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INVESTMENT SERVICES

Weekly Relative Value

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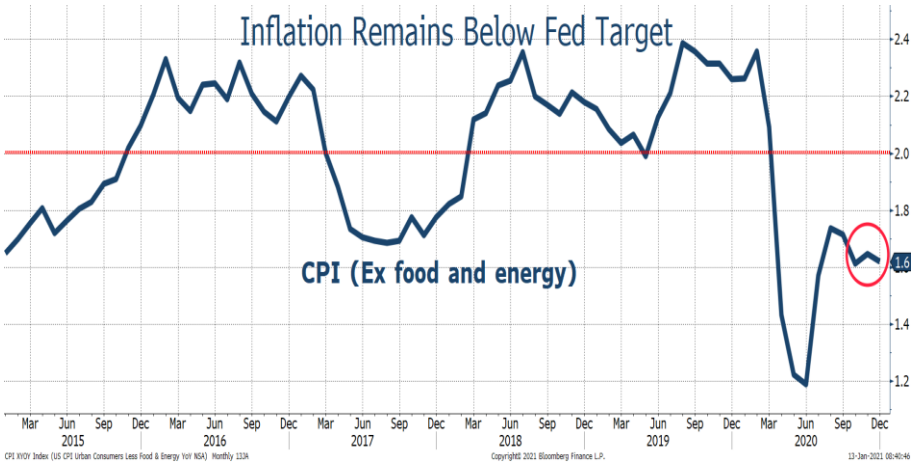
WEEK OF JANUARY 19, 2021

A Contrarian's View

"With inflation running persistently below 2%, we will aim to achieve inflation moderately above 2% for some time so that inflation average is 2% over time and longer-term inflation expectations remain well-anchored at 2%." – Fed Chairman Jerome Powell

"If we got 3% inflation that would not be so bad." – Chicago Fed President Charles Evans

Last week, I was watching CNBC and the entire conversation revolved around inflation. The discussion reminded me of the same narrative surrounding the stimulus in late 2009 that continued for over a decade. It also reminded me of the story about the boy who cried wolf.



There are legions of analysts out there who think they have figured out that repeated rounds of fiscal stimulus and the vaccine rollout will ensure a future of booming growth and rising inflation. But when you ask them for their "model," they don't have one. It's just a hunch… a story.

Regardless, the inflation data reported last week surely did not move the needle, with the core Consumer Price Index (CPI) rising a grand total of 0.1% in December. More significantly, for the past 12 months, core CPI remained at 1.6% and well below the Fed's elusive goal of 2%. Get this: Over the past three-months, the core CPI has slowed to a mere 1.3% annual rate. So while inflation may eventually reappear down the road, there is no evidence today.

