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INVESTMENT SERVICES

Weekly Relative Value

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Embracing Uncertainty

One of the more challenging aspects of investing (and life for that matter) is dealing with uncertainty. From the macro perspective, we often make investment decisions based on data that are often lagging and many times dubious in nature. There are always uncertainties.

And there all also environments where the unknowns are amplified. Currently, we are operating in a prime example of that environment.

- We are in the middle of a global pandemic. How much more economic damage and human loss will this country endure? When will we have access to an effective vaccine? Will people take the vaccine?
- We are 24 hours from a highly contested and consequential election. The canidates' platforms and policies could not be further apart. The polls point to a Biden victory, but as we all know, the 2016 polls were wrong. What are the economic, market and social implications for either a Trump or Biden White House? Or a contested election? And what about the emotional consequences of November 3? For example, a USA Today poll finds that 75% of Americans are "very" or "somewhat" concerned about violence on Election Day and afterwards.
- It's unclear what's next for the largest fiscal and monetary policy program in modern history. Already the government and the Federal Reserve have thrown over $5 trillion at the pandemic. Any additional spending will add to the massive debt pile today and create lasting and long-term consequences.

Got all that?

French mathematician Blaise Pascal was one of the forefathers of dealing with uncertainty. Pascal's wager, as it is known, argues that a rational person should live as though God exists and seek to believe in God. According to Pascal, if God does not actually exist, such a person will only suffer a finite loss, but if God does exist the person will have infinite gain. In investment parlance, that would be akin to owning a cheap option with no expiration. Typically, not a bad "trade."

The point is that we should embrace uncertainty and realize that almost everything in life, including investing, is a probability-based decision. The sooner we can get comfortable with it, the easier it is to accept this uncertainty.

Let's start with the election.

THIS WEEK

- ELECTION 2020: T-MINUS 24 HOURS
- GDP BOUNCES 33%
- SPEAKING OF RECORDS
- WORKING FROM HOME
- RUNNING OUT OF FIREPOWER
- CLIMATE CHANGE

PORTFOLIO STRATEGY

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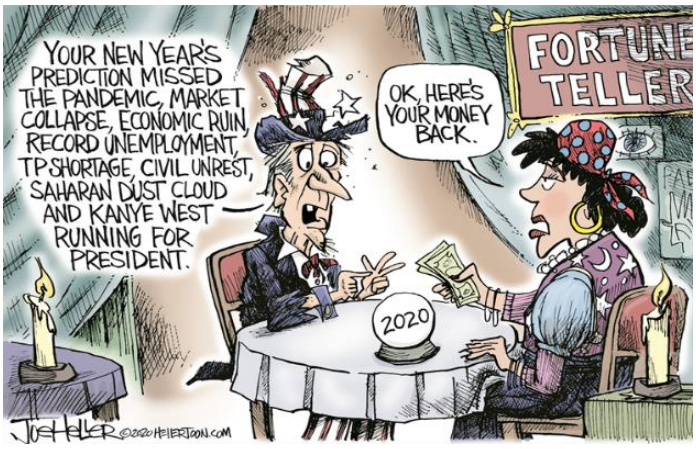
ELECTION 2020: T-MINUS 24 HOURS

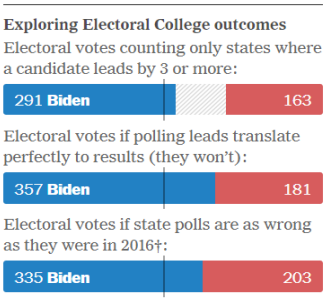
We are 24 hours away from what has been characterized as the most consequential elections of our lifetimes. It is now highly likely more people will vote in this election percentagewise than any election since 1908. Early voting has been historically record-breaking. As of today, over 95 million Americans have voted (70% of total voters in 2016). I don't know what that means for the outcome, but clearly people are extraordinarily passionate.

