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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF NOVEMBER 16, 2020

Managing Expectations

"We do see the economy continuing on a solid path of recovery, but the main risk we see to that is clearly the further spread of the disease here in the United States… With the virus now spreading, the next few months could be challenging." – Federal Reserve Chair Jerome Powell

I have repeatedly argued the path of the economic recovery is determined by the path of the virus. Unquestionably, the blockbuster Pfizer vaccine news of 90% efficacy seems almost too good to be true (hopefully it is true). But if Pfizer is successful, it surely is a game changer and could go down in history with Moses splitting the Red Sea as being one of the biggest miracles (with or without divine intervention). Indeed, in a remarkable scientific feat this will be the first time a proven vaccine has been developed and distributed within a year of a global pandemic.

Unquestionably, prospects of a vaccine coming to the fore will likley result in a quicker path to normalcy. But while we all truly hope for the best, there is plenty of room for disappointment. There are logistical concerns about distribution and storage of the Pfizer vaccine. Notably, the vaccine must be kept frozen at an ultra low (-94°F) until a few days before it is used. That requires special freezers, complicating its distribution.

Most importantly, we still don't know for how long the Pfizer vaccine will work. The virus is much smarter than we are and it could find a way to mutate. If so, the vaccine would lose its effectiveness. Thus, the "unknown" hasn't changed, which is the timeline — and what will happen between now and the time we all get inoculated.

THIS WEEK

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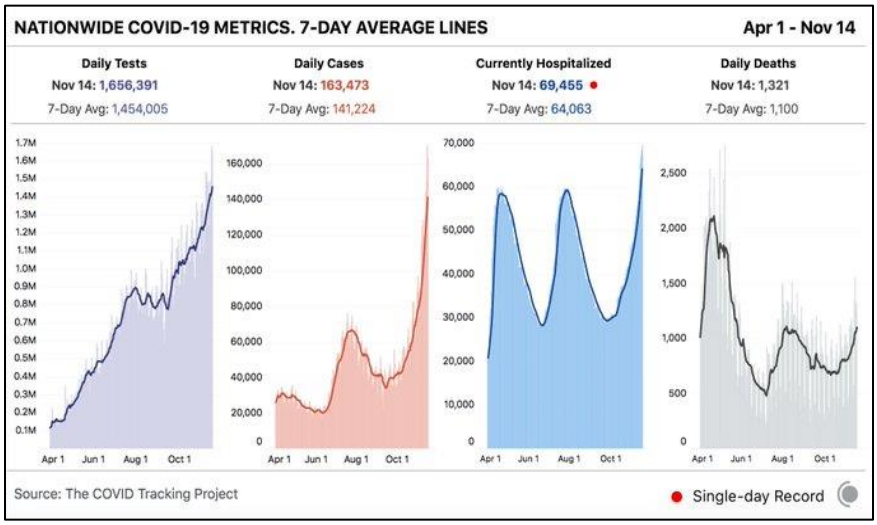
THE LONG DARK WINTER ARRIVES

"I am alarmed by the surge in reported COVID-19 infections, hospitalizations, and fatalities. This crisis demands a robust and immediate federal response which has been woefully lacking."
– President-elect Joe Biden, November 14, 2020

Vaccines and treatments are on the way so we have reasons to celebrate, but (and you knew there was a but) a devastating surge is now under way. Worldwide, cases top 52.3 million and deaths exceed 1.28 million. Here at home, new coronavirus infections jumped by 40% over the past week. We are averageing about one million cases per week, with no sign of slowing down. Once the numbers are this large, it's very easy for them to get much larger, very quickly – and they will. It's like a runaway train. The whole nation is in the midst of a terrible surge and cases are not confined to a region or a state; with cases rising in all 50.

But it's not just confirmed cases that are on the rise. The U.S. is also experiencing a steep increase in hospitalizations. Utah, Illinois, Minnesota, Colorado and other states are already reporting that hospitals and intensive care units are at or near capacity. America is also the world leader in coronavirus fatalities, with over 244,000 COVID-19 related deaths. More than 1,400 people died from the virus in the U.S. on Friday — the most deaths that day of any country. We are now averaging 1,100 reported deaths a day; those are the highest numbers since mid-May, and they are still rising sharply. For the moment, daily deaths are below the peak of around 2,200 daily fatalities the U.S. saw in April. But deaths are known to lag behind rising infection rates, as it often takes several weeks for the virus to become fatal.

