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INVESTMENT SERVICES

Weekly Relative Value

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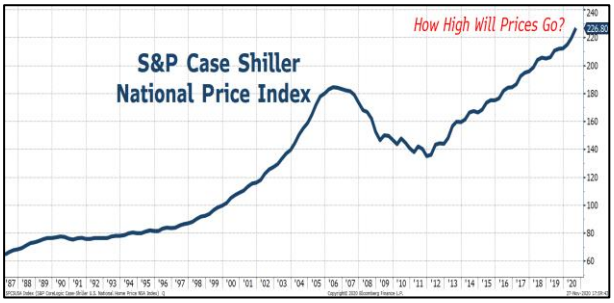
WEEK OF NOVEMBER 30, 2020

Through the Roof

House prices are going nuts despite a terrible economy. To wit: Redfin, an online real estate platform, reported that median home prices nationwide in October were up 14.2%. Likewise, the S&P/Case-Shiller National Home Price Index rose 1.4% in September, the largest gain since March 2013. Year-over-year, home prices are running at a +7% pace.



There are many reasons for the rise in home prices. Working from home causes people to look for a larger place. Many are moving out of the core cities and shifting from rental apartments and condos in high-rise buildings to single-family houses. Of course, record-low mortgage rates are making things more affordable for those looking to trade the condo for a backyard. Layer on a drum-tight supply/demand backdrop (supply of existing homes fell to a new low of 2.5 months in October) and it is no wonder prices are rising as they.

The story within the story is that homebuyers are seeking additional space in single-family homes. Of note: Bloomberg reported that properties with gardens and outdoor gathering spaces are in high demand and this trend persisted even after the lockdowns ended. Likewise, Realtor.com found that single-family home listings in the 100 largest metro areas that included outdoor-related keywords such as "garden, courtyard, deck, greenhouse, backyard" sold 12 days faster (27%) than similar listings without those keywords.

THIS WEEK

- LIQUIDITY LAUNCH
- BACK TO THE ECONOMY
- PLAYING CHICKEN WITH FISCAL STIMULUS
- BLACK FRIDAY

PORTFOLIO STRATEGY

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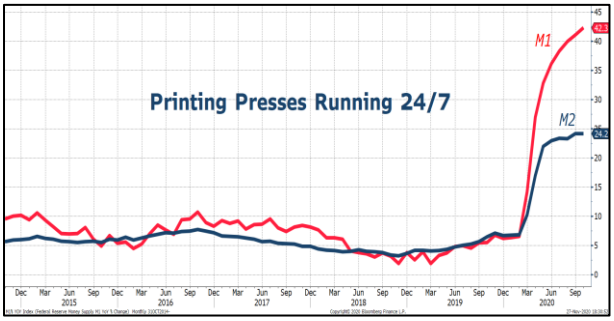
While it is strange to see a surge in home prices in the midst of a pandemic, it should be highlighted that those individuals who experienced the greatest damage (people working in leisure and hospitality, restaurants etc.) had a much lower homeownership rate (40%) than those least affected and who are able to work from anywhere (80%).

How high can prices go? Normally, prices running north of inflation and wage growth would lead to questions of sustainability and how long can they continue to go up. But, given the low inventory, a secular change in consumer behavior towards single-family homes, and ultra-low mortgage rates for those unaffected by the pandemic, there may be room for this trend to continue.

LIQUIDITY LAUNCH

"The Fed will stay here and be strongly committed to using all of our tools to support the recovery for as long as it takes until the job is well and truly done." – Fed Chair Jerome Powell

An investment banker named Jerome Powell has discovered the wonders of the Gutenberg printing press. M1 and grown 42% year-over-year while M2 has risen 24%. For perspective, these increases are more than double the rate of money growth in the 1970s (high inflation) or 1980s. Because the trend in money growth has so far exceeded the underlying trajectory in GDP, the "excess" is finding homes all over the financial marketplace, especially in equities, everyone's favorite asset class.

