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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF FEBRUARY 16, 2021

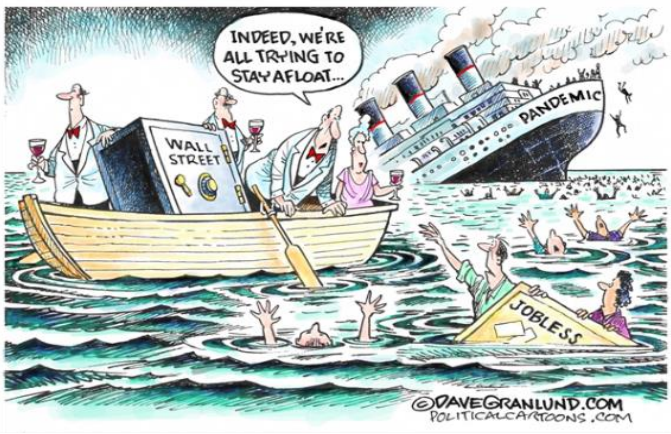
Momma, Let Your Babies Grow Up to Be Hedge Fund Managers

"The top 15 earning hedge fund managers earned $23 billion of compensation in 2020."
– Bloomberg News

Wow. Suffice it to say, the COVID-19 pandemic has not hurt hedge fund managers.

While hedge fund managers, may be an extreme example, the top 10-20% of wealthiest Americans have financially benefited from the COVID-19 pandemic, while many in the bottom 80% have been hit the hardest through job loss and lost wages. Thus, the COVID-19 pandemic has further increased the gap between the "haves" and "have-nots."

The income/wealth inequality divide in this country is not a new theme. It has been discussed numerous times in this space and elsewhere. The reason I keep coming back to this topic is because a wide and growing dispersion of income and wealth has had and will continue to have a knock-on effect on economic growth and potentially even political and social unrest.



Let's look at some data.

In 2019, those in the top 1% were raking in nearly 20% of all pre-tax income nationally. To put that in perspective, 50 years ago it was 10%. Meanwhile, the bottom 50% have seen their share decline from 21% to under 14%. This is the widest level of inequality since the Robber Baron days in the 1930s.

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The Gini Index, a measure of how far the country's income distribution deviates from total equality, reached 0.45 at the end of 2019, making the U.S. the third-most unequal country within the Organisation of Economic Co-operation and Development (OECD), behind Mexico and Chile.

The same story is true when comparing wealth data. According to Federal Reserve data, the top 1% of Americans hold a combined net worth of $34.2 trillion while the bottom 50% of the population hold just $2.1 trillion. In other words, the top 1% have 15X more wealth than the bottom 50% combined. It is good to be king!

One of the primary reasons for this growing wealth dispersion has been the Federal Reserve. The extreme, ultra-loose monetary policy (recently exacerbated due to the pandemic) was and is designed to drive asset prices higher to create a wealth effect. According to the "Masters of the Universe" inhabiting the Eccles Building, the so-called wealth effect would fuel consumption and drive economic growth higher.

However, inflated asset prices have accrued to the wealthiest tranches of the population. To wit, the wealthiest 1% of households hold more than half of all equity wealth while the bottom 50% hold less than 1%. In a nutshell, those who own financial assets have been the primary beneficiaries of the Fed's generosity. This is part of a much bigger and consequential disconnect between the economy and financial markets, or what is commonly referred to as "Main Street versus Wall Street."

But here's the problem. The lower income segment of the population, which is more likely to spend a financial windfall than save, is seeing fewer benefits from the equity boom than the wealthy. The wealthy have a proclivity to save and not spend. After all, how many Teslas does one need in the driveway?

In other words, there is more money flowing into the hands of those who do not spend it (i.e., the high-income asset-owners) than those that will spend it. This translates into a continued drag on gross domestic product (GDP) as consumers who have the propensity to spend tighten their belts in the face of a challenging job market recovery.

NOT LIKLEY TO CHANGE

Over the past 40 years, labor income as a percentage of GDP has been on a secular decline. However, what started out as a gradual drawdown from the 1960s through the 1990s, turned into a complete collapse after the tech-induced productivity boom of the 1990s. Since the internet revolution, companies have adopted technologies that have allowed

them to capture record shares of the value generated by the economy. Thus capital has benefited at the expense of the labor markets.

