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Weekly Relative Value

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WEEK OF OCTOBER 26, 2020

QE to Infinity

"It may be that there is a simple macro fact that the Treasury market being so much larger than it was even a few years ago, much larger than it was a decade ago and now really much larger than it was even a few years ago, that the sheer volume there may have outpaced the ability of the private market infrastructure to support stress of any sort there…

Will there be some indefinite need for the Fed to provide — not as a way of supporting the issuance of Treasuries, but as a way of supporting a functioning market in Treasuries — to participate as a purchaser for some period of time? I haven't concluded that that's the case, the institution certainly hasn't concluded that that's the case, but I do think it's an open question."
– Randal Quarles, Federal Reserve Vice Chair for Supervision

Last week, Federal Reserve Vice Chair for Supervision Randal Quarles, made surprisingly candid comments when discussing the ballooning size of the U.S. Treasury market and the central bank's role in it. In essence, he alluded to the fact that the the Fed will likely be in the quantitative easing (QE) game forever.

First, the most notable phrase in the above quote was *"indefinite need."* I have never heard a Fed official mouth these words. Effectively, Quarles acknowledged that he's grappling with the question of whether the Fed has no choice but to buy bonds forever.

The implication of this, of course, is that there is so much Treasury debt and it is potentially destabilizing. As such, the Fed may need to "monetize" the debt in some form, whether by conducting large-scale asset purchases or re-purchase agreements.

Later in the day, Quarles tried to walkback his remarks, saying, "*I wouldn't want the comments that I made today about thinking about Treasury market structure to suggest that I think that there's some need for some permanent backstop of the Treasury market in normal times."*

Sure thing. I'd be curious to know what *"normal times"* means to Quarles and other Fed officials. Currently, and frankly for almost a decade, the the Fed has supressed long-term borrowing rates as a complement to keeping the fed funds rate near zero to boost the economy. Would the Fed allow interest rates to rise to their market-driven equilibrium

THIS WEEK

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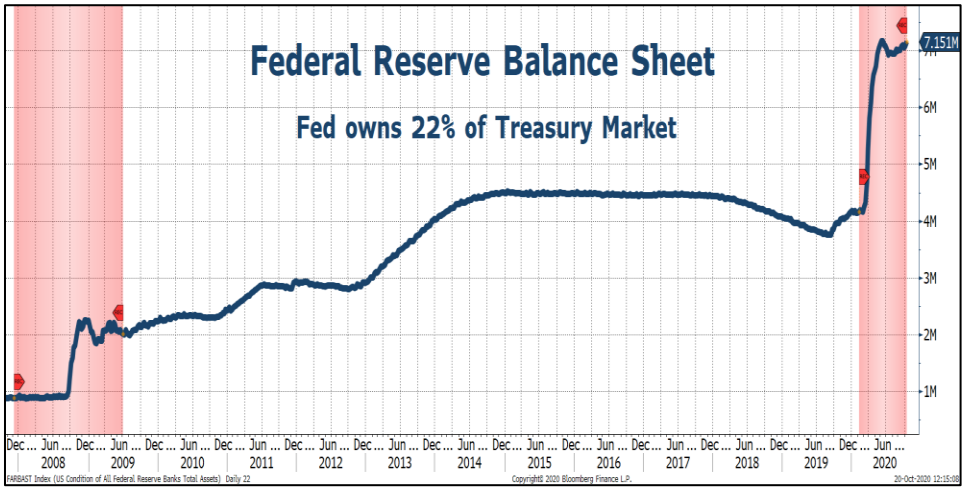
levels and squelch the nascent recovery? Doubtful. So is *"normal times"* when the central bank is raising interest rates again?

Frankly, the idea of "QE Infinity" has been something of a punch line for a decade after the Fed launched into multiple rounds of quantitative easing in the years after the financial crisis. So in some ways, I'm not sure if that is "new" news, considering that the Fed never really managed to bring its balance sheet below $4 trillion (or five times the pre-crsis norm before this latest crisis). Notably this bloated balance sheet was maintained in the context of a fully employed economy, 10 years of expansion and a quintupling of the stock market. As shown below, the Fed could never normalize its balance sheet or interest rates, for that matter. So if they can't unwind the balance sheet in good times, when can they?

