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Weekly Relative Value

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WEEK OF NOVEMBER 9, 2020

America Votes for Capitalism

"For all those of you who voted for President Trump, I understand the disappointment tonight. I've lost a couple of times myself. But now, let's give each other a chance. It's time to put away the harsh rhetoric, lower the temperature, see each other again, listen to each other again… To make progress, we have to stop treating our opponents as our enemies. They are not our enemies. They're Americans. They're Americans."
– President-elect Joe Biden

After one of the most toxic and divisive campaigns of all time, it's safe to say that last week was like a very long dentist appointment. But the good news is, it's over (I think!) "Sleepy Joe" Biden became the forty-sixth president-elect of the United States with an all-time record high 75,000,000 votes and will likely end up as many as 306 electoral votes.

Meanwhile, President Donald Trump remains in a state of denial and has no intention of conceding**.** He continues to fire off tweets with unfounded allegations of widespread voting fraud. He is focused on legal fights to overturn Biden's victory, which could last a month or more, possibly pushing the 2020 political wars toward Christmas. According to news sources, Trump plans to hold rallies focused on the litigation. How much fun would that be? Regardless, while President Trump has every right to issue court challenges, they won't go anywhere. It's over. The proverbial fat lady has sung.

THIS WEEK

- AND NOW WE RETURN TO OUR REGULALRY SCHEDULED PANDEMIC
- JOBS RECOVERY COOLING
- NO CHANGE
- MR. BOND

PORTFOLIO STRATEGY

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Here are my 10 key takeaways from the 2020 election:

1. Pollsters are paid to try to get things right, but they were seriously, dreadfully wrong. Biden's comfortable lead both nationally and in swing states bore very little resemblance to actual voting. Nate Silver of FiveThirtyEight (the Lebron James of polling) was offering Trump 10:1 odds on November 2. This follows a similar miss in 2016. In that regard, the pollster resembles the meteorologist and the economist, which believe their elaborate models can reveal the future. They can't!
2. It was very encouraging and impressive to see record voter turnout, especially in the context of a pandemic. Suddenly, we have a nation engaged and taking ownership over the direction of the country.
3. Character matters. While both candidates offered a contrasting policy mix, this election was more about the integrity and dignity of the individual. Americans voted for decency at the White House.
4. Yet, let's face facts. Trump still nearly won despite his own high unlikability ratings. Going into the election, his approval rating was a lowly 45%. Americans are familiar with Donald Trump's character (or lack thereof). Yet, outside of Joe Biden's 74.6 million, nobody ever secured more votes than Trump did this past week. That was seven million more than in 2016! What does that tell you? Therefore, the fact that Trump almost pulled this off is the big story. This was supposed to be a landslide and it wasn't. America did not repudiate "Trumpism."
5. However, this was not a pro-Trump vote. It was an anti-left vote. There will be a run-off in Georgia for two Senate seats; the odds overwhelmingly favor Republican victory and control of the upper house. Meanwhile, House Democrats saw their majority cut in half; they may lose up to 10 seats. Don't think for a second that the GOP is not eyeing the House to reclaim a majority in 2022. For the time being, the message is loud and clear, to the world and at home, that America is not turning towards socialism. We are a center-right country. Thus, the biggest loser wasn't Donald Trump. It was the far left. No denying this message.
6. The "Ghost of John McCain." Arguably, one of Trump's biggest political miscalculations was berating Arizona's "beloved" John McCain. Trump referred to McCain as a loser for being a prisoner of war (POW) in Vietnam. Well… Arizona turned blue and now has two Democratic Senators. Think about that!
7. Massive fiscal stimulus and tax hikes were expected under a Democratically controlled government. Kiss that forecast goodbye. There is no green energy deal. There is no sweeping re-regulation. There are no tax hikes on corporate profits, capital gains, dividends or high-end personal incomes. No wealth taxes. The Bernie Sanders/Elizabeth Warren agenda has been locked up in a box. Not to mention, it will still be the Senate Republicans that approve all appointments, from the cabinet to the courts to the Federal Reserve.
8. It's kind of a cliché that gridlock is good for markets, but… gridlock is good for markets. So, for capitalism, what is there not to like here? It is more than just possible Republican Senate control and Biden in the White House that will be bullish for the economy. Why? No left-wing wave. No more trade wars. No re-regulation. The markets like that! In fact, the S&P 500 had the biggest post-election rally ever, gaining at least 1% every day last week for a cumulative gain of more than 7%.
9. We come out of this election with more evidence of a nation not just divided but extremely polarized. This is not the first time this has ever happened, mind you, and this era of ultimate discord and acrimony shall pass.
10. As with any presidential election, approximately 50% of Americans are disappointed. As President elect Joe Biden said, losing is hard, but it's time to heal and come together as a nation. Country over party!

