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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF FEBRUARY 22, 2021

Thank You, Uncle Sam

"Fugayzi, fugazi. It's a whazy. It's a woozie. It's fairy dust. It doesn't exist. It's never landed. It is no matter. It's not on the elemental chart. It's not [bleeping] real."
– Mark Hanna in *The Wolf of Street*

Despite consumer sentiment in February sagging to a six-month low, households wasted no time in spending the giveaway from Uncle Sam. Retail sales boomed 5.3%, well above the consensus forecast of +1.1%. In just one month, consumers bought almost as much as they did cumulatively from May to December of last year.

The internals were robust with every sector from electronics to autos posting strong sales:

- Electronics: +14.7% (fourth strongest on record)
- Furniture: +12.0% (third strongest of all time)
- Online sales: +11.0% (second best result ever)
- Sporting goods, books & music: +8.0%
- Restaurants: +6.9%
- General merchandise: +5.5%
- Clothing: +5.0%
- Building materials: +4.6%
- Food stores: +2.4%
- Health and personal care: +1.3%
- Motor vehicles: +1.3% (up in five of the past six months)

THIS WEEK

- PRODUCTION POPS
- GDP TO SURGE!
- HOW MUCH FUGAZI?
- COMMODITY PRICES BOOM
- PPI RISES

PORTFOLIO STRATEGY

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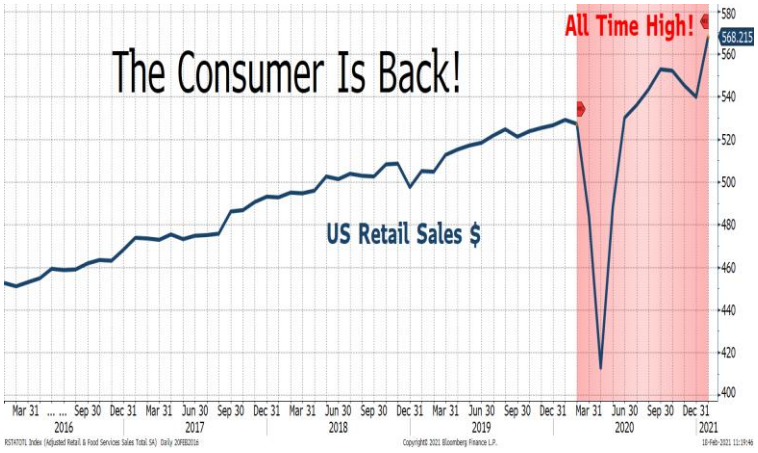
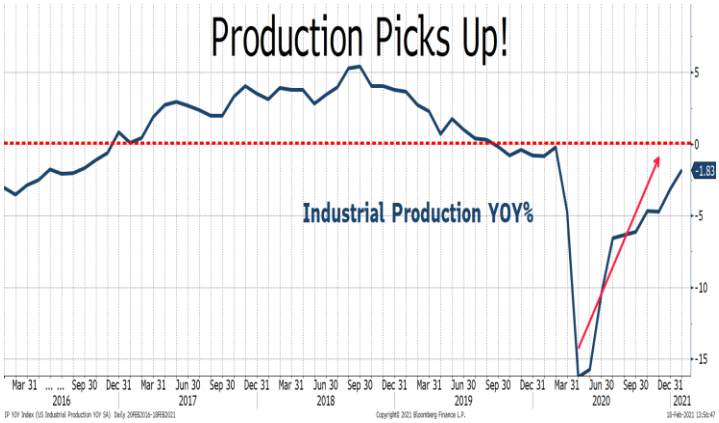
Amazingly, retail sales have now recovered the severe losses over the past three months and now sit at an all-time high. While most of the prior stimulus has been spent, there is more coming and double what was doled out in late December.



PRODUCTION POPS

In addition to the retail sales data, the report on January industrial production surprised to the high side. Output more than doubled consensus views with a 0.9% bounce (the expectation was +0.4%). The three-month trend is now running at a +13.3% annual rate.