The betting money and polls continue to point to the Dems retaking the White House. Predictit assigns a 63% probability to a Biden victory. Highly respected Nate Silver at FiveThirtyEight is now assigning a 90% probability that Biden wins the general election. According to the most recent Wall Street Journal/NBC News poll, the polls really have to be wrong by twice what they were heading into the 2016 vote because they have Biden ahead 10 points and Biden holds a 6-point lead across a set of 12 battleground states. The President cannot afford to lose any of these four battleground states — Florida, Pennsylvania, Arizona and North Carolina. If he loses one of these, it's game over (he did take these four years ago). Thus, the path for a Trump victory is very narrow and Biden's lead in other key states, like seven points in Wisconsin, suggests this could be a landslide. But what happens if neither Trump nor Biden decides to concede?



Then again, there are reasons to be skeptical of the polls, as we all know. But these high-single-digit leads are surreal. Hillary Clinton may have had the lead a week before the November 2016 vote, but not like this. And there are two big differences between 2020 and 2016: no Hillary, and the COVID-19 crisis. Hillary was arguably the most despised politician of our generation. In fact, many believe she was the reason Trump won.

So once again, "What if the polls were as wrong as they were in 2016?" The *New York Times* has the analysis, and the answer is grim for Trump. Here's the bottom line:



Source: The New York Times

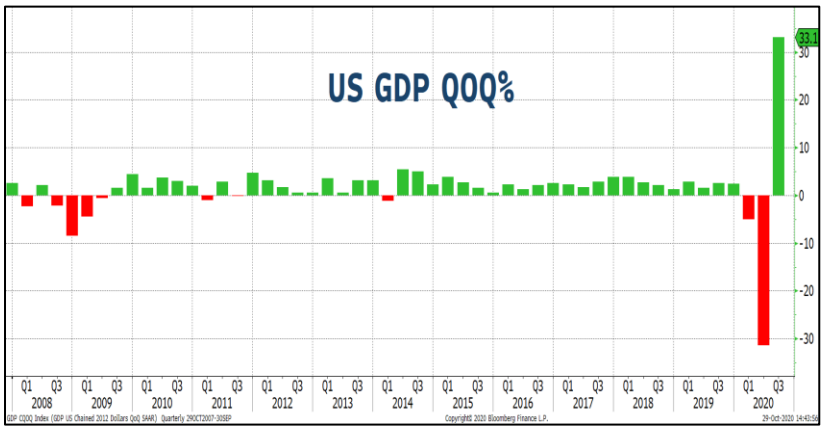
In short, as we all know, polling has not been totally reliable, but it is the best information we have. Yet one thing we've learned in 2020 is that just about anything can happen. That said, if Trump wins, then I will recommend a total shutdown of the polling industry until they can figure out what's going on.

Moving on. As we approach the end of the political season, stress, anxiety and acrimony have never been higher on both sides of the aisle. Frankly, I have never seen the country so divided as it is right now. Many expect that Trump may refuse to accept results if he loses. Why? Because he has told us he will fight the voting rules and results all the way to the Supreme Court. The chances of sporadic violence, significant unrest or voting issues are quite high, according to basically every federal and state official monitoring voting and its aftermath in 2020. Thus, if not a landslide, brace yourself for 78 days of drama and turmoil from November 4 through Inauguration Day. In a sign of these high-anxiety times, have a read of *A Divided Nation Agrees on One Thing: Many People Want a Gun* (The New York Times). A truly sad social commentary. My advice: put away the guns and pick up a book!

This is a fact. No matter who wins, 40% of Americans will be very unhappy. My true and sincere hope is that we have a quick, decisive and peaceful election result as we have had for the past 250 years. No matter the outcome, the country can and must reunite and work together. United we stand; divided we fall.

GDP BOUNCES 33%

U.S. GDP accelerated at a 33.1% annualized pace in the third quarter. That growth is both record-breaking and meaningless at the same time. Yes, it's true that the GDP is a record. But it also comes after a record contraction from Q1 to Q2, and a total loss of 10.3% throughout 2020, so it doesn't even come close to making up what was lost amid the pandemic.



That GDP shortfall in the U.S., as an aside, is close to a -4.0% annual rate. Yes, that is the math after -5.0% in Q1, -31.4% in Q2, and +33.1% in Q3. In fact, the 4% total GDP shrinkage during 2020 means we are still down almost as much as we were during the height of the Great Recession.

