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INVESTMENT SERVICES

Weekly Relative Value

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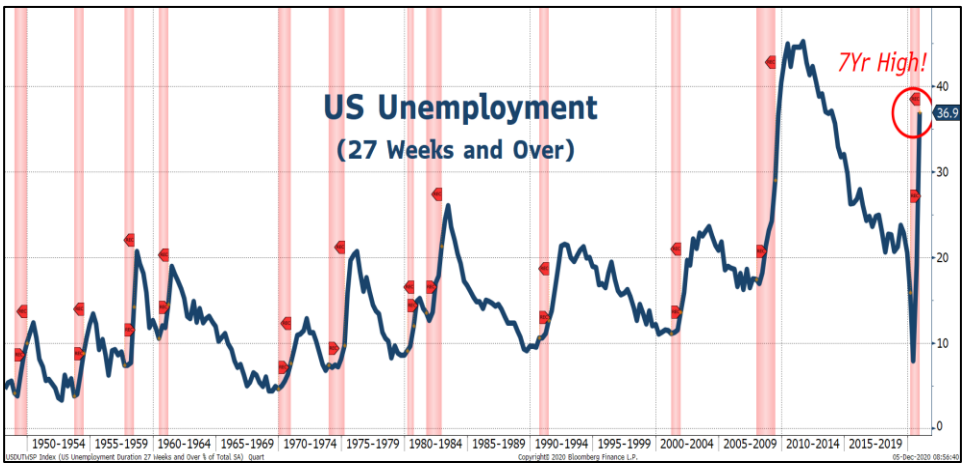
WEEK OF DECEMBER 7, 2020

A Big Fat F

The November jobs report was the worst employment report since the downturn ended (supposedly) in April. The actual job tally in the non-farm payroll report survey (aka the "establishment" survey with companies, governments, nonprofits, educational institutions, etc.) showed that gains totaled +245,000, which has about half the consensus forecast of 500,000. Private sector employment was up 344,000, a big haircut from +877,000 in October. The workweek was flat at 34.8 hours.

Here's the recent pattern of job gains: June: +4.78 million; July: +1.76 million; August: +1.49 million; September: +0.71 million; October: +0.61 million; and November: +0.25 million. See the pattern?

From the April lows, non-farm payrolls have rebounded 12.3 million, recouping 56% of the 22.2 million COVID-19 shutdown. That's the good news. The bad news is, we're still 9.8 million jobs below the February peak. Making matters worse, the number of individuals that have now been officially unemployed for at least 27 weeks is at a seven-year high of 3.94 million. This is a fourfold increase from the lows!



In fact, the "permanently unemployed" as defined by the Bureau of Labor Statistics (BLS) has risen from 22% in July to 44% today. That is incredible. Nearly half of the unemployed see that their old job is not coming back.

Adding insult to injury, the duration of the long-term unemployed is now up to 23.2 weeks; more than double the level in May. And many studies show the longer people are out of work, the less employable they inevitably become. Needless to say, this adds tremendous

THIS WEEK

- IN RIPLEY'S BELIEVE IT OR NOT
- DAMN THE TORPEDOS FULL SPEED AHEAD
- $900 BILLION HERE, $900 BILLION THERE
- THE ROARING TWENTIES (AGAIN)?
- THE END OF THE BULL MARKET IN BONDS (AGAIN)?

