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INVESTMENT SERVICES

Weekly Relative Value

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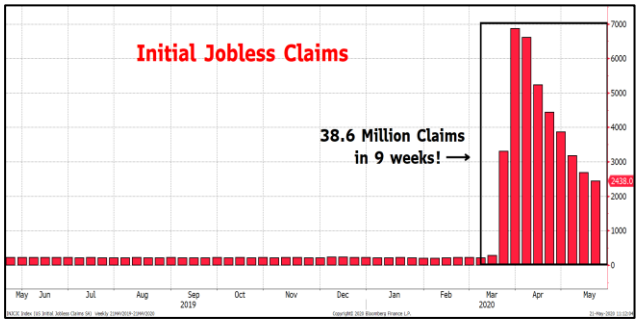
WEEK OF MAY 26, 2020

Week Nine

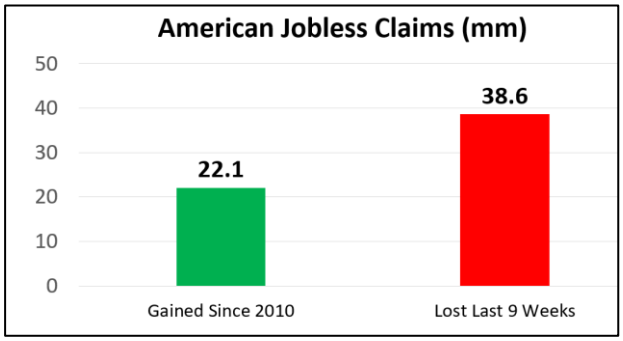
"More than 40 million Americans have lost their job in the last 60 days. That is a catastrophic sum and a level of concentration labor market devastation that is nearly impossible to overstate, and which written and verbal articulation remain a deficient vehicle for sufficiently conveying." – U.S. Macro analyst Christian Drake

In the wake of COVID-19, the string of unprecedentedly huge spikes in jobless claims continued unabated last week. For the week ending May 16, 2.44 million new Americans filed for unemployment benefits for the first time. That brings the nine-week total to a mind-numbing, gut-wrenching 38.64 million (25% of the labor force), which is massively worse than the prior worst nine-week period in the last 50-plus years.



Source: Bloomberg

The graph below shows the cumulative damage done on the labor front. The jobless claims filed over the past nine weeks is 74% greater than the number of jobs created since the economic recovery commenced in 2010.



Source: Bloomberg

THIS WEEK

- Changing Attitudes
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PORTFOLIO STRATEGY

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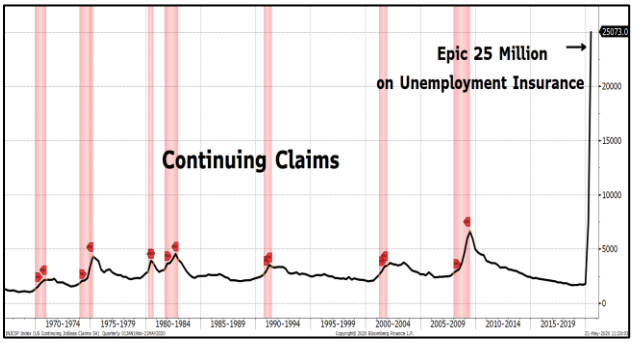
But as horrific as these numbers are, they are even worse. These "initial claims" exclude the gig workers, self-employed, and contract workers who are now eligible to receive unemployment insurance under the special and temporary federal program in the stimulus package called Pandemic Unemployment Assistance (PUA). When regular initial claims and PUA initial claims are combined, the total more than doubles to 4.4 million.

Last week's "continuing claims" came in at the highest level ever. For definitional purposes, laid-off workers who filed an "initial claim" for Unemployment Insurance (UI) and who are still looking for a job a week later are added to the "insured unemployment." The number of these "continued claims" spiked by 2.5 million to 25.07 million, having weeks ago blown past the pre-COVID-19 record of 6.63 million in May of 2009. But again, remember that theses "insured unemployed" do not include the PUA claims. Including all types of claims, the total uninsured unemployed combined surged to 27.3 million.



