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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JUNE 29, 2020

Flexibility Over Certitude

"I think we're off to the races in what will be a very strong V-shaped recovery."
– Larry Kudlow, White House Economic Advisor

After the longest economic recovery ever (128 months), the U.S. economy has succumbed to COVID-19. The National Bureau of Economic Research (NBER) – official arbiter of recessions – announced that the expansion ended as of the end of February.

Last week, the final estimate for first quarter (Q1) 2020 was reported at -5%. And as shown below, GDP for second quarter (Q2) 2020 will be much, much lower with economist estimates ranging from -35% to -50%.

Currently, and as shown in the following graph, the Atlanta GDPNow forecast is projecting that Q2 GDP will decline by 46%! If that figure is anywhere close to accurate, this quarter will be remembered as the most disastrous economic quarter that we have ever seen in all of U.S. history.

Source: Bloomberg

Many major industries, from live entertainment to air travel and even in-person shopping, remain in dire condition. International trade is looking very weak. Borders went up quickly once the virus hit and will go down much more slowly. State and local governments seem certain to lay off millions more workers in coming months, given the unprecedented magnitude of budget crunches.

THIS WEEK

- IT'S A MESS
- THERE IS NO "V" IN JOBS!
- SENDING MONEY SIX FEET UNDER
- THE "COVID 15"

PORTFOLIO STRATEGY

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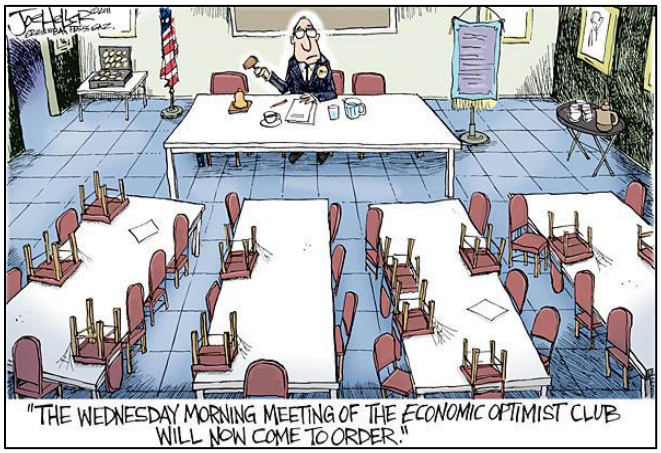
But rather than dwell on the vertical drop in the first half of 2020, the focus should be on the shape and strength of the nascent recovery taking hold. More specifically, what the path to recovery will look like.

In other words, will the recovery be V-U-W-L shaped?

Let's review the recovery scenarios.

1. V-shaped recovery: A sharp rebound that regains much of the output and employment lost by the end of this year.
2. U-shaped recovery: A long, drawn out recovery lasting years in which only a small share of lost output and employment is regained in 2020.
3. W-shaped recovery: A short-lived recovery followed by a severe drop in activity later this year (double dip) due to a second wave of containment measures.
4. L-shaped recovery: The economy bottoms at a very low growth rate and stays there. Japan is the stereotype for this scenario.

Stating the obvious, the best-case scenario is a V-shaped recovery. White House Economic Advisor Larry Kudlow, for one, is sure the economic recovery will last.



Source: Cagle

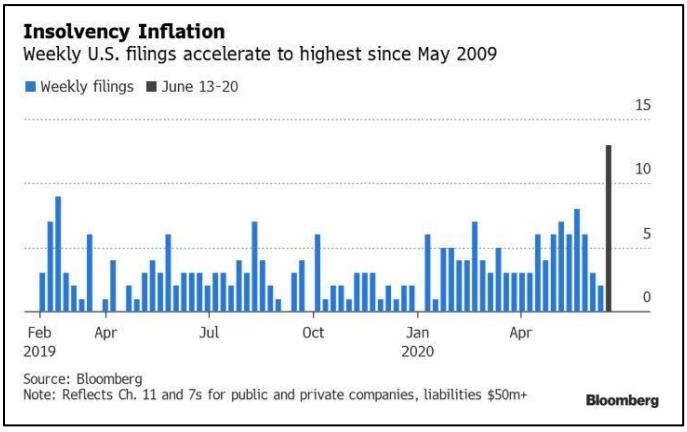
This is the bullish case and could transpire if the massive worldwide scientific race to develop a vaccine, or other medical treatments, reduces the need for social distancing faster than expected. However, it should be noted that there never has been a vaccine developed in less than four years and while there is a massive global effort in place, it is virtually impossible to make high-probability predictions on when we will have an effective and widely available vaccine. Hopefully, sooner rather than later, but hope is not a good investment strategy.