PORTFOLIO STRATEGY

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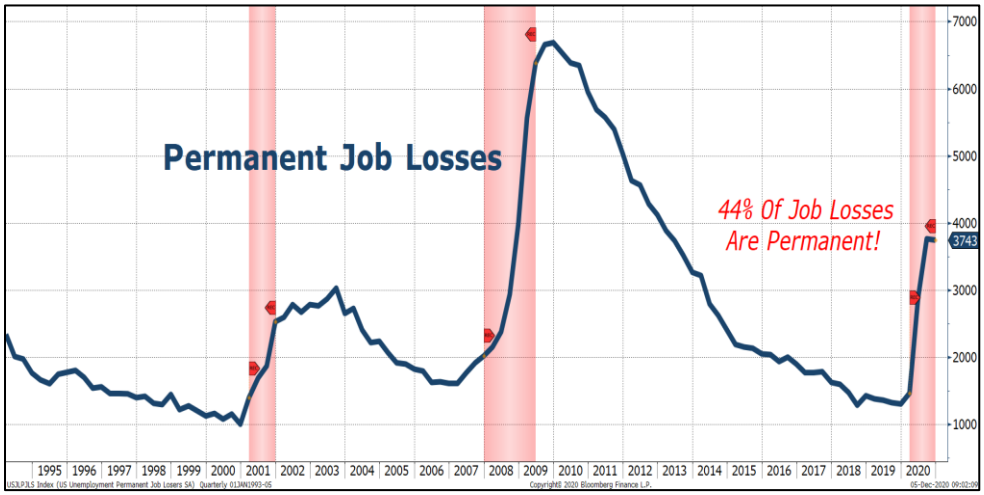
strain and stress to their personal life along with significant implications for fiscal deficits and social instability. Thus, our friends in D.C. should quickly turn their attention to how to get these people back to work. Have these people not heard of FDR?



A couple more points. The payroll survey (the "establishment" survey) is the headline jobs number. It is based on surveys of establishments (does not include gig workers) for the pay period through November 12. Also, you should note that in the payroll survey, three part-time jobs count as three jobs. The BLS attempts to factor this in, but they do not weed out duplicate Social Security numbers. The potential for double-counting jobs in the payroll survey is large.

The "household survey," on the other hand, tracks people who are working full or part-time, including gig workers. In the household survey, if you work as little as one hour a week, even selling trinkets on eBay, you are considered employed. And if you work three part-time jobs, 12 hours each, the BLS considers you a full-time employee. And if you don't have a job and fail to look for one, you are not considered unemployed; rather, you drop out of the labor force. Looking for jobs on Monster does not count as "looking for a job." You need an actual interview or to send out a resume.

All in all, these distortions artificially lower the unemployment rate, artificially boost full-time employment, and artificially increase the payroll jobs report every month. Yet, even still, the household survey showed that employment actually declined down to 149.7 million. This wasn't a slowdown in growth, but an actual decline of 74,000 working people, the first month-to-month decline since April.

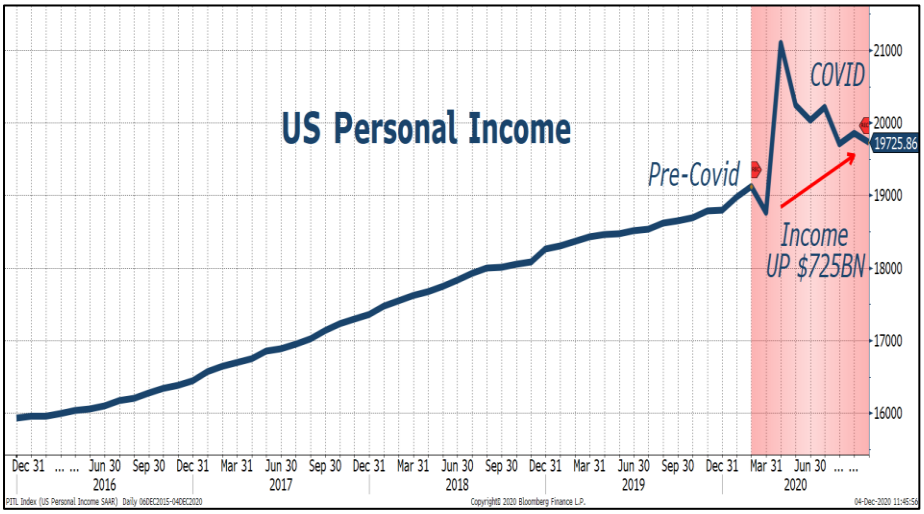
Finally, this employment data, as dreary as it is, attempted to capture the labor market conditions the way they were through November 14. In the three weeks since then, conditions have worsened, and they're in the process of worsening further with the renewed restrictions now rippling across the country. December is going to be rougher on the employment front.

In summary, this was a bad employment report. Any teacher would give this jobs report a big fat "F."