And so, we have the world's central bank *de facto* monetizing debts of all sorts. Currently, Chaire Jerome Powell's Fed owns 22% of the Treasury market, almost doubling that share in the past year and at a record-high – up from a peak of 20% in 2014. In September 2019, it represented just 13% of the Treasury market. I highly doubt that it will ever reach such a low percentage again — and I doubt I'm alone in that thinking.



That has significant implications for the coming years, particularly given expectations that a Democratic sweep of the White House and both houses of Congress will usher in trillions of dollars of fiscal stimulus. That would follow a fiscal year during which the U.S. budget deficit more than tripled to $3.1 trillion, pushing the national debt higher than the economy's size.

It should also be noted that the Fed has been vociferous about the need for additional fiscal stimulus. To support the fiscal stimulus and increased debt issuance, all the Fed would have to do is pledge to increase their monthly purchases of Treasuries in line with certain policy initiatives, such as extra unemployment benefits or funding for state and local governments. But that would give away the game, which is why they consistently describe their bond buying in terms like "market functioning."

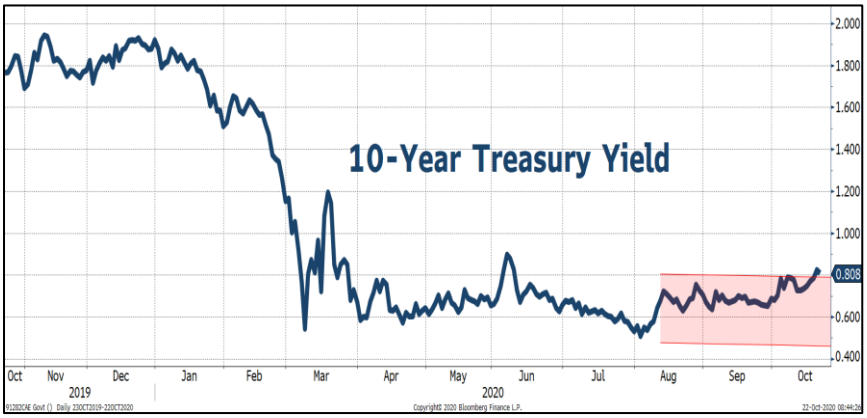
Cutting to the chase, it sure sounds like infinite QE to me – and it's another page out of the Bank of Japan's playbook. But just don't expect many more Fed officials to say it.

YIELD CURVE CONTROL

In September and October, the 10-year Treasury yield swung by a mere 23 basis points from high to low. The rate is now at 0.81%. That is the narrowest two-month range of the past couple decades. Despite the narrow trading range, bond investors are getting skittish.

With eight days before U.S. elections, the bond market has become quite hyper about the prospect of a huge fiscal stimulus — and not just a $2 trillion Mnuchin-Pelosi package (as big as the CARES plan was in March!) but now investors are salivating over a Democratic clean sweep on November 3, which will usher in an era of endless fiscal stimulus financed on the Fed's balance sheet. Think of current Fed Governor Lael Brainard as the next Treasury Chairperson.

Should this scenario unfold, look for the Fed to step in to prevent rates from rising to levels that will stifle the economy. Frankly, yields are almost behaving as if we have yield curve control already. Call it stealth yield curve control. It's a step that central banks in Australia and Japan have already taken. The Bank of Japan has been pinning 10-year rates at around zero, while the Reserve Bank of Australia targets three-year yields at 0.25%.



Don't forget the Fed is still purchasing about $80 billion of Treasuries and at least $40 billion of mortgage securities a month and they will continue buying at that pace at minimum to support the flow of credit and the nascent economic recovery. Minutes of the Fed's September meeting indicated a readiness to possibly increase the purchases, on top of keeping policy rates near zero at least through 2023. Officials suggested they might shift some purchases toward longer-term debt to create a bigger downward force on rates.

