alloya
INVESTMENT SERVICES

# Weekly Relative Value

**Tom Slefinger**
*SVP, Director of Institutional Fixed Income Sales*

WEEK OF SEPTEMBER 8, 2020

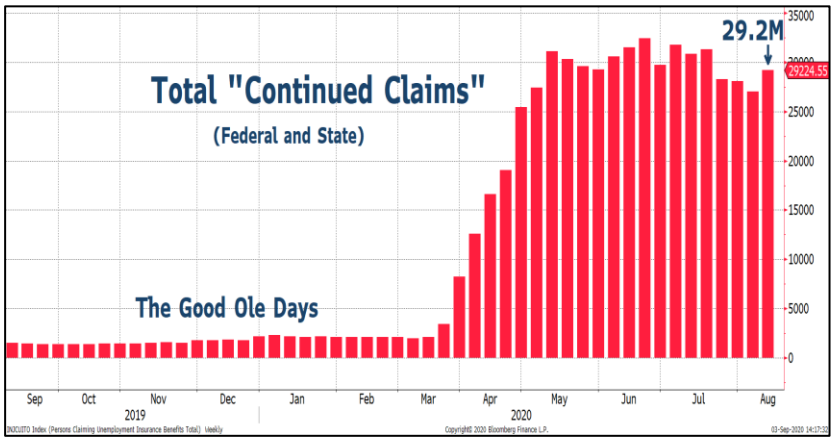
## Healing, But Not Healed

*"We think that the economy's going to need low interest rates, which support economic activity, for an extended period of time. It will be measured in years."*
*– Fed Chair Jerome Powell*

Personal consumption represents 70% of GDP. Therefore, no single piece of economic data is more important than the employment picture. So, with this in mind, let's review the most recent jobs reports from last week.

The initial jobless claims number in the week of August 29 was better than expected at 881,000 – the lowest since March 14. Even still, this is a huge number. For perspective, in the 2008/09 Great Recession, the worst monthly claims report was 665,000. Never mind that a "normal" economy has claims around 200,000.

The backlog of continuing claims also fell by 1.23 million, to 13.25 million, and well below the 24.91 million peak on May 9. This is a good sign unless these folks are dropping out of the labor force. But again, the pre-COVID-19 continuing claims were around 1.7 million.




Finally, the claims data that include all forms of benefits, as of August 15, jumped to 29.2 million from 27 million. These 29.2 million people, who continued to claim unemployment insurance (UI) under all programs translate into 18.3% of the civilian labor force (160 million).

