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INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF FEBRUARY 8, 2021

Too Much Stimulus?

"Last year, the average household in the bottom quintile of earners received more than $45,000 of government transfer payments."
– Phil Gramm and Mike Solon,
excerpted from the Wall Street Journal Op-Ed, The Risks of Too Much 'Stimulus'

Total employee compensation in the second and third quarters of 2020 was down by $215 billion compared to the first quarter. Even still, while many Americans lost jobs as the economy closed, the U.S. Federal Government provided over $893 billion in transfer payments. This amounted to four times the compensation lost.

The bottom 10% received more than $45,000. While I truly support helping those who have suffered through this pandemic, let us just say that $45,000 is a hefty sum and doesn't even include all the savings from preventing rent evictions and the benefits from loan forbearance programs. In a nutshell, Uncle Sam borrowed money and stuffed our pocketbook.

Because of the massive transfers of "income" from the federal government to the household sector, real personal earnings managed to expand 5.5% in a year in which real GDP shrank 3.5%. So, as the U.S. economy experienced the worst downturn since 1946, personal income saw the largest increase in 20 years. And get this. All of this occurred before the $900 billion December stimulus took effect.

"A new stimulus is needed to help families at risk of going hungry or losing the roof over their heads." – Treasury Secretary Janet Yellen

Meanwhile, another $1.9 trillion of "stimulus" appears to be on the fast track. If passed, the Biden plan and the December stimulus combined are expected to add another $311 billion a month in personal income.

This added stimulus is coming even as the Fed projects 4.2% growth in 2021, and the International Monetary Fund raised its U.S. growth estimate to 5.1%. The always-optimistic Congressional Budget Office (CBO) raised some eyebrows by boosting its annual average U.S. real GDP growth for the next four years to 1.7% from 0.7%. Now, even without added

THIS WEEK

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stimulus, the CBO expects GDP to return to its pre-pandemic level in mid-2021. I truly hope this GDP projection is right. And yes, it is possible, but not probable.

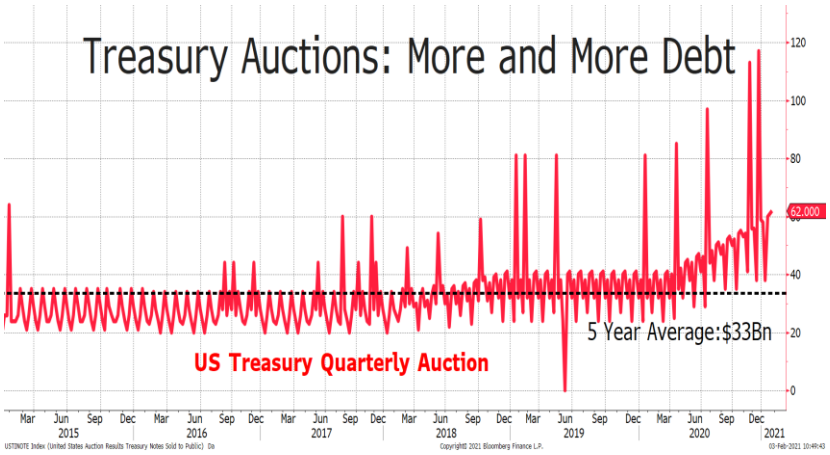
Betsy McKay of the Wall Street Journal penned this little ditty…

Stimulus is all you need

Nothing you can do
But you can learn how to be you in time
It's easy
All you need is stimulus
All you need is stimulus
All you need is stimulus, stimulus
Stimulus is all you need

One thing is certain. President Joe Biden's push for a stimulus bill is sure to increase the amount of government debt going forward. The fiscal deficit is already $2 trillion and heading higher… much higher. Prior to the COVID-19 pandemic, debt was at very uncomfortable levels. Since March 2020, total U.S. debt outstanding has gapped higher by $5 trillion (+18%). Yet, policy makers are acting as if running up the national debt does not matter. Full speed ahead!

As shown on the graph, the Treasury has already significantly boosted its so-called quarterly refunding (two-year, three-year, five-year, seven-year and 10-year notes) in each of the last three quarters. The most recent refunding in November was $62 billion. The five-year average is $33 billion. Never has the economy seen such U.S. government spending and borrowing before, especially in the context of an economy not in recession and not at war and one that appears to be on the mend. In other words, do we really need another $2 trillion of stimulus at this point?