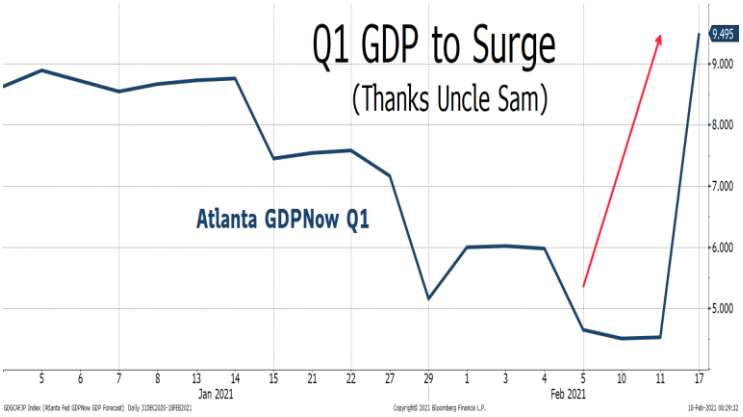


GDP TO SURGE!

It was not so long ago (say 3-5 months) that the gross domestic product (GDP) outlook was for a decline in the current quarter. Scratch that. The much stronger-than-expected retail sales combined with the better-than-expected industrial production data suggest a very strong first quarter GDP report. Just last week, the Atlanta Fed GDP Nowcast model was revised higher from 4.5% to a ripping 9.5% annualized real GDP. Economists are now aggressively upwardly revising growth expectations for 2021 with the Wall Street consensus now up to 6% or higher.

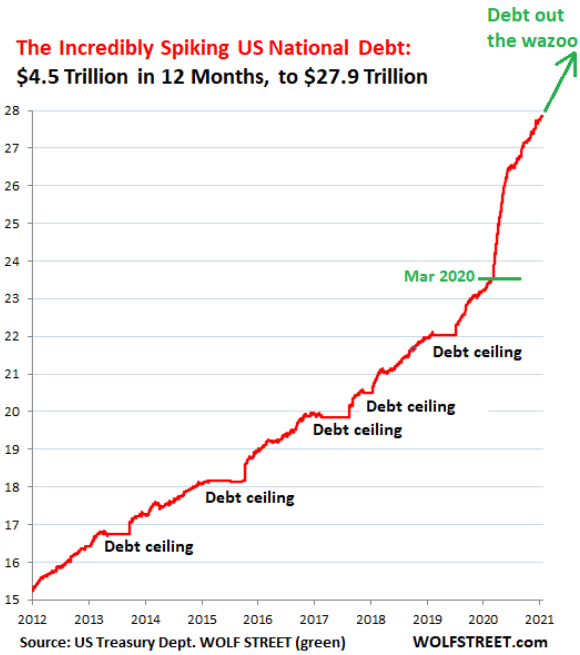
Even with approximately 20 million Americans unemployed or underemployed, growth is surging. While this is indeed welcome news, the bigger story is that all of this is happening on borrowed money from the government. Make no mistake, as we get even more stimulus and the reopening phase gathers steam, there is bound to be more follow-through.

These transitory rounds of stimulus checks are providing the glue ("fugazi") for this recovery, but this is artificial and not long lasting. Remember, the "stimulus" is like your boss giving you a bonus one year to only then take it away the next year. That money spent in year-one comes with a hangover in year-two. That's why there is no such thing as a free lunch.



HOW MUCH FUGAZI?

Driven by stimulus and bailouts and fired up by the tax cuts and grease and pork, the U.S. national debt has skyrocketed by $4.55 trillion in 12 months, to $27.92 trillion, after having already spiked by $1.4 trillion in the prior 12 months.