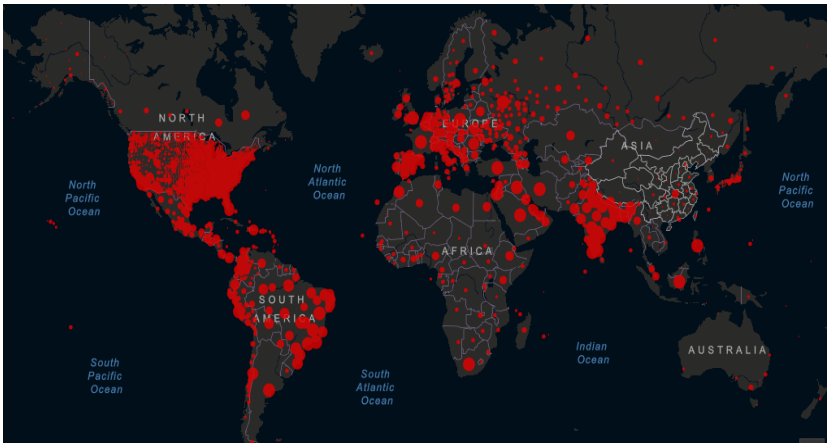
Furthermore, without the training wheels from the $2+ trillion of fiscal stimulus, the GDP bicycle would have tipped over in Q3 at over a 10% annual rate. So, treat the Q3 GDP report with an enormous grain of salt.

Bottom line: There was a strong rebound but we're still in a hole of historic proportions and the best part of the stimulus and re-opening aspect to the recoveries is in the rear-view mirror. In other words, do not expect a V-Shaped recovery. Entire industries, from travel to entertainment to urban commercial real estate are still effectively shut down. The only way we'll get back to pre-pandemic levels of economic activity is to get a real grip on the pandemic. And sadly, that isn't happening.

SPEAKING OF RECORDS

"We're in for a whole lot of hurt. It's not a good situation… All the stars are aligned in the wrong place as you go into the fall and winter season, with people congregating at home indoors. You could not possibly be positioned more poorly."
– Dr. Anthony Fauci, the country's leading infectious disease expert

U.S. hospitalizations have soared 46% so far in October alone, and by 12% this past week, to the highest level since mid-August (and this can't be boiled down to "we're doing more testing"). The case count has hit a record in the U.S. (548,000 in one week) and the spread is broadly based across 24 states. Hospitalizations have jumped 50% in October (up 12% in the past week). Imagine we are now up to 9.2 million cases and 232 thousand deaths... and winter hasn't even arrived yet. So, we have definitely "rounded the corner" and now we're returned to where we began.



Source: Johns Hopkins

And if you think that's bad, look at Europe where the daily average has topped 176,000 last week (more than double the 72,300 in the U.S.). A European double-dip recession is now a high likelihood with the renewed partial lockdowns in Germany, France and Italy. And it now looks as though U.K. Prime Minister Boris Johnson is being pushed into an about-face. The U.K. will enter a second lockdown this week after cases spiked there.

Bottom line: the virus showed us that it's in charge yet again this past week. And until we control the virus, the economy will spin and spin its wheels.

WORKING FROM HOME

Almost 40% of the U.S. population has been working at home through the coronavirus versus 12% prior to COVID-19. A survey cited in the Report on Business magazine over the weekend that 36% of companies are going to provide their employees with a post-pandemic option to work from home. So, you also have to pity the commercial real estate market. And guess what? A Qualtrics poll found that 77% of men say they feel more productive working from home (though that number is lower for women at 46% — guess which parent is the one multi-tasking to keep the home clean and the kids educated?).

RUNNING OUT OF FIREPOWER

Last week, we heard from two Fed heavyweights, one current and one former, who weighed in with the clouded economic outlook and the limitations of monetary policy going forward. Fed Governor Lael Brainard delivered a speech

titled *Achieving a Broad Based and Inclusive Recovery*. She makes it very clear that it is fiscal policy that needs to take over policy leadership, though she doesn't rule out the Fed doing more in the way of asset purchases. But much of her speech dealt with forward guidance and how that is being tweaked to be supportive, but that does not compare to the "shock and awe" intervention last March.