Sadly, this second wave is not a huge surprise, which makes our lack of preparation even more tragic. The medical communitity had warned us that as the fall and winter months arrived, COVID would reassert itself. It sure has. They urged us to prepare but we did not.

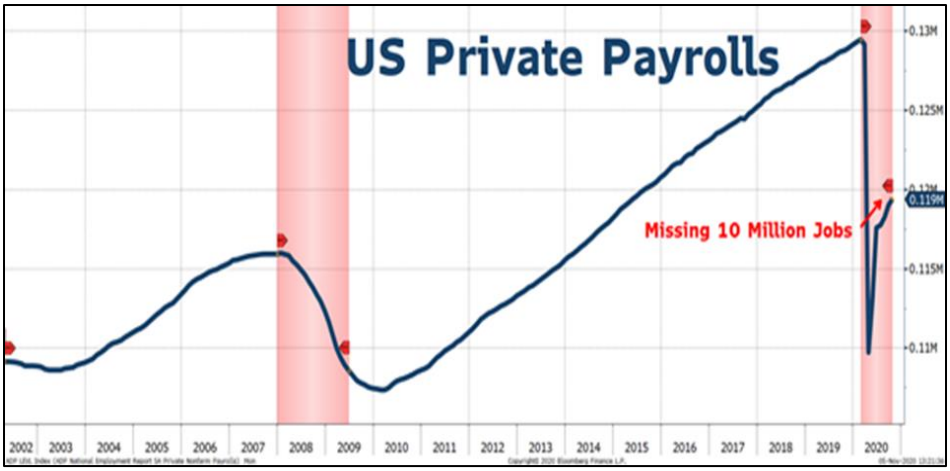


The good news: We are no longer in the open-ended, dreadful period of spring 2020, when we did not know if we'd even have a vaccine or whether any therapeutics would work. Now, we can see the cavalry coming, but until it's here, we need to lock ourselves down once again. I get it. All of this is unpleasant, but the alternative is much worse. So, yes, there is a light at the end of the tunnel but the tunnel is fraught with human misery and economic uncertainty before we get that inevitable state of nirvana.

But let's not fool ourselves. The 'miracle' vaccine will take time to distribute and it is still uncertain how quickly Americans will be vaccinated. So, between now and then there may not be enough fiscal stimulus to bridge the economy through a dark winter. I must remind everyone that the recent recovery is truly a function of unprecedented and massive policy stimulus. Without Uncle Sam, real GDP would have contracted at a 6% annual rate in the third quarter as opposed to the mirage +33% gain.

"Even after the unemployment rate goes down and there is a vaccine, there is going to be, probably, a substantial group of workers who are going to need support as they find their way in the post-pandemic economy, because it is going to be different in some fundamental ways." – Fed Chairman Powell

In the meantime, a lot of economic damage probably lies in our path. As shown below only 65% of the job losses have been recouped and we are still missing 10 million jobs. A divided Congress may fail to provide meaningful fiscal support, which could mean a longer journey back to full employment and a shallower recovery than hoped.



NEW NORMAL

"Americans are viewing their home as something more than what it was before…
Right now, there is a greater interest for larger-size homes, and naturally they are more expensive."
– The National Association of Realtor's Chief Economist Lawrence Yun

Count me among those encouraged by the the recent vacccine news, but I urge caution on the expectation that everything goes back to normal. We're recovering, but to a different economy.The economy we knew is probably a thing of the past.

Here are a few of many of the behavioral changes since COVID arrived.

First, the work-from-home theme is clearly not going away. Over 70% of the workforce wants to work at home more often even after the vaccine arrives. Not everyone, but that's a whole lot of folks. People have invested in their homes by adding more space, and more expensive space, because they know that the old Wall Street refrain of "work in a cave, live in a castle" has been replaced with "work and live in a castle." After all the investments made in their homes as a

workplace, do not expect a whole lot of folks to return to the office permanently. For downtown urban centers, this is going to pose a problem.