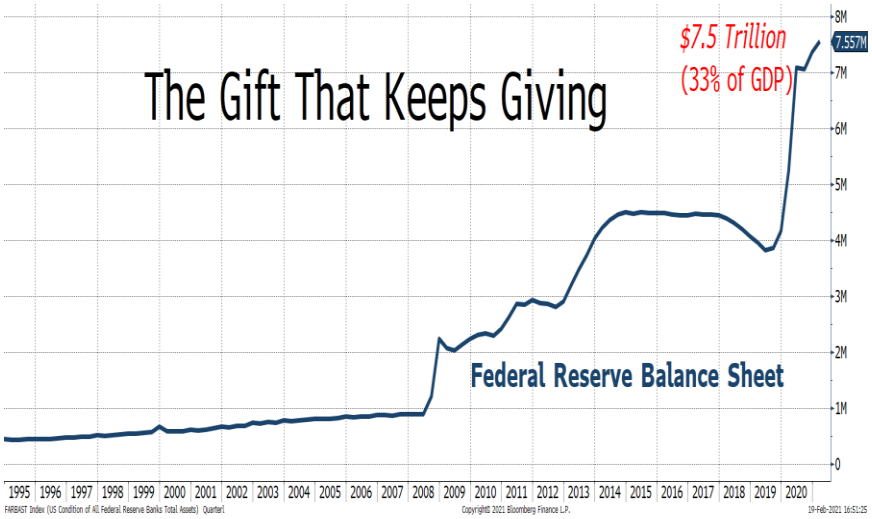


If you are wondering who is buying all this debt, look no further than the Federal Reserve. The Fed is currently buying about $80 billion worth of Treasury debt and $40 billion in mortgage-backed securities per month and now owns 18% of the outstanding Treasury debt.

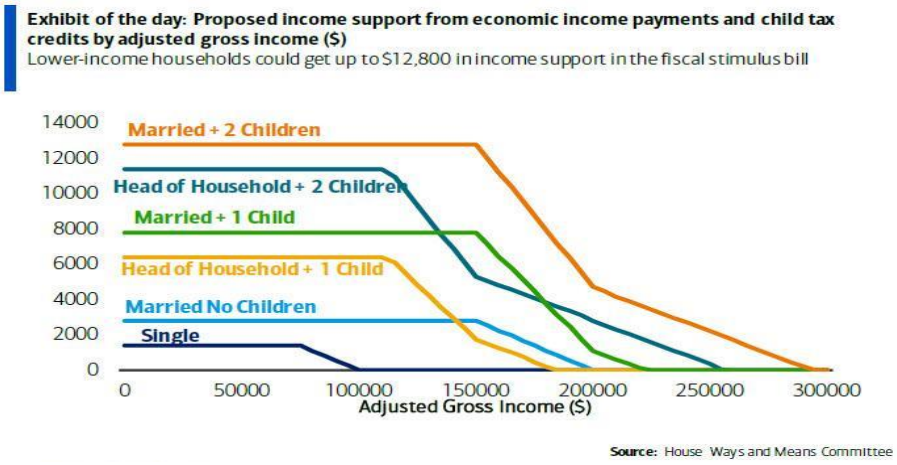
Currently, the Fed's balance sheet sits at over $7.5 trillion. In fact the Fed is actually stimulating "animal spirits" more now than it was when the economy was deep in recession over a decade ago during the Great Financial Crisis. The Fed is

like the Energizer Bunny, that keeps going and going and printing and printing. It truly has been the gift that keeps on giving!

And there's more fugazi coming our way. Last week, Treasury Secretary Janet Yellen strongly defended the $1.9 trillion fiscal relief plan while Fed Chair Jerome Powell said that we need a society-driven decline in unemployment. Also worth noting is a Gallup poll that showed 93% of the public (including 87% of Republicans) in support of government intervention to create jobs for those people who lost their jobs during the pandemic. While I have concerns, this has got to be an improvement over endless (and generous) benefits paid to have the unemployed remain idle indefinitely.



Maybe Jerome and Janet will concoct something big. A New Deal. And yes, there may be benefits for a New Deal, but who pays? The cost would be trillions of dollars tacked onto an already grotesque debt pile. I suspect those that subscribe to the Modern Monetary Theory (MMTers) say, "No problem. Just load it onto the Fed balance sheet!" Seem far-fetched? Maybe. But we must recognize that the left-leaning Yellen-Powell "do what it takes" partnership between the Treasury and the Fed makes debt monetization a nontrivial probability.



Anyways, while markets wait to see what the final size and scope of the proposed $1.9 trillion Biden administration stimulus will be, what we know currently is the big winners of the proposal will be be low to middle-income households with young children. As shown by the orange line in the graph above, a family of four making less than $150,000 a year could qualify for $12,800 in federal income support over the next 15 months.