IN RIPLEY'S BELIEVE IT OR NOT

The COVID-19 recession was the first ever recession where personal incomes actually rose. To wit: because of the massive fiscal stimulus, personal income growth doubled from what it would have been had the pandemic not occurred. Meanwhile, we are 10 million jobs shy of the pre-pandemic peak.

Frankly, the government stimulus has been beyond comprehension. Think about that. If not for the pandemic and the government response, personal income would have been $500 billion less. This is akin to taking sour cream and turning it into ice cream.



Likewise, COVID has done wonders for equity and credit markets. Want to know how it is that the S&P 500 is now up 14.5% year-to-date? Take a look at today's Wall Street Journal article, *Thank the Fed for This Year's Run in the Stock Market*. In fact, had the central bank not succeeded in destroying the equity risk premium, the index would only be up 1.0% for the year and 13.5% lower than it is today! The same phenomenon occurred in the so-called "high yield" market rates, where yields were 100 basis points higher prior to the pandemic. So global pandemics are good for risk assets. It does make you wonder why investors want a vaccine so quickly because life has been good for risk assets this year as governments and central banks primed the pump like never before.

Regardless, this a great story to tell your kids and grandchildren down the road. Because of COVID-19, the stock market ended up being higher as a result of the crisis and incomes ended $725 billion higher than had the pandemic never happened. Your kids will think it's a tall tale. Frankly, not even Ripley would believe it.

DAMN THE TORPEDOS FULL SPEED AHEAD

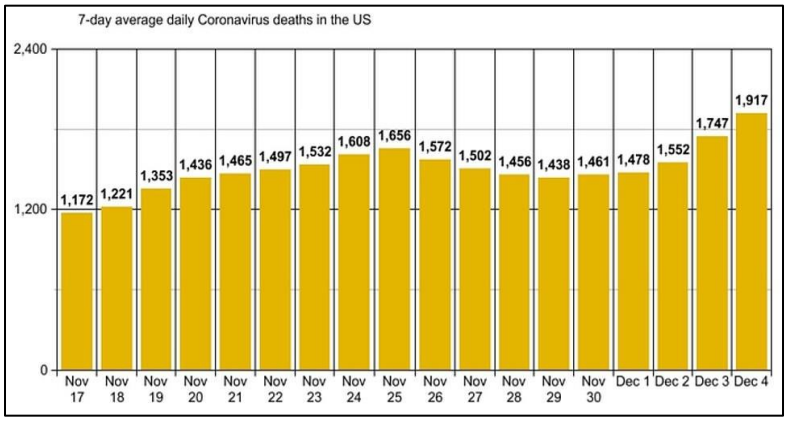
"The next few months are likely to be among the most difficult in the public health history of this nation."
– CDC Director Robert Redfield

After the first cases of COVID-19 were confirmed in this country on January 20, it took almost 100 days to reach one million infections. Now, the country has added more than one million cases to its grim total in just five days, bringing the total to more than 14.5 million confirmed cases and 281,199 deaths from the virus. During President-elect Joe Biden's first hundred days, deaths are expected to surpass 500,000.

We are back to a grim situation where the medical system is being overwhelmed. More than 100,000 COVID-19 patients have been hospitalized nationwide for the past four days, according to the COVID Tracking Project.

While hospitalizations hit record highs, the average percentage of infected people who are hospitalized with COVID is dropping. It comes as overwhelmed hospitals are facing major bed shortages and are forced to enforce stricter

guidelines on who can be admitted, even as deaths across the nation increase. The seven-day average went up to 1,917 deaths per day with projection that the average daily death rate will reach 3,000 a day.



Source: Axios

I have always believed that the virus will greatly determine the recovery's timing and vitality. If the number of COVID-19 cases, hospitalizations and deaths run up to higher levels this winter, which is likely, and if people have to continue their physical distancing practices, the overall economic impact of the pandemic could end up making the recession last longer than is currently recognized.

But this is the power of the vaccines. There are several that reveal surreal efficacy levels. Last Friday, the Wall Street Journal noted that Johnson & Johnson could have interim efficacy data on its vaccine candidate next month (and this requires just one shot and can be stored with normal refrigeration).