In the bearish case, a much slower U-shaped recovery would result from a second wave of COVID-19. It should be noted that a second pandemic wave is not a low-probability event. They are the norm rather than the exception. In this scenario, lockdowns would lift more gradually, and activity would be slow to recover to pre-COVID levels.

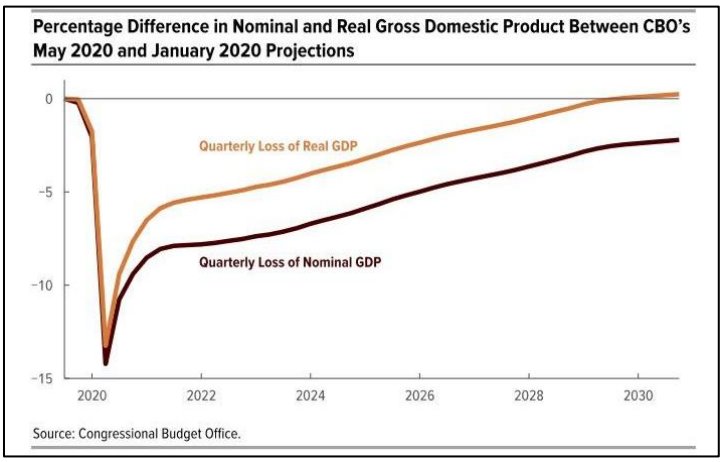
As I have highlighted for quite some time, many thought a recession was close even before the pandemic. The expansion had run longer than any other. Pent up demand had been exhausted and cracks were forming, and the main question was what would trigger a decline.

I thought we were headed for a credit crisis, centered on corporate debt. The Fed's decades-long easy money policies have many businesses leveraged to the hilt. That remains the case and we are already seeing the fallout from COVID.

According to Bloomberg data, no less than 13 U.S. companies sought bankruptcy protection last week, matching the peak of the global financial crisis**.** The filings were the most for any week since May 2009. High debt levels combined with low economic activity over the next 12-24 months would exacerbate the problem and force more companies to reduce, if not slash, investments and jobs. Meanwhile, our unelected and omnipotent Federal Reserve is busy stoking the fire of moral hazard by bailing out the junk bond market and just-above-investment grade corporate credits.



Needless to say, a double-dip W-shape in economic activity, caused by significant second waves, could easily turn a bad scenario into a very ugly one. Bankruptcies of companies, many of them small and medium sized that have thus far bridged the time to recovery with emergency liquidity, would become more likely, and many temporary layoffs would turn into permanent job losses. The all-important American consumer would turn much more cautious, save more and spend less. Thus, jobs, wages and bankruptcies will be key. Federal Reserve Vice Chair Randal Quarles is telling banks to prepare for a W-shaped double-dip recession.



And finally, there is the L-shaped scenario. The economy bottoms and then grows at a sub-par growth rate for years to come. Japan is the poster child for this outcome. For decades, Japan's growth rate has stabilized at approximately 1% and this experience has been often labeled the "lost decade." Will we follow in the wake of Japan?

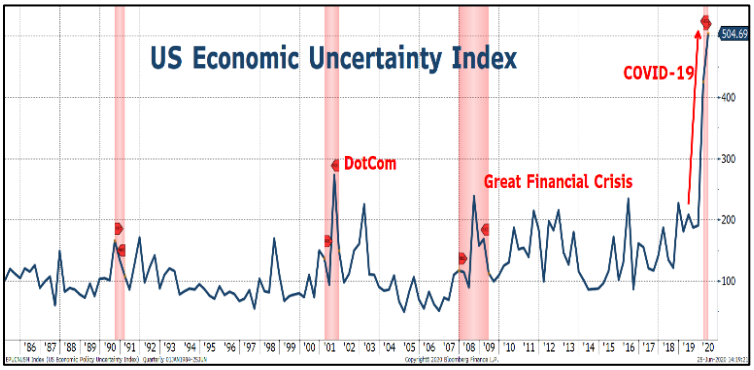
The shape of the recovery is critical in that it will directly affect the future of millions of unemployed Americans. It'll also determine the fate of many small business owners.

