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Weekly Relative Value

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WEEK OF AUGUST 10, 2020

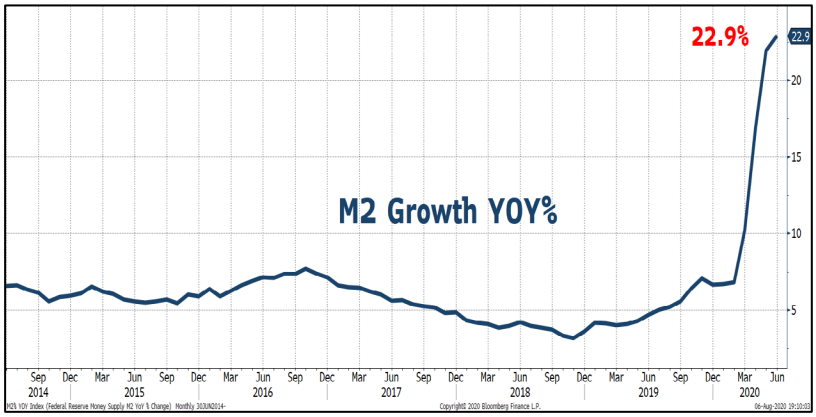
It's (Not) the Economy, Stupid!

"Money talks. But it don't sing and dance and it don't walk."
– Neil Diamond, "Forever in Blue Jeans"

Bill Clinton campaigned in the 1990s with "It's the economy, stupid!" But that was when the economy actually mattered. Today, the ONLY thing that matters is money. We are in a massive liquidity bubble.

To give you a sense of how hard printing presses have been working, look at the money supply growth. Every central bank is boosting their money supply at rates we haven't seen in decades. In total, since the pandemic began, there has been $8 trillion of new monetary stimulus. But in the U.S., it is a record. To wit, the year-over-year growth in M2 money supply in the U.S. is +23%. Nobody else is even in the same orbit (e.g., the eurozone +9%, Japan +7%). Fed Chair Jerome Powell has managed to make both. He's become former Fed Chair Ben Bernanke on steroids.

This Fed is the most aggressive Fed of all time and will seemingly stop at nothing. Frankly, it will bypass its own charters to get back to full employment and to generate a sustained inflationary environment.



Source: Bloomberg

M2 now exceeds $18 trillion. And when the Fed prints money in excess of real economic growth, it flows into financial markets one way or another. It could go into cash, and a good chunk is, with money market mutual funds bloated with nearly $5 trillion of assets. But it

THIS WEEK

- TAKING MATTERS INTO HIS OWN HANDS
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PORTFOLIO STRATEGY

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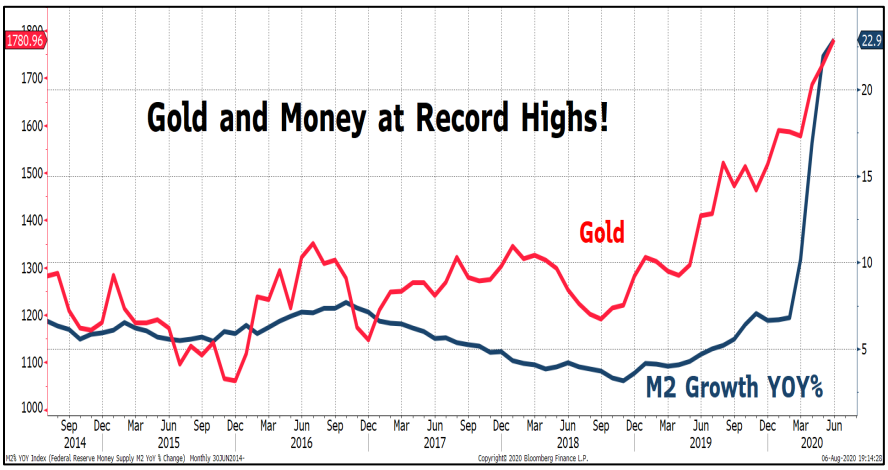
also goes into stocks and commodities. In fact, there is a 90% correlation between asset prices and money supply growth.