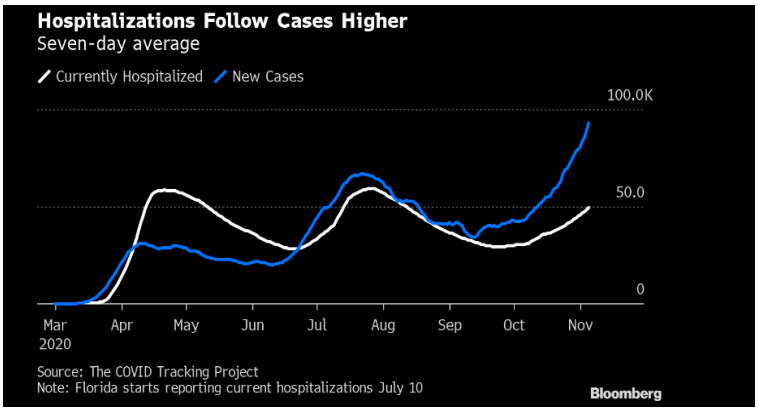
AND NOW WE RETURN TO OUR REGULARY SCHEDULED PANDEMIC

"At the current growth rate, we expect the total number of currently hospitalized patients to hit 60,000 – a breaking point in past surges – by November 15… At that point, restrictions will gradually intensify."
– Hunter Hammond, senior analyst, Height Capital Markets

While the U.S. election took COVID-19 off the front pages, make no mistake: it is still there. The medical community led by Dr. Anthony Fauci and Dr. Deborah Birx has steadily and forcefully warned that the COVID spread would quicken as we move into the fall/winter season. And it sure has! The pandemic's recent acceleration has been ferocious. It took 32 days for the number of cases to rise from 30 million to 40 million. It took just 21 days to add another 10 million. The number of coronavirus deaths worldwide also set a new daily record of more than 10,000. More than 1.25 million people have died from the virus.

The U.S. has surpassed 10 million on the COVID-19 case count (and the world is topping 50 million) and setting records for four straight days. Hospitalizations are on the rise, too, as are fatalities. Thus, while there may not be a "Blue Wave," there sure is a "Second Wave" of COVID. People say, "please, stop; I've got COVID-19 fatigue." The thing is, the coronavirus doesn't care. But I guarantee that you will care if you get it ("Ahhh...I'll be fine").

Flash news: Markets are spiking this morning after Pfizer announced that its coronavirus vaccine trial was more than 90% effective (similar to the effectiveness of the measles vaccine) in preventing the disease among a group of volunteers and produced no serious safety concerns. The company released only sparse details from the trial, and scientists have cautioned against hyping early results before long-term safety and efficacy data has been collected. However, if validated, this indeed would be a game changer and very welcome news. Most had expected that the first-generation vaccine would be 60-70% effective. The news flow on this file will be key in the next two weeks.