The bottom line: if the U.S. recovers more quickly on the back of robust fiscal stimulus, and presumably a vaccine, we could see a move up in yields. But if we see a really rapid ramp-up that risks derailing the recovery, that's certainly a case where the Fed would step in. That's not exactly yield curve control, but it clearly is intended to reduce the probability that long-term yields rise.

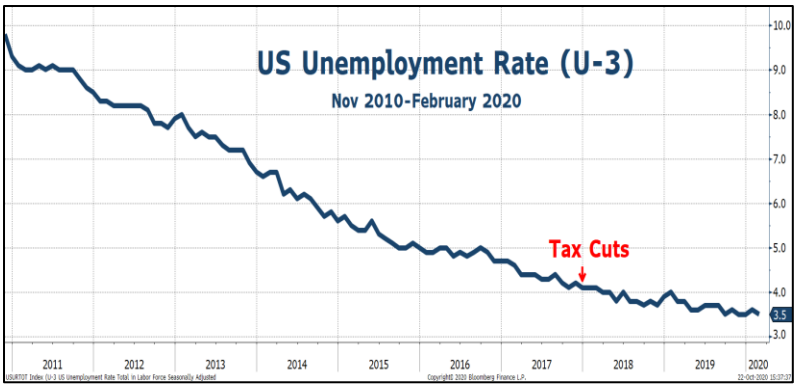
Any increase in yields should also draw foreign investors, with over $16 trillion of global investment-grade debt yielding less than zero. With hedging costs having cheapened and the U.S. yield curve steepening, the pick-up on 30-year Treasuries for euro-hedged investors is roughly 80 basis points above German bunds. Thus, there are two factors that will keep long-end Treasury yields from moving too high: the Fed and the foreign buyers.

THE FACTS ARE THE FACTS

The Wall Street Journal printed an op-ed by Alan Blinder, titled *The Trump 'Jobs Boom' Is a Convenient Myth.* The facts are the facts, and what they show is that when it comes to GDP growth, employment gains and even the stock market, the near-four-years of the Trump presidency (not including the pandemic period, which everyone acknowledges was not his fault) are barely distinguishable from his predecessor Barack Obama's last four years. Go figure. For all the tax relief, deregulation and bravado, the needle hardly moved.

Let's review.

Tax cuts and deregulation were President Trump's primary economic initiatives over the past four years. But did they give the economy a big boost? Take a look below and decide.



From my vantage point, the unemployment rate was in a steady downward path after the Great Recession (November 2010) to right before the COVID-19 catastrophe slammed the economy (February 2020). The unemployment graph ends in February 2020 because the roof caved in the next month. But prior to the black swan, the unemployment rate was trending down, from over 9% to a wonderfully low 3.5% rate. But the question is, can you see any discernible break in the trend when Mr. Trump replaced Barack Obama? Or when the tax cuts took effect in 2018? Could it be possible that Trump simply inherited an economy that was well entrenched in a recovery?

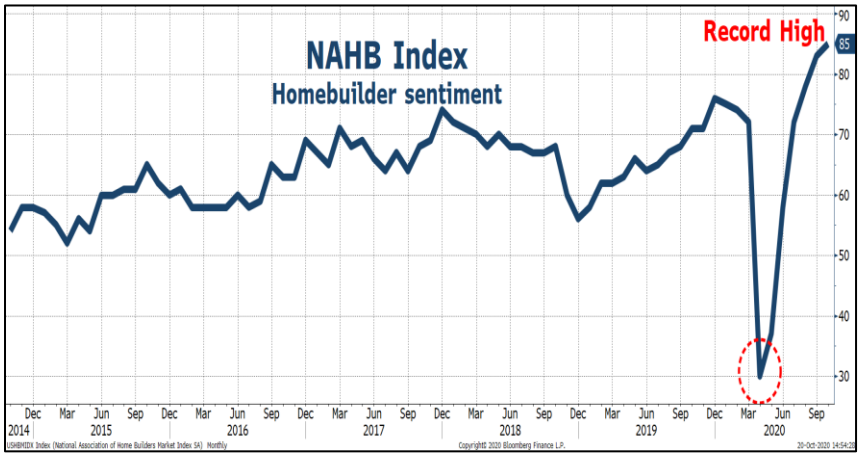
Real GDP growth tells a similar story. In the three years prior to COVID (2017-2019), the economy grew at a 2.5% annualized rate. For perspective, in the last three years of the Obama administration, GDP growth averaged (wait for it) 2.4%. There you have it.

