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Weekly Relative Value

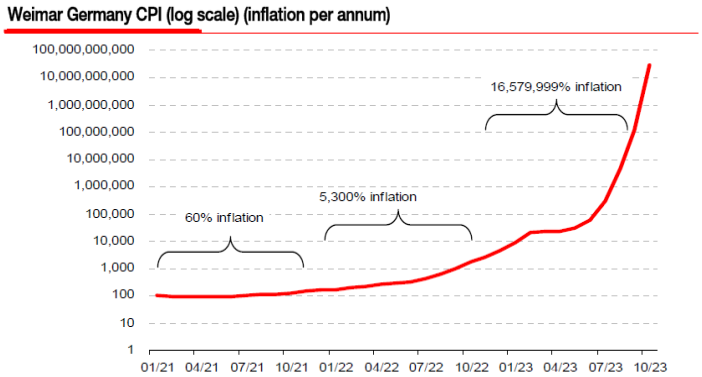
Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF AUGUST 17, 2020

Inflation or Deflation?

"Inflation is always and everywhere a monetary phenomenon in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." – Milton Friedman

Milton Friedman was correct when he explained the relationship between money and inflation. Now, of course, decreasing supply and increasing demand will lead to higher prices as well. But when considering real inflationary pressures in the economy, monetary policy is often the key culprit. Too much money chasing too few goods lifts prices.



Source: Bresciani-Turroni (1931), SG Cross Asset Research

Perhaps the most well-known example of monetary driven inflation is in the Weimar Republic following World War I. By way of background, the Weimar Republic at the end of the war the economy was faced with the toxic combination of a substantial debt burden, low productivity/growth, and the burden of reparations.

To pay off their debt the Weimar government (no longer on the gold standard) printed their fiat currency (D-mark) and began to buy foreign currency to then pay reparations.

Rapidly increasing the supply of their currency led to a massive currency devaluation. By July 1922, the German Mark fell to 300 marks for $1; in November it was at 9,000 to $1; by January 1923 it was at 49,000 to $1; by July 1923 it was at 1,100,000 to $1. It reached 2! 5 trillion marks to $1 in mid-November 1923.

THIS WEEK

PORTFOLIO STRATEGY

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So, the printing presses ran, and once they began to run, they were hard to stop. The price increases began to be dizzying. Menus in cafes could not be revised quickly enough. Supposedly a university student ordered a cup of coffee at a café – the price on the menu was 5,000 marks. He had two cups, and when the bill came it was for 14,000 marks. *"If you want to save money,"* he was told, "*and you want two cups of coffee, you should order them both at the same time."*

Inflation 1923-24: A German woman feeding a stove with currency notes, which burn longer than the amount of firewood they can buy.

Source: Google

By the end of the Weimar Republic's inflationary period, a loaf of bread in Berlin that cost roughly 160 marks at the end of 1922, cost 200 billion marks by late 1923. Hyperinflation, baby! Eventually of course, marks become so worthless that they were burned to provide heat in the winter.

It goes without saying that we are certainly not on a path to hyperinflation akin to the Weimar Republic, Hungary following World War II, or Zimbabwe in 2007 and 2008 (recording the highest monthly inflation rate estimated at 79.6 billion percent month-on-month, 89.7 sextillion percent year-on-year in mid-November 2008).

But the consequences for increasing the supply of a fiat currency are real. And as Mark Twain famously wrote:

"History does not repeat itself, but it rhymes."

