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INVESTMENT SERVICES

# Weekly Relative Value

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WEEK OF JUNE 8, 2020

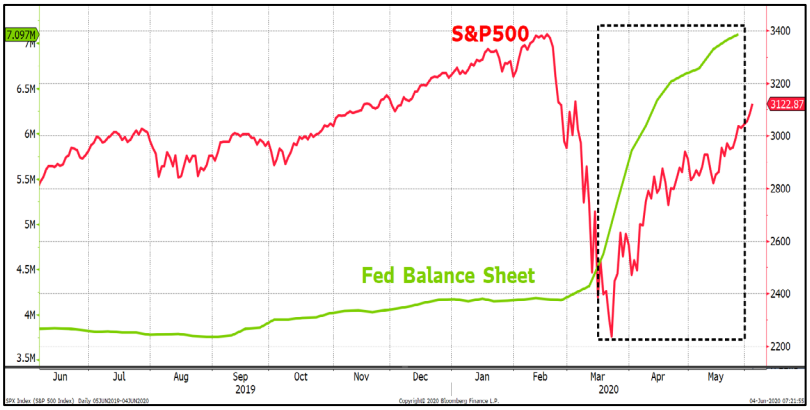
**THIS WEEK**

- FAKE NEWS
- THE YIELD CURVE STEEPENS
- YIELD CURVE CONTROL

**PORTFOLIO STRATEGY**

## The Madness of Markets

*"I understand people who bet on moral hazard. I understand people who bet on the Fed backstop. I don't do it. I don't think that's a good way to invest... I'd rather invest on the basis of fundamentals…This notion that it doesn't matter what happens to fundamentals. It doesn't matter what happens to corporate earnings. It doesn't matter what happens to economic growth... because the Fed will buy what I want to buy... that's the mindset of the market right now." – Chief Economic Adviser of Allianz Mohamed El-Erian*




*Source: Bloomberg*

We are experiencing the worst social unrest in 50 years. The global pandemic is ongoing. Earnings are plunging. The phase one trade deal with China is in shambles in terms of actual volumes. There is no vaccine, and while we've had a slowing of infections of wave one of the virus, it is still ravaging in places such as Brazil and Mexico and back on the uptick in countries that have reopened their economies. The jury is still out.

And employment? Companies continue to make layoff announcements, and more are to come.

And then there's this: The Dow is up almost 10,000 points (46%) since the March low. The Nasdaq 100 topped its all-time closing record in the most vertical and aggressive V-shaped rally ever.

To give you a sense as to how disconnected the markets have become from fundamentals, consider the graph below. The following measure is the price of the Wilshire 5000 market capitalization level divided by GDP. This, by the way, is Warren Buffett's favorite valuation

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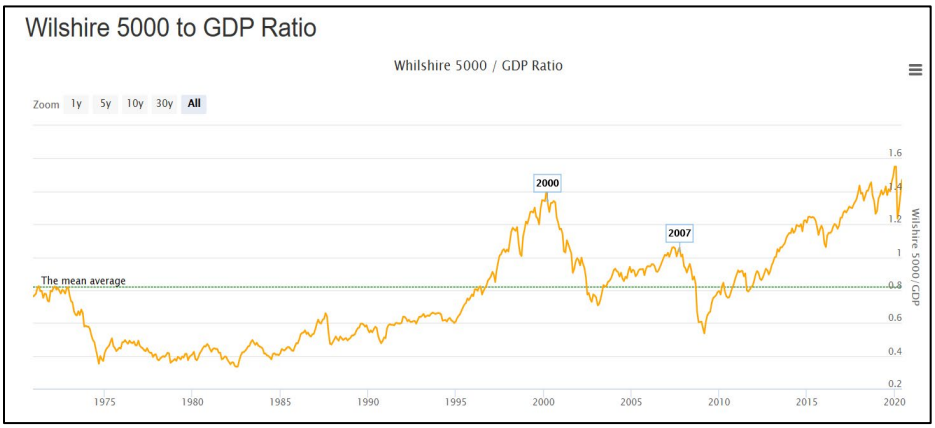
measure. Given that the stock market is not the economy, asset prices should reflect underlying economic growth rather than the "irrational exuberance" of investors.

