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INVESTMENT SERVICES

Weekly Relative Value

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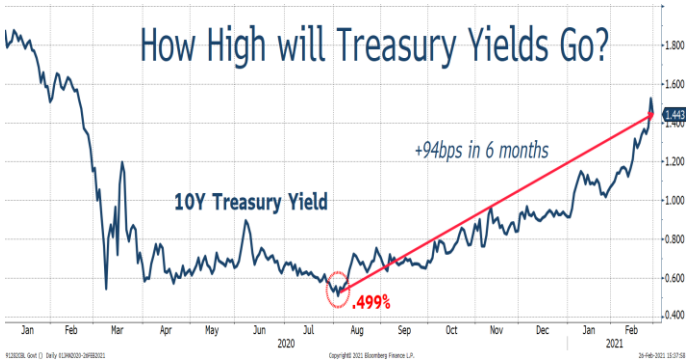
WEEK OF MARCH 1, 2021

Nothing Moves in a Straight Line

"Our policy is accommodative because unemployment is high, and the labor market is far from maximum employment… It's true that some asset prices are elevated by some measures. That doesn't necessarily lead to inflation because inflation is a process that repeats itself year over year over year… rather than a one-time surge."
– Fed Chair Jerome Powell

It was a frenetic week for bonds globally, with yields climbing to levels last seen before the COVID-19 pandemic commenced. Last Thursday alone, the 10-year Treasury benchmark yield rose 15 basis points to 1.523%, the highest reading in a year. Its 30-year counterpart hit a similar milestone, climbing rapidly higher to 2.277%. Yes, yields are up significantly since the summer lows, but keep in mind they are roughly where they were a year ago.



Importantly, the sell-off was not contained in the long end of the curve. After record-low demand at the seven-year Treasury auction, yields in the intermediate sector surged. The five-year note surged 20 basis points to 0.821%. Technical factors including hedging, convexity selling, supply indigestion, a $50 billion position unwind, and vanishing liquidity exacerbated the moves. This essentially meant various traders and hedgers sold at the same time, causing an extremely chaotic rush for the exits. Rather than major economic signal, it should be partly understood as one of those things that happens in markets from time to time. Some of it is noise.

While the technicals were messy, from a fundamental perspective, markets continue to fear that more stimulus coupled with rapid progress of vaccinations, may lead to an overheating economy and inflation will accelerate rapidly. Perhaps the rates market is signaling to the Biden team that it is way overdoing it on the fiscal stimulus front given the pace of

THIS WEEK

PORTFOLIO STRATEGY

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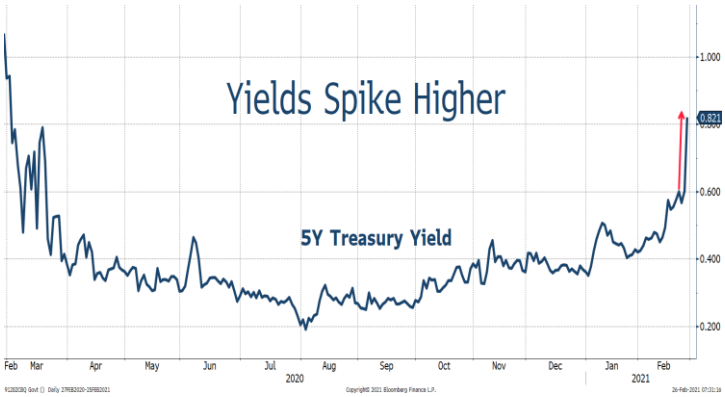
vaccination and economic reopening. In other words, the bond vigilantes are saying enough is enough. We don't need that $1.9 trillion, Joe!

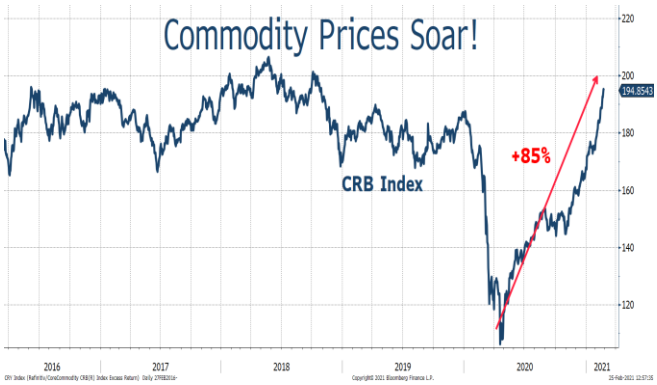
Last week, the Treasury market had begun to price in the Fed raising rates almost a full year ahead of schedule, to hike nearly 100 basis points by the end of 2024. However, the Fed has made clear that it wants to get back to full employment and yet right now we're nowhere close to the Fed's goals. The unemployment rate is probably close to 10%. That's not a level where the Fed is even thinking about thinking about hiking rates.



