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INVESTMENT SERVICES

Weekly Relative Value

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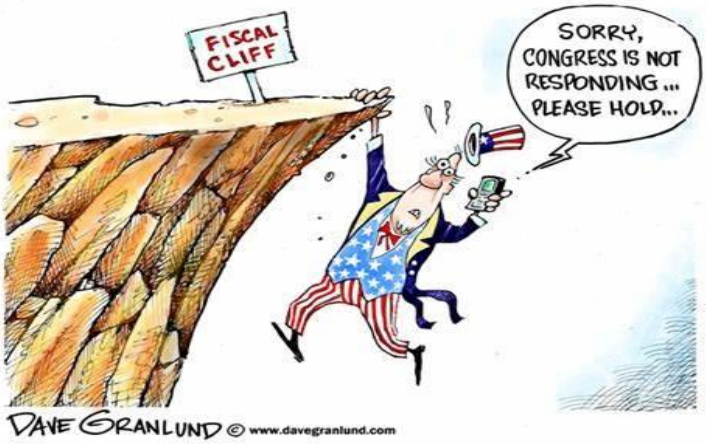
WEEK OF NOVEMBER 23, 2020

Approaching the Fiscal Cliff

"We have this big debate: Is it $2.2 trillion, $1.5 trillion? You've got to be kidding me… Just split the baby and move on. This is childish behavior on the part of our politicians."
– Jamie Dimon, CEO of JPMorgan Chase

There's a large swath of America – particularly among low-income groups – that is struggling. Talks over additional stimulus have been stalled for months over the size and makeup of a package. Hanging in the balance are nearly 30 million households entering into varying levels of distress as we head into 2021 amidst a do-nothing, lame-duck Congress. This is not a partisan issue. But make no mistake, a stimulus package is needed as a bridge for the economy as the world waits for vaccines to be widely distributed.



Fed Chair Jerome Powell looked set to extend key lending facilities this past week that were due to expire at the end of the year. The Treasury had other plans as it is attempting to force those programs to expire at the end of the year, just weeks before President-elect Joe Biden takes office. Secretary Steven Mnuchin sent the central bank a list of funds to be repaid, that would allow Congress to "re-appropriate" $455 billion that was earmarked for Fed support programs. That means a number won't be carried into the new year, including the Main Street lending facility, and backstops for the municipal and corporate bond markets.

It's fair to say that the market doesn't need help right now, but this action knocks out a safety net at a time when lawmakers have no clear plan. No one needs reminding that the

THIS WEEK

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U.S. is heading into a tough winter, with infection rates setting daily records, renewed restrictions on activity, school shutdowns and more businesses closing.

The Fed, which had taken pains to appear on the same page as Treasury, put out a stunning statement, saying it "*would prefer that the full suite of emergency facilities established during the coronavirus pandemic continue to serve their important role as a backstop for our still-strained and vulnerable economy.*"

What's next?

As I have discussed previously, the economy remains addicted to policy stimulus and, absent that, real GDP would have contracted at a 6% annual rate in the third quarter (Q3). Only by the good graces of Uncle Sam's checkbook did we manage to post that "epic," though clearly non-organic, +33% headline print for the quarter.

We are getting ever closer to year-end and the expiration of policy stimulus at the same time that the virus and hospitalization counts are on the rise. What are the consequences of no additional stimulus?

- An estimated **12 million Americans** face an end to unemployment support by the end of the year.
- The CARES Act prevented landlords (Federal Housing Administration) from evicting anyone who missed their rent payments. If this is not extended, the Census Bureau estimates that **14 million renters are at risk**.
- The loan forbearance under the CARES Act runs out on December 31, and the estimate for eligible homeowners in forbearance as of November 8 is **2.7 million.**

In total, we are facing a fiscal cliff as nearly 30 million Americans are at risk of some kind of financial duress if no further fiscal stimulus comes our way. Anecdotally, New York's Metropolitan Transportation Authority plans to cut 9,367 jobs to prepare for the pullback in subway, bus and train service (expecting a renewed decline in activity of 40% to 50%!) if no federal assistance comes to the fore.

