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INVESTMENT SERVICES

Weekly Relative Value

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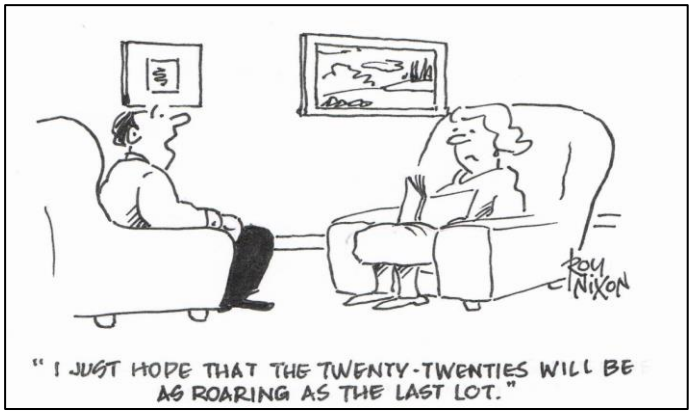
WEEK OF SEPTEMBER 28, 2020

The Return of the Roaring Twenties?

"I looked back on the roaring Twenties, with its jazz, 'Great Gatsby' and the pre-Code films as a party I had somehow managed to miss." – Hugh Hefner

I was listening to CNBC last week and the shills were out in droves. One analyst said we will likely see a replay of the "Roaring Twenties" that took hold in the aftermath of the 1918-19 Spanish Flu. Really?



Source: Cartoon Stock

The 1920s versus the 2020s

In the Roaring Twenties, World War I had ended, and industrial growth exploded. Productivity was booming. American consumerism took hold. Large-scale manufacturing and automobiles, telephones, movies, radio, and appliances were signposts of the decade. By the middle of the decade, prosperity was widespread. Real GNP (GDP was not used back then) growth during the 1920s was an amazing 43%, or 4.2% a year from 1920 to 1929. This was the age of jazz and elaborate parties. The Wall Street crash of 1929 ended the era, as the Great Depression brought years of economic misery to the masses. Except for its ending, the Roaring Twenties were a great decade to be in America!

As I have discussed numerous times in this space and most recently at Alloya's virtual Credit Union Executive Leadership Symposium (view the recording in Premier Portfolio), the U.S. has two primary long-term structural headwinds – debt and demographics – that will lead to slow growth and a low rate environment.

THIS WEEK

PORTFOLIO STRATEGY

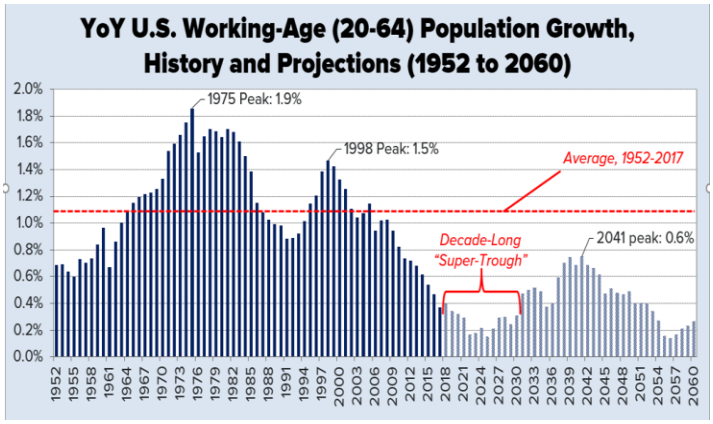
SUBSCRIBE

"Turning Japanese, I think [we're] turning Japanese, I really think so." – The Vapors

Let's discuss the Big D's.

Back in the Roaring Twenties, the U.S. had a debt-to-GDP ratio of 30%. Today, debt-to-GDP is at a whopping and unprcedeted level of 137%. And it is quite possible that total U.S. debt could reach $50 trillion by the end of this decade. And for all the talk about higher inflation, we should appreciate that higher rates could lead to a fiscal crisis. Even at the historically low rates, the the U.S. government pays over $1 billion in interest every single day! Now imagine rates rising significantly from today's levels. Do you really want to go there?

Now consider the demographic backdrop. Back in those Roaring Twenties, only 5% of the U.S. population was over the age of 65. The average life expectancy was 63 years of age. Today, the 65+ crowd is 4X higher at 20%. The average life expectancy of Americans today is 79. And they are living longer than ever. This is great, but it also means this cohort will be much more reliant on the social welfare state – Social Security, Medicare and Medicaid, which are on shaky financial legs as I type.