Source: Bloomberg

The number of unemployed in the monthly so called "official" jobs report is derived from household surveys. The household surveys that were collected in mid-April became part of the jobs report released on May 8. For that period in mid-April, the number of unemployed surged to 23.1 million. But not all the people who are out of a job and are looking for work receive UI benefits. So, the household surveys, when they catch up, should show an even higher number of unemployed than the 27.3 million of "insured unemployment" reported.

Source: Hedgeye

A household survey from the Census Bureau released last week offered further evidence of the widespread pain: 47% of adults said they or a member of their household had lost employment income since mid-March. Nearly 40% expected the loss to continue over the next four weeks.

"I hate to say it, but this is going to take longer and look grimmer than we thought,"
– Nicholas Bloom, Economist at Stanford University

Mr. Bloom estimates 42% of recent layoffs will result in permanent job loss.

The precariousness of the path ahead was underscored last Thursday by the Federal Reserve chairman.

"We are now experiencing a whole new level of uncertainty, as questions only the virus can answer complicate the outlook… for the economy to fully recover, people will have to be fully confident." – *Fed Chair Jerome Powell*

Central banks cannot print jobs…

CHANGING ATTITUDES

Personally, I will do a lot to avoid getting COVID-19. As a 45-to-64-year-old, my odds of being hospitalized if infected look to be about 1 in 25. No thanks! I will pass on getting on a plane or going to a crowded restaurant.

I am not the only one. Millions of Americans are engaging in self-imposed austerity to stay on the safe side. A Reuters poll of 4,000 American adults showed that only 40% would return to sporting events, concerts or theme parks even if a vaccine were to become available and some of the airlines are reporting that between 25% and 30% of their flights are full.

Source: Cagle

The best solution is to develop an effective vaccine. But this takes time. No vaccine for any disease has ever been rolled out in less than four years. Let's all hope Moderna's "vaccine" is the real deal.

The next best option is to create a comprehensive national testing, tracing and quarantining program, which would enable us all to feel a lot more confident that we are not going to run into people with COVID-19. So far, though, the U.S. remains wedded to its local vision of public health governance, in which states largely do their own thing. The

result will be a patchwork approach to contact tracing. Connections that cross state or even county lines will likely be missed, allowing recurring outbreaks to undermine consumers' confidence.

That said, even without a vaccine the economy will recover but numerous chain reaction ripple impacts will delay the economic recovery.

If social distancing rules become the new normal, causing thinner crowds in restaurants, theaters and stores, at sports arenas, and on airplanes, then fewer workers will be required.

On the retail side, some stores will disappear never to come back. It will take a while for people to feel comfortable sitting in a full capacity theater, stadium or airplane. Some people forced to cut their own hair will continue doing so. Some people who seldom cooked, learned how. They will be slow to return to eating out for many reasons. One reason is because it is fairly straightforward to make awesome food out of simple unprocessed ingredients, why would you go back? In general, any person who suffered a huge income reduction will be very slow to resume eating out, traveling, or buying a car.

"Hertz has notified 12,000 employees in North America that that they were losing their jobs, and another 4,000 are on furloughs. Its US workforce stood at 38,000 employees at the start of the year, with about a quarter of them represented by union." – CNN

Large companies have noticed no loss in productivity. And many already expect more of their workers to continue to work remotely. Think Twitter and Facebook. Facebook announced an expansion of shifting permanently toward more remote work – a move topped by Twitter, which granted the option indefinitely. If so, they do not need a large real estate footprint. This, in turn, will reduce the foot traffic that feeds nearby restaurants, shops, nail salons and other businesses.

The same applies to teleconferencing instead of air travel. Companies that were forced to allow more work-at-home cut down on eating out and driving (think local restaurants and gas stations). This is an additional hit to car rental companies and hotels. This means more layoffs or fewer people recalled from furloughs.