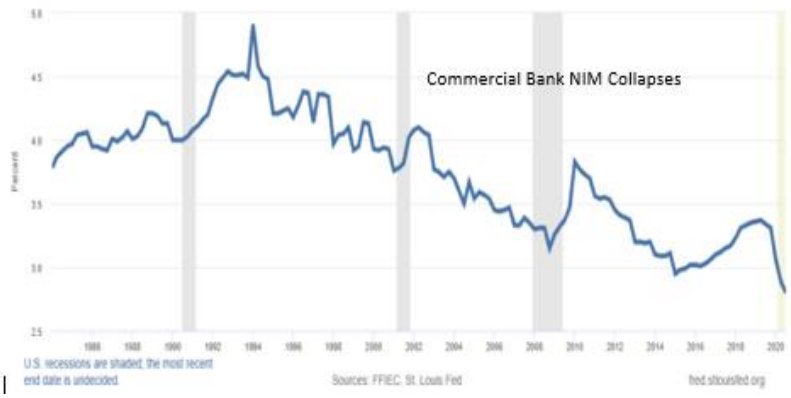


SO WHO'S BUYING?

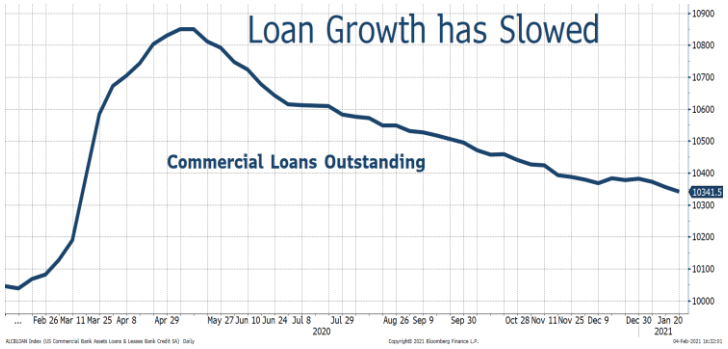
What if there isn't enough demand? Or, more to the point, how high will long-term yields need to go to draw out enough buyers?

One large buyer could be commercial banks (and credit unions), and this is why.

For all the work the Fed has done to encourage lending, the compression in interest rates is putting downward pressure on net interest margins and has reduced banks' incentive to lend. Slashing rates and intervening in Treasury markets to make borrowing cheaper works out well for debtors, but for the banks (major suppliers of credit), it acts to compress margins, especially when the short-term borrowing rates are constrained by a lower bound. As shown below, net interest margins have already been on a downward trajectory for the better part of 30 years but fell off a cliff at the outset of the crisis and are at the lowest ever.

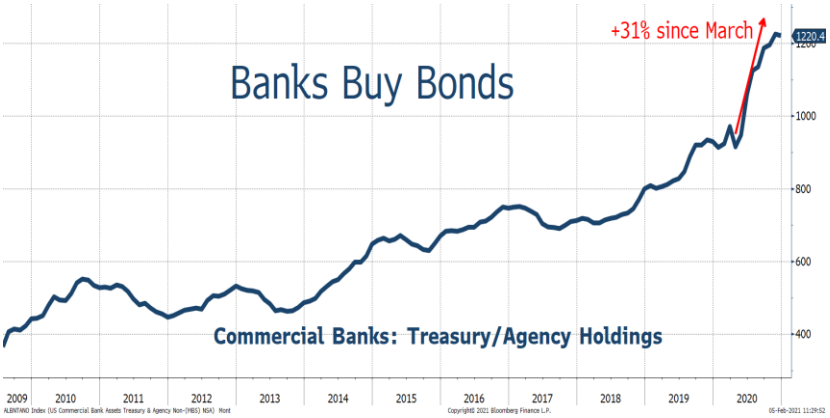


Commercial banks across all sectors have slowed quite significantly despite the best intentions of the Fed to create credit growth.



As shown below, cash balances have doubled to $3.2 trillion since March. Now imagine, with the combination of another round of $1,400 checks and the ongoing $120 billion monthly quantitative easing (QE), how high cash levels might soar.