There is no history that shows valuations above 150% market cap-to-GDP are sustainable. None. Normally, asset bubbles happen at the end of a business cycle. Now we have one with nothing and the global economy still in a recession, which also supports current valuation concerns. This might explain why Warren Buffet is sitting on $137 billion in cash.




*Source: LongtermTrends.net*

This is what you get when you have a market that treats a phase one trade deal as something better than the trade volumes that were in place before the trade war ever started. This is what you get when a market treats phase one COVID-19 vaccine trials as an actual vaccine already in place. This is what you get when a market prices in a perceived uptick in employment from a total collapse as an economy already having returned to full employment. But most of all, this is what you get when a market perceives the injection of trillions of dollars as a substitute for actual growth in the economy.

The market doesn't care about anything except the fact that the Fed continues to print money to support asset prices. The Fed and other central banks around the world have turned the monetary spigots on in a way that surely would have had the likes of Arthur Burns and William Miller (the Fed chiefs in the inflationary 1970s) spinning their heads.

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*"The bigger the business, the more it moves the major averages, and that matters because this is the first recession where big business… is coming through virtually unscathed… I think we're looking at a V-shaped recovery in the stock market, and that has almost nothing to do with a V-shaped recovery in the economy."*
*– "Mad Money" Host Jim Cramer*

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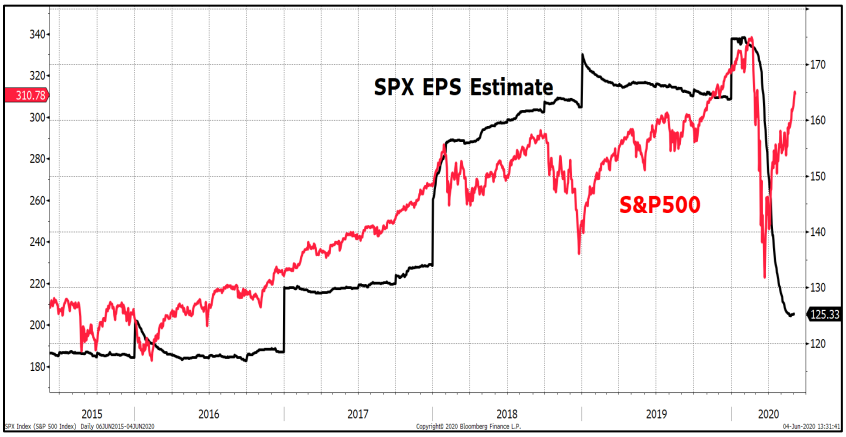
The Fed has expanded its balance sheet more in three months — by over 70% to $7 trillion-plus — than it did in the six years from December 2007 to November 2013. And there is indeed a 90% correlation between the Fed's balance sheet and the S&P 500. In the meantime, earnings are expected to sharply decline, and the forward price-to-earnings multiple has expanded in three months to 23x. Think about that. A full bull market lumped into three months and a valuation level that typifies a market peak as opposed to a trough.

From lockdowns to reopenings to curfews. It doesn't seem to matter.

Markets pretend that nothing's happened, and things are back to normal. But they aren't. Far from it, but that's the illusion purposefully propagated by central banks. Don't kid yourselves. The market is not forward looking. It's blindly

