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INVESTMENT SERVICES

Weekly Relative Value

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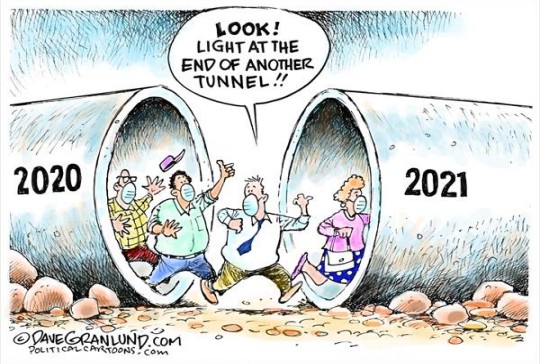
WEEK OF JANUARY 4, 2021

The New Normal

"We're recovering, but to a different economy." – Fed Chairman Jerome Powell

It is well recognized that in the past year we were dealt a health crisis that morphed into an economic crisis, which morphed into a financial crisis that was ten times worse than the Great Financial Crisis. This string of events forced the Federal Reserve to explore the outer limits of extreme monetary policy intervention while the Treasury Department embarked on the most aggressive spending program since the 1930s.

When looking back over the past year, we experienced an economic "depression" (not recession) disguised only by unprecedented fiscal and monetray policy stimulus. The economy is now recovering but only because central banks have acted like hedge funds and politicians have spent like drunken sailors. In essence, this is an economy doped by high liquidity and low rates. Think about it this way. Just because your kid has training wheels does not mean he (she) knows how to ride the bike.



As we bid good ridance to 2020, it's time to assess the economic landscape for 2021. What the world looks like when the crisis ends is truly anyone's guess, but I feel confident we will look back in five years and realize that the primary economic effect of COVID-19 was how it accelerated change faster than any of us had anticipated. It's as if the world went on fast-forward. Not a bad thing, just a lot to adjust to. But periods of rapid change also bring lots of opportunities.

Here are a few ways the world will be different in 2021 (and possibly much longer).

THIS WEEK

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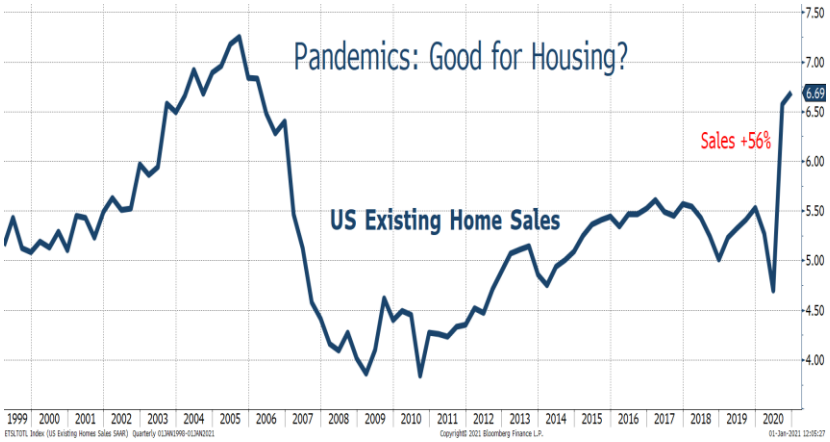
First, before the pandemic, the emphasis was on "just-in-time" production, with parts being delivered just when they were needed. Globalization was the word. Going forward, global supply chains could shrink, and in areas deemed to be in the realm of national security – pharmaceuticals, food and high-tech – we might see the full repatriation of manufacturing processes. In the post-pandemic economy, the emphasis could shift to some extent to "just-in-case" supply chains, emphasizing proximity and certainty of delivery. While this may offer greater security, it will come with an economic cost.

Second, the pandemic has triggered a secular fundamental change in individual behavior and corporate culture. The work-from-home theme is here to stay. Surveys show that a whole lot of folks want to work at home more often even after the vaccine arrives. A Gartner survey of company leaders found that 80% plan to allow employees to work remotely at least part of the time after the pandemic, and 47% will allow employees to work from home full-time. And why not? Surveys show that productivity and job satisfaction have increased dramtically since remote working started. According to Upwork, prior to the pandemic approximately 4% of the work force worked remotely. When the dust settles, look for that number to rise to 20-25%. This is a staggering 87% increase from the number of remote workers prior to the pandemic!