Accelerated automation is a secular theme. As we emerge from this crisis, this trend toward automation is likely to not only continue but accelerate as firms look to further automate business processes. This will lower labor costs, boost profit margins and help mitigate future pandemic risks (robots do not get infectious diseases). This is another way of saying corporations have figured out that they can produce more (or the same) with less labor.

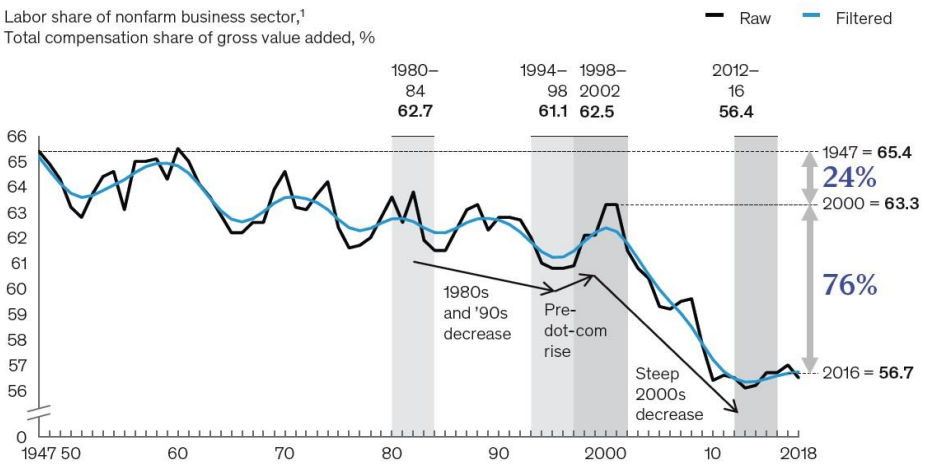
Today, as a result of the pandemic, over four million Americans have exited the labor force and nearly 10 million low-skilled workers are still out of a job. According to Brookings Institute, one of the industries most prone to automation will be the accommodation and food services sector. As we are painfully aware, this industry has been ravaged by massive shutdowns with employment down three million since the onset of the pandemic (an epic 21% year-over-year contraction).

The cruel fact is the service sector – that employed millions of low-paid people pre-pandemic – is likely to be the one most affected by automation. Sadly, those who are being displaced by robots and machines will struggle to gain employment. Nothing like kicking a person when he is down on his luck.

Exhibit 2

Three-fourths of the decrease in labor share in the United States since 1947 has come since 2000.

The accelerating decline in labor share in the United States



[1] Detrended using Hodrick-Prescott filter (restriction parameter = 6); adjusted for self-employed income (non-farm business sector, 75% of total economy), from Labor Productivity and Costs database, Bureau of Labor Statistics.

Source: BLS (March 2019 release); McKinsey Global Institute analysis

INFLATION, WHERE IS THY STING?

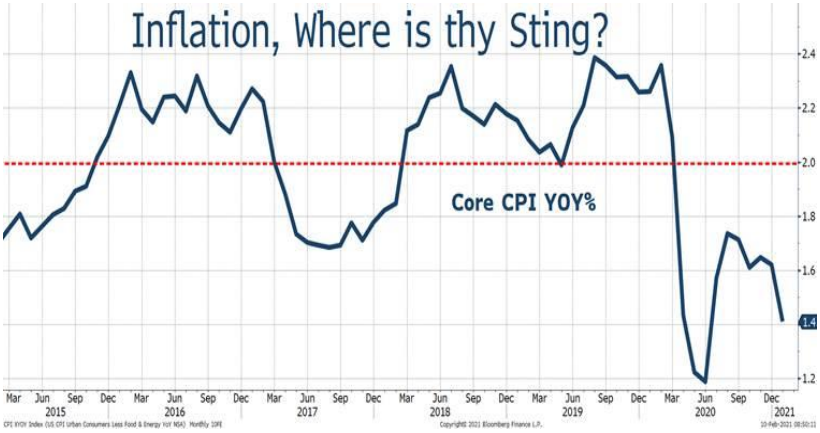
"Monetary policy would remain very accommodative until there was substantial further progress on employment and inflation." – Fed Chair Jerome Powell