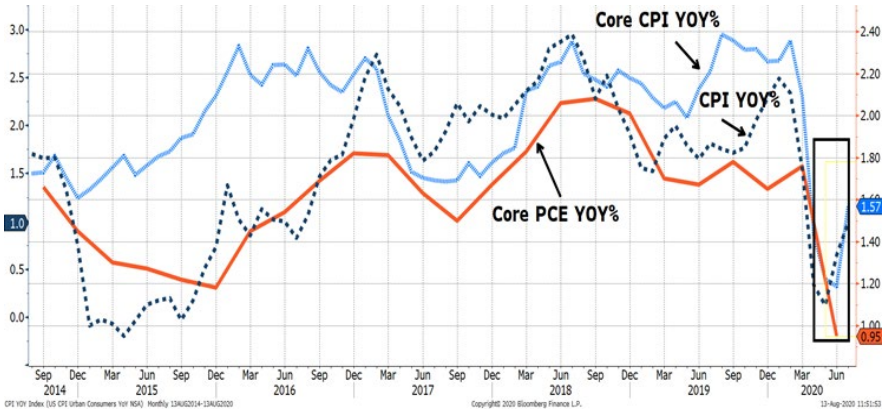
Indeed.

THE INFLATIONISTAS

During the pandemic a supply shock and a demand shock hit at the same time and it produced chaos in the economy and in pricing. There was a sudden collapse in demand in some parts of the economy – restaurants, gasoline, jet fuel, for example – and a surge in demand in other areas, such as eating at home, ecommerce and transportation services.

So, for a few months the inflation data was going haywire, with some prices plunging and others spiking. Price discounting in the spring was necessary and now we are seeing some payback as consumer demand has recovered with the re-openings.

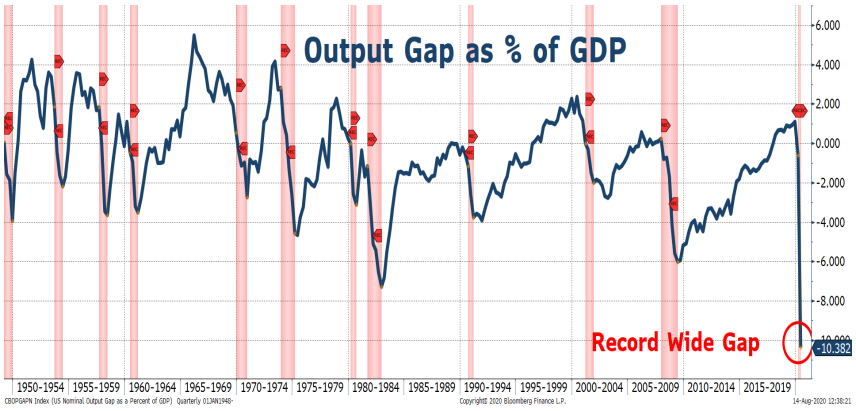
Nevertheless, the inflationistas come out in full force as the core Consumer Price Index (CPI) in July spiked 0.6% higher and the the sharpest jump in three decades. However, one data point does not make a trend. I also think it is important that we not extrapolate this past week's inflation data into the future, because there is a ton of noise in the numbers and it represents a wild swing from the unprecedented discounting during the lockdowns when many companies weren't even able to sell anything at any price. It should also be noted that the Fed's preferred inflation metric for core Personal Consumption Expenditure (PCE) is only 0.9% which is 50% below the Fed's target of 2%.



Source: Bloomberg

And frankly, it is tough to get excited about inflation in the U.S with one in six Americans now either unemployed or underemployed. The official unemployment rate is 10.2% and the broad U6 measure is 16.5%. You cannot squeeze inflation on any sustained basis with this excessive amount of idle labor capacity. And on the manufacturing front, the capacity utilization rate is 68.6% and is at least 10 percentage points below levels that historically touched off an inflationary experience.