"Each machine handles work typically performed by four people… Our robotics systems, they never get tired. They never take breaks." – Kevin Kuntz of Global Logistics Fulfillment

Finally, concerns about working in close quarters and too much social interaction could also accelerate the trend toward automation, which means fewer employees. To wit: Gap is speeding up its rollout of warehouse robots – which are not susceptible to disease – after reaching a deal to more than triple its fleet by the fall.

The bottom line: COVID-19 has changed the way we approach work and spending.

Anyone who expects a fast recovery out of this mess is delusional.

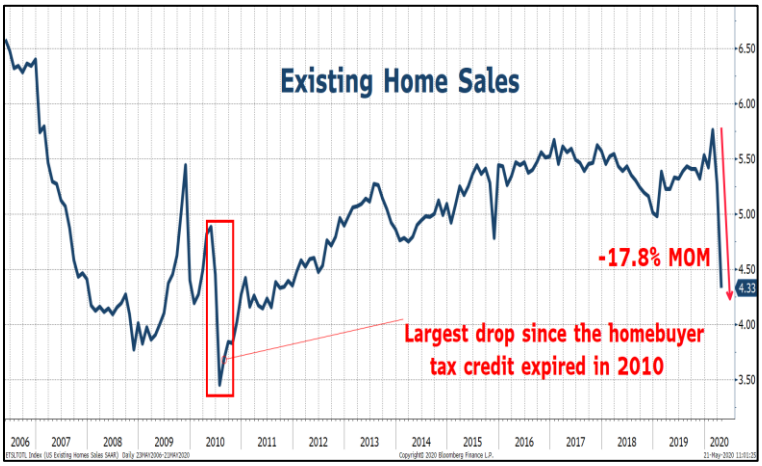
HOMESICK

"The economic lockdowns – occurring from mid-March through April in most states – have temporarily disrupted home sales… But the listings that are on the market are still attracting buyers and boosting home prices."
– Lawrence Yun, the National Association of Realtor's chief economist

Housing starts fell 30.2%, permits 20.8%, and completions 8.1% due to COVID-19. This is the greatest month-over-month decline in the history of these stats. The housing data date back to 1959.

And existing home sales in April plunged 17.8% month-over-month to the lowest annualized since September 2011. This is the largest drop since the government's homebuyer tax credit expired in July 2010 (the two-month drop is around 25% annualized). April sale prices rose, bit that was heavily skewed by the reduction in sales.

Existing home sales slumped in all U.S. regions in April**,** led by a 25% drop in the West. Price is sure to follow traffic lower, and real estate agents will get hit twice. First on the amount of traffic, and second as prices decline.



Source: Bloomberg

But April will not mark the bottom in sales. Here is why.

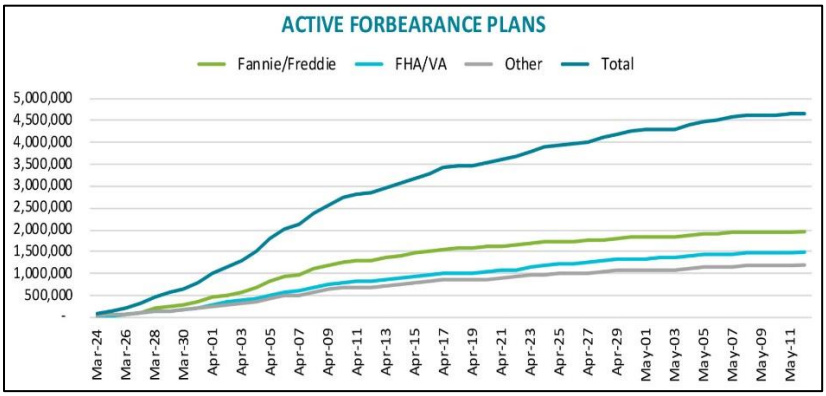
- Existing sales are recorded at closing whereas new sales are counted at signing.
- April sales represent transactions that occurred in February and March.

May sales (transactions in March and April) are sure to be worse. Even June sales could be worse.

