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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 24, 2020

Socialized Investing?

"Adventure upon all the tickets in the lottery, and you lose for certain, and the greater the number of your tickets the nearer your approach to this certainty." – Adam Smith

Mr. Adam Smith, a Scottish philosopher and economist, is widely considered to be the Father of Capitalism. In his most famous work, *The Wealth of Nations* (aka the "bible of capitalism"), he emphasized minimizing the role of government intervention and taxation, instead arguing that rational, self-interested activity and competition will lead to economic prosperity. In other words, he invented the American Dream!

From Smith comes the idea of the "invisible hand." Every person, by looking out for themselves, helps to create the best outcome for all. For example, a hypothetical chef, woodworker and jeweler hope to make money by selling products that consumers want. If they are successful, they are rewarded financially while also providing products that people want. Smith argued that this kind of system creates wealth for the chef, woodworker and jeweler, in addition to creating wealth for the entire nation.

Source: Cagle

Fast forward to the year 2020. My how things have changed. The role of government is the largest it has ever been within our "capitalist" system. President Donald Trump's "greatest economy ever" has become dependent on big government to bail them out of the debt they were encouraged to take on to create this illusion of the "greatest economy ever."

And yes, I appreciate and understand that when a once-in-a-lifetime pandemic hits, government should take a more active interventionist role in providing a safety net in times of hardship. But the truth is, the Fed has been intervening consistently and aggressively for over a decade.

THIS WEEK

- SHORTEST BEAR MARKET EVER
- $5 TRILLION
- NO CLARITY
- HOTTER THAN A FIVE DOLLAR PISTOL
- THE BEST OF TIMES… THE WORST OF TIMES
- NO. 3 IN THE NATION
- STAGFLATION

PORTFOLIO STRATEGY

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Here are the facts. There are 12 people at the Eccles Building determining the most important commodity of all: the price of money. They have printed money 24/7, bailed out companies (many of which did not deserve to be bailed out), and manipulated/levitated markets. Price discovery has been abolished. No one really knows what any asset price should be. But I think it is safe to say there are no markets priced to economic reality or underlying fundamentals. Free capitalistic markets have been on an extended sabbatical.

To use a phrase that has become quite politized of late, "it is what it is."

But the bigger question is: how does it end?

Or does it?

Given the unprecedented intervention on the part of the central banks and governments, the overriding question is: will free market capitalism be allowed to flourish in the future? In other words, will the central planners of the world relinquish their control and let markets determine the price of money, market valuations, winners and losers? Or has the table been set for socialized investing? And the longer the Fed stays in the manipulation game, the harder it will be to disengage.

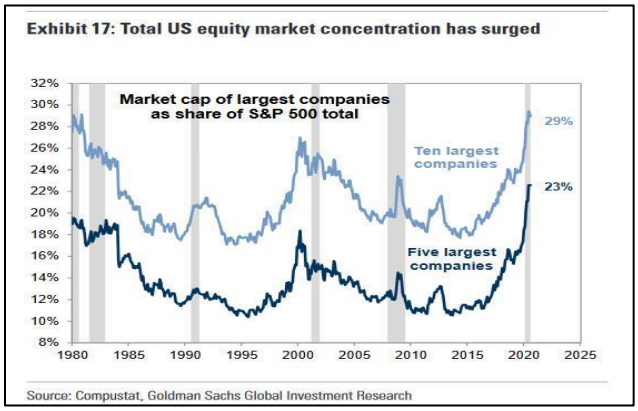
Today, the stock market is an optical illusion. Houdini himself could not have done a better job. That a company like Tesla can surge 6.6% in one day and 40% in one month is evidence enough to show just how speculative this market has become. As an aside, all you need to know about the speculative nature of this market, beyond Tesla's stock, is that Jordan Belfort (the Wolf!) is now teaching the investment neophytes how to trade.

