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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JUNE 15, 2020

THIS WEEK

- NBER CALLS IT
- REOPENING
- FISCAL CLIFF AHEAD
- HOW HIGH WILL IT GO?
- 2020 ELECTIONS

PORTFOLIO STRATEGY

The Grand Illusion

"Welcome to the Grand illusion
Come on in and see what's happening
Pay the price, get your tickets for the show
The stage is set, the band starts playing
Suddenly your heart is pounding
Wishing secretly you were a star"
- Lyrics to "The Grand Illusion" by Styx

As the second quarter economic backdrop gets further downgraded, the S&P has plunged -34% from its peak to the trough to back up +44% to be unchanged on the year. From the intra-day lows three months ago, the S&P has rallied a massive 47%. And the tech-heavy Nasdaq has risen more than 11% in 2020. From March's low to last week's highs, the Wall Street narrative machine has been in full force – fully loaded with "V-shaped recoveries," "2020 earnings don't matter," "Trump is reopening the economy" and "Fed liquidity is bullish."

Source: Bloomberg

Speculation abounds. Caution gas been thrown to the wind. As I have been saying for months, the equity market has become a casino. From mid-March to early June, Fed Chair Jay Powell became a blackjack dealer handing out chips for free.

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"It's the mother of all 'money illusion' rallies. In 3 months, the Fed juiced up M2 by a cool $2.5T, and the S&P 500 mkt cap surged dollar for dollar. Who needs earnings? Who needs productivity? Who even needs buybacks anymore? MMT arrived early and with a Republican in office!!"
– David Rosenberg, Chief Economist & Strategist of Rosenberg Research & Associates Inc.

Between March and May, new retail accounts at Robinhood have explode higher from 12 million to 36 million. At Fidelity Investments, new accounts rose 77% to 1.2 million from a year ago! TD Ameritrade is averaging 3.5 million client trades a day so far in June, which is insane. Let's think about this. Over 20% of Americans are unemployed and wages and salaries are down 8.5%. So where is the money coming from? Government transfers to individuals. Where has the money gone? Online trading. This is akin to the soup lines being debited to your bank account, but not going for soup.

Consider the following pithy quote from the Wall Street Journal article: *New Stock Investors Take On Risk Where Pros Fear to Tread*

"Stocks only go up; this is the easiest game I've been part of! … It took me a while to figure out that the stock market isn't connected to the economy. I tell people there are two rules to investing. Stocks only go up, and if you have any problems, see rule No. 1." – Dave Portnoy, founder of Barstool Sports

A woman is quoted as saying the following as she put her $1,200 stimulus check into the market.

"It was basically free money, so, you know, I decided to play around with it. You might lose some, you might win some. It's like a gambling game. You can make a pretty good amount of money in one day."

Seriously? Imagine a system where stimulus checks are used to open commission-free stock accounts to trade!

In the same article an electrician said:

"I do not necessarily miss sports that much because there are other things that entertain me far more, i.e., the stock market."

Or how about this one: an out-of-work salesman put his life savings into Hertz shares (trading at a buck and change) on June 4 and a day later doubled his money and put a third of his winnings right back into the stock. This guy said:

"I'm happy with doubling my savings overnight. Where else are you gonna find that?"

I started in the business in 1980. At that time, companies issued debt and equity to fund capital expenditures to grow their businesses to increase revenue and earnings. Now companies issue gobs of debt to buy back their own shares to artificially increase their earnings-per-share and drive their stock prices higher. The corner suite loves it. But tell me, does that create durable employment, wealth and income?

In essence, we have morphed from a "real" economy, using the markets to grow business, to a financial economy, leveraging debt and stock buybacks to create paper wealth. The "wealth" is not generated from producing goods and services. And make no mistake, the past decade was one of financial engineering on steroids.

If Adam Smith could see what was happening, he would be rolling over in his grave. Unfortunately, most Americans don't even know who Adam Smith is anymore.