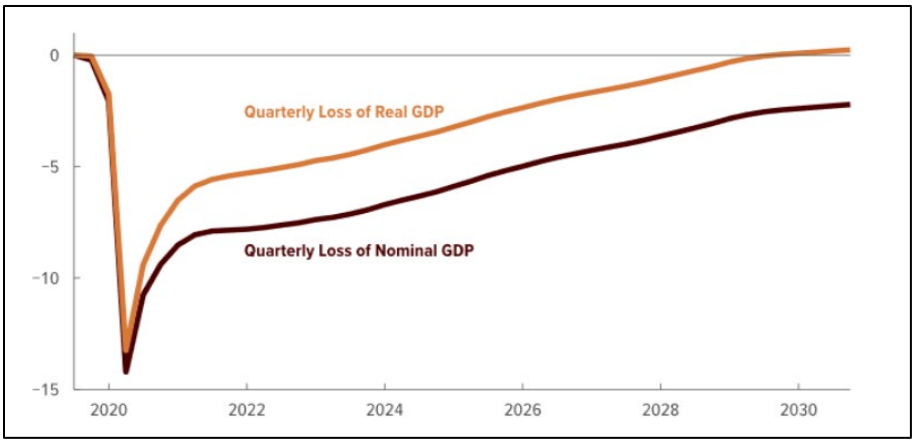
chasing liquidity and, by doing so, has blindly gone vertical and embraced, in my view, an unsustainable path of historical valuations.




*Source: Bloomberg*

As for fundamentals, the non-partisan Congressional Budget Office (CBO) is forecasting a 5.6% real GDP plunge for this year with hardly any rebound at all slated for 2021. And according to the CBO forecast, the economy will not recoup all of the devasting loss for at least eight years. Its entire forecast for U.S. real GDP has been marked down $7.9 trillion, or 3%, for the entire 2020-2030 period. So, call it a "no-recovery" recovery. The CBO is also forecasting a deficit-to-GDP ratio of 17.9% this year and a debt-to-GDP ratio of 101%; and the unemployment rate averaging 11.5% this year and staying just below 10% in 2021. And we still have the lack of earnings visibility and a wave of defaults and bankruptcies lying ahead of us.

**Percentage Difference in Nominal and Real GDP**
(Between CBO's May 2020 and January 2020 Projections)




*Source: CBO*

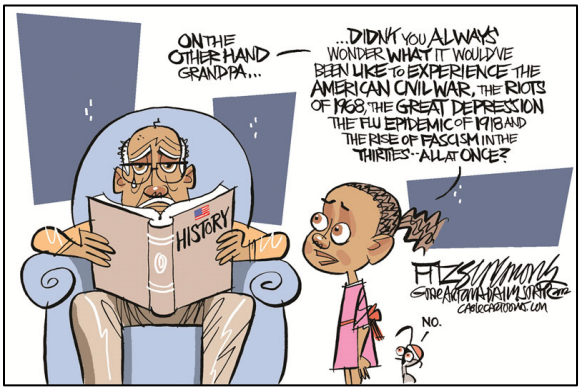
The markets have priced a V-shaped recovery into the fourth quarter and beyond. We all hope for a speedy V-shaped recovery, but we should be realists and understand that the odds of quickly rekindling the economic growth rates from the prior decade are poor. In other words, the recovery is most likely not a "V" or "U" shape. It resembles the Nike Swoosh logo with a sharp decline and a long period of recovery.

That said, we will have a recovery in the third quarter. That is obvious because of two things. The natural bounce from what looks to be a -50% annualized GDP plunge in the second quarter (Q2), which followed a 5% decline in Q1. All the high-frequency data are showing that we will finish Q2 with some positive momentum but, again, in the context of an absolute detonation. The key question is what happens after this bounce off the bottom.

## FAKE NEWS

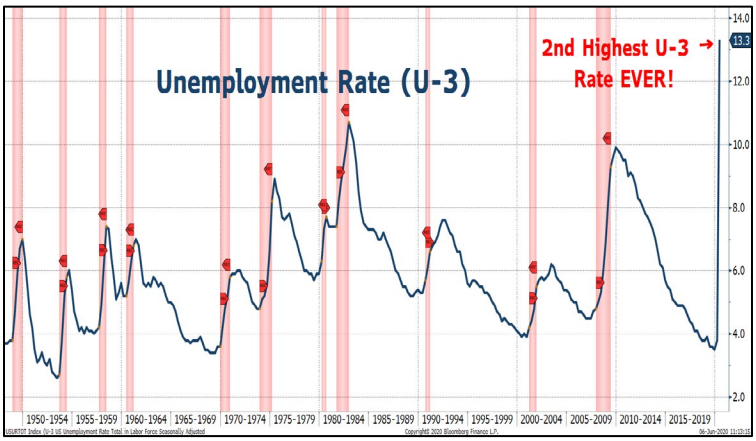
"Lies, damned lies, and statistics" – *Mark Twain*

