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Weekly Relative Value

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Who's Going to Pay?

"All crises have involved debt that, in one fashion or another, has become dangerously out of scale in relation to the underlying means of payment."
– John Kenneth Galbraith, excerpted from "A Short History of Financial Euphoria"

The one thing that never gets discussed is how our massive deficits and debts amassed during the pandemic will get resolved. When President Donald Trump took office in January 2017, the national debt stood at $19.9 trillion. Today, the national debt is at a new high of $28 trillion. That's an increase of almost 36% in less than four years. The economy is set to reach a $4.2 trillion deficit in 2020. U.S. federal debt held by the public as a percentage of GDP is now at levels not seen since World War II. Making matters worse, the trend is on a sharp upward trajectory.

Source: Committee for a Responsible Federal Budget

In 2020 alone, total debt across the entire U.S. economy swelled by $6.2 trillion. Overall, the U.S. economy is saddled with $82 trillion of debt. The total debt-to-GDP ratio has ballooned to 365% from 326% before the crisis. Get this: the U.S. has added as much debt in the past nine months as was added in the prior twenty years. In dollar terms, the debt amounts to $82 trillion (or $620,000 per household). Think about that number. For comparison, in 2000 the debt per household was $260,000.

One would think this massive deficit financing would lead to explosive growth. The problem is most of this government spending has shifted away from productive investments. Instead of things like the Hoover Dam, which creates jobs, spending shifted to social welfare,

THIS WEEK

PORTFOLIO STRATEGY

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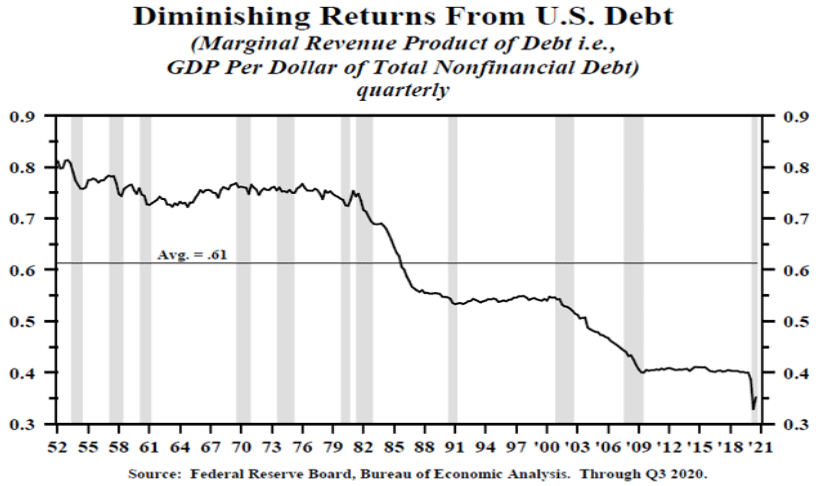
defense and debt service, which have a small and maybe negative multiplier effect. According to the Center on Budget & Policy Priorities, "nearly 75% of every tax dollar goes to non-productive spending."

Yes, this debt expansion was necessary to stave off a modern-day depression, and it has eased the short-term pain, but it also misallocates resources and reduces future growth. Simply put, debt is future consumption denied! As shown in the graph below from Lacy Hunt at Hoisington Investment Management, growing public and private debt suppresses economic growth as the additional debt has a smaller and smaller effect.



Source: Hoisington Investment Management

WHAT IF RATES RISE?

The main support behind these ever-increasing debt levels has been the lower interest rates. So, to truly gauge what the impact of the debt drag is, we need to understand what happens if rates rise. According to Bloomberg economists, the outstanding debt is so high that, if interest rates rose 100 basis points, GDP would be 0.6% lower next year. In an adverse scenario where U.S. borrowing costs rise 2% above current market expectations, the price tag to service the nation's debt would jump from 2% of GDP in 2020 to nearly 6% of GDP in 2030.