HOUSING BOOM CONTINUES

The National Association of Home Builders (NAHB) Housing Market Index surprised a consensus looking for an unchanged October reading of 83, and instead we saw a new record-high of 85. The present sales index for single-family homes jumped to 90 from 88 and the hope-based six-month expectations segment climbed to 88 from 85. Then again, real estate industry folks are always optimistic, don't you think? Regardless, it is still hard to believe that in April, it was sitting at a depressionary 30 reading.

Despite soaring, record-high homebuilder sentiment, U.S. housing starts disappointedly dropped in August. That said, the weakness was centered in the multi-family space, and as I have been saying of late, coming out of the pandemic there is heightened awareness of the need and desire for open space. So after a 25.9% plunge in August, multi-family starts sagged 16.4% in September. However, the single-family sector is in a bona fide bull market, with starts rising 8.5%

in September, the fifth consecutive increase in 1.1 million units, the highest since July 2007. The trend is set to continue as permits popped 5.2% month-over-month. Notably, single family permits (up 24.3% year-over-year) are behind the robust permit data.



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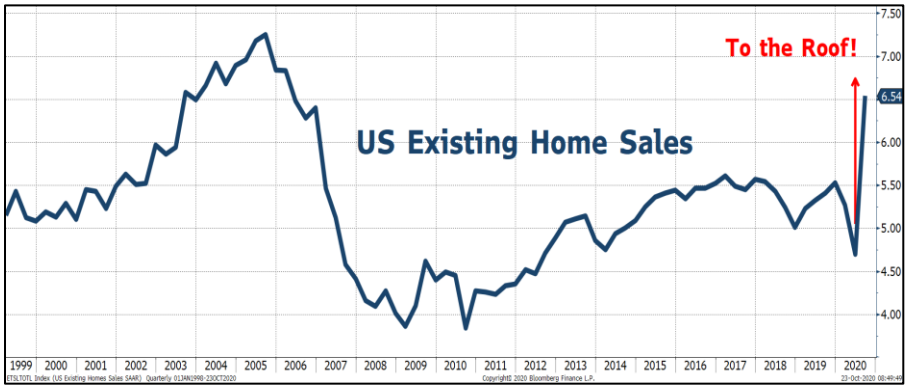
HOUSING HITS THE ROOF… AGAIN!

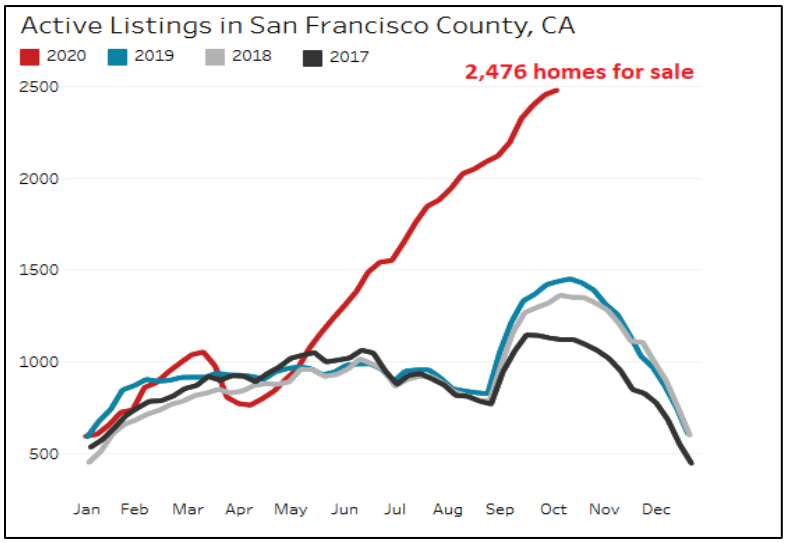
U.S. existing home sales – the largest share of the housing market – "beat the street" and came in at a 14-year high of 6.54 million units (annualized) in September (up 9.4% month-over-month and topping the consensus estimate of 6.30 million units).