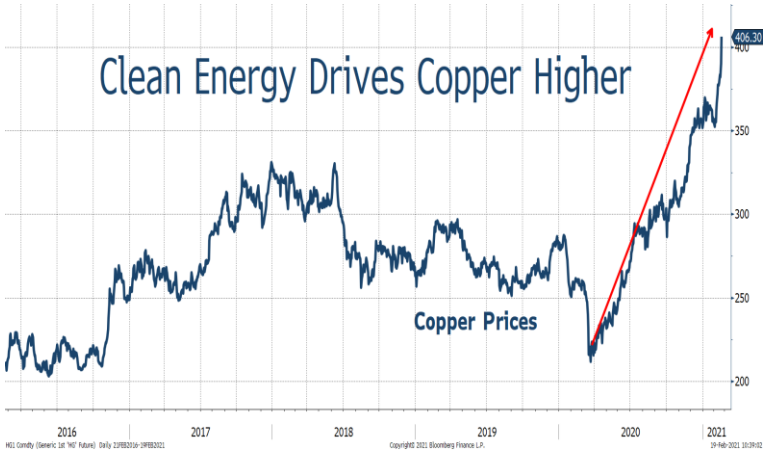
We need a stimulus bill. Seriously. People who have lost jobs and businesses that are closing doors need help. The problem is we do not need to send "bonus" checks to people who have not been impaired by the pandemic. Yet in the current proposal, there is no distinction. Everyone gets free money whether or not they have been impacted by the pandemic or are fully employed or not. Heck, my kids who are and have been gainfully employed throughout the pandemic will receive another check. While grateful, does this make sense? Can we afford it? Why are we loading up the debt of the entire United States to help a few selected constituencies? I truly hope the powers that be focus on the real needs of those hit hardest in the COVID recession. Just saying.

Meanwhile, it looks like the vaccine rollout is coming fast and furiously. Over the next few months, the U.S. will have more than enough doses available to vaccinate all adults before the end of July. The U.S. is currently administering 1.6 million doses a day. Enough vaccine should eventually become available to boost that figure to 4.5 million. Dr. Marty Makary (Professor at the John Hopkins School of Medicine) said we could reach herd immunity from COVID by April. Yes, April! So the worst of the pandemic is behind us at the same time the $1.9 trillion stimulus arrives. Thus, if the stimulus package passes in its current form, coupled with a quicker-than-expected reopening, we could have an economic boom through 2021.

COMMODITY PRICES BOOM

*"The [copper] market is now on the cusp of the tightest phase in what we expect to be **the largest deficit in a decade**… as Chinese buying triggers the next leg higher." – Goldman Analyst Nicholas Snowdon*

The endless flood of both central bank and fiscal stimulus means that hundreds of billions of liquidity (to the tune of approximately 0.7% of global GDP every single month) are entering the market monthly. The result is not only the continued push higher in risk assets but soaring commodity prices. Industrial metal prices have powered to the highest in years on bets an economic recovery and worldwide push for cleaner, greener energy will unleash vast, pent-up demand.



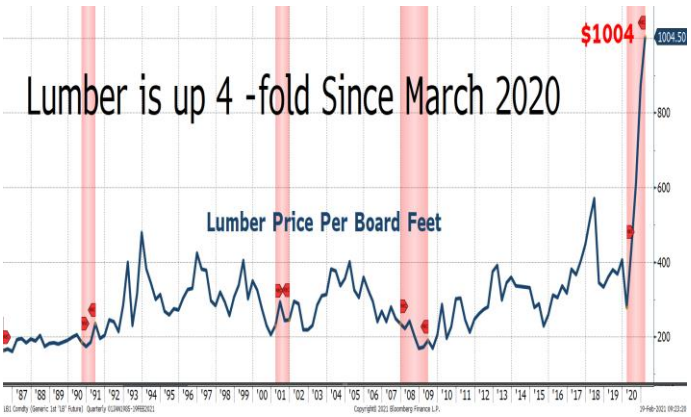
Copper remains red hot and is at a fresh eight-year high. Likewise, nickel is at its highest point since 2014. The clean energy movement has created intense demand due to the building out of electrical infrastructure (copper is used for wiring and cabling). As noted above, Goldman estimates that the copper deficit is quite high at an estimated 500,000 TONS! This suggests that copper prices have plenty of room to run.