The Federal Reserve's problem is that interest rates MUST remain low due to the massive levels of debt. The Fed cannot normalize rates without meaningfully slowing economic growth. This is, in a nutshell, why rates are not going higher.

Thus, until this debt is reduced via a "debt jubilee" or restructuring, the U.S. is left with an anchor that will act as a persistent drag during future expansions. Ultimately, the Federal Reserve and the Biden administration will have to face hard choices. However, history shows that political leadership never makes hard choices until those choices get forced upon them. Instead, the politicians and bankers will kick the can down the road and continue to solve a debt problem with even more debt. As such, we are in a massive debt trap that is increasingly deflationary and show no capacity or courage to emerge from it. Ultimately, all this adds up to a future of lower rates and slower growth.

What if deficits do not matter as long as you can service them, and so the role of government can keep expanding – which it has with steadily larger bailouts, persistent deficit spending, mounting government debts and increasingly easy money out of central banks to finance it all. Could it be that we are in a new era of permanently low interest rates?

Think Japan.

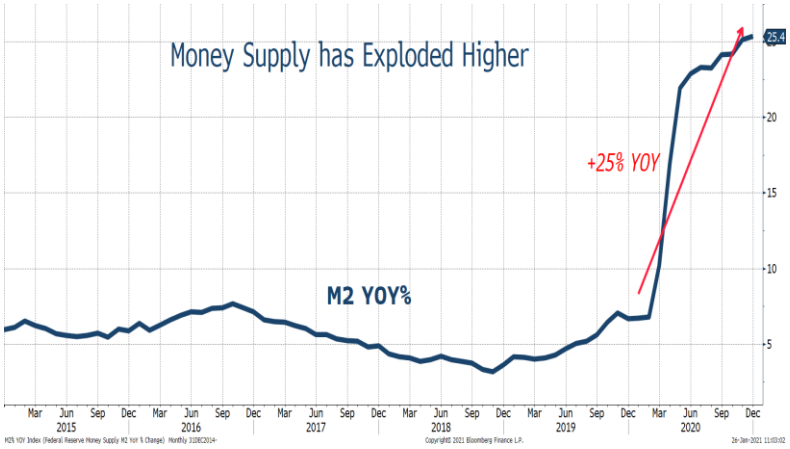
INFLATION ON THE MIND

"Inflation is always and everywhere a monetary phenomenon, in the sense that it cannot occur without a more rapid increase in the quantity of money than in output." – Milton Friedman

Inflation is on everyone's mind and it is the key to the future path of interest rates. Many market strategists and economists have argued that, given the Fed's tsunami of liquidity, economic growth and inflation will explode higher, leading to a higher rate structure. They base their view primarily on the massive increase in money supply and more fiscal stimulus.

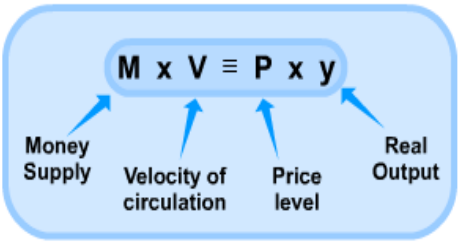
"In summary, my indicators tell me that U.S. growth will be strong, and we are on the right side of the four quadrants framework. As prices seem set to accelerate, we are moving into the upper half, which means that 2021 should see an inflationary boom in the U.S." – GaveKal, provider of global investment research

There is little argument currently that the Federal Reserve is "printing money" without any reservation. The chart below shows money supply (M2) has exploded by 25% since March. So will the dramatic increase in money supply drive inflation?



Let's run it through the Quantity Theory of Money model. This model says that prices rise when there is more money in an economy, and they fall when there is less money in an economy.

The equation for The Quantity Theory of Money is: MV = PY where M is the quantity of money, V is the velocity of circulation, P is the price level, and Y is real GDP.



