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INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF JUNE 1, 2020

Yield Curve Control

"Yield-curve control, which has now been used in a few other countries, is I think a tool that can complement – potentially complement – forward guidance and our other policy actions." – Federal Reserve Bank of New York President John Williams

The pandemic has taken a heavy toll on the U.S. economy. Another 2.1 million Americans filed for unemployment insurance benefits in the week ended May 23, bringing the total to 40.7 million since mid-March.

Uncle Sam has passed $3 trillion of fiscal measures to cushion the blow from the virus and are debating another round of aid. The Federal Reserve has already unleashed a barrage of new policies – slashed interest rates to near zero, flooded financial markets with liquidity and unveiled a number of emergency lending programs – to keep credit flowing.

But with unemployment at levels not seen since the 1930s, and Congress deadlocked over another round of fiscal stimulus, many believe the Fed will initiate a new program. After all, Fed officials have been painting a bleak picture of the economy near term and they cannot keep a negative economic outlook without easing monetary policy further.

"Some banks decided in addition to that, to use negative rates. We don't think that that's an inappropriate tool here in the United States. I would say the evidence on whether it actually works is mixed… We also have institutional arrangements here that would not work with negative rates." – Fed Chair Jerome Powell

While some countries have tried negative interest rates, and some investors are betting that U.S. central bankers will follow that path at this juncture, Fed officials unanimously rejected the idea.

THIS WEEK

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PORTFOLIO STRATEGY

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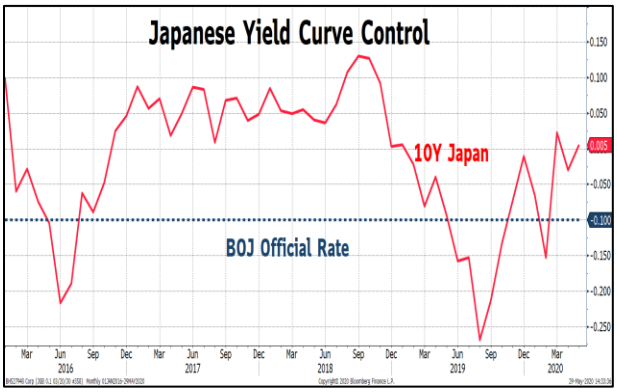
"Yield curve control would reinforce that the Fed is going to keep rates low and allay fears it will be overly reactive by removing accommodation at the first sign of inflation." – Jonathan Cohn, strategist at Credit Suisse

Enter "yield curve control" (YCC), which involves purchasing Treasuries as it has done under quantitative easing programs, but it would buy (or conceivably sell) the debt in whatever volume is needed to maintain the predetermined targeted yield. For central banks that already cut short-term interest rates to zero, it signals that they will stay low for an extended period, tamping down Treasury yields while helping pin down longer-term borrowing costs**.**



Source: Bloomberg

This is not new. The U.S. engaged in yield curve control to help finance World War II. At that time, the Fed agreed to cap 30-year bonds at 2.5%. Japan has implemented YCC for the past four years. Australia initiated its own YCC in March of this year.

After years of huge bond buying failed to fire up inflation, the Bank of Japan (BOJ) cut short-term rates below zero in January 2016. The move crushed yields across the curve, crushing financial institutions' margins. To pull long-term rates back above zero, the BOJ adopted YCC by adding a 0% target for 10-year bond yields to its -0.1% short-term rate target. Put simply, yield curve control is the Bank of Japan's attempt to keep a tight leash not only on short-term rates, but also on long-term interest rates in the economy. The Bank has promised to "control" the market to make sure that the yield on the country's 10-year government bond remains at zero percent.

In Japan, the short-term policy rate is minus 0.1 percent. What this means is that banks in Japan will have to pay the central bank 0.1 percent on the excess reserves they maintain with it. The intent is that banks should maximize lending. It hopes to keep tabs on long-term rates through its yield curve control. With short-term rates at -0.1 percent and the 10-year at zero, it will ensure a steeper yield curve. This is good news for banks as they can now borrow money at cheaper short-term rates and lend at higher longer-term rates to pocket some margins.

