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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 31, 2020

The Great Debate

"What happens to inflation after the pandemic will affect macroeconomic theory and teaching, perhaps forever."
– Charles Goodhart, a scholar at the London School of Economics

Today there is a great debate. I'm not talking about the GOP vs. Democrats, or Trump vs. Biden. Today, there's hardly any question that carries greater weight in the bond market and interest rates than the direction of inflation. And there is a raging dispute over whether we are inflating, deflating or stagnating.

The "inflationistas" are convinced that massive stimulus to counter COVID-19 will be the catalyst for driving prices higher to levels not seen in decades.

On the other hand, the "deflationists" argue that the in the aftermath of the COVID stimulus, the conditions that have driven prices lower over the past decade (e.g., massive debt, demographics and wealth inequality) have actually been exacerbated. Thus, this school of thought believes that deflation, rather than overheating, remains the big threat.

The stagflation camp believes inflation will rise as the economy sputters. This is the worst-case scenario, leading to higher consumer prices as economic growth and wages slow, leading to a decline in purchasing power at the same time.

Thus far, the jury is out. As always, the data will ultimately settle the question, but it could take years to trickle in.

In this week's edition, I discuss the key themes surrounding the inflation narrative.

THIS WEEK

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- DEMAND PULL INFLATION
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- CENTRAL BANK POLICY
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- DEBT AND DEFICITS
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PORTFOLIO STRATEGY

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MONEY SUPPLY

"Today's policy measures are injecting cash flows that will directly raise the broader measures of money,"
– Charles Goodhart and Manoj Pradhan of Talking Heads Macro

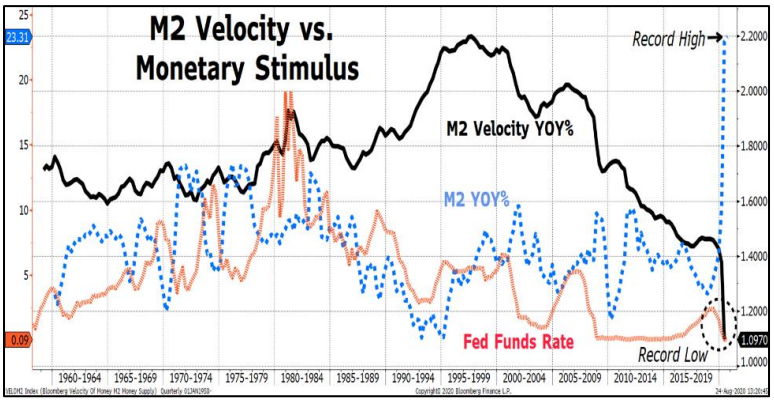
Money supply as measured by M2 is up a record-high 23% over the past year. Many argue that the inevitable outcome, as the recovery ensues, will be a surge in inflation. But just remember that these same pundits also forecasted higher inflation – if not hyperinflation – after the Fed implemented quantitative easing (QE) and zero rates. They were dead wrong!

Moreover, the key to inflation is not how much money the central bank prints, but rather the relationship between M2 money supply growth and the "velocity" of money – the frequency with which it changes hands, as people use it to buy goods and services.

The Quantity Theory of Money: M*V = P*Y (where P is inflation and Y is real GDP growth)

Following the Great Financial Crisis, money velocity never really recovered and has since careened to an all-time low. The banking sector data, both actual lending and the latest Fed survey, show a full-fledged credit contraction. Households are paying down their credit card balances at an epic rate. Commercial and industrial loans are contracting sharply after the initial big drawdown of business credit lines in March. You can't have inflation in a credit contraction. You can't have inflation where the money supply, no matter how fast it is running, is not coinciding with a rising turnover rate.