Second, consider saving behavior. Before this most recent crisis, over 50% of households didn't have enough cash saved to get through three months of joblessness. Many Americans may have been permanetly scarred by the pandemic and will be much more frugal going forward. In other words, saving more and spending less. Currently, there's $4 trillion sitting in money market funds earning nothing! This is often defined as a "liquidity trap." This is what the Fed faces, and it is deflationary.

"But for many people, money stashed in a savings account represents important protection against potential financial hardship. Easy access to that money outweighs the fact that they are being paid peanuts in interest."
– Bank Deposits Swell as Rates Fall, The Wall Street Journal

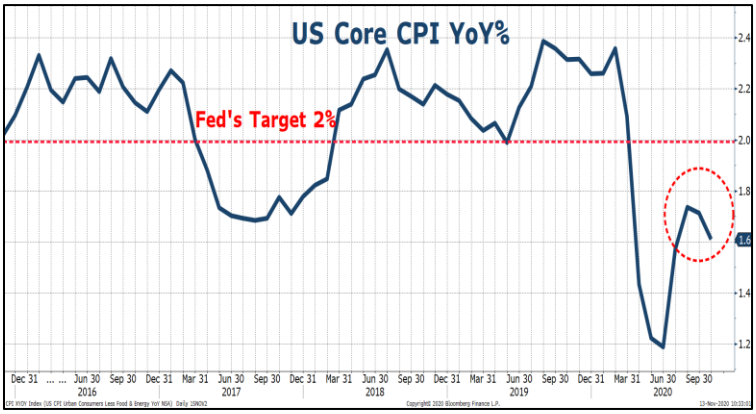
Third, the conventional wisdom is that restaurants(which employ millions of Americans) will be in full-fledged boom once COVID-19 is done for good due to pent-up demand. Then again, maybe not. The pandemic may have triggered a fundamental long-term change in behavior. For example: money saved on restaurants went into retooling the kitchen and buying new houshold appliances – air fryers, Instant Pots, breadmakers (and cookbooks), you name it – are off the charts! In esssence, the virus has forced us to morph into in-house chefs. This is not bad.

And I really doubt that just because we will be empowered to go out to restaurants and bars we will. This is not about safety or frugality, though. We will be eating out less because many of us learned how to cook this year. Having small outside babecues or dinner parties is just as much fun and you don't have to tip or worse, pay a corkage fee on your wine!

Please don't misunderstand me. We will return to the restaurant and bars and have some fun. The restaurant sector – which employs millions of Americans – will not go away but it will be smaller.

INFLATION, WHERE IS THY STING?

Last week, the bond market recived some great news on the inflation front. Consumer prices were flat in October versus the expectation of +0.1%. The year-over-year inflation rate eased to +1.2% from +1.4%. The key was the "core" inflation rate and it was flat (a one-in-twenty event) – taking the year-over-year pace down a notch to +1.6% from +1.7%.



This was the fourth time in 2020 that we have seen the core (excluding food and energy) composite fail to rise. Amazingly, this happened in the wake of a 33% surge in GDP in the third quarter, gobs of monetary and fiscal stimulus, all the re-openings in the economy and jubilation in risk assets and this is what we get…Flat consumer price? If you are bearish on Treasuries, this may be cause for pause.

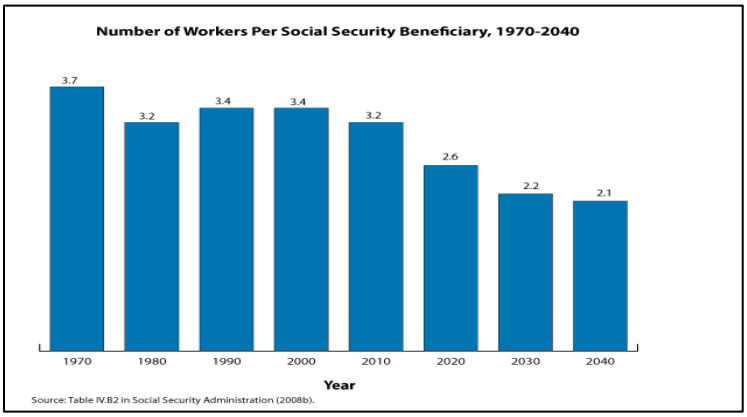
LOWER FOR LONGER

We will recover from the coronaviruspandemic and we will undoubtedly see a boost in growth from pent-up demand. But do not mistake a trade for a trend. Once we move beyond the COVID pandemic, the same long term structural issues facing the economy – massive debt, aging demographics, wealth/income inequality and decling productivity – will persist as they did pre-pandemic. The vaccines won't change that.