**THIS WEEK**

- THE SECOND WAVE
- BALL AND CHAIN
- HUGE BUBBLE

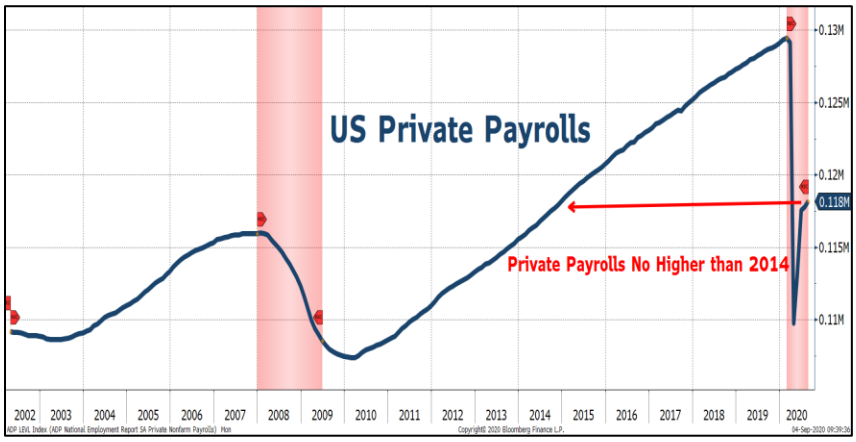
**PORTFOLIO STRATEGY**



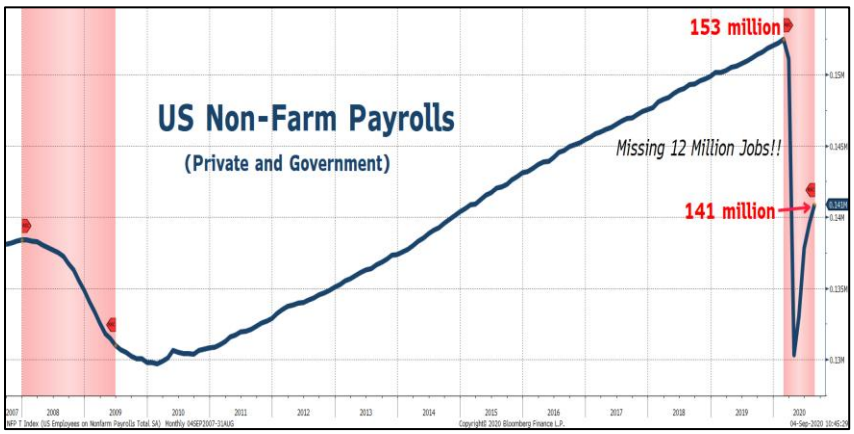
SUBSCRIBE

This number is almost two times higher than what the Bureau of Labor Statistics (BLS) reported last week (see below). So, even though we have seen jobs come back, we have a four-month recovery on our hands alongside 29 million people technically unemployed. Fascinating.

Last week, we also saw a big slowdown in ADP. Private payrolls rose 428,000, which was less than half the one million consensus estimate. In this painful grind-it-out recovery, only 43% of the job loss has been recouped in these past four months. The overall level of ADP employment today is no higher than it was in December 2014. Think about that!




Finally, last week the BLS reported that the U.S. economy added 1.4 million jobs (government and private) in August, which followed an impressive 1.8 million in July. But juicing that number were 238,000 census workers. This led to a 251,000 jump in federal workers, and a near-record 344,000 increase in total government jobs. This means that **government jobs were a whopping 25% of all job gains in August**. Once government is stripped out, private payrolls came in at 1.027 million, which actually was below the 1.325 million consensus forecast and a big haircut from the 1.481 million July jump. While it is good news that we have seen a 10.6 million rebound in private sector payrolls since the April trough, we are heading into the fifth month of stimulus-fueled recovery and still less than half of the earlier plunge has been recouped.




Bear in mind, another 2.8 million people have left the workforce altogether. The BLS does not count them as members of the workforce. And various adjustments make data look better than it is. For example, according to the BLS, the formation of over 881,000 new jobs occurred over the last three months due to net new business formations. The likelihood of that being true seems quite remote given the circumstances we are facing.

Not only that, the sense of permanence to the job carnage is palpable. The number of folks who have been unemployed for 15 weeks or longer rose 2.0% in August, up 147% since June and 359% since April. The number has soared to 8.1 million from 1.8 million four months ago. The number of "permanent" job losses jumped 534,000, to 3.4 million. This metric has soared 71% since April and is up a resounding and disconcerting 146% from year-ago levels. This points to the ongoing business closures, bankruptcies and investment cuts across the country. At its current pace, the U.S. would approach 2009-level permanent unemployment, at least relative to the total jobless, by the end of the year.


In other labor market developments, the Challenger layoff announcement data for August was not a pretty picture. There were 115,762 pink slip announcements, a 116% surge from year-ago levels and the highest number for any August in 18 years. Layoff announcements have jumped triple-digits in each of the past six months.

The National Federation of Independent Business (NFIB) found that one-in-five small business owners said that many small businesses are now reportedly running out of the money they received through the federal Paycheck Protection Program (PPP). Many will be shutting down their operations barring a sustained acceleration in economic growth in the next six months. Thus, maintaining improvement in the labor market is unlikely once government support diminishes.

Randstad RiseSmart released a survey of human resource executives in 20 industries that found that nearly half of U.S. employers who have already furloughed or laid off staff as a result of the pandemic are considering making additional cuts over the next 12 months. Goldman Sachs estimated that nearly a quarter of U.S. workers that were temporarily furloughed probably will not be called back. That is millions of people.

