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INVESTMENT SERVICES

Weekly Relative Value

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Goodbye V, Hello L?

Since the COVID-19 pandemic wreaked heavy damage on the U.S. economy, letters have become the norm to describe the shape of the economic recovery. The most widely used letter has been the "V" to signify a quick and robust recovery. Obviously, we all hope for a quick rebound, but it is also quite possible that the economic recovery will take years to recover to pre-pandemic levels. If so, the letter "L" may best describe the economic recovery over the foreseeable future.

According to Bloomberg economists Dan Hanson and Yelena Shulyatyeva, over the past 36 recessions L-shaped recoveries are much more prevalent than the hoped-for V-shaped recovery.

In fact, according to their analysis, on average, a recession reduces growth by 4.7% from pre-recession levels. More importantly, the gap persists after three years. In other words, recessions tend to deliver permanent shocks to the level of GDP.

Their study suggests that the average shortfall among the G-7 could still be 8% below its pre-crisis path in three years' time. The consensus forecast from the Bloomberg economists is for a 4% deficit. In other words, historical experience suggests the long-term damage from the COVID shock could be twice as severe as consensus forecast of 4% suggest.

But the key is the labor markets – and things could easily turn out worse. There are now 3.7 million Americans (and rising) who have been unemployed for more than six months. Recent data suggest about 30% of job losses may be permanent.

Harvard projections show long-term unemployment peaking in early 2021. Depending on the speed of the recovery, it's likely to reach 3.9 million people at best, and 5.1 million in a

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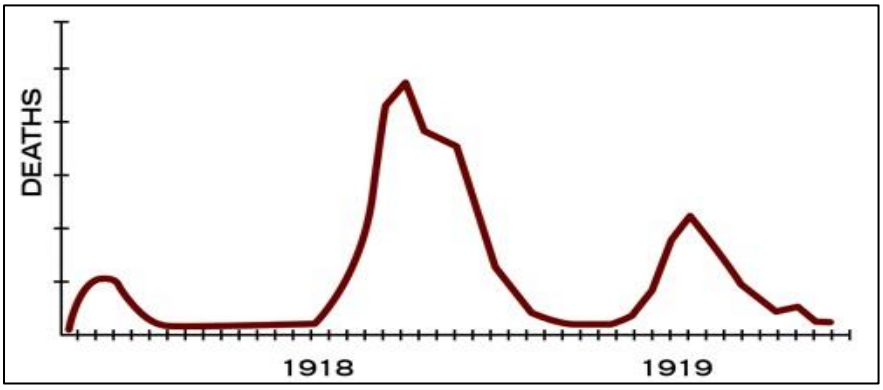
worst-case scenario. Mark Zandi, chief economist at Moody's, sees a peak of five million long-term unemployed as a baseline scenario. While the economic recession looks like it ended in April, rising long-term unemployment acts as a drag on the broader economy. Without new stimulus, the number of jobless could end up being almost as bad as the Great Recession.

So, with many jobs gone forever as a result of the pandemic, long-term damage to the labor market may be the biggest risk. Many of those who've lost their jobs have already been defined as long-term unemployed, which leads to atrophied skills and still longer-term joblessness. In turn, wage income stalls or declines. Likewise, workers are also more likely to accept lower wages during a downturn, exacerbating the slowdown on income and spending.

As of now, the world is likely facing a second wave of COVID infections this winter. Remember the history of the 1918-19 Spanish Flu (see graph below) as Old Man Winter rolled in? Thus, it's not hard to imagine how the pandemic could inflict significantly more long-term damage than forecasters envisage. This is not particularly comforting but forewarned is forearmed.



Source: CDC.gov

By this time next month, the regular flu season will be well underway. This is a problem because people with flu symptoms may think they have COVID-19 and panic. Or people with COVID-19 may think it's just the flu and not seek treatment. Either would be bad. But on the bright side, the masks and social distancing might reduce flu transmission. Regardless, everyone should get a flu vaccine.

The bottom line: I wasn't thrilled with the economy a year ago, but I'd take it again in a heartbeat. We will get through this, but the recovery in front of us will be slower than we like. History shows it will take time. We're only at the end of the beginning of the pandemic.