The destabilizing and deflationary debt levels have become even worse and have to be dealt with. We now have a debt albatross of $85 trillion as we come out of the pandemic. Debt at every level of society, government, business and consumer is at an unheard-of 392% ratio to GDP. For perspective, at the end of 2019, that metric was 326%. So in six months we increased debt by as much as we did in the previous 10 years combined. Wow! And as I have discussed numerous times in this spaace excess debt does not create growth. All it does is pull growth forward which serves to tap future economic activity.Furthermore with so much leverage in the system , how can rates rise in a sustained manner without crushing the economy. My view: Only once we normalize debt levels via a debt restructuring or debt jubilee will rates be allowed to rise in a sustained manner.

Second, Father Time moves on and we ain't getting any younger. Currently, there are 76 million baby boomers (born between 1946 and 1964) with a median age of 65. Fast forward a decade, and this group will have a median age of 75 and will have largely left the labor force. In fact, by 2040 the share of Americans in the 65-year-plus categoty is expected to skyrocket to 22%. An aging population will impact productivity, consumption and growth as we move forward. Think Japan!

On the other end of the demographic spectrum, the working-age cohort (15 to 65 years), is expected to continue to decline steadily, from 65% in 2019 to an estimated 61% by 2040. Thus, there is no surge of younger adults to pay into Social Security and Medicare. This is a ticking time bomb.



With a growing share of elderly, who are often one of the most active voting blocks, policies that support social benefits like the Affordable Care Act or even a Universal Basic Income could be popularized in the near future. These benefits are already popular among many Gen Y and Millennials, so the balance of opinion shifting in this direction is not out of the question.

Third, the Trump Administation's hostility to immigration was distinctly populist to the potential detriment of the economy. Pro-growth Republicans should be making the case with a the country facing a demographic headwind, growing the economy will require more, not less, immigration.

Here's a factoid. Did you know that immigrants start businesses at higher rates than native-born Americans, and those new businesses fuel innovation and create jobs? If future green cards were issued to immigrants with relatively more skills, the benefits to the economy would be even more considerable. If we don't take down the "Immigrants Not Welcome" sign, the U.S.'s role as a magnet for some of the world's most ambitious and hardest-working migrants will diminish, threatening future prosperity.

In conclusion, a massive debt overhang, aging demographics, and limited immigration will act as significant constraints on economic growth that will outlast the brief boost to demand we will get once the vaccine arrives.

ILLUSORY TRUTH EFFECT

"The illusory truth effect (also known as the illusion of truth effect, validity effect, truth effect, or the reiteration effect) is the tendency to believe false information to be correct after repeated exposure. Repetition makes statements easier to process relative to new, unrepeated statements, leading people to believe that the repeated conclusion is more truthful." – Wikipedia

It's been said, the more you say something the more people believe it. One of Donald Trump's greatest slogans over the past four years has been: "I have created 'the greatest economy in the history of the country.'" The numbers tell the story. As shown in the table below, the economy expanded at a mere 1.1% annual rate over his four-year tenure. For comparison, only Herbert Hoover presided over a weaker economy.