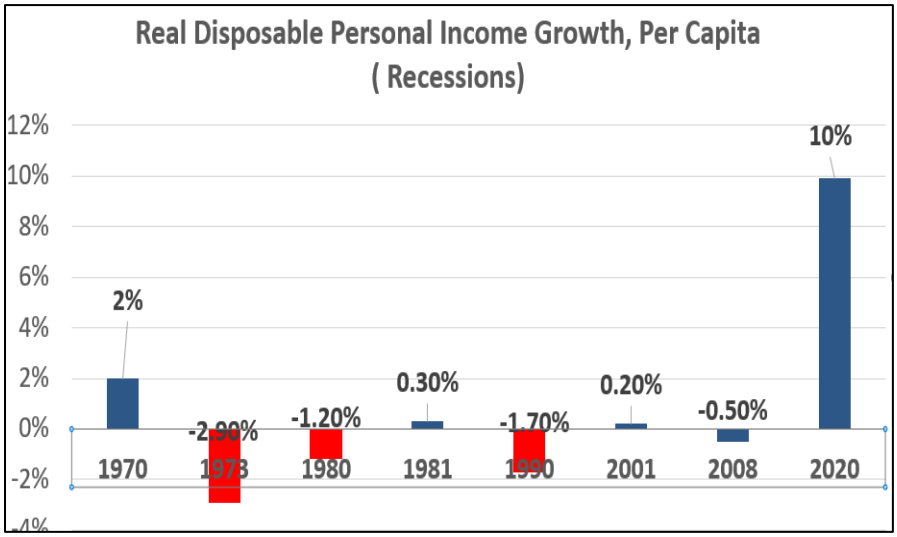
The bottom line: we may have a ton of money supply. But that's not necessarily going to lead to a ton of inflation. And that is why, as shown below, inflation has remained subdued since 2008, even as central banks cranked up the printing presses.



DEMAND PULL INFLATION

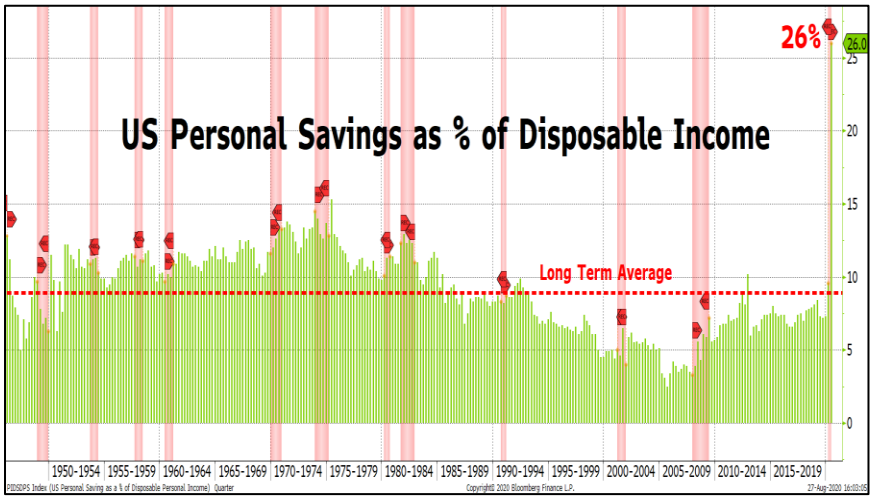
"We're clearly not back to normal in the short term until people spend the money that the Fed has created, and the government has sent them," – John Ryding, chief economic advisor at Brean Capital

So how it is that the U.S. economy is doing so well with 28 million people in a *de facto* soup line collecting jobless benefits? Well, it's due ONLY to the most radical monetary and fiscal stimulus of all time, which now exceeds $5 trillion to combat a loss of GDP of $2.4 trillion. The medication has outstripped the pain by nearly a two-to-one ratio. Wages and salaries may be down 8% this year, but Uncle Sam's deep pockets have ensured that total personal income soared 10%, which is double the pace had the pandemic not reared its ugly head.