RETAIL SALES

If you are wondering what the economic impact will be if we do not extend fiscal stimulus, consider last week's retail sales data. October retail sales ticked up by just 0.3% from September, the smallest month-to-month increase since the trough in April and was revised down to +1.6% from +1.9%. Critically, the core control index, which feeds directly into the consumption segment of the GDP data, slowed sharply to a mere +0.1% – a huge "miss" since the consensus was looking for +0.5% and, yet again, September is now +0.9% instead of +1.4%.

Notice the trend. Retail sales have lost momentum since the springtime post-reopening breakout. In June, sales increased +8.6%. In July, +1.6%. In August, +1.4% In September, +1.2% and in October, +0.1%. The momentum is clearly fading.

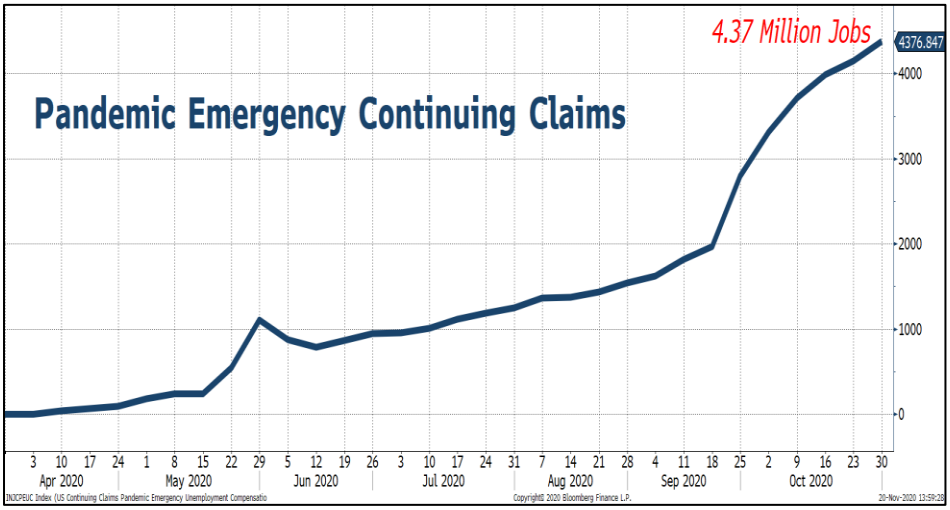
This is a small taste of what life looks like as the fiscal stimulus fades and concerns over the pandemic influence consumer behavior. Note that the retail sales data in October occurred before the latest widespread spike in the coronavirus, which surely will cause households to become even more cautious, a theme I am sure we will see in the November figures.

And while the vaccine news has been very encouraging, knowing the light at the end of the tunnel is nearer to us will also be an incentive to spend more time at home and less time heading out to the malls, casinos and restaurants. In fact, restrictions across numerous states will make social gathering more difficult in the coming months, which will detract from spending growth heading into year-end... the most important shopping season of the year.