UPRECEDENTED

"The word unprecedented is rarely used properly. This time, it's being used properly. It's unprecedented what's going on around the world, and obviously COVID itself is a main attribute. The economy would be in shambles without the safety net of the CARES Act. In a normal recession unemployment goes up, delinquencies go up, charge offs go up, home prices go down; none of that's true here. Savings are up, incomes are up, home prices are up. So you will see the effect of this recession; you're just not going to see it right away because of all the stimulus."
– JPMorgan Chase CEO Jamie Dimon

Thanks to the generosity of Uncle Sam, this is the first ever recession in which incomes rose when wages fell 10%. Think about that. In fact, personal income growth is more than double with the pandemic than it would have been without it, all because of the deep pockets of Uncle Sam. Even Houdini would be jealous of this magic act.

Today, personal incomes (borrowed money from the government and financed by the Fed) are higher than pre-COVID – and that has back stopped the economy. Consumer spending is 70% of the U. S. economy, and we have seen a huge third-quarter snapback. The Atlanta Fed GDPNow is projecting a 35% jump in GDP in the third quarter (Q3). The more somber New York Fed model is projecting an increase of 14%. Wall Street economists are looking for something in between with a 20% plus bump in Q3 GDP.

But a year from now when we look back, will we realize that this is the good part of the economic recovery and that incomes will fall in the next phase as government programs end? If so, instead of the normal economic recovery cycle from bad to better to good and then full recovery, maybe the sequence will be from bad to better to bad again and then we just stall at a low growth rate (the L-shaped recovery).

As we move forward, we need to determine if the current recovery is in reverse? And is this as good as it gets?

I truly hope I'm wrong, but I say "yes" to both questions.

THE VACCINE

"When lost output and health setbacks are taken into account, the economic toll of the pandemic is expected to exceed $16 trillion, or about 90% of U.S. annual gross domestic product."
– Journal of the American Medical Association (JAMA), 10/12/2020

The U.S. leads the world in total coronavirus deaths, with 214,776 as of Monday and more than 7.5 million confirmed infections of COVID-19. And there is no end in sight as the spread continues unabated. No country has an effective vaccine, treatments or hospitals that give them an advantage over the rest of the world. According to the JAMA, the difference comes down to each country's response. The U.S. largely failed to embrace public health and policy measures that have helped other countries reduce death rates.

By April, the first-generation vaccines should be widely available. And while there is tremendous hope over a vaccine it's important to note that vaccines are rarely 100% effective. The vaccine is expected to be possibly 60%-70% effective. The question will then become whether people will people want it. For those who take the vaccine, they may remain uncertain as to whether they were in fact immunized. This, in turn, could mean that their behavior will not change

dramatically. Consider the math. A 60% effective vaccine given to 50% of the population will mean only 30% of us are protected, and we won't know exactly which 30%.

That's not enough to change public behaviors, which are key to normalizing the economy. Fear and caution are what disrupt the economy. It's perfectly rational, too.

Secondly, the first vaccine is likely to be effective mainly/only against prevention of severe COVID-19 and NOT effective against reducing transmission. As a result, immunized people may not get sick, but could still pass on the virus to others.

As a result, we should have fewer deaths, but may end up having a faster spread as more immunized people don't realize that they are sick even if infected. I should also point out that no one under the age of 18 years old is being tested with these vaccines, so the whole school-age transmission issue will still exist for some time until the vaccines are proven safe and effective on children.

I had once thought that a vaccine would be a game changer — but maybe that's not the case. A vaccine will help for sure, but it will not necessarily spell the end to the saga. Because of vaccine limitations, my own view is that we are probably one to two years away from normality. Americans will have to continue to use measures like social distancing and mask wearing to limit transmission of the virus. Such steps will be particularly critical in the winter and spring, when colder weather pins much of the country indoors. Hopefully reality is better than expected.

THE GREATEST ECONOMY OF ALL TIME

Presidents are often given too much credit for a strong economy and too much blame for a weak economy. The reality is, there are many factors that affect the economy, and most are outside any one person's control. Long-term macro trends such as demographics, globalization and events like wars and pandemics have a much larger impact on the economic report card.

Because the state of the economy is important to all of us, as we enter what will likely be one of the most contentious and consequential elections of our lifetime, it's important to review what has happened over the Trump administration and compare those results to prior administrations.