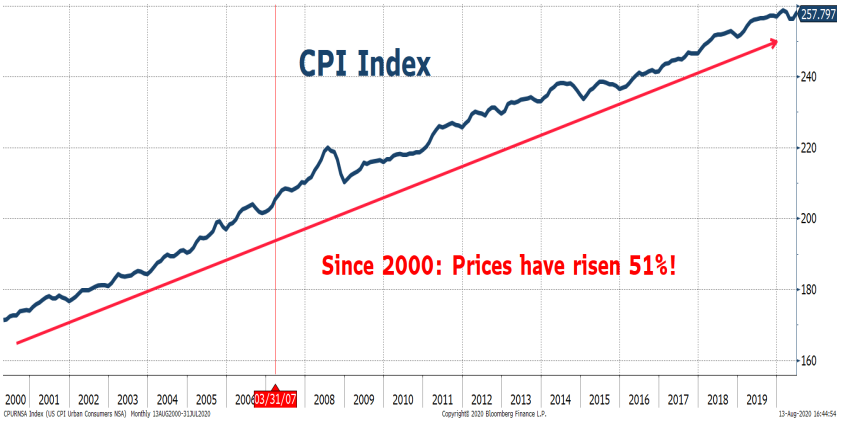
Finally, there is nothing more powerful than the output gap because it measures the differential between aggregate supply and aggregate demand, or if you prefer actual Gross Domestic Product (GDP) vs. potential GDP. As shown below, the output gap is at a deflationary all-time record wide level. Currently, the gap stands at -10.38. The Congressional Budget Office (CBO) is forecasting -6.4 at year end, which is where it was at the deepest point of economic despair in the 2008-2009 Great Recession. In fact, get this – the CBO's estimates of the supply and demand dynamics are such that even by the end of 2030, the economy will still be left with an "output gap" of 0.5%. Thus, sustainably high and rising prices is unlikely.



Source: Bloomberg

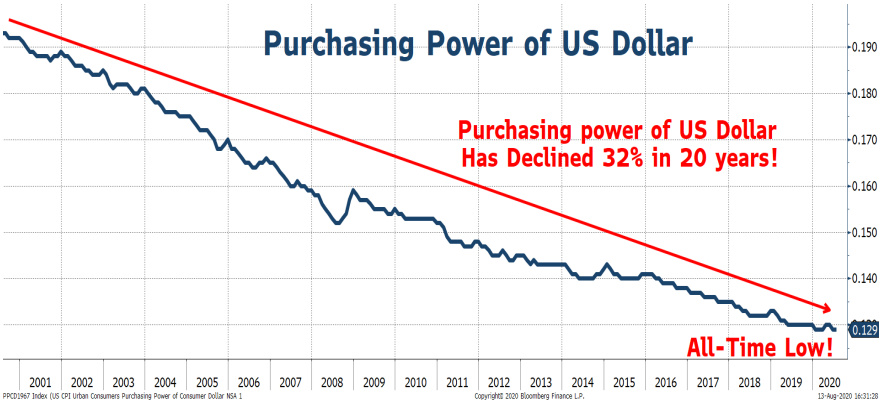
GETTING LESS FOR YOUR BUCK!

While 1-2% annual inflation rates seem almost inconsequential, these increases are insidious and add up over time. As shown below over the past 20 years consumer prices have risen by 51%. And, one could easily argue that the so-called official inflation data greatly understates the true cost of living. Consider health, education, and housing costs. These indexes do not include home prices, only rent. The purported medical inflation is a joke. Anyone who buys their own medical insurance will tell you their costs are up more than the reported 5.9%. Anyone in college has not been pleased with the rising cost of tuition and rent in college towns. Anyways, the graph of CPI below shows a fairly consistent uptrend from the bottom left to the right top. Yet, the Fed wants this line to move up at a steeper angle, and they then take great pride in it when it does.



Source: Bloomberg

Meanwhile, the purchasing power of the dollar just hit a new all-time ever low. For consumers who make their living by working, consumer price inflation means the purchasing power of their wages gets whittled down. Goods and services are more difficult to pay for, their paycheck gets eaten up by rising costs, and there is less money left over to make mortgage payments and other debt payments. And this is a massive problem for society as it contributes to the horrendous income disparity in this country.



Source: Bloomberg

On the other hand, rising prices make debt payments easier for those who can raise prices – businesses, particularly Corporate America where pricing power and debts are concentrated. These price increases go into corporate profits. And this has contributed to the huge shift from labor (which pays for these price increases) to capital over the past decades.