When yields rise, the BOJ can simply ramp up buying. When they fall, it could reduce purchases. YCC is an efficient way to cap borrowing costs in a country like Japan, where the central bank already owns nearly half of the bond market. Having already gobbled up so many bonds, it is hard for the BOJ to commit to buying more at a set pace. Under YCC, it only needs to buy as much as needed to achieve its 0% yield target. The BOJ has managed to pin yields around its target for nearly four years because of its dominance in Japan's $9 trillion bond market.

The BOJ had to target 10-year yields because that was the most liquid zone in Japan's bond market. Other central banks could instead target the shorter end of the curve, such as the three-year zone like that for Australia. When yields are stable around the target, the BOJ can taper purchases. At a time like now when the government is ramping up debt

issuance to fund a huge stimulus package, the BOJ can accelerate purchases. By doing so, it can help keep government borrowing costs low and maximize the effect of fiscal spending.

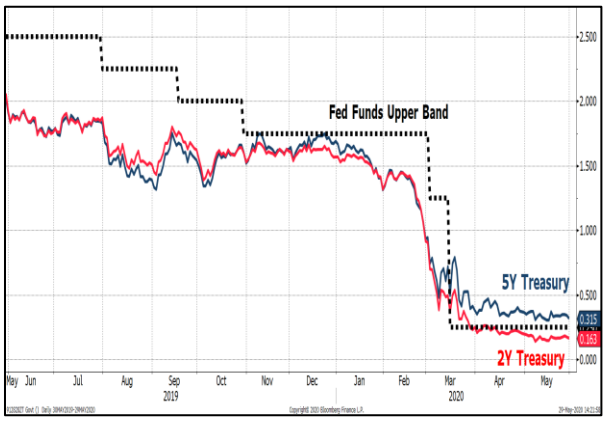
When the Reserve Bank of Australia (RBA) adopted the idea in March, it plumped for three-year debt and a target yield of 0.25%. The idea was to control the shape of the yield curve so that short- to medium-term rates – which affect corporate borrowers – fall, without pushing down super-long yields too much and reducing returns for pension funds and life insurers.

The Fed may not be ready to follow suit right now. According to minutes of its last rates meeting in April, the Fed is more concerned about demonstrating a commitment to staying loose. However, Fed officials – such as Lael Brainard who favors the yield curve control strategy – also see it as a way of putting an exclamation point on their intentions to keep the short-rate low for a period of time. New York Fed President John Williams said the Federal Open Market Committee (FOMC) is "thinking very hard" about targeting specific yields on Treasury securities as a way of ensuring borrowing costs stay at rock-bottom levels beyond keeping the benchmark interest rate near zero. Such action can potentially complement the Fed's forward guidance on rates and other policies and ensures that the risk-on trade is not thwarted by any bond vigilantes (do they even still exist?).

That said, given the large and diverse $18 trillion U.S. Treasury market, if yield curve control is initiated, the U.S. is more likely to follow the Australian example and focus on the short end of the curve. That could mean maturities of two and five years. That would allow longer-term yields to move above those targets and keep the curve upward-sloping, which enables financial institutions to generate profits.

"We do expect yield-curve control by year-end," – Priya Misra, Head of Global Rates Strategy at TD Securities

In summary, should the Fed follow in the steps of the BOJ and RBA, expect short-term rates to remain low for a very extended period as the yield curve steepens. The gap between shorter- and longer-dated government debt has already been widening. Yields on the 10-year note were fluctuating around 0.7%, more than double the record low posted in March. Two-year yields were trading at 0.16%, and five-year debt at 0.30%. That fits with the pattern of recent weeks, which have seen those maturities trade either side of the 0.25% level that marks the top of the Fed's target range.



Source: Bloomberg

BENEFIT OF THE DOUBT

We are now up to at least 10 coronavirus vaccines under development and investors are pricing in just one coming to market; that it will be timely, effective and allow for a complete return to normality. And there is no doubt that we have the world's best and brightest working day and night on vaccines and treatments. And I sense (hope) that we are much further ahead on these clinical trials than anyone would have thought a few months ago when the COVID-19 virus was being compared to the Black Plague or the Spanish Flu. So, while I'm no epidemiologist, we will get there, but not in the quick timeframe. FDA chief Scott Gottlieb says a vaccine will likely not be available for broad public use until we are well into 2021.

