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Weekly Relative Value

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WEEK OF OCTOBER 19, 2020

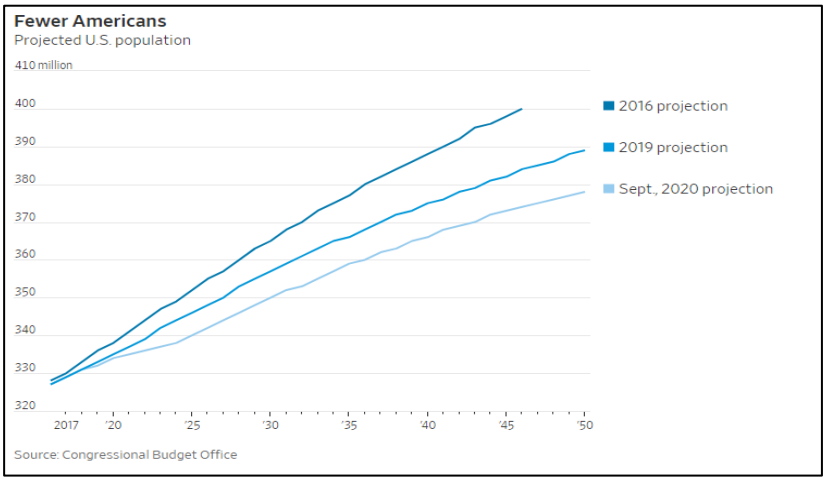
Debt Trap

"If you're worried about the short-term economic outlook, I have bad news: the long-term outlook is worse.
That's what emerges from the latest long-term budget outlook released by the Congressional Budget Office… It contained this sobering number: the agency expects annual economic growth to average just 1.6% over the next three decades—down by about a quarter of a point from its forecast a year ago—and just 1.5% by the 2040s. The U.S. hasn't had trend growth that slow since the 1930s. Only a bit of this is because of the pandemic. Most reflect longer-lasting forces, namely demographics and productivity." – Greg Ip, Wall Street Journal

The above excerpt was taken from Greg Ip's Wall Street Journal column, *Demographics and Debt Hang Over Long-Term U.S. Growth*.

It sounds familiar, does it not? For the past decade I have argued that U.S. growth, inflation and interest rates would remain "lower for longer" for the same reasons that Mr. Ip highlights in the above excerpt. While I am well aware of the risk of "confirmation bias," I believe that Mr. Ip is on the money.

Let me once again review the case for "lower for longer."



THIS WEEK

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PORTFOLIO STRATEGY

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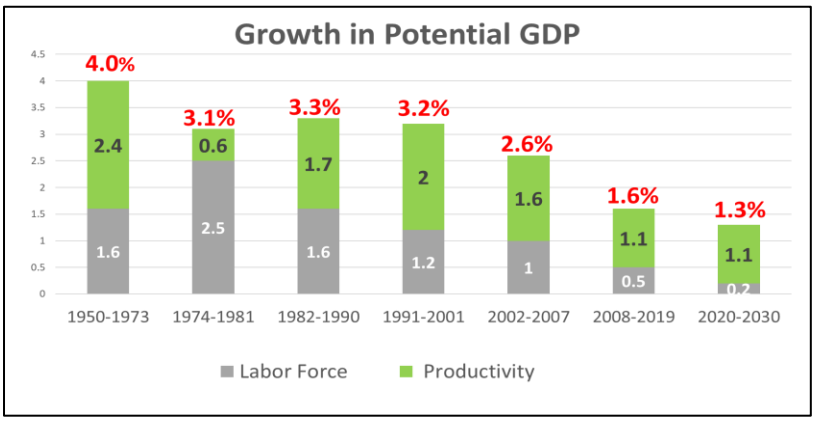
First, there is absolutely no doubt that the U.S. is aging fast and the labor force is contracting. Since 1980, the average life expectancy has inceased by eight years. On the other side of the ledger, the Congressional Budget Office (CBO) is projecting that the fertility rate will decline to 1.6 next year. If so, this would represent the lowest fertility rate in the past 100 years. More importantly, this rate would be well below the 2.1 rate at which each generation exactly replaces itself. Such low births translate into fewer people entering the labor force 20 years later.