President	Federal Spending	Federal Deficit	Fed Funds	Real GDP	Employment Growth	Real Consumption	S&P 500
Kennedy/Johnson (1960-1968)	4.1%	-1.0%	3.7%	4.4%	2.7%	4.5%	7.2%
Nixon/Ford (1969-1976)	-2.5%	-1.6%	6.4%	2.7%	1.9%	3.5%	-0.3%
Carter (1977-1980)	2.8%	-1.9%	10.7%	3.2%	0.1%	2.5%	6.7%
Reagan (1981-1988)	4.3%	-1.1%	10.5%	3.6%	2.0%	3.9%	9.5%
Bush Sr. (1989-1992)	0.3%	-1.1%	6.5%	2.2%	0.6%	2.2%	11.4%
Clinton (1993-2000)	-1.4%	-0.5%	5.5%	3.8%	2.4%	4.1%	15.8%
GW Bush (2001-2008)	4.6%	-2.2%	2.9%	1.8%	0.3%	2.3%	15.8%
Obama (2009-2016)	-0.5%	-5.6%	0.1%	1.9%	0.9%	2.1%	-4.9%
Trump (2017-2020)	3.8%	-6.7%	1.4%	1.0%	-0.8%	1.0%	11.6%
Trump (pre-COVID) (2017-2019)	3%	-4.2%	1.7%	2.5%	1.5%	2.6%	12.2%

The table above summarizes key economic variables as well as monetary and fiscal policy based on six decades of data. I will let the readers decide whether or not this has been the greatest economy of all time but below I provide some of my thoughts.

Prior to COVID-19, the Trump administration was heading towards a comparably strong economic outlook versus the Obama administration. That is not saying much as the economic recovery during the Obama recovery was the weakest recovery of all time. Trump's economy, boosted by massive deficit financed tax cuts in 2016-2017, was on pace for the highest growth rate since the Clinton administration. But keep in mind, even with the massive fiscal stimulus, the economy pre-COVID was beginning to slow as we entered 2020. In fact, the Fed was forced into lowering rates three times in 2019. This is hardly the sign of the greatest economy of all time.

Furthermore, when factoring in COVID, the economy has been decimated with the average annual growth now the weakest of any presidential term. This obviously points to how a single event or "black swan" can decide the results of an economy, regardless of president or political party.

At the same time, employment and consumer spending were slowly recovering after the long grind out of 2008. The unemployment rate fell to 3.5%, its lowest point since 1969. But again, with the massive job losses since the outbreak of COVID, this presidency is the only one to record negative overall employment growth as it stands now.

Regarding the stock market, it was on track for one of its best performances, save for the pre-dot-com bubble. Overall, the S&P 500 has still fared only slightly better than during the Obama and Bush Sr. administrations. And we know this market was largely driven by unprecedented fiscal and monetary stimulus.

Here's the bottom line: our next president will be forced to make difficult decisions about government spending and taxation to help the U.S. emerge from this unprecedented catastrophe.

NO BILLIONAIRES LEFT BEHIND

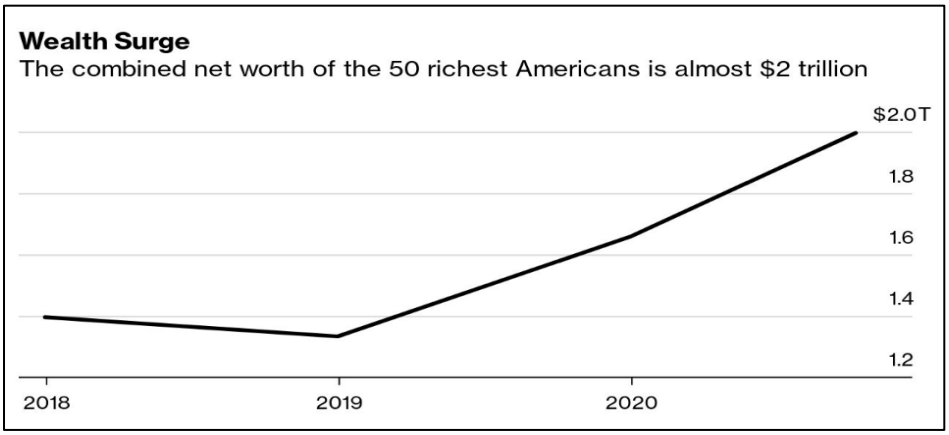
"The pandemic is further widening divides in wealth and economic mobility… A long period of unnecessarily slow progress could continue to exacerbate existing disparities in our economy." – Fed Chair Jerome Powell

COIVD-19 combined with extreme monetary policy have exacerbated income and wealth inequality in the U.S., with job losses falling heavily on low-wage service workers. Meanwhile, many upper-middle class professionals are working from home, watching their retirement accounts rise after the U.S. Treasury and Fed pumped stimulus into the economy and markets.