In my mind, the market has turned into a lottery game . And anyone knows that the more lottery tickets you purchase, the greater the odds you will lose. This is exactly what Adam Smith is saying.

SHORTEST BEAR MARKET EVER

Measured from the S&P 500's previous record-high on February 19 to its trough on March 23, the bear market lasted a mere 33 days, compared to the median age of 302 days for 20 bear markets going back to the 1920s. Yes indeed, the S&P is up +52% from the March lows. However, three companies have been doing all the heavy lifting. Amazon is up 80% for the year. Apple is up almost 60%. Microsoft has surged 34%. Outside of these three mega caps, the total return for the first seven months of the year is -4.1%.

Here's a crazy stat: Apple, Microsoft, Amazon, Facebook and Alphabet (aka Google), now represent about 23% of the market cap for the S&P 500, doubling in just four years' time, and a level of concentration not seen in 70 years, having taken out the 2000 tech craze. Maybe it is high time to rename the S&P 500 to the S&P 5?



$5 TRILLION

The stock market recovery has been mind-numbingly fast and third quarter gross domestic product (Q3 GDP), according to the Atlanta Fed model, is expected to show a very strong rebound. As shown below, Q3 GDP is currently projected to increase by 25%. But keep in mind, there has been more than $5 trillion of monetary and fiscal stimulus this year. Most estimates expected an economic contraction of $3 trillion in GDP.

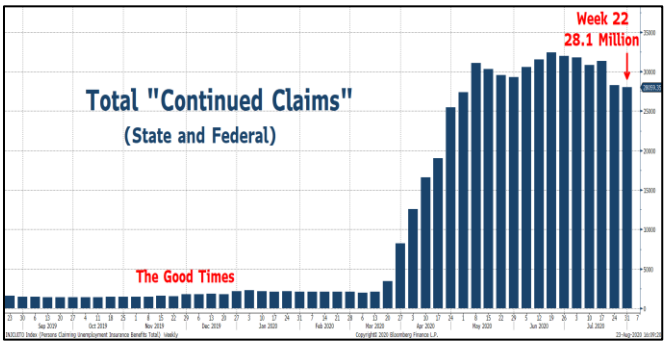
Consider that even with 28 million people collecting unemployment benefits, for the first time ever, personal income is up 12% year-to-date, having come off a recession where an 8% decline in wages and salaries was swamped by a 146% surge in government assistance. American households, in aggregate, are seeing their "income" growth running twice as fast with COVID-19 in place than without it. Now you know why retail sales are at an all-time high and whiskey and cannabis are flying off the shelves. How ironic.

I don't expect the National Bureau of Economic Research (NBER) to declare this recession to be over because of a Q3 statistical bounce that followed a complete Q2 detonation. And let's not forget, a 5% GDP contraction in Q1... which preceded the lockdowns.

What "growth" we do see is courtesy of government support mechanisms.

NO CLARITY

Last week, the Labor Department reported that over 28 million people claimed unemployment insurance under all (state and federal) programs. Yet the monthly jobs report by the Bureau of Labor Statistics (BLS) asserted that in July, there were only 16.8 million unemployed.

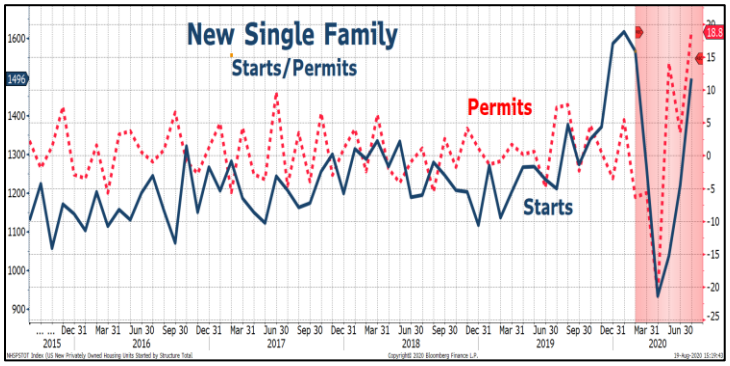


There is still no clarity. But we know the labor market is still in terrible condition even though the peak of the unemployment crisis is likely in the past. But the increase in both federal and state initial claims is a disconcerting factor.