Please remember that it usually takes four years on average to develop a vaccine. So, if it happened by year-end, it would be a grand slam. However, it could take many quarters or even years — which means many more quarters of social distancing and caution holding back the consumer. That would mean, at best, a very weak recovery with mountains of unemployment and bankruptcy. And that assumes we do not go back into lockdown mode.

Yet, the stock market believes that a vaccine will be proven to be safe and effective by this fall. Let's hope so. However, hope is rarely a good investment strategy.

As an aside, everyone knows I think the overall stock market (financial assets in general) has become a casino with no true price discovery given all this global central bank alchemy. Seriously, the Fed buying junk-bond exchange-traded funds (ETFs) with BlackRock's help, no less, is beyond the pale from a moral hazard standpoint and has created a one-sided and distinctly anti-capitalist "heads you win, tails we bail you out" psychology. Zero chance this ends well. But if you really want to see the extreme divide between Wall Street and Main Street, look no further than Iran where the economy has been in a constant tail spin and yet the Tehran Stock Exchange has soared almost 100% since mid-February! Is this the new Capitalism?

"Profits, the mother's milk of stocks" – Larry Kudlow, Director of the U.S. National Economic Council

Meanwhile, the market is completely ignoring that even before the eye of the storm, first quarter earnings were coming in -13% year-over-year — the worst slump since the 2009 Great Recession. The consensus for second quarter earnings has downshifted to -30%. For the entire year, the consensus for 2020 earnings-per-share estimates has declined to -20%. And the equity market has soared in the past two months. While the S&P 500 is -10% off its highs, it has rallied almost +41% off the March lows.

Go figure.

For those of us still grounded in economic reality, the truth belying all this exuberance is much dourer. The Federal Reserve, Treasury and Congress are desperately attempting to paper over the cracks of a slowing economy (with corporate debt-to-GDP at an all-time high) by drowning America in liquidity (read: more debt).

Consider the following:

The Chicago Fed conducted a survey (670 firms), which found that three-quarters of firms say the U.S. economy needs at least a year to fully recover from COVID-19. Half of those surveyed told the Chicago Fed that the recovery will take between one and two years. The other half was split between a recovery in less than a year or one that would take more than two years. The report stated: "Many of the small businesses we heard from — especially those in the

entertainment, tourism, recreation, restaurant, and retail sectors — are in danger of financial distress… Many businesses are facing very difficult challenges that are unlikely to go away quickly."

The survey also found that not returning to full capacity will be devastating for the service sector. To wit: "moderate" social distancing rules and limiting gatherings of 50 people (or less) would create financial distress after three months for 88% of restaurants, 65% of retailers and 38% of manufacturers.

So, for the 30 states where there is indoor dining, half have limited capacity to 25%-50%. But the reality is that restaurants with 25%-50% capacity will go bust. These are not typically high-margin businesses. The bar is often the profit center for restaurants that have active bars. Now social distancing rules simply prohibit a functioning bar in the way we know it. I think people have to understand that restaurants have tiny margins (10% or less). Good luck with partial reopening and social distancing. Industry analysts suggest that the restaurant establishment have to get to 97% to survive.

Further, a Cowen survey of 2,500 U.S. households found that three-quarters plan to dine out less frequently or avoid restaurants altogether. Let's face it, everyone has already filled their pantries with so much food, who really needs to eat out? On top of that, during the shutdown we have all learned how to cook! And it is cheaper to boot. Frugality is now cool!

It a reasonable assumption that 30% to 40% of the restaurants in the U.S. will not make it. Many ancillary companies depend on working restaurants, and that means millions of jobs lost.

In the hotel industry, the occupancy rate in the week ending May 16 increased to 32%. Yes, up from the low of 21% in the week of April 11, but half the pre-COVID-19 level of 62%. Compared to last year, revenue per available room is down a whopping 74% from a year ago. Not good.

In the luxury hotel space, occupancy rates are even more depressed, at 18%, and it will likely take years for upscale properties that cater to conventions and business groups to recover.

And it is not just restaurants and hotels. The retailing community is also going to struggle. Just recently, I walked through the once-bustling Mall at the University Town Center in Bradenton, Florida and, while open, it remained a ghost town.

Data from the Transportation Security Administration (TSA) show that air travel is at 8% of pre-crisis levels.

The New York City subway is running at 10% of its level a year ago.