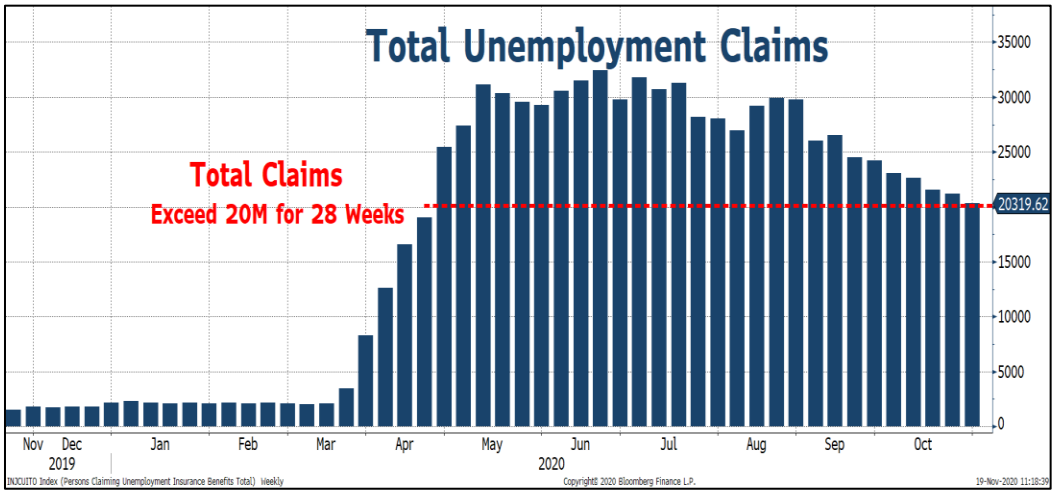
JOBS UPDATE

"During the 2007–09 recession and its aftermath, the level and persistence of the aggregate unemployment rate was largely attributable to individuals who were unemployed for at least six months. The contribution of this category currently is below its 2007-09 recession level, but it is likely to grow if the crisis persists. The share from long-term unemployment is an important factor to monitor because it may signal increasing persistence of high unemployment in the future." – San Francisco Federal Reserve

Pandemic Emergency Unemployment Compensation (PEUC) claims come into play after someone exhausts all their regular state unemployment benefits. Last week PEUC claims jumped to 4,376,847. Based on the number of people already on federal and state benefits, 12 million workers will be on one of the two main CARES Act programs – Pandemic Unemployment Assistance (PUA) and PEUC — when funding expires on December 26. Unless there is a deal, about 12 million people will lose all their unemployment benefits in December. Bankruptcies, evictions, and foreclosures will likely soar.

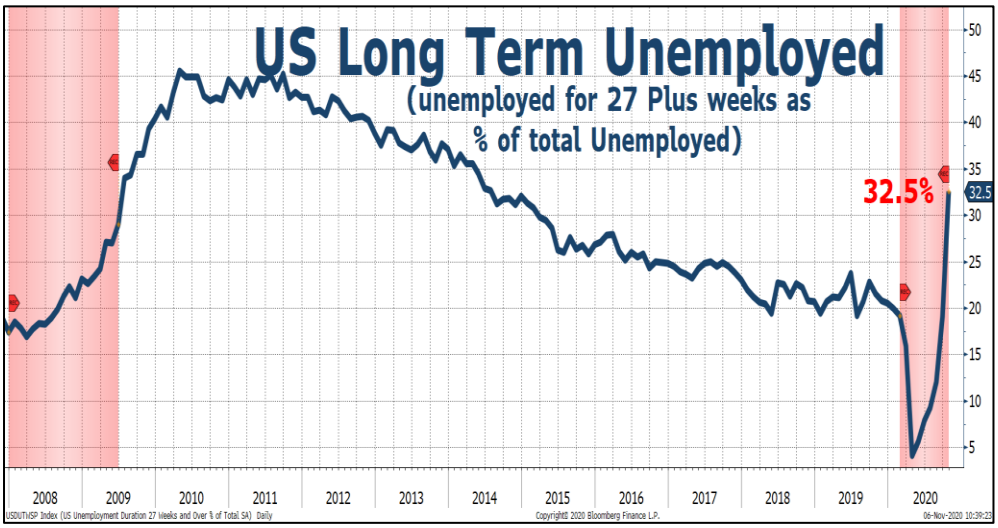


And despite the reopening of the economy, there are still over 20 million people on some sort of benefit plan. For comparison, that is more than double the number at the worst part of the 2008/09 Great Recession.



The Great Recession saw the unemployment rate rise over three years as the pool of permanently unemployed rose. And once again, the growing number of permanently unemployed workers is making folks nervous, and for good reason. There are currently 3.5 million folks who have been out of work for 27 weeks or longer. Sadly, this number could rise dramatically and keep rising for perhaps a year after the recession is over. More significantly, this time the employment shock has been much more severe. Unlike the last crisis, this one has targeted low-skill occupations in industries that rely on face-to-face contact. What employment alternatives will these workers have if the shift to the "stay-at-home" economy continues?