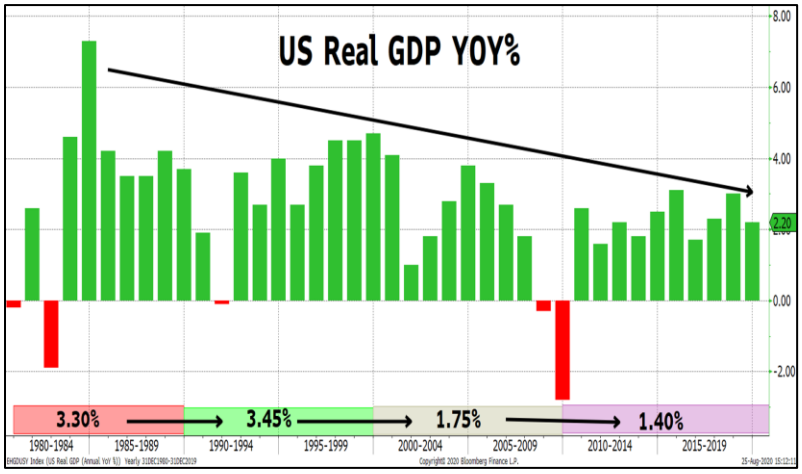
Source: Hedgeye

Back in the Roaring Twenties, there were many more taxpayers. The share of the population that was 15 years of age and younger (i.e., the future taxpayer) was over 30%. Today, that demographic cohort is barely 20%. Record-low fertility and birthrates comined with record-low immigration will lead to a smaller labor force. As shown in the graph above, the growth rate of the U.S. working-age population, which has been slowing dramatically over the last two decades, will reach a historic low during most of the 2020s before rising modestly and temporarily in the 2030s and 2040s. At just +0.2% per year, the average growth rate in the 2020s will be barely above zero. Thus, an aging population combined with a declining workforce (meaning lower tax revenue to fund the social programs) will continue to stress the already strained social welfare state. Simply put, demographics are destiny.

While we all hope and pray for better days ahead, it is preposterous to think that we will return to the economic growth rates of the 1920s once we exit the COVID recession. In the following graph, I show real GDP by year and also by the decade.

As one can glean from the graph, the U.S. economy grew at a consistent and predictable growth rate of 3.5% from the 1980s and 1990s. The trend shifted sharply lower over the past two decades with GDP coming in at approximately 1.5%.

More importantly: what is the intermediate to long-term trajectory for growth potential? If the Congressional Budget Office (CBO) is correct, don't expect a growth surge anytime soon. To wit, the CBO cut its secular economic growth outlook — not just for the next decade, but for the next three decades, from 2020 to 2050, by a quarter of a percentage point to an average annual pace of 1.6%. Compare and contrast to 2.5% annually from 1990 to 2019. Secular stagnation shows no end in sight.



In other words, no way no how will the economic resurgence post-COVID resemble the boom that took hold after the Spanish Flu. It is amazing how Wall Street can create a story of hype and hope without any substance. My advice: avoid shills at all costs.

BLOWOUT COMING…

But, make no mistake, the third quarter (Q3) real GDP will be a blowout as the reopenings, pent-up demand and the epic fiscal stimulus all went to work. According to the Wall Street consensus, GDP will clock in at 25% this quarter. The previous record growth rate was 16.7% in the first quarter of 1950. The Atlanta Fed is at 32% annualized growth. The St. Louis Fed is at 19.6%. Meanwhile, the somber New York Fed's model has a 14.3% growth rebound for Q3. Needless to say, the divergence is unprcedented. We won't get an actual GDP figure until October 29, and subsequent revisions to that number could be large.

Q3 2020 GDP Forecasts	
Atlanta GDPNow	31.95%
St. Louis Nowcast	19.59%
New York Nowcast	14.27%

Once again, let's hope and pray that the Atlanta Fed is closer to the mark. The fact of the matter is, the hole is so deep that even with the higher of the three estimates for Q3, the economy will still have shrunk at an 8% annual rate when taking into account what has happened into the lockdowns, during the lockdowns and now after the lockdowns. Think about that for a second. It would be by far the worst year ever for the economy in the post-World War II era — double the GDP decline in 2009.