Commercial real estate faces a crisis, particularly if only two people can ride in an elevator at a time, which is the restriction imposed by many cities.

Finally, a survey conducted by financial services company Azlo found that nearly half of small business owners think they will eventually have to close their businesses for good. Forty-seven percent of the small business owners surveyed said they anticipate shutting down, and 41% said they are looking for full-time work elsewhere.

This is on top of the small businesses that have already shut down and will never reopen. There are 30 million small businesses in this country. Small businesses employ 58.9 million Americans, making up 47.5% of the country's total employee workforce. Yes, the economy will rebound strongly in the third quarter, but I believe it is absurd to think the economy is going to come roaring back when nearly half of small business owners expect to shut down.

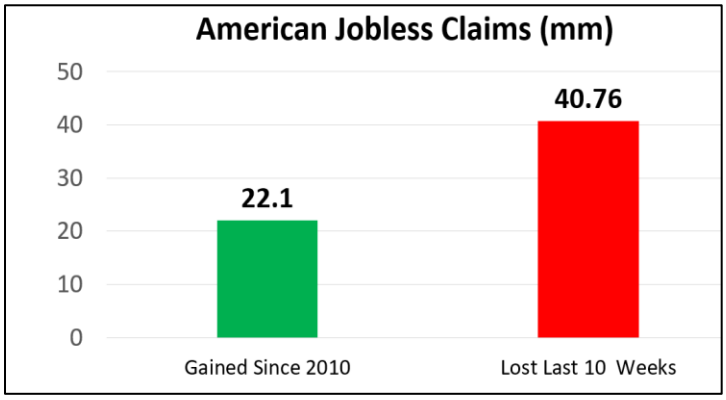
How does all of this equate to a V-shaped recovery?

AS CONSUMERS GO…

"This is an emergency of a nature that we haven't really seen before" where a 50-year low in unemployment turns to a 80-90 year high "in the space of 60 days." – Fed Chair Jerome Powell

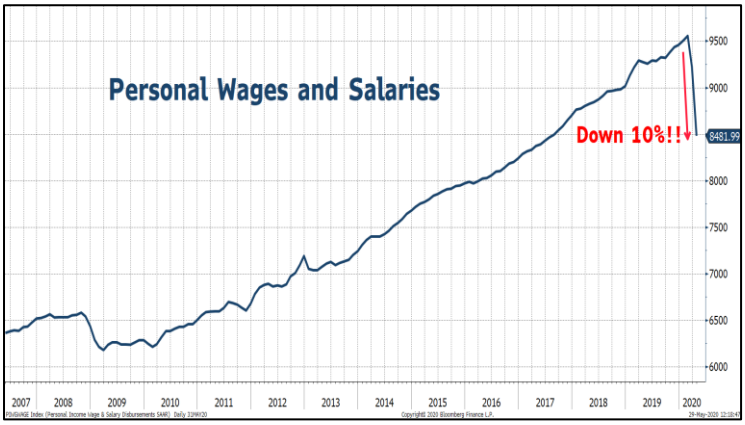
In the last week, 2.123 million more Americans filed for unemployment benefits for the first time. And as I noted previously, what is most disturbing is that in the last 10 weeks, almost twice as many Americans have filed for unemployment than jobs gained during the last decade since the end of the Great Recession (22.13 million gained in a decade, 40.767 million lost in 10 weeks).

A survey of those unemployed in California showed that 85% of respondents expect to get their jobs back. Similar surveys on a national level put the figure at 77%. Even with those numbers, there would still be an unacceptable 9% unemployment level. That will cause social unrest.