In nothing short of a stunning report, the total number of jobs rose by 2.5 million in May compared with expectations for a decline of 7.5 million following the April collapse of 20.7 million jobs and the March plunge of 1.4 million jobs. Over the past three months – the period spanning the collapse of the U.S. labor market – employers reported shedding 19.6 million jobs.




*Source: Cagle*

Meanwhile, the unemployment rate, according the household surveys, fell to 13.3%, the second highest in the history of the data going back to 1948, after the record set in April (14.7%). The median estimate in a Bloomberg survey called for it to jump to 19%.

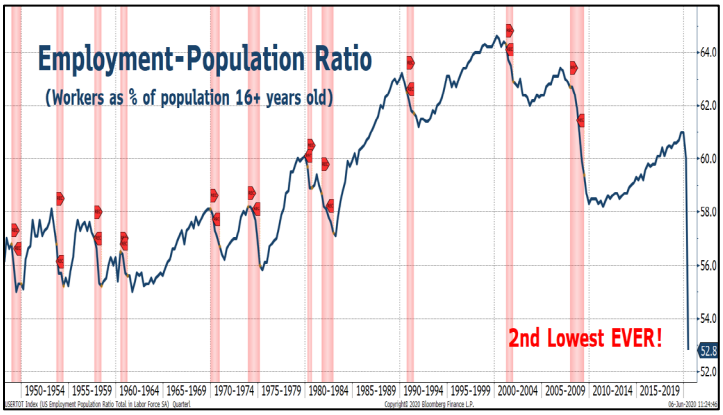



*Source: Bloomberg*

Importantly, the drop in the unemployment rate is due specifically to the substantial drop in the labor force. Since February, 6.3 million people have decided they no longer wanted to work, according to the Bureau of Labor Statistics (BLS). Such is substantially more than would be expected even based on the large increase in unemployment.

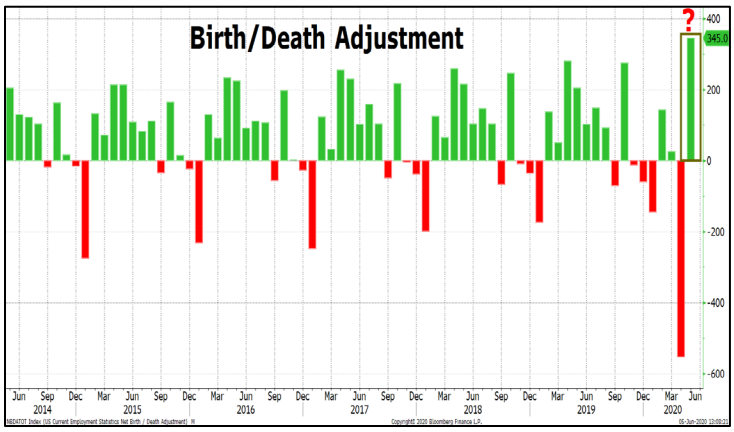
And none other than the BLS itself admitted that a **"misclassification error"** led to the unemployment rate being as much as 3% higher than reported if the surveys had been responded to correctly. In other words, the unemployment rate was 16.3% using their own data, which suggests the number of unemployed is closer to 26 million. While that number is down from April, it is still higher than any other unemployment rate in over 70 years. (But the 13.3% number was as well.)

The Employment-Population Ratio rose to 52.8% in May, the second-lowest rate in the history of the data going back to 1948, after the collapse in April (to 51.3%). This ratio is the percentage of people who have jobs compared to the overall working-age population (16 years and older). It includes full-time, part-time and gig workers.