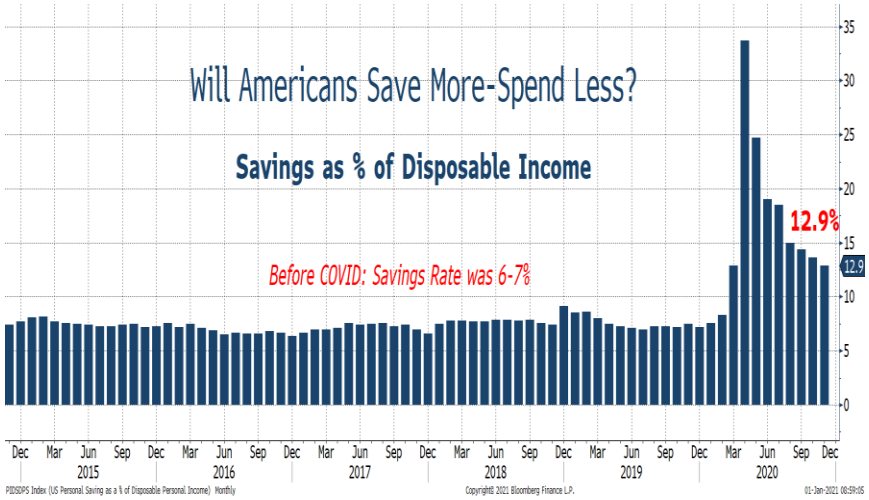
Third, as people continue to shift to working from home, employers will realize they need less office space, which, in turn, means fewer office buildings. This is a major problem for commercial real estate and the ripple effect throughout the urban landcape (e.g., bars, restaurants, retail, etc.) will be significant. Core urban areas will be duller. With people working in their home offices, there is going to be a sharp reduction in travel to work and travel in general. Technology will be the big winner. Zoom is here to stay!

Fourth, burbs are cool again! The pandemic has led to a much greater appreciation for more space (inside and out). The possibility of having to obey "stay at home" orders for a family of four in a two-bedroom city apartment is something Americans will not want want to repeat. Many are looking for housing in less urban areas. This process is already evident in the housing data as single family homes have soared since the pandemic bagan. But don't take my word for it. The National Association of Realtors' (NAR) Chief Economist Lawrence Yun recently said, "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."



Fifth, many believe that restaurants and bars will be in a full-fledged boom mode due to pent-up demand once the pandemic is over. I don't see it. Yes, we will go out, eat and drink, socialize and have fun again. But I believe this activity will be less than pre-pandemic times. The reason being, we have become much more self-sufficient. We have learned to become our own in-house chefs and many of us like it. We have realized that having dinner parties is just as fun and you don't have to tip — or worse, pay a corkage fee on your wine!

Sixth, the pandemic has changed changed consumer behavior. Americans are likley to be much more frugal where savings will be much higher than before. Come on, people. How can that not be the case? Prior to the pandemic a wide swath of the Ameican population had less than $500.00 in their savings account. They experienced a major trauma this past year and there will surely be long-term after effects. This means more saving and less spending. While this behavior is good for individual balance sheets, it's bad for a consumer-driven economy.



THIS TIME IS NOT DIFFERENT

For the past decade I have argued that economic growth, inflation and interest rates would remain low due to high debt, aging demographics and wealth inequality. All of which which have become greatly accentuated by the pandemic. As we start anew year, this time is not different. As such, economic growth will likley underwhelm in the years to come.

On the debt file, the U.S. government is doing the same as they did in 2009. Extend and pretend. Massive liquidity injections by central banks have been used mostly to perpetuate elevated government spending and fund public debt without real economic return. Over the past four years, the national debt has increased 36% from $19 trillion to $27 trillion. The current U.S. debt-to-GDP ratio is at a whopping high 130%.