Historically, the U.S. labor force (22 to 64-year-olds) has increased by 1.2%. Currently, the labor force is expected to grow at only 0.2% for the next decade. This will be the lowest growth in the labor force ever. And it's too late to fix the secular downtrend in the labor force. You can't buy babies on Amazon… Demographics are more or less set in stone.

So, without a growing labor force, the U.S. will have to rely on productivity gains to increase economic growth. Unfortunately, as shown below, productivity has been waning over the past decade and is also expected to fall over the next decade to 1%, or 50% lower than productivity gains realized in prior decades.

The change in labor productivity growth and potential labor force growth add up to potential GDP growth.



Data Source: Bloomberg

The CBO estimates that GDP growth will register 1.3% over the coming years, a blend of 1.1% productivity growth and 0.2% labor force growth. But 1.1% productivity growth may be a highly optimistic assumption. Barring a major technological revolution (not evolution), productivity could very well move lower, not higher, in the decade to come.

At the same time that the labor force is shrinking and productivity falling, debt has been exploding higher. Since March, debt has risen by $3 trillion! In the past decade, debt has increased by $14 trillion to $27 trillion. By Inauguration Day, federal debt will be approaching $30 trillion.

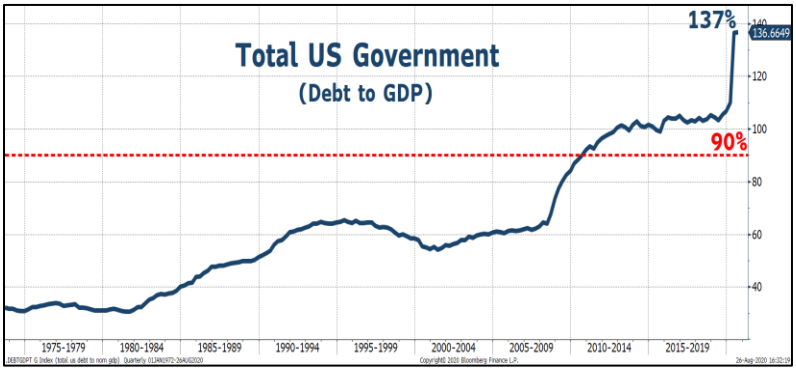
Meanwhile, Corporate America has gone absolutely debt crazy. Such leverage has a deleterious effect on productivity. Dr. Lacy Hunt proposes that productivity growth falters under the increased weight of debt, a thesis I've outlined many times. Here's why: many companies will have to allocate even more cash to repaying this debt, leaving them with less to spend on expanding payrolls or upgrading facilities in months ahead. This is a major headwind to productivity and growth.

At this juncture, the massive debt burden is past the point of being constructive for the economy. All we are doing is pulling demand and growth forward (buying time for today). In other words, today's debt binge is a tourniquet on future economic growth. Simply put, debt is future consumption denied. Many empirical studies (Reinhart and Rogoff being the most recent and well-known) show that growth slows significantly once the debt-to-GDP ratio exceeds 90%. We are now at 137%. It will likely get worse. The CBO thinks the federal debt will soar today to over 200% of GDP in 2050.

FISCAL FOLLIES

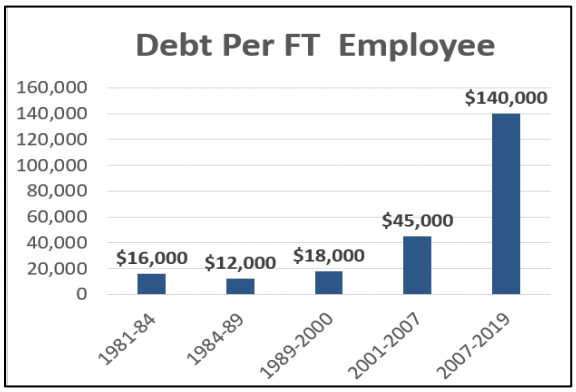
The final tab for the U.S. was a $3.1 trillion deficit for the 2020 fiscal year. Incredible. The U.S. spent $6.55 trillion ($2.2 trillion used as part of pandemic relief). The debt burden is now nearly $27 trillion, or 137% of GDP. This is where many had forecast to be 10 years from now due to the weight of a retirement boom and what will still turn out to be a Social Security time bomb. In any event, the real shame, the crime in fact, is that under what had historically been a fiscally prudent GOP, the budget deficit last year was close to one trillion. Such massive deficits should not be occuring in the "greatest economy of all time".