While we all hope for a rapid economic recovery, the consensus among economists is now that we'll see a U-shaped or "swoosh-shaped" recovery, where there's a sharp drop, a relatively small bounce back, and then a long period of subpar growth. The non-partisan Congressional Budget Office (CBO) is forecasting that it will take up to a decade for the U.S. economy to return to pre-COVID levels.

That said, the range of plausible forecasts is high and continues to shift. Frankly, as shown below, there's never been more uncertainty about the economic outlook.

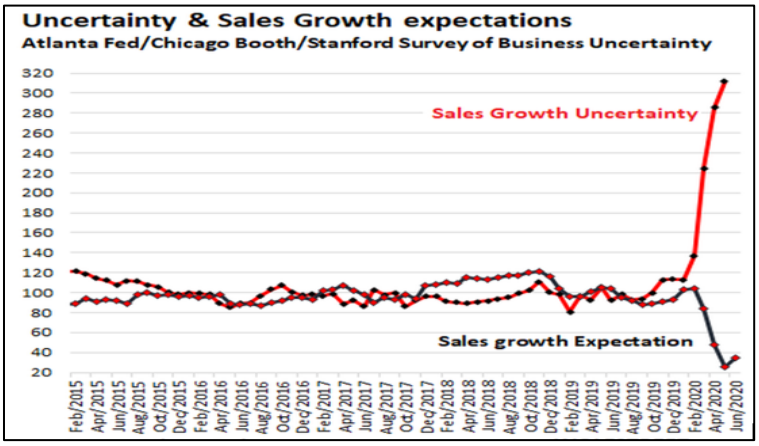
IT'S A MESS

As we move forward, there undoubtedly will be many twists, turns and surprises. And let's not forget – the underlying force behind the economy and markets is the pandemic. I definitely do know this: THE VIRUS DOESN'T CARE ABOUT RACE, POLITICS, RULES, ECONOMIES, GROWTH OR JOBS. It is what it is. A rapidly evolving COVID-19 pandemic could easily push the economy into better or worse trajectories over the next six- to 12-month horizon. Attaching probabilities to these scenarios is a fool's errand. Flexibility over certitude is the key to navigating the COVID recovery.



Source: Bloomberg

To further drive home the point of uncertainty, the Atlanta Fed conducted a survey of all businesses – small and large, nationwide, and cutting across all sectors. Respondents were asked what their expectations were around sales growth, employment and capital investment. The results are displayed in the graph below.



Source: Atlanta Fed

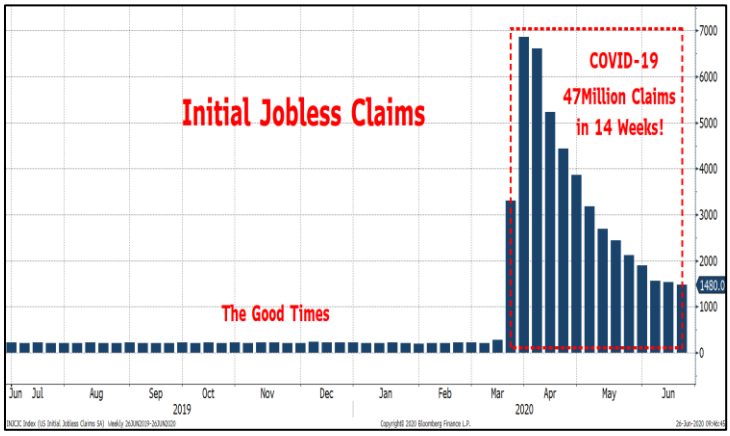
What these businesses are saying is this: They took a big hit in sales in June but still expected those sales to remain at low levels for the next 12 months. But they have no visibility over those 12 months, and have no clue how this will turn out, and lack any kind of confidence in their own expectations of where sales might go.

Practically by definition, a business decision maker has to expect sales growth, and has to figure out how to make it happen. That's part of the job. But it's going to be tough to plan and make long-term decisions with confidence unless visibility increases and certainty about their own expectations increases. From a business point of view, this is a mess.

In addition to the virus, there are underlying U.S.-Sino trade frictions as we head to the U.S. elections. A flare-up of the trade war could easily sap business confidence, tighten financial conditions, and derail a fragile economic recovery.

THERE IS NO "V" IN JOBS!