While the economy will bounce back sharply in Q3, economic growth for Q4 is showing signs of weakening already. The trio of major indicators reported two weeks ago – retail sales, industrial production and housing starts – all came in well below expectations and downward revisions are expected in each one of them.

BUT STILL ON LIFE SUPPORT

"The economy is recovering robustly, but we are still in a deep hole." – Fed Vice Chair Richard Clarida

This is an economy still totally reliant on government assistance, and I'm not talking about the stimulus for income support. I'm referring to the 3.5 million home loans that are currently in forbearance. That does not include all the other personal and business debt in arrears but not yet forced into foreclosure.

The New York Times stated that 60% of landlords can no longer defer payments. While the media may portray the landlord as being heartless, they are victims, too. They need their own cash flows to meet utilities, insurance, interest, taxes, etc.

The Census Bureau's Small Business Pulse Survey showed that 31% of small businesses experienced declining revenues. Only 9% experienced an increase in sales. Yikes! Not surprisingly, only 7% of small businesses increased hiring while 10% shed staff. If not laying off workers, approximately 15% of small companies are cutting hours worked. This is twice the rate of companies that are expanding the workweek. Incredibly, only 5% see their business' operations "returning to normal" within the next three months. Fully, 15% say it will be between four and six months and 44% stated it would be more than six months. Consider that 7% say their operations will "never" get back to pre-COVID-19 levels. That folks, is a long time indeed! Suffice it to say this is disheartening news for the 30 million Americans relying on Uncle Sam's unemployment benefits.

BANKS PILE INTO TREASURY BONDS

Sometimes the bankers see things even before the masses do. For several weeks now, commercial banks have become more cautious over the economic outlook. This is not "due to what they have been saying" but rather "what they are doing." Or in this case, what they are not doing. Total bank credit declined in the week of September 9 by $7.5 billion in addition to the $26.3 billion contraction the prior week. Credit growth is now down an epic $110 billion in six of the past seven weeks. Commercial and industrial loans shrunk $5.9 billion, and have declined by approximately 20% over the past seven weeks.

In the meantime, cash balances (liquidity) have explode higher. So what are banks doing with the massive liquidity? Well, they are investing in U.S. government securities. They added $17 billion more to their cache of Treasury securities in the week of September 9. Over the the past month, banks have added over $67 billion of Treasuries to their portfolio. And get this: over the past year, the commercial banks have bought a net $270 billion of Treasury notes and bonds. This is a 30% surge in securities and five times the pace of growth in traditional lending. In a word: epic.

So what does it mean when banks have become so cautious that their Treasury securities are the fastest-growing component of their balance sheets? Either the banks aren't willing to take on the added risk or households and businesses are hunkering down themselves and focused more on savings and less on debt-financed expenditure.

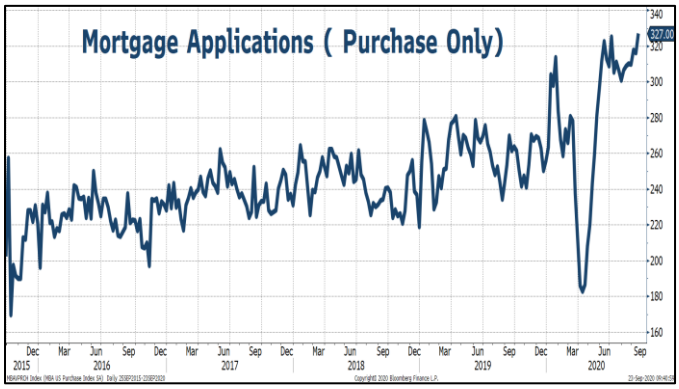
Actions speak louder than words. Think frugality, balance sheet repair.

THE HOUSING JUGGERNAUT

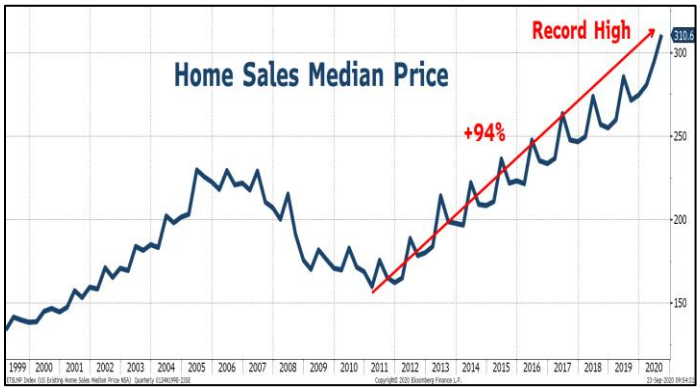
The housing juggernaut remains in full effect. Weekly mortgage application data suggest the "purchase party" remains in full palooza formation. Purchase applications have accelerated to +25% year-over-year.