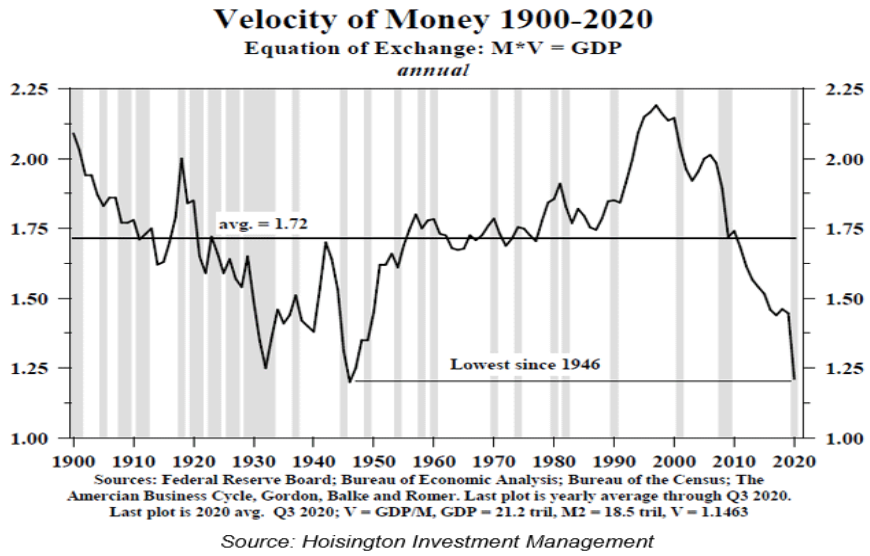
Source: Economy101

Today, M2 money equals 25%; V (money velocity or turnover of money) equals -21%; Y (real GDP 2021 growth consensus forecast) equals 4%.

To solve for inflation (P), you plug these inputs into the Quantity Theory of Money formula. Voilà! Inflation is 1%.

Moving on.

But surely massive fiscal expansion will lead to higher inflation, right? Well, no. In an economy saddled by $82 trillion in debt, the debt is no longer productive. This is why "monetary velocity" began to decline in 2000 as total debt passed the point of being "productive" to becoming "destructive." In fact, debt is deflationary as the cost of servicing the debt reduces capital available for the real economy.



Source: Hoisington Investment Management

Monetary velocity tells the story. The velocity of money measures the rate at which money is used for purchasing goods and services. High money velocity is usually associated with a strong and expanding economy. Low money velocity is usually associated with slow economic growth and low inflation.

The Federal Reserve is trying to stimulate an economy that already had too much debt with yet more debt. As you can glean from the graph above, despite intervention after intervention and ultra-accommodative monetary policy, it's not working. Velocity has continued lower. Most of the stimulus simply stays on the sidelines.

Bottom line: The Fed can print money 24/7, but unless that money finds its way into the real economy, velocity will not rise… and neither will inflation.

TAXES ARE GOING UP

After the 1918-1919 Spanish flu pandemic, the U.S. had a 10% government debt-to-GDP ratio. Today it's 100%-plus. One of the big reasons the "Roaring Twenties" ensued was because tax rates were cut across the corporate and individual spectrum.

Once we exit the COVID pandemic, we no longer have the ability to reduce tax rates. Rather, once we take care of the pandemic at some point later in 2021, the markets will start to price in a future of higher tax rates, likely with those at

the high end of the food chain taking the biggest hit. But these massive deficits and debts cannot be remedied without the middle class taking a hit, too. The "rich" alone cannot solve this.