At $4.4 trillion, the banks now hold more in government paper and cash assets than they have loaned out in mortgages, credit cards, auto loans and all other forms of household loans. This once again reminds the Fed that, while they can lower rates, they can't force banks to lend and borrowers to borrow. The same dynamic has played out in the credit union space where core deposits have skyrocketed 25% to over $200 billion. If loan demand does not pick up soon, this excess cash will need to be deployed. As such, U.S. banks and credit unions have the capacity to emerge as a significant bond buyer.

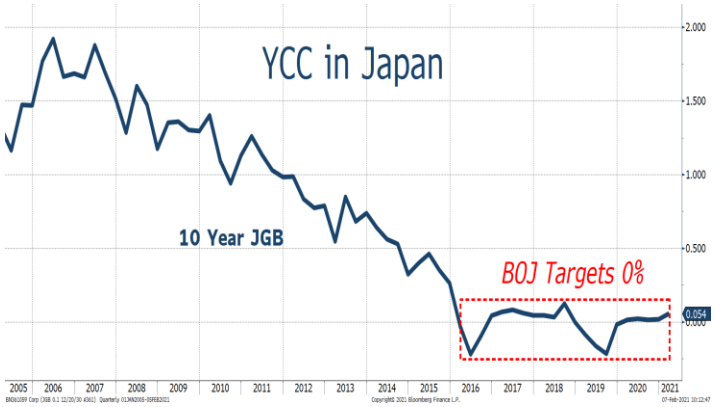


YIELD CURVE CONTROL

"Whether yield curve control would usefully complement our main tools remains an open question."
– Fed Chairman Jerome Powell, Federal Open Market Committee Meeting, June 2021

Many believe that under no circumstances will the Fed allow rates rise to a level that negatively impacts the economy (think housing and autos). If rates were to rise to 2% or above, so would rise debt service costs to problematic levels. Needless to say, it would greatly impact the so-called "Zombie" companies (20% of Corporate America) that exist only because of extraordinarily low rates.

So should rates rise, I see significant probability the Fed will impose some kind of "yield curve control" (YCC) policy on Treasury yields. Under YCC, the Fed would announce it wants, say, the 10-year Treasury yield (or a different benchmark) to be X%, and then would purchase as many bonds as necessary to achieve this.



You say no way. Well, this isn't a new idea. The Fed actually employed YCC during World War II. Today, many other central banks are already doing it. Japan is the prime modern-day example. In 2016, the Bank of Japan (BOJ) added YCC to its ongoing QE and other programs. Ten-year Japanese Government Bond (JGB) yields were fixed in a narrow band around 0%. The BOJ is buying JGB securities in whatever amount necessary to maintain that band.

In fact, the BOJ now owns 43% % of the JGB market (the Fed owns 14% of the Treasury market) and buys practically every bond the Japanese government issues. That's a lot because the Japanese debt-to-GDP ratio is close to 250%. The BOJ's intervention has all but eliminated bond trading by investors. In fact, if the BOJ doesn't show up to the bond market, there is no trading.

But others have followed. In March 2020, the Reserve Bank of Australia set a 0.25% "target" for three-year Australian Government Bonds, later lowering it to 0.1%. This is another form of YCC. Now the European Central Bank is doing something similar.

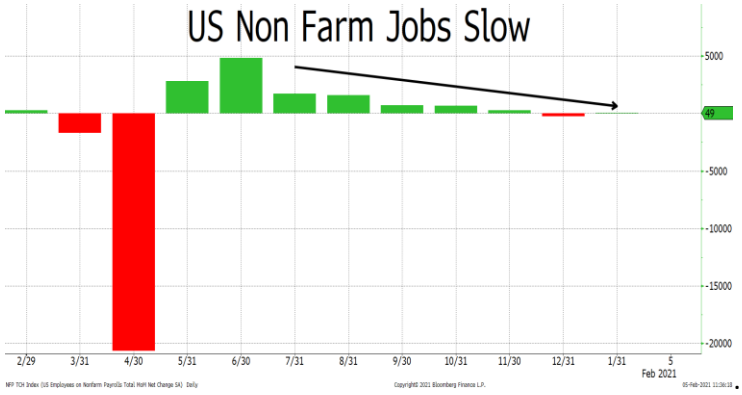
What comes next?

YCC greatly increases the incentives for governments to borrow. The U.S. government has a big agenda to spend on infrastructure, environment, education, etc. None of which we can afford. So, yes, expect more debt. To manage and minimize the cost of this ever-growing mountain of debt, YCC will be firmly back on the agenda. The Fed has few options at hand if it wants to stem a rise in longer-term yields driven by rising inflation risks, which may unseat the equity market and feed negatively into the real economy. Direct action on longer-term yields is more likely if yields keep rising.

