Is the Worst Behind Us?

“The economy would be in shambles without the safety net of the CARES Act. In a normal recession unemployment goes up, delinquencies go up, charge-offs go up, home prices go down; none of that’s true here. Savings are up, incomes are up, home prices are up. So you will see the effect of this recession; you’re just not going to see it right away because of all the stimulus.” – Jamie Dimon, CEO of JPMorgan Chase

Last week it was stunning to see five years of economic growth wiped out in one quarter. Second quarter (Q2) GDP plunged -32.9% (annualized) and surpassed the previous largest drop of -10%, hit in 1958. While the decline was priced in, it was some five times worse than the revised Q1 GDP decline of -6.9%. As shown below, the drop was much more severe than the Great Recession downturn. By comparison, GDP declined by 4% from peak to trough during the Great Recession, underscoring the unprecedented scale of the COVID-19 downturn.

![US GDP QoQ (Annualized)](image)

Source: Bloomberg

But as large as the decline was, it could have been much worse. Since the COVID-19 pandemic started and the economy shut down, the underlying fundamental weakness in the economy has been concealed by the $2 trillion in government transfers (10% of GDP) and borrowed money financed by the Federal Reserve to American consumers.

Amazingly, and unlike any other recession on the planet earth, personal disposable incomes actually rose 12% to the end of May and are now above pre-COVID levels, despite wages falling over 10%.
No recession in history has ever seen a flood of government cash a month after a recession started.

Consumption drives the economy (70% of GDP). Over the past month, we have witnessed surprisingly strong retail sales. But remember, those sales were driven by borrowed money from the government.

According to the University of Chicago, 68% of those receiving benefits were getting paid more than what they made before. The median payment was 34% higher than their previous weekly paycheck. Let’s do the math. There are about 30 million Americans receiving jobless benefits, amounting to $60 billion per month. That isn’t small.

Also worth highlighting, according to JPMorgan and the University of Chicago, all the consumer spending growth (May-June) came from the unemployed. On the flip side, the roughly 80 million employed slashed their spending by 20%. That’s right, everyone is relying on the unemployed, low-end household to carry the economy with all those stimulus checks. How very interesting.

“We are so far apart, we don’t care. We really don’t care.”
– President Donald Trump, regarding a broad economic recovery package

Meanwhile, as we turn the page, the House Democrats and Senate Republicans could not be farther apart on the fiscal stimulus package. A $1 trillion versus a $3.5 trillion stimulus package difference is as big as it gets. And hanging in the balance are the extended unemployment insurance benefits. The Democrats want to extend that $600 per week jobless assistance package to year-end and the Republicans want to trim it to $200.
According to the Household Pulse Survey by the Census Bureau, it should be noted that over 62 million people had no pay last week and 87.3 million people expect an income loss in the next four weeks.

I’m guessing that the two parties will reach a compromise somewhere in the middle. Even still, handouts, and therefore income and spending, will be declining as we move forward and could very well scorch green shoots of recovery.

So, if we were to fast forward to a year from now, will we then realize that the third quarter was the strongest stage of the economic recovery, and the next stage is that incomes fall when government programs end?

If so, instead of the normal economic recovery, from bad to better to good to full recovery, will the economy go from bad to better to bad again and then stall with permanent job losses and consumer frugality?

**PARADOX OF THRIFT**

“Do not save what is left after spending but spend what is left after saving.” – Warren Buffet

Frankly, there is no doubt the economic implosion would have been much more severe if the federal government had not stepped in to provide support. Yet, the reality is, in the face of rising unemployment and economic uncertainty, households saved a large chunk of the government sponsored cash infusion sent their way. The personal savings rate has averaged 22.7% over for the second quarter (a far cry from the 7.5% before the crisis). These numbers resemble the Great Depression of the 1930s.