Seasonally, home sales normally decline in late summer and fall. But not this year. The seasonal adjustments of the above numbers are designed for normal seasons. The median price of existing homes in September jumped 14.8% year-over-year to $311,800. The median price is skewed by a shift in the mix, and the price increase could also be a partial result of red-hot demand for higher-priced homes. Again, much of what is fueling this boom is the impact from COVID, the ability to work remotely and the desire for more space, coupled with historically low rates.

Look at what is happening in San Francisco. Something similar is happening in Manhattan and other cities. San Fran has been characterized by its "housing shortage" that escalated home prices and rent. Despite there being plenty of housing, it was high-priced and people couldn't afford it. Suddenly, that "housing shortage" has turned into a glut. The city is flooded with a historic amount of inventory, including a record-breaking number of condos for sale. There is a large offering of vacant apartments, and rents have plunged, with one-bedroom rents down 19% in five months.

As of the week ended October 11, there were a record 2,476 homes listed for sale, up by 72% from the same week last year, with condos accounting for the lion's share. Note how the glut has blown all seasonality out of the water.



Source: Redfin

Meanwhile, many homeowners are steeped in turmoil. Nearly 7% of all mortgages are in forbearance, according to the Mortgage Bankers Association. Delinquency rates of Federal Housing Administration-insured mortgages (which cater to the lower end of the market) have skyrocketed to a record 17.4% in August, and with 23 million people still claiming state or federal unemployment insurance. That's the other part of the "K-shaped" recovery.

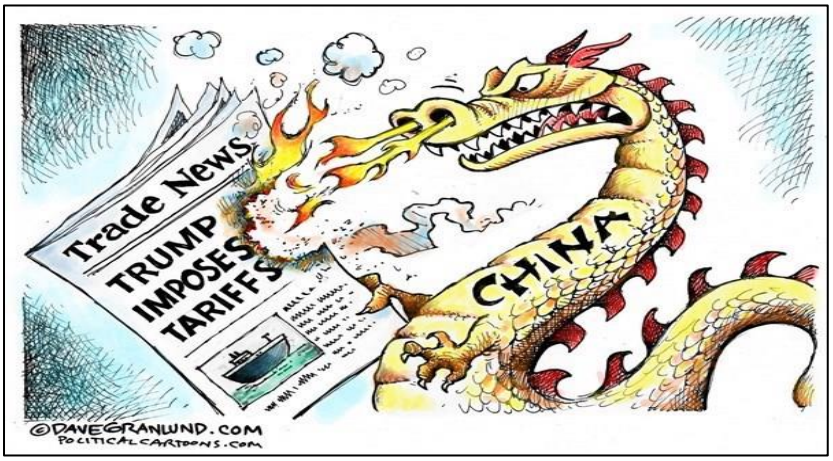
SLAYING THE DRAGON

No matter who wins the presidential election, it seems almost certain that the U.S. will continue to "decouple" from China. But here's the thing, China remains extremely important to the global economy. According to the World Bank, China represents 14% of global GDP and 13% of exports (worth $2.4 trillion) in 2019. Twenty years ago, those numbers were 5% and 2%, respectively. This trend demonstrates just how much China has surged through since its entry into the global trading bloc in 2001.

We also must recognize that China is coming out of this pandemic stronger than the U.S. or Europe. The country's share of global GDP was expanding into the crisis, during the crisis, and now post the crisis. That is a fact. And its economic influence continues to grow at a faster clip than anyone else in the world and it will continue to rise.

So how to deal with the dragon? It really depeands on the party in power. The Republicans would be more inclined to continue President Trump's aggressive tariff approach. Yet it is insightful to know that despite all the tariffs, both threatened and actual through the first term of the Trump presidency, there was absolutely no improvement at all in the bilateral trade deficit with China. But back at home, manufactures and individuals paid for the tariffs.