STRESSES ARE EMERGING

According to the latest Federal Open Market Committee (FOMC) minutes, the Fed's attention has turned to financial strains and imbalances, and for good reason. National mortgage delinquencies (mortgages in arrears for at least 30 days) posted a 90% increase; soaring by 1.6 million in April (to 3.4 million loans). This was the sharpest increase on record and almost three times the previous single-month record set in 2008. For context, it took more than 18 months before the first 1.6 million homeowners became delinquent during the Great Recession and there is still potential for a second wave of delinquencies in May.

As of May 12, 4.7 million mortgage borrowers were in forbearance or almost 9% of all mortgages. The prior peak was 7.9 million as of January 2010.



Source: Black Knight

Note: Regardless of a borrower's forbearance status, servicers of loans in government-backed securities (FNMA, Freddie Mac) must make advance principal and interest (P&I) payments each month for these loans. P&I advance payments are capped at four months for servicers of GSE-backed mortgages.

And the stress is not just with residential housing. COVID -19 and the ensuing lockdown, has essentially frozen the commercial real estate market.

Buildings that were once used for restaurants, offices, hotels, spas or anything else classified as non-essential have seen soaring vacancies. As vacancies soar, tremendous downward pressure is being put on almost every asset class tied to commercial real estate.

The latest Trepp remittance data compiled by Morgan Stanley showed a quarter of all commercial mortgage-backed securities (CMBS) could be on the verge of default.

Finally, stresses are mounting at the consumer level. April had nearly 15 million credit cards classified as being in "financial hardship" programs. Nearly three million auto loans have entered into such programs, too. The former is a 3% share of the total loans and the latter is 3.5%, which represent huge increases from 0.03% for credit cards a year ago and 0.5% for auto loans.

ZOOM!

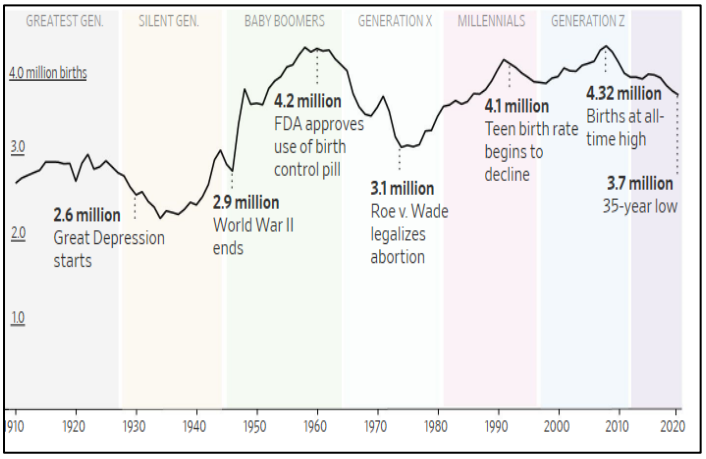
There are winners and losers in every crisis. Obviously, airlines, retailers and the leisure/hospitality sector of the economy have been hard hit. But on the other side of the ledger, Amazon, tech companies and a heretofore unheard company has become a household name. As Google has become synonymous for searching online, Zoom will be become synonymous for communicating online. And stockholders have been handsomely rewarded. Zoom is now worth more ($48.7 billion) than the world's seven biggest airlines combined ($46 billion).

Source: Bloomberg

BABY BUST

"People that were products of the Great Depression, the birthrates were much lower for that cohort than they were for people born after World War II." – Rhode Island University Assistant Professor of Sociology Melanie Brasher

The Wall Street Journal reported last week that the U.S. birth rate has plunged to a 35-year low. After peaking in 2007, births in the U.S. have decreased for 11 of the last 12 years. About 3.75 million babies were born in the U.S. in 2019, down 1% from the prior year. The general fertility rate fell 2% to 58.2 births per 1,000 women aged 15 to 44, its lowest level since 1909.



Source: Wall Street Journal

The economic fallout from the coronavirus pandemic is expected to further depress births in the coming years.