The same is true for platinum, which is needed for catalytic converters. Ditto for lithium, which is key to powering electric cars and backing up renewable energy.

But it's not just the metal complex. Corn and soybean prices are their highest in seven years. That has a ripple impact on feeding livestock. These high feeding costs are rippling through supply chains to meat counters. Expect to pay more for that next juicy steak!

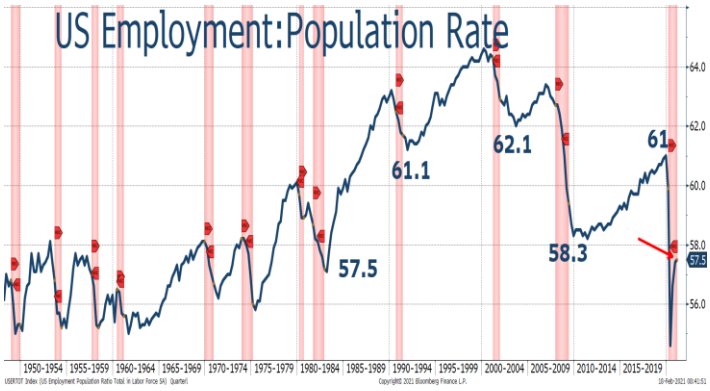
Elsewhere in the commodity space, lumber shortages everywhere are driving the price above $1,000 per board foot for the first time ever!

So as commodity prices boom in the near-term, the inflation impact could be big. But here's the thing. There have been 10 commodity cycles since 1950 and guess what? They don't last indefinitely. They come and they go. Most importantly, the correlation of commodity prices to consumer inflation is statistically insignificant**.**



PPI RISES

In the wake of the strong Product Price Index (PPI) data surging 1.3% in January, talking heads and pundits continued to scream about a secular rise in inflation. While prices did surge, it should be highlighted that over the past three decades, core producer prices have had an extremely low correlation (15%) with core consumer inflation.

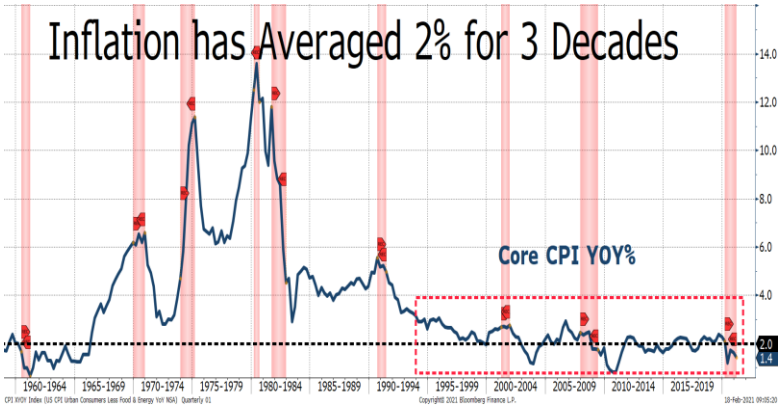


Unlike the PPI data, the employment-to-population ratio has a 60% correlation to inflation. In other words, labor is 4x more important than raw materials in driving consumer inflation. If historical correlation proves true, with a gaping hole in the labor market it will be a challenge for consumer inflation to rise in a sustained manner.

As shown above, the employment-to-population ratio remains at a recessionary 57.5%. Prior to COVID-19, it was 61%. This means we have a jobs shortfall of 9.4 million in the U.S. economy. Or consider that at the worst point of the 2008-2009 Great Recession, the employment-to-population rate was 58%. We are now below that! At the worst point in the 2001 recession, the rate was 62% and during the downturn in 1909-91 the lowest level was 61%.