Everyone has inflation on the brain. It's as if you can just snap your fingers and it comes. Think about this: rates have been zero for the greater part of the last decade and the Fed's balance has been growing steadily. The government spending spree has taken the U.S. budget deficit to $736 billion through the first four months of the 2021 fiscal year – oh, only up 89% from a year earlier. For the 12 months ending January, the deficit totaled $3.47 trillion, or 16% of GDP.

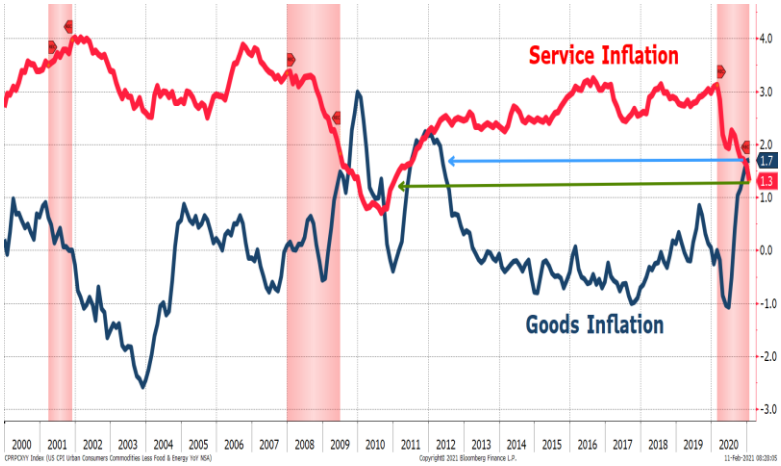
For comparison, former President Franklin Delano Roosevelt (some called him a socialist) never ran a deficit north of 7.5% of GDP, and that was with all the New Deal spending (and at least that put people to work instead of paying them not to work).

Yet, despite the massive monetary and fiscal stimulus, the measured rates of inflation have remained well below the Fed's target of 2%. Last week, the latest inflation metrics still showed no acceleration in prices.

The headline Consumer Price Index (CPI) rose for the eighth straight month in January, yet year-over-year prices have risen 1.4%. More importantly, core CPI missed expectations, unchanged in January, versus an expected 0.2% month-over-month rise. The data highlight once again the enormous contrast between the reported inflation and the one for asset prices.



It should be noted that even though overall inflation is tame, "goods" inflation is soaring, now at its highest since April 2012, with services inflation at its lowest since 2010. That said, the U.S. is a service-based economy, and the trajectory of service prices drive the overall inflation rate.



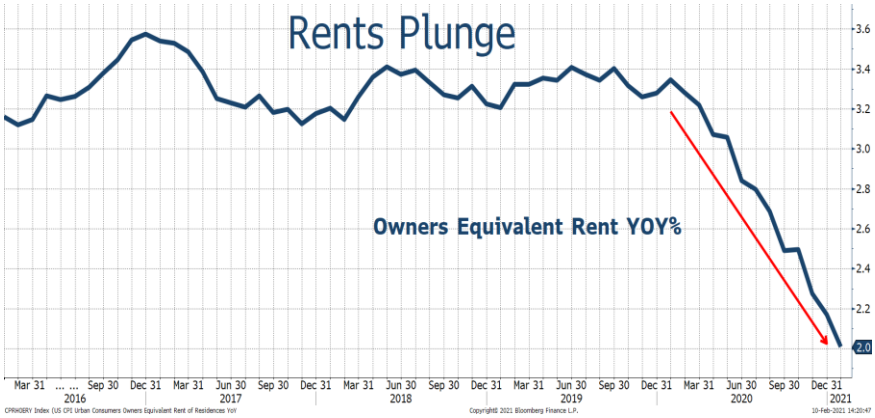
RENTS PLUNGE

"You've got to keep sweetening the pot…to temper the decline."
– Jonathan Miller, President of Miller Samuel

On the bright side for many, shelter/rent inflation continues to slow.