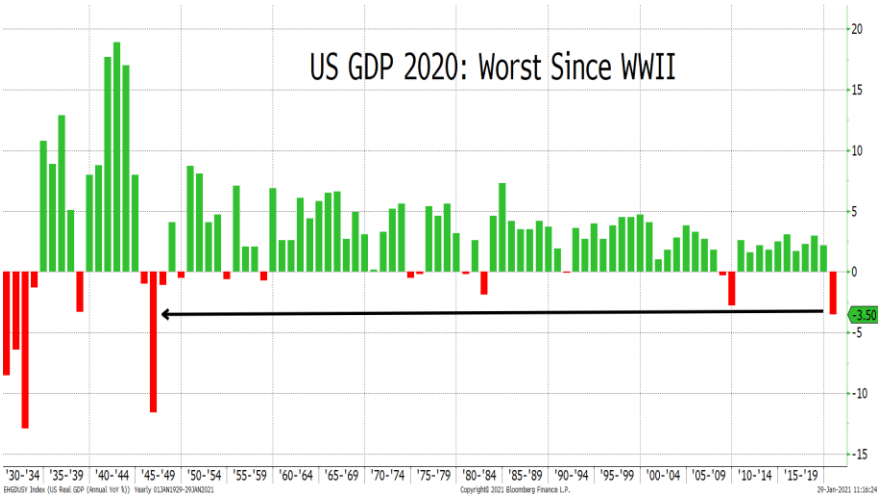
Over the next decade, taxes rise and cut into private sector incomes. It may not be from the federal government initially, but cash-strapped state and local governments are already moving in that direction. Higher income taxes are being contemplated in New York and now Connecticut is openly discussing a new property tax on home values at $430,000 or more.

GDP RISES 4%

The headline growth came in at an annual rate of +4.0%, more or less in line with consensus views (which were centered around 4.2%). Real GDP for all of 2020 contracted 3.5%, which may be the worst showing since 1946, but it is a lot better than anyone would have thought in February and March when we all feared we had the Black Death on our hands. So, clearly the mountains of policy stimulus and the vaccines helped prevent an unmitigated disaster.

The good news is the economy has now recouped 86% of the GDP loss incurred in the first half of the year. That said, recapturing the other 14% is going to take a lot longer even with more stimulus and the hopeful return to some sort of normalcy before the end of 2021.

The main message here is that without the vaccines and without all the policy stimulus, the economy is completely lacking in vitality and vibrancy. This economy can't operate without the funds rate being pinned at zero.



THE HOUSING BUBBLE IS BACK

"The housing sector has more than fully recovered from the downturn, supported in part by low mortgage interest rates." – Federal Reserve Chair Jerome Powell

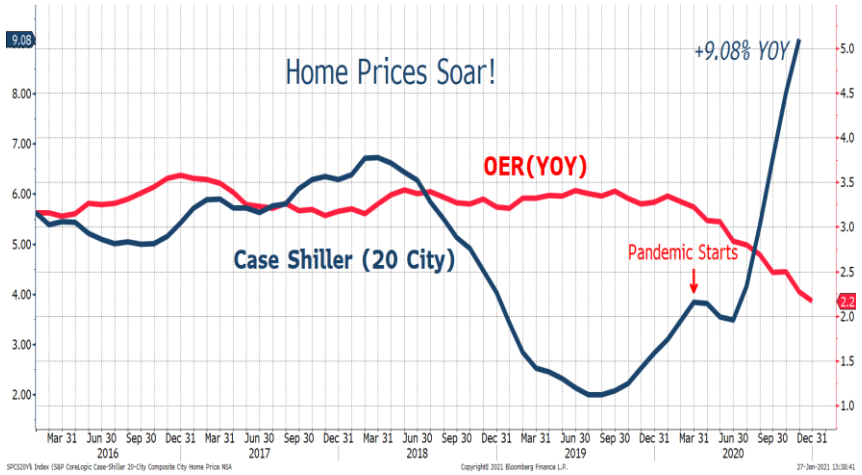
Who would have predicted that the financial markets and real estate would go up so much after the pandemic started?

The S&P/Case-Shiller 20-City Composite Home Price Index for November spiked 1.4% in November. This was on top of a 1.6% surge in October. The year-over-year trend is 9.08%. In other words, it takes more than 9% more dollars than it

took a year ago to buy the same house. The average change is just over 4.0%. Now, home prices are selling at nearly an 8% premium over inflation. Also, the home price-to-rent ratio is 13% above the norm of the past decade.