Data Source: Bloomberg

And in an attempt to prevent the wealth effect from reversing, the Fed has propped up equities. Year-to-date, global investors (in bonds and stocks) have made almost $10 trillion ($6.66 trillion from bonds and $3.07 trillion from stocks), after being down over $25 trillion at the trough in March. Likewise, home prices have hit new highs. All it took was zero percent rates and almost $10 trillion in global liquidity.



There are those that argue that fiscal stimulus, unlike the monetary kind, goes directly into people's bank accounts – where it's likely to get spent. One may point to a 19% savings rate (though off its April peak of 26%) as a sign of "dry powder" for future spending, which opens the door for what's known as "demand-pull inflation."

On other hand even though incomes have soared through the recession, thanks to government intervention, not all the money is getting spent. Savings rates have soared too. To be sure, that's partly a function of lockdowns that left

restaurants and bars shuttered, and air travel widely shunned. But even as economies reopen and consumers have more options, worries about health and work could mean they stay cautious.

Let's not forget that we went into this crisis with more than half the household sector having insufficient cash-on-hand to get through even a three-month period of idle economic activity. Many have been scarred much like what happened after the Great Depression.

And this frugality theme seems to be playing out. Based on the recent Conference Board survey, many who are still working are cutting discretionary expenses because they doubt the economy will bounce back quickly, which in turn could jeopardize their jobs. Auto and home buying plans receded to four-month lows and big-ticket appliances to a five-year low.

And get this. Almost one in five actually see their incomes going DOWN — which is the second highest in more than seven years. Seriously? How is the consumer going to be able to afford higher prices when their income is expected to contract in the next six months? The bull market ahead is in precautionary savings and that is more deflationary than inflationary.

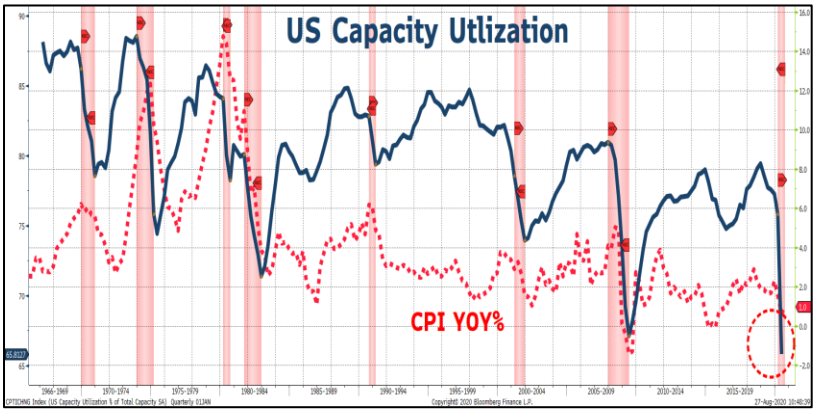
SUPPLY PUSH INFLATION

Cheap imports, technological advances, and corporations with the market power to suppress wages, have been the driving forces behind the disinflationary trends over the last 30 years. But the same trio also gets blamed for widening inequality, and faces growing political scrutiny that could create a regime shift in inflation dynamics.

The fight against COVID-19 has often been compared with an actual war that historically has triggered inflation. Military conflicts wreck the supply side of the economy, like factories, leading to bottlenecks and shortages that push prices up.