Never in the history of modern U.S. history have stock prices skyrocketed as the U.S. economy plunged into a recession. What we have been witnessing is extremely bizarre. Bullied around by algorithms and six million or so stimulus-funded Robinhood accounts, narratives can drive the momentum in markets… for a while anyway. This truly is the grand illusion. And it will be fascinating to see how long it can last. Anyone remember the dotcom bust?

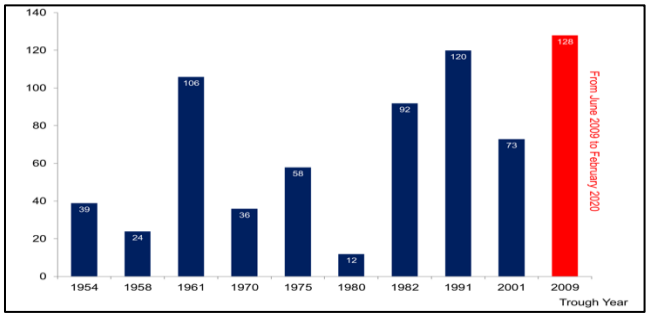
NBER CALLS IT!

"Economic impacts are dire everywhere. The recovery will be slow, and the crisis will have long-lasting effects, disproportionately affecting the most vulnerable people."
– Organisation for Economic Co-operation and Development (OECD)

While it should hardly come as a surprise to anyone who can fog a mirror, the National Bureau of Economic Research (NBER) – the official arbiter of whether America is in recession or not – issued a statement confirming that February 2020 marked the end of the expansion that began in June 2009 and the beginning of a recession. This was the longest period of economic expansion in U.S. history at 128 months.

As an aside, the NBER dated the start of recession prior to the peak pandemic fear and lockdowns, in a clear sign (as I have been arguing for some time) that the pace of activity was in decay prior to the health crisis.

Economic Recoveries (Months)



Source: NBER

The good news is it appears that the economy has bottomed in April. The only question is how strong will the recovery be.

A day after NBER announced the recession began in February, the World Bank issued a warning that even with all the gobs of stimulus and massive rebound in risk asset prices, this still will go down as the weakest year for the global economy since the end of World War III (real GDP -5.2%). Not to mention ranking as the top four worst downturns of the past 150 years.

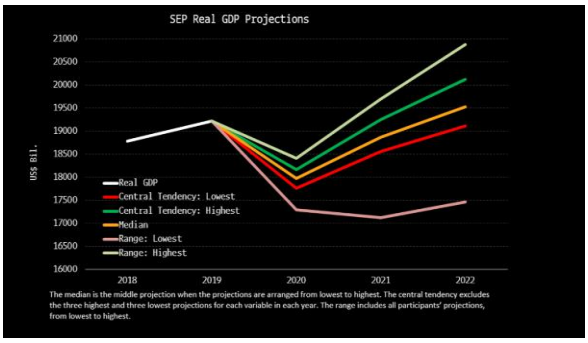
In confirmation, the OECD reported a day later that it expects the world economy to contract by 6% this year if a second wave of infections and containment measures "can" be avoided. If there is a second wave of the virus, the OECD sees a 7.6% contraction. It also warned that any recovery would be uneven, echoing sentiments from the World Bank. In the U.S., the OECD sees GDP contracting 7.3% in 2020 and at an 8.5% rate if a second outbreak occurs.

Finally, the Federal Rerserve sees GDP plunging 6.5% in 2020 (before bouncing back to a 5% gain in 2021). And while Fed Chair Jerome Powell vowed to continue aggressive stimulus "and keep interest rates near zero for years," the updated Summary of Economic Projections showed GDP not returning to pre-crisis levels until 2022.

Powell struck a cautious note on jobs, undercutting the hopes for a V-shaped recovery. And this is one reason why. Coresight Research found that as many as 25,000 U.S. stores will be closing permanently this year. This is a depression, not a recession. A painful post-pandemic restructuring of the economy could mean a protracted period of high unemployment across major advanced economies.