The World Bank considers debt to be at a tipping point when the debt ratio is greater than 77%. As debt increases above this level, economic growth will slow. A recent 50-year analysis by Ned Davis Research shows that as government debt rises, growth slows, and the jobs recovery is weaker. Using data from 1951 to 2020, their analysis shows that as

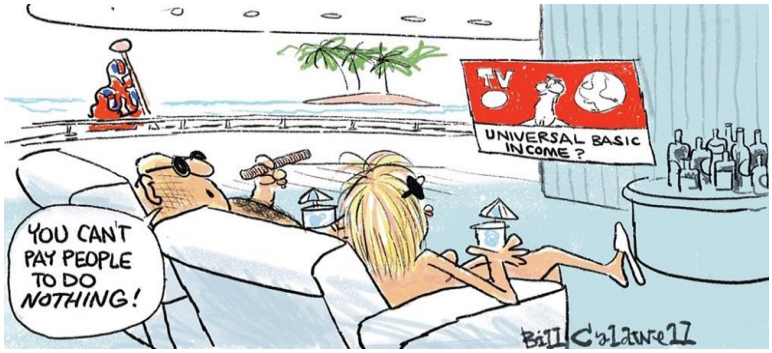
government debt to GDP exceeds 100%, real growth per annum falls to 1.6%, non-residential investment falls and payrolls rise at only 0.6% per annum.

The real question going into 2021 is whether President Joe Biden can spend further into debt to do more stimulus. Or will a shift toward fiscal responsibility begin to take hold? Much will depend on the Senate run-off outcome in Georgia. Assuming you believe the polls, Democrats are in the lead in both Georgia Senate races.

And on the corporate ledgers, balance sheets have never been more leveraged, which has led to excess overcapacity and an unprecedented "zombification" (thanks to the folks at the Federal Reserve) of the economy. With so much leverage on the balance sheets, many corporations will be unable to make necessary investments to increase productivity, jobs and economic growth.

On balance, we will exit the COVID crisis with debt at every level of society, government, business and consumer at a whopping 365% ratio to GDP. At the end of 2019, that metric was 326%. Think about this. In just two quarters,we have added as much to it as we did in the previous 10 years combined.

Demographics are destiny and the median age of the baby boomer cohort is now 66 years old and, in a decade, it will be 76. As if we don't have a Social Security and pension crisis ahead of us. That can is not going to be kicked down the road these next 10 years as it was these past 10 (or 20). This is a ticking time bomb for fiscal finances at a time when they are only made sustainable by near-zero rates. Aging demographics combined with a massive debt overhang will act as significant headwinds on aggregate demand that will outlast the brief boost to domestic demand that we will get once the vaccine arrives.



Moving on. Prior to the pandemic, income inequality was approaching levels not seen since the height of the Roaring Twenties in 1929. The reason this is so important is that better-off households tend to spend much less of their income. According to the Consumer Expenditure Survey, the richest 10% of households spent just 64% of their after-tax income and saved the rest. The other 90% of households, on average, spent 99% of their income. COVID-19 has greatly exacerbated inequaulity and those Americans most impacted by COVID – less educated, minorities and women – will have the slowest recoveries. This will act as a huge drain on the economy and pose a significant challenge for policymakers.

If the recovery in 2021 is frustratingly slow, don't be surprised if some kind of a "citizens income" or Universal Basic Income (UBI) will be implemented to boost the 70% of the economy we call the consumer. Indeed, the stimulus payments for individuals in the CARES Act and current stimulus package have shown that bipartisan support can be reached in Congress for such a measure. Also, if the GOP loses two Georgia senate seats, the movement to a universal basic income would surely gain momentum if the Democrats end up with the "Blue Wave" after all.

In summary, markets are looking ahead to the success of the vaccines and to 2022 and beyond. The stock market is telling us that the "new normal" will be a"reversion to the mean." That once we all get vaccinated, life goes back to normal. And to that I say, "not so fast." Yes, we may get to "normal," but it will be a "new normal." Bet on it. We should be wary of the negative repercussions on the economy and markets as a whole as we look towards an uncertain future of persistently high levels of unemployment, social instability and unsustainable debt burdens.

But, if we do somehow revert to the old normal, remember that the prior 10-year period was one of low growth, low inflation and low interest rates.

$2,000 NONSENSE!