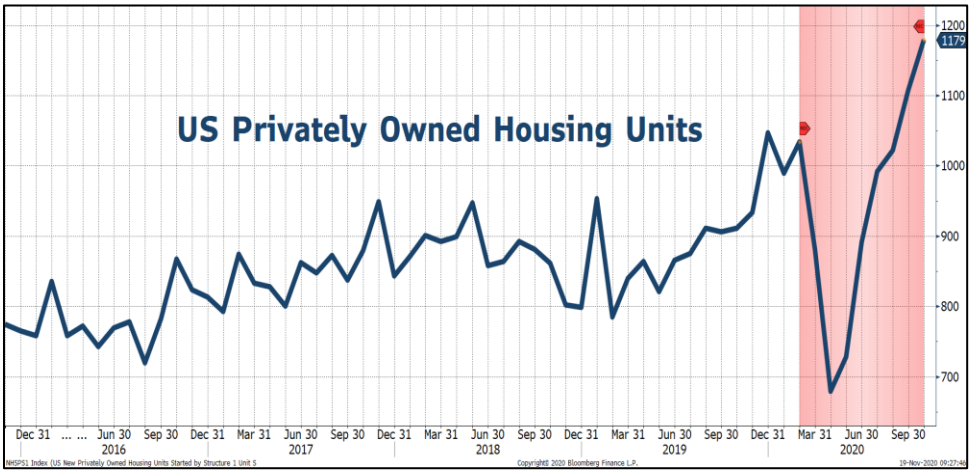
The changing structure of the economy foreshadows an era of structurally higher unemployment. As of November 14, even with all the exciting vaccine news, the Census Bureau's Small Business Pulse Survey showed that 46.7% of the companies say their operations will not be back to "normal" for at least another six months and 7.3% said "never." The latter is barely hanging in. If there is any truth to that figure, it will imply that 2.3 million jobs will be gone permanently on top of the estimated two million positions that have already vanished since the pandemic hit.



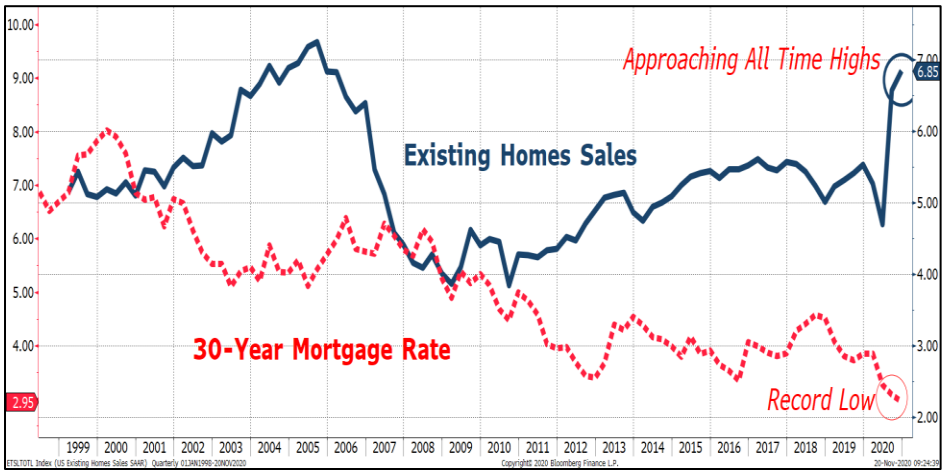
BURBS ARE COOL AGAIN!

If you are looking for some good news on the economy, turn to the housing market. The pandemic has certainly been no match for the lowest mortgage rates on record. U.S. housing starts went through the roof in October, surging 5% on top of an upwardly revised 6.3% bounce in September (initially reported at +1.9%). At 1.53 million units (annualized), starts are at their highest level since February. But beneath the headlines, the big story is about the dramatic trend away from multi-family housing to single-family abodes.