And Gold is exploding to daily all-time highs as helicopter money is off the charts.

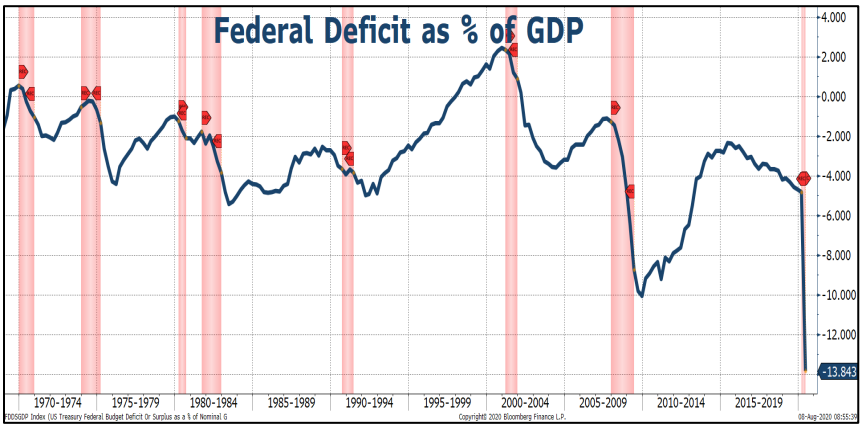


Source: Bloomberg

Meanwhile, the fiscal debt and deficits are exploding. In the April-June quarter, the Treasury borrowed $2.753 trillion in marketable debt. This week, officials estimated they will issue another $947 billion in the third quarter and $1.2 trillion in the fourth. First quarter was $477 billion. So, for this calendar year, the Treasury will have borrowed almost $5.4 trillion. Or maybe I should say "at least" since there is a very good chance these estimates will prove low.

Everyone (including me) expects another "stimulus" package between $1 to $2 trillion. The bulk of that will be spent in 2020. That means U.S. federal debt will be $29 trillion and perhaps $30 trillion as we ring in the new year, or shortly thereafter. Not to mention, $3 trillion in state and local debt.

As shown below, the deficit is already the highest in 50 years. Should the politicians agree on a new stimulus package, the deficits will likely approach 25% and exceed the record 27% deficit reached during World War II.



Source: Bloomberg

As a result of helicopter money and massive deficits, the U.S. dollar is being debased. The DXY (U.S. Dollar Index) is now down 10% from the March peak. At this point, it is a correction. Meanwhile, even Goldman notes, the dollar's reserve

status is on borrowed time due to a tsunami of printing and debasing. Possibly the mighty dollar is headed for a bear market.

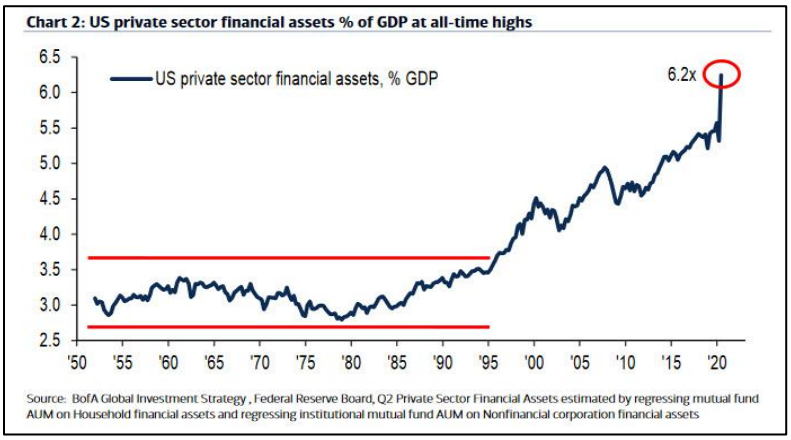
This is exactly what the Fed, with the support of the Treasury and the White House, wants. A weaker dollar makes U.S. exports more attractive. It also helps the Fed reach its inflation targets. It adds additional liquidity across the planet and, as such, drives credit spreads lower. Therefore, it lowers the cost of capital and boosts asset prices for a wealth effect on spending.