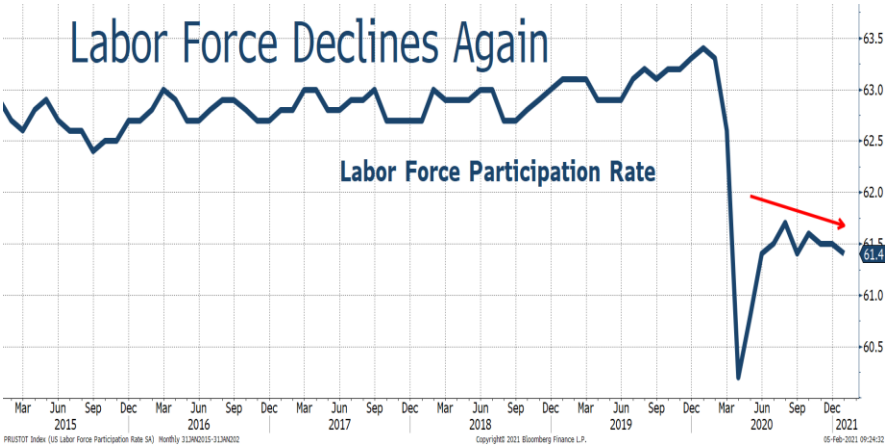
Bottom line: If rates continue to rise to damaging levels (say 2%), look for the Fed to strongly consider YCC. Frankly, with Janet Yellen and Jerome Powell both in the mix, now I think the probability of YCC has risen significantly.

JOBS DISAPPOINT

The most important four-letter word for the economy is "jobs." Following last month's dismal unemployment print, which saw the first contraction in payrolls since April, expectations were high for a solid rebound in January – maybe too solid – and unfortunately, while jobs did grow in January, the final number of +49,000 came in well below the 105,000 consensus estimate. Making matters worse, downward revisions subtracted a total of 159,000 jobs from the past two months.

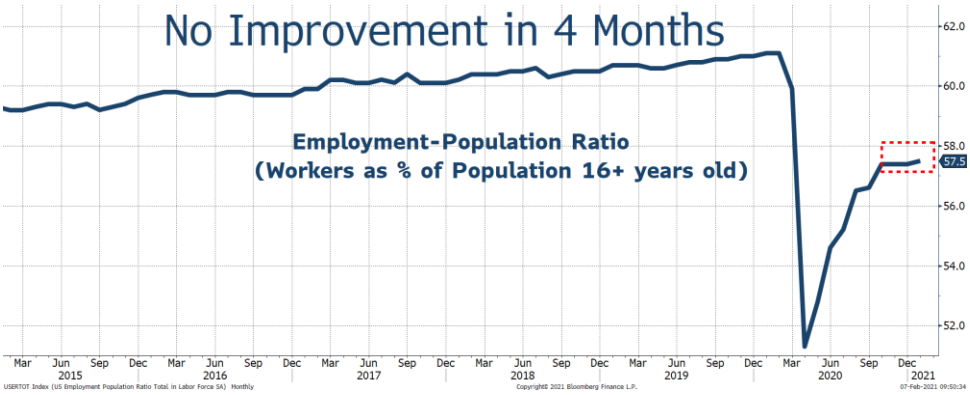


We have only recouped 56% of the job loss, nine months after the employment trough has been turned in. Fully, 75% of the jobs recovery occurred three months from the April low; just 25% in the past six months. That's a way of saying that the easy lifting has already been done.



Yes, the unemployment rate declined to 6.3% from 6.7%, but if not for the massive 406,000 plunge in the labor force, it would have come in at 6.6% or still at least three percentage points above the so-called "full-employment level." Most of the very mild growth came in public education, with just 6,000 jobs in the private sector. If one were to include those Americans who have dropped out of the labor market entirely, or who are underemployed, the real level of unemployment is 23 million. The broader U-6 rate is over 11%, which is more real-world.

The employment-to-population ratio, which is far broader and covers the working-age population (16 years or older), at 57.5% has barely budged over the past four months.