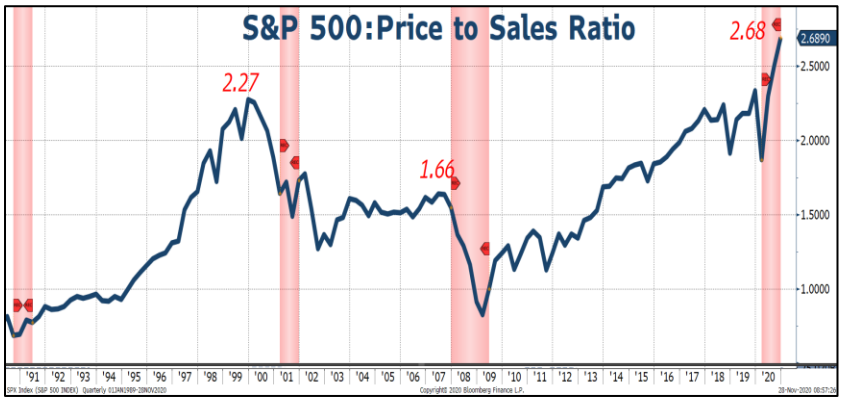


The MSCI World Index has soared 13% in November, the best performance on record. In the U.S., the three major American stock gauges were at their all-time highs at the end of a week in which unemployment claims unexpectedly jumped, incomes fell and the coronavirus infection rate accelerated. Go figure.

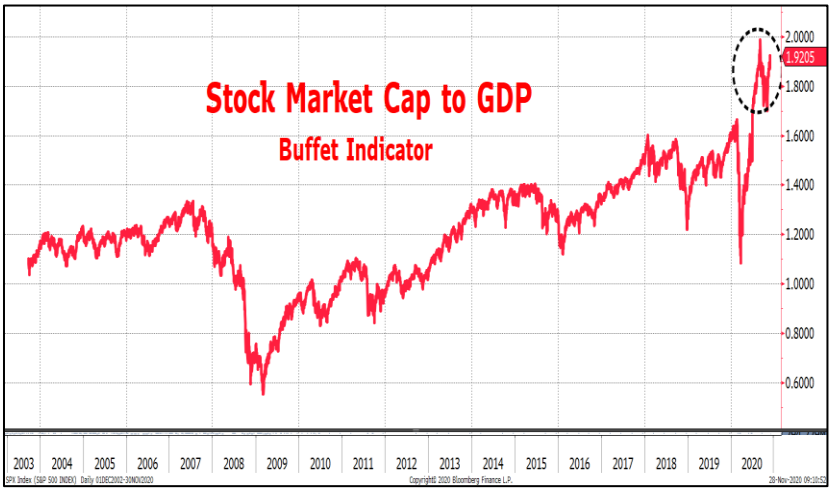
If global stocks finish November with the biggest monthly gain since the late 80s, investors can rationalize it with the good news. A vaccine gets closer every day. The transition process to a new U.S. president has begun, and Joe Biden's

pick for Treasury secretary is the "Mother of All Doves," known and trusted. But make no mistake. At the end of the day, the reason the stock market has risen to today's extreme levels is because of the liquidity firehose. Every major central bank, not just the Fed, has opened the monetary spigots. It is no wonder the market is levitating.

As you can glean from the graph below, the S&P price-to-sales ratio (unlike price-to-earnings, this ratio cannot be manipulated) has never been at such lofty valuations and well above the previous all-time record of high of 2.27 back in March 2000.



Warren Buffet's favorite valuation metric – TMC to GDP (Total Market Capitalization of U.S. Stocks to nominal GDP) – is at extreme levels. It all smacks of liquidity and speculation to me.



Did you know that 15% of the stock market universe is made of companies who make no profit and that 20% of publicly listed companies are labeled as "zombies"? In other words, defunct without government support. Overall, the S&P trades worth a forward price-to-earnings ratio of 21 or 25% above the historical norm. While valuations are in nose-bleed territory, this does not mean stocks can't go higher. As they say on TV, "the market just wants to go higher." Indeed.