THIS WEEK

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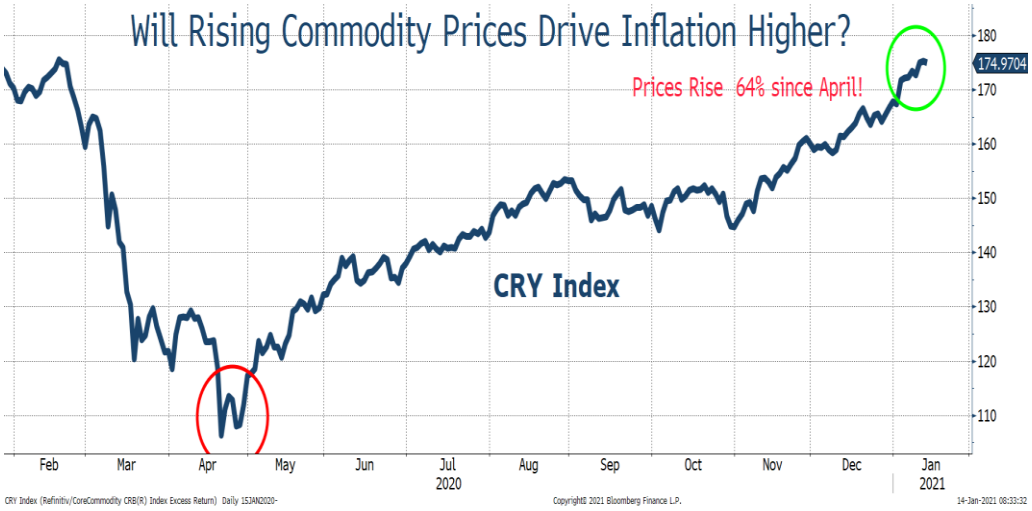
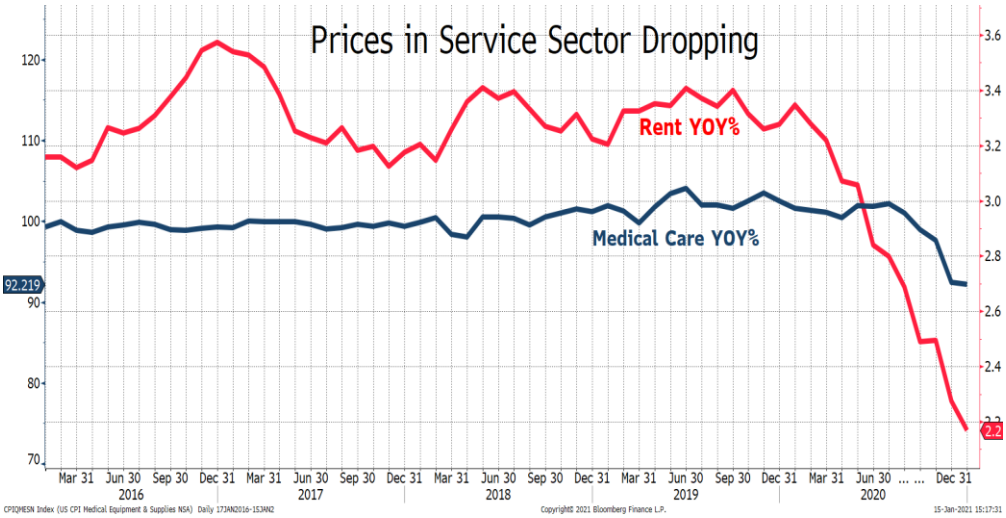
Yes, commodity prices have been on a tear since April 2020. But this price action has been influenced primarily by dollar weakness, supply constraints and weather. The Fed cannot do anything about oil production cuts by the Organization of Petroleum Exporting Countries (OPEC) Or the polar vortex? Likewise, declining inventories of grains (due to a dry weather spell in key growing regions in the U.S. and South America) have sent prices for corn, soybeans and wheat to their highest levels in more than six years. Heck, we may need those "stimulus" checks from Joe Biden just to pay for the grocery bill.