At the same time, layoff announcements keep piling up. The Challenger data came out for January and showed an increase in pink-slip announcements of 79,552, a three-month high and the highest for any January since 2009. On average, January sees 57,000 layoffs, so the current number is 40% above the norm for this time of year.

Some of the job losses are temporary. But others are long-term and structural. The number of permanent job losses jump 4% in January to 3.5 million. This is nearly triple the 1.3 million prior to the pandemic shock. These jobs aren't coming back. The number of people who have been unemployed for at least a half-year also rose 1.7% to over four million. This is almost a four-fold increase from the pre-pandemic norm of 1.2 million. Many of these folks are not going to be re-employed, either. We are talking about a minimum long-term job loss of four million, or nearly the equivalent of two years' worth of labor destruction.

This is why the job recovery will be challenging. First, while employment at restaurants will come back, employment at hotels, the entire travel industry and supporting sectors face a structural issue. Businesses have learned to hold meetings without getting on a plane. The corporate cost-cutters are now on top of that, and the profit motive is driving it. There will always be business travel, but much of the travel done before has now been revealed as replaceable by virtual meetings.

Another example is employment at some brick-and-mortar retailers, which will continue to decline, having been taken out by ecommerce, as stores will continue to close. Yes, the ecommerce industry will continue to add jobs – from coders and robotics specialists to warehouse workers – but those are not the same jobs as those in brick-and-mortar retail.

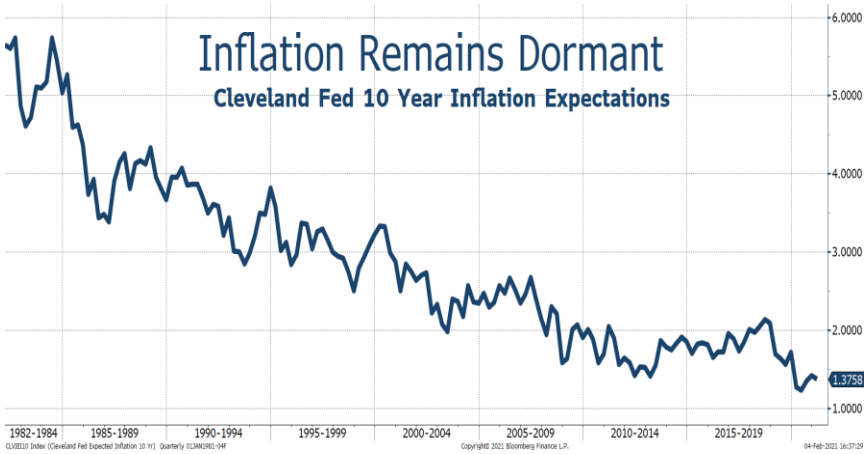
I recommend a read of the Wall Street Journal article, "*Toll Worker Job Losses Highlight Long-Term Fallout of Pandemic.*" The article is about workers at the Pennsylvania Turnpike who were laid off and will not be coming back due to the switch to labor-saving technology This is very likely becoming a broader trend within the corporate world – big and small companies alike. I'm guessing the accelerated pace of automation during the pandemic is not well appreciated by those who think the labor market is going to stage a meaningful comeback. If it took seven years for the labor market to fully heal after the Great Financial Crisis, how long do you think it will take this time around? (Spoiler: Longer).

The pandemic has shaken corporate thinkers out of their routines and habits, and consumers have changed, too. When you look back at prior recessions, each has had a lasting impact on how the economy operates. But the pandemic has triggered shifts in thinking that are far larger than in the prior two recessions. Some of those changes will impact the employment situation for years to come. The healing process will take years, not months or quarters. This promises to be a tough slog.

A BROKEN RECORD

With all the money printing and rock-bottom interest rates, inflation must be around the corner, right? A growing legion of analysts believes excess fiscal stimulus, on top of a tinderbox of monetary expansion, will generate rising prices and eventually higher interest rates.