It has been reported that “small businesses” with under 500 employees get their loans converted into grants IF they kept their employees on payroll until June 30. And their larger brethren, businesses with 500+ employees up to America’s biggest private employer, Walmart, with 2,200,000 employees, get the same loans converted to grants if workers are kept on payroll until September 30. So, October 1 is the day of reckoning for them. The companies can keep the money free and clear. The unknown is: will these small/medium-sized businesses reduce headcount at the same time?

HOTTER THAN A FIVE DOLLAR PISTOL

The key beneficiary of the pandemic appears to be the U.S. housing market, which is hotter than a five-dollar pistol. Housing demand continues to accelerate, ultimately providing support to an economy that otherwise has stagnated. In July, housing starts rose 1.49 million and single-family starts rose 8.2%, to 940,000. The single-family sector has now recouped just over 70% of the recession damage.

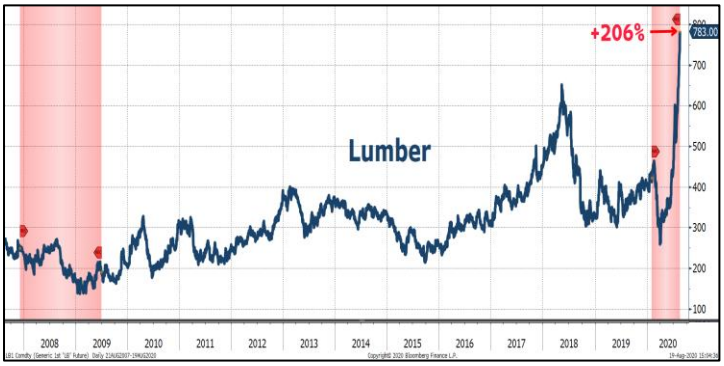


Fully, 75% of the entire growth in nationwide starts activity in July happened in the South. The areas of weakness geographically were in single units in the Northeast (-2.6%) and Midwest (-0.8%). The Southern states have now seen

almost 90% of the recession slump recouped; that reversal is 64% in the Northeast and Midwest; and only 50% out West (is anyone building anything in Portland?).

Building permits surged 18.8% in July to 1.495 million annualized units. This is the largest increase since 1990 and is above the pre-pandemic rate. More than 90% of the carnage has now been reversed. Single-family permits rose a hefty 17.0% in July and this bodes well for the housing sector over the coming months. On a regional basis, it is all about the South.

It's no surprise then that lumber futures have more than doubled over the last six months.



After a 20.7% month-over-month surge in June, July's existing home sales were up a stunning 24.7% month-over-month (crushing expectations of a 14.6% increase month-over-month) and sending home sales up 8.72% year-over-year. The annualized rate rose from 4.70 million to 5.86 million in July, the highest since December 2006.

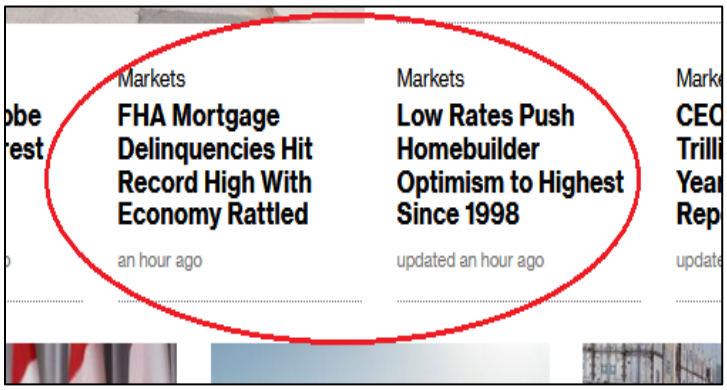
The median existing home price for all housing types in July was $304,100**,** up 8.5% from July 2019 ($280,400), as prices rose in every region. July's national price increase marks 101 straight months of year-over-year gains. And, for the first time ever, national median home prices breached the $300,000 level.