"The vaccines are a game-changer. When the facts change, you change your mind."
– Mike Bell, Global Market Strategist, JPMorgan Asset Management

The keys are timing of distribution and acceptance. Dr. Anthony Fauci has said 70-75% of Americans will need to vaccinate to get the country on the road to normality. An alarming number of Americans say they'd reject a COVID vaccine. But this light at the end of what now seems to be a fairly short tunnel is what makes the current adverse news on case counts, hospitalizations and deaths different for the markets than was the case in the spring, when the view was

that any vaccine was likely years away. Now we have several. Like a miracle, we could be six to nine months from having herd immunity.

$900 BILLION HERE, $900 BILLION THERE

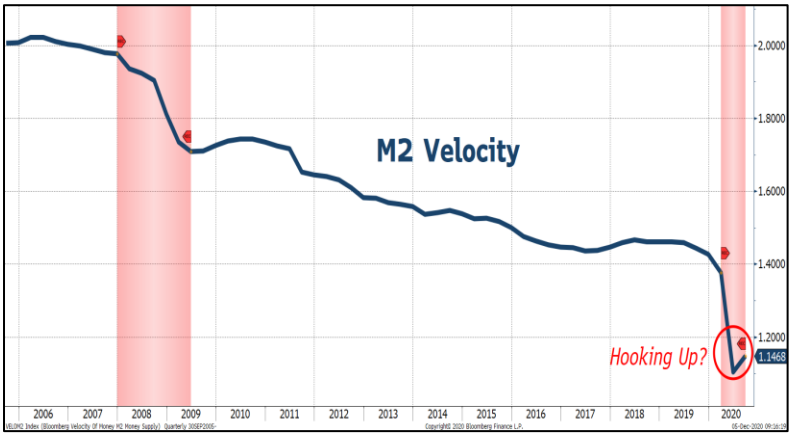
The grim COVID and employment stats data are bullish because these reports will speed up the timing and beef up the size of fiscal stimulus.

Republicans appear to be warming to the idea of a $908 billion stimulus package. With the exception of the CARES Act, this would be the largest package ever. Think about this. If this package passes, it will be 30% larger than the 2009 Obama package during the Financial Crisis and 9X the size of the Bush tax cuts.

Could it be that the economy doesn't need anything close to that degree of fiscal largesse? Will we look back in a year's time and realize the government and central banks overstimulated. Maybe. But this is a classic case of "damned the torpedoes, full speed ahead!"

Meanwhile, M2 money growth is at a record +25% year-over-year. That leaves nominal GDP growth at +5% at a time when the Fed is suppressing risk-free yields near zero. This is how bubbles are created.

As shown below, while money velocity is depressed, it has stopped contracting. This is important because one of the key factors holding inflation and growth back has been the consistent decline in money (M2) velocity.



But this is the stich. The Fed is not going to stop easing. I would expect the Fed to continue to ease in its multifaceted ways and, as such, asset prices will continue to take the path of least resistance higher into bubble territory. So enjoy! Yet, when investors say market valuations are justified based on negative real interest rates, just know that it is like saying the cake I baked tastes so sweet because I added an extra cup of sugar to the recipe.

As I have said, for many years, timing a bubble is impossible. They have a mind of their own and can get bigger and last longer than anyone can fathom. Maybe investors do not need to be overly concerned with that risk right now, especially in this central-bank-manufactured "heads I win, tails you lose" market. But while bubbles have a mind of their own, and can go much further than logic dictates, they always end up in tears.

THE ROARING TWENTIES (AGAIN)?

A number of Wall Street firms have been hyping the theme that the coming 2020s decades will be like the "Roaring 1920s." The most recent firm to high this narrative is the venerable Goldman Sachs, who released a report titled "Roaring 20s Redux." The gist of the report is the economy in the post-pandemic world will roar back like it did after the 1918 Flu Pandemic (otherwise known as the "Spanish Flu" and World War I. For perspective, in the 1920s, U.S. economic growth rose by a robust 4.2% per year from 1920-1929. Unquestionably, these were the golden years for America's economy and society.