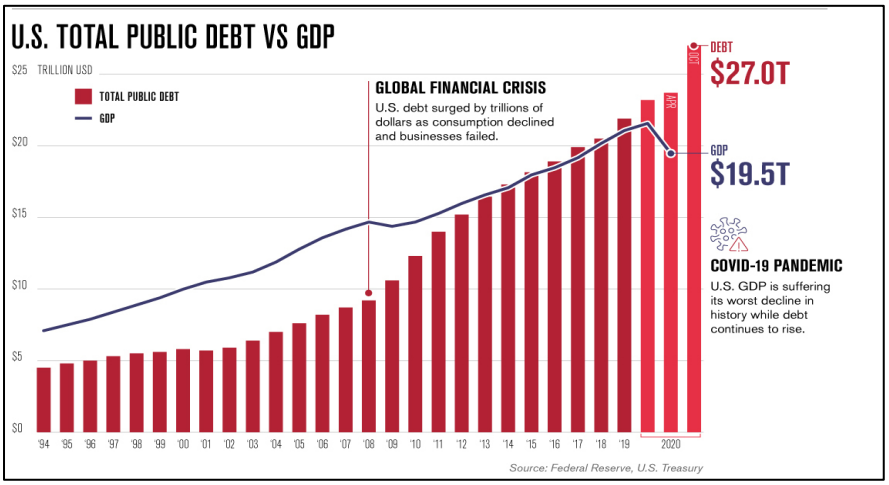
Given the lack of a bazooka, everything else going forward is tinkering. The labor market remains impaired and Brainard makes the case that the decline in inflation has become increasingly structural over time. This is another reason why a sustained bear market in long bonds is simply not in the cards.

Next, we heard from former New York Fed President Bill Dudley who authored a column in Bloomberg Business Week titled *The Fed is Really Running Out of Firepower*. The title says it all, but it was the opening paragraph that really provided the exclamation mark:

> *"No central bank wants to admit that it's out of firepower. Unfortunately, the U.S. Federal Reserve is very near that point. This means America's future prosperity depends more than ever on the government's spending plans — something the president and Congress must recognize."*

Dudley said that "the outlook for the economy is deteriorating" and added that there is "some downside risk of a double dip." Indeed, all you need to do is read *U.S. States Face Biggest Cash Crisis Since the Great Depression* on the front page of the Wall Street Journal. Politics got in the way of this one. And this could greatly impact the economy as the public sector is responsible for $2.3 trillion of GDP and employs 19 million people.

The Fed has done its part in the credit or interest-sensitive sectors, like housing and autos and big-ticket household items. But the Fed is not really equipped to deal with other forms of spending, and in this case, parts of the expenditure pie impaired directly or indirectly by the COVID-19 —airlines, hotels, live entertainment, sporting events, theme parks and the like. Barely more than 60% of the plunge in service-sector spending has been recouped. Never mind not being anywhere close to the pre-recession peak, service spending is no higher today than it was in April 2018.



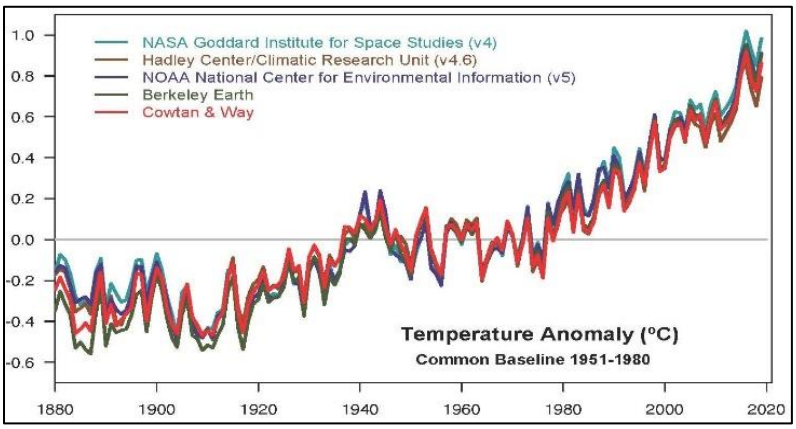
CLIMATE CHANGE

"An ounce of prevention is worth a pound of cure."