The U.S. Federal Reserve reported its latest data on wealth distribution in the U.S., and the data point to a gaping disparity by race, age and class. The top 10% of U.S. households hold 69% of the country's wealth, or $77.3 trillion, up from a 60.9% share at the end of the 1980s. And the top 1% of Americans have a combined net worth of $34.2 trillion or 30.5% of U.S. wealth, up from 23.7% in late 1989.

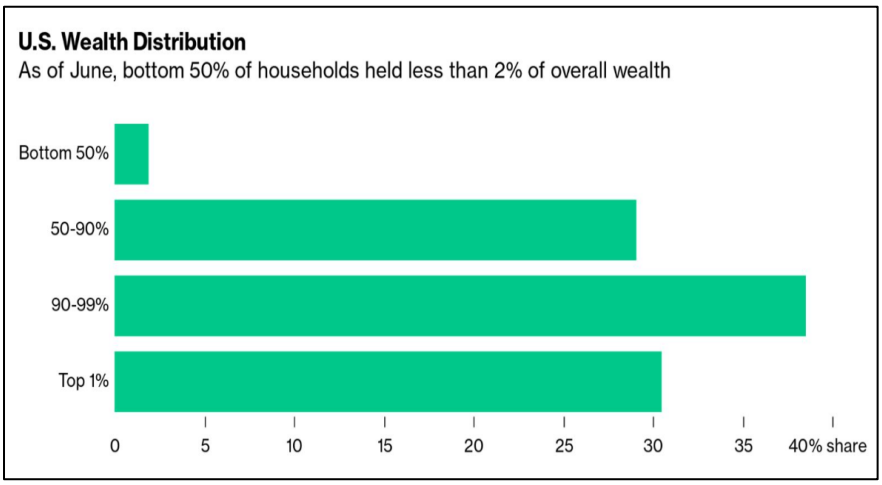
The very richest Americans are almost entirely responsible for the huge gains. Since the stimulus and central bank shenanigans, the rally in stock prices has pushed the wealth of just over 2,000 billionaires finally over the well-deserved $10 trillion mark, beating the previous record of $8.9 trillion at the end of 2019. The 50 richest people are worth almost $2 trillion, up $339 billion from the beginning of 2020. Get this: between April 7 and July 31, billionaires in the

technology, healthcare and industrial sectors saw their wealth increase by 36% to 44%. No billionaire's billions left behind.



Source: Bloomberg

On the other side of the spectrum, the poorest 50% — about 165 million people — hold just $2.08 trillion, or 1.9% of all household wealth. In a nutshell, the 50 wealthiest Americans now hold almost as much wealth as half of the U.S.



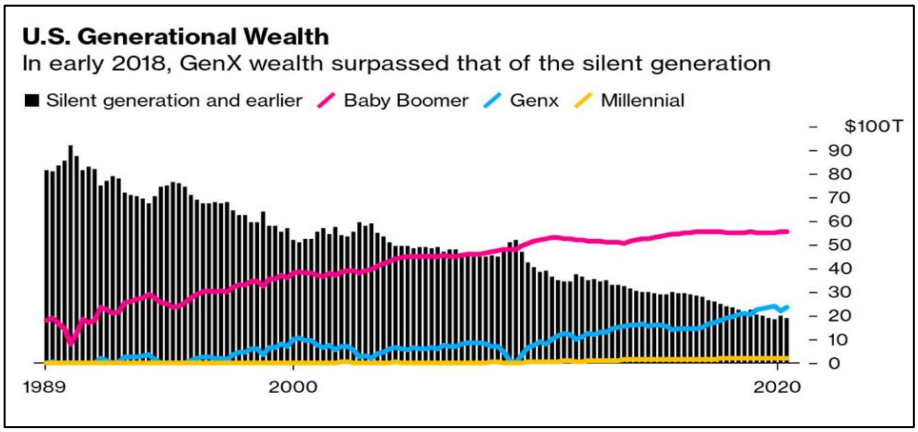
Source: Bloomberg

The reason for this gaping difference is because the wealthiest 1% own more than 50% of the equity exposure. The next 9% of the wealthiest own more than a third. In total, the top 10% of Americans hold more than 88% of the equity exposure.