The President in 2016 vowed to balance the books and instead, at the peak of the economic cycle and with a 50-year low unemployment rate, he ran a deficit of nearly $1 trillion. I know many don't care. Interest rates are zero, so let's borrow and spend and cut taxes and drive up the public debt load. Even if things go awry, the Fed will be there to absorb it all. Debt doesn't matter and there there are absolutely no consequences. It's a brave new world. I tell ya this reminds me of shades of the late 1960s. Have a read of the Amity Shlaes masterpiece *Great Society: A New History* for a reminder that sorry, no, there ain't no such thing as a free lunch.



But what makes this debt albatross so much worse is the demographic backdrop. Americans are living longer than ever. Life expectancy in the U.S. has risen to 79. Meanwhile, declining birthrates coupled with declining immigration will reduce the labor force and lower tax revenue necessary to fund the expanding social welfare state.

The chart shows the parabolic rise in growth of federal debt per the net growth per full-time employee (15 to 64-year-olds). It all adds up to more debt per the 130 million full-time employees. In any event, somebody is going to be paying for all this. Once we get over the COVID panic, the next President will have to deal with this massive fiscal tab. One can safely say the era of tax cuts is long gone.



Data Source: Bloomberg

DEATH OF A MALL

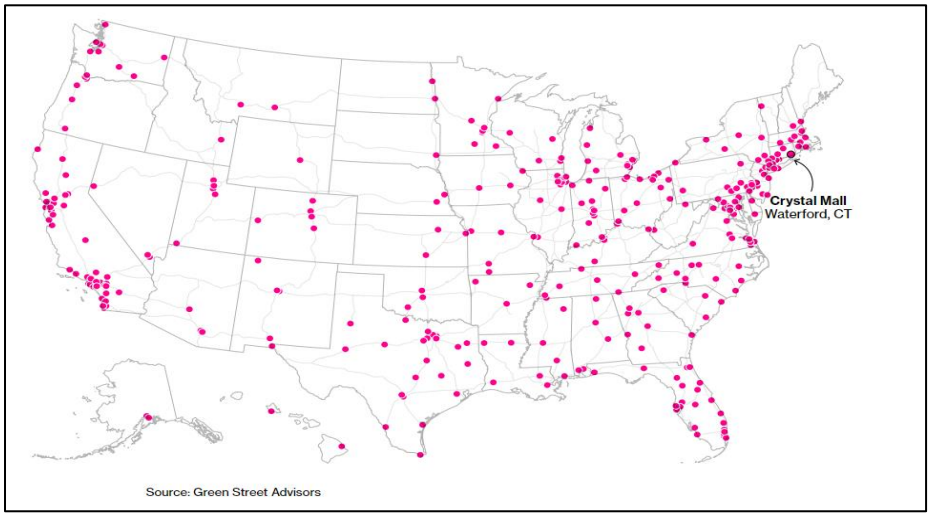
According to Green Street Advisors, more than 300 malls in the U.S. are categorized as Class B malls.

These malls tend to have average sales, mix of national and regional tenants and one or more anchor vacancies.

Some will weather the storm, but many won't.

A recent Bloomberg article discussed the Crystal Mall in Waterford, Connecticut as an example of the fate of "Typical Class B Mall, Anywhere, USA." Six retailers in the mall have filed for bankruptcy in the last three years. With 35 vacant storefronts already, the mall appears doomed. Between bankruptcies, distressed owners, store closures and existing vacancies, at least half of Crystal Mall's square footage is now at risk.

The same fate awaits hundreds of similar malls across the country. According to Coresight, as many as 25,000 stores could close in the U.S. this year, mostly in malls. That would demolish the previous record of about 9,800 closures, set in 2019.