*Source: Bloomberg*

And then consider this: according to the BLS report, which was based on a survey from May 10 through May 16, when virtually all of the U.S. was still shut down, the government decided that a record number of new businesses were formed.




*Source: Bloomberg*

According to the BLS's birth/death model, which is used to adjust the raw payrolls data for estimated new business openings and closures, a record 345,000 new jobs were created due to new businesses opening in a month when – I will

repeat again – the U.S. was largely shut down! This also means that over 60% of the business closures from the month of April (April birth/death -553,000) were somehow undone in a month when the U.S. was still mostly closed down.

Needless to say, this was another statistical adjustment, one which even the BLS felt ashamed of, because in a little-noticed addendum to the jobs report, the BLS announced it had made "changes" to its net birth-death model due to the coronavirus pandemic. Changes which apparently included the modeling of massive business reopening when millions of small businesses were shutting down.

In short, instead of another 553,000 drop in jobs due to massive shuttering (as was the case in April), the BLS decided to "add" 375,000 jobs because, well... it felt like it. And that is how you get an almost one million swing in monthly payrolls based on nothing more than a statistical revision.

But wait, there's more. According to the American Dental Association, there are just over 200,000 dentists in the U.S. So how surprising it must be that at a time (as a reminder the survey was from May 10 through May 16) when most dental offices across the U.S. were still shuttered (and in places like California, they still are), a record 245,000 dentist office jobs were added, effectively undoing half of all the April job losses in this job category.

How can one explain any of this?

This report was laden with statistical noise and distortion. If you want an example of fake news, this report is it.

That said, it's good to see that the catastrophic collapse of the U.S. labor market has bounced off what hopefully was a bottom, as some people – particularly those working in restaurants, bars and retailers, but also in many other businesses – have returned to work, while continued job losses occur at other operations and hit other people. The overall job market remains in an abysmal condition, though slightly less abysmal, and has a long road ahead to full recovery. In other words, don't expect full employment anytime soon!

## THE YIELD CURVE STEEPENS

The U.S. yield curve has been steepening quickly, led by the long end of the curve. The 30-year Treasury yield has risen for five days in a row, closing on Friday at 1.67%, up from 1.41% on May 29, and up from 1.17% on April 20. This is the highest level since March 19, when the Fed was unleashing its multi-trillion dollar "Everything Bubble Bailout."


*Source: Bloomberg*

The 10-year benchmark yield closed at 0.90%, the highest since March 26, and has broken through the top end of the range it's held since the end of March. Obviously, these yields are still in the financial repression torture basement, but the rises are showing some impatience in the market.

While the long end of the curve has taken the brunt of a Treasury market sell-off, the short-term yields are just a hair above zero, with the three-month yield at 0.13%. This makes it the steepest yield curve since October 2017, when measured by the spread between the two-year yield and the 30-year yield, which has widened to 146 basis points.


*Source: Bloomberg*

Most notably, the spread between five-year notes and 30-year bonds widened to 126 basis points, a level unseen since December 2016. And this steepening of the yield curve has been happening although the Fed has bought $1.6 trillion in Treasury securities since early March, as part of its $2.9 trillion Everything Bubble Bailout.

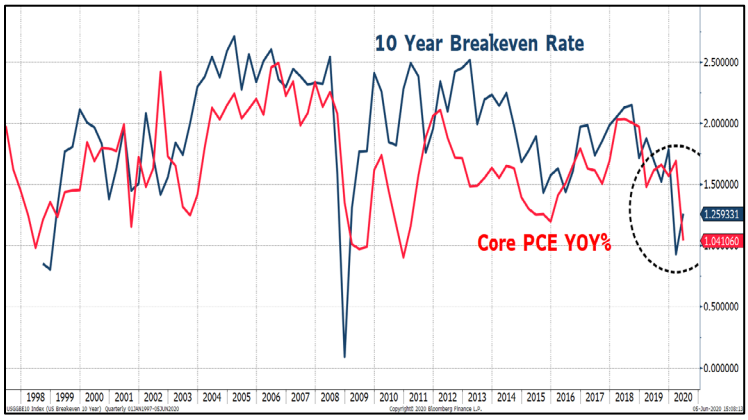
So, what's going on?