FRONT PAGE NEWS

"It is still our base case that a secular increase in inflation is not happening… Only when full employment has been restored and wages are rising can we start to worry about the type of inflation that may result in a test of the Fed's Average Inflation Target." – Head of U.S. Rates Strategy Lawrence Dyer, HSBC Holdings

Meanwhile, inflation continues to make the front-page news. As discussed recently, inflation is primarily in the commodity market due to the pandemic's impact on supply chain disruptions. In other words we have shortages in raw materials currently. But this is likely temporary and transitory as increased capacity will come back as the economy reopens. And with more capacity, this run-up in material costs will peter out as they all do. Historically, commodity spikes create hiccups, but no lasting inflationary effects.



Furthermore, while wholesale prices may rise, how much of the price increase can be passed on to consumers when the economy is short millions of jobs?

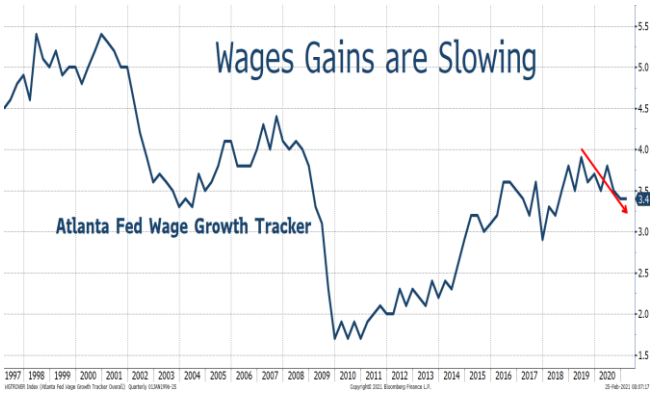
Currently, there are 17 million people who are currently on some type of unemployment assistance. Given the ongoing high level of slack in the labor market there is no bargaining power.

The reason wages are critical to the inflation story is because labor is the largest cost for most businesses. Look at the table below.

Typical Cost Structure for Business	
Cost Inputs	**% of Total Costs**
Freight	5%
Rent	10%
Raw Materials	**15%**
Labor	**70%**

Over the foreseeable future, I think it is a safe bet that commercial rents will be under pressure for some time to come. Meanwhile, since 70% of business costs is labor, it is fascinating to see the Atlanta Fed Wage Growth Tracker – a leading index on wages – showing that wages are slowing down, not speeding up. For perspective, wage gains were approximately 4% in 2019 and have since declined every month since then. The latest update shows wages rising at only 3.4%. Thus, wage growth is slowing, not speeding up.

Powell and others at the Fed have told everyone that will listen to them that there is no real or sustainable inflation with a *de facto* 10% unemployment rate. It may take years for employment levels to return to pre-pandemic levels. This is the reason why Powell & Co. are primarily focused on unemployment and not inflation. To achieve their "full employment" mandate, the Fed says yields should and need to stay low.



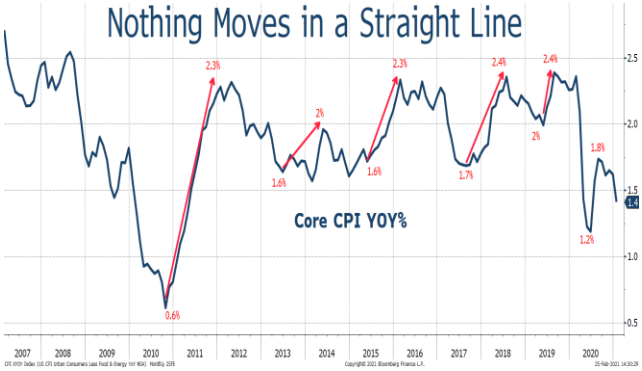
NOTHING MOVES IN A STRAIGHT LINE

"We are eating humble pie after the bond market served up a lesson in humility… This cyclically driven move does not change the more secular, lower-for-longer view. But it does require pragmatism as left tail risk has reduced, whereby the chances of the gloomiest scenarios playing out are now less."
– Head of U.S. Rates Strategy Lawrence Dyer, HSBC Holdings

As shown in the following graph, in the 2009-2019 cycle there were six mini-cycles of rising inflation. These spasms were short-lived, but more importantly, these inflation peaks progressively came in at lower levels. When looking at the

whole decade, inflation declined from 2.5% to 1.4% currently. Inflation has remained in a secular downtrend due to excess debt, aging demographics, technological advances and globalization.