On the other hand, the bottom middle to upper middle income earners (50-90%) of Americans have seen their equity assets decline to 10%. The bottom 50% own a miniscule 0.5% of all equities.

By race, White Americans hold 83.9% of the nation's wealth, compared with 4.1% for Black households. Interestingly Black Americans have not increased their exposure in three decades.

In terms of age cohorts, baby boomers' wealth is $59.6 trillion, twice generation X's $28.5 trillion and more than 10 times millennials' $5.2 trillion. Even though they are the largest with 72 million Americans.

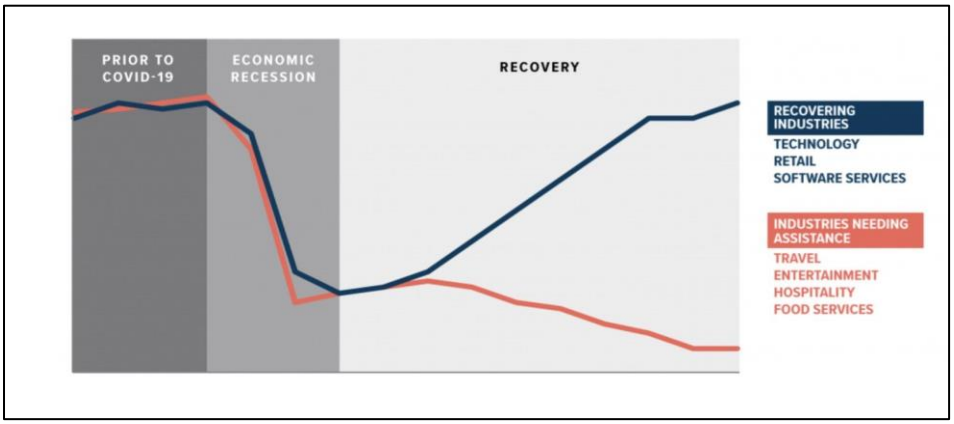


Source: Bloomberg

DIVIDED WE FALL

"Opportunity and inclusion are important for achieving a strong economy, and the recently announced revision to the Fed's strategy for setting monetary policy explicitly states that we view maximum employment, one part of our statutory mandate, as a broad-based and inclusive goal." – Cleveland Fed President Lorretta Mester

The COVID-19 crisis is exacerbating the gulf in income and wealth that had widened in the past 30 years as the people most affected work in sectors that offer some of the lowest levels of compensation (e.g., travel and tourism, dine-in restaurants). This is something every one of us should care about because shared prosperity acts to move the economy forward.



Source: Bloomberg

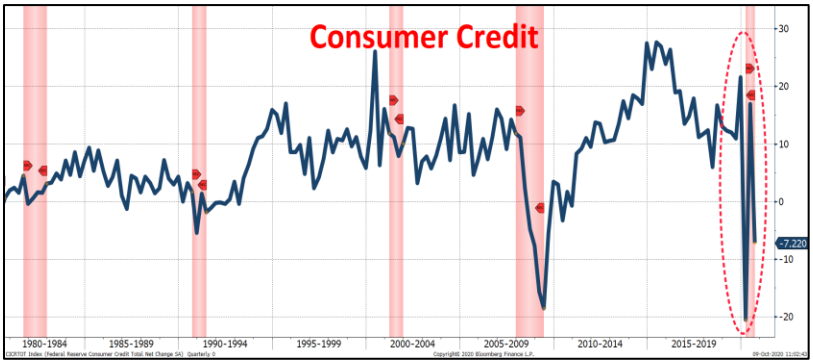
Growing inequality, on the other hand, is a brake on growth, meaning that the K-shaped recovery will only serve to worsen the inequities that grew after the last recession.