The work-at-home theme continues to dominate the rental business as tens of thousands of city dwellers have moved to suburbs or rural communities to escape the metro areas' socio-economic implosion.

In Manhattan, apartment landlords are resorting to the largest concessions ever – a whopping 2.3 months of free rent – to fill the cavern of empty rental units. Listings are almost triple what they were a year ago, with vacant inventory rising to 12,477 units. Overall, the vacancy rate in large cities is 7% and median rents are down 19% year-over-year to $2,812. While it's true rents are climbing in small cities, Detroit and Phoenix do not quite make up for New York and San Francisco.

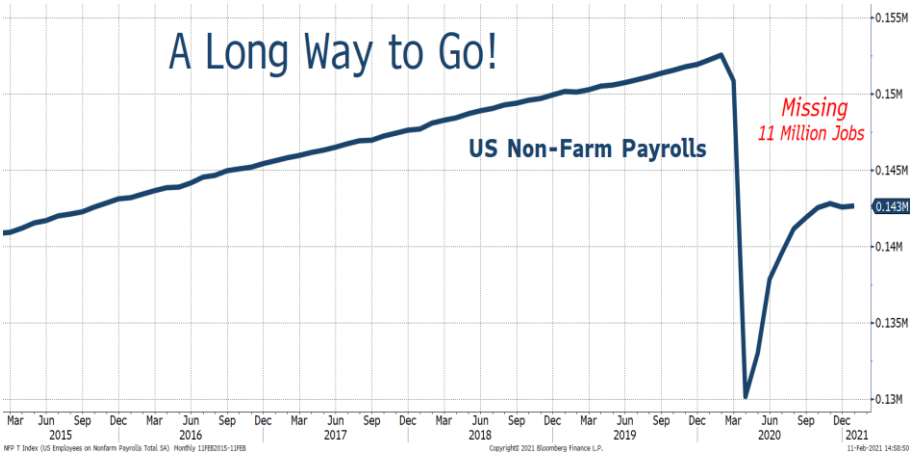


A LONG WAY TO GO!

"Published unemployment rates during COVID have dramatically understated the deterioration in the labor market."
– Fed Chairman Jerome Powell, Economic Club of New York

Last week, Fed Chair Powell explained that the latest 6.3% unemployment rate is not indicative of the economic reality and underlined that the U.S. economy is 10 million jobs down from where it was a year ago. He believes the real unemployment rate is over 10% today.

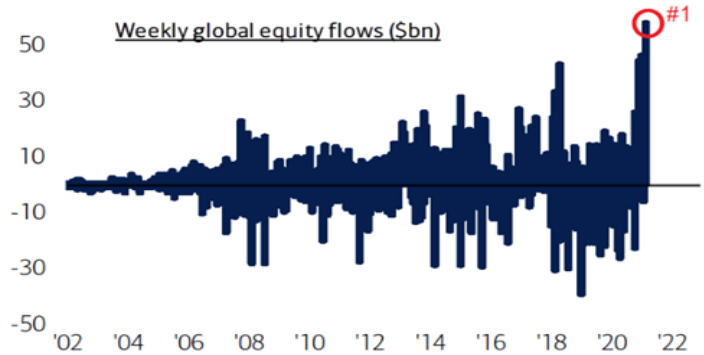
He has stated that he will remain accommodative until we reach 4%, the level the Fed considers full-employment. So, how long will it take? To replace all these lost workers by year-end 2022 (which is when consensus expects the first rate hike to take place) and accounting for natural labor market growth, we will need an average payrolls figure of over 500,000 every month through next December. **S**ince it is virtually assured that the U.S. economy will not be adding half a million people per month for a long time, it is safe to assume that the Fed's rate hikes, as per Powell's guidance, have been put on indefinite hold.