"Borrowing from our grandkids to do socialism for rich people is a terrible way to get help to families who actually need it."
– Senate Majority Leader Mitch McConnell

Last week, Mitch McConnell assured everyone that a big fiscal relief plan is not forthcoming. Frankly, I believe Mitch is right on. There is something very wrong with handing out $2,000 checks willy-nilly to every employed or unemployed American. If they are working, aren't they already getting a paycheck? Today, there are 20 million unemployed Americans who desperately need financial support. This is where the aid should be targeted. Instead, we have politicians (including the President) who somehow believe sending $2,000 checks to an additional 140 million people is a good idea. According to a Wall Street Journal editorial last week, the House bill would provide benefits to a family of five that brings in $350,000 a year. This is nonsense!

Someone should inform Donald, Chuck and Nancy that Americans who are otherwise financially secure save most of this "windfall." What good does it do the economy to hand out money to people who merely save it? Do these people in Washington ever actually do any work such as means testing to determine who actually needs the fiscal aid?

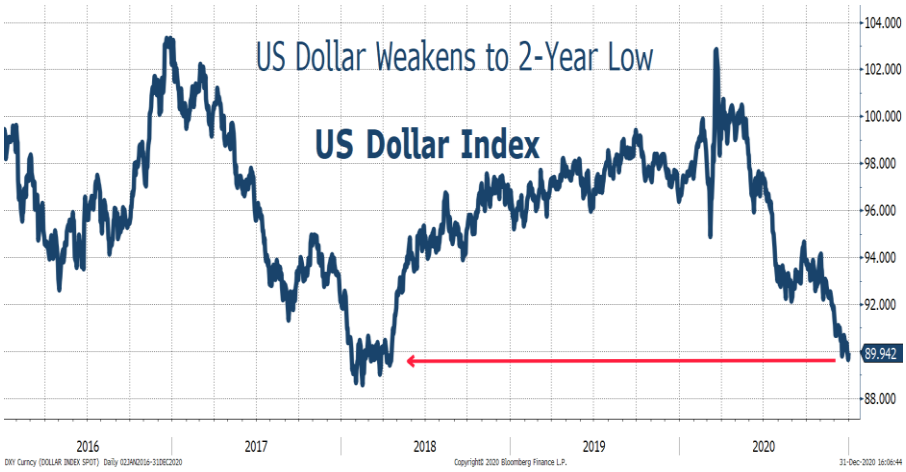
THE MMT EXPERIMENT

Modern Monetary Theory (MMT) starts with a logical truism, namely that a sovereign government, in control of a sovereign central bank, can never be forced to default on its own currency debt. This being the case, in an economy where there is a lack of aggregate demand, a government can just ramp up government spending or cut taxes to remedy the situation. As the deficit rises, the central bank can buy more of the government debt to prevent any increase in long-term interest rates. MMT argues that there isn't any problem with this until inflation appears. If inflation does crop up, the government can just raise taxes to quell demand. The theory posits that the economy can emerge from recessions faster and hover at close to full employment for longer.

Without acknowledging it, we have already embarked on the MMT experiment. Frankly, with debt loads so high any significant increase in rates will cause the econmy to come to a screetching halt. We may be at a point of no return with the invetibale monetary and fiscal cooperation and the monetization of its debt. Heck, Japan has been doing this for a decade. In Japan, the Bank of Japan has a 43% share of the entire JGB market, compared with a Federal Reserve share of U.S. Treasuries of just 14%. Japan's policy enforces a yield curve that's incredibly flat, ranging from a negative 0.1% on some very short-term cash reserves to about zero percent for 10-year JGBs. Simply put, the government issues debt and the Bank of Japan buys the vast majority of the debt to keep rates low. If the U.S. follows the Japanese playbook, look for the Fed to intervene more often and more aggresively to cap any rate increase.