All-time low rates, lower forever rate expectations, all-time tight existing market supply conditions, prospects for a long-term deurbanization trend, the possibility around climate-related migration and a grab for inflation hedge assets remain the powerful and delicious cocktail underpinning housing.

What is amazing about the spike in purchase volume is that it's happening at the same time mortgage credit availability is tightening. Presumably, this underscores the broader inequality dynamics that have pervaded the pandemic economy. Job loss is concentrated among those least able to shoulder it, whereas the wealth/income gains have disproportionately accrued to owners of capital and financial assets. Simply put, everyone who's qualified is buying a house, while everyone who isn't wishes they could.



The supply/demand dynamics are currently providing strong support to the housing market. Existing home sales have risen to a 14-year high while inventory is down -18.6% over the past year. In a low-rate tight housing market, prices have continued to appreciate. Indeed, after moving above $300,000 for the first time ever, median prices accelerated to +11.7% over the past 12 months, marking the fastest pace of growth since 2013. Since 2011, home prices have risen 94%!



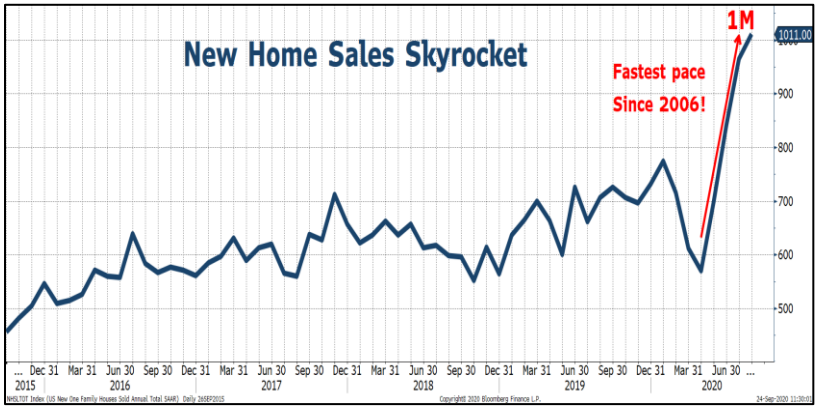
In keeping with the strong housing theme, new single-family home sales jumped by 45.6% year-over-year to 83,000 (not seasonally adjusted) matching July deals, and a notch above June deals (79,000). All three of them were the highest monthly sales since April 2007. This is a massive shift. It's not that the numbers are huge but the increases in sales are huge, and they're becoming persistent.

The seasonally adjusted annual rate – the number of sales for an entire year if sales continue at the August pace – jumped by 43.2% to 1.01 million houses, the highest since the November 2006. As incredible as it sounds, new home sales are up at a 458% annual rate from April lows. The South is clearly in the lead in the housing sweepstakes (at least when it comes to new housing). At 636,000 units, sales are at their highest level since December 2005. So, sales are up in the South by over 13% and dropped 7.2% in the rest of the country.

There has been a pile of anecdotal evidence that a shift is taking place from some cities, and especially from apartments, to houses a little further out, or in more distant suburbs, or to other towns in cheaper parts of the country. This evidence includes plunging rents and rising apartment vacancies in cities like New York City, San Francisco or Seattle. And part of this shift is showing up in new houses. While this still could be just a blip, with people flocking back to cities soon, it's harder to write off as a blip after three months of soaring demand for new houses.

There are all kinds of explanations for this phenomenon. Working from home for many employees reduces the issue of commutes. The virus makes high-rise living less than desirable, so folks flee for the suburbs where it's easy to social distance. Record-low mortgage rates. Younger couples decide to start a family and need more space.

But now that new home sales have crossed above the one million mark for the first time in 14 years, it's a pretty safe bet that this is as good as it is going to get. The frenzy is most likely now in the rearview mirror.