We have now endured 14 consecutive weeks of initial jobless claims topping one million (nearly 1.5 million last week). While a fraction of the six-million range in late March, it is still more than twice the magnitude of the spikes during the prior unemployment crises in 1982 and 2009, and approximately 6x the average weekly claims reported prior to COVID-19. The all-time record for a single week prior to this year was just 695,000, and that record had stood since 1982. But now we have more than doubled that old record for 14 weeks in a row.



Source: Bloomberg

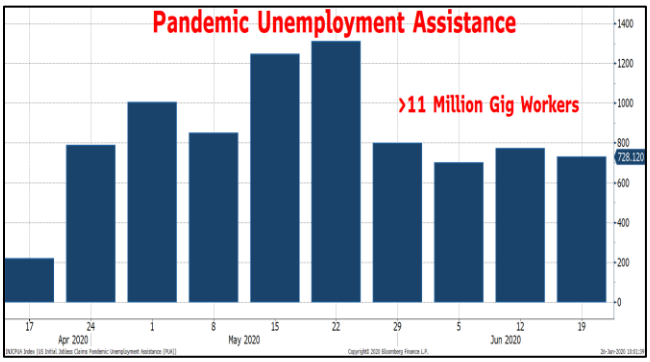
Even while workers in restaurants, bars, retail stores, hotels, hair salons, etc. are getting called back to work, it's corporate jobs that are getting axed now. Layoffs at small companies happen quietly, and we rarely see them in the news. But layoffs at big companies make the news, such as Macy's announcement that it will lay off 3,900 staff in corporate and management areas. This trend will continue. Big companies, including airlines, have already announced layoffs for the coming months. Many of them are well-paid jobs. This is one of the ways in which the unemployment crisis is shape shifting.

Likewise, states and municipalities are slow in laying people off, but the process has started. Budgets are in terrible shape, and everyone is counting on a federal bailout. But layoffs, shortened work hours, or partial furloughs are now being worked on around the country. Thus, we will have to add several million more late-stage layoffs to the 32,000,000 early-stage layoffs tabulated to date. Some of them have already happened.

An additional 728,000 filed for benefits from the Pandemic Unemployment Assistance (a federally funded emergency program aimed at covering workers who don't qualify for traditional unemployment insurance such as self-employed and independent contractors – aka gig workers). There are over 11 million individuals (at last count on June 6) receiving

federal Pandemic Unemployment Assistance. Gig workers now account for 36% of total state and federal unemployment rolls.

There is no escaping the conclusion that at this point, the jobs revival that many people were counting on continuing through the summer appears to be at risk. This underscores the pain that remains on Main Street.

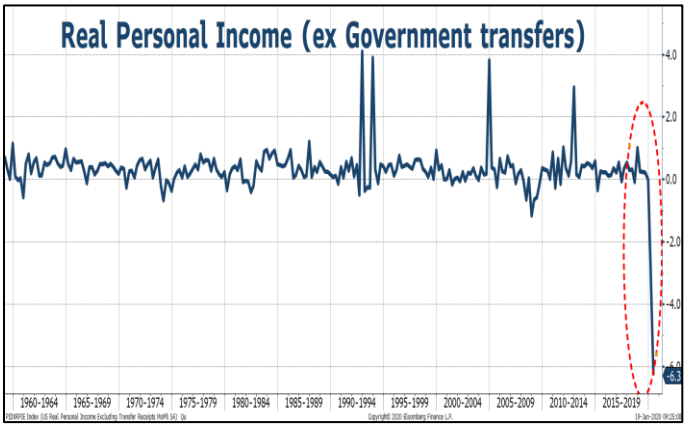


Source: Bloomberg

It should also be recognized that most haven't felt a severe income loss thanks to government programs and stimulus payments. Some are even making more now. Even more striking is that as of May, when total personal income was just shy of $20 trillion annualized, the government is now responsible for over a quarter of all income.

Putting that number in perspective, in the 1950s and 1960s, transfer payment was around 7%. The number then jumped again after the financial crisis, spiking to the high teens. And now, the coronavirus has officially sent this number into the mid-20% range, after hitting a record high 31% in April.

But underlying this income boost is a massive decline in wages and salaries. In fact, real personal income – excluding government handouts – has witnessed the greatest decline ever.



Source: Bloomberg

But what happens to the U.S. economy when millions of Americans remain unemployed and fiscal "liquidity" dries up?