On the month, single-family starts jumped 6.4% while multi-family starts were flat for the second month in a row. More impressively, single-family starts have risen six months in a row to 1.179 million units (highest tally since April 2007). On a year-over-year basis, single-family construction has surged 29.4% while multi-family is down 18.2%. This is a fundamental shift in housing preferences. The proof is undeniable!

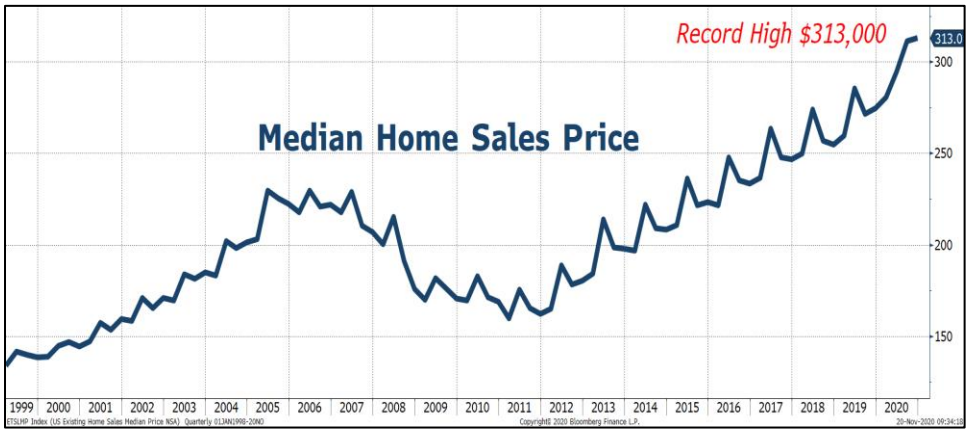


And it's not just a preference shift from multiples to singles. There is also a regional shift afoot. Overall, housing starts gains were clearly biggest in the South – up 12.9% month-over-month in October. The West was up 4.2%, the Midwest was up 3.3%, and the Northeast was down 38.6% to a five-month low. But the story beneath the story is that single-family housing starts in the Northeast cratered 17.9% in October and have shrunk in three of the past four months. Starts in the region's multi-family sector are down 84.9% (!) since the turn of the year.



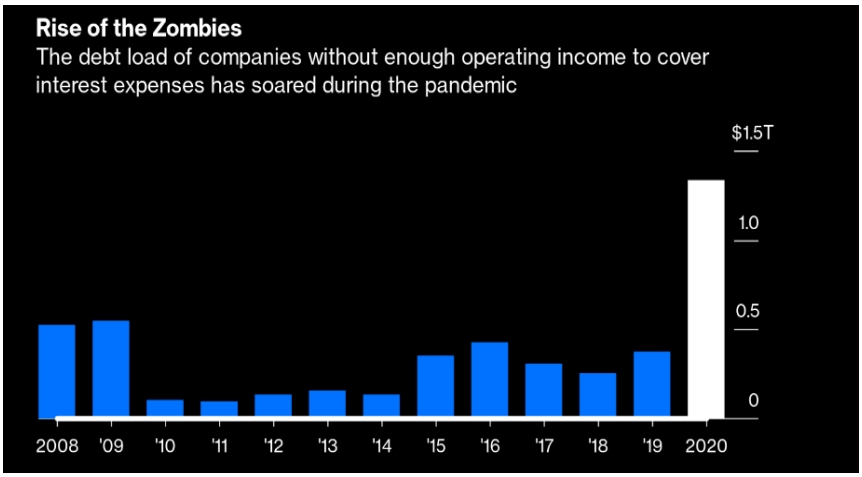
Confirming the housing sector strength, existing home sales have risen for the past five months (+4.3% in October). At 6.850 million units, re-sales are at their highest level since February 2006.

And prices have soared. Reason being is there are fewer homes on the market. To wit: sales are up 27% in the past 12 months, but inventory has plunged approximately 20%. The inventory backlog is now at a record-low 2.5 months' supply. A balanced market is 5-6 months' supply. This is why prices are being driven inexorably higher. In fact, as shown below, the median price of an existing home has moved up to a record-high of $313,000. A year ago, it was $273,820. This is a ripping 16% on a year-over-year increase, the fastest pace since October 2005. Pandemics are good for housing. Go figure. It does boggle the mind.