Since the financial crisis, the birth rate has risen year-over-year only once, in 2014. It appears millennials, generally less financially secure than generations before, are on the whole moving much slower in establishing family.

"The fact that births and fertility continued to decline in 2019 despite the booming economy suggests that this is a permanent shift to a lower fertility regime in the U.S."
– Cheryl Russell, a demographer and editor to the journal American Demographics.

In 2008 when Japan's birth rate fell to 1.34 average number of children a woman had in her lifetime, the country realized that the economy would stagnate if the trend weren't immediately reversed (combined with the "super-aged" nation having over 20% of its population older than 65). In 2008, Japan's birth rate was so low that workers were told to go home early and use their remaining energy to procreate. This is true!

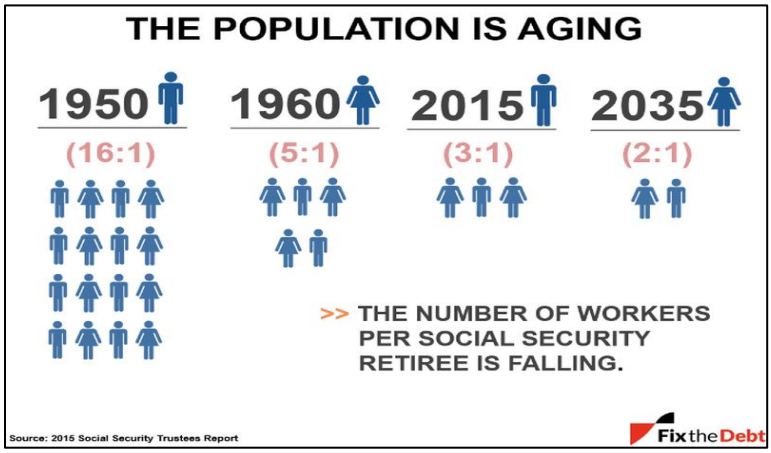
"Demography, however, is destiny for entitlements, so arithmetic will do the meddling." – George Will

Do not expect a "quarantine baby boom." Most demographers predict the historic skyrocketing unemployment and negative long-term economic prospects will be the driving factor in continued low births.

The demographics are a big negative for long-term growth and exacerbating a shortage of young workers to help offset the Medicare and Social Security costs of America's aging baby boomers.

One of the primary problems continues to be the decline in the ratio of workers per retiree as retirees are living longer and lower birth rates due to an increased life expectancy coupled and a decrease in the fertility rate.

In 1950, there were 16 workers per social security retiree. By 2015, the support ratio dropped to 3:1, and by 2035 it is projected to be just 2:1.



I KID YOU NOT!

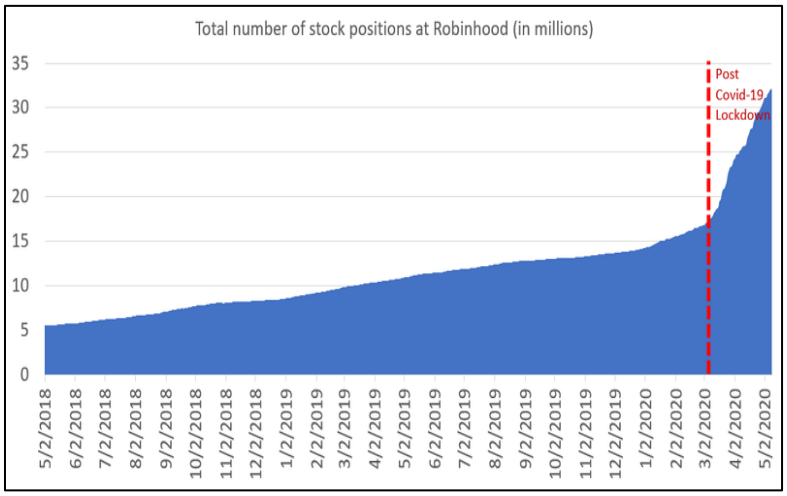
"Investors beware… the gamblers have moved from the blackjack table to your territory. I kid you not!"- Dave Rosenberg

A survey from the World Economic Forum of business executives shows that two-thirds of the 350 polled see a "drawn-out downturn" that is expected to last for the next 18 months. And according to the Bank of America Merrill Lynch (BAML) survey of global institutional investors, only 10% of global portfolio managers see a V-shaped recovery; 75% are in the "W "or "U" camps; only 25% see this as new bull market while 68% dub the environment as a "bear market rally."