Anyone who fell asleep a year ago and just woke up would never have known that the first global pandemic in a century produced the worst recession since the 1930s from February to April.

The CEO of Zillow, Rich Barton has called this "The Great Reshuffling." In effect, the pandemic has, perhaps, permanently reshaped how people live and work. According to Barton, 70% of Americans report working from home some of the time and all Americans are spending on average nine hours more at home per day. With the sizable shift in remote work, current homeowners are looking for larger homes, a back yard, and that home corner office. This, of course, has inflationary implications on not only existing home prices, but also new builds.

THE BEST OF TIMES… THE WORST OF TIMES

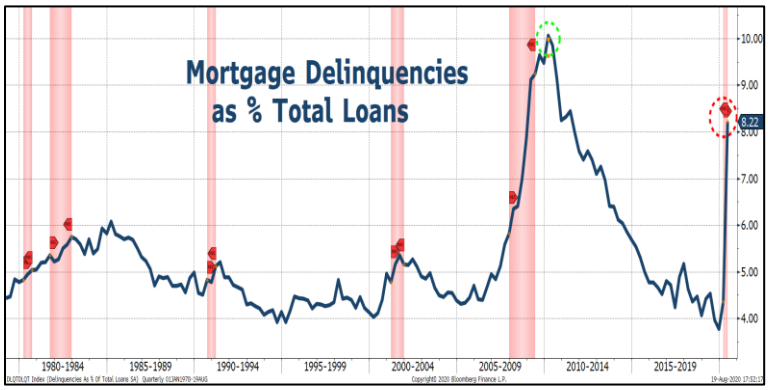
As builder sentiment reaches the highest level ever, and housing starts and home resales boom, ahead there is another side to the housing story. See the graphic below which was snipped from Bloomberg.



As the housing industry trends toward ever greater exuberance, the mortgage delinquency-and-forbearance mess keeps getting messier – in record-setting ways.

The overall delinquency rate for mortgages on residential properties soared to 8.22%, the highest in nine years. This 4-percentage-point jump in the overall delinquency rate was the largest in the history of the Mortgage Bankers Association's (MBA) survey going back to 1979.

- In July, the delinquency rate of Federal Housing Administration (FHA) mortgages jumped by nearly 6%, the biggest jump in survey history (since 1979), to a delinquency rate of 15.65%, the highest delinquency rate in survey history.
- The delinquency rate of Veterans Affairs (VA) mortgages jumped by over 3% to 8.05%, the highest since Q3 2009.
- The delinquency rate of conventional mortgages jumped by 3.5%, to 6.68%, the highest rate since Q2 2012.



Delinquency rates include mortgages that were <u>already at least one-month delinquent before they entered into a forbearance program</u>. So, these mortgages are still delinquent, but the lender has agreed to not pursue its legal rights for the agreed-upon period of forbearance.

In essence, the mortgage is put on ice during the forbearance period. The borrower does not to make payments and the lender may no longer consider the mortgage delinquent, and therefore still show the mortgages as "performing," and still show interest income from it, though no one is making payments.

As of August 18, 3.9 million homeowners remain in active forbearance, representing 7.4% of all active mortgages. Together, they represent $833 billion in unpaid principal. Meaning 3.9 million homeowners have stopped making payments, in addition to the homeowners that have stopped making payments but are not in forbearance programs.

This mess playing out in the mortgage market has been largely swept under the rug of widespread, government-supported forbearance programs. No one really knows what will happen to those mortgages when these forbearance programs end. And the exuberance in other parts of the real estate industry is a contradiction to what is going on with these swept-under-rug delinquencies that will eventually come to a head.