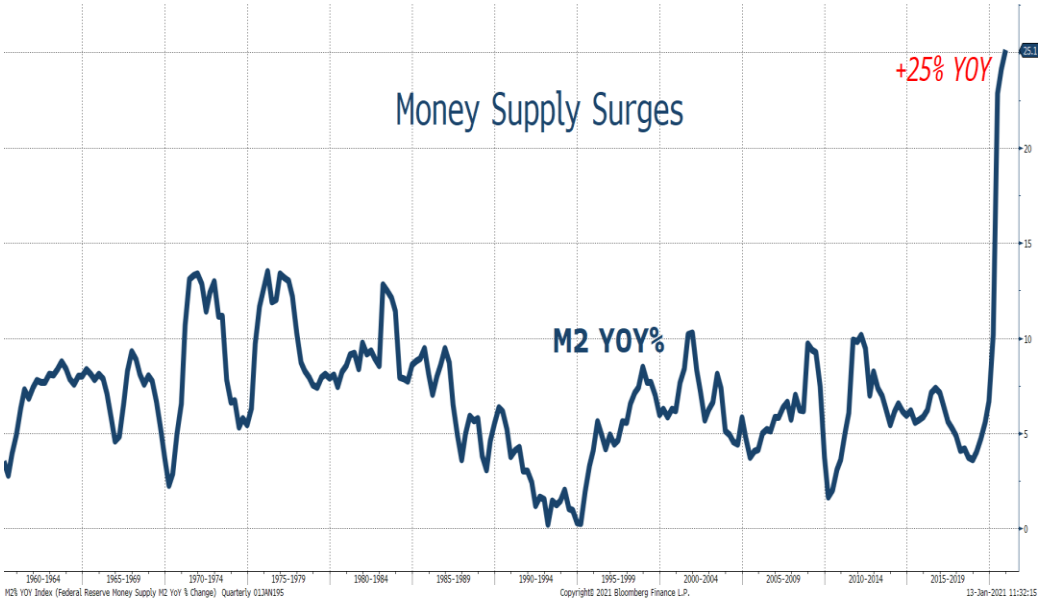


Furthermore, given that the U.S. is a primarily service-based economy, the link between the level of commodity prices and the general level of inflation has weakened considerably. Goods are 20% of the CPI while services command a 60% share. Those services are disinflating fast. To wit: the service sector prices are at a nine-year low of 1.6%. Notably, rents are pulling the services index lower. On a year-over-year basis, rents (based on Owner's Equivalent Rent) have slowed from 3.3% to 2.2%. Elsewhere in the service sector, medical care, transportation, education and hotel rates are also disinflating.

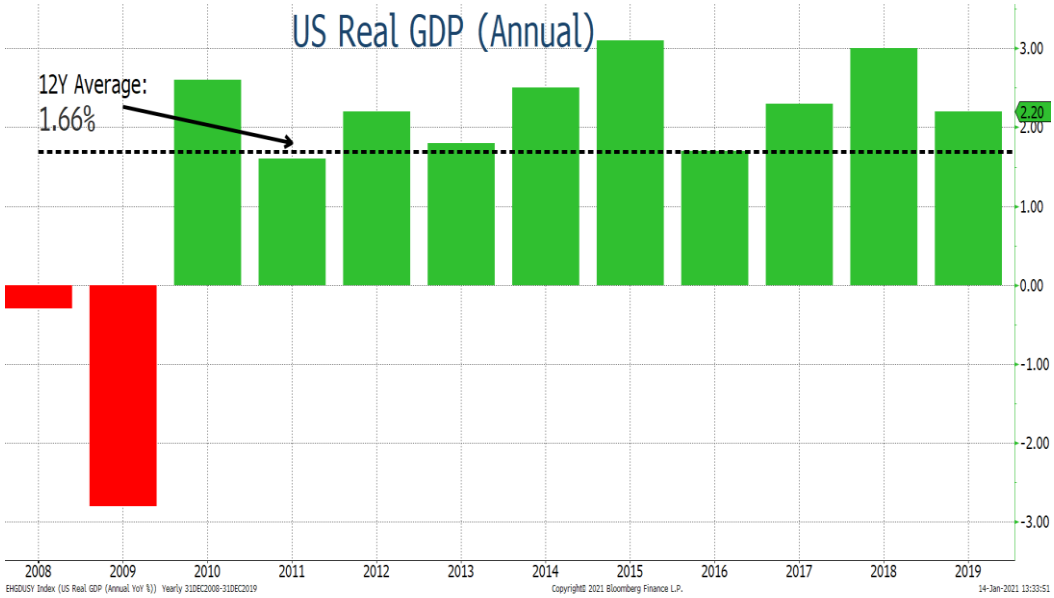


Moving on. To be sure, money supply growth has been rampant with M2 growing at 25% year-over-year. But at the same time, there has been virtually no growth in commercial bank credit. In fact, commercial banks continue to load up on cash and Treasury securities. Importantly, M2 velocity has plunged 21% year-over-year to a six-month low. With credit growth so tepid, there is no turnover in this monetary creation. Thus, the increase in M2 is sitting idle, resulting in

excess liquidity getting trapped in the financial markets. (By the way, this is why asset prices have risen.) The crux of the matter is: prices of services and goods cannot rise so long as money velocity plunges.