Despite the high valuations, according to the Investment Company Institute (ICI) mutual fund data, equity portfolio managers have just 2% cash. Which means, of course, that there is no excess liquidity to prop up the market should it go the other way, especially if the funds face liquidations.

In addition, everyone is now swimming in the pool. Bullish sentiment is off the charts. The CNN Fear & Greed Index is at an extreme 92. According to Investors Intelligence, there are four bulls for every bear. I believe markets are overpriced and investors are over-exposed.

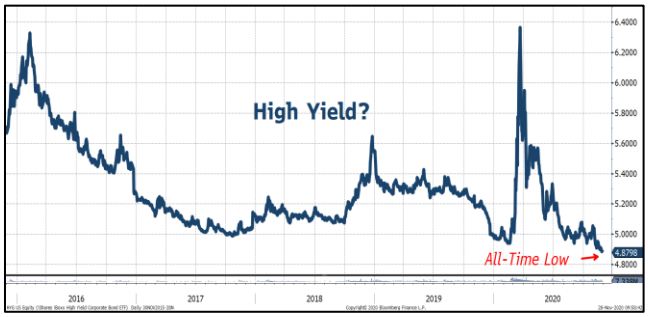
Finally, what about the economy? As many as five million jobs will not come back. Approximately 8% of small businesses say they will never be returning to normal levels of operation. Never is a long time, but you see the point. According to the Congressional Budget Office (CBO), the combined direct and indirect loss of economic activity in the U.S. alone is $16 trillion, or 80% of a full year's GDP. Furthermore, the CBO believes that it will take a full decade to recoup the economic damage done from the pandemic.

But as we all know, equities do not need a strong economy to rally. These same markets soared in the aftermath of a 20 million job detonation and through an epic 30% plunge in real GDP. As we have learned over the past decade, the stock market is NOT the economy.

Source: CNN Business

This is the scoop. Fundamentals, valuations, excessive sentiment, and economics take a back seat to massive liquidity growth. And it's not just liquidity, but overt intervention and manipulation of asset prices which has all but nullified true price discovery. Frankly, many have argued that the real reason for the stock market's artificial surge has been not just Powell's pledge to maintain ultra-low rates past the point of full employment and 2.0% inflation, but the view that the Fed will start to buy equities if they decline significantly. Equities have become a protected species.

It's not just equities that are mispriced. Since the pandemic, high-yield bond yields have plunged nearly 100 basis points and now trade at a historic low 4.8% yield at a time when "default fundamentals" would ordinarily mean a yield closer to 8.0%. High yield has averaged 9% over the past three decades and 13% in recessions. Is there an asset class anywhere more mispriced than the market for high-yield debt?



Or consider that sovereign countries such as Greece (BB) and Italy (B+), which are now within three basis points of trading with a negative yield for their five-year bond maturities. Junk bonds with a negative yield? Fascinating global financial market.

And what's quite interesting (humorous) to me is that those in the bullish camp say rates have to rise from current levels. Really? Don't they realize that the glue holding their bullish narrative together is the uber-low interest rate environment, which has allowed valuations to exceed where they were prior to the pandemic.

Here's the bottom line. Financial assets have become nothing more than a casino with no true price discovery or risk assessment. This is because Powell is the dealer handing out chips for free. For investors this is surreal. The game is played in a world where everything is a "spread" off $17 trillion of global bonds that trade with a yield below zero. If a Martian landed on earth, he would think we have all gone mad.

And if you're not rampantly bullish, you are viewed as a lunatic or "gloom and doomer." Mention "bubble" to a stock market bull today and it's the same reaction you got from uttering the same label to a real estate agent back in 2007: a shrug and a sneer. Anyways, while the markets may continue higher, I believe there is much more risk to these artificial markets than meets the eye.

Consider the following:

"The near-term risk to growth, and risky asset prices, remains acute… U.S. economic activity is slowing even before stricter control measures are imposed to prevent a collapse in the U.S. healthcare system." – BCA Research

Also from today's Wall Street Journal, a read of *Beware the Dow 30K Euphoria* is recommended.