Anti-China sentiment in the West is certainly understandable, but before anyone thinks the country can be defeated in some sort of economic warfare, think of China in the context of over 3,000 years of civilization; think of it as one of the world's four ancient civilizations (the U.S. is the world's best experiment of all time, but is still an ongoing experiment).



In a nutshell, despite the rhetoric and bravado, it is going to be extremely difficult for any President, or any country for that matter, to try and punish and decouple from China's economic prowess. That horse left the barn a long time ago. And it is doubtful that any actions by the current or future administrations will help curb Chinese ambitions.

On the other side of the aisle, the Democrats would try to rebuild American production at the expense of Chinese production. But there is a price to be paid, if this relocation ever does happen, via a higher cost of production in the U.S. 2016 protectionism could backfire and increase China's resolve to forgeahead with regional partnerships that lock the U.S. out.

Frankly, it isn't clear that either Democrats or Republicans could be successful. Furthermore, the rest of the world will have to think very carefully about how far it will want to isolate China's economy that is very likely going to be an even more dominant driving force for the world than it has been since it gained entry into the World Trade Organization (WTO) two decades ago. Should China maintain its growth trajectory of recent years, it will become the world's largest economy, passing the U.S. within the next decade.

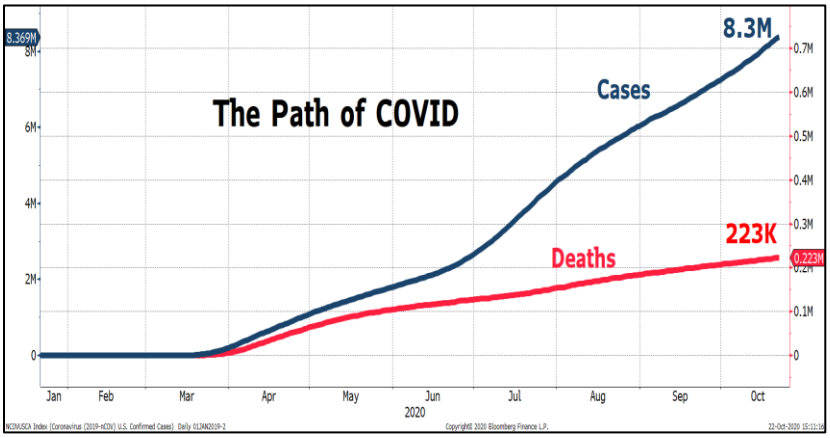
SLEEPWALKING INTO SECOND WAVE

"As we head into the winter flu season, more indoor activity will likely cause cases to accelerate more, echoing the 1918 pandemic." – Scott Minerd, Chief Investment Officer, Guggenheim Investments

Note: The 1918 influenza pandemic killed an estimated 50 million people worldwide. The current health crisis has killed more than one million so far.

The World Health Organization said some countries in the northern hemisphere are facing a "dangerous moment" with the spread of COVID-19 showing little sign of slowing in Europe or the U.S. Despite Trump's claim that we are "rounding the corner" and COVID "will go away," the virus is resurging in nearly 75% of the country. The U.S. added more than 85,000 coronavirus infections on Sunday. To be clear this is not just about "more testing" because the positivity rate has jumped to 5.6% from 4.6% a month ago. The daily death toll was 1,038 Americans, bringing the total to 224,280 people.

The seven-day moving average of deaths has outpaced the 14-day average in eight of the past 13 days (as in, not good). President Trump's chief of staff admitted the U.S. is "not going to control" the pandemic.



U.S. hospitalizations have hit a two-month high of 40,271 (up 31% this month alone). Much of the increase is centered in the Midwest. States like Illinois, Indiana, Michigan, Minnesota, Nebraska and Wisconsin have recorded rises in case numbers in the last two weeks. Public health officials attribute the spikes, in part, to cooler weather that is forcing people indoors. In Europe, governments are deploying curfews as they try to slow rapidly rising cases. Winter is right around the corner and coming before any broad distribution of a vaccine.