When a yield curve steepens, it is sometimes reflecting a strong economy. And that would be a good thing. But this is the worst economy in our lifetimes, and any improvement – there will eventually be some improvement – will just make the economy a little less terrible.


*Source: Bloomberg*

Currently, the Treasury market is being impacted by the massive combined forces of Fed interventions and government borrowing. Futures pricing suggests the target policy rate will be at the zero-bound for at least the next five years, and that's keeping front-end yields pinned down. The prospect massive deficit spending to lift the economy out of the deep recession, meanwhile, is driving up the longer end.

Rather than seeing a strengthening economy, markets might be worrying about inflation, given this massive money experiment in combination with trillions of dollars in government stimulus spending. But that's tough to reconcile with a 10-year breakeven rate around 1.2%, which implies the Fed's preferred inflation measure will be little more than half the 2% target over at least the next decade. Core personal consumption expenditures (PCE), which exclude food and energy components, declined to 1.04% in the 12 months through April. The median assigns 25% probability to the likelihood that year-over-year core PCE inflation drops below zero for at least three consecutive months in the next two years. The U.S. hasn't experienced a similar bout with deflation in records going back to 1960.

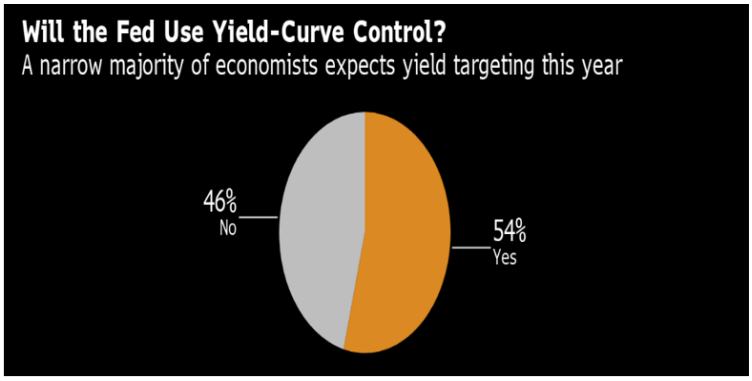



*Source: Bloomberg*

The Fed is not likely to react to inflation, having already hammered home many times that interest rates are going to stay low for a long time. Markets see this too. If consumer-price inflation takes off under the combined pressure from money-printing and stimulus-spending, while wages cannot keep up because of high unemployment, this will further crush those that make a living by working. The rise in yields, and the steepening of the yield curve, might be an expression of a growing distaste for this type of scenario.

## YIELD CURVE CONTROL

The Fed could still impose "yield curve control" (YCC) over the market, where it essentially pegs long-term yields via forward guidance and by buying long-term bonds to maintain the peg. YCC is aimed at lowering longer-term borrowing costs as a way of stimulating economic activity. New York Fed President John Williams said on May 27 that officials are "thinking very hard" about using the tool.




**If 'Yes,' When?**

If yield-curve control is coming, when will the FOMC announce it?

| | |
|---|---|
| June 10, 2020 | 7% |
| July 29, 2020 | 14 |
| Sept. 16, 2020 | 64 |
| Nov. 5, 2020 | 0 |
| Dec. 16, 2020 | 14 |
| H1 2021 | 0 |
| H2 2021 | 0 |

*Source: Bloomberg*

The Bank of Japan has been doing this for years.

Of those expecting YCC, most said the announcement would likely come in September. Just over half of economists surveyed by Bloomberg said they anticipate the Federal Open Market Committee will eventually set target yields for certain maturities of Treasury securities with two- or five-year maturities targeted.