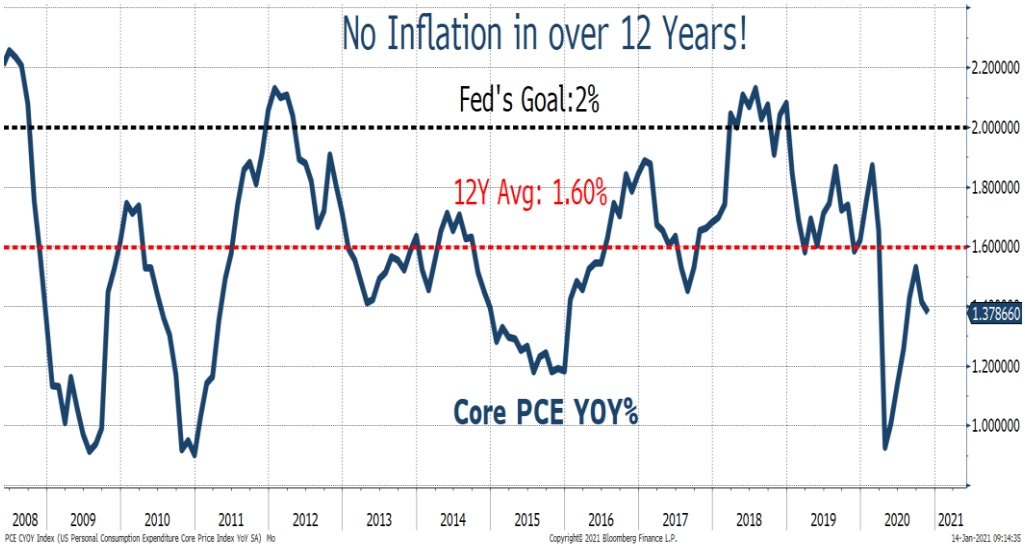


I have to wonder if the bond bears realize there was massive fiscal stimulus over the past decade, beginning with the Obama infrastructure ($600 billion over 10 years) and ending with the Trump tax cuts. Did either of these stimulus packages see economic growth rise beyond one or two quarters? No.



What about inflation? Take a look below. Since 2008, despite massive fiscal expansion and unprecedented monetary policy, inflation has averaged a whopping 1.6%. Only over a few months was the Fed able to achieve their 2% target. What does that say? Today, core personal consumption expenditures (PCE) are running at 1.37%.

As I have discussed numerous times, the structural factors impeding economic activity (e.g., excessive debt, aging demographics, extreme income inequalities and accelerating technological change) that slowed organic growth and capped core inflation over the past decade are even more acute today.



LABOR PAINS

It's also quite surprising that inflation is dominating market sentiment when one considers the massive hole in the labor market. The Job Openings and Labor Turnover Survey (JOLTS) reported last week serves as a case in point. Job openings in November plunged 105,000 and declines were notable across manufacturing (-33,000), state and local government (-28,000), leisure/hospitality (-16,000) and the once-hot construction (-10,000) sector.

This is consistent with the December ADP and non-farm payroll reports, which indicated that the jobs recovery had not just stalled in December but gone into reverse. All in, there are nine million more folks that are unemployed right now and many have little prospect of finding a new job soon. Most economists estimate that only three million will come back to the workforce. That leaves six million unemployed long-term on top of the four million who have already exited the labor market. This is the light at the end of the tunnel? Not for these individuals. The structural damage incurred by the labor market during this crisis does not receive the attention it deserves.

BUT WHAT ABOUT THE DEBT?

Much of the bond moves seen of late were driven by concerns over massive debt coming. Indeed, last week, the market had to absorb record-breaking Treasury auctions ($58 billion in three-year notes, $38 billion of 10-year notes; and the $24 billion in long bonds). And more debt is coming.

Due to expected massive stimulus and more debt, there are high hopes over a 21st century edition of the "Roaring Twenties." But these predictions of a return to prosperity are ignoring history at their own peril. The reality is this new debt accumulated over the past year is deflationary, not inflationary. Stimulus on top of stimulus on top of stimulus (with no lasting impacts) and all we get are consistently higher debt ratios, which constrains aggregate demand and sows the seeds of even lower Treasury yields.

Consider the following quote:

"There is no evidence that more [bond] supply drives yields higher. The association between increased debt and yield levels has dominantly been the other way for the [past] two decades. More debt has been consistent with lower yields in the major developed markets and even some of the emerging markets... in addition to the overhang of debt weighing on future growth, there are a number of trends that will not suddenly disappear. For example, aging populations require greater savings… greater savings also mean less of a consumption boost for the economy... ultimately, policies like quantitative easing and fiscal stimulus are responses to a lack of demand in the economy." – Steven Major, Head of Global Fixed Income Research at HSBC

Debt is the principal reason the Fed has been increasingly troubled with low inflation. Currently, there is $83 trillion of total debt outstanding, powering a $21 trillion economy. Include future liabilities such as social security, and the amount of debt nearly doubles.