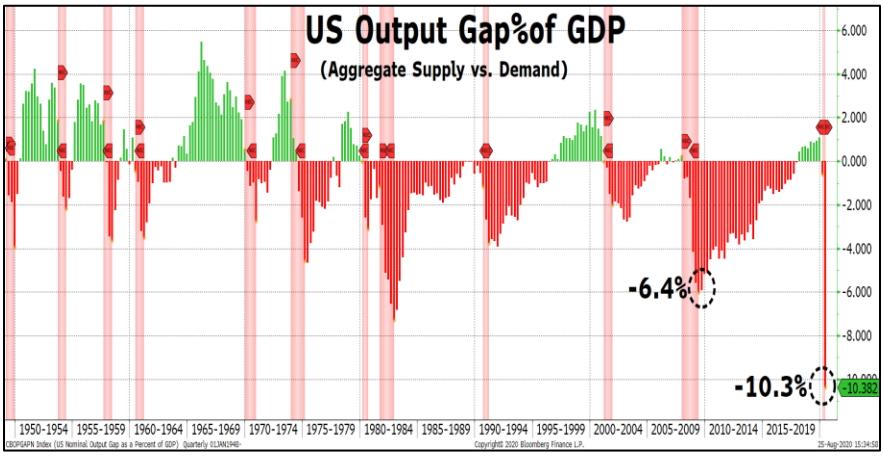
But the coronavirus has left those facilities intact – even if they're not being used right now. In fact, capacity underutilization is the greatest it has ever been. It's important to note that capacity utilization in the U.S. has been on a downward trend for over 50 years. For inflationary pressures from the supply side to build, this trend needs to be reversed.

Even still, the nature of the COVID-19 crisis may just provide that type of shock in the intermediate term (two to three years from now). As a period of deglobalization (more countries bring manufacturing home) combines with more government regulation, prices will be pressured higher.



But remember, there is nothing more powerful than the output gap because it measures the differential between aggregate supply and aggregate demand. Currently, the gap is -10%. A negative output gap is deflationary because the economy has unutilized manufacturing and labor capacity, driving down the price of goods and services. By year-end, it is seen at -6.4%, which is where we were at the deepest point of economic despair in the 2008/09 Great Recession. The Congressional Budget Office (CBO) still sees a sizeable output gap of -3.4% by the end of 2021. Using the projected estimates, the output gap will last through 2030 (44 quarters).

The gap between supply and demand is far too wide to be worried about inflation now, or in the very near future. Still far too much excess supply for businesses to be able to make price increases stick. They can try, but it won't be successful because consumers will balk.

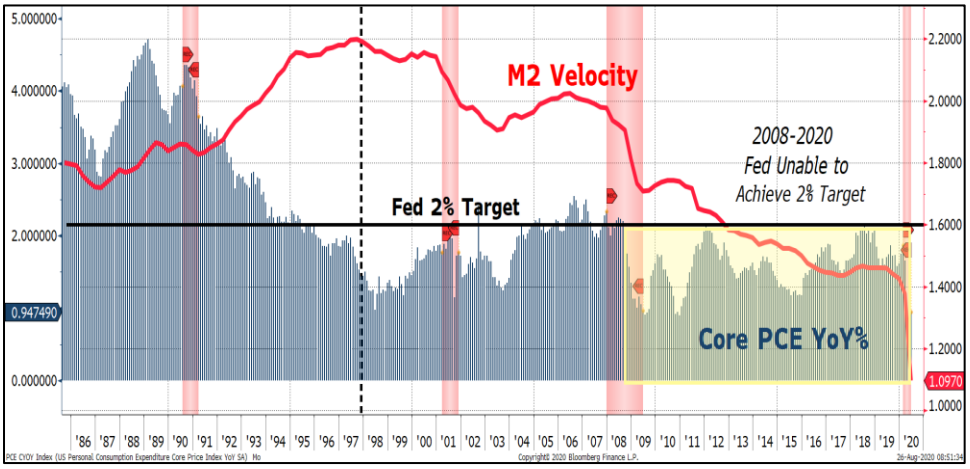


CENTRAL BANK POLICY

"…inflation that is persistently too low can pose serious risks to the economy…"
– Fed Chairman Jerome Powell