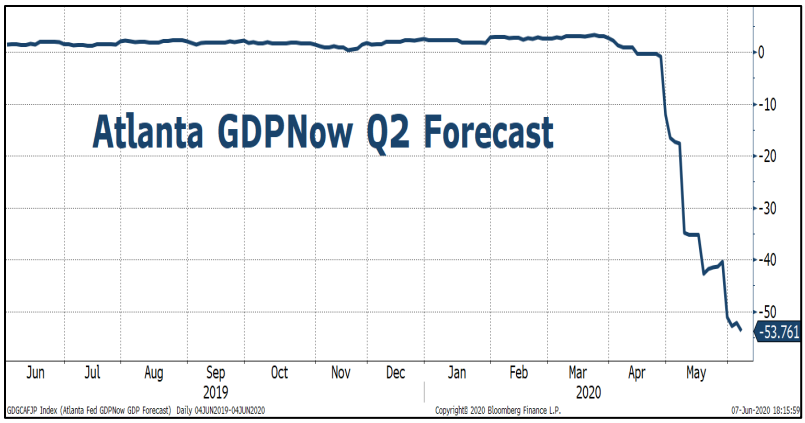
## MARKET OUTLOOK AND PORTFOLIO STRATEGY

I hear that there is no relationship between riots and markets. I hear tensions between the U.S. and China will not be allowed to escalate and "Phase One" will not be jeopardized. I hear more Fed and fiscal stimulus (aimed at the state and local governments) is on its way. I hear that a vaccine or a treatment are coming soon. I hear that there are few pockets of any second wave with the reopenings. I hear people are moving around and driving around and starting to spend more.

Risk assets have long been suggesting the worst economic damage is in the rearview mirror. I don't buy it! My take on this is asset markets simply have become far too detached from the economic fundamentals. I am watching this fantasy show from the sidelines.

Longer-term rates have risen over the past few days but it's easy to forget that the 10-year Treasury yields at less than 1% are historically unprecedented and signal a highly pessimistic view of the U.S. economy in the decade to come. And should money velocity reverse course, inflation may rear its ugly head. But not anytime soon. We remain in a deflationary demand economy. When you have one in every five Americans either unemployed or underemployed, even after what was a so-called blockbuster jobs report, there simply is still too much idle capacity to be bidding up inflationary expectations at the moment. That's why Treasuries and high quality debt are a very good buy right now. Growth may well come; inflation isn't for a long time.

As we move forward, there will be stops and starts in terms of economic data. Market volatility will remain high until there is greater clarity on the future. The Fed is unlikely to raise rates anytime soon. The market does not anticipate the Fed to lift rates off zero until 2023. And while longer-term rates will "zig and zag," a long-term bear market in bonds is a low-probability scenario.




*Source: Bloomberg*

The issue at hand is the markets have priced in a V-shaped recovery, which is well ahead of what the economic data suggest. Such was seen in Friday's employment report fiasco. In a risk-off rotation, money will flow into bonds from equities. Given bonds are deeply oversold, versus a grossly overbought equity market, that rotation is likely coming sooner rather than later.

We continue to believe that cash will be a poor performing asset and credit unions should continue to invest excess cash reserves while maintaining a diversified high-quality ladder strategy. The recent sell-off provides an excellent opportunity to take advantage of the recent sell-off in the bond markets.

## 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

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> – Rhonda Schroeder, CEO of Blackhawk Area Credit Union

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## MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (800) 782-2431, ext. 2753.

**Tom Slefinger**, Senior Vice President, Director of Institutional Fixed Income Sales, and Registered Representative of ISI has more than 30 years of fixed income portfolio management experience. He has developed and successfully managed various high profile domestic and global fixed income mutual funds. Tom has extensive expertise in trading and managing virtually all types of domestic and foreign fixed income securities, foreign exchange and derivatives in institutional environments.

At Alloya Investment Services, Tom is responsible for developing and managing operations associated with institutional fixed income sales. In addition to providing strategic direction, Tom is heavily involved in analyzing portfolios, developing investment portfolio strategies and identifying appropriate sectors and securities with the goal of optimizing investment portfolio performance at the credit union level.