Some of this debt is productive and results in growth, which pays for itself. Examples of productive debt would be education, health and infrastructure, which can boost GDP. That said, slowing productivity, GDP, corporate earnings, and wage growth argues a large percentage of the debt was non-productive debt.

Non-productive debt boosts economic activity for a short period. That is why the Fed encourages more debt in times of sub-optimal economic growth. The flaw of this logic is that the debt is not self-funding and does not produce enough income to pay off future debt. In other words, debt pulls consumption forward but at the same time it weighs on future economic growth. Debt is future consumption denied. Thus, it requires ever more debt to keep the economy rolling.

With the debt growing substantially faster than the ability to pay for it, there are three options to deal with the debt overhang: 1) Austerity, 2) Default, or 3) Inflation.

The Fed will not pursue option one and two. Austerity would squash economic growth, which the government will not tolerate. Defaulting on debt will devastate the financial markets and hurt the economy. Yet, ironically, while both options require severe short-term pain, they promote more robust growth in the future.

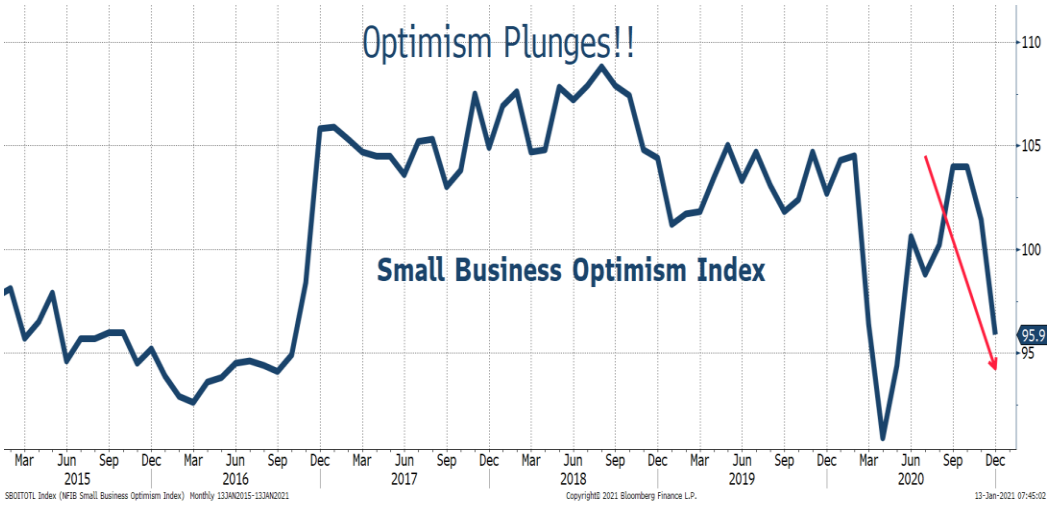
That leaves inflation the Fed's preferred way out of the debt morass. Here's why: inflation deflates the real value of debt. Higher wages, profits and taxes resulting from inflation make debt payments less onerous.

Here's the catch: the Fed wants robust economic growth, but this can only occur with more debt and leverage. To make existing and additional debt manageable, rates must be low. At the same time, the Fed desperately wants higher inflation to pay off the debt. So, in a nutshell, the Fed wants low rates and higher inflation. But higher inflation and low rates are incompatible. Thus, the only way to maintain the Fed's debt scheme is for the Fed to continue to intervene via quantitative easing (QE) and/or yield curve control.

SMALL BIZ SENTIMENT PLUNGES

The National Federation of Independent Business (NFIB) Small Business Optimism Index dove hard in December, in the aftermath of the election and the latest coronavirus wave, but also including the announcement of that $900 billion "stimulus" package. This was the weakest since April 2016.

Drilling below the headline numbers, the internals were not positive. Expansion plans went to a seven-month low of 8% in December. Hiring plans sagged to a six-month low of 17% from 21% and the pattern of deterioration in business expectations for economic improvement is rather breathtaking: September: 32%; October: 27%; November: 8%; December: -16%. Notice the trend?