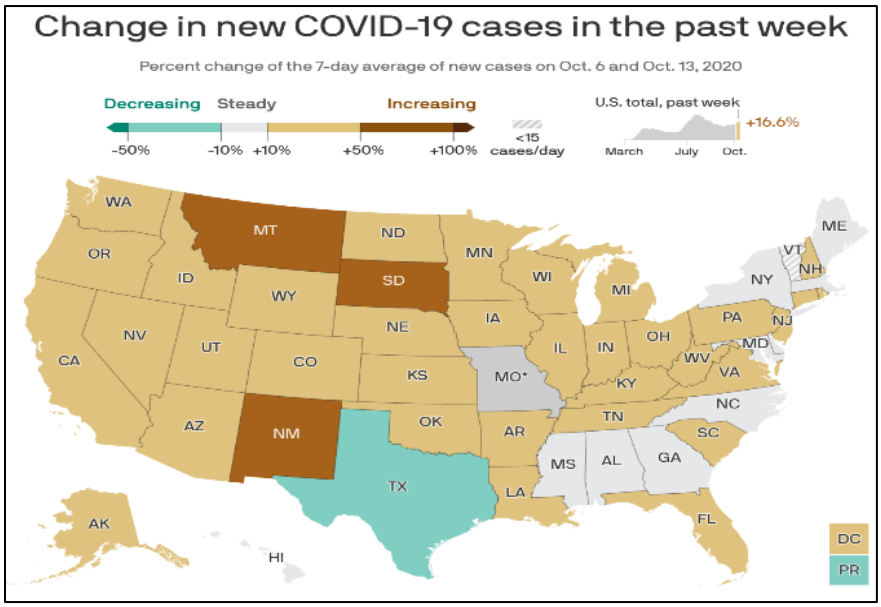
YOU FIRST!

In terms of what is happening with COVID-19, it is pretty obvious the U.S. is headed solidly in the wrong direction as the spread is accelerating across the country. Frankly, the COVID-19 spike is unnerving as no fewer than nine states are seeing record cases and the nationwide tally has crossed over 60,000 daily new cases for the first time in two and a half months. Total infections are approaching eight million and deaths near 220,000. The rise since mid-September has been especially profound in the Midwest and Mountain West, where resistance to masks and other precautions has been running high and the virus has often been seen as just a big-city problem. Hospitals are filling up and rural areas are seeing staggering outbreaks – and winter hasn't even started.

"I see this as one of the toughest times in the epidemic. The numbers are going up pretty rapidly. We're going to see a pretty large epidemic across the Northern Hemisphere."
– Dr. Peter Hotez, an infectious-disease specialist at the Baylor College of Medicine in Texas

Michael Osterholm, Director of the Center for Infectious Disease Research and Policy at the University of Minnesota, said "the next six to 12 weeks are going to be the darkest of the pandemic." Osterholm claimed the country had a "major problem in messaging" and a lack of leadership, which has remained a criticism of President Trump. An influential model, from the Institute for Health Metrics and Evaluation at the University of Washington School of Medicine, forecasts there will most likely be about 389,087 deaths – or 78% more fatalities – by February 1.

Is it any wonder that Prime Minister Justin Trudeau of Canada proclaimed the U.S.-Candian border will remain closed until we get our act together.



Source: Axios

Meanwhile, at the NBC town hall last week, President Trump was unapologetic on the coronavirus front and credited himself with "an amazing job," saying the virus fight is "rounding the corner." Really?

The fact that the breakout in cases is actually happening before the real cooler temperatures take hold is surely cause for concern. Brace for a long winter with a 1918-1919 style of "second wave." Hopefully the vaccine comes to the fore and is in everyone's hands by the spring. In the meantime be, safe. Please continue to social distance and wear a mask in public. It is the right thing to do for yourself and your fellow citizens.

An effective and widely ditributed vaccine is key to ending the saga. However, as for our "savior" vaccine, the question is: who is going to be the first to take the shot? A Wall Street Journal/NBC News poll found that "20% of respondents said they would take a vaccine as soon as one becomes available."

You first!

GROUNDSCAPERS OVER SKYSCRAPERS

One of the themes coming out of the COVID-19 crisis is how "space" is undergoing a profound change. Throngs of individuals are exiting condos in crowded, more expensive cities and heading to much larger, lower cost single-family cribs in the burbs. Have a look at *Renters Flock to Suburbia, Upending Decadelong Urbanization Trend,* from the Wall Street Journal.

As the exodus continues, rents have been plunging in New York City and San Francisco. According to Bloomberg, the median monthly rate for a studio unit in San Francisco has collapsed 31% year-over-year in September. One-bedroom rents are down 24% and two-bedroom units are off 21%. Rental inflation has turned to disinflation and is on its way to being a dominant deflationary influence (rent + owners'equivalent rent together account for 30% of the Consumer Price Index (CPI) and 40% of the core index). Another reason to love bonds!