Source: Bloomberg

Today, Americans are watching unelected people impose unprecedented pressure on the value of their hard-earned currency. They didn't vote for "P/E Powell" to print money. And they didn't elect a Goldman Guy (U.S. Treasury Secretary Seven Mnuchin) to write "big checks" either!

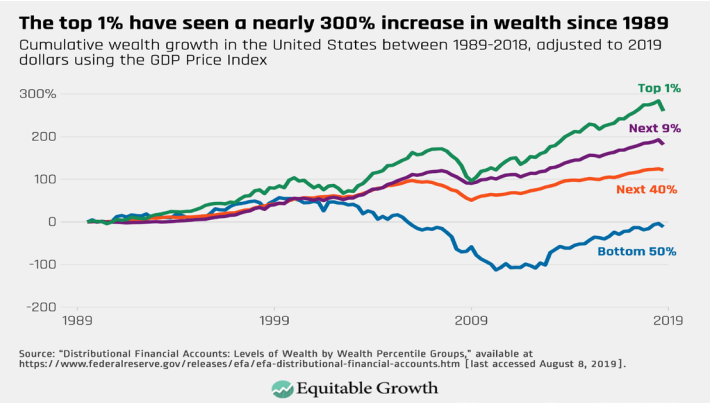
The only way central bank liquidity "seems" to be a success is when viewed through the lens of the stock market. Through the end of the second quarter 2020, the stock market has returned almost 135% from the 2007 peak. Such is more than 12x the growth in GDP and 3.6x the increase in corporate revenue.

Currently, the top 10% of income earners own nearly 87% of the stock market. This group has benefited from this weak dollar policy but that's not an economic solution. A devalued dollar perpetuates gross inequality. Take a look below. The value of U.S. financial assets (Wall Street) are now hitting an all-time high 6.2x the size of GDP (Main Street). In other words, not only is Wall Street now "even bigger to fail," but in its attempt to "fix" inequality, the Fed has made it greater than ever.

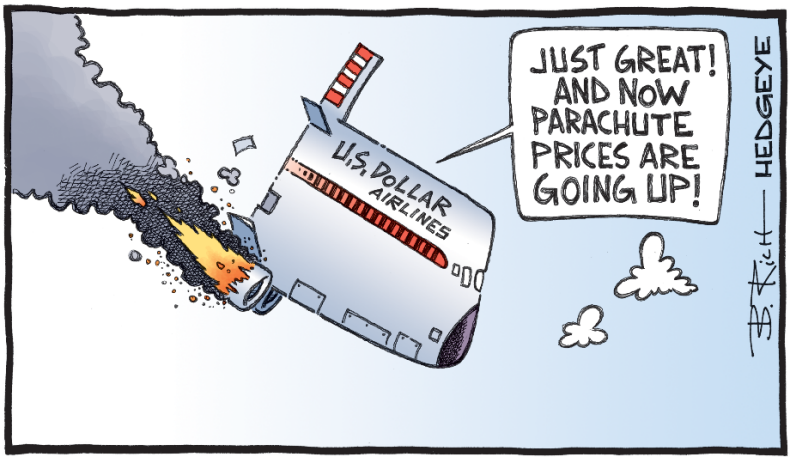


The rest are just struggling to make ends meet. Since 50% of Americans didn't have $1,000 on hand coming into this recession, they obviously can't buy tech, Treasuries, commodities, bitcoins, etc. to make up for their budget gap with wealth appreciation. And the now daily violence on America's streets is the most immediate consequence.