BUT WHAT HAPPENS IF…

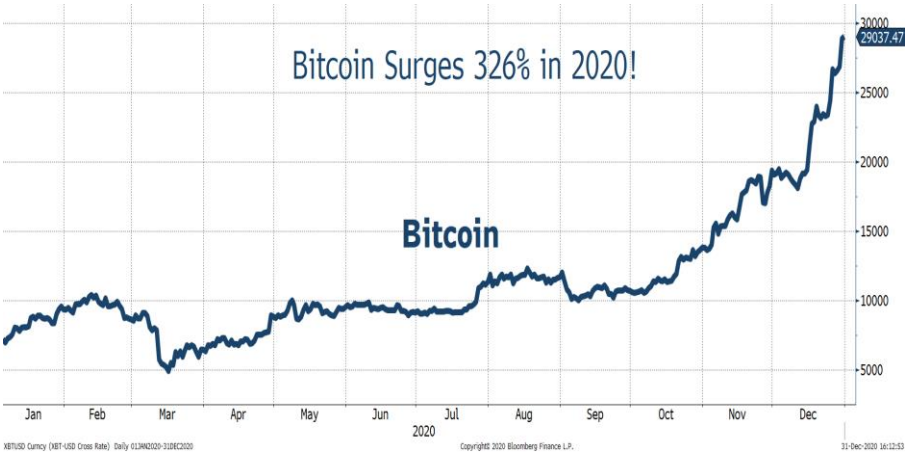
MMT exploits the trust that people place in fiat currency – namely, the idea that a dollar is a safe and reliable store of value. The more successful MMT is in pushing the economy towards full employment, the more likely it is that that trust will be undermined and eventually broken. Moreover, trust in money once lost (like marriage fidelity), is exceedingly hard to regain.



Surprisingly, the pro-markets Wall Street Journal makes no bones about how everyone can get rich with this "nudge, nudge; wink, wink" desire of an ever-weaker U.S. dollar. Have a look at *King Dollar Is Abdicating and That's OK*.

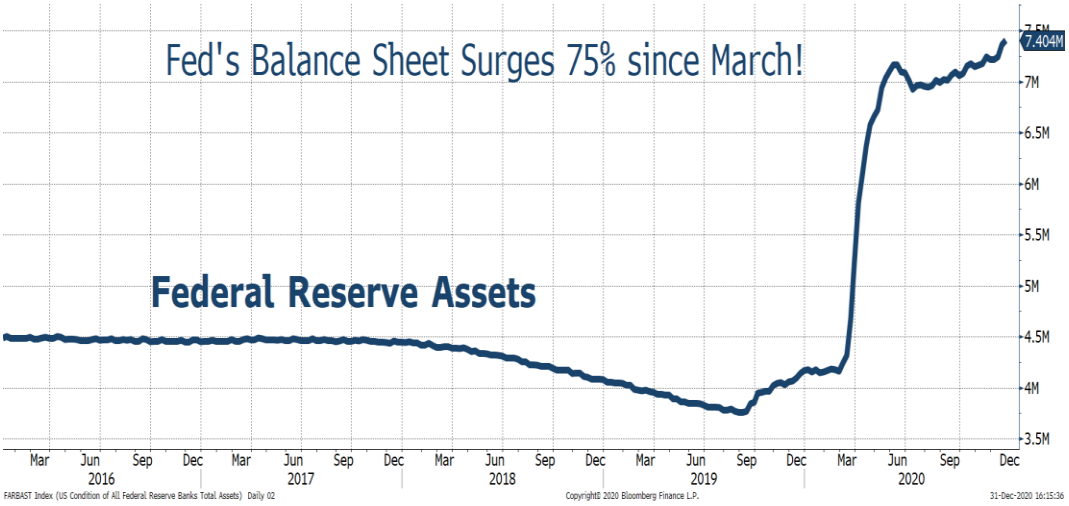
"As most assets are priced in dollars, a weaker dollar often means higher asset prices on everything from stocks to commodities to emerging-market bonds... the perennially strong dollar may be a thing of the past. Investors are unlikely to miss it." – Former Fed Chair Alan Greenspan

Maybe this is why Bitcoin has soared by over 326% in 2020.



The Bitcoin craze took gold off the headlines even though the yellow metal enjoyed its best year (+25%) in a decade and silver, "poor man's gold," rallied a nice 48% in 2020.

No matter how you slice or dice it, the markets are losing faith in the U.S. dollar. And this is hardly surprising when you consider what the Federal Reserve that oversees the world's reserve currency has printed money 24/7 and its balance sheet up 75% in little more than eight months.