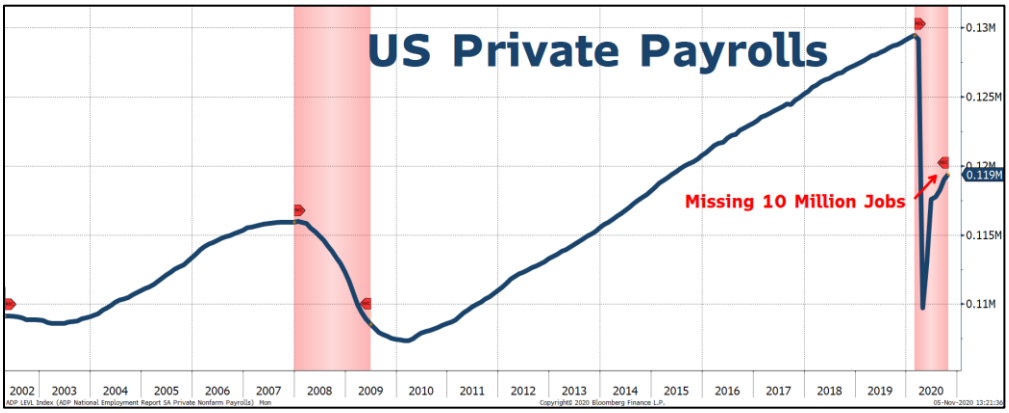
JOBS RECOVERY COOLING

Last week, the ADP measure of private sector payrolls came in "light," at +365,000 in October. The consensus was looking for +643,000 and this was less than half of the +753,000 pick-up in September. Ordinarily, +365,000 would be reason for jubilation. But the problem is, the hole is so deep that the level of employment is still 10.1 million lower now than it was before the pandemic hit in February. To be sure, 9.64 million jobs have been "created" from the April trough. That sure sounded good on the campaign trail. But we had lost 19.71 million jobs prior, so the real story is that here we are, six months into a "recovery," and less than half (49%) of the plunge has been recouped. It will take 27 months to get back to the old high.

The jobless claim numbers remain at recessionary levels with over 21 million Americans still collecting unemployment benefits. The Challenger data showed that layoff announcements were the highest for any October since 2008 — a month after the Lehman collapse.

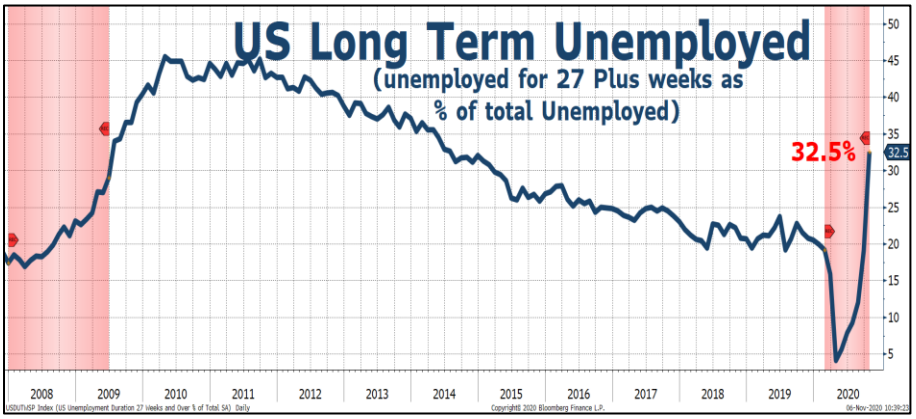
The official unemployment report showed the labor market strengthening in October, defying expectations for more subdued gains amid an intensifying pandemic and lack of additional fiscal relief. Non-farm payrolls increased by 638,000 after an upwardly revised 672,000 gain the prior month. The unemployment rate fell by one percentage point to 6.9% –

a bigger drop than projected and double the prior month's decline. In any event, barring a "recount" of the employment data, Friday's report was rock-solid but there were blemishes.



The number of permanent job losers was little changed at 3.7 million in the month, a positive sign after two straight significant increases. Yet, jobs remain 10 million below pre-pandemic levels and sadly many of these jobs will be slow to return, if ever.

Other figures point to an increasingly fragile labor market beneath the headline numbers. The number of long-term unemployed – those jobless for 27 weeks or more – increased by 1.15 million to 3.56 million, and now makes up a third of those out of work.



As we move forward, colder weather will also challenge businesses like restaurants that have depended on outdoor dining when many Americans are fearful of gathering indoors. This makes the economy's path highly dependent on the development and distribution of a successful vaccine, especially if virus restrictions re-emerge as they have in other parts of the world.

