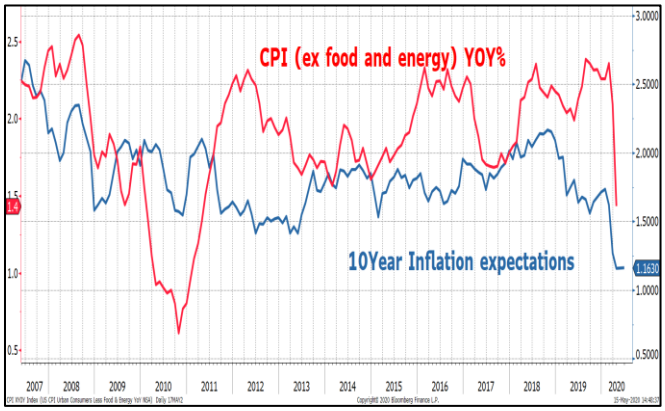
Having crashed in March, April industrial production was expected to crash even harder. Industrial production plunged 11.2% month-over-month, the worst since 1919**.** Manufacturers in the U.S. were among the first to experience the pandemic's economic drag as producers fell victim to supply-chain disruptions, a severe weakening in the exports market and a drop in domestic demand.



Source: Bloomberg

Meanwhile, we are into a demand-destruction-deflation process, which is not fully appreciated. Last week, the Consumer Price Index (CPI) showed the largest single monthly decline in consumer spending in 55 months. And, as shown in the following graph, inflation expectations continue to decline. In fact, according to the Cleveland Fed, inflation expectations over the next decade have reached an all-time low.

Recall that the Fed was already struggling with inflation creation long before COVID-19 redefined the global economy. If an environment with nearly full employment is unable to trigger the needed wage-gains, then how does the layoff of millions of workers solve the problem? In a vacuum, it will simply exaggerate the issue.



Source: Bloomberg

WORST SINCE 1706

The global virus case count has reached 4.7 million and fatalities are now at 315,000. The Asian Development Bank put out an estimate that the economic carnage will come to $8.8 trillion or 10% of global GDP.

The U.K.'s economy imploded in March, contracting 5.8% (or by more than a 70% annual rate) and is on track for its worst performance since 1706 (expected a 14% GDP decline this year as a whole). The first quarter saw real GDP contract 2.0%. Markets are now discounting 40% odds of a rate move to zero by the Bank of England; and like the U.S., they are starting to think that negative rates are coming.

Elsewhere**,** German real GDP contracted by 2.2% in the first quarter, as expected, which is an incredible -9.0% at an annual rate. We have not hit the eye of the storm yet and already the world's fourth largest economy was in recession prior to the pandemic because 2019 fourth quarter real GDP got revised down a tad to show a -0.1% dip.

In Asia, Japan's real GDP shrank at an annual rate of 3.4% (consensus is -21.5% for Q2). Thus, the globe's third largest economy has slipped into official recession terrain a week after Germany signaled that the same condition.

"Assuming there's not a second wave of the coronavirus, I think you'll see the economy recover steadily through the second half of this year… For the economy to fully recover people will have to be fully confident, and that may have to await the arrival of a vaccine." – Fed Chair Jerome Powell

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The major difference between the current crisis and any previous recession is the service sector job destruction. In the 1920s, roughly 26% of the U.S. population worked in the service sector. Manufacturing and agriculture were far more powerful. Today, 86% of the country works in some form of the service sector. We have lost 30 million and counting service sector jobs. This is a different type of crisis than we have ever faced.

Many of the job losses will be permanent and probably millions of small businesses will fail. The notion that we will see a full and expeditious recovery and that consumers and businesses do not retrench is not particularly plausible. Bottom line: Thoughts of a V-shaped recovery are pure fantasy. Sadly, the trudge toward labor market and economic normalization is going to be painfully longer than we all would like.

Furthermore, deglobalization and the threat of punitive measures and financial market restrictions has U.S.-China relations simmering again. Since it worked out so well for global commerce the first time, its only makes sense we having another go at it less than a year from the cessation of prior trade hostilities and amidst the largest macro shock in a century.

Presidents who face this kind of economy in the last year of their term almost never fare well, and Trump has the virus issue on top of it. With the economy weighing on Trump's re-election and betting markets moving towards even odds of Democrats taking the Senate, some measure of higher taxes and redistribution initiatives have become more probable.

And while governments have already spent staggering amounts of money, this is not "stimulus" as we normally use the word. It's more like "life support." They are helping contain the damage, but they aren't going to bring the economy back. This combination of extreme leverage, depressionary economic collapse and earnings recession is a toxic cocktail that could have a much longer-lasting impact.

In the brave new world, the economy of the future is one of savings, balance sheet repair and frugality. This is the new normal.

Source: Hedgeye

In terms of markets, I will not argue that there is not much room for interest rates to fall in the current environment; there is also not much tolerance for increases. Since interest rates affect "payments," increases in rates quickly have negative impacts on consumption, housing and investment. Remember, we were extremely leveraged heading into the crisis. Now we have so much more debt and leverage. And we know that more debt is not the solution as it leads to slower growth.

If you are wondering how this story ends, look no further than Japan. As has been the case over the last 30 years, so goes Japan, so goes the U.S. The US has taken page after page out of the Japanese playbook. And now, like Japan, the U.S. is caught in an ongoing "liquidity trap" where maintaining ultra-low interest rates is the key to sustaining an economic pulse.

Meanwhile the Fed is effectively dictating bond yields and well on its way to full-scale "yield curve control" similar to Japan. The end game is lower growth and low rates for longer… much longer!

For credit unions with excess liquidity, we continue to advocate a fully invested, diversified, high-quality investment portfolio. Any sell-off provides an opportunity to put excess cash to work.

In terms of sectors, we favor low coupon 10-year MBS. Low WAC 10-year MBS pools offer stable and predictable cash flows and very little refi risk as there is no shorter product to refi into. They offer yield spreads of +90 over the curve. In addition, seasoned low WAC 15-year 2.5% story continues to offer both stable cashflows and slower prepayments. Finally, high-quality bank notes offer an attractive way to pick up extra yield in a low yield world.

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 is 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.