And yes, I fully understand that investors will have to take losses if businesses cannot service their debts, but that's how it's supposed to be.

Why strip bare the working people to enrich the investor class?

But back at the Eccles building the Fed isn't *"even thinking about thinking about"* containing the decline of the dollar's purchasing power.

DOES THE FED HAVE A NEW PLAN?

"In the next few months, the Federal Reserve will be solidifying a policy outline that would commit it to low rates for years as it pursues an agenda of higher inflation and a return to the full employment picture that vanished as the coronavirus pandemic hit.

Recent statements from Fed officials and analysis from market veterans and economists point to a move to "average inflation" targeting in which inflation above the central bank's usual 2% target would be tolerated and even desired. To achieve that goal, officials would pledge not to raise interest rates until both the inflation and employment targets are hit." – CNBC

Anyone who reads this piece knows that I have been an unabashed deflationist and long-term secular bond market bull. And that view has played out well as long term interest rates have declined from 16% to approximately 1%.

And I still believe the odds favor a low growth, low inflation, and low yield environment for some time to come.

But this Fed, and its global brethren, have shown this year just how aggressive and desperate they are willing to be. They will seemingly do whatever it takes to drive inflation higher. They are actually discussing Modern Money Theory (MMT). So, if the Fed rolls the dice this time, i.e. distributing checks ("helicopter money") directly to individuals who could spend this money on products and services, an inflation overshoot could be a hallmark of the next recovery.

I get it. And I am on top of it.

But assuming they don't do anything radical, how is the statement above different than the past decade of promises for higher inflation? When the Fed initiated quantitative easing (QE)1, QE2 and QE3, folks said those policies were very inflationary. Likewise, Japan has tried many heroic measures to try to pull themselves out of their slow growth, low inflationary environment. Great results were promised but have not materialized.

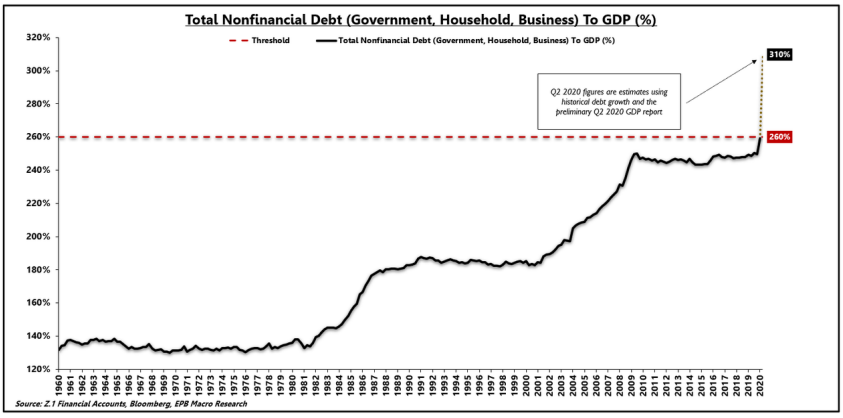
That said, Fed economists are seriously discussing letting inflation hang above the 2% target after periods of undershooting to keep expectations from drifting lower. From a practical perspective, this means keeping rates lower for longer, letting the economy run hot, and prices rise faster than would normally be tolerated during the recovery. However, in this scenario the Fed will be forced to buy more bonds to keep yields low (the "yield curve control" strategy). This also means real rates will drift lower to even more negative extremes during the expansion as inflation rises while nominal yields are capped by the central bank.