THE MANIA

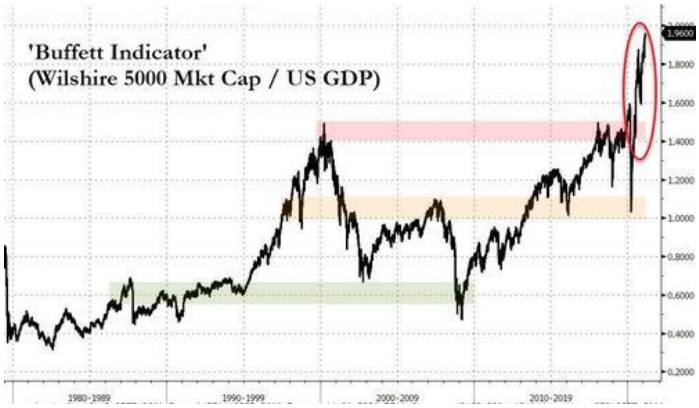
"The public buys the most at the top and the least at the bottom." – Bob Farrell

Investors poured a record amount of money into equity funds. Likewise, Bank of America's gauge of market sentiment – the so-called "Bull & Bear" indicator – is approaching levels of extreme bullishness. According to JPMorgan, investor complacency is at a two-decade high.



Source: BofA Global Investment Strategy, EPFR Global

As discussed previously, valuations remain off the charts and continue to be stretched higher. The "Buffett Indicator" is a simple ratio: the total market capitalization of U.S. stocks divided by the total dollar value of the nation's GDP. It first crossed above its previous dot-com era peak in 2019. Now, with U.S. market cap more than double the level of estimated GDP for the current quarter, the ratio has surged to the highest-ever reading. Glance at the following chart and Buffett's most-famous catchphrases comes to mind: investors should "be fearful when others are greedy."



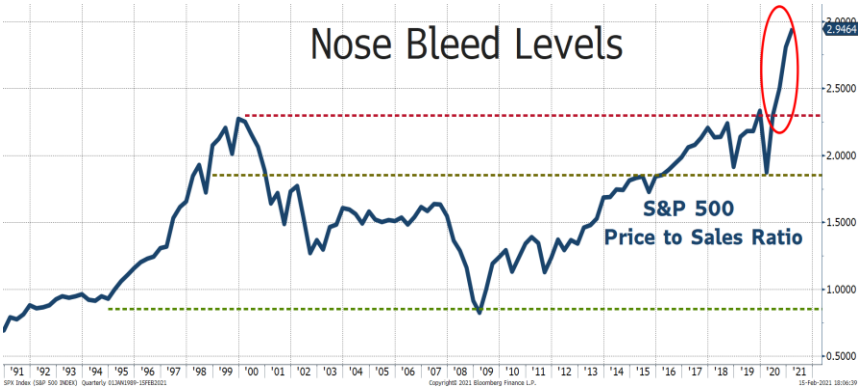
Source: Bloomberg

This detachment of the Buffett Indicator joins a myriad of other valuation metrics that have exceeded their previous records in the rebound from the pandemic-induced bear market last year – if not years earlier. Price-to-earnings and price-to-sales are among the metrics firmly above dot-com era levels that many investors assumed were once-in-a-lifetime peaks.

The central banks have turned the markets into a commodity. The market is not hostage to the real economy or corporate fundamentals. Instead, liquidity is possibly the only thing that matters. As such, historical valuations become increasingly irrelevant, and price momentum is the only thing that matters.

And for those who continue to claim that "valuations don't matter, and low rates mean 'There Is No Alternative' (TINA) than stocks" may have been pleased to hear Fed Chair Powell last week reiterate that the central bank's extreme emergency manic-panic-frantic stimulative policies will not be reeled in anytime soon.

"When growth is above trend, monetary policy is ultra-loose and fiscal policy is on overdrive, markets tend to exhibit the financial variant of Newton's Law: they stay in motion until acted upon by another force."
– JPMorgan Market Strategist



Who am I to call the "top," but I do know whenever these markets revert to the mean it will be fast and furious. In other words, markets do not correct by going sideways. That said, the Fed sees no bubbles and has seemingly given investors a green light to buy with impunity. Frankly, as long as the Fed keeps applying the opioid of cheap and abundant money, markets can go higher. Heck, maybe much higher.

"Fortunes are made by buying low and selling too soon"- Nathan Rothschild

My view: enjoy the ride, but also remember why these markets have reached such heights and understand the risk involved. This mania may end sooner than everyone realizes, "stuff happens", and always when we least expect.