NO. 3 IN THE NATION

On the topic of COVID-19, I get that everyone and their mother has an opinion on this. But, regardless of what you think, COVID-19 isn't going away. And serious damage has already been done by the virus.

Thomas Frieden, MD, former director of the Center for Disease Control and Prevention (CDC), said, "*COVID is now the No. 3 cause of death in the U.S. – ahead of accidents, injuries, lung disease, diabetes, Alzheimer's, and many, many other causes."* In fact, COVID-19 is so deadly, over 175,000 in the U.S. died from it. In Europe, over 200,000 people have died. Globally over 800,000 people have died.

Source: Cagle

It is safe to assume those totals are huge undercounts. Yet there remain many who believe it's not really a problem. I constantly hear it's just a cold, a hoax and that mask-wearing and social distancing are communist plots. I constantly hear the refrain "only old people get ill and die." Some find this a laughing matter and make insane jokes about it. Sad indeed!

Consider the following from a professor at a well-known university in England:

> *"Another report from investigators in Missouri found that adherence to universal masking for source control as mandated by city ordinance and company policy helped prevent transmission of SARS-CoV-2 from 2 symptomatically infected stylists at a hair salon in Springfield, Missouri. Before they were diagnosed as having COVID-19, the hair stylists had served 139 clients but* ***had been required to wear masks at all times*** *while working with them. After public health contact tracing with the hair salon clients and after 2 weeks of follow-up,* ***no symptoms of COVID-19 were identified among the exposed clients or their secondary contacts****. Among 104 interviewed clients,* ***102 (98%) reported wearing face coverings for their entire appointment****…"*

Finally, virtually all scientific/medical studies show that masks reduce the spread of this virus and could in turn save thousands of lives. Even if you believe this is media hype, "fake news," or a partisan issue, isn't it better to be safe than sorry? In other words, isn't it the right thing to do?

As we move into the flu season and a potential second COVID-19 wave, is it too much to ask everyone to do what's right for their fellow citizen and community and wear a mask?

Moreover, for the economy to fully recover, the virus must be under control. Period.

STAGFLATION

Last week, I discussed the possibility of inflation and deflation. But what if we enter a period of stagflation instead?

First, I believe a V-shaped recovery is a non-starter. Recovery will be very slow and bumpy over several years. That said, there are many discussing cost push inflation and the dreaded stagflation.

And here's why:

1) There are major supply chain problems. Globalization is fading and many companies will bring production back to America for security of supply, which will raise costs.

2) Airline and other travel expenses will increase by necessity; restaurant prices will increase.

3) Construction costs are increasing rapidly.

4) Food prices are skyrocketing. Go into any supermarket and you will see holes on the shelves indicating supply chain problems.

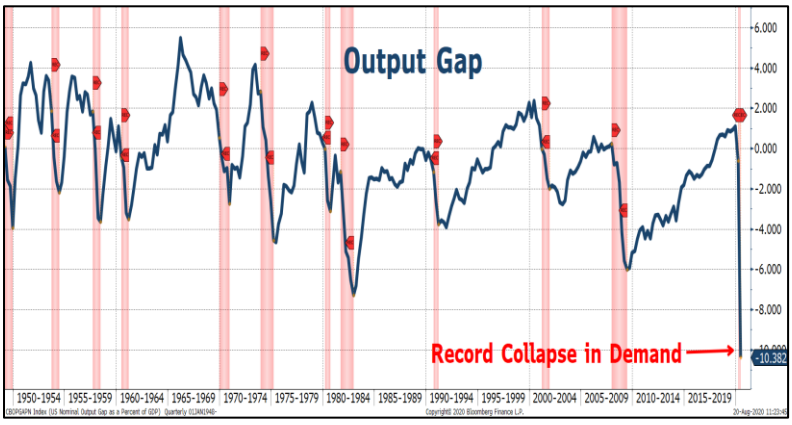
5) The price action of many commodities like copper are sending us a message.