BEIGE TURNING BLUE

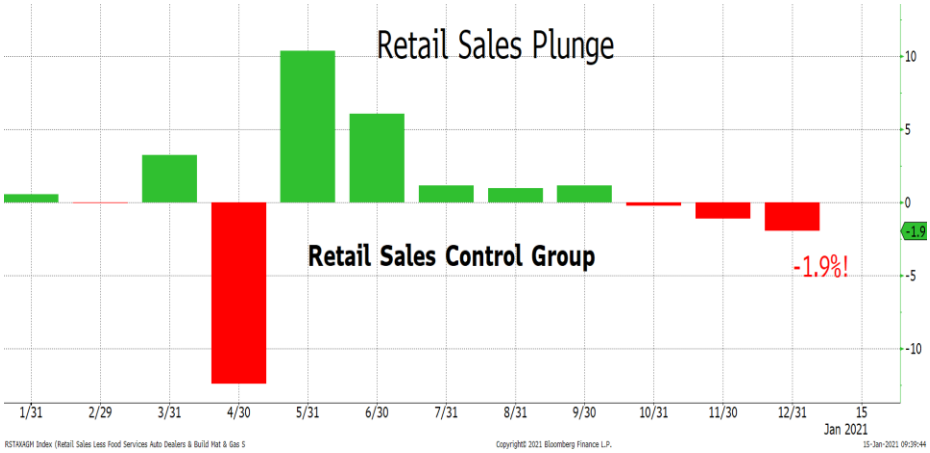
The Fed's Beige Book came out last week and it was not very constructive on the economic landscape. While it noted that "economic activity increased modestly," it cited that two Districts stagnated and one contracted. Not a ringing endorsement. The consumer spending backdrop was described as "mixed" with "noted declines" in leisure and hospitality. The Beige Book also reported that auto sales activity "weakened." Interestingly, the Beige Book stated that there was "little or no change in loan volumes" in the banking sector. As for the labor markets, they "generally remained weak. And for wages, the best they can do is "increase modestly." That's it? How exactly do we get inflation at a time of a weak job market and stagnant credit growth?

It wasn't all bad, though. On the bullish front, activity in the energy sector was said to have "expanded." Industrial activity "continued to recover" thanks to the weaker dollar. Housing "remained strong" but the commercial real estate market was still marked with "weak conditions."

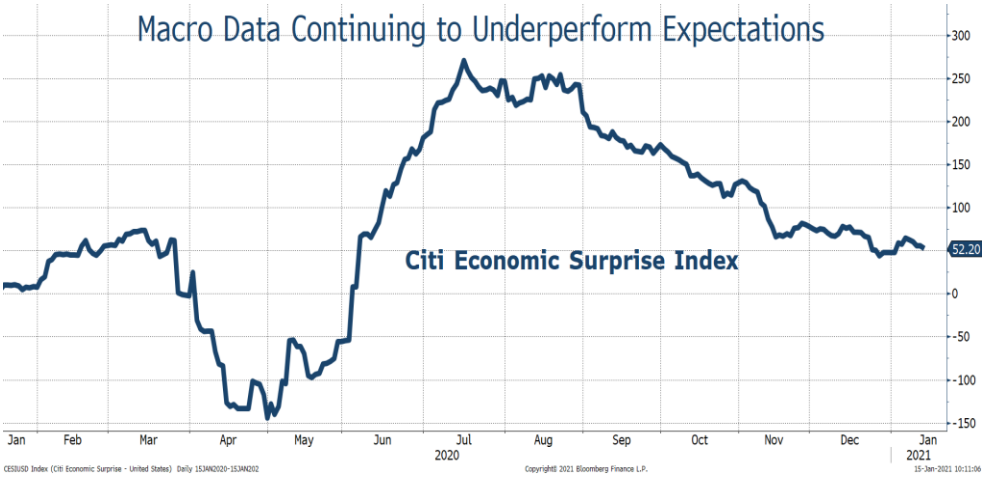
TIGHTENING BELTS

Consumer spending took a step back in the fourth quarter. U.S. retail sales declined for the third straight month in December, sliding 0.7% month-over-month (versus 0.0% expected). Retail sales excluding autos declined 1.4% in December, the most since April. The biggest headline under the surface is the fact that non-store retailers (e.g., Amazon etc.) plunged 5.8% month-over-month following a 1.7% slide in November.