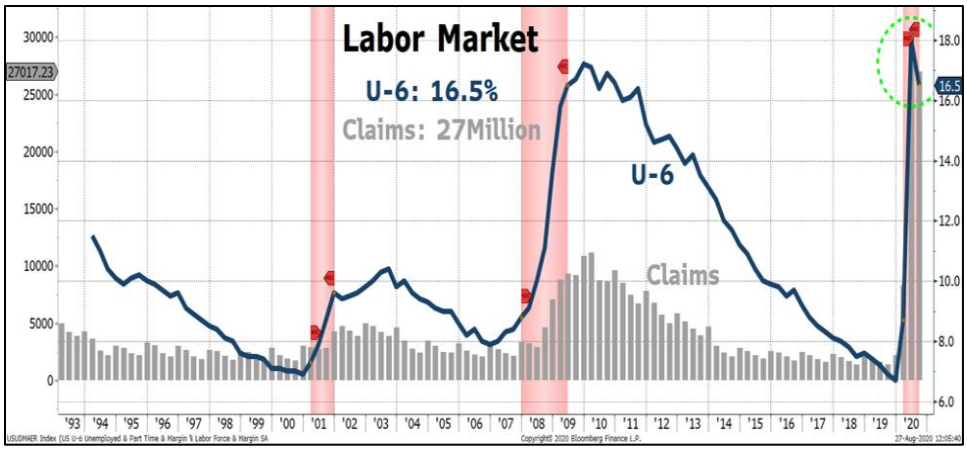
Since 2008, the Fed has been unsuccessful in achieving their price stability target of 2%. Core personal consumption expenditures (PCE) have risen at a 1.6% annual rate in the past decade. And now bankers are willing to let the economy run hot to somehow achieve the holy grail of 2%. Is it possible that the Fed could snap its fingers and create a new inflationary cycle? And why is Powell targeting a goal of 2% inflation with no explanation as to why the goal should be 2% in the first place. Maybe it's all talk. There were no official targets stated and no specific time frames.

Come on, folks. If a 50-year low 3.5% jobless rate couldn't do it; if a five-fold surge in the Fed balance sheet couldn't do it; if rates at the floor for seven years; if a massive expansion in the fiscal deficit that began in earnest more than two years ago couldn't do it... what do you think the Fed is going to be able to do on its own? Thus, try as they might, the Fed has shown in word, and in deed, that it has no magic wand to deal with the secular forces – technology, demographics and globalization – at play that have driven inflation down over time.



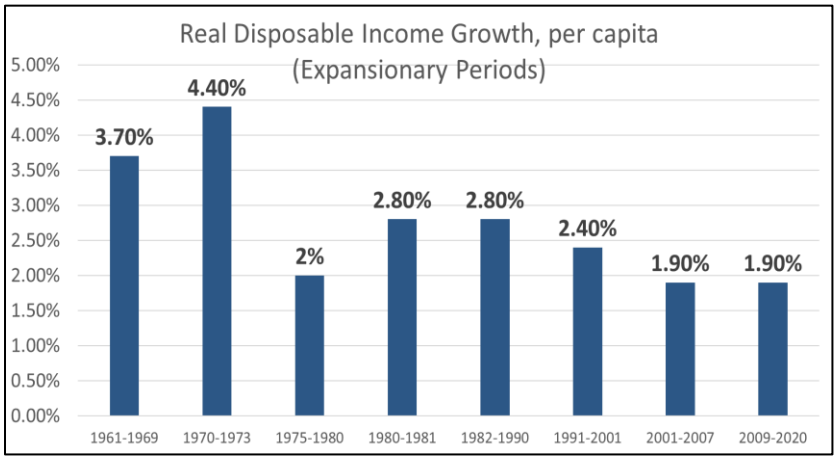
LABOR MARKETS

Initial jobless claims, where the rubber truly meets the road on the economic backdrop, came in over a million in the week of August 22. That is still a horrendous number after three months of re-opening and six months of unprecedented policy stimulus. Remember, in a normal economy, it is closer to 200,000. At some point, large number gravity will drag the totals lower as you invariably begin to run out of people to fire… although that week was not last week and with second round layoffs percolating, many will own the dystopian distinction of being laid off more than once.