According to a BAML survey, global institutional investors have remained on the sidelines during the recent rally. Hedge funds have a record-short position in futures. Likewise, a recent survey showed that 50% of individual investors are

bearish. Only 23% are bullish. Equity-based mutual funds have seen a $93 billion withdrawal over the past five weeks. In fact, retail investors have been so cautious that they have plowed a near-record $852 billion into money market funds over the past two months. That equates to a 20% surge despite miniscule rates.

So, who the heck is buying the equity market? The Financial Times had an interesting article: *Frustrated Sports Punters Turn to US Stock Market*. The tag line ("Three of the top online brokerages see almost 800,000 newly added accounts in March and April") and opening sentence ("Gamblers who cannot bet on professional sport because fixtures have been scrapped are flocking instead to the US stock market, creating a new class of customer for online brokerages and adding fuel to the market rally") say it all.



Source: Robinhood

RED ALERT

While most people are still trying to come to grips with the rapidly unfolding COVID-19 crises, the national debt has soared and now stands at more than $25 trillion, up 15% since a year ago. U.S. public debt to GDP now stands at a whopping 120%. But it will not stop there. Since the COVID-19 crisis, the CARES Act, a $2.3 trillion relief package, will add to the mountain of debt. By year-end, the tally will approach, if not exceed, $30 trillion.

Source: usdebtclock.org

But this debt explosion is not due to the coronavirus. This profligate spending been an ongoing trend over the last three year and beyond. In many ways, the Trump-proclaimed "greatest economy ever" is a mirage based on nothing but

deficit spending. The bottom line is that we entered this crisis in the midst of a "false economy" and it is only by the grace of this huge deficit spending that we are not languishing at the bottom of a deep economic pit.

The combination of Nancy Pelosi and President Trump has been toxic to anyone interested in holding government spending at a reasonable level. However, I do find it incredibility ironic that after criticizing former President Barack Obama and the Democrats for taking us down this road, we find Trumponomics is little different. Fiscal conservatives, where art though?

Government spending is a poor substitute for the free market in allocating capital to where it is most effective, and it is not economic growth but simply a method of borrowing from the future. Deficit spending is not a silver bullet nor a free lunch. The Japanification of America is well on its way.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The velocity of money is important for measuring the rate at which money in circulation is used for purchasing goods and services. Velocity is useful in gauging the health and vitality of the economy. High money velocity is usually associated with a healthy, expanding economy. Low money velocity is usually associated with recessions and contractions." – Investopedia

Many analysts and economists are trying to predict the shape of the economic recovery post-COVID 19.

Yes, the economy and growth will bounce back, but to what level?

Starting with the pandemic, we know there has never been a vaccine created in less than four years. And there has never been a pandemic without a second wave before a treatment existed. Taking both things into account, the idea that many investors have that the worst is discounted may be overoptimistic.

Already companies are announcing layoffs by the thousands seemingly every day. The latest being IBM, Nissan, Rolls Royce, and even the Trump resort in Miami. Of course, bankruptcies are starting to dominate the headlines; Friday's announcement of Hertz filing for bankruptcy being the latest example and surely not the last.

There is no V-shape. High unemployment will remain with this economy for a long time no matter how much the Fed prints. Considering that 75% of job losses have come from the services sector (travel and leisure, education, health and professional services), it is also safe to assume that the jobs recovery will be very slow, considering the loss in the number of businesses and the weak response from consumers in the return to activity, as wages are unlikely to rise and households will likely try to save as much as they can to prepare themselves for another shock.