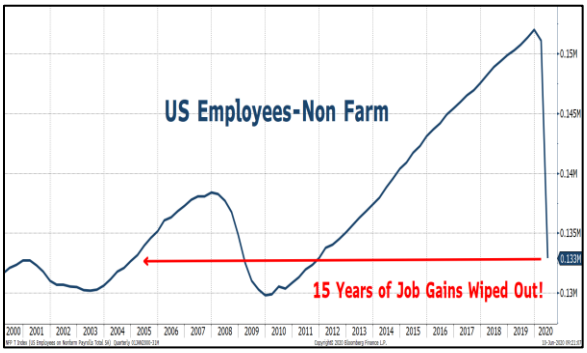
"My assumption is that there will be a significant chunk, well, well into the millions of people who don't get to go back to their old jobs and there may not be a job in that industry for them for some time. It could be some years before we get back to those people finding jobs." – Fed Chair Powell

Nearly 3 Years for Pre-Virus Levels to Return



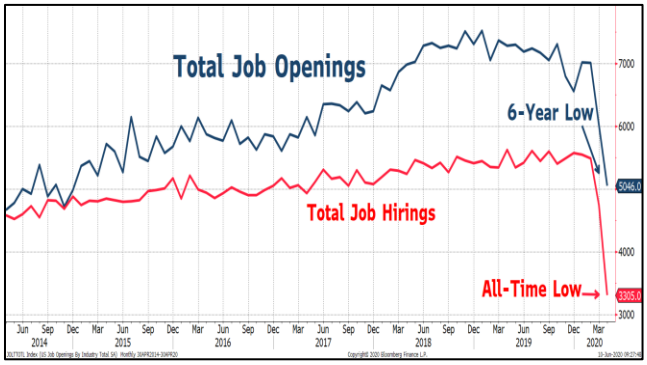
Source: Bloomberg

Powell expects unemployment to end the year at 9.3% and projects that the unemployment rate will fall slowly back to 5.5% by the end of 2022 – still well short of what most economists consider to be maximum employment (estimate 3.5%). Look at the following graph, which shows the utter devastation in the labor markets. Since the pandemic, 15 years of jobs have been wiped off the slate. Again, 15 years of job gains lost!



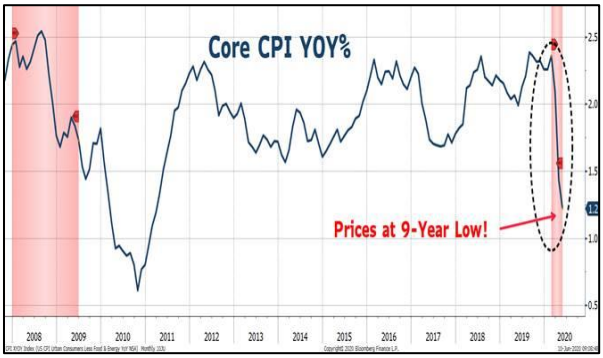
Source: Bloomberg

And last week, the Job Openings and Labor Turnover Survey (JOLTS) data showed that job openings slumped to a six-year low and new hirings plunged to an all-time low. There are 18 million more unemployed workers than there are job openings, the biggest gap on record. As a result, there were about 4.5 unemployed workers for every job opening. Layoffs amounted to 7.7 million in April; the second highest amount of "pink slips" ever handed out for a single month; more than three times anything we saw in the 2008-09 Great Recession. If this data is accurate, then hopes for a sharp rebound in the labor market will be dashed because employers are simply not hiring.



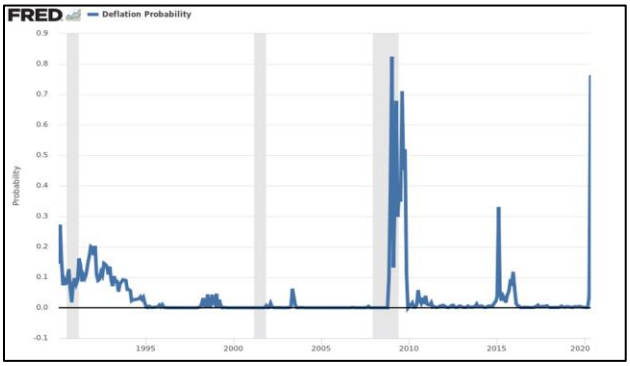
Source: Bloomberg

Over the same period, the Fed expects inflation to remain below 2%, its definition of stable prices – and Chair Jerome Powell hinted in his press conference that the path back to the 2% target might be very long indeed.