Climate change is already one of the most hotly debated topics in the U.S. and around the world. Sadly, today in the U.S., "science" has become a dirty word. Trump regards climate change as a "hoax" and has no plan to deal with what he considers to be a nonexistent issue. He continues to support the fossil fuel industry and reduce regulations on environmental controls.

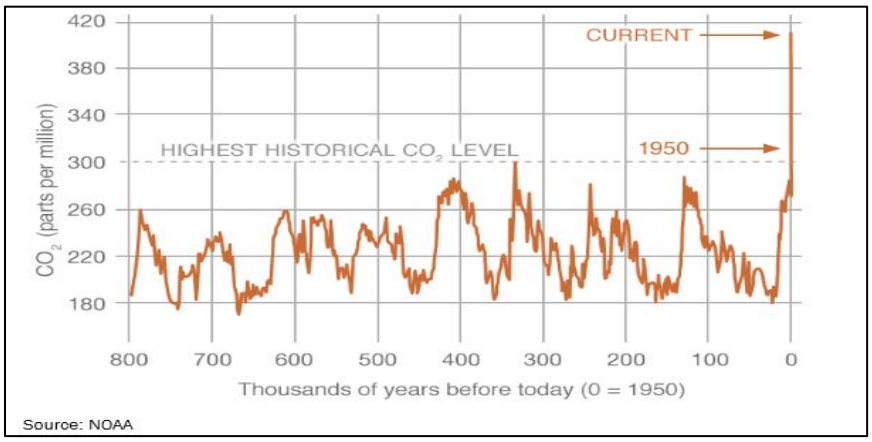
On the other hand, the Dems believe that climate change is an "existential risk" to the U.S. and world. A Democratic administration will embrace green spending to protect the earth from a possible and irreversible catastrophe.

Whether or not you believe climate change is a "hoax," the scientific evidence is more than compelling. Temperature data show rapid warming in the past few decades. According to NASA, the previous six years have been the hottest years over the past 140 years, and we are now approaching the critical 2°C warming threshold.



Source: NASA

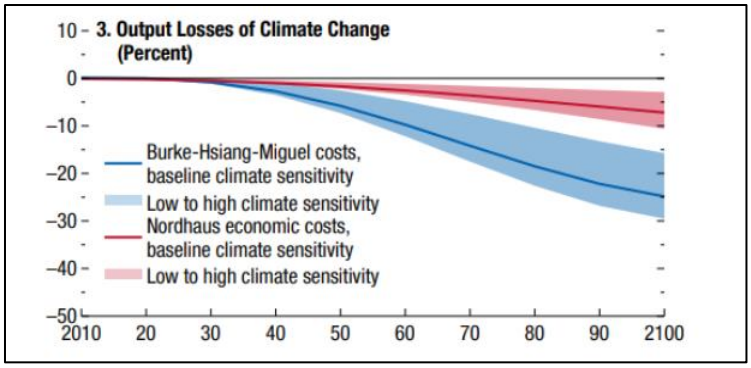
Since 1989, we have seen numerous global agreements (Kyoto Protocol, Paris Climate Agreement) and civic action (global climate strikes) to reduce carbon dioxide and other greenhouse gas emissions. I don't think one has to be an expert to understand that the trend in CO2 is downright scary.



And while some have labeled climate change as a "liberal" issue, is it not prudent and "conservative" to make sure we do not destroy Mother Earth. Let's face it: unless you want to take a flight to Mars with Elon Musk, we have no backup plan. Possibly the "mad scientists" are wrong, but what if they are correct? Other than political ideology or gut feelings, most of us are not in a position to judge the issue. As stated up front, Blaise Pascal would argue that a rational person should live as though climate change exists and believe in science (not politicians and idealogues). If climate change is not real, we will only suffer a finite loss, but if climate change exists (and we ignore it) we would have infinite loss.