The so-called "control group sales," which exclude food services, car dealers, building-materials stores and gasoline stations, plummeted 1.9%, also the most in eight months. The measure is often considered more reflective of underlying consumer demand. Could it be the consumer is maxed out and there is no more pent-up demand for the things we bought in the past year? Yes, services like airlines, restaurants, theme parks, recreation services and events have the potential for a big post-vaccine rebound. However, this spending represents 6% of total consumer spending and 4% of GDP. Once we are all vaccinated and as we start flying and dining out and going to concerts, the pullback in electronics, appliances, vehicles, home remodeling and renovation and furniture could pose a huge offset.



Overall, the incoming macro data have been worse than expected, as shown in the Citi Economic Surprise Index.



ASSET BUBBELS AND THE WEALTH EFFECT

"A healthy respect for uncertainty and focus on probability drives you never to be satisfied with your conclusions. It keeps you moving forward to seek out more information, to question conventional thinking and to continually refine your judgments and understanding that difference between certainty and likelihood can make all the difference."
– Robert Rubin, former Treasury Secretary

Based on everything I read these days, the Wall Street consensus for 2021 is universally bullish, if not exuberantly bullish. That said, it should be duly noted that Wall Street is always bullish. To wit: the McKinsey Group found that over the past 25-year time frame, Wall Street analysts pegged earnings growth at 10-12% a year when in reality earnings grew at 6%. In other words, analysts have been persistently overly optimistic for 25 years. On average, analysts' forecasts have been almost 100% too high.

"Maybe this time is different. Those words, supposedly the most dangerous to utter in the investing realm, came to mind amid the frenzied pops in the highly anticipated initial public offerings recently."
– Randall Forsyth, associate editor at Barron's

The only other time in history where the Dow advanced this rapidly was during the 1995-1999 period of "irrational exuberance." There are certainly many similarities between today and 1999 – from exceedingly high valuations (S&P 500 forward P/E of 23X), to overpriced stocks (i.e. Airbnb and Tesla) to IPO mania. Yes, yes, maybe "this time is different." Or, it could just be the inevitable beginning of the ending of the current bull market cycle, which is now approaching 12 years.

Will 2021 turn into another positive performance? Maybe. But, honestly, I don't really know. What I do know is that the real economy is not supportive of asset prices at current levels. The more extended prices become, the greater the potential for a future market dislocation. This is why risk management is more important than chasing incremental returns. Don't be greedy. Have some cash available for a sell-off. For investors that are close to or in retirement, some consideration should be given to capital preservation over chasing potential market returns. Buy some insurance. Hedge yourself at this current extreme.

"Bulls make money, bears make money, pigs get slaughtered." – Jim Cramer, host of Mad Money on CNBC

Please, don't be that pig!

WHERE TO FROM HERE

"President-elect Biden has released the details of his COVID-relief plan, which the transition team estimates to cost $1.9 trillion (8.6% of GDP). We do not expect all of the elements of the proposal to pass, but we are increasing our assumption of additional near-term fiscal measures from $750 billion (3.4% of GDP) to $1.1 trillion (5% of GDP). We expect to make modest further upward revisions to our forecast in light of these revised assumptions."
– Goldman Sachs

The markets seem convinced that a "blue wave" is all but certain. Not so fast. It's not clear how the GOP will vote regarding a blockbuster spending splurge and the Democrats have a thin 10-seat majority in the House and, in the Senate, it's 50-50 with the Vice President-elect casting the tiebreaking vote. There will be Republicans who won't vote for a doubling in the minimum wage or all the aid to the state governments. Furthermore, some Democrats are not fully on board with massive stimulus. Let's not forget, that the second half of the year will be filled with discussion on tax hikes on corporate income rates (21% to 28%) and capital gains (20% to 40%).

You must always respect the market. But in the end, it is only a price. At times, you must also respectfully disagree with its assessment of the future. As a contrarian, here's my take: the markets are pricing in a big fiscal stimulus coming as soon as March. I am highly doubtful. We also have to realize that while we will "stimulus," it's really just income replacement checks with no lasting effect.

Also regarding those stimulus checks academic research and survey data found that just 20% of those who received checks spent them. Another 32% put the money into savings. The remainder used the checks to pay off debt. As for the CARES act, University of Chicago found that 75% of the folks getting all the "pork" didn't really need it (and were making more "on the dole" than they were when they were working).