Massive stimulus obscures a reasonable assessment of economic fundamentals. If anything, for an economy on government life support and little else, further economic improvement will hinge on Uncle Sam's generosity. That is no sure bet.

## THE SECOND WAVE

The first wave of job cuts hit the lower level retail, hospitality and leisure sectors (retailers, hotels, restaurants, gyms, movie theaters, etc.). Just in the retail sector alone, more than one million lost their jobs in April. Retailers then focused on reducing higher paying corporate jobs. Airlines followed shortly thereafter by offering voluntary buyouts and early retirements.

While millions of lower-paid employees are now being brought back, a whole new wave of layoffs has been building momentum. And now it's well-paid jobs with decent benefits at big companies that are being shed. Big manufacturers, tech companies, airlines, and companies in the entertainment industry are now slicing high-paying jobs. It is sort of a sector rotation of layoffs, with layoffs rotating into industries with higher pay and decent benefits, hitting many of the people that had been spared in the early months of the pandemic.

We got a dose of those big-company layoffs over the past few days:

- After October 1 (the date in which they are no longer bound to the terms of the PPP), the big three U.S. airlines (American, United and Delta) may shed more than 50,000 employees.
- Schlumberger, the giant U.S. oil-field services provider, cut another 21,000 job.
- Raytheon Technologies said that it cut 8,000 people.
- General Electric had already announced in May that its aviation unit would cut 13,000 jobs.
- Salesforce is laying off 1,000 employees later this year.
- Coca-Cola Company announced that it is offering voluntary buyouts to about 4,000 employees.
- C.H. Robinson, a large freight broker, said that it has fired furloughed employees and they will not be coming back, as the company said these cuts would result in "permanent cost savings from our investments in tech."
- Wells Fargo ended its moratorium on job cuts, which may lead to tens of thousands of jobs getting cut over the next many months through "attrition, the elimination of open roles, and job displacements," according to CEO Charlie Scharf.
- MGM Resorts said that it would lay off 18,000 workers in the U.S. who had been temporarily furloughed in March. That is over a quarter of its workforce in the U.S.
- In early August, NBCUniversal started cutting up to 10% of its workforce across its broadcast and cable-television divisions, movie studios and theme parks. AT&T has also started slashing its workforce.
- Stanley Black & Decker announced at the end of July it would lay off 1,000 people and make those layoffs permanent, while reversing the furloughs of 9,000 people and bring those people back.
- Also in July, LinkedIn announced it would lay off about 1,000 employees, as its business has gotten hit by the slowdown in hiring during the pandemic.

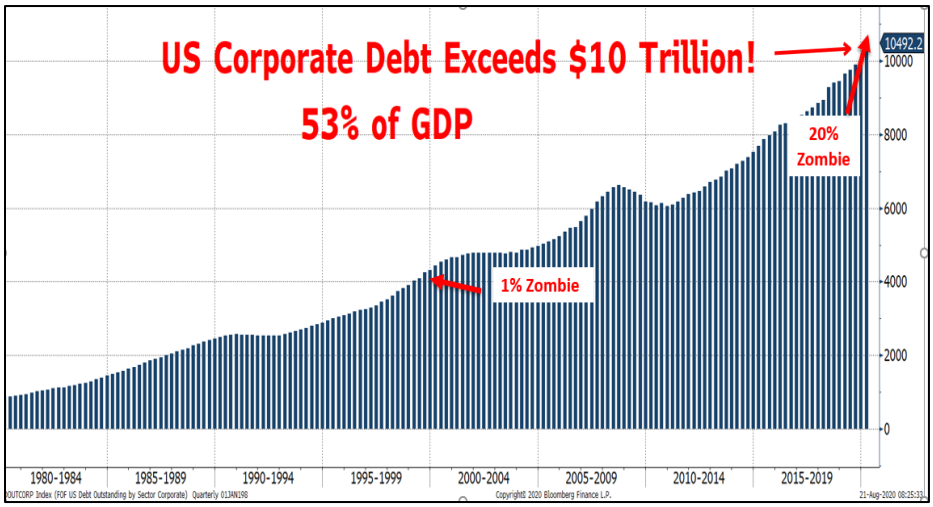
**The Bottom Line:** We are healing for sure. But we are not completely healed. The job market is still millions of jobs short of where it was before the coronavirus pandemic clobbered the economy. Higher paying jobs are now being impacted and the long-term picture shows a disturbing permanence to the long line-up of joblessness. Thus, it is encouraging to see improvement in employment amid the COVID-19 pandemic, but assuming the post-pandemic recovery will be robust or "V-shaped" is disingenuous. Given the profoundly uncertain outlook, it would be wise to avoid rose-colored lenses just yet.