Presidential Economic Performance		
President	**Term**	**Annual Real GDP**
Warren Harding	1921-1923	+9.6%
FDR	1932-1945	+7.1%
Harry Truman	1945-1953	+6.2%
William Howard Taft	1909-1913	+5.8%
LBJ	1963-1968	+5.2%
JFK	1960-1963	+4.2%
Bill Clinton	1992-1996	+3.8%
Ronald Reagan	1980-1988	+3.6%
Calvin Coolidge	1923-1929	+3.4%
Jimmy Carter	1976-1980	+3.2%
Teddy Roosevelt	1900-1908	+3.1%
Dwight D. Eisenhower	1954-1960	+3.1%
Richard Nixon	1968-1973	+2.9%
George H.W Bush	1988-1992	+2.3%
Gerald Ford	1973-1974	+2.1
Barack Obama	2008-2016	+1.9%
George W. Bush	2000-2008	+1.8%
Woodrow Wilson	1913-1921	+1.8%
Donald Trump	**2016-2020**	**+1.1%**
Herbert Hoover	1928-1932	-5.6%

To be sure, the coronavirus "black swan" wasn't Trump's fault. Anyone in charge would have also dealt with a significant recession as we have seen around the world. So, to be fair and balanced, let's look at the track record pre-COVID. In the three year prior to COVID-19, the Trump economy posted real GDP growth of 2.5%. For comparison, during the same last three-year span of the Obama Administration, real GDP averaged... wait for it… 2.4%. Bill Clinton's economy averaged 4.3%. For the "Gipper" himself (Ronald Reagan), real GDP was 3.8%. So, despite the hoopla over tax cuts (which blew out our deficits) and deregulation, the economy barely performed any differently under Trump than it did under Obama. Numbers do not lie.

By the numbers, the "greatest economy of all-time award" goes to Warren G. Harding, followed by Franklin Delano Roosevelt, Harry Truman, William Howard Taft, Lyndon B. Johnson, John F. Kennedy, Bill Clinton and then Reagan. Even if you do not include the effects of the pandemic, Trump riveled Jimmy Carter, who, even with a recession of his own, managed to post a 2.9% average annual growth rate over his four years.

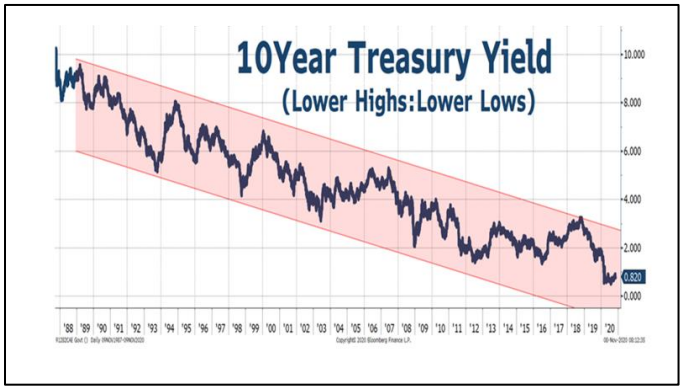
MARKET OUTLOOK AND PORTFOLIO STRATEGY

As a baseline, let's assume "normal" means returning to the last decade (2010-2019) pre-COVID.

- Real GDP growth averaged 2.3%
- Inflation averaged 1.8% despite massive fiscal and monetary stimulus
- Productivity averaged 1% per year
- The fiscal deficit doubled from $1.5 trillion to $3 trillion
- The 10-year Treasury yield declined from 3.8% to 1.9%

In a nutshell, going back to "normal," means low growth, low inflation, low investment, low productivity, low interest rates, even with massive fiscal deficits and Fed easing.

I want to make this final point. Treasuries were in secular bull markets before anyone even knew what COVID-19 was. And as we have seen, since the great bull market in bonds commenced in 1980, there have been and will always be periodic selloffs. They come and they go. But as they have been for the past four decades, these are temporary corrections in a long-term secular bull market of lower highs and lower lows.



In the near-term, rising COVID cases coupled with uncertainty about a potential vaccine are likely to keep demand for bonds elevated, which will cap yields close to current levels. As vaccines become widely available (6-plus months), these concerns will subside, and some pent-up economic activity will be released. As such, longer-term rates could indeed head higher over a short period of time. However, a large bond market sell-off remains unlikely as the "post COVID" recovery might still be quite a long ways away as fiscal stimulus will likely be limited. Most importantly, as outlined

above, the structural impediments of massive debt and leverage, combined with aging demographics, ensure a very troubling future for economic activity post-COVID. And that, in turn, means rates will remain lower for longer.

My advice: Stay fully invested. Minimize excess cash. Maintain a risk-appropriate ladder strategy. Take advantage of sell-offs.

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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.

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