Did all of the self-interested Fed fans and market supporters really think this dollar story through?



Anyway, who really cares about this stuff anymore. Let's go bailout some airline execs who levered up their balance sheets to buy back stocks, reduce their share count, and get paid bonuses on earnings-per-reduced-but-levered-up-shares.



Source: Hedgeye

Final note: This strategy could backfire if bond yields were to rise and inflation pressures show up, but there is no appetite at the central bank to let this happen, which is why the Fed is debating "yield curve control." And that means negative real interest rates could go even more negative in the future.

TAKING MATTERS INTO HIS OWN HANDS

"The pen-and-phone theory of executive lawmaking is unconstitutional slop." – Sen. Ben Sasse (R-NE), member of both the Senate Judiciary and Finance Committees

President Trump on Saturday announced four executive actions aimed at coronavirus relief after Congressional stimulus talks broke down once again last week.

The new orders will:

- Eliminate the payroll tax
- Extend unemployment benefits by $400 per week
- Defer student loan repayments through the end of the year
- Extend protections against evictions

A few comments…

The payroll tax cut lasts until December 31. Although the payroll tax cut is legal, not even the Republicans supported it. This does not help people without a paycheck. Furthermore, the payroll tax change doesn't change the underlying obligation, which means that workers, and perhaps employers, would still be on the hook for the taxes eventually. American workers will then get a particularly nasty surprise in their pay packets come January. So, would Americans spend this "windfall?"

Also, it is far from certain that employers would actually stop withholding and submitting the payroll taxes. That is because they may be concerned about having to withhold more taxes from workers next year, or about being stuck with the obligation themselves.

Regarding evictions, the executive order does not create an eviction moratorium. It asks certain federal agencies to see if they can maybe do something on evictions.

Regarding the extension of unemployment benefits, the federal government would pick up 75% of the cost. That means it's really $300. It's unclear how states will respond. It's also unclear what happens if cash-strapped states don't have the money. The extra benefit only goes to December 6. The election is Tuesday, November 3. How convenient. After the election, would Trump really care?

To be absolutely clear, it is not known if this is either legal or logically feasible.

COVID-19 DEATHS UNDERSTATED?

There has been so much debate about COVID-19 deaths and death rates. Much of what people try to prove is politically motivated. Some use statistics to "prove" that this virus is "just another flu." Or that the U.S. has an extremely low death rate, percentage wise.

Let's look at various measures of death rate. President Trump's favorite is deaths per cases because it shows the U.S. has a relatively low death rate.

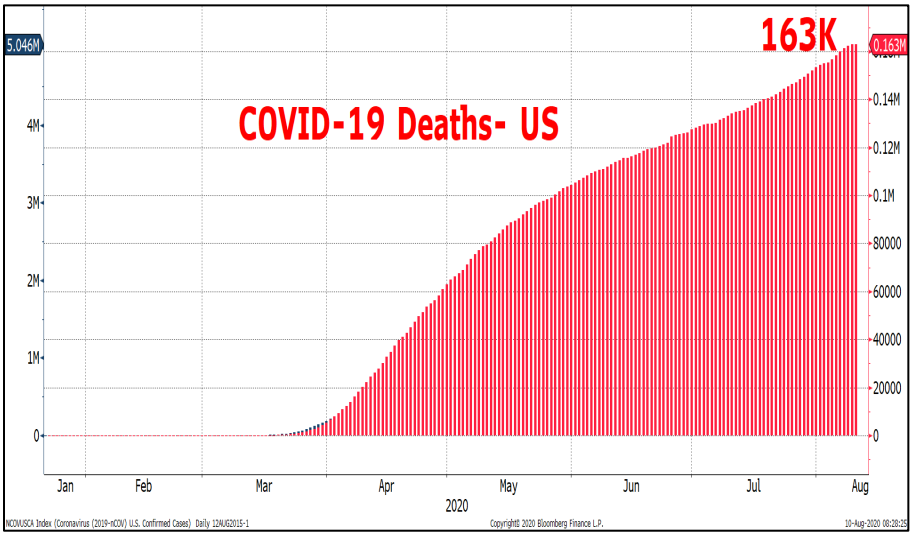
Deaths per cases:
165,000/5,100,000 = 3.2%

As a result, Trump would tell you that the U.S. is doing so much better than the rest of the world in managing the pandemic.