THE DEBT HANGOVER

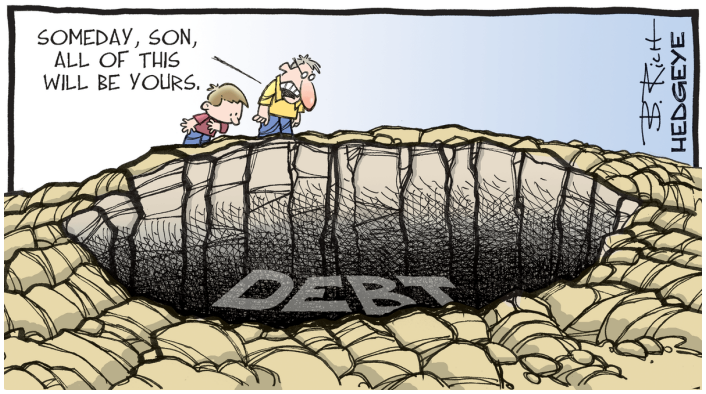
Here's the thing – the COVID-19 pandemic will eventually go away, but the debt will not. The COVID recession has

"pulled-forward" the most growth in modern history. Without this intervention, the U.S. economy would be in a much worse recession or possibly even a depression. Even though borrowing excessively may have been the lesser of two evils, the burgeoning debt will have ramifications in the future we will end up with a massive debt hangover. Public debt could reach $30 trillion by Inauguration Day and is projected to reach $45 trillion in 2024 and $78 trillion in 2028.

The Bureau of Industry and Security (BIS) is owned by 62 central banks from countries around the world. It is the bank of central banks. In the study entitled, *"The Real Effects of Debt,"* the BIS found, *"at moderate levels, debt improves welfare and enhances growth. But high levels can be damaging."* The research examined data from 18 countries from 1980 to 2010. The conclusion? **When government debt exceeds 85% of GDP, economic growth slows. Currently, the federal debt to GDP ratio is 136.58%.** And with total nonfinancial debt to GDP soaring to 310%, the U.S. has eclipsed all peaks in total debt dating back to the 1800s.



Regular readers know I worry about debt, mainly that the world has too much of it. But it's not that simple. Some debt is good, and some debt is bad. The difference is determined by how the debt is used. Debt is bad when it funds unnecessary consumption. For example, going on vacation is generally a bad idea if it saddles you with years of credit card payments. But debt is good when is utilized to finance productive assets. In fact, the economy needs this kind of debt to grow. Access to credit helps entrepreneurs start businesses that create jobs and offer innovative products. This kind of debt should, if all goes well, be self-funding and generate new wealth to pay for itself and more. The challenge is to keep it under control. Lenders and borrowers both get overextended in good times and then overcompensate. The resulting cycle is one reason we have recessions.



Source: Hedgeye

The recovery in economic growth is still dependent on massive levels of domestic and global interventions even as our debt and deficits extend out the wazoo. And as I have discussed, and highlighted ad nauseam in this space, excessive debt slows economic growth. While debt can pull forward current economic activity, debt is future consumption denied.

Because of the massive debt and leverage in the economy, sharply rising rates will immediately curtail growth as rising borrowing costs slows consumption. Thus, as we move forward fiscal policy and monetary policy will be forced to work hand in hand together. This is what the Japanese government and the Bank of Japan (BOJ) are doing.

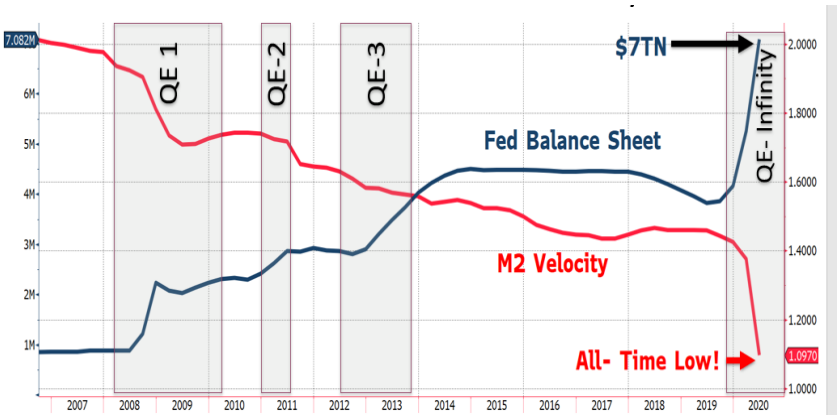
So as the government issues more debt, the Fed will need to be the buyer of last resort to prevent higher rates from short circuiting the recovery. And if inflation does, indeed, make a comeback then the central bank's ability to manage it could be severely hobbled by this new mandate to monetize the debt to whatever extent is necessary.