Continuing claims fell to 14.535 million and has declined now for four weeks running. Again, a normal number here is closer to two million. And even now it is almost triple the numbers we had at the peak of the angst in the 2008/09 Great Financial Crisis. The total number of claimants (state and federal) is 27 million in a total workforce of 160 million, which is a *de facto* unemployment rate of around 17%.

As shown below, one of the defining and troubling themes of this economy is that real wages have steadily declined since the 1980s. So, it's difficult to see wages/salaries rise when there is so much idle capacity. It's probably not wise to knock on the corner office and ask for a raise with so many unemployed and those that are working have taken pay cuts. Rising wages drive inflation and prices will only face sustained upward pressure when the economy is using all its resources – including labor.

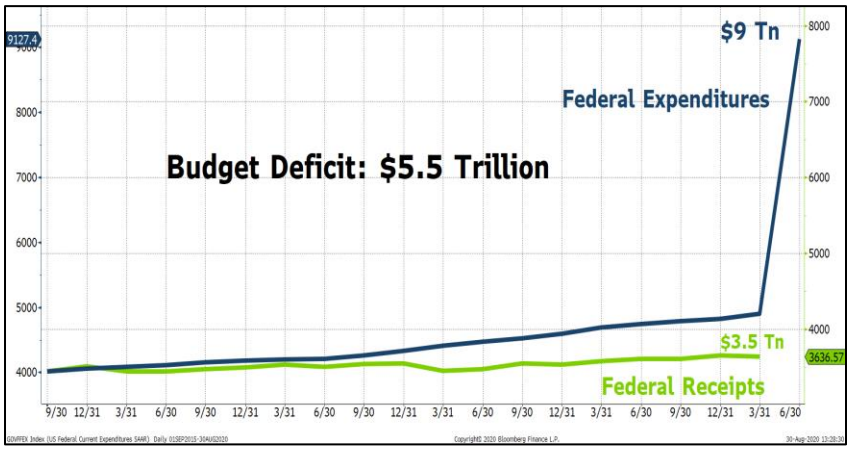


Data Source: Bloomberg

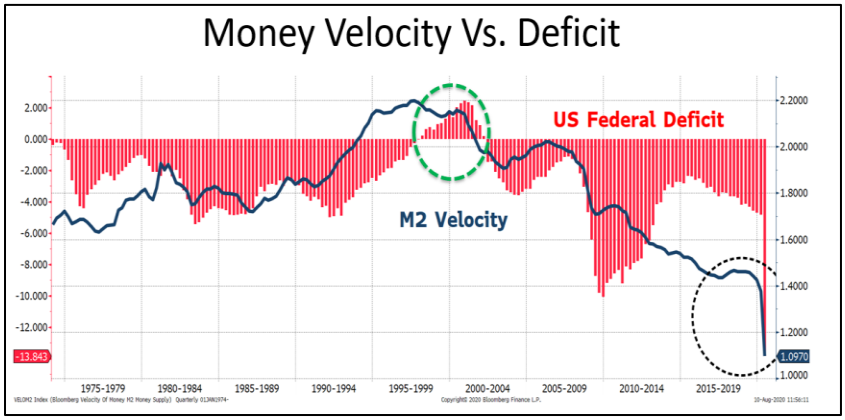
DEBT AND DEFICITS

The latest second quarter (Q2) 2020 budget deficit numbers for the U.S. have been released, and they don't look pretty. Federal government expenditures (annual rate) have ballooned to $9 trillion while federal government receipts (annual rate) have dropped to $3.5 trillion. This has resulted in an annually adjusted budget deficit of $5.5 trillion.

The inflation crowd says that as debt/deficits rise, the Federal Reserve will have to massively increase its balance sheet via more asset purchases. As the Federal Reserve prints more money to buy up assets, the U.S. dollar will lose value due to ultra-low interest rates and QE, and inflation will rise.