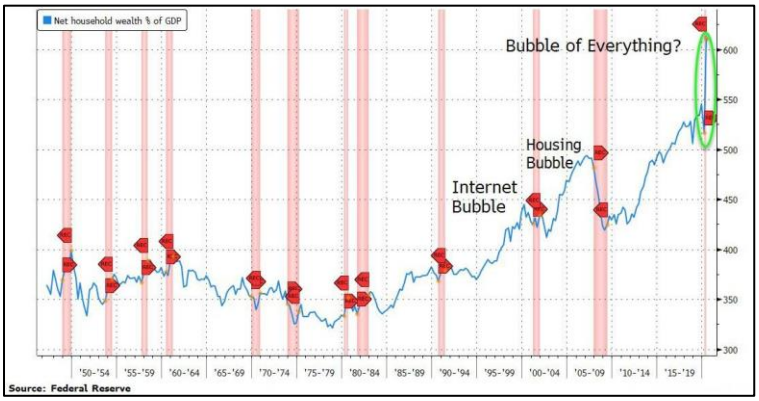


MISSION ACCOMPLISHED

Thanks to unprecedented fiscal and monetary stimulus, U.S. household wealth jumped to the highest level ever! The net worth of households and nonprofit organizations jumped 6.8% in the second quarter, to $118.96 trillion. That is about $380 billion more than at the end of 2019, before the COVID pandemic wiped out more than $7 trillion of household wealth. Please understand that asset pricing is not a function of corporate or economic fundamentals. Asset prices have been driven higher by massive money printing at the Federal Reserve.

Since March alone, the Fed has printed over $3 trillion! Most of that money has ended up in the financial markets. So, the Fed has accomplished its mission of driving prices higher to create a positive wealth effect. But I would consider this "fake news."

This is also known as the "everything bubble." It works until it doesn't. Sadly, like all asset bubbles, they eventually burst. Just don't know when!



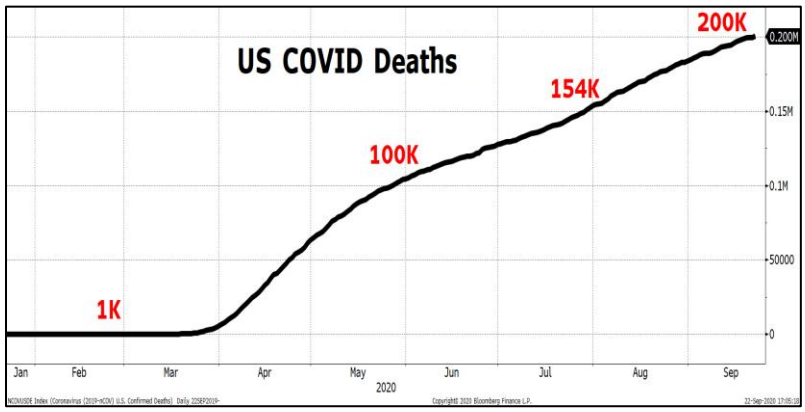
WE BLEW IT!

"We've done a phenomenal job. Not just a good job, a phenomenal job. Other than public relations, but that's because I have fake news. You can't convince them of anything, they're fake… On public relations, I give myself a D. On the job itself, we take an A+ with the ventilators and now with the vaccines that are years ahead of schedule."
– President Trump on his pandemic performance, September 22, 2020

Last week marked another devastating milestone in the 2020 history books:

- **February 29:** First reported U.S. coronavirus death.
- **May 23:** U.S. death toll hits 100,000.
- **September 22:** U.S. death toll hits 200,000.

How large is 200,000? That equates to an average of 858 American lives lost per day. It is equivalent to 1.5 deaths per minute, a plane crash every day, 67 9/11 attacks. And it is more than the number of Americans killed in the five most recent wars combined: the Korean War, the Vietnam War, the Iraq War and the Persian Gulf War.



I realize this is a politically charged environment, but from my perch, the U.S. has abjectly failed in its response to this pandemic.