"If you're bold, enjoy the ride in the meantime. But please, don't throw away those Dow 30K hats. Put them back in the back of your drawer along with other not-quite-obsolete items, like that Keith Richards photo and your AOL password."

BACK TO THE ECONOMY

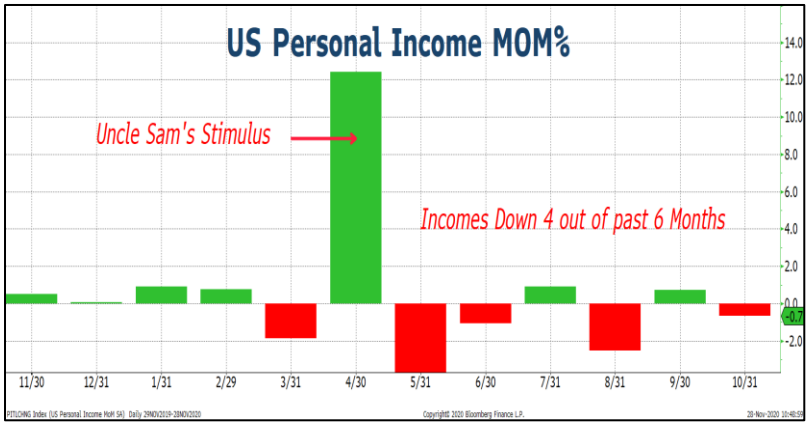
Undoubtedly, the Fed has proven it can inflate assets, but its policies have little impact on the so-called "real economy." It does not create jobs nor income. For the latest week, initial jobless claims are back to a five-week high and have jumped 67,000 this month. Do not be surprised if we see a surprise decline in non-farm payrolls in one of the next two months.

Now let's talk about income. A massive mailing of government checks at the start of the pandemic kept personal income and spending afloat. However, in October, income dropped 0.7% and has now fallen in two of the past three months.

Remember, personal income is "the mother's milk" that fuels consumption and 80% of the economy. If you recall, both retail sales and employment disappointed last month as well.

As a reminder, this has been the first ever recession in which incomes rose 12% while wages fell 8% because of the 146% jump in government transfers. So, I'll pose the question: what if we look back next year and realize that this is the good part of the economic recovery and that the next chapter is that incomes fall when government programs end?

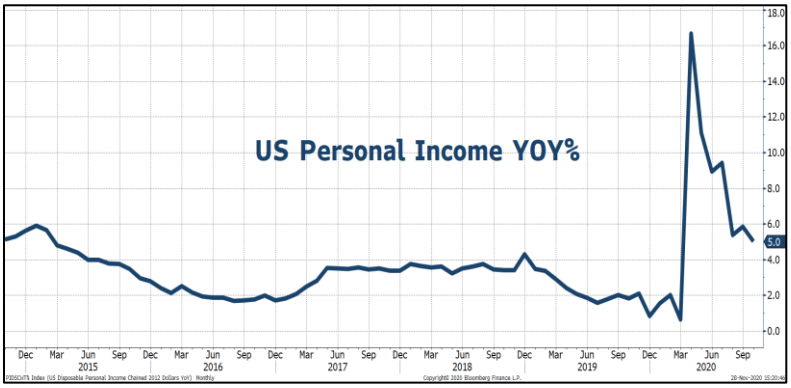
Then one must wonder how much permanent damage there has been to the labor market and personal income. How many job losses are permanent? The latest University of Michigan Consumer Sentiment Survey showed heightened job and income loss anxiety, not just for the next year but for the coming five years. Think these people are going to be dining out as much as they did before? Think again.



PLAYING CHICKEN WITH FISCAL STIMULUS

Who would have thought that with zero rates, a $7.2 trillion Fed balance sheet and a $3.5 trillion deficit we would still be seeing calls for more stimulus?

But it's true. We need more stimulus. And here's why. Unemployment benefits as of September amounted to $365 billion. Of the $365 billion in unemployment insurance benefits paid in September, $176 billion (48%) of that was contributed by three federal government programs of the CARES Act. As it stands today, these funds will disappear as of December 31. There is no grandfathering for those that started receiving the benefits later and do not use the full amount. It just ends. Unless there is a deal, about 12 million people will lose all their unemployment benefits in December. Bankruptcies, evictions and foreclosures will soar. All at a time when restrictions are being put back in place.