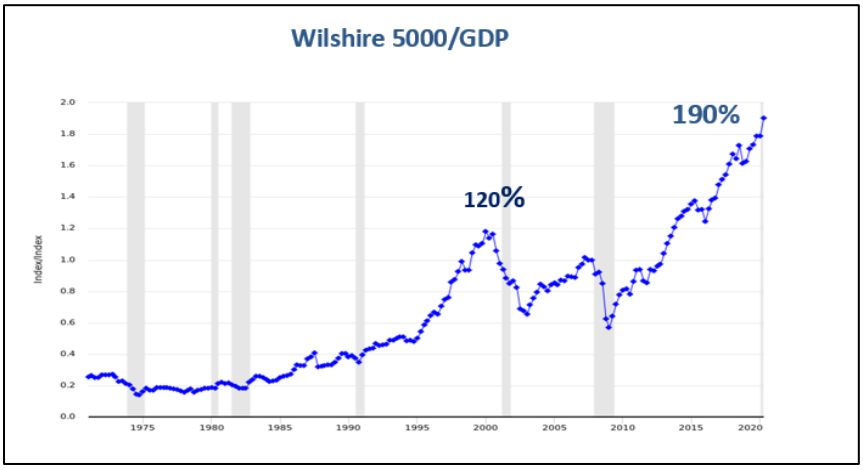
But there is no evidence that higher debt leads to higher inflation. In fact, debt has proven to be deflationary over the past decade. The reason being that debt servicing costs reduce the amount of money that can be invested in productive investments in the economy. Thus, growth slows. As you can glean from the graph, when the U.S. was running a surplus, M2 velocity rose. This increases the turnover of money leading to higher growth and inflation. Just the opposite occurs when we are running deficits. Since 1999, as deficits have increased, M2 velocity has steadily declined and is now at a record low.



CONCLUSION

Yes, inflation or stagflation may be in the future, but the price paradigm does not change on a dime. It takes time. And this can only happen once excess labor and manufacturing slack is reduced, and the record output gap closes significantly. Until that happens, cost increases will not be passed on to any meaningful degree.

Further, while inflation is indeed a monetary phenomenon and money supply growth is off the charts, unless the trend in money velocity reverses, the impact to prices will be *de minimis*. Finally, the secular forces afoot from aging demographics, to accelerating technological advance, to a new era of consumer frugality, are going to make 2%, or higher core inflation, an ever-elusive objective. It is difficult to envision a sustained and sharp rise in consumer prices in the near- to intermediate-term.



Source: St. Louis Fed

As has been the case since the Federal Reserve went off the reservation with its monetary experiments, the inflation we are going to get is the only inflation we have been getting all along, which is in asset inflation. As shown above, the total level of U.S. equity valuation relative to GDP (Warren Buffett's favorite valuation metric) has soared to 190%, taking out the 2000 tech-mania peak and the highest in the modern era. The S&P 500 market cap-to-GDP ratio has soared to 132%, taking out the dot-com peak of 127%. Remember how that ended. Bulls win. Bears win. Pigs get slaughtered.