DEFLATION IS THE HERE AND NOW

"The velocity of money is important for measuring the rate at which money in circulation is used for purchasing goods and services. Velocity is useful in gauging the health and vitality of the economy. High money velocity is usually associated with a healthy, expanding economy. Low money velocity is usually associated with recessions and contractions." – Investopedia

While I do have these immediate concerns, deflation (as I discuss below) is currently the dominant theme due to massive debt loads and the global demand destruction.

First, let me say that while the Fed may want inflation, their very actions continue to be deflationary. Over the last decade, the Federal Reserve has engaged in never-ending "emergency measures" to achieve their dual mandate of price stability and full employment. They have literally created trillions of dollars out of thin air.

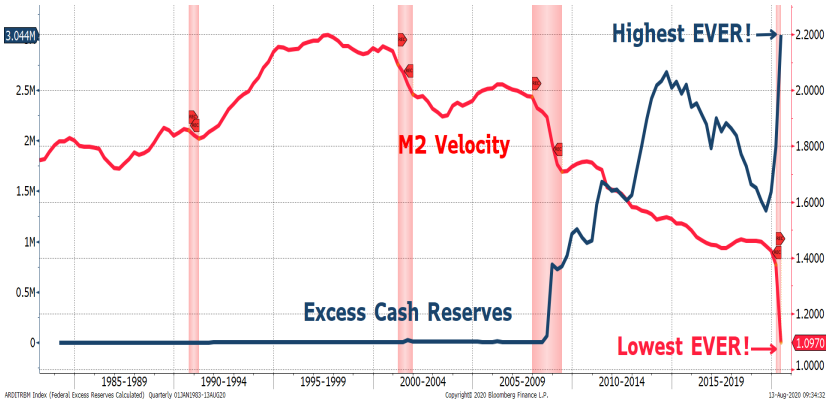


Source: Bloomberg

However, with each monetary policy intervention, the breadth and strength of economic activity has underwhelmed. For example, since 2009 the Fed has expanded its balance sheet by 612%. During that time, the cumulative total growth in GDP (through second quarter 2020) was just 34.83%. In effect, it required $17.58 for every $1 of economic growth. And they have not come close to achieving their inflation targets.

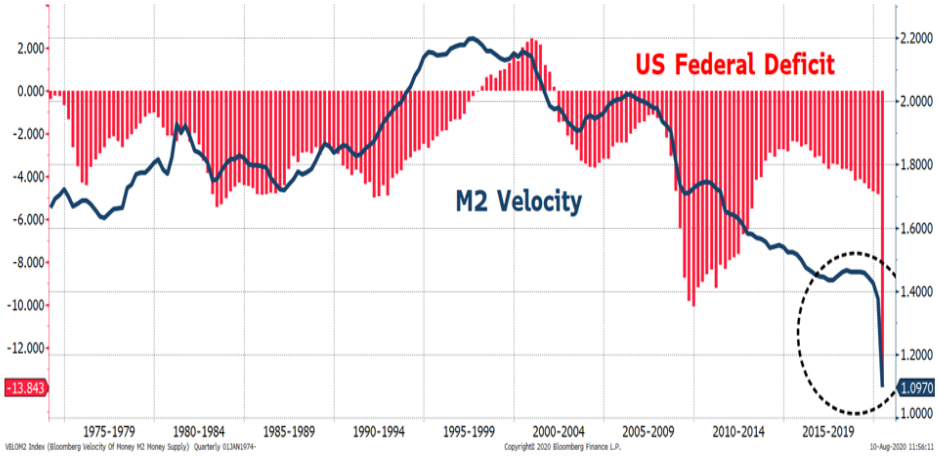
Monetary velocity tells the story. Visit **www.youtube.com/watch?v=BKEp1pzwTsg** to see a short video graphically explaining money velocity.