## BALL AND CHAIN

The "law of diminishing returns" applies to debt. For the past four decades, economic growth has been on a steady trend lower as the debt boom has just gotten bigger and bigger and bigger. There is nothing wrong with "good debt" that is self-funding and creates economic growth. But sadly, much of the debt that has been incurred is "bad debt" that produces no long-term economic growth. For example: There was no productivity payback from the mortgage boom of 2002-07 and no productivity from that unprecedented corporate debt-for-equity swap from 2010 to 2019. There will not be any payback from the COVID fiscal stimulus.

As shown below, zombie debt now represents 20% of the corporate debt universe. Zombie companies are companies that do not have the wherewithal to pay back the principal on maturing debt. Their existence depends on the ability to roll over their debt at low rates. Thanks to the Fed. Without the Fed's support many of these companies would default and many jobs would disappear. Yet, many of these same companies loaded up on debt to buy back their stock instead of using the proceeds for the purposes of capital expenditure and increased productivity.

So, we are pulling growth forward today on Uncle Sam's credit card to preserve social stability. But this comes at a future cost to economic growth. So much for recessions being used to expunge the excesses.




More debt equals less growth. The economy is totally weighed down by this ball and chain. The table below illustrates the long-term decline in the payback from debt. Each dollar raised in debt (household, business and government sectors) now generate just 26 cents of incremental economic activity. This is one-third of the level it was back in the more stable economy of the 1950s and 1960s. This is not surprising. Anyone in Japan (or Europe) would tell you the same thing.

| Period | Change in Debt ($ billions) | Change in GDP ($ billions) | Ratio |
|---|---|---|---|
| Q1-1949 to Q4-1959 | 346.34 | 258.00 | 0.74 |
| Q4-1959 to Q4-1969 | 749.68 | 509.50 | 0.68 |
| Q4-1969 to Q4-1979 | 2,737.80 | 1,685.80 | 0.62 |
| Q4-1979 to Q4 1989 | 8,738.80 | 3,023.30 | 0.35 |
| Q4-1989 to Q4 -1999 | 13,022.02 | 4,152.20 | 0.32 |
| Q4-1999 to Q4-2019 | 45,008.09 | 11,848.00 | 0.26 |

One debt bubble ends up being replaced by another debt bubble. Maybe it is too painful to deleverage. But the debt burden is clearly acting as a tourniquet on economic activity. For those that believe more debt-financed growth will promote economic growth in the future, they are in for a big surprise. For decades, Japan built bridges to nowhere, all with borrowed money financed on the central bank balance sheet. Japan has a total economy-wide debt-to-GDP ratio of 635% versus 550% a decade ago. The results? In the decade that preceded this pandemic, real GDP growth in Japan averaged less than a 1.0%. Inflation? It averaged the grand total of 0.6%. Japan is the poster child for the law of diminishing returns as they apply to excessive debt.