The second big assumption the market is making is that herd immunity will be here by June. At that point, the economy will boom in the second half of the year. Let's hope so, and it's definitely possible, but thus far, the vaccine rollout has not come close to "warp speed." Of course, we have to be worried about the virus mutating and negating the efficacy of the vaccine. To that point, California's health department says the fast-spreading U.K. variant is now being identified across the state.

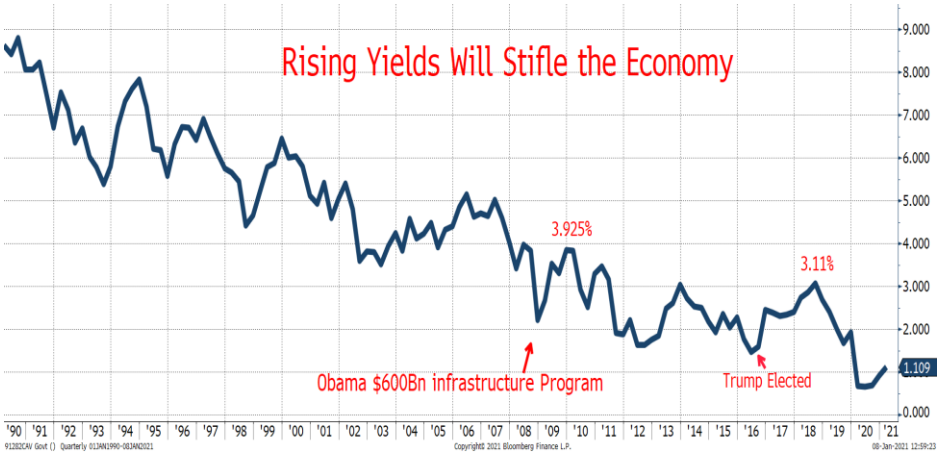
In a nutshell, what if there are Senate roadblocks for endless fiscal stimulus? What if herd immunity becomes a 2022 story? What if the beloved asset bubble bursts and the wealth effect reverses?

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Now is not the time to be talking about exit [from bond-buying]…
[When the time does come,] we'll let the world know." – Fed Chairman Jerome Powell

The overwhelming consensus is that interest rates will rise throughout 2021, owing to the expectation that additional fiscal stimulus coupled with an easy monetary policy will create an inflationary cocktail as pandemic-related shutdowns end.

Heck, maybe the consensus – which has been dead wrong for 7+ years on predicting higher rates – may get it right this time. Even still, I take the opposite view. Being bullish on Treasuries is still warranted because the economic harm from the pandemic will take years to repair. The potential for government spending to spur the economy appears to be disabled in part by high debt loads, which will leave it worse off than if no damage was incurred.



To be clear, this doesn't mean periodic upward pressure on bond yields cannot occur. In fact, expect them. But it is not whether rates can rise, since it happens transitorily every year (see graph below), but whether they can stay elevated. To wit: from mid-2009 to early 2020, the 10-year Treasury yield rose 5,000 cumulative upside basis points on daily spasms but none of these sell-offs violated the long-term fundamental downtrend in yields. Full stop.

Long-term, the vaccines are a godsend and a game changer. Who would have thought we would have vaccines in such a short period of time? So there is light at the end of the long dark tunnel. But, near-term, there is tremendous fragility beneath the surface for risk assets and for the economy. Retail sales are down three months in a row. Personal incomes have declined by 10% (annualized) since August. Jobless claims are pointing to a second consecutive decline in payrolls. Confidence appears to be rolling over. Not a very bullish mix. You can look at the light at the end of the tunnel all you want; just be mindful sweeping the land mines on the way.

In terms of portfolio strategy, excess cash remains the least attractive asset to own in the current environment. Credit unions should continue to reduce excess cash while maintaining a disciplined, risk-appropriate ladder strategy of high-quality securities. In terms of sectors, a significant underweight is appropriate in CDs and agency securities. Overweight positions are recommended in the higher yielding MBS and CMO sectors. Last but not least, from a tactical perspective, try to capitalize on temporary bouts of bond market weakness. To put it simply, buy the dip!

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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.