The fact is that COVID-19 is making everything take longer and cost more. If these prices are passed on to the consumer, we might get the worst of all worlds with little or no growth, and rising inflation like the 1970s. Inflation starting in the early- and mid-1970s was a big surprise with wage and price controls.

At some point, we could be in for another surprise. Central banks have been trying to get inflation up for a decade. There is an old saying: Be careful what you wish for because you might just get it.

While supply is pressuring prices higher, you must also factor in the demand side of the equation. As I discussed last week, near-term I believe deflation has the upper hand due to the demand destruction and slack labor capacity. The Congressional Budget Office (CBO) is forecasting that demand will lag behind supply (and an output gap of less than zero all the way to 2030). So, while businesses may want to raise prices, how much, if any, of the cost increase will actually be passed on to the consumer? It comes down to "will the price hike stick?"

That said, my eyes are wide open. Undoubtedly, the combination of demand driven inflation combined with monetary driven inflation has the potential to be a toxic elixir. Especially the latter ingredient.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

Everyone has a letter for the economic recovery. Will it be a V, L, U, W-shaped recovery? How about a K-shaped recovery?

The rationale for the K is that many companies and individuals have sailed through the health crisis in good shape, while many others are suffering. K-shaped economic and market data abound and show a widening gap between the comparatively privileged – for instance, those with jobs they can readily do from home – and the disenfranchised. The COVID-19-exacerbated gap between the privileged and the rest is a depressingly pervasive pattern, and it's reflected in the bond market.

Also, in corporate land, there are many large companies that can access record-low borrowing rates. But it's not the same for every company. In fact, more banks have tightened standards on lending to small businesses than at any time since 2009, and the stakes are higher than ever now, amid warnings of record corporate defaults and bankruptcies.

The painful and long-term implications of a K-shaped recovery are kryptonite to the Fed, which has faced widespread accusations of exacerbating inequality in its response to the global financial crisis.

So where to from here?

After declining by 6% and 32%, respectively, in Q1 and Q2, the economy is expected to bounce back sharply in Q3, driven by the massive stimulus.

But as the stimulus fades, will the economy continue to strengthen, or will it slow down as we enter Q4?

Consider the following:

- Enhanced unemployment benefits expired at the end of July with recipients receiving unadjusted benefits in recent weeks (national average benefit is approximately $380/week, back down from the enhanced benefit of approximately $980/week).
- Temporary job losses are shifting to permanent job loss in many industries. According to Goldman Sachs research, one quarter of the 20 million jobs lost during the peak of the pandemic scare and lockdowns, will not be coming back. That is akin to two years' worth of job creation lost forever.
- Early evidence (Walmart earnings commentary, grocery sales, etc.) suggest consumer spending has begun to moderate as stimulus and enhanced benefits have ended.
- Paycheck Protection Program (PPP) funds have been exhausted and a majority of small businesses have indicated high risk of failure/closure if spending doesn't fully renormalize by year-end. Full economic renormalization is not a high probability outcome and, suffice to say, the longer demand remains depressed, the higher the probability for fresh layoffs.
- Fully, 45 companies with at least $1 billion of liabilities have failed so far this year, already breaking the 2009 record of 38 (courtesy of the weekend Financial Times). Dig into smaller firms, and there have been 157 that have filed for bankruptcy (liabilities exceeding $50 million).
- The decline in enhanced benefits and the rolling expiry of loan forbearance programs (where deferred loan payments have had the opportunity to be diverted toward other discretionary spending) remain significant risks to ongoing, durable recovery in the consumption economy.

In terms of overall portfolio strategy, stay the course and minimize excess cash reserves. Continue to make high-quality loans (or loan participations) and maintain a fully invested ladder strategy of high-quality investments.

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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

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> – 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.