I expect a deal, but the game of fiscal chicken is cutting it close. Whoever you blame for the deadlock, the simple fact is a bill needs to pass soon. We have just about reached the limit of the job recovery absent a vaccine. That leaves us with a real-world unemployment rate higher than the Great Recession's worst. Should the extension, or replacement, of benefits be missed, along with the growing risk of another round of lockdowns, consumption would plummet, and GDP could decline before the vaccine-supported recovery can take hold.

BLACK FRIDAY

According to surveys, retail traffic fell by 52% compared with last year, as Americans by and large went online for their shopping. For the six key weeks of the holiday season this year, traffic in retail stores is expected to be down 22% to 25% year-over-year. Spending online on Black Friday this year surged 22% (at the low end of forecasts) to hit a new record, as consumers rang up $9 billion worth of purchases on the web. That makes Black Friday 2020 the second-largest online spending day in history in the U.S., behind Cyber Monday last year. This season, Cyber Monday is slated to become the largest digital sales day ever, with spending reaching between $11 billion and $13 billion, which would represent growth of 15% to 35% from a year ago.

Even as shoppers avoided the malls, travelers had little problem traveling with almost 50 million Americans making a journey over the Thanksgiving holiday. Though the data does also include road travel, the Transportation Security Administration (TSA) said Saturday was the busiest flying day since March.

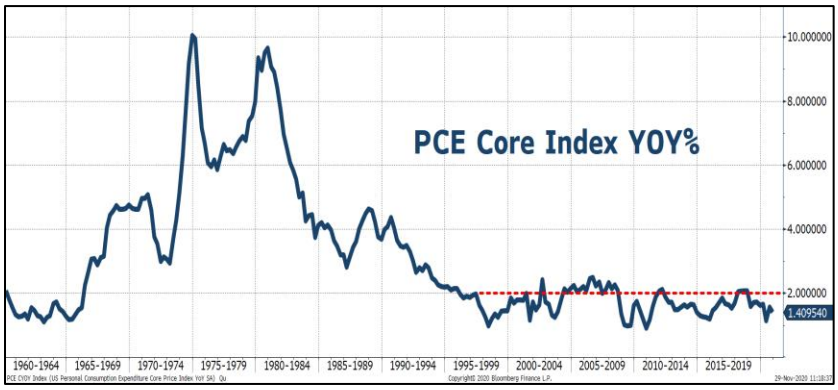
Meanwhile, Dr. Anthony Fauci, warned yesterday that the country could see a "surge upon a surge" of new virus cases in the coming weeks, adding "you know, we don't want to frighten people, but that's just the reality... I cannot see all of a sudden a relaxation of the kinds of recommendations or restrictions." At the same time, the Wall Street Journal published an article titled *Restaurants Push Back Against New Closures*. You can't help but roll your eyes. These are the sorts of people that likely would have been the first to cheat during that four-year period of rations in World War II.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

In the third quarter (Q3), GDP surged 33% led by transitory developments including re-openings (now being reversed), the lower coronavirus case count (the summertime downtrend was a brief affair) and the lagged impact of the fiscal stimulus. If not for the fiscal juice, real GDP actually would have shrunk at a 6% annual rate in Q3. Now we have the prospect of low-single-digit growth for Q4. The vaccine will ultimately end the pandemic and the economy should receive the benefit of pent-up demand. But the unknown is how long will that demand last? One quarter… two quarters? Further I would argue that the downside risks remain to economic growth before getting to the other side of the valley. The odds of a Q1 2021 contraction are high and rising.

More importantly, as has been discussed in this space, before the pandemic the economy was facing three major secular growth headwinds: fiscal deficits and debts, aging demographics and income and wealth inequality. Once the pandemic is over, debt and deficits will be significantly higher, we will be one year older, and wealth and income inequality will be off the charts. Thus, these same and now much larger structural and secular headwinds of the prior decade are bound to constrict the coming decade to an even weaker outcome.