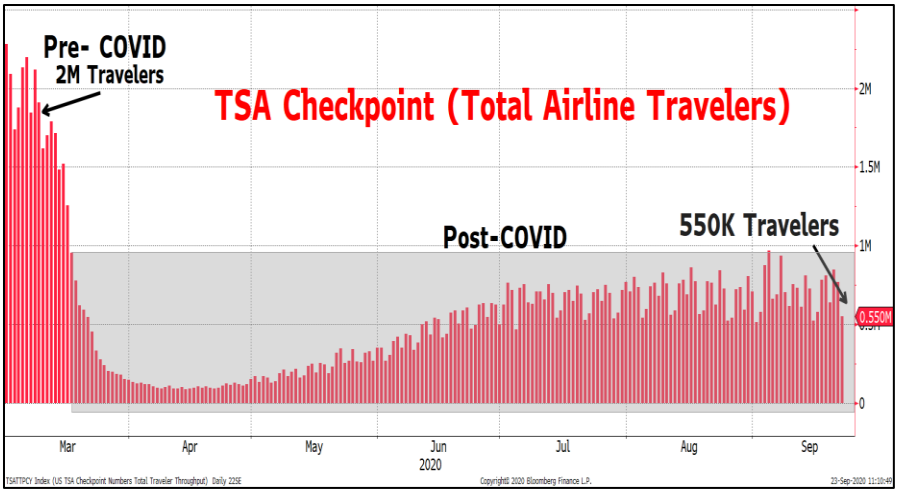
- The federal response has been abysmal**.** Period.
- Many states made errors around quarantines and face mask rules.
- The populace isn't immune from blame**:** America has been an outlier for its culture wars over face masks and social distancing.

The bottom line: While some want to politicize this health crisis, the cold hard reality is the U.S. has never managed to get the virus firmly under control. In fact, the entire U.S. posted 45,444 new cases on Saturday and is up 0.7% in the past week. No improvement in the trend at all. Deaths keep coming. Furthermore, with no vaccine on the horizon, the misery will not end anytime soon. Dr. Anthony Fauci came out and said, "we're afraid things could actually get worse." Cases and deaths could get worse again as the weather gets colder and people move indoors, and the onset of flu season could make treatment more difficult.

People, this is not a socialist hoax! For the wealthiest, and strongest country on planet earth, this is unacceptable. Then again, it is what it is.

FIGHT FOR SURVIVAL

U.S. airlines are fighting for survival. They have no choice but to shed massive amounts of employees with traffic down about 74% from normal. Airlines received $25 billion to keep employees on through September 30. Layoffs begin October 1. Republican senators introduced a bill last week for $28 billion in aid to airlines.



In this political environment, it is difficult to say what, if anything, passes. But according to Leeham News, at a minimum we are talking about a reduction of about 100,000 direct airline jobs. And more importantly, how long will it take for the airline industry to recover? Estimates vary widely from four to nine years depending on the source.

SIX WEEKS TO GO

"How did things ever go so far? Well, no matter. A lot of foolishness has come to pass. It was so unfortunate, so unnecessary." – Vito Corleone, The Godfather

We are now within six weeks of the election. And I believe it is safe to say, this election will be like no other. We may not know who won the electoral college vote the day after, and quite possibly not until January. There is a precedent for

this. Remember the "chads" in Florida, which held the keys to the White House. This went all the way to the Supreme Court, which overturned a decision by the Florida court. The election was November 7 and the uncertainty wasn't dampened until the Supreme Court ruling on December 12 of that year. Five weeks of agony.

But the 2000 election will prove to be a walk in the park compared to the election in 2020. The President has already said he won't go quietly while Congress ensured a smooth transition. Anarchy cannot be ruled out. You have to go back to 1876 to see such a volatile (and frankly, embarrassing) political situation. This surreal and extreme political divide and discord reminds me of that scene in *The Godfather* at the big bank building. Vito Corleone stands up and asks: "How did things ever go so far? Well, no matter. A lot of foolishness has come to pass. It was so unfortunate, so unnecessary." There is so much more at stake and the rancor and divisiveness are in the stratosphere.

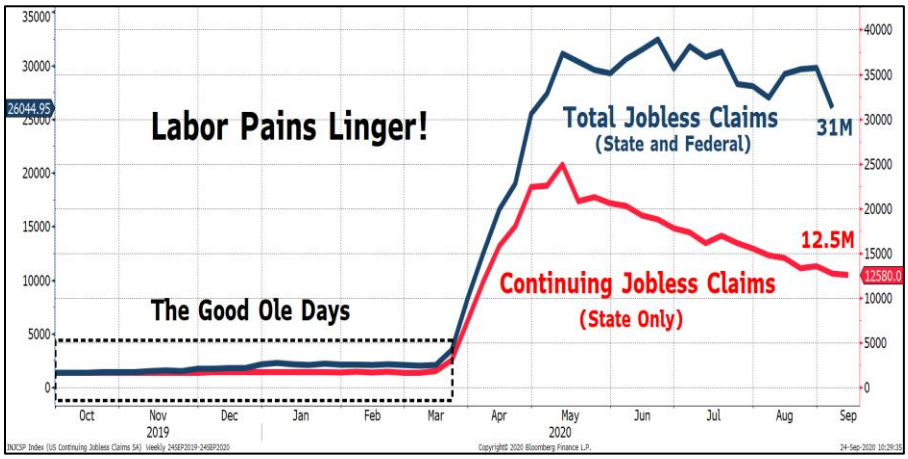
Buckle up for the next six weeks. It will be a ride to remember (and hopefully forget)!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The most difficult part of the recovery is still ahead of us." – Boston Fed President Eric Rosengren