Other measures of death rate show a much different story.

Deaths per million population:
U.S. 498 deaths/million and climbing every day

You can try to trick people with certain statistics. But the U.S. is still in serious pandemic trouble. According to Johns Hopkins University, there have been 163,000 deaths in the U.S. However, according to the Centers for Disease Control and Prevention (CDC), 200,000 people have died nationwide (from March 15 to July 25). That number is 54,000 higher than the official count of coronavirus deaths for that period.



Source: Bloomberg

Deaths are one thing. There is near zero reporting on long-term effects of COVID-19: heart, brain, lung, liver, nervous system, kidney damage. So much unknown but we are told to go back to normal.

And the U.S. economy is not going to recover strongly until it gets the pandemic under control. And throwing more money at the economy is a waste if you don't get control of this virus.

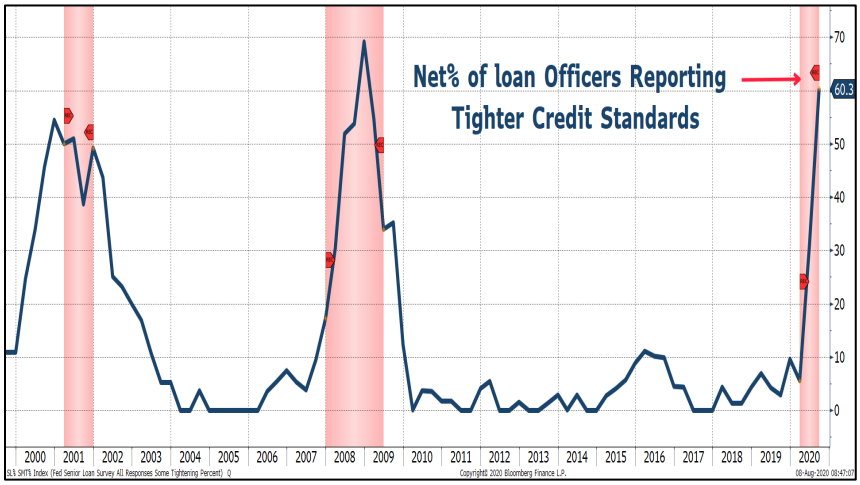
Why doesn't the President sign an executive order mandating social distancing and masks?

Why can't he follow the examples of countries that have reduced cases and deaths by over 90%?

CREDIT CRUNCH

Meanwhile, as the market is stuck in the biggest bubble ever, banks refuse to lend. Commercial banks see what lies ahead in terms of defaults, delinquencies and bankruptcies. The Fed's third quarter Senior Loan Officer Survey reveals the extent of the credit shock. Simply put: Banks won't lend and 71% of loan officers reported tighter bank lending standards in the second quarter. It's worse for small firms. In fact, banks are tightening business loan standards at the fastest pace since 2008. Worse, it's happening despite massive Federal Reserve efforts to encourage and subsidize bank lending.

And it's understandable. If you're a loan officer, lending to a restaurant or hotel right now it is a pure gamble. Banks aren't gamblers. But this means the businesses, which are the actual engine of growth for the economy, can't get credit. Less credit means less capital investment and consumption and therefore little growth, if any.