Barron's hosted an online conference on wealth inequality recently, and a key theme was the role that addressing it will play in the economic recovery from the pandemic (Read: Closing the Wealth Gap is one Key to Recovering from the

Pandemic). The growing disparity in economic outcomes has also become a talking point for the Fed. In her recent speech to the African American Chamber of Commerce of Western Pennsylvania, Cleveland Fed President Loretta Mester took the time to highlight the barriers that economic inequality puts on the most disadvantaged, and reemphasized that inclusive growth is now a part of the Fed mandate.

THE FRUGAL AMERICAN

Over the past six months, households have paid down a total of $67 billion of non-mortgage debt, which is unprecedented.



The sharpest declines are occurring in credit cards (very service oriented, as in the link to travel/tourism) where balances have receded in each of the past six months. Outstanding consumer credit declined $7.22 billion in August. At $985 billion in credit card debt outstanding, the level is actually lower today than in November 2007, at the peak of that business cycle 13 years ago!

Now, I ask you: cutting up a credit card or two... just how un-American is that? Surely deserving of a presidential tweet, don't you think?

The bottom line: many Americans are exhibiting an increasing level of frugality.

LIVING WITH LOWER FOR LONGER = BUY BONDS ON PRICE DIPS!

Bond bears are out in full force. They say that there is no value in the Treasury market. That we are on the precipice of a reflation cycle, aided and abetted by endless monetary and fiscal stimulus. Yawn.

First, the really big picture. At the end of the 2008-09 recession, the yield on the 10-year Treasury was 3.7%. The economy was taking hold and there was endless policy stimulus through the entire period (e.g., infrastructure, tax cuts, expansion of the Fed's balance sheet).

And the same "pundits" were saying the exact same thing as they are now. Back then, yields also were viewed as being too low and only had one way to go and that was up. Same old, same old. And here we are today, with yields having plummeted 300 basis points for both maturities since the end of the last recession. So now the yield on the Treasury benchmark has risen a measly 10 basis points in a matter of a few weeks, and the same bond bears were telling you to get out of the Treasury market. And... they're back.

Let's take the 10-year Treasury as an example. The table below plots the recent upward moves in the 10-year Treasury yield since 2019. In 2009, the yield spiked 77 basis points (3.21% % to 3.98%). The bears said, "Sell the farm!" Then in 2010-2011, the yield rose from 2.41% to 3.65% for a 124-basis-point surge. "Dump your bonds," before it's too late!

As shown below, rates do not move in a straight line and there have been sell-offs over the past decade. But every time rates rose, they rose to lower highs and when rates reversed, they ended up at lower lows. That is why we have repeatedly advocated that credit unions "buy the dips" and maintain a fully invested portfolio. "Lower highs and lower lows" have been the name of the game since 2009.

Previous Hiccups in the 10-year Treasury Yield				
Start	End	Low (%)	High (%)	Chg.(bps)
10/01/2009	04/06/2010	3.21	3.98	77
10/08/2010	02/09/2011	2.41	3.65	124
07/25/2012	03/12/2013	1.43	2.03	60
05/01/2013	09/09/2013	1.66	2.90	124
01/30/2015	06/12/2015	1.68	2.39	71
07/05/2016	03/14/2017	1.37	2.60	123
09/07/2017	11/05/2018	2.05	3.20	115

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The markets continue to feed off stimulus hopes. But for the economy, the backdrop is fragile, and the outlook is clouded. That surely came across loud and clear in the latest set of Federal Open Market Committee (FOMC) minutes and in the Census Bureau's released latest survey results from September 16-28.

Brace yourself:

- 60 million Americans expect someone in their household will either lose a job or see a pay cut in the next four weeks.
- 27% of those between 25 and 54 years of age anticipate income losses for them or someone they live with in October.
- 32% of Americans find it "somewhat" or "very" difficult to meet their household expenses – half of these folks are now borrowing from family or friends to make ends meet.

The Conference Board found that one-third of workers are uncomfortable going back to the office. Amazingly, a mere 17% actually want to return! So much for the view promulgated by some that workers are dying to come back. More

like, they don't want to die, period. Or, more likely, get sick. Half of those polled say their biggest fear is going back to work out of the home and contracting the disease.

The economy remains in really rough shape. This is the primary reason why we continue to hold to the view that credit unions should continue to maintain a duration appropriate ladder strategy and bonds should be bought on price dips.

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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.