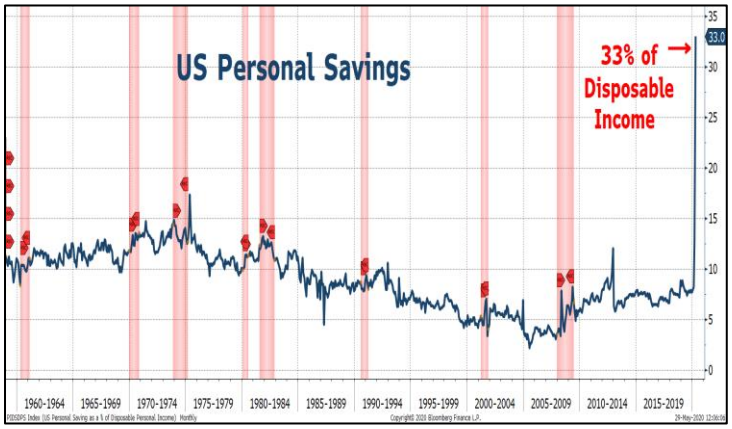
Data Source: Bureau of Labor Statistics

And wages for private industries plunged to $7 trillion annualized from $7.7 trillion in March, and from $7.8 trillion last April. The drop of 10.1% was the biggest annual drop on record, surpassing even the worst drop during the financial crisis. Furthermore**,** this means that three years of private wage growth was lost in one month, as the last time private wages printed an annualized $7.0 trillion was in April 2017!



Source: Bloomberg

Job and income insecurity lead to one path only and that is towards a further rise in the personal savings rate. And while economists will say that consumers better start spending all those pent-up savings soon to reboot the economy, that is not happening yet. As shown below, savings as a percent of disposable income has skyrocketed to an unheard of 33%.



Source: Bloomberg

Here are the key reasons why savings have risen so sharply:

1. **Stimulus Checks** – As a result of the CARES Act, American received stimulus checks for $1,200. These are a one-time play and the effect will roll off.
2. **Forbearance Plans** – Credit card companies, auto loan companies, rent companies and mortgage companies all allowed consumers the right to skip payments if they requested. These amounts will have to be made up later.
3. **Work-From-Home** – We have just avoided a ton of expenses, such as commuting, overpriced take-out lunches, dog walking in my case, dry cleaning business suits, etc. Cost of living goes down when you no longer commute to work in many cases.
4. **Travel Curtailed** – Spring break did not happen. That's $3,000 to $6,000 for any family going on vacation.
5. **Stores Closed** – Stores are closed, so of course people are saving more. Restaurants, bars and general merchandise stores are closed. Services such as barbers and beauty salons are also closed.
6. **Large Purchase Sales are Down** – Cars, boats, housing and furniture purchases have been postponed.
7. **Price Drops** – Prices generally moved lower. Gasoline, plane tickets and rental cars are standouts. Also, some insurance companies voluntarily dropped rates as people are driving less. Buying a 4kTV from big box store for a mere $200 for my new home office?
8. **Deferred Medical Spending** – Elective medical and dental procedures were halted.
9. **Delayed Tax Payments** – Keeping 2019 federal and state tax monies owed until July 15.

As we move down the road, a spending rebound is coming up, but it will not take things back to what they were before COVID-19 hit. Stimulus checks will disappear, AMEX will collect all those owed monies. Mortgage forbearance is ending, which will mean that that five million households will go from spending $0 on housing back to full mortgage payments when the program expires. That is roughly $6 billion/month (five million households with mortgage payments of roughly $1,200/month) that will either not get paid or be rediverted back from other (already depressed) discretionary consumption. Taxes will be paid. So many of those gains to savings will be short lived.

But most importantly, Americans have been scarred by the COVID-19 crisis and remain worried about what the future holds. It will take time to restore the animal spirits of the average American.

The U.S. economy is driven by consumption, which represents 70% of U.S. GDP. So as the consumer goes, so goes the economy. The $20 trillion question is: when will Americans feel confident about opening their purse strings?

To demonstrate the impact of consumption on GDP, look no further than the Atlanta Fed's closely followed GDPNow tracker estimates for second quarter real GDP growth. They declined from -41% to -51.2% in one week! The reason for the dramatic decline was attributable to personal consumption expenditures (PCE) declining from -43% to -56%. So once again, as the consumer goes, so goes the economy. For the sake of the U.S., those predicting a V-shaped recovery better hope that Americans head back to the malls and fast!

Source: Bloomberg

A STICH IN TIME

The ongoing debate of whether the economy should have locked down continues. I can appreciate arguments on both sides, but the folks who now question the wisdom of the lockdowns remind me of Monday morning quarterbacks.

It may or may not have been an overreaction, but the reality is that the U.S. was late to the game and was ill-prepared. Remember: in mid-February, the "official" forecasts on the case count and deaths were truly frightening. The U.S. response to the coronavirus has turned a mid-sized pandemic into a catastrophe. Given the fast-spreading virus and stressed medical staff, can you imagine what would have happened if we had carried on without closing down? We should thank state governors who had the courage to act. Let's face it, what good is GDP if it kills you? The expression "a stitch in time saves nine" seems appropriate.