The bottom line: risk management is paramount in these liquidity driven markets.

DASH FOR TRASH

"Investors are so hungry for lower-rated offerings they're calling up companies and asking them to borrow."
– Bloomberg

High yield has gone totally nuts.

Over the past three decades, high-yield corporate debt has averaged 9% and 13% in recessions. Yet, today, despite a supply deluge, the yield on the Bloomberg Barclays U.S. Corporate High Yield Index has dropped to a record-low 3.2%. But here's the thing. In the best of worlds, junk bonds tend to produce 3-5% losses over the business cycle. Does anyone think junk bonds with a yield of 3% compensate for the inherent risk?

Regardless, investors are piling into speculative-grade bonds as if there is no tomorrow while issuers are literally laughing their way to the bank as investors line up to buy this junk. New junk bond issues through February 3 topped $55 billion, a figure which towers above the comparable period all prior years including the pre-COVID-19 boom last year. In this dash for trash, companies rated in the riskiest CCC lowest non-investment grade tiers have set records for new issuance so far this year. It's party time for zombie companies. Or in the municipal arena, consider that junk-rated Chicago Public Schools and the city of Detroit just floated issues at yields of less than 2%. What insanity.

Needless to say, this avalanche of junk is great news for zombie corporations (20% of Corporate America), which will be able to obtain cheap access to cash, allowing them to continue their cash burning existence for another year or two or even longer.

But there are consequences. Debt-ridden zombie companies are the very inverse of Schumpeter's "creative destruction." Rather than permitting the free market to cleanse the economy of inefficient and uncompetitive business operations, the Fed's drastic interest rate repression allows them to stay alive, thereby impairing the reallocation of labor and capital to more efficient companies, which drives capitalist prosperity. If the Fed wanted higher growth and higher inflation, they would do less intervention (picking winners and losers) and allow the free markets to work their magic.

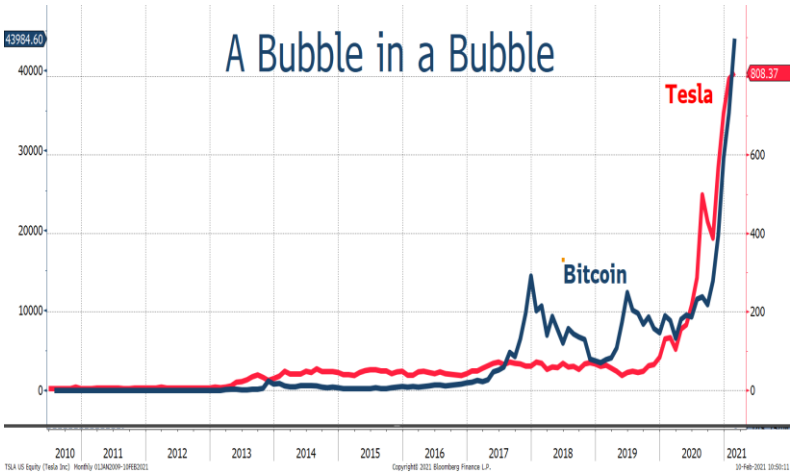
Regardless, here we are today. "High yield" has become "low yield" and reflects nothing more than the speculative frenzy of the liquidity-driven hordes. So as much as I believe that the U.S. equity market is extremely overpriced as an asset class, the corporate bond market is even more overvalued.

BUBBLE WITHIN A BUBBLE?

"What value does cryptocurrency add? No one's been able to answer that question to me." – Steve Eisman

In a modern-day example of the Greater Fool Theory, Tesla announced it is making a $1.5 billion investment in Bitcoin and will begin accepting the digital token as a form of payment for its electric cars. Bitcoin then soared to a new record-high of over $48,000.

Amazing. Tesla buying Bitcoin. One bubble chasing the other. Remember, despite its cult following, Tesla commands a tiny fraction of the global auto market, yet it is now worth more than 6X the combined value of GM and Ford.