On the inflation front, despite the growing narrative that inflation is coming, it's nowhere to be seen currently. The personal consumption expenditures (PCE) deflator was flat for the first time since this recovery began in May. The year-over-year trend was cut to 1.2% from 1.4%. It started the year at 1.9%. This is a key reason why Treasuries have managed to stay range-bound, even with the massive bounce we have seen in equities and commodities. After trading to as high as 0.960% in March (on vaccine news) the 10-year yield has retraced 13 basis points to 0.839%. At 0.83%, the 10-year yield is where it was at the close of March 25 when the S&P 500 was at 2,475. A near-50% surge in the equity market and Treasury investors go "huh"?

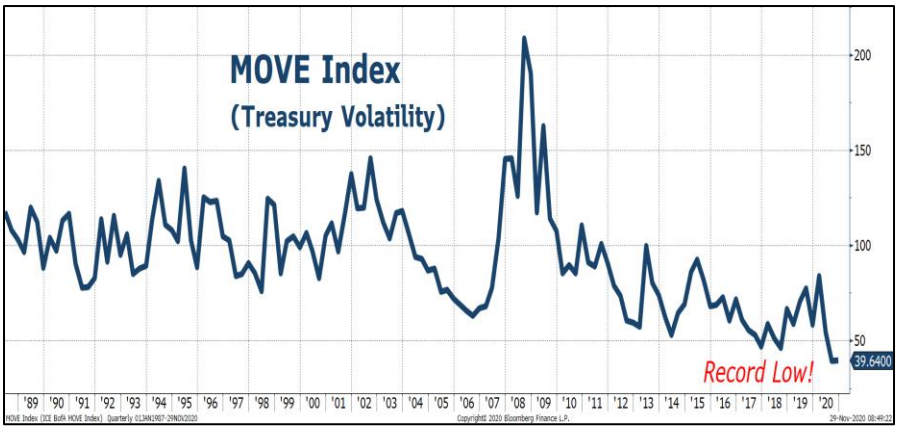


Could it be that the bond market is the real forward-looking indicator? Equities are looking across a valley, but the world across the valley doesn't look so forgiving given the permanent nature of the economic damage and the massive volume of deficits and debts that have been accumulated.

Furthermore, investors should remember that saving the day from COVID-19 meant the entire country going into debt like never before. Debt at all levels of U.S. society (households, businesses and governments) has soared to nearly 400% of GDP, or nearly $80 trillion. This means if the average level of interest rates were to rise one percentage point, the economy would have an additional $800 billion deadweight drag on the economy from higher debt-servicing charges. That would equate to a 4% hit to GDP. As such, the massive debt build-up renders interest rate back-up nearly impossible.

With the Fed making it crystal clear that policy will remain accommodative for years, the Intercontinental Exchange, Inc. (ICE) Bank of America MOVE Index – which measures expected price swings in the Treasury market – has dropped to an all-time low. As we move forward, keep a close eye on the incoming economic data. Of note, the November payroll report this Friday will be closely scrutinized. The consensus is for a gain of 500,000 jobs but the recent rise in initial claims could result in far fewer jobs created in November.

Also, with several pandemic jobless benefit programs set to expire at the end of December, the economy will require more fiscal support. If not, as discussed above, the economy could end up in a very large pothole.



From a portfolio strategy perspective, "excess cash" remains the least desirable asset. With the Fed on hold for months and possibly years to come, cash will have a detrimental impact on investment portfolios and balance sheets. Rather than holding on to low-yielding cash, please continue to maintain a disciplined and risk-appropriate ladder strategy. In terms of maturities, the Fed may use its December 15-16 meeting to overweight purchases of long-term U.S. Treasuries to create more or reduce longer-term yields. The Fed currently buys Treasuries across a range of maturities without a skew toward one sector. If so, the long end of the yield curve will outperform. In terms of sectors, mortgage-backed securities (MBS) and high-quality bank notes should be overweighted. Agency debentures and CDs should be underweighted.

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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.