Undoubtedly, the housing boom boils down to interest rates. But remember, rates are so low because the market is discounting very weak economic growth in the futures, even accounting for a brief relief spending spurt after the pandemic is in the rearview mirror.

This is the point. Low rates are the tentpole for holding up home and equity prices. Should we ever enter a phase where interest rates back up for whatever reason, the hit to household assets from the correction we see in both equities and housing could be rather spectacular, and not in a very positive manner. The only thing I will say is make sure your financial position can handle a potential mean reversion of prices.



DOUBLING DOWN

"You hold your nose, and you buy. Stocks have been divorced from fundamentals."
– David Kudla, Chief Investment Strategist at Mainstay Capital Management, LLC

Last Wednesday, the Federal Open Market Committee (FOMC) kept monetary policy unchanged.

Here are the key takeaways:

1) **Whatever It Takes:** Undertake open market operations as necessary to maintain the federal funds rate in a target range of 0 to 1/4 percent.
2) **Full Range of Tools:** The Federal Reserve is committed to using its full range of tools to support the U.S. economy in this challenging time, thereby promoting its maximum employment and price stability goals.
3) **Accommodative Financial Conditions:** Overall financial conditions remain accommodative, in part reflecting policy measures to support the economy and the flow of credit to U.S. households and businesses.
4) **Let Inflation Run Hot:** With inflation running persistently below this longer-run goal, the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent.
5) **No End Date to Accommodative Stance:** The Committee expects to maintain an accommodative stance of monetary policy until these outcomes are achieved.

6) **More Quantitative Easing (QE):** The Federal Reserve will continue to increase its holdings of Treasury securities by at least $80 billion per month and of agency mortgage-backed securities (MBS) by at least $40 billion per month until the pandemic no longer poses considerable risk to the outlooks for economic activity, employment and inflation.
7) **Roll Over QE Auction Proceeds:** Roll over at auction all principal payments from the Federal Reserve's holdings of Treasury securities and reinvest all principal payments from the Federal Reserve's holdings of agency debt and agency MBS.

"The pace of the recovery has moderated in recent months... The overall recovery in economic activity since last spring is due in part to federal stimulus payments and expanded unemployment benefits, which have provided essential support to many families and individuals... overall economic activity remains below its level before the pandemic, and the path ahead remains highly uncertain... as with overall economic activity, the pace of improvement in the labor market has slowed in recent months... the economy is a long way from our employment and inflation goals, and it is likely to take some time for substantial further progress to be achieved..." – Fed Chairman Jerome Powell

I share Mr. Powell's sentiment, yet how can such a somber economic outlook co-exist with a bubble in virtually every risk asset class.

To no surprise, the FOMC statement made no mention of the obvious bubbles it is blowing. Further, in the Q&A after the meeting, Powell dismissed asset bubbles saying they were based on speculation on vaccines and fiscal policy, not monetary policy. Come again? Just six weeks ago, he indicated that equity valuations can be justified by the current microscopic level of interest rates, and now he says they take a back seat to fiscal policy and the vaccines!

On top of that, he either doesn't acknowledge there is a bubble, or he knows he's lying or doesn't care. As clear as day, asset bubbles in housing and speculation in stocks like GameStop are as obvious a Pinocchio's nose. We have an explosion of SPAC/IPO (special purpose acquisition company/initial public offering) issuance, $850 billion of margin debt (or 75% above 2015 levels), the most shorted equities up 75% versus 16% for the S&P 500 since October (bulls running over bears), record-high call versus put volume. So, while Powell buries his head in the sand, this balloon is just going to get bigger and the burst, when it does happen, will be absolutely spectacular.