The policy cliff looms large in the back half of the year.

- In June, credit card and auto loan forbearance ends.
- On July 1, state and local budget cuts start.
- On July 15, delayed federal income tax check payments are due.
- On July 31, enhanced unemployment benefits roll off.
- On September 30, student loan forbearance programs end.
- On October 31, mortgage forbearance programs start to roll off.
- And then December 31, the PPP grace period ends.

The National Federation of Independent Business (NFIB) conducted a survey last week and found that 14% of employers plan to cut workers and more than 40% of business owners stated that there was no improvement in sales even as restrictions eased in most states over the past month.

The adverse impact of all this on consumer confidence is hard to estimate, but it will surely cause ever further reductions in consumption spending than we have seen to date. The impact on business confidence and investment spending should also be severe.

The next phase of this recession will be when demand stays low because people lack spending power. The open question is how widespread it will be, and that depends largely on health-driven behavioral decisions.

A V-shaped recovery without a vaccine is a fairy tale.

SENDING MONEY SIX FEET UNDER

According the New York Times, $1.4 billion in stimulus funds were sent to dead people. In fact, my dad who died over a year ago, received a $1,200 check this year. And yes, it was returned. But I do have some advice for Treasury Secretary Steven Mnuchin: Check the death records before sending out stimulus checks. The deceased aren't going to spend the money. "Haste makes waste," as my dad always said.

At some point, investors will take notice of what all this means for the November election. With that in mind, I recommend the lead editorial of the Wall Street Journal: *The Trump Referendum*. If you're a hardcore Trump supporter, I wouldn't bother, but the point is made that the President's approval rating has fallen below 40%, which is exactly where Jimmy Carter was at this time in 1980.

As the author states… *"President Trump may soon need a new nickname for 'Sleepy Joe' Biden. How does President-elect sound? On present trend that's exactly what Mr. Biden will be on November 4, as Mr. Trump heads for what could be a historic repudiation that would take the Republican Senate down with him."*

THE "COVID 15"

"You have an individual responsibility to yourself, but you have a societal responsibility, because if we want to end this outbreak, we've got to realize that we are part of the process"- Dr Anthony Fauci

According to a Wall Street Journal article, *The Covid 15: Lockdowns Are Lifting, and Our Clothes Don't Fit*, most of us have added an extra 15 pounds to cure our anxiety and boredom while getting less exercise. Time for us to get back in shape.

By the way, the COVID-19 crisis is far from over as 33 of the 50 U.S. states are seeing their case count back on the uptrend. U.S. governors are pausing their plans to reopen their states as the case count sets new records. Texas has halted its reopenings altogether as Houston has run out of ICU beds. North Carolina, Louisiana, and Kansas just put their plans to loosen restrictions on pause. Even in Florida, Governor Ron DeSantis is putting a hold on his reopening plan, and in Arizona, which just saw the biggest single-day increase in hospitalizations (183 to 2,453), is being pushed in that direction.

The University of Washington's Institute for Health Metrics and Evaluation is projecting that COVID-19 deaths, currently at 145,000, could rise more than 45%, to 180,000, by October. The stock market promoters say don't worry, it's only old people. If you are looking for morality, don't listen to Wall Street!

Folks, this is still the first wave. We haven't even seen the second wave yet. Yes, more and more stimulus will be forthcoming but, at some point, the markets will see this as government and central banks merely throwing spaghetti against the wall.

The good news (I think) is that baseball has agreed to a 90-game season. Play ball!

Source: Cagle

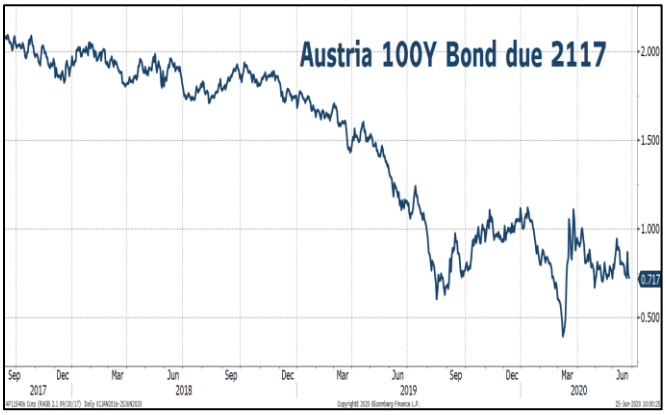
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The economy rode the elevator down but will have to climb the stairs back up."
– Richmond Fed President Thomas Barkin

Declining economic growth and inflation, combined with monetary intervention, have driven yields lower and lower. The graph below shows benchmark U.S. Treasury securities are trading close their record lows. Yet yields appear to have either paused or found their bottom after a dramatic tumble this year.