That said, inflation could rise in the short-term. Part of that "rise" is obviously commodity prices. Also easy year-over-year comparisons will likely show an uptick in the inflation data. Inflation dropped with the onset of the pandemic, so year-over-year comparisons for March, April and May will likely show annualized Consumer Price Index (CPI) inflation over 2% for the first time in almost 10 years. Even still, I think – and more importantly, Fed Chair Powell thinks – any inflation uptick will be transitory as the overall trend of the decade is going to be disinflationary/deflationary.



Regardless, the Treasury market is focusing on the here and now and are being gripped by visions of a massive and sustainable post-pandemic growth surge, and reflation morphing into a secular rise in inflation.

Let's step back and look at the bigger picture. The melt-up in Treasury yields is a rare event but has actually happened many times in the past two decades. From 2008-2019, the Treasury yield witnessed a cumulative daily increase of 5,000 basis points. There were 10 mini-bear blips averaging approximately 100 basis points. They came and went. In fact, every sell-off proved to be an excellent time to buy. From 2009 through January 2020, through all these hiccups, the 10-year Treasury yield still plunged 160 basis points from 3.5% to 1.9%.

As of Friday's trading, yields on the 10-year Treasury are up nearly 100 basis points from the lows of August. The reality is that higher rates cannot be sustained in such a highly-leveraged economy. We are now choking on over $80 trillion of debt, which means every 100-basis-point back-up in interest rates siphons $800 billion (4% of GDP) to pay for the higher debt-service. Never before has the economy been so susceptible to higher borrowing costs as is the case today.

BE CAREFUL WHAT YOU WISH FOR

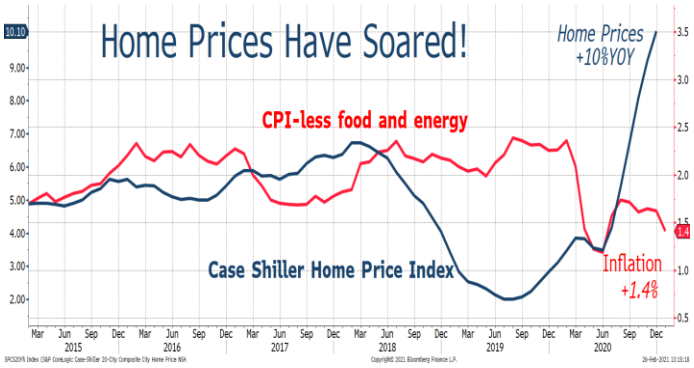
The latest S&P CoreLogic Case-Shiller Home Price Index is now up 10.4% over the past 12 months. At the same time, overall inflation has remained very weak at 1.4%.

The thing is, usually home prices go up with inflation plus an additional 1-2% premium. Never has home price appreciation exceeding CPI inflation by 9% ever been sustained.

In fact, the recent run-up in bond-induced mortgage rates is already taking its toll on the housing market. Mortgage applications for new home purchases cratered 11.6% in the week of February 19, and have now declined in each of the past three weeks and in four of the past five. Over that stretch, purchase applications have plunged 23.9% in the sharpest slide since the Great Financial Crisis.

Refinancing activity also plunged 11.3% on the week and is down in five of the last six weeks. This slowdown in housing is occurring after a modest 35-basis-point uptick in the 30-year mortgage rate to 3.15%. Pray tell, what happens to housing if rates really rise.

Should the bond market become unhinged, expect the mean-reversion process to involve a big correction in home prices ahead. This, in turn, will be to the detriment of the "wealth effect" and the expected recovery in demand and inflation.



WHAT ABOUT STOCKS?