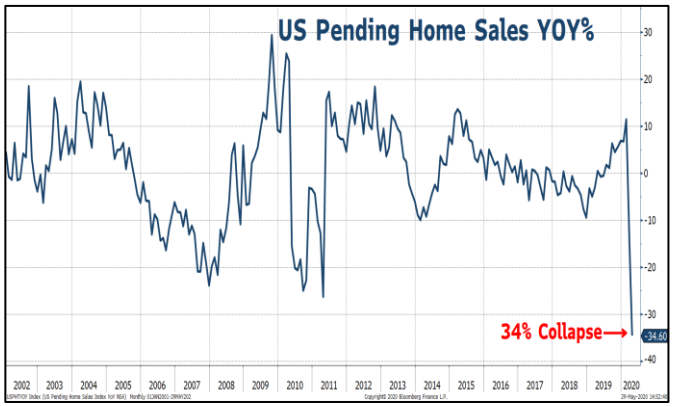
And then I hear, all too often, that 50% of the deaths have been in nursing homes and that another 30% are people over the age of 65 who are not in nursing homes, is more than just a bit insensitive and disingenuous.

Finally, many critics of closing down America use Sweden as a test case of why the shutdown was not necessary. Well, the truth is, Sweden experienced the same economic carnage as anywhere else and a much higher mortality rate. Was that a good tradeoff?

My view: Locking down was the right call, as is ending it now since the medical infrastructure can handle any future escalation in the case count.

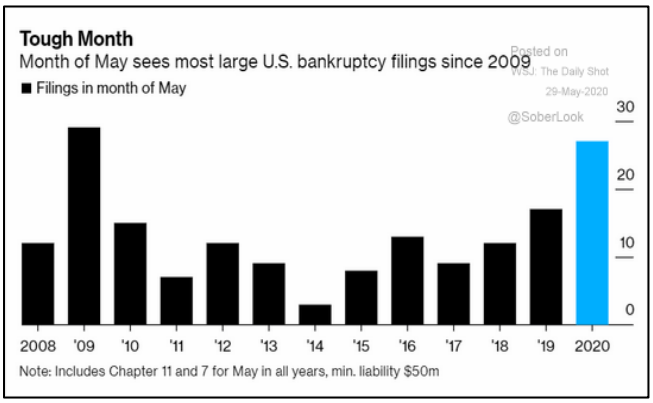
HOUSING PURGATORY

Pending sales of existing homes of all types in April – contracts on houses, condos, etc., that were signed in April but that haven't closed yet – collapsed by 33.8% from April last year, after having plunged 16.3% year-over-year in March. When sales volume collapses to this extent – no matter what the market is – it changes everything. It represents a market that has essentially frozen, with few buyers and few sellers, and lots of uncertainty.



Source: Bloomberg

In May, those markets have begun to unfreeze. But the market is facing ferocious headwinds, including 31 million people now collecting state and federal unemployment insurance. More mass layoffs by big companies are announced every day, such as American Airlines' message to its employees late Wednesday that it would cut its management staff by 30%. Delta came out with plans to shed staff via early retirements and buyouts, along with Chevron that said it would cut up to 15% of its global workforce of 45,000 people, and Boeing which said it would cut 7,000 workers. These are not restaurant jobs. These are jobs that come with good paychecks and benefits. In May alone, some 27 companies reporting at least $50 million in liabilities sought court protection from creditors – the highest number since the Great Recession. And with a lag, more defaults and bankruptcies are set to spike.



Source: The Daily Shot, Sober Look

This constant flow of announcements creates uncertainty among potential home buyers that kept their jobs and it removes potential home buyers from the market that have lost their jobs. This is a gigantic unemployment crisis, interspersed with a tsunami of bankruptcy filings, such as Hertz, each accompanied by more layoffs.

Eventually the job losses will end as more workers will return to work, and employment will start to rise, but from abysmally low levels. And unprecedented policy support, all-time lows in rates alongside a "lower forever" policy outlook will help support the eventual housing recovery.