On the corporate front, there was no earnings growth in 2019, a very possible -20% earnings decline for aggregate 2020, and soon you are looking at an aggregate of three years with no earnings growth. Suddenly we will have an economy $30 trillion in debt, a Fed with a balance sheet of $10 trillion dollars with no vision or hope of ever raising rates again with unemployment still north of 10%.

This is happening at a time when the political rhetoric between China and the U.S. is increasing during a highly contentious political election year. And for Wall Street, the outcome of this election may have consequences. The presumed Democratic nominee Joe Biden is talking about repealing the recent corporate tax cut, raising taxes for Americans earning more than $400,000 per year, and for Amazon to pay its taxes.

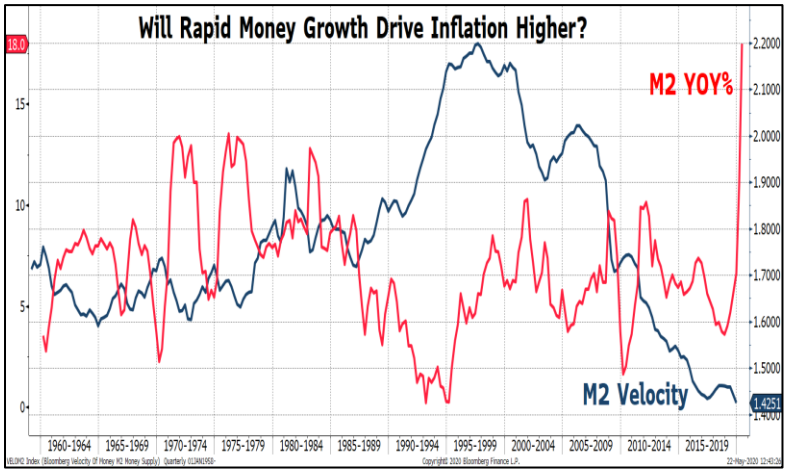
Not to mention, companies already streamlining their operations through work-at-home/offsite are looking to extend well into 2021 which triggers a shift in supply chains and changing consumer behaviors.

Not an attractive investment environment. Yet markets remain oblivious to risk.

Finally, if the previous recoveries came with poor wage and capital expenditure growth and high debt, the next one will likely be even worse. Recent history tells us that L-shaped recoveries are not an anomaly, but the norm. This one may not be different. Over a longer-term perspective the growth rate of America is likely to shift lower towards the 1% range.

On the inflation front, some people say that inflation is around the corner because of rapid money supply growth. Unquestionably, monetary growth is running at record growth rates and Jay Powell has made it clear that more monetary pump-priming is coming our way as well. But any impact here requires a bottoming-out in money velocity (see the blue line in the following graph). There is no evidence the Fed's "zero interest rate policy" led to robust economic growth via the transactions of goods and services. Monetary velocity has been clear on this point. For the near-term, the impact from COVID-19 is plunging aggregate demand.

And that will likely remain deflationary, at least for the coming year. The economic hole is just far too big for inflation to become a problem for anyone for the time being. To wit: the core Consumer Price Index (CPI) declined 0.1% in March and 0.4% in April. Over three months, consumer prices have declined -1.2% annualized – the lowest in the six-decade history of the CPI data. The core Producer Price Index (PPI) also fell 0.3% in April and has receded in two of the past three months — during which it has declined at an unprecedented 1.6% annualized pace.



Source: Bloomberg

Finally, although the Fed has been consistently skeptical about the benefits of negative interest rates and while it still remains a low-probability event, markets are pricing in some tail risk that U.S. policy rates will go below zero. Frankly, if the markets start to price in negative rates, the Fed will follow. Even if the Fed does not go negative, expect them to implement yield curve control (another page out of the Japan playbook).

Also, keep your eyes on the Bank of England, a leading indicator and the only central bank with a track record back to 1694, is openly contemplating a negative interest rate policy just a few weeks after being the first central bank to embark on outright debt monetization.

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.

> *"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

> *"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

> *"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

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.