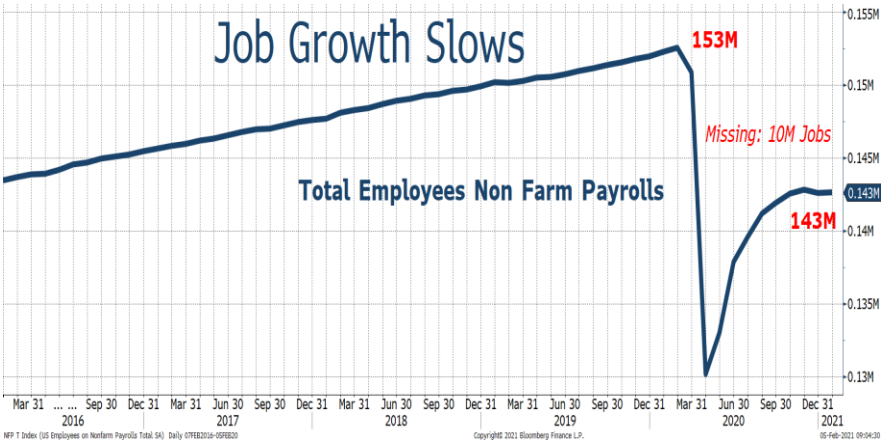
Yet, as shown below, long-term inflation expectations remain dormant.



To be clear I am not suggesting that a bout of inflation will not come back near-term. We are seeing supply bottlenecks, rising commodity prices and a weaker dollar. All of which could create a higher level of inflation. There are pockets of inflation where there are material shortages, to be sure, but the disinflation across wide swaths of the service sector are dominant. One example is car insurance rates, which are declining nationally at a 4% annual rate, the first such deflation in seven years.

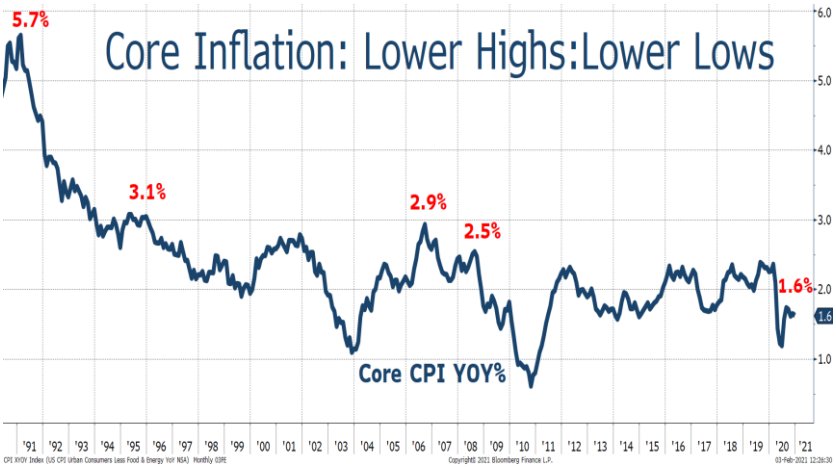
There is also some reason for concern as the Fed is firmly committed to maintaining an accommodative stance, keeping rates low well into the recovery. But the bigger question is: can any price gains be sustained? Technology, globalization and negative demographics serve as significant structural headwinds against a secular rise in inflation. Further, unlike the rising trend of inflation in the 1970s, the impact of unions on wages is nonexistent. Thus, the ability to mandate higher wages and cost of living adjustments are not available to perpetuate a wage-price cycle.

As discussed above, only 50% of the prior job detonation has been recouped. At January's pace, it would take five years before we get back to the pre-crisis level of employment. This is a big reason why I find it tough to believe that inflation will emerge as a pervasive problem — the excess capacity in the jobs market isn't going away for a very long time.



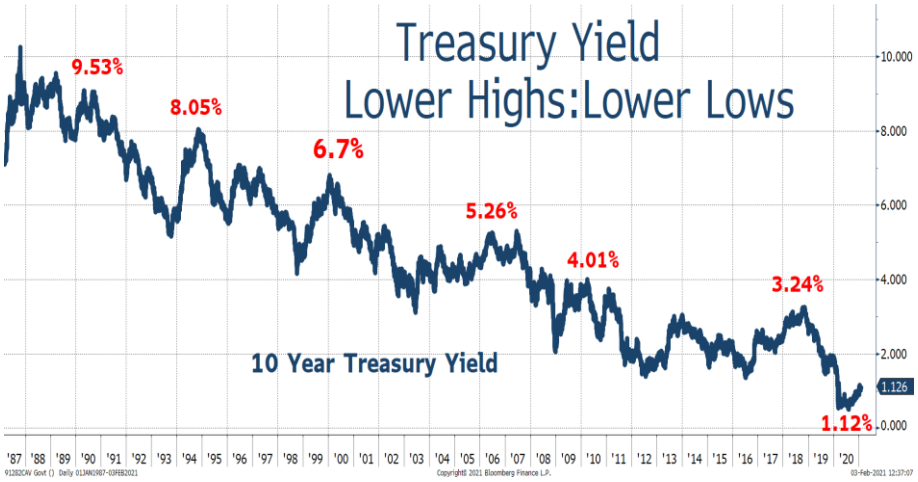
In the final analysis, it is the massive debt overhang that has kept a firm lid on inflation, cycle in and cycle out. Total all-economy debt at $82 trillion is now 4x GDP. The correlation between velocity of money and the total level of outstanding debt has always been negative, but not like it has over the past three years, which is -97%. The cost of servicing the ever-growing debt burden is unprecedented, yet we continue to fight recessions with more and more debt.