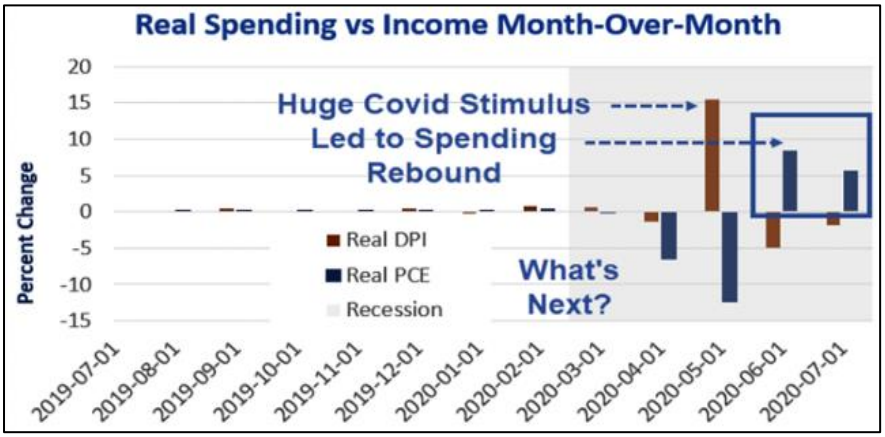
Finally, why isn't there more talk about Powell's real message from last week —that the U.S. has turned into Japan? Why is it good to tell the public that it can expect many more years, or even decades, of zero interest rates? Why is that really a good thing, unless you are debtor or leveraged investor? Is it a good thing to force cautious savers into risky assets where capital can erode (or have bear markets been outlawed)?Because most people have no basic learning in economics, they don't see that low interest rates depict a fundamentally weak economy

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Consumers continued to spend in July, but it won't last because the COVID stimulus expired on July 25 when the last weekly stimulus check of $600 was sent. As of August 28, consumers will have missed five weekly checks of $600 each. That means over 27 million people missed five weekly checks of $600 each. That works out to $81 billion dollars! That is money consumers don't have to pay rent, pay mortgages, or buy food.

Yet, despite the fact that over 20 million people are severely impacted, there is no end in sight to the bickering. Now folks are sitting on the edge of the national chair, waiting for the next stimulus check and the extra unemployment money – because without them, many folks won't have enough money to keep splurging on goods like this. A financial cliff is not coming up, it has already started. It will show up in the August data accompanied by a jump in evictions and repossessions.

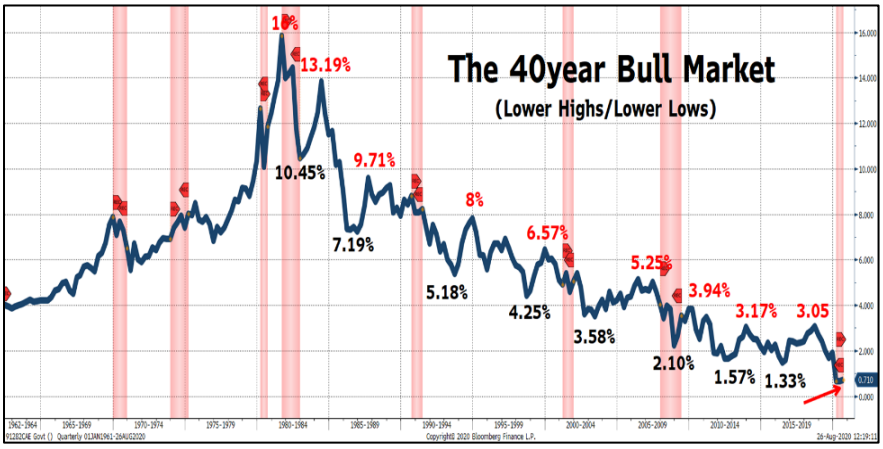
Keep your head on a swivel. The next few months are going to be a wild ride for investors.



Source: Mish Global Economics

As for Treasuries and high-quality debt, we are building up to another in the long series of buying opportunities. As shown in the graph above, there have been many sell-offs in the four-decade bull market in bonds. But as you will glean from the graph, every time the bond market has sold off in the past, the rise in rates is capped at a lower level. For 40 years, we have seen a trend of lower highs and lower lows. This is because in such a highly leveraged economy, any rise in rates will very quickly slow growth, which in turn, eventually forces rates lower. Today the financial leverage across the government and corporate sector is by far and away the highest it has ever been!

I believe there is a lot of downside in the 10-year yield if consumer confidence, jobless claims and the profit cycle continue in their current negative trends. And let's face it, there are very few things that are more important than the job of a human being and their confidence about their future.



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.

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.