Unfortunately, most of the money the central bank has created has not filtered into the real economy. Take a look at excess reserves held at the Fed. Since 2008, excess cash reserves have ballooned to $2.2 trillion. Thus, the banks can print to their heart's content but if banks don't lend and consumers don't borrow that money sits idle and will not impact the trajectory of economic growth or inflation.



Source: Bloomberg

Monetary policy is "deflationary" when "debt" is required to fund it. To illustrate the last point, below I compare monetary velocity to the U.S. Federal deficit. And as can vividly glean from the graph, monetary velocity increases when the deficit reverses to a surplus. This is because when we have a surplus, revenue is then allocated to productive investments rather than debt service. (And I should note, last week it was reported that the fiscal deficit is at $2.8 trillion through the first ten months of the fiscal year – a massive 224% jump from a year ago!)



Source: Bloomberg

The only reason Central Bank liquidity "seems" to be a success is when viewed through the lens of the stock market.

The chart below says it all... it's all about Jay Powell and his gang of monetary bandits. The excess liquidity that has been absorbed by the real economy has found a home in the financial economy.

Through the end of the second quarter 2020, the stock market has returned almost 135% from the 2007 peak. That is more than 12x the growth in GDP and 3.6x the increase in corporate revenue.

Source: Bloomberg

MARKET OUTLOOK AND PORTFOLIO STRATEGY

This year has been wild ride.

After the worst economic collapse since the Great Depression and millions of newly unemployed Americans struggled amidst economic shutdown, the U.S. economy is re-opening and bouncing off its lows. We must now grapple with the extreme uncertainty of whether the U.S. economy will quickly recover, or if a more challenging work-out period is about to commence.

For context, this has been the journey thus far:

The COVID-19 shock and economic shutdown plunged the economy into a recession. The reopening of the economy has resulted in a bounce in economic activity off the shutdown lows. But now 'permanent' job losses are accelerating at the fastest rate since the Great Financial Crisis. Further, stimulus is up in the air. As such, the best of the "dead-cat bounce" rebound in the U.S. may be behind us.

Consider the following:

- According to the latest National Federation of Independent Business (NFIB) Survey, as of July 21, 71% of small businesses have exhausted the entirety of their Paycheck Protection Program (PPP) funding.
- Half of small businesses indicated the need for additional financial support over the next six months.
- In a separate American Express survey, 62% of small businesses indicated they needed consumer spending to return to pre-virus levels by the end of 2020 in order to stay in business.
- Air travel has collapsed 80% year-over-year.
- Big hotel companies face an uncertain future with capacity running at 60%.
- Households are now using stimulus checks to pay down debt. The personal savings rate sits at 19% at the moment.
- Pedestrian traffic in Times Square is down 83% year-over-year; office buildings in midtown Manhattan are "all but empty" and restaurants as well as retail stores are "shuttered or operating at greatly diminished capacity."
- The International Energy Agency (IEA) just cut its oil demand forecast.

- The delinquency rate on commercial real estate loans nearly doubled last month to 5.78% and is fast approaching 2008 recession levels.
- 12.1% of adults say, even after the re-openings and all the policy stimulus, that they don't have enough food to eat (that is up from 9.8% in early May). The data on households with kids is particularly disturbing —20% state they can't afford enough food for their children

Meanwhile, the Wall Street strategist/economist consensus is currently anticipating V-shaped recovery.

Clearly, I don't share "Street's" optimism.

The recovery will remain bumpy and growth could decelerate sharply in fourth quarter. A sustainable and strong recovery is not in the cards until we have a widely distributed safe and effective vaccine.

In terms of strategy – stay the course. Make high quality loans and maintain a fully invested, diversified, high quality laddered investment portfolio. Excess cash will remain a drag on the balance sheet. And like I have been saying since I joined Alloya – continue to buy those price dips in Treasuries.

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

> *"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

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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.

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