Let's look at inflation through the arc of time. In the past decade, the core Consumer Price Index (CPI) has risen 22%. Over the past three decades, reality core inflation averaged just 2%. To be crystal clear, this does not mean we will not see a temporary inflation spike. To wit, in the 2009-2019 period, core CPI ranged from a low of 0.6% to a cycle high 2.4%. At that time, the bond bears were prophesizing inflation was heading much higher. They were pounding the table to sell bonds before it was too late. Well that never happened. Likewise, in the 2002-2007 cycle, core inflation was as low as 1.1% and as high as 2.9%.

In conclusion, absent a wage expansion cycle, it's hard to manufacture a sustained rise in prices.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

"To me, there is only one inescapable economic conclusion – inflation and interest rates are heading higher as better economic growth in the last half of 2021 is delivered by the unprecedented stimulus. Unfortunately, the stimulus is in the form of mostly transfer payments and not in expansion of productivity or capacity. The economic boom will be a sugar-based high and there is an almost inevitable bust cycle emerging by or in 2023 when the heady fiscal stimulus ends." – Doug Kass

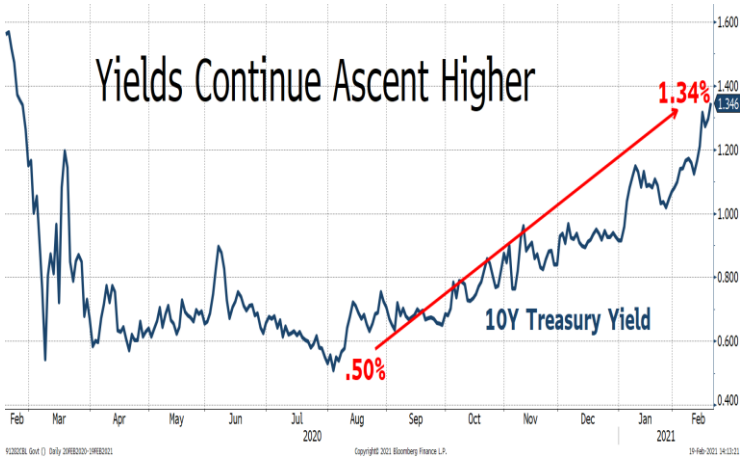
There is tremendous excitement and great expectations in the U.S. right now over the fiscal stimulus, the sharp drop in new infections, the pickup in the pace of vaccinations and the reopening. The inflation narrative is taking hold in a major way, as if the past two months of 0% readings in the core CPI never happened.

Regardless, the reflation/reopening trade is clearly having a big impact on bond yields, where we have seen large jumps on the long end of the yield curve.

Most of the pundits are currently suggesting that interest rates are about to surge higher still due to economic growth and inflationary pressure. I am skeptical. Economic growth is "governed" by the level of debt and deficits. In an economy laden with $85 trillion in total debt, higher interest rates have an immediate impact on consumption, which is 70% of economic growth.

Currently, with rates at near-historic lows, consumers are rushing out to buy houses and cars. However, if rates rise to between 1.5% and 2%, economic growth will quickly stall since increases in rates negatively impact consumption, housing and investments, which ultimately deters economic growth. Furthermore, in a heavily indebted economy, increases in rates are problematic for markets whose valuation premise relies on low rates.

While rates may rise near-term, the weight of the debt is so huge that it is a pervasive constraint on growth and means that interest rate cycles get truncated very quickly due to a crisis, recession or a bear market. Debt is the reason why, for the past four decades, the peak in the fed funds rate and the peak in bond yields keep getting lower and lower, and not even a $1 trillion pre-pandemic fiscal deficit and a 3.5% unemployment rate changed that dynamic.



In other words, a secular bear market in bonds is a low probability. That said, one has to respect the price action and the bears appear to be in control right now. So yields may continue to be pressured higher, but at some level higher rates will inflict serious pain on the real economy as well as asset prices.

As I have stated previously, if you think you can time the perfect entry point, go for it and best of luck. But history tells us that timing is nearly impossible. "Stuff happens" and sometimes when we least expect it. As such, the most prudent investment approach in managing excess cash reserves is to maintain a risk-appropriate, diversified ladder strategy while using a disciplined dollar averaging strategy. Over time, this approach will deliver consistent returns, keep you out of trouble and most importantly provide you with a good night's sleep.

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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.