But it's not just individuals exiting the urban arena. In the following New York Times article, *On the Hunt for Office Space, Companies Stay Low to the Ground*, the author points out that more and more companies are shifting from skyscrapers to groundscrapers. The article explains that having the ability to take the stairs and not wait for elevators is a key benefit — becoming "doubly attractive during the pandemic."

PLAYING POLITICS

Both the Democrats and the GOP are playing politics, but I am amazed that House Speaker Nancy Pelosi can't accept a $1.8 trillion budget package. Maybe she feels that she has more than acquiesced enough by coming down from $3.5 trillion. But c'mon people… $1.8 trillion is a lot of stimulus. Meanwhile, the fiscal hawks in the Senate don't want to spend a penny more than $1 trillion, and frankly, I don't blame them.

Needless to say, the upcoming contentious and consequential election is clouding things, but hanging in the balance is a renewed economic collapse in the fourth quarter and likely into the first quarter of 2021. This is because if no deal is going to get done by elections as many as 20 million jobless people on extended benefits lose them, and without an extension, we also head into 2021 with an eviction crisis on our hands. That would mean an estimated 12 to 16 million Americans who are at risk of losing their homes or getting booted out of their apartments in the middle of a global health crisis.

Yet, based on headlines today, the overwhelming belief is we will see a budget deal. President Trump has raised the ante and is prepared to go bigger than $2.2 trillion. Nancy Pelosi has stated that she will extend a deadline for the budget talks until tomorrow. Investors clearly expect something. Why? Because we always have. Then again, this is a whole new political ball game. The level of acrimony is on a scale that is probably as high as the Civil War. And I do not believe that is an overstatement.

RETAIL SALES JUMP

Retail sales – sales of goods in stores and online – in September jumped by 1.9% from August, to a record of $549 billion. Compared to September 2019, retail sales were up 5.4%.

So why did retail sales jump?

First, retail sales do not include services such as doctor's visits, insurance, airline tickets, hotel bookings, rent, etc. As we know, there were a lot of things consumers didn't do, such as travel. Passenger traffic in the U.S. was down 65% from a year ago. The same trend occurred with hotels, movies, indoor dining, etc. The money not spent on these services was spent on other things.

Second, about 7% of households with a home mortgage got their mortgage moved into forbearance, which means that they did not have enough to make mortgage payments for the forbearance period. That money not spent on mortgage payments was spent elsewhere. Ditto for renters. Some renters, protected by eviction bans, have stopped making rental payments and spent the money on other stuff.

Third, there were the stimulus payments, starting in April, some of which are still going out to people the IRS had trouble locating. Meanwhile, the extra $600 per week in unemployment benefits, and the federal program for gig workers (PUA) that states had trouble processing, were sent out often way behind and in lump-sums.

The extra $600 a week was replaced in August by the extra $300 a week, which states started sending out in late August and September, also in lump-sums. In California, the first lump-sum payments of $900, covering three weeks, were sent out in early September, and more was sent later in September.

ELECTION UPDATE

A lot of deep pockets don't seem to want another four years of high-drama reality TV as former Vice President Joe Biden's campaign reaps massive campaign contributions and the coffers are filled to the brim. Meanwhile, the just-released WSJ/NBC News poll of registered voters shows Biden's lead at 11 points (double where Hillary Clinton stood at this same time in 2016, prior to the James Comey's bombshell, which cut her lead in half. "Sleepy Joe" has at least a three point lead in the major battleground states. According to Predictit, Biden has a 66% probability of winning the Novemebr 3 election. Trump's odds are currently at 38%.

The problem for Trump is that Biden's "likeability" factor is so much higher than Hillary Clinton's, and he is ahead in all but a few battleground states. Trump holds a 54% disapproval rating while Joe is at 42%. As Karl Rove stated in his Wall Street Journal op-ed column, *Trump Has No Time Left to Spare*, Biden is "in the catbird seat" and advises that "as insurance, Republicans better fight like hell to keep the Senate."