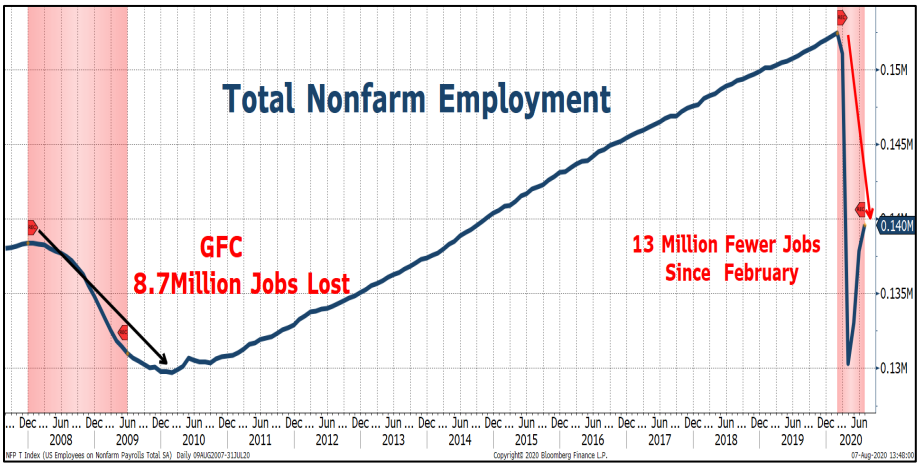


Source: Bloomberg

DOES NOT ADD UP

The Bureau of Labor Statistics (BLS) reported that non-farm payrolls came in at +1.8 million in July, which beat expectations of +1.48 million. The unemployment rate sank to 10.2% from 11.1%. From the April trough, payrolls have rebounded 9.3 million. So, this bounce in the past three months has reversed just 42% of the March-April detonation. We are still nearly 13 million in the hole from the February employment peak. Furthermore, the job gains are being dominated by part-time work and companies are cutting hours even as they take more workers back.

The graph below shows where we are, even as the job market climbs from the abyss.



Source: Bloomberg

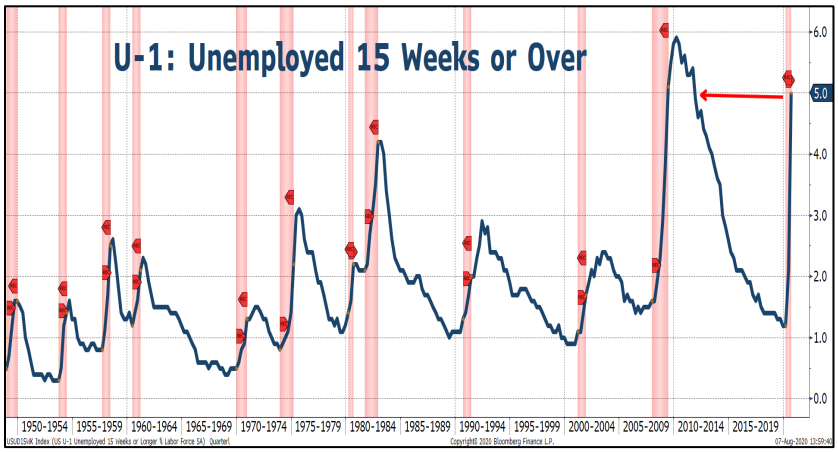
But the real kicker was the number of people who were freshly laid off – those who were let go within the past five weeks. The number rose by over 350,000.

On top of all that, the more forward-looking Challenger job layoff announcement data showed some ominous signs. Pink slip announcements came in at 262,649 in July, a 576% year-over-year surge (and +54% month-over-month).

Source: Bloomberg

Those off work 15 weeks or longer is 3.2 million and the unemployment rate has shot up to 5.0% as of July. It is unprecedented for U-1 to jump this fast and to the highest long-term structural jobless rate in nine years. Dare I say this is an ominous sign.

Long-term unemployment is typically a very lagging indicator. Normally, businesses cut hours, then more hours before mass layoffs begin. Thus, layoffs increase as recessions grow in length. Some believe the August report (due September 4) will show a spike above 10 million. If so, that would exceed the previous record set in the Great Recession.