As a reminder, the U.S. remains one of the "highest" yielding bond markets in the world. To wit: as bizarre as the present bond market seems, Austria returned to the century-bond club last week with a new ($2.3 billion) 100-year debt issue with the stunning yield of just 0.88%.

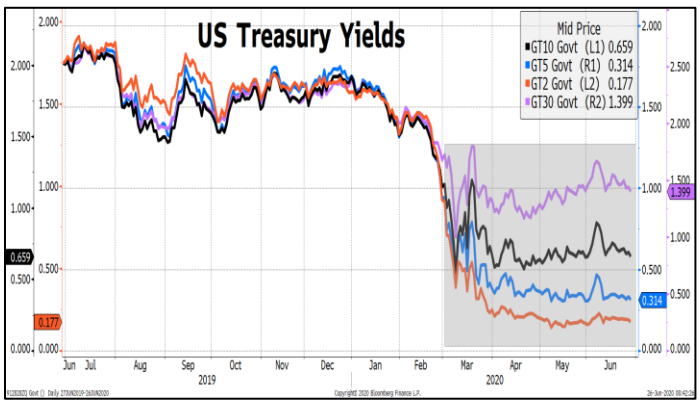
That's right. In the "new abnormal," investors are willing to lock in a paltry return below 1% for 100 years, and they are doing so in droves. Get this. The auction was 8x oversubscribed with over $17.7 billion in demand for the bond**.** The strong demand came from pension funds and insurance companies looking for ultra-long assets to match their future liabilities.



Source: Bloomberg

Austria is not alone: in the past, Ireland and Belgium also issued 100-year debt but in private placements, while France and Italy both sold 50-year maturities. What would have seemed like crazily low yields three years ago are just run-of-the-mill now as rates are driven lower. At this rate, 30-year debt will soon just be viewed as medium-term maturity.

Moving forward, economic growth and inflation will shape the trajectory of bond yields. The fiscal stimulus has been massive. And the Fed is providing unprecedented liquidity and market support. (I'm sure the Fed has broken a few laws along the way, but nobody seems to care.) Even still, much damage has been done and a self-sustaining recovery is years away. As Mr. Barkin said, the economy took the elevator down, but the recovery is likely to take the stairs. On inflation expectations, the Cleveland Fed says they are at record lows with no turnaround in sight.



Source: Bloomberg

Monetary and fiscal policies will be skewed toward more easing, even in better-than-expected economic scenarios. Higher debt levels and larger budget deficits for longer will require ongoing central bank support. Large-scale debt monetization, explicit or implicit yield curve control, and zero or negative policy rates will be lasting legacies of the COVID-19 crisis. This ever-closer fiscal-monetary cooperation will be difficult to reverse implying nominal and real interest rates will be lower for longer. This is the world we find ourselves in.

Rates near record lows leave many credit unions reluctant to invest excess cash reserves into longer term securities. Some believe that rates are at rock bottom and can't go lower. They argue that rates will rise, or loan demand will pick up, or both. So, many credit unions with excess liquidity sit in cash waiting for "better opportunities."

Let's hope that the economy accelerates, loan demand picks up, and rates rise. But what if they don't?

The table below quantifies the opportunity cost of staying in overnight cash (earning five basis points) versus investing in other higher yielding investments.

I believe the numbers in the table speak for themselves.

The cost of holding high excessive reserves is quite punitive to the investment portfolio and balance sheet.

For credit unions experiencing low loan demand, we continue to advocate a risk-appropriate, fully invested, laddered portfolio of high-quality debt instruments.

Opportunity Costs of Staying in Cash								
Annual Income								
Investment	Alloya O/N	2Y Agency	5Y Agency	2Y Bank Note	5Y Bank Note	10Y 2's	15Y 2's	20Y 2.5
$10,000,000	$5,000	$29,000	$49,000	$41,000	$83,000	$90,000	$107,000	$144,000

Finally, I want to wish everyone a safe and happy Independence Day!

Source: Cagle

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.