Bitcoin maintains its allure as an alternative to fiat currencies. The bulls say, unlike the fiat currencies, Bitcoin is designed to have a fixed supply of 21 million coins. Unlike the U.S. dollar, euro and yen, central banks cannot print new Bitcoin. Even still, there are no barriers to entry to cryptocurrencies. What happens if new competitors arrive?

Besides, does anyone really use Bitcoin for any other reason than for speculative purposes? Maybe Bitcoin is useful as a means of payment, but how can it be a store value when it is so volatile?

"It's gold for nerds." – Stephan Colbert

Some believe that Bitcoin is digital gold. But I wonder if Bitcoin will go down in the history books as the "digital tulip?" I say sell it to the folks who bought GameStop, which has lost 88% in the past two weeks.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"When all the experts and forecasts agree, something else is going to happen." – Bob Farrell

The view of booming growth, inflation and rising yields has become a widespread consensus, which, according to Bob Farrell's market rules, means something else is going to happen.

From President Joe Biden, to Treasury Secretary Janet Yellen, to most members of Congress, there is a demand for more "stimulus."

Suppose Congress passes the $1.9 trillion in immediate relief for multiple segments of the population. In that case, that will bring the cumulative amount of fiscal stimulus in the past 12 months to $5 trillion or almost 25% of GDP. Nothing in modern times comes close, especially during peace times.

The problem with monetary interventions, like direct checks to households, is that while it may provide a short-term bump in spending, it does not promote confidence. The reason that stimulus payments don't improve consumer confidence is due to the understanding that such payments are a one-time benefit. This explains why much of the prior stimulus checks went towards reducing debt and building savings. The key to economic prosperity and confidence is employment and wage increases.

The biggest problem with more artificial stimulus is the increase in the debt required to fund it. Take a look around the world. Never have increased debt levels lead to more robust rates of economic growth or prosperity. Since 1980, the overall increase in debt has surged to ungodly levels. Yet, U.S. and global economic growth are now at the lowest levels on record. As discussed in this space *ad nauseum*, the increase in debt continues to divert more tax dollars away from productive investments into the service of debt and social welfare.

Thus, the additional stimulus will stave off a more in-depth economic contraction, but these programs likely provide only a short (a quarter or two), transitory GDP boost. Its impact becomes less and less over time. There are numerous examples from Japan, Europe and here in the U.S. The 2018 tax cuts, for instance, pushed GDP above potential for a little while but by 2019 the effect had largely faded.

Worse, these programs actually have a "negative" multiplier once the effects play out over a few years. The new debt issued to pay for them weighs on growth and the economy is worse than ever. Raising taxes wouldn't help, either. Both taxes and government debt divert money out of the private sector. This is ultimately the problem with all debt-supported fiscal and monetary programs.

Thus, while mainstream economists believe more stimulus will create lasting robust economic growth, no evidence supports the claim. Yes, we will get a short-term burst and inflation and interest rates could be pressured higher. However, such will quickly collide headlong into the massive debt levels overhanging the economy, which will continue to retard economic growth. Coming out of the 2020 recession, and after the initial stimulus boost, I believe the economic growth trend will revert to what we had experienced prior to the pandemic. In other words:1.5-2% growth.

From a portfolio perspective, near term, the path of least resistance appears to be higher long-term rates and a steepening of the yield curve. The 10-year Treasury yield has risen over 50bps since mid-2020 and currently sits at 1.265%. That is a post-COVID-19 high and the bears are currently in control. On a technical basis there is nothing stopping yields from rising (as in, 2% on a near-term basis is not out of the question). The long bond has already blown through the 2% barrier. The long bond is over 2%. The 2s10s spread is now 110bps, the widest spread since April 2017.

At some point these higher rates will weigh heavily on the economy (think housing) and may prove to be the pin that bursts the lovely equity bubble.

Also in Powell's speech last week, he reiterated the message rates would stay low. So, inquiring minds wonder how long before the Fed openly intervenes to push rates lower on the long end of the curve.

With the Fed on hold, banks and credit unions are well positioned to benefit from higher rates and a steeper yield curve. As such, we continue to encourage credit unions with excess cash reserves to continue to dollar-average into the recent market weakness by investing in a risk-appropriate, diversified ladder strategy.

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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.