Source: Bloomberg

One thing is for sure — the near-term outlook is one of deflation. The St. Louis Fed measure of deflation risk has soared to 78%. Over the past three decades, the number has only been this high one other time (January 2009).



Source: St. Louis Fed

The Fed does not expect a V-shaped recovery and neither do I. As discussed last week, a 'swoosh' recovery is a more likely scenario. In other words, after a sharp downturn, it will take years for the economy to recover to pre-COVID economic levels.

REOPENING

"[The infection won't] burn itself out with mere public health measures… We're going to need a vaccine for the entire world, billions and billions of doses." – Dr. Anthony Fauci

The excitement is all about the reopenings and the willingness of people to go out and spend. But COVID-19 is not behind us. Last week, Dr. Fauci called the coronavirus pandemic his "worst nightmare" and warned that the outbreak is far from over.

Source: Cagle

Remember a few months ago when the financial markets were literally freaking out over one million confirmed coronavirus cases? Today, that number is nearing eight million globally. The U.S. has more coronavirus cases than any other country, with about two million, and leads the world in pandemic deaths with more than 112,000. Last week Houston warned they are experiencing the highest rate of COVID-19 since the pandemic started. Officials are on the verge of reimposing stay-at-home orders.

"There is no second wave. I don't know where that got started on Wall Street."
– Larry Kudlow, National Economic Council Director

No matter how many times Larry Kudlow insists the U.S. won't resort to another round of lockdowns under any circumstances, investors will inevitably pay close attention to the infection and hospitalization numbers out of the country's second class of hot spots: California, Florida, Texas, Arkansas and the roughly 20 other states where infection rates are climbing. At the same time, the pandemic is just getting started in Latin America and Africa. And even in the places where it is under control, economic conditions are not remotely back to normal. Many are still staying home (and I believe, rightly so, if they are in a vulnerable group).

That said, I am certain the economy will not be "locked down" a second time regardless of the severity of the outbreak. Politicians have learned their lesson. As U.S. Treasury Secretary Steve Mnuchin said last week.

"We can't shut down the economy again." – Treasury Secretary Steve Mnuchin

However, the risk of a secondary infection will deter consumers from returning to the economy.

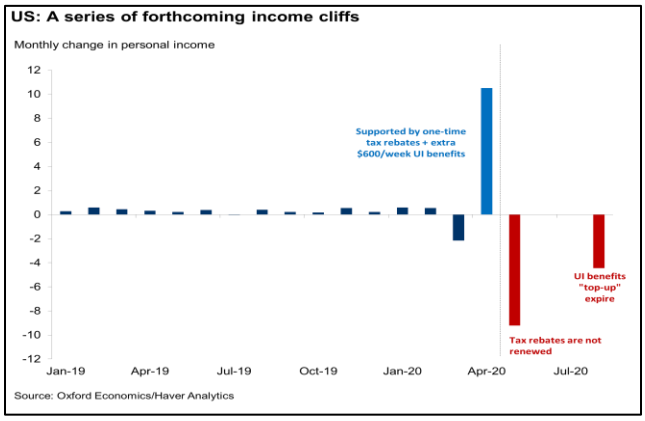
The partial reopening of the economy did lead to some hiring last month but going from zero staff to a skeleton crew with a limited opening is one thing. Getting back to full employment, which will require substantially increased demand, is quite another.

Importantly, the government's Paycheck Protection Program (PPP) certainly boosted employment in May. However, while the program "encouraged businesses to keep people on payroll," if demand doesn't return before the money runs out, layoffs will rise.

So, while "hope" is high that the virus is behind us, that there will be no "second-wave," that a vaccine will be available by year-end and more stimulus is on the way, there are many things that can go wrong.

FISCAL CLIFF AHEAD!