Needless to say, we would all welcome another repeat performance over the coming decade. But other than a pandemic, there are virtually no similarities. Below I list a few reasons why a repeat of the Roaring Twenties is highly improbable.

1. The entire European economy was decimated in the wake of World War I. This allowed U.S. manufacturers to dramatically increase market share. In fact, by 1929, the U.S. had effectively become the manufacturer of the world with a 50% global manufacturing share.

2. During the so-called "Spanish Flu," the U.S. economy was not shut down. There was no lockdown. Instead, people adjusted and tried to live with the disease. Herd immunity finally ended the crisis. Unlike today, there was no social safety net. Welfare, unemployment insurance and company bailouts were non-existent. It was essentially every man and woman for themselves. A sense of community and charity filled the void.

Yes, the economy collapsed but the government did not blow its brains out on fiscal largesse. Back then, government debt-to-GDP was only 10%, not over 100%. As a result of the strong financial position, policymakers were able to cut rates for corporations and individuals. To wit: top rates for corporations were lowered from 13.5% to 11%. Ditto for individuals who saw their tax rate decline by 50% from 58% to 24% by 1929. Given our massively bloated balance sheet today, you can kiss tax cuts goodbye for some time to come.

3. In the 1920s, half the population then lived out in the country as compared to 20% today. As Americans moved to the cities, it provided a huge stimulus to the economy. It's hard to quantify but, as an anecdote, look at the explosive growth as the Chinese population moved from the rural areas to the cities over the past two decades. Meanwhile, Americans are now leaving the core metropolises to live in the green acres.

4. In 1920, homeownership was 40% versus 65% today. Back then, the "American Dream" of owning a house was the rage as people shifted from renting to homeownership. Owning a home is a key driver of consumption and economic growth.

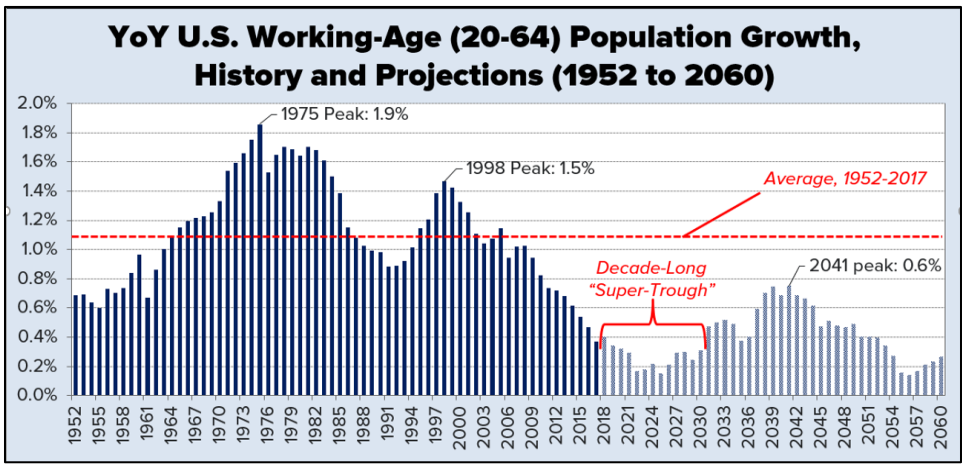
5. The U.S. was a manufacturing economy with one-third of the workforce compared to less than 10% now. The economy was much more geared towards industries that were "essential" (actually making things) that could not be closed down. These industries also had a powerful multiplier impact through the rest of the economy. Today, the U.S. economy is heavily service-oriented with many "non-essential" businesses, as we witnessed when the U.S. economy went into full lockdown mode.

6. Corporate America was less focused on short-term results and financial engineering. Instead, Americans companies were focused on building more efficient and cost-effective businesses and products by improving productivity. In fact, manufacturing productivity grew at 5%.

7. The central bank understood that mild deflation was no big deal. Consumer prices actually declined modestly, which, in turn, supported spending power. Today, in the eyes of the central bankers, deflation is the clear and present danger. Achieving 2% inflation is the mantra today because today's central bankers are consumed with bailing out debtors and penalizing savers. When was the last time you heard a central banker tell you that inflation erodes purchasing power? Never.