But it makes total sense. People fearful about losing their jobs and being unemployed for an extended period of time aren’t going to make large discretionary purchases. It is healthy and wise to live within your means. But when individuals ramp up their savings to increase their financial reserves, it actually depresses the economy as a whole and causes a self-perpetuating spiral of declining growth.

“It’s a recession when your neighbor loses his job; it’s a depression when you lose yours.” – Harry S. Truman

Fear and frugality do not apply only to individuals. Coming out of any recession, businesses also cut costs (mostly labor costs – jobs and wages) and save more via higher retained earnings.
The paradox is a business’s costs are someone else’s income. Therefore, slashing wages and jobs enhances the business’s bottom line, but this comes at the expense of your employee’s income. Thus, the increased retained earnings depress income for households, leading to less spending, and subsequently to lower revenues for the rest of the business sector. Hence the paradox.

The key driver of this economic uncertainty is the brutal labor market. While the 33% crash in Q2 GDP was expected, rising jobless claims weren’t. Initial jobless claims were above a million last week for the nineteenth straight week and rose for the second week in a row. More importantly, it was the second straight week where initial claims rose, after declining 15 straight weeks. That barometer is more meaningful (and concerning) than the historic GDP report.

One survey discovered that 47% of all unemployed workers now believe that their job loss is likely to be permanent.

“In April, 78% of those in households experiencing job loss felt that that situation would be temporarily. But now, 47% think that job loss is likely to be permanent, according to The Associated Press-NORC Center for Public Affairs Research.” – USA Today

The median duration of unemployment is now up to 13.6 weeks (the highest since October 2014) and trending in the wrong direction.

People losing their jobs and sitting on the sidelines for longer and longer isn’t going unnoticed by those who are still lucky enough to have jobs. The sight of 30+ million Americans receiving jobless benefits has a depressing impact in terms of job security, even for those who have not been laid off. And the risk here is of the labor market becoming increasingly sclerotic over time.

IN OTHER NEWS

Our illustrious/unelected/unaccountable Fed Chairman Jay Powell remains in La La Land as he continues pouring gasoline on a raging asset price bonfire. Look no further than shares of Eastman Kodak in this week’s edition of “Markets Gone Wild!”

In case you didn’t know, the one-time camera manufacturer is apparently now a “pharmaceutical” company. And in case
you didn’t know, over 72,000 Robinhood investors sent the stock up as much as 2,189% last week – this after the company announced a $765 million loan from the U.S. government to begin drug production.

To be clear, what we are witnessing right now is an incomprehensible escalation of market distortion and moral hazard across the board, courtesy of our friends at the Fed and Treasury.

Meanwhile, despite overwhelming evidence to the contrary, Powell remains adamant that that Fed monetary policy is “absolutely” not contributing to wealth inequality. Okay, try telling that to the 30 million Americans who literally didn’t have enough to eat last week, as billionaires Jeff Bezos, Mark Zuckerberg and Elon Musk minted another $115 billion this year alone.

**BURBS ARE COOL AGAIN**

The U.S. housing market capped off a surprising June as sales of new single-family homes rose 6.9% in June, compared to June last year, to an annual rate of sales of 776,000 houses, and thereby making it the highest rate of sales since July 2007 as pending home sales came in better than expected – rising 16.6% month-over-month.

With a continued move away from condos in the city to single-family homes in the suburbs, and with mortgage rates hovering at record lows, the positive momentum behind the single-family space has benefited the housing data. In fact, the National Association of Realtors highlighted in its press release that this theme is already well underway: “...as house hunters seek homes away from bigger cites — likely in an effort to avoid the coronavirus — properties that were once an afterthought for potential buyers are now growing in popularity.”

![30 Year National Mortgage Rate Chart](source:Bloomberg)

I’m still undecided if this shift from condos to houses and from urban centers to the suburbs is the early phase of a long-term trend in line with the shift to work-from-home and demographic dynamics, or just a knee-jerk reaction to the pandemic that will blow over and reverse in a few months.