In 1994, The "Maestro" Alan Greenspan called the dollar's weakness "troublesome and unwelcome." He understood the necessity of the world's reserve currency to exhibit stability and maintain confidence in its value. Here is what he told Congress that year:

"The weakness of the dollar against other currencies is unwelcome and troublesome. Dollar weakness while overdone, is unwelcome because it adds pressures to our economy. It is important to contain such pressures. It is symptomatic of the underlying problems of our economy."

The U.S. dollar's position as the dominant global reserve currency is an immensely important factor in supporting the ballooning U.S. government debt, the Fed's drunken money-printing, and Corporate America's ambition to offshore

production to cheap countries. They all have become dependent on the willingness of other central banks to hold large amounts of dollar-denominated paper. But from the looks of things, those central banks might be getting a little nervous.

A destabilizing decline in the greenback is surely a "black swan" risk in 2021 that few, if any, are talking about.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"When all experts agree, something else tends to happen." – Bob Farrell

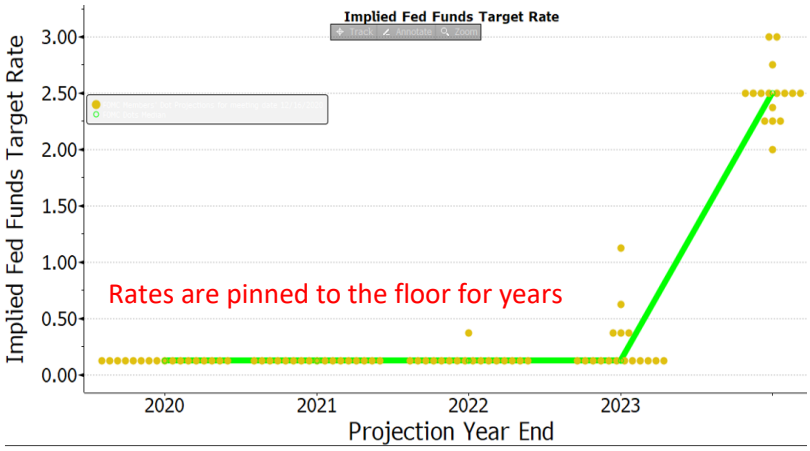
What do you think a Martian would say if he landed on planet Earth to see how many people made a killing in the markets as the coronavirus made a killing in terms of 350,000 deaths, more than doubling all the U.S. fatalities in World War I (116,000) and more than World War II (nearly 292,000)? Then again, the market is not a measure of morality.

Regardless, investors are of the mindset that life is going to resume as it was before the pandemic. That seems unrealistic to me, but that is what the markets are signaling. As we start the new year, everyone is on the same side of the boat. Currently, every single analyst has the same story going into 2021.

- Prepare for an economic boom.
- Interest rates will rise.
- Inflation is coming back.
- The stock market is going up and up!

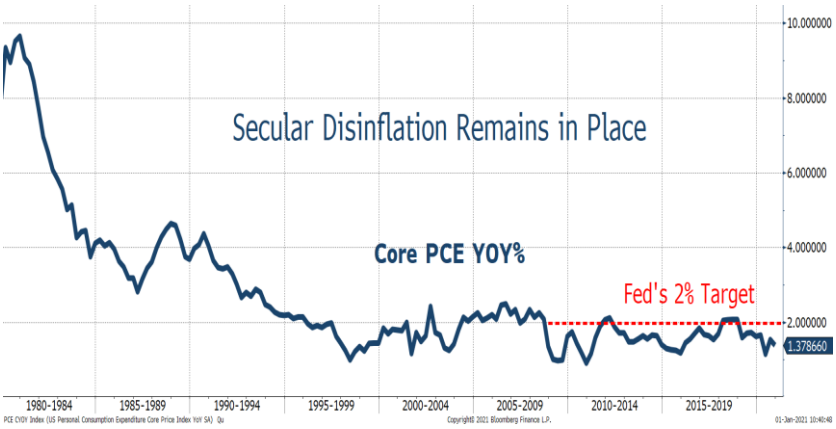
You get the idea. Everyone is incredibly "bullish" about the coming year. While that "wish list" could undoubtedly turn out to be the case, there is much that could go wrong. Remember what happened to Gordon Gekko at the end of Wall Street.