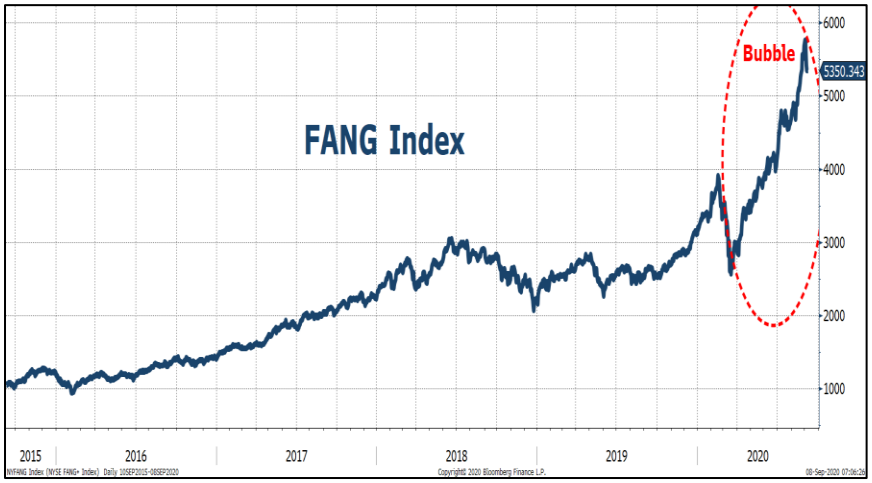
## HUGE BUBBLE

Let's be honest. We are in a huge bubble, folks.

In the late 1960s, it was the Nifty Fifty stocks. Back in those days, owning a Polaroid camera was the rage. The Polaroid has been replaced by the iPhone today. In the late 1980s, it was commercial real estate and the leveraged buyout (LBO) craze. The late 1990s were all about tech and telecom. The bubble that burst in October 2007 was housing and banks.


*Source: MarketWatch*

Today, the bubble is in passive indexing. It is a bubble in mega cap stocks, which now dominate the index weightings. Eight mega cap stocks (Amazon, Apple, Facebook, Microsoft, Netflix, Tesla, Google and Nvidia) account for 45% of the Nasdaq, or 28% of the S&P 500. We have never ever seen this much concentration in the market. And as people plow more money into indexes, the funds have to purchase more of these stocks irrespective of price.




Current extremely high valuations are not premised on past, or current, performance but on extrapolations and assumptions of the revenue and profit streams that will be delivered in the future. Expectations are extremely lofty and very likely completely unreasonable. Needless to say, there is reason for caution as we move forward. Starting valuation (aka what you actually pay for a business) has always mattered and still does.

And for all the talk about "fundamentals," we know for a fact Tesla has a global market share of less than 1%, makes no money yet has a market cap bigger than the rest of the auto industry. Over the past four quarters, Tesla's total revenues

were $26 billion. Tesla's shares are now valued at about 20 times annual revenues or approximately $476 billion. You see what I mean?

For some perspective, before last week's tumble, Amazon was up 90% for the year, Apple up more than 80%, Microsoft and Facebook up nearly 50%, and Alphabet by around 30%. There is nothing fundamental at all behind these extraordinary surges, day in and day out, in these mega caps. It is just the inflows into index funds.

And we all know that at some point this will end. But when we reach the end for egregious valuations and the inevitable mean-reversion process, it will be absolutely spectacular. As for when, no one knows. But do not expect a catalyst. There was no catalyst at the other bubble peaks. The market does not ring a bell at the top. The bursting of the Nasdaq in 2000 had nothing to do with an event or news headline. Always remember the market makes the news; the news does not make the market.

## MARKET OUTLOOK AND PORTFOLIO STRATEGY

The year-over-year change in employment is now down -6.8%. You look at it and say "Wow, it's not down -13.4% anymore!" as it was in April. And it's not even down -7.6% like last month. But guess what, it is still down -6.8%! And as far as I can see when you go all the way back, it's real hard to find any negative number. Never mind down -6.8%.

This is what they call the "V-Shaped" recovery?

This is the problem. There are people like me that are gainfully employed, making and saving money. But there are also a lot of other people that don't have a job. *Like 28 million people.*

The unemployment rate – whether they overstate it at 8.4% or 9% – doesn't matter.

On top of that, consumer confidence hit almost Draconian lows of the cycle as well.

The consumer is not what you watch on TV with the cheerleaders and pom-poms from CNBC. It's just noise. At the end of the day, we have a major unemployment problem.

So, as I said at the start of this article, as employment goes so goes consumption… and the U.S. economy.

Anything you are modeling as a "V-Shaped" recovery is a "W" at best.

**In terms of portfolio strategy, reduce excess cash and continue to maintain a fully invested, laddered portfolio of high-quality debt instruments.**

## 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 hand. 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 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.