If it turns into a long-term trend, it will have big implications for real estate and for how cities are being structured.
IT DID NOT NEED TO BE THIS BAD

“By almost every measure, the U.S. is one of the worst, and I think we can change that but it’s an ugly picture... adding that the politicization of face masks is one of the reasons we are doing worse than other countries.”
– Bill Gates

COVID is surging again. Millions of people in northern England returned to a partial lockdown. Italy, the original European epicenter, has also seen an increase in cases, along with France, Germany and Spain. Take note that new coronavirus cases in the U.S. have climbed back above 70,000 on a daily basis and are now tracking their highest levels in a month. The number of confirmed cases is approaching 4.65 million yesterday and the death toll passed 154,000. The seven-day average for fatalities has pushed above 1,056. In the past week, the death count rose in 36 states. Dr. Deborah Birx stated that the pandemic has reached a new widespread stage: “What we’re seeing today is different from March and April... It is extraordinarily widespread. It’s into the rural as equal urban areas. And to everybody who lives in a rural area, you are not immune or protected from this virus.”

I have to admit, I am dumbfounded over how wearing a mask has become such a source of political division in this country. Scientific evidence shows face masks can help control the spread of the coronavirus. Nowhere else in the world has this become anything less than a consensus opinion. If people don’t abide by the rules (in so far as there are any) or just follow logic, all the testing and tracing in the world aren’t going to accomplish very much.

So seriously, for the greater good, is it too much to ask people to wear a mask to slow the spread and reduce sickness and deaths in this country?

We are all in this together!

PUSHING ON A STRING

The era of shock and awe is behind us. Except for maximizing liquidity, lowering financing costs and keeping zombie companies intact, we’re in a world where added monetary stimulus will have limited upside. We have witnessed this story in Japan and Europe. And it has arrived in the U.S. of A.
Think about it. The Fed has cut the reserve requirement for banks to 0% as of April this year. Thus, the Fed is no longer worried about banks not holding sufficient reserves and are not concerned about inflation. They want to get the cash out the door and into the hands of borrowers to help drive consumption.

But the dilemma is that the private sector is not going to be willing to add even more debt to already debt-heavy balance sheets. This is deflationary. It’s almost funny to hear about inflation coming back when the real yields on 10-year TIPS, after all the gargantuan fiscal and monetary stimulus, have plunged to a negative -1.01 basis points.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

“The path of the economy will depend significantly on the course of the virus. The ongoing public health crisis will weigh heavily on economic activity, employment, and inflation in the near term, and poses considerable risks to the economic outlook over the medium term.” – Federal Open Market Committee (FOMC) Statement

Everyone knew that Q2 GDP would be a stinker. And it was. In fact, we should all be aware that the recession began in Q1, not Q2. The downward pressures were already in play, as GDP contracted 6.9% in the first quarter alone.

Take note that we are going to be getting a bounce-back in Q3 — something close to a 12-15% annual rate, which would offset less than half of the Q1-Q2 GDP decline. And we know that momentum is beginning to slow, complicating the Q4 outlook. No wonder President Trump is tweeting about a delay in the election!

And the virus remains ever present. COVID-19 infections are accelerating and plans for physical classes at many schools, colleges and universities this fall risk further contagion. On the other hand, staying closed or holding virtual classes promotes dropouts, pressure to cut tuition and fees, and financial disaster for many schools.

Then there are the problems of reopening businesses, reestablishing and reorienting supply chains, and encouraging many to return to work who are now paid more by federal and state unemployment benefits than when they were employed.
Take a look at some recent economic activity.

As of mid-July, 55% of the 132,500 business closures on Yelp have now shown to have been permanent. Restaurants and retail are clearly the hardest hit. Flight and hotel reservations are now being cancelled at peak season. Bars are being forced to close again, even in Vegas! Data from OpenTable reveal that restaurant activity has tapered off following a brief burst of demand in May and June. Data from Homebase supports the thesis that the jobs recovery is stalling.