I realize there will need to be much political and economic capital spent but the cost of inaction could be far greater — rising sea levels present an existential threat to a large percentage of the global population, disruptions to food and water supplies, increased frequency and damage of natural disasters and the influx of "climate refugees" from uninhabitable locations, are just some notable effects that will influence economic growth.

In fact, in its latest World Economic Outlook, the International Monetary Fund (IMF) states that the losses from unmitigated climate change on global GDP will average 15% by 2100 (with a range of 3% to 30%). Likewise, the Network for Greening the Financial System (established by eight central banks following the signing of the Paris Agreement) indicates a reduction of 1.5% to 23% in global annual GDP per capita.



Source: International Monetary Fund

Bottom line: The developed world has been losing its growth and edge. The economic recovery from the COVID-19 pandemic is an important opportunity for governments to increase global stimulus by accelerating investments in green infrastructure spending like wind, solar, electric cars and the like. Indeed, it is going to take tens of trillions of dollars to "green" our economy. But much like the industrial revolution, the coming decades will open to a number of technology initiatives, opportunities for economic growth, job creation and investments that could shock to the economic system and drive us out of the dreary slow growth rates of the last two decades. What an opportunity to have a win-win.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Since 1980, I've been following markets and the economy and people have been talking about how rates have nowhere to go but up. As shown below, that clearly has not been the case as yields have relentlessly declined over the past four decades. Yes, yes… there have been brief periods of times when rates rose for various reasons but as rates rose, the economy slowed and the long-term secular downward trend of rates continued.

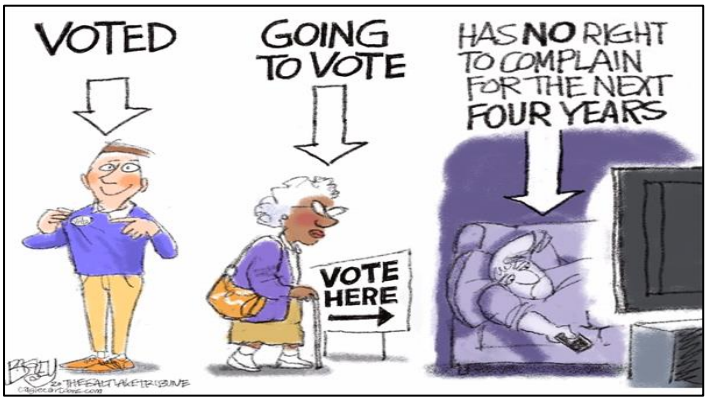
The Fed has made it clear that it won't hike rates until the economy hits certain employment and inflation benchmarks. There's some ambiguity about where those levels really are, but there's an assumption that we won't be back to pre-crisis levels of unemployment, or see sustained inflation anytime soon, so the market surmises that there's no chance of a rate hike before 2023.

Let's say things get really bad again. Say COVID rages out of control and results in a partial/full shutdown? Suppose the Democrats control the purse strings, and the Fed implements yield curve control or goes the way of the Bank of Japan and buys every bond in sight, thus essentially capping any yield increase? Did you know that Japan's debt-to-GDP is close to 250% today… yet their yields are "negative" out to 10 years? Or suppose there's no more stimulus coming. What if the stock market finally trades to reality and results in a major reallocation out of stocks into bonds?

I could go on, but you get the picture. There are a lot of potential scenarios that could cause rates to potentially go higher (or lower) post-election. And at this point, no one really knows. But should rates rise in a sustained manner, our grossly overleveraged economy would come to a screeching halt and rates would reverse, as has been the case over the past 40 years.

With so much uncertainty, what should credit unions do? I started this article by saying we should embrace uncertainty realizing that almost everything in life, including investing, is a probability-based decision. From my vantage point, the best way to embrace the uncertainty is to 1) stop guessing; 2) stay the course with a duration/risk appropriate ladder and 3) capitalize on market weakness. Tried and true.

Finally, please vote and make your voice heard!



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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.