THE RISE OF ZOMBIES

A fundamental strength of capitalism is that failed companies go out of business making way for new ideas and better models. Yet here we are. Companies are being artificially kept alive at the expense of more productive companies. A Bloomberg analysis showing that, of the 3,000 largest publicly traded companies, "zombies," or those firms who couldn't cover their debt-service charges out of internally generated cash flows, are now a 20% share of the market. Now get this. They have added, with the help of the Fed, nearly $1 trillion of debt since the pandemic started. That is more than double the $500 billion of debt these dubious entities had on their books at the height of the Great Financial Crisis 12 years ago.



Source: Bloomberg

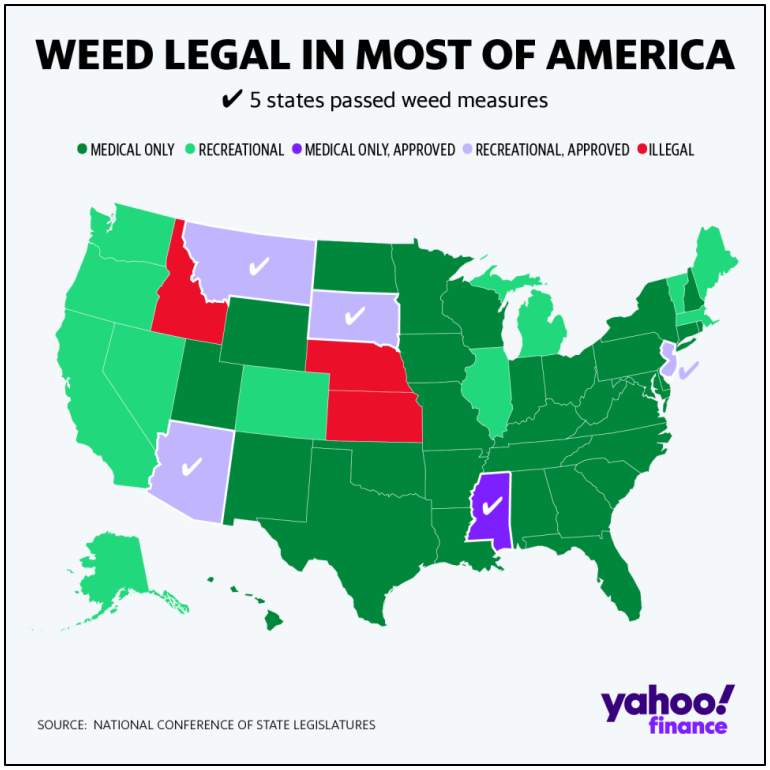
The outstanding debt for zombie companies is now $1.36 trillion. Before the pandemic, zombie debt stood at $378 billion. The number of zombies has risen from 335 at the end of 2019 to 527 currently! In the meantime, even with the huge pile of zombie companies, the stresses in the business sector are on full display. As noted in the Wall Street Journal article, *Federal Dollars Couldn't Stave Off Bankruptcy for Hundreds of Firms*, about 300 companies that received as much as $500 million in pandemic-related government loans have now filed for bankruptcy. Not to mention that nearly 15% of the companies make absolutely no money.

By keeping unproductive and poorly managed companies afloat, the Fed has kept excess supply intact that otherwise would have been absorbed, which is d-e-f-l-a-t-i-o-n-a-r-y. Not to mention, having badly managed companies stay alive through public support has a Chinese feel to it. Why does that sound un-American to me?

The bottom line: There is now a wide swath of zombies populating the business sector. And it's not just the airlines — it is real estate, financials, healthcare, telecom, consumer-related and energy. Whoever knew that society was in such dire need of so much market manipulation? This is the market Jay Powell has delivered — but as we all know, for the greater good. Right?

CANNABIS COMETH?