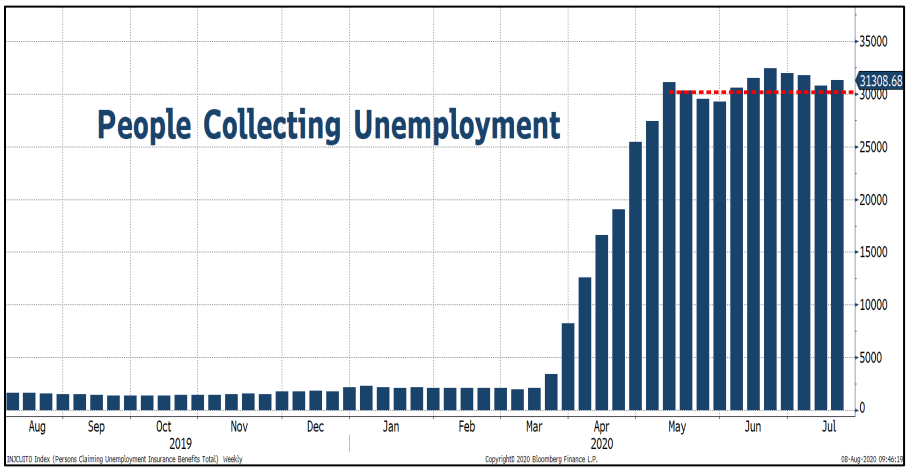
Source: Bloomberg

32 MILLION ON THE DOLE

As shown in the following graph, those on federal unemployment programs remain above 30 million. I fail to see an improvement here! That is roughly double the number of unemployed that BLS reports. The U.S. workforce is about 160 million people, so 16 million unemployed gives you the 10% unemployment number. If 31.3 million are unemployed (assuming those receiving benefits are actually unemployed, a reasonable assumption) then the unemployment rate is 20%.

Then add an unquantifiable number of those who don't qualify for unemployment insurance of any kind, as in those who worked "off the books" for cash or otherwise fell through the cracks. It's a significant number.

Meanwhile, as of July 21, almost 30 million Americans didn't have enough food on the table for their families (census data). Now just how bullish is that last statistic for the equity and credit markets?



Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

In the wake of reopening, massive government stimulus, and a stock market rally of historic proportions, 32 million Americans are collecting benefits and less than 30% of the plunge in full-time employment from the pre-recession peak has been recouped. From my perch, the labor market is heading in the right direction, but it has a long way to go to reach pre-COVID levels.

The numbers above show we are nowhere close to "recovery." To talk about a V-shaped or any other shaped recovery is sheer absurdity. The future recovery, and there will be one, will be unlike anything we have ever experienced. This is a completely different economic animal. The economic weakness comes from a virus whose presence stifles economic activity. Thus, the recession can't end until one or all of the following occur:

- A widely distributed, effective vaccine
- Effective treatments that sharply reduce fatality rates, or
- A large part of the population has been infected and survived with immunity.

The relevance of debt growth versus economic growth is all too evident. Over the last decade, it has taken an ever-increasing amount of debt to generate $1 of economic growth. The problem is the debt, and you can't solve a debt problem with more debt.

And once we emerge from this recession, we will be saddled with unprecedented debt levels. Remember, debt is future consumption denied. Further, the era of tax cuts is long gone. Higher taxes are almost a guarantee as we move into recovery mode.

When I warned about secular stagnation and economic growth at "only" 1-1.5% % a year, everyone thought I was a Danny Downer. We may long for those days.

The deck is now stacked. Too much debt and aging demographics is the formula for lower growth ahead. It will be a long road back.

But perhaps by understanding it, we can figure out how to get out of it.

In terms of strategy: stay the course. Maintain a fully-invested, diversified, high-quality laddered portfolio.

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> – Darin Higgins, President of Western Illinois Credit Union

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> – 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.