The Johnson Redbook data show that retail sales in the week of July 25 have deteriorated to -8.7% year-over-year from -7.5% on June 18 and -5.5% as of July 11. This is the second week in a row that sales growth has deteriorated.

International air passenger volume in June was still down -96.8% from June last year, and only a minuscule 1.5 percentage points up from May (-98.3%), which had been as close to zero traffic as you can get without actually reaching zero.

A measure of business for airlines, “revenue passenger kilometers” (RPKs), was still down -86.5% in June, compared to June last year, but a smidgen less bad than in May (-91.0%), according to the International Air Transport Association. By comparison, during the six months following the 9/11 attacks – “considered to be the most severe aviation crisis prior to 2020” – RPKs declined by 12%.

In July, the Transportation Security Administration (TSA) checkpoint screenings, which measure on a daily basis the number of people entering into the security zones at U.S. airports, were down -78.0%. This was the biggest year-over-
year decline since June 28. The seven-day moving average, which smooths out the day-to-day volatility, has edged down from its “peak” in early July and has now been essentially flat for July.

And as discussed above, the all-important labor market is cooling off in a material way. With each passing day, more companies are announcing layoffs. And every worker that gets laid off is another American that doesn’t have a paycheck to spend.

The Census Bureau’s Home Pulse survey showed that from payroll survey week to payroll survey week, employment was down 6.7 million. Yet the consensus is at +2 million for the July payrolls report, which will come out this Friday. I think we could be in for a downside shocker.

So, while the record plunge in GDP likely marks the conclusion of the coronavirus recession, there will be lingering scars during the recovery. I expect a long and bumpy road ahead. A full recovery to pre-COVID levels is going to take years.

Yes, the Fed will continue to provide massive liquidity. And while it’s true too much money creates inflation, it matters not if the velocity of money is declining. As shown below, all this Fed-created liquidity hasn’t found its way into the real economy, as shown by the collapse in the velocity of money.

To wit: the core personal consumption expenditures (PCE) index, which is what the Federal Reserve uses to track inflation, fell 1.1% (its first decline ever) in the second quarter.
As usual, the truth tends to reside over in the bond market. Mr. Bond never bought into the sharp V-shaped recovery. Recall that yields on 30-year government bonds started to decline on January 2, anticipating the fallout from the budding coronavirus crisis that had taken hold in China. Fast forward and 30-year yields have fallen from 2.35% in early January to a recent 1.19%. And 10-year Treasury benchmark yields have declined 130 basis points to 0.52%.

“If I would remind people that long-term rates in Europe are below the policy rate in Germany. The German bund rates are below the overnight policy rates... Would not be surprised to see the market take over and drive interest rates into negative territory” – Scott Minerd, Global Chief Investment Officer of Guggenheim Partners

And if Europe and Japan have taught us anything, it’s that the bond yields can fall much lower than they already have. Consider the following table of relative global yields across the curve. Most of Europe is in negative yield territory out to 10 years. Germany is negative all the way out to 30 years. In Japan, yields are negative to 10 years.

And here we are back, for just the third time ever, to a world where nearly $16 trillion of global bonds are trading with a negative yield. This is bullish for U.S. bonds. Central banks have made it their job to make “cash” the most painful trade of all. And U.S. securities – believe it or not – have some of the highest yields on Planet Earth!

Here’s a fun fact. If the yield on the 30-year Treasury (1.21%) ends up converging to German bund yields (-0.10), investors would earn a 35% return (within a year). As I like to say, bonds have more fun!
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<th>Region</th>
<th>2 Year</th>
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“We are not even thinking about thinking about thinking about raising rates.” – Fed Chairman Jerome Powell

**Bottom Line:** Given that the Fed has stated they expect to remain at zero-bound for years, we view “excess cash” as the least attractive investment. Thus, unless credit unions can make risk-appropriate loans in the current environment, we continue to favor high-quality, risk-appropriate, longer dated investments.

**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 handy. 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 Alloyd’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 Alloyd 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.

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