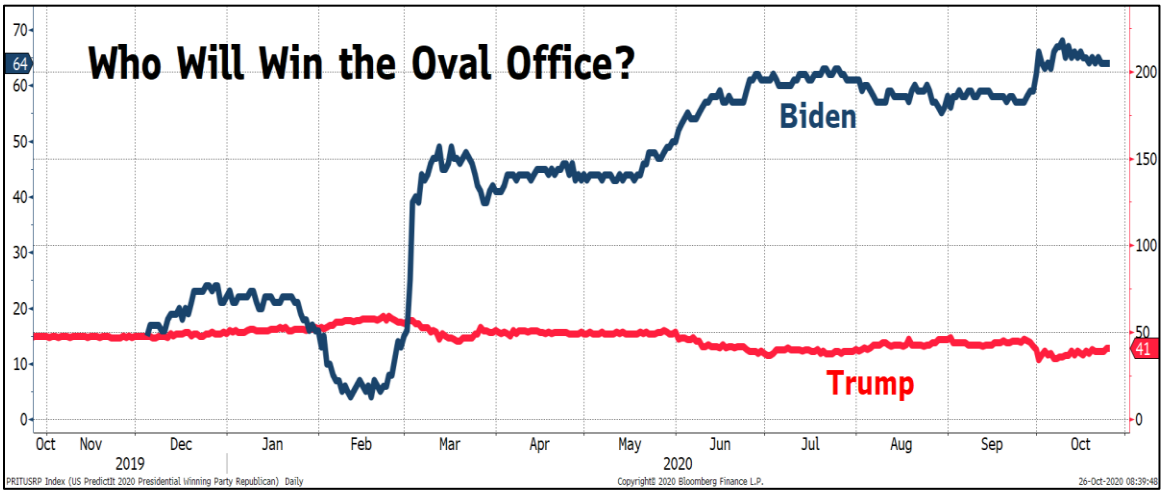
From an investor's perspective, a second and larger wave in infections could add to the political havoc around the November 3 election in the U.S., resulting in sharp tightening in financial conditions and a pullback in consumer spending and business investment. Let's face it, the economy will underperform until COVID is dealt with. It does not take a "lockdown" to cause the economy to slow. All it takes is a change in consumer attitude. You simply won't see people confidently going to the movie theater, bars, restaurants, etc. with the risk of infection rising. Thus, the odds of a double-dip recession (or a delay in the current one ending) have increased.

Meanwhile, the chance of a stimulus package before the November 3 election is dimming**.** There was no breakthrough over the weekend as both sides got stuck playing the blame game. The Senate is set to leave Washington today and the House has already left. While both could be recalled with 24 hours' notice, it is unlikely during the last week of campaigning ahead of the election. Even if the two parties were to agree to terms, there is a strong possibility that the Senate Republicans would not vote in favor of a package even after the election.

HIGHEST SINCE 1908

As for the debate last week, it was a big improvement by President Trump, but Joe Biden held in — so it is very tough to see it as being a game-changer. Besides, a record number of Americans already mailed in their ballots and the share of "undecideds" has never been this low one week ahead of any election. With eight days before the election, 59.4 million Americans have cast their vote. This represents 43% of the total votes in the 2016 election. The U.S. Elections Project is predicting a record 150 million ballots, representing 65% of eligible voters for this election, the highest since 1908!

The betting market does show a small post-debate shift to President Trump but is still barely over 30% odds of him winning versus 64% for Biden.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

Let's get a grip. Yes, bond yields have backed up. Yes, the curve has steepened. But one would think this was the first time we have ever seen a near-20-basis-point back-up in less than a month. Let me provide some perspective. We had no fewer than 50 occasions from the time the recession ended in July 2009 to the end of 2019, where there was at least a 20-basis-point lift in the 10-year Treasury yield. And yet, through the entire period, the yield plunged 150 basis points through all these hiccups (from 3.3% to 1.8%). No fewer than 50 such yield spasms over a decade-long period, and each time the bond bears came out like the boy who cried wolf to claim that the new era of inflation was upon us. Every single time, these inflation-phobes came out of the woodwork. As they are today. Fade them, please.

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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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