Take a look at the long-term trend of inflation in the graph below. We see lower highs and lower lows in the core inflation rate over the past 30 years. Over time, the peaks in core inflation are getting progressively lower. And each cycle, the Fed is engaging in an ever-increasing volume of firepower. All core inflation does is peak at lower and lower levels for a range of structural factors. Every recession is followed with weaker and weaker economic phases. And so it goes.



Thus, the massive build-up in debt will cap economic growth and inflation in the ensuing expansion. Until we redress this debt morass, inflation has no staying power. Full stop.

As inflation has declined, so have long-term Treasury yields. Along with lower peaks in both core inflation and growth, the peaks are getting lower and the lows are getting lower each cycle.



Yes, for the reasons mentioned above, I would not be surprised to see a blip in inflation and bond yields. It has happened numerous times over the secular bull market in bonds. This too shall pass. Like I have said previously, if you look at the long-term graph of interest rates from 1987 through today, the 10-year yield has risen a cumulative 20,000 basis points. But over the entire period, rates have declined from 10% to a smidge above 1%. More recently, from 2009-2019, the 10-year yield rose 5,000 basis points of cumulative daily increases. Yet, at the end of the day, the 10-year yield declined 150 basis points. So if you are a trader and feel you can time the short-term cyclical moves, by all means, go for it. But as asset liability risk managers, we should all be looking past the trees to see the forest.

Bottom line: Inflation has come and gone. These upticks are simply deviations on a long-term trendline. Until the secular patterns of lower lows and lower highs on bond yields are broken, this remains a fundamental bull market in Treasuries.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

If we get the stimulus package, some on Wall Street are calling for 10% real U.S. growth in the second quarter (Q2) and 7.5% in the third (Q3). Thus, as Treasury supply mounts, coupled with concerns over rising inflation expectations, the bond markets have been spooked of late. The yield on the 10-year Treasury note is up around three basis points, to 1.19%. Overnight, the long bond touched 2.0% for the first time in a year. The catalyst here were comments by Janet Yellen that the U.S. is on the verge of retaining full-employment status with more fiscal stimulus on its way.

The yield curve has also steepened dramatically, telling you that the bond market has joined the stock market in discounting a big reflation-recovery trade. At a 109-basis-point spread for the 2s/10s, we have the widest gap since April 5, 2017.

As for 10-year Treasury yields, we are now just 20 basis points shy of where they were back in July 2016. Back then, the output gap was 1.3%, not 2.3%. The U-3 unemployment rate was 4.8%, not 6.3%. The U-6 jobless rate was 9.6%, not 11.1%. The employment-to-population ratio was 59.8%, not 57.5%. The participation rate was 62.8%, not 61.4%. The core inflation rate was 2.2%, not 1.6%. And the Fed was in the early stages of a tightening cycle, not pledging to pin the funds rate at zero for the next three years, so the “carry” is so much more constructive today.

I could go on and on but this bond sell-off is overdone. Yes, it may need a catalyst for yields to reverse lower, but I recommend patience. In the interim, it is difficult to say what news there will be to drive yields higher from here, and we are already in overshoot territory. But at this point, there is simply no case for a secular bear market. Remember, with the Fed on hold and the yield curve steepening, no sector benefits more from this recent steepening than banks and credit unions. By extending out the curve, credit unions can enhance their spread versus excess cash reserves, earn additional income and enhance their net interest margin.

In terms of portfolio strategy, the recent sell-off presents an attractive re-entry point for bond investors. Credit unions should continue to 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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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.