I have been asked by my kids if I have any "experience" in the cannabis space. My answer was and remains, I was born in the late 50s and have two older brothers.



Anyways, every statewide cannabis legalization measure on a ballot this election passed as Arizona, New Jersey, Montana and South Dakota voters all approved recreational cannabis possession and sales. Meanwhile, South Dakota and Mississippi voters approved new medical marijuana programs in their respective states. There are now 15 states with recreational marijuana programs, and another 22 states have medical programs. Since the Controlled Substance

Act (CSA) was signed into law by President Richard Nixon in October 1970, Americans have long changed their attitude toward legalization. Current national surveys show that 66% of Americans now favor legalization.

I fully realize there are concerns about abuse, addiction, etc. I get it. But the recent election suggests that we are at a point of no return on prohibition of marijuana. Furthermore, clearly everyone must see the hypocrisy of legalizing liquor and tobacco but not cannabis. When it comes to relative risks and harm, marijuana is proven to be far less harmful than other products, particularly alcohol and tobacco. In fact, the use of marijuana for medical purposes has shown many health benefits including treating glaucoma, stress and pain, rheumatism, insomnia, and even poor memory.

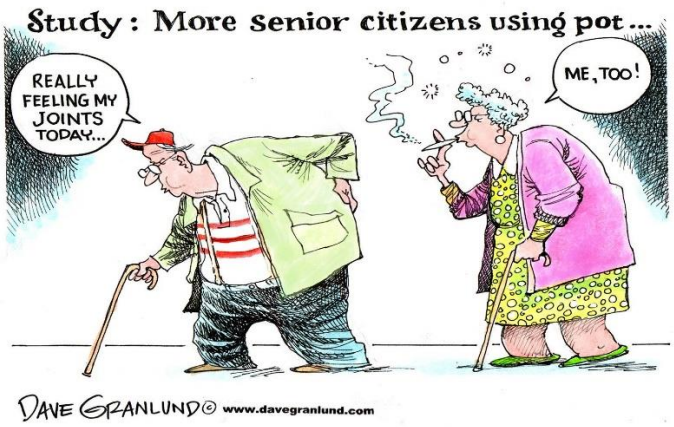
But I believe the big reason we will see a real change in Washington is M-O-N-E-Y.

In 2019, federal lobbying expenses totaled nearly $11 million, up 206% from the 2018 level. Final 2020 numbers are not available, but many analysts suggest that spending by the cannabis industry could be upwards of $30-40 million in 2021, with at least a similar amount in 2022. This suggests that by the midterms, the cannabis industry will have spent close to $60-80 million lobbying to have marijuana removed as a schedule one drug from the CSA. Can that level of spending change a few votes in the Senate? Time will tell!

From an economic perspective, should "pot" be legalized nationwide, the industry will boom, creating tens if not hundreds of thousands of jobs and much needed tax revenue for the barren State coffers. A report from the Marijuana Industry Group (MIG) indicates that an estimate of 10,000 new jobs have been created in Colorado since recreational marijuana sales began. If the entire U.S. will legalize marijuana, it will certainly create, if not millions, at least hundreds of thousands of legitimate jobs. States like Colorado and Washington that tax and regulate marijuana have already generated millions of dollars for healthcare, education and other public investments. According to a study from NerdWallet, if all 50 states legalized marijuana today, the country could gain over $3 billion in tax revenue.

In addition to bringing in funds, legalization of marijuana gives the country an opportunity to save billions of dollars per year. According to Harvard economist Jeffrey Miron, a whopping $8.7 billion a year is being spent for enforcing laws against marijuana in the U.S. What are we getting for the billions of dollars spent in stopping cannabis use? Nada. Nothing.

Finally, the greatest reason why marijuana may be legalized is because people, who want to smoke weed, will smoke weed – legal or not. So instead of wasting time, money and effort in trying to eliminate this long-standing issue, why not legalize it, regulate it, tax it and create much needed revenue to help fund education, healthcare and other government programs?