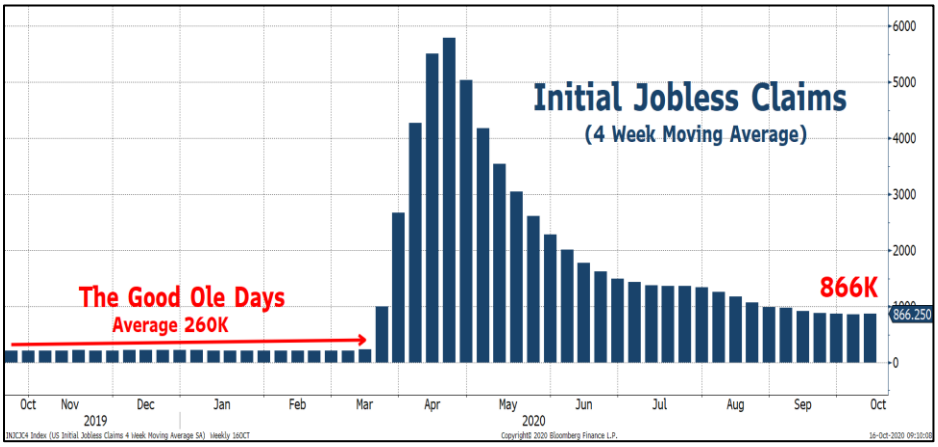
From my lens, it's not about the economy. It's not about Russia or China. And believe it or not, I do not think it's about COVID-19. I believe that the same people who voted against Hillary and for Trump to shake things up in 2016 have simply grown tired of all the high-drama, 24-hour a day reality TV, conspiracy theories, and rage tweeting in their lives. Politics should not be front page news day in and day out. People are tired of the 'show' and want a sense of normalcy.

Anyways, with 16 days until the election, approximately 29 million voters have cast their ballot early, either in person or by mail. This represents nearly 29% of the total votes counted in the 2016 election. Heck by Election Day moe than 50% of voters will likley have cast their vote. And from an investment perspective, this truly is a very consequential election. If we we have a blue tsunmai, you can expect the Democrats will pursue an aggressive spending campaign. But guess what? If Biden wins and the Senate stays in GOP hands, there isn't going to be any big stimulus plan coming our way in 2021. Gridlock is the word!

DEEP HOLE

Larry Summers co-authored an aricle in the Journal of the American Medical Association that found a total economic loss of $16 trillion from the virus. This huge number is the direct damage to the economy from job declines and business closures, and also the collateral damage to the economy from deaths and illness. Putting that number in perspective, the $16 trillion total loss is four times as severe as the GDP loss from the Great Financial Crisis.

In the all important labor markets, we are still missing 11 million jobs from where we were before the pandemic hit in February. Many estimate that between five to seven million jobs are lost for good. The latest initial jobless claims data show that the labor market recovery has clearly stalled. The 53,000 run-up in claims in the week of October 10 was the steepest increase in two months. And as you can glean from the graph below, the four-week moving average remains stubborly high at 866,000. Pre-COVID, the four-week average was 260,000!



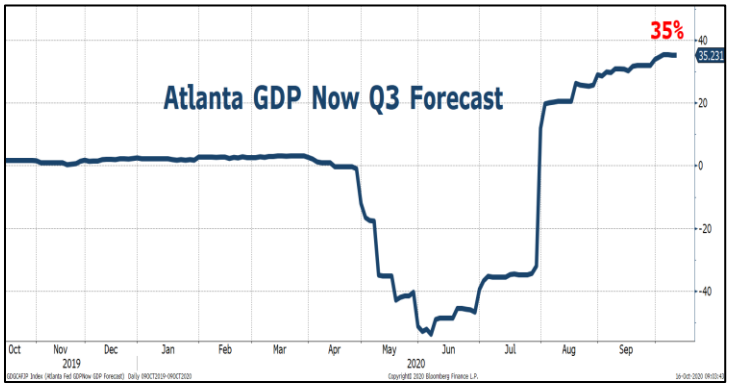
Take a look at a few economic metrics year-to-date (even with all the reopenings and policy stimulus):

- Industrial production: -12.0%
- Employment: -11.8%
- Manufacturing output: -11.3%
- Non-residential construction: -8.6%
- Real personal consumption: -6.8%
- Real personal income ex transfers: -5.8%
- Wages and salaries: -5.0%

Of course, there are areas of the economy that are excelling. New home sales, resale activity and remodeling has been booming since January. Obviously, anything related to the technology sector and home delivery has done swimmingly well.

As for the recovery, we will see a huge 25-35% rebound in third quarter real GDP. But don't be fooled. This recovery is due to the tooth fairy stuffing households with a surreal $6.6 trillion of income transfers. That money has been plowed back into the economy. Heck, some of it ended up in casinos and the stock market (but then again, what's the difference?).