Consumers remain cautious about the future, and with good reason. Beyond disappointment over the expected V-shaped recovery and the timing of any vaccine, the prospect of a fiscal cliff post-July is fast approaching.



Income has risen by 12% and savings (as a percentage of disposable income) is now to over 30%, the highest ever on record. This is the result of $3 trillion stimulus packages passed over the last two months. An extra $600-a-month federal unemployment benefit helped replace the lost income for many. For some, the unemployment benefit is more than they were making prior. It actually sparked the largest monthly household income jump ever. Who knew?

But as shown in the previous graph, most of those temporary benefits will expire soon. Federal unemployment goes away July 31. The various loan extensions/foreclosures/evictions also begin to come back in the third quarter.

The theory is that the economy will be back, everyone will have their jobs, and that life can go on. But who actually believes that? Maybe, with luck, the economy can get back to 90% of the pre-COVID levels, but if that occurs, we are still looking at an ugly downturn from where we were in 2019. As noted above, the OECD and others say it will take five

years or more to fully recover. It is easy to imagine 10% unemployment at the beginning of next year. A lot of small business just won't come back. Some large businesses, too.

I think it is safe to assume Washington will do everything possible (aka more stimulus) to minimize pain prior to the November election.

HOW HIGH WILL IT GO?

The most recent speculation is another $2 trillion stimulus package to win some votes! After that, all bets are off.

Over the past week alone, debt spiked $1 trillion. In five weeks, debt has exploded by $2.5 trillion and we are just eight months into the current fiscal year and public debt has skyrocketed to $26 TRILLION! Federal debt will almost certainly reach $30 trillion in 2021 from a combination of increased spending and reduced revenues. Add in another $3.2 trillion state and local debt. Already the national deficit is pressing against the $2 trillion mark (almost doubling in May from a year ago). The fiscal deficit-to-GDP ratio is 20% of GDP — three times what FDR ever ran in the 1930s.

I know some say debt does not matter, but the data say otherwise. I have repeatedly shown how excessive debt reduces potential GDP growth. So, the more debt, the slower the growth. Once again. Think Japan.

Source: Bloomberg

Debt is future consumption denied. Future generations (kids and grandkids) are being handed the bill. This is ''generational theft." Which means, if we want to keep spending, we must pay for it ourselves. Which raises the question, with what?

We are now past the point of no return. We can have a debt jubilee and a major reset.

More likely the answer seems to be with ever-rising debt and increasingly with monetization by the central banks.

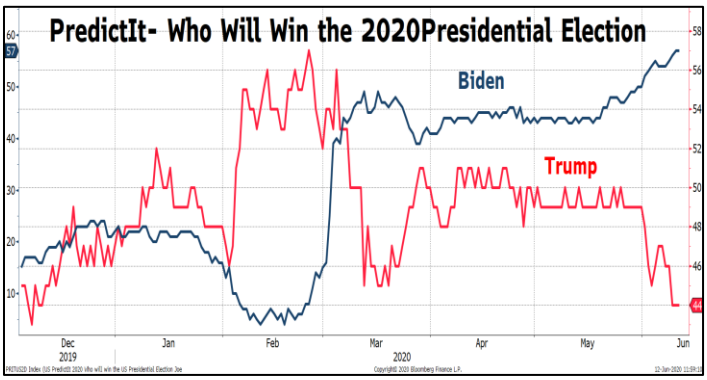
2020 ELECTIONS

Beyond disappointment over the expected V-shaped recovery, the timing of any vaccine and the prospect of a fiscal cliff post-July, the biggest risk in the coming months will be political in nature.

And don't look now, but the most recent Real Clear Politics poll average shows President Trump really lagging behind Joe Biden — 41% to 49%. And Mr. Trump's approval ratings have actually fallen in the past two months across every demographic — and what should be disturbing for him is that he trails Biden by 25 points among female voters.