But housing activity will not return to normal levels until employment has returned to normal levels – and having lost over 30 million jobs so far, this is just going to take a while. Further, with credit tightening, application rejection rates rising, more than five million loans in forbearance, delinquency rates doubling to 6% and continuing to rise, already acute supply conditions, declining international demand, underlying conditions will ultimately constrain the amplitude of any upside housing rebound.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Extreme monetary policy has not only artificially inflated capital but has also greatly exacerbated the boom bust cycle, leading to two once-in-a-generation economic crises in just over a decade."
– Jesse Felder, former hedge fund manager and founder of "The Felder Report"

There are all kinds of reasons to doubt the quick economic recovery narrative including over-leveraged zombie companies, the battered labor market, the second wave, etc. Everything is getting better. That is not the issue. The question is whether we will get back to pre-crisis levels. Getting to 70%, 80% or even 90% is not enough. Worldwide, excluding the U.S., cases are still growing. This virus is not slowing down and will keep the global supply chain impaired. To get to 100%, we need put the virus behind us – through a therapy or a vaccine.

Source: Cagle

As we move forward, the precarious and trudging recovery in labor and consumption will be occurring against a backdrop of slower credit expansion and depressed CapEx and global trade. Last Friday, Trump stated that China had "ripped off," "raided," and "gutted" U.S. industry while conducting "espionage to steal industrial secrets." In other words, global trade will continue to decline from already negative pre-virus growth and supply channels in disarray.

The economy will be slow to return as lockdowns end, leaving the world in a deflationary environment. That said, I do not think the current recession/depression will last anywhere near as long as the Great Depression, but I do expect it to scar this generation just as much. This is truly going to be the Rocky Mountain Recovery. Some sectors will boom, others struggle in the valleys before rising. There will be no V's or U's or swooshes or other letters. It will have exhilarating moments but also hard work and struggles.

Meanwhile, central banks can create the illusion of growth, not the real thing. Excessive debt inevitably slows growth. And the central bank has managed to reinflate the stock market bubble despite the economic weakness, but it is nothing but a Fed-induced sugar-high. Over at the Fed, when asked whether the Federal Reserve's latest actions would increase inequality, Chairman Powell replied, "absolutely not." Meanwhile, U.S jobless claims are now tracking in the vicinity of 40 million Americans. In short, it was just another totally "normal" week in the 2020 Twilight Zone – at moments shocking, surreal, and sad. All at once.

Central banks desperately trying every trick in the book to revive their economies can hardly be a comforting thought. An anemic level of economic growth, such as the one seen in Japan and Europe, has growth implications for the rest of the world.

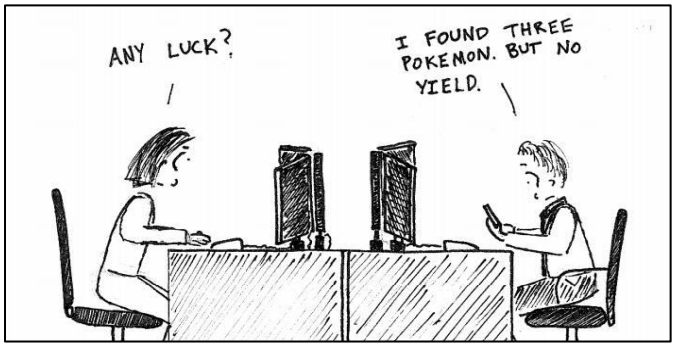
We appear to be turning Japanese. If so, the government will issue more and more debt and to keep rates low the Fed will buy that debt via excess bank reserves so it would not be inflationary.

Yield curve control has arrived. It is the **de facto** reality.

In terms of the rates markets, the Treasury will need to do a lot of borrowing. In January, the Treasury said it would borrow $360 billion in the first quarter; last week that number ballooned to $3 TRILLION. Meanwhile, the Fed is the buyer. As I have written previously, we are following the Japanese playbook to a tee. In Japan, there is no private securities market. The only players are the Japanese government and the BOJ. We will simply turn Japanese and have central banks buy the debt with excess bank reserves.

As such rates are likely to stay lower for longer.

The bottom line: If rates rise, lock in while the going is good.



Source: Cagle

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> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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– Shawn Nikkel, Finance Director of Denver Fire Department FCU

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– Darin Higgins, President of Western Illinois Credit Union

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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.