But here's the problem: without the massive and unprecedented stimulus, the economy would have contracted at a 10% rate. Thus, under the cloak of government stimulus, the economy is still in recession. This recession will end only when will the economy be able to stand on its own? That may be quite a long time away.

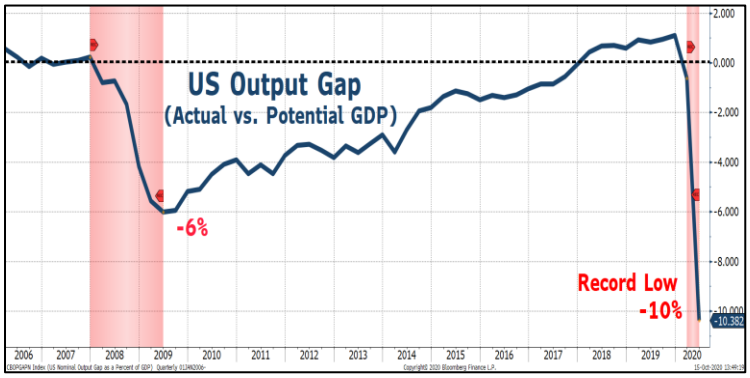


MARKET OUTLOOK AND PORTFOLIO STRATEGY

The talk of "stimulus" creating economic acceleration, higher inflation and higher rates reminds me of the last decade when we had Zero Interest Rate Policy (ZIRP) for seven years, repeated rounds of quantitative easing (QE), a five-decade low in unemployment at 3.5%, a massive Obama infrastructure package and epic Trump tax cuts. Get this, there was virtually no inflation and the yield on the long bond and 10-year Treasury managed to decline 150 basis points!

Now we have the same bond bears clinging to the same call for the same (faulty) reasons of a decade ago. But the key is the output gap and how the global supply glut affects the inflation/interest rate landscape, irrespective of all the fiscal stimulus, which is still just filling up the massive economic hole as opposed to creating an overheating economy.

We have a deflationary output gap of -10.0%. In the 2008/09 Great Financial Crisis, it never got below -6.0%. We are supposed to be in a recovery. As per the CBO projections, the output gap will end this year at -6.4%, will be -3.4% at the end of 2021 and -3.0% at the end of 2022. Inflation pressures don't tend to accelerate and pose a problem for bond yields until the gap closes and that isn't supposed to happen until... the end of 2025.



With the gap so wide, the Cleveland Fed estimates the fair-value of the funds rate is currently-2.5%. This is why the Fed has created a "synthetic" negative interest rate via QE. In any event, this is what makes it next-to-impossible for bond yields to enter into some fundamental uptrend any time soon.

As discussed, up front, the fundamental factors that have led to the low-interest rates over the past decade are debt, aging demographics, low productivity gains and massive wealth inequality. Today, these same factors are more entrenched. We are much deeper in debt and much older. Bad combination. Thus, from an investment perspective, until this debt is reduced via a debt jubilee, restructuring or modern monetary theory, a sustained rise in rates is highly unlikely.

So, as for interest rates, the Fed has already told you that even with its macro forecast of inflation returning to 2.0% and the unemployment rate plunging back down to 4.0%, it is going to be keeping the funds rate pinned to the floor until the end of 2023 at the earliest. So, the Fed should not be a factor in interest rates. And with a 10% output gap there is too much excess capacity in the economy, and I think it will take at least three years, to mop it up to create a higher inflation environment.

In terms of overall rates, I expect 10-year Treasury yields to trade between 0.25% and 1.0% for quite some time. As such, we are now a little above the middle of this range. But it is crystal clear that shorter-dated yields (from overnight to two years) will remain very close to zero as far as the eye can see. So yes, we have indeed all turned Japanese when it comes to interest rates. Europe actually was ahead of us. But this is where we are. Frankly, we were heading in that direction well before the pandemic arrived.

I realize this may be cold comfort to credit unions who want higher rates. But some of the forces leading to low interest rates will persist for a long time, so credit unions need to prepare for lower for longer. Credit unions need to make sure their expectations about investment returns reflect the current and likely future reality and reconfigure their investment plans accordingly. This is an environment in which every basis point counts!

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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.

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