8. The demographic backdrop was very different. In the 1920s, the population's median age was 29 years. It is 38 years today. In the 1920s, half of the population was under 30 years of age, which fueled a spending boom. Also, only 7% of the population was over the age of 65. Today that demographic cohort is on the cusp of 20% for the first time in recorded history. As we all know, this segment of the population has a proclivity to save and not spend. Need I remind everyone the U.S. economy is dependent upon consumption?

Finally, and most importantly, all economists would agree that the driver of long- term economic growth is the growth in productivity plus the growth of the working-age population. Today, productivity is less than one percent while the labor force growth rate of only 0.5% per year is essentially baked in the cake over the next decade. Add the two factors up and you get 1.5% GDP versus over 4.0% in the 1920s. There is no math that brings us back to that trend in the coming decade.



Source: Hedgeye

THE END OF THE BULL MARKET IN BONDS (AGAIN)?

"If it was up to economic forces and trading in sort of a free-market fashion, we probably would see the bond yield moving even higher – to above 1%." – Economist Ed Yardeni

Revived talk of potential economic stimulus, growing vaccine hopes and the Federal Reserve's signal of optimism for the year ahead sent 10-year Treasury yields to a roughly three-week high.

Yet, rates are still only testing their post-U.S. election peak from several weeks ago, and there's a host of obstacles to a sustained climb. Labor conditions are already deteriorating, with millions of Americans still out of work. Add to that the fact that U.S. virus cases are surging and spurring fresh state restrictions, and the threat to the recovery is clear.

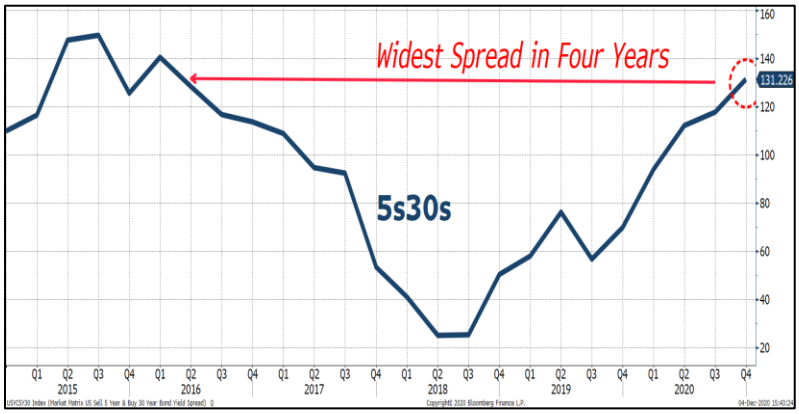
There is also the massive number of people on the precipice of being evicted, or foreclosed, within the next two months. The Census Bureau's latest survey shows 5.8 million that face this prospect. As an aside, there is now a total of 17.8 million who have been protected by the government as they are behind in their rent and mortgage payments, but the bailiff has been ordered to leave them alone. That protection goes by the wayside at year-end without that fiscal extension.

But the key force keeping long-term yields from taking flight is that the Fed has convinced markets that it won't allow it while the recovery remains tenuous. Some predict the Fed will adjust their bond-buying purchase program at this month's meeting, scheduled for December 15-16, by tilting Treasury purchases more toward longer maturities to tamp down long-term borrowing costs to buoy the economy.

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.

On Friday, the benchmark 10-year Treasury yield closed at 0.984%, closer to 1% than any time since March.

And the yield curve is now the steepest in four years!



MARKET OUTLOOK AND PORTFOLIO STRATEGY

Vaccines matter, but so does the pandemic. We all have a tendency to live in the here and now, but we are still in the infancy of this pandemic and even after we reach either herd immunity or a widely distributed vaccine, people will still be recovering from the overall psychological, social and economic shock of the pandemic.

While yields have risen over the past weeks, and may rise further, short-term "excess cash" still 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. Should market yields rise near-term, especially on the longer end of the yield curve, credit unions should "average in" to put excess cash to work.

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. 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.

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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.