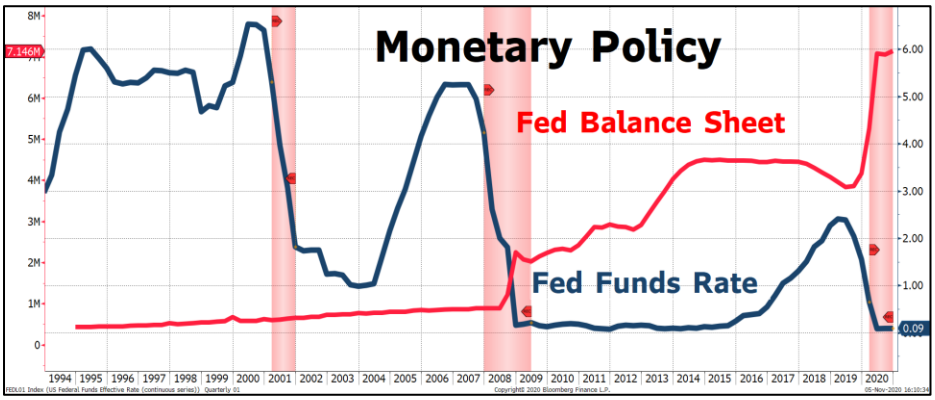
In addition, the congressional election results this past week probably reduced the chances that any new stimulus will be as massive as Democrats sought, meaning limited cash for the unemployed and businesses most affected by the virus.

NO CHANGE

As universally expected, the Fed made no changes to monetary policy. It left the fed funds rate unchanged. Nor did it change its quantitative easing (QE) program as it will continue buying assets at the current pace ($80 billion in Treasuries

and $40 billion in MBS per month). The Fed did intimate that they may decide to shift asset purchases toward longer maturities in order to constrain any rise in long-term bond yields.

The Fed's assessment of "considerable risks" surrounding the economic outlook over the medium term remained in the statement, signaling that officials did not take much comfort from the 33% rebound in third quarter GDP. The current Fed forecast is for a 3.7% decline in GDP for 2020. Officials continued to emphasize the considerable downside economic risks over an extended period and the need for additional spending.



This gives policymakers an unprecedented opportunity to delve into unconventional policy decisions like Modern Monetary Theory (MMT), based on the argument (which isn't without merit) that "extraordinary times call for extraordinary measures." If MMT is adopted, the reign of monetary policy dominance will come to an end. However, American politics are a bit more than frayed. Backlash from both sides of the political spectrum will no doubt result in concessions and a watered-down response that falls short of what theoretical models of MMT suggest could work (setting aside whether MMT could work even under the most favorable conditions).

MR. BOND

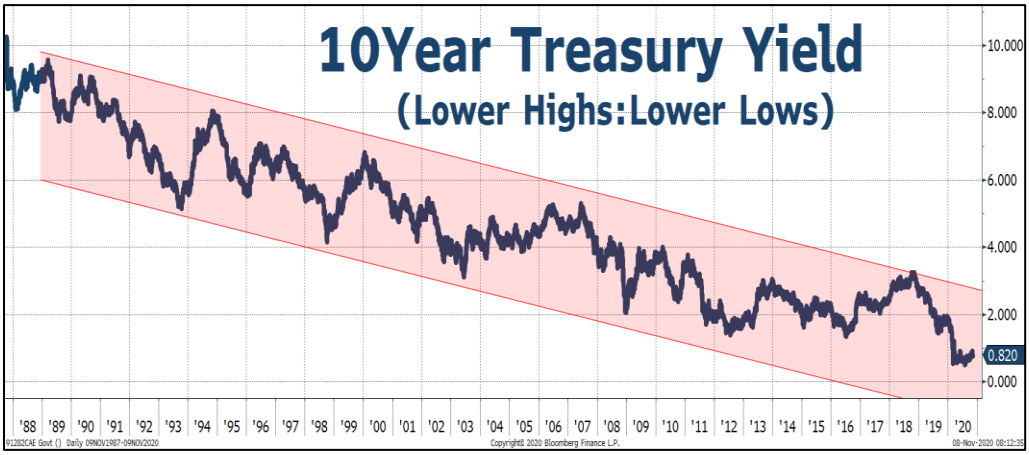
Sean Connery was by far the best Bond. So, in the same week that the legend died, how apropos is it to talk about Mr. Bond. Long-term yields have risen sharply on election relief and of course the positive news on the vaccine released today. On the long end 20-year and 30-year Treasury yields have gapped higher to 1.496% and 1.72%, respectively. After hitting the closing low of 0.54% back on March 9, 10-year Treasury yields jumped to 0.943%.

And, as they have for the past decade, every Tom, Dick and Harry economist and strategist has now come out of the woodwork proclaiming we are in a new bear market in bonds. Think about this. With the stock market up 50%, massive fiscal and monetary stimulus, and this is all we get? Up 50 basis points, to 0.92%? Never mind that we started the year near 2.0%. If this was happening in the stock market, it would be dubbed a "buy-the-dip-correction."