COVID, COVID, COVID

"This is faster. It's broader. And what worries me, it could be longer." – Dr. Deborah Birx

On Friday, more than 195,500 new infections were reported – a number many considered unheard of just weeks ago. The highest number of single-day cases during the country's summer surge was a little more than 77,100 in July. While infections continue to soar, hospitalizations are also hitting grim records, with now more than 82,100 COVID-19 patients across the U.S. A rising death toll follows. Last Friday, the U.S. reported 1,870 fatalities. In just the past week, more than 10,000 American deaths have been reported – nearly double the weekly death toll of just a month ago.

The past several months have been like watching a brutal, deadly, avoidable, slow-motion train wreck. I've lost the patience to entertain the dismissive "but what about" questions focused on anything that provides an excuse to ignore nearly 257,000 U.S. fatalities.

In the best case, we won't have broad vaccine availability until the first quarter of 2021, but we've launched into an acceleration of the pandemic here and now. That means that this moment – in the interim when a vaccine is in sight but not yet available – is the most important opportunity to save lives. We as a country need to contain this virus. But containment doesn't require "lockdown." It doesn't impose a violation of individual "liberty." It just asks that we care enough about others to avoid needless fatalities.

Here's containment in a nutshell:

1) Reduce the probability of transmission (masks, distancing, shorter interactions, airflow, hygiene).

2) Reduce the number of people you come into close contact with (limited groups, reducing unnecessary travel, avoiding hub and super spreader events).

I know you're tired and exhausted by this pandemic. I am, too. But we're in a critical window here, in the space where potentially safe, effective vaccines are now in sight, but still months before they will be widely available.

We have the capacity to reduce the rampaging virus not by shutting down the economy, but just by maybe accepting a little bit of inconvenience. What is it that makes this so difficult?

Say it with me. Containment is not lockdown. It's just a basic act of respect for the lives of others.

WILL YOU TAKE IT?

"Despite a quarter million deaths, despite more than 11 million infections, despite 150,000 new infections a day, they don't believe it's real." – Dr. Anthony Fauci

The vaccines are sure to come and very likely be effective, but will people take the vaccine? Even with the great Pfizer and Moderna news (the former now at 95% efficacy!), a New Jersey State survey finds that more than one third of residents would choose not to get vaccinated even when a safe vaccine is available. And fewer than half (49%) say they would either "probably" or "definitely" take a first-generation vaccine. Why? Well, 80% of those who are reluctant say it is concern over side effects. In fact, a Gallup survey showed 42% of Americans will choose not to get the vaccine.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Markets may be riding a new wave of optimism, but investors still need a hedge against the massive uncertainties of the months ahead. These include final approval of the experimental vaccines, a complicated rollout and decreasing chances of generous fiscal stimulus. In a world of rates stuck at zero, a risk-free asset that yields 0.9% should be quite appealing."

Retail, hotels, restaurants and movie theaters are likely in for a very rough winter. An effective vaccine (likely several) will be forthcoming. But I contend that the distribution may take longer than expected, the economic damage between now and then is being underestimated and life is not going back to normal for many people and there is going to be permanent damage to the economy. Thus a double-dip recession is right in front of us, before we start getting those vaccine shots.

As discussed above, the big risk is the fiscal cliff because, between all the emergency jobless benefit plans, we may have as many as 12 million Americans being cut off from support at the end of the year. That doesn't include the evictions and end of mortgage loan forbearance, too. All at a time when restrictions are being put back in place. And while the vaccine distribution is surely a positive for medium-term and long-term growth; for the near-term it will serve as an incentive for households to play it safe. And playing it safe means less emphasis on going out and spending money.

As such yields, remain capped amid rising expectations of easier monetary policy. Of the tools available to the Fed, lengthening the maturity of Treasury purchases seems to be a low-hanging fruit. Markets have not been oblivious to this possibility, though some parts of the curve have yet to reflect this. Going forward, look for a flattening of the yield curve with the long end outperforming.

In terms of portfolio strategy, continue to reduce excess cash and maintain a risk appropriate ladder strategy.

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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.