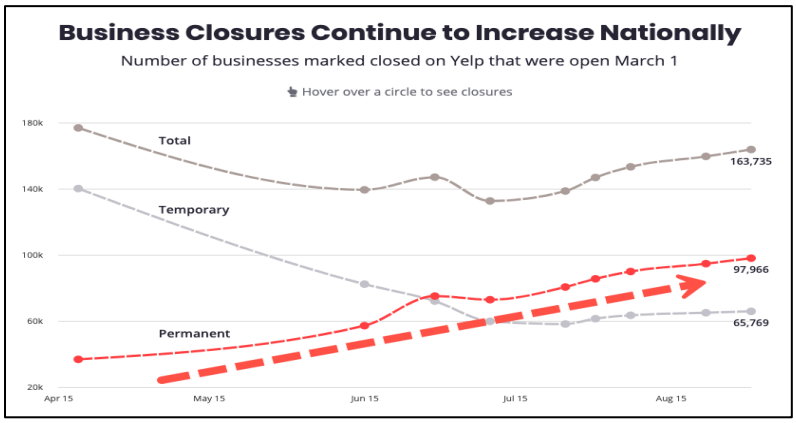
In the near term the economy appears to be fading for the reasons below:

1. Another week of higher-than-expected initial jobless claims — coming in at 870,000 in the week of September 19, versus the 840,000-consensus expectation. The backlog of continuing claims came in far above expectations, at 12.580 million (for September 12) and the September 5 week saw a big upward revision to 12.747 million. These numbers are mind-blowing and in a very negative way. The improving trend through spring and summer has completely stalled out. We have now seen 27 straight weeks of claims stuck above 800,000, which is a horrific number and shows what is happening in the absence of fresh rounds of fiscal assistance – and the Paycheck Protection Program (PPP) in particular, which incentivized companies to hang onto their staff. It expired at the end of July.
2. PPP funding is exhausted, enhanced unemployment insurance (UI) benefits have been dramatically reduced and are nearing full exhaustion.



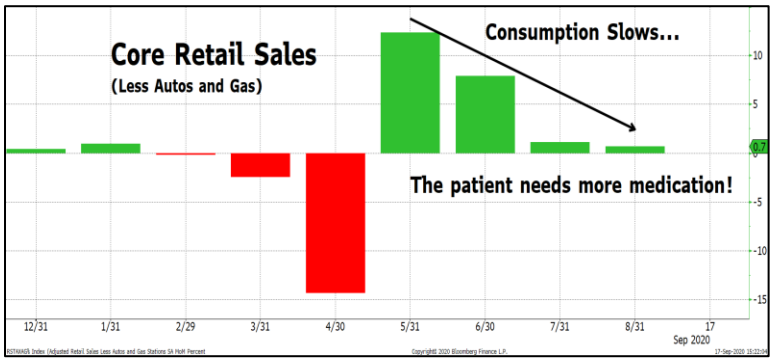
3. The transition from temporary to permanent unemployment has begun and is set to accelerate in the coming months.

4. The ranks of small businesses now transitioning to permanent closure continues to ris



Source: Yelp

5. Consumer Income Expectations (University of Michigan) are now making lower lows. Similarly, retail sales have marched progressively lower with core retail sales printing negative in August.



The bottom line: Things are not going back to "normal." Even if we do get a vaccine in the near future (and enough people are willing to take it, which is doubtful), the scale of this pandemic shock is such that significant structural changes are coming. These include a secular shift towards greater precautionary savings and declining investment. It all adds up to lower for longer for economic growth, inflation and interest rates.

As we have consistently shouted from the roof tops, in the lower for longer interest rate environment, credit unions will face contracting NIMs. Excess cash will continue to be the "house of pain" and every basis point counts. We continue to advocate that credit unions maintain a fully invested portfolio while overweighting the higher yielding sectors.

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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.