Anyways, to me, it all comes down to inflation and Fed policy, which is far more important than fiscal, foreign or even regulatory policy. Powell has gone on record saying that policy rates will be pinned to the floor for at least the next three years, even if the unemployment rate drops below 4% and inflation goes above and staying above 2%. In essence, the Fed has committed itself to maintaining an exceeding accommodative monetary policy stance well into the recovery phase.



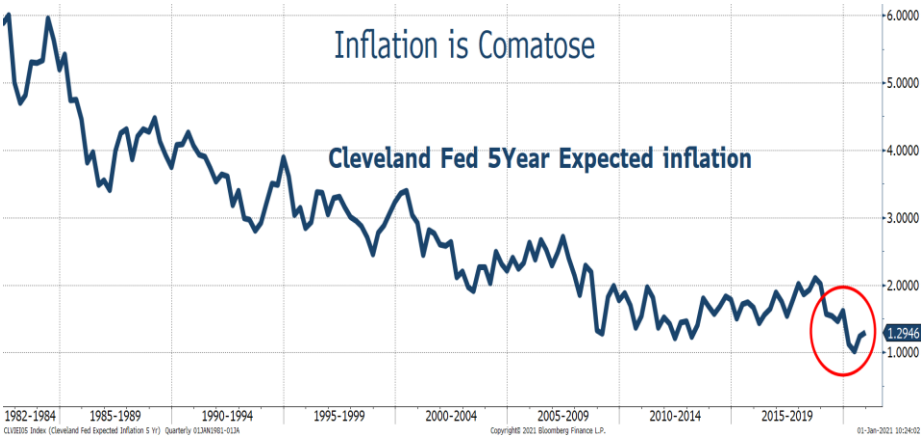
Meanwhile, inflation remains comatose. The core Consumer Price Index (CPI) inflation rate is currently sitting at 1.6%. At the end of 2019, it was 2.3%. The core personal consumption expenditures (PCE) inflation rate is 1.4% — at the turn of the year, the trend was 1.8%.

The Cleveland Fed's five-year inflation expectation barometer is just 1.3% (was 1.6% a year ago). According to the San Francisco Fed, 35% of the goods and services that make up the consumer spending pie are now deflating. Likewise, the St. Louis Fed shows that the share of items with an inflation rate of between 0% and 1.5% has jumped from 30% at the end of last year to 45% presently.



While the money supply numbers are booming, M2 velocity has all but stagnated for the past three months. There has been no growth in bank credit for the past eight months. Without money velocity, rising wages and credit increasing, it will be very difficult to build for an inflation to breakout to the upside.

The bottom line is inflation remains pretty much non-existent as we end 2020. Much like in Japan, the deflation/disinflation theme has proven to be secular and structural in nature. Cost-saving technologies, the descent of unionization breaking the wage-price spiral of decades gone by, excessive debt and aging demographics have all served to tamper price increases.



The biggest problem, of course, is the debt. If inflation does indeed rise, interest rates will also increase due to the surge in the money supply. With the gap between economic growth and debt at the highest levels on record, even small increases in debt service costs have an immediate and negative impact on growth. Somewhere between 1-2% on the 10-year Treasury, the proverbial "wheels" come off the $86 trillion debt "cart."

At some point, inflation will come back, and the Fed will find itself lagging behind and will be forced to take out some of its incredible amount of stimulus out of the system. And make no mistake, if for any reason, we see the market take rates higher (dollar collapse, sloppy Treasury auctions), this is where the next bear market comes to be, and I sense it will be spectacular. But it is probably not a 2021 story.

In conclusion, as we commence a new year, there is very little, if any, Fed policy risk. In other words, "What will the Fed do next?" is off the table for the time being.

As discussed above, economic growth has many secular headwinds. And if inflation remains dormant this means sustained low interest rates for quite some time to come. And, in general, zero rates in a low growth and low inflation environment take us back to where we were from 2010 to 2019, when, if you recall, high-quality fixed income securities performed remarkably well.

In terms of portfolio strategy, we start the new year where we ended 2020:

- Reduce excess cash.
- Maintain a duration risk-appropriate ladder strategy.
- Overweight the mortgage sectors.
- Underweight agency debentures.
- Buy the dips by capitalizing on intermittent 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.