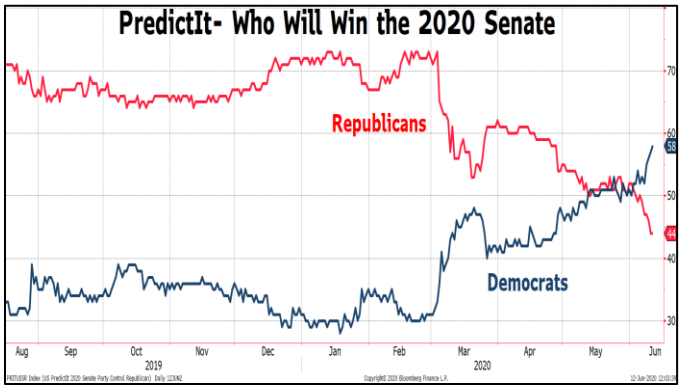
And it cannot possibly be good for any incumbent when the most recent Wall Street Journal/NBC News polls show 80% of the country to be "spiraling out of control." This isn't "fake news."

PredictIt is pricing in a sweep of the White House, Congress and the Senate for Democrats.



Source: Bloomberg

So, once we get beyond COVID-19, the focus will shift hard towards the November election. And this current group of Democrats is not one bit a friend to the S&P 500. This is not the party of Bill Clinton or even Barack Obama. Think Hubert Humphrey, George McGovern or Eugene McCarthy. I realize how politics for some is like discussing religion, so without angering anyone with anymore "facts," I will leave it here.



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"The issue at hand is the markets have priced in a '**V-shaped'** recovery which is well ahead of what the economic data suggests. 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."

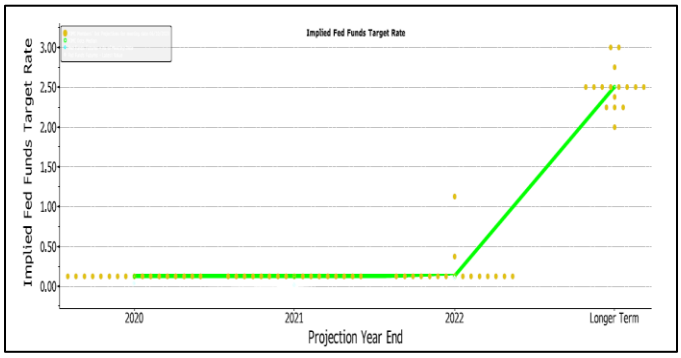
Last week, everyone said inflation was imminent and yields were going to the moon because of the V-shaped recovery. That was not our opinion whatsoever.

For the here and now, the Atlanta Fed GDP model is currently showing -48% quarter-over-quarter annualized "growth" for U.S. second quarter GDP. That compares to -42.8% in mid-May and -12.1% at the end of April.

Source: Bloomberg

As we move forward, COVID-19 is not behind us, and a V-shaped recovery is not ahead of us. More importantly, the Fed is forecasting at least two more years of below-target inflation and zero policy rates, not to mention the pledge to continue balance sheet expansion. And we now know that yield caps were discussed at the Federal Open Market Committees (FOMC) meeting.

Near Zero for Years to Come



Source: Bloomberg

"The usefulness of yield-curve control in the U.S. remains an open question… We will continue our discussions in upcoming meetings and will evaluate our monetary policy stance and communications as more trajectory of the economy becomes available." – Chairman Powell

You know what this is? It's Japan. The Fed is now headed toward the kind of "yield curve control" (YCC) Japan has had for years. The main result has been to snuff out Japan's bond market. Nominally, they still have one, but it doesn't matter because the Bank of Japan simply dictates the "market" rate. Meanwhile, their debt keeps growing and their economy doesn't.

Folks, this is all you need to know. The Fed is not raising rates for at least another 2.5 years. This is great news for Treasury notes and bonds (high-quality securities in general). The threat of "yield curve control" alone will render rate backups, as we just saw, as excellent buying opportunities. So, think of the long bond yield ultimately heading to 0.5%.

Source: Bloomberg

As stated repeatedly throughout the year, we continue to believe that cash will be a poor performing asset and credit unions should continue to stick with the tried and true "ladder strategy." Excess cash reserves should be invested in a diversified, high-quality ladder strategy.

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

> *"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.