Since the great bull market began in 1980 yields have steadily declined. Yes there have been many periods when rates rose for various reasons. But every time rates rose the economy slowed and rates continued their secular trend lower.

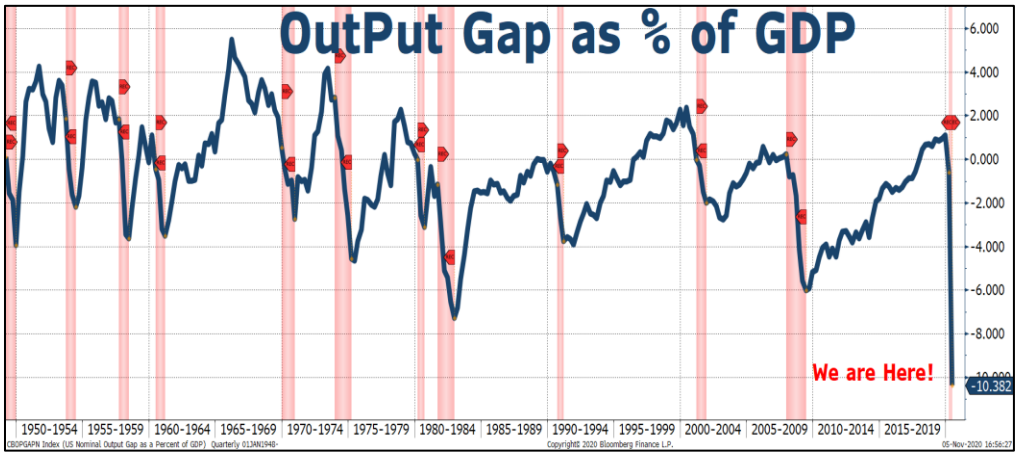
So, for a bear market in bonds to be established, the multi-decade pattern of new lower lows in yield, and new lower highs in yield, has to be broken. Let's review. The post-Volcker era saw the late 1980s' low in the 10-year note yield at 7.0% and the high at 9.0%. The 1990s cycle saw the low at 5.0% and the peak at 8.0%. The 2000 to 2007 cycle went from a low of 3.0% to a peak of 5.0%; and this past cycle, it was a range of 1.3% to 4.0%. Notice the pattern? Lower lows. Lower highs. And if we get to 1.0%? It's still a bull market

Fundamentally speaking, at some point the rise in yields would cause mortgage rates to back up and that will snuff out the housing recovery —the sector that led the economy back from its deep recess. In other words, if housing slows bonds will rally again. So any sell-ff will self-correct on its own. All the more so in such a highly indebted economy, which is why interest rate increases are hiccups that cannot be sustained. They cause too much debt-servicing pain and strain.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

While the economy is still healing, the wedge between supply and demand in the economy is still unbelievably wide (and according to the Congressional Budget Office (CBO), it will be for some time). The CBO projects that the economy will be operating below capacity through 2027. This disconnect between what can be produced and what is needed is going to sustain weak price growth, which means growth will be sub-optimal and the risk of inflation in the near-term is very low.



As we go forward, the tunnel-vision market will go from tax hikes, to spending stimulus, to no-stimulus and no tax hikes, to the next focal point, which will be a fourth quarter loss of economic momentum at a time of government policy limbo. Yes, we will get stimulus! but it will not be enough to fill the hole in the economy.

Meanwhile the Bank of England and Reserve Bank of Australia have both announced plans to expand bond buying, while the Federal Reserve discussed a shift in its program to buy longer maturity debt. In fact, almost $600 billion of bonds have seen their yields turn negative this past week, which brings the total of negative yielding debt to $17.05 trillion, the

highest level ever recorded. This means 26% of the world's investment-grade debt is now sub-zero. And it also makes U.S. Treasuries very attractive with an 94-basis-point yield advantage.

Strategically, any dips in the bond market are an opportunity to invest excess additional excess cash. And as we start the week, bond yields have backed up, but there is no inflation risk given the lingering size of the output gap, and there is absolutely no Fed policy risk. Anything north of 1.0% on the 10-year Treasury will be a very nice re-entry point for bond investors.

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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

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