In any event, the day trader mania has been on full display and has culminated the retail investor (David) taking on the institutional investor (Goliath). Just as individuals used social media platforms to organize protests and riots across the country, traders used websites like Reddit to organize a successful short squeeze on Wall Street hedge funds. That short squeeze, which forces heavily leveraged hedge funds who were short stocks to cover the positions, sent a handful of

stocks to the moon. Fundamentals be damned. Notably, GameStop, a retail store that is on the verge of bankruptcy, has been the movement's poster child. The price of GameStop moved from $20 to $350 (+1,650%) this month. As the most shorted stocks rose, the hedge funds were forced into covering their shorts and took huge losses. Of note, Melvin Capital lost a stunning $7 billion in January (53% of its capital).

Ray Dalio, co-chief investment officer of the world's largest hedge fund, Bridgewater Associates, had this to say:

"What concerns me more is the general anger – and almost hate – and the view of bringing people down that now is pervasive in almost all aspects of the country… That general desire to hurt one another is of concern… Yet they remind me a lot of me at that age… I started investing at an early age and I was rebellious and wanted to do it my way and bring it down."

Bill Gross, co-founder of the largest global fixed income investment company, Pacific Investment Management Co., had this to say about the short squeeze*:*

"This is a populist political uprising characteristic of recent U.S. and other foreign elections… the will of the 'common' investor has imposed significant hurt on short-selling, 'unpatriotic' hedge funds that have long profited at retail's expense, not only with their 2/20 fee structure but their financial clout to drive equities up or down and to issue capital calls if only to stay alive to rule another day."

Many would say it is about time Wall Street got a little bit of what they have been dishing out on Americans for years. This is understandable. In 2000, Wall Street shysters knowingly dumped worthless companies on unsuspecting individuals, eventually costing many their retirements. In 2008, it was outright mortgage fraud. From 2009 to the present, Wall Street has used algorithms, high-frequency trading, and user data purchases to front-run "the little guy" by scalping them for profit.

Source: Twitter

Regardless, suffice it to say, this not a typical market with the normal investors or investment rules. We have moved from a world where it once was "when E.F. Hutton talks, everyone listens" to "I got a hot tip from my Uber driver." To be sure, this is no market for fundamentalists.

This is what Reddit CEO Steve Huffman said about recent trading activity:

> *"The advice that I think any savvy investor would give — the advice that Warren Buffett would give, for example — is: Do your own work. Do your own research. And if you don't do your own work, you are investing at your own risk, at your own peril. And most investors... they're all lemmings... The smart ones — they do their own work. Most of them do not."*

Oh, so true…

This is the reality. A grotesque level of speculation has taken us to where we are now. And speculation, is the outgrowth of undisciplined monetary policy. Today, the equity market – rampant with speculation and dare I say, recklessness – has far more in common with Steve Wynn (Vegas) than Warren Buffett (Omaha).

The Fed's misguided attempts to defeat routine consumer price deflation have fueled the destructive build-up of unproductive debt, margin debt and asset bubbles that eventually collapse. History will bear this out.

The last word goes to Carmen Reinhart, Harvard Kennedy School economist:

> *"If there is one common theme to the vast range of the world's financial crises, it is that excessive debt accumulation, whether by the government, banks, corporations, or consumers, often poses greater systemic risks than it seems during a boom."*

Indeed.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Wall Street consensus is bullish, but then again, Wall Street is always bullish. The dominant narrative is everything will return to normal once we are all vaccinated. But if we return to normal, we are talking about low growth, low inflation and low interest rates. As the resident contrarian, and as discussed above, 2021 will likely be a disappointment to those expecting more robust economic growth and inflation.

I also continue to believe we are in a huge financial bubble and the Fed is turning a blind eye to it and its future consequences. If this bubble should burst, it would reverse the wealth effect and slow consumption and economic growth. Should this come to fruition, look for high-quality bonds to be the primary beneficiary.

In terms of portfolio strategy, reduce excess cash reserves, maintain a duration-appropriate, fully invested portfolio of high-quality fixed income securities. In terms of sectors, underweight traditional agency and CDs and overweight the higher yielding MBS and CMO sectors.

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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.