"The ratio has certain limitations in telling you what you need to know. Still, it is probably the best single measure of where valuations stand at any given moment." – Warren Buffet

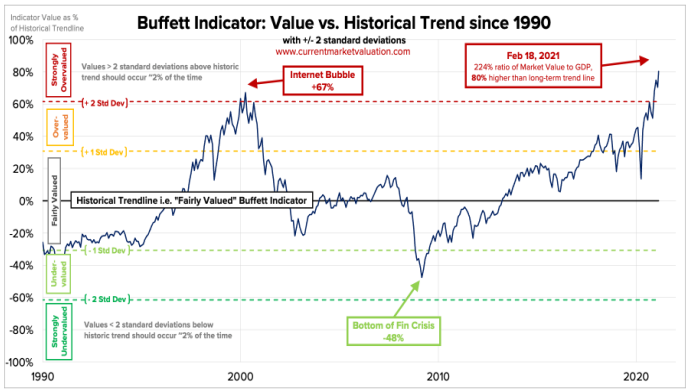
The Wilshire 5000 Index/so-called "Buffet Indicator (the total stock market divided by U.S. GDP) has expanded for six straight months and now stands at about 195% or 80% higher (see graph below) than the long-term trend.

For perspective, this metric is well above the 159% seen just before the dot-com bubble. Back then, everything was hunky dory until it wasn't. Who knew at the time what was coming down the pike? As Mark Twain once said, history may not repeat itself, but it surely rhymes!

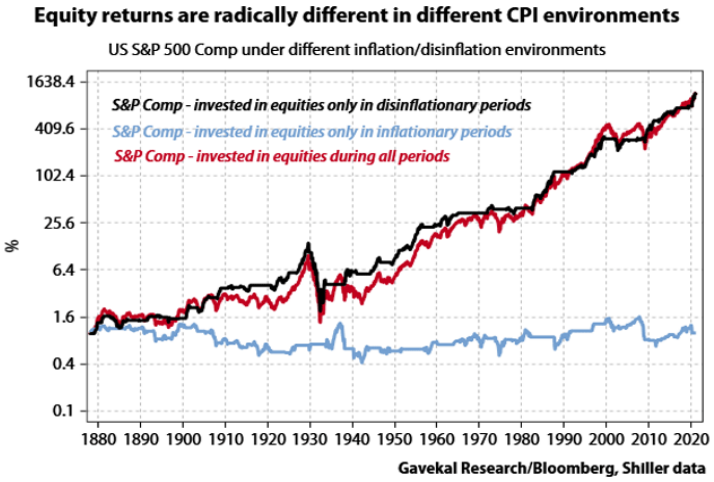
In his letter to clients, Paul Singer, head of Elliott Investment Management, expressed some less-than-optimistic thoughts on the market.

"'Trouble ahead' is signaled by a rare combination of low-quality securities, staggering valuation metrics, overleveraged capital structures, a scarcity of honest profits, a desperate dearth of understanding evinced by the most active traders, and economic macro prospects that are not as thrilling as the mobs braying 'Buy! Buy!' seem to think… We continue to press on for the day when we can say, 'We told you so.'"
– Paul Singer of the $42 billion Elliott Investment Management

Thus far, despite extremely lofty valuations, the latest leg of the bond sell-off has drawn only a mild reaction from equity markets. Yet, if yields rise and rise fast, that could be an issue for stocks. Remember: the stock market thrived in the pandemic as rates stayed extremely low. Low rates allowed for market multiple expansion. Thus, while the improved growth outlook is good for Main Street, it may be less so for Wall Street given the implications for higher rates and a potentially contracting price/earnings (P/E) market multiple.



If we see regime change, where once again bond yields and stocks diverge, that means that as rates go up, the stock market will fall. Note in the graph below, there is a marked difference between how the stock market performs in periods of disinflation (declining rates) versus inflation (rising rates). According to Gavekal, all stock market returns for the last 140 years came in disinflationary periods.



The single biggest danger to the stock market is that central banks lose control of the narrative. If and when the market stops believing the Fed can control interest rates and bond vigilantes take over, things will radically change across all markets. If rising rates spark a stock bear market, a recession could follow. If stocks decline, the "wealth effect" works in reverse. That is by definition deflationary and would increase unemployment. Not what the Fed wants.

Thus more days/weeks of high volatility and rising interest will likely force the Fed into action. Currently, the Fed is buying $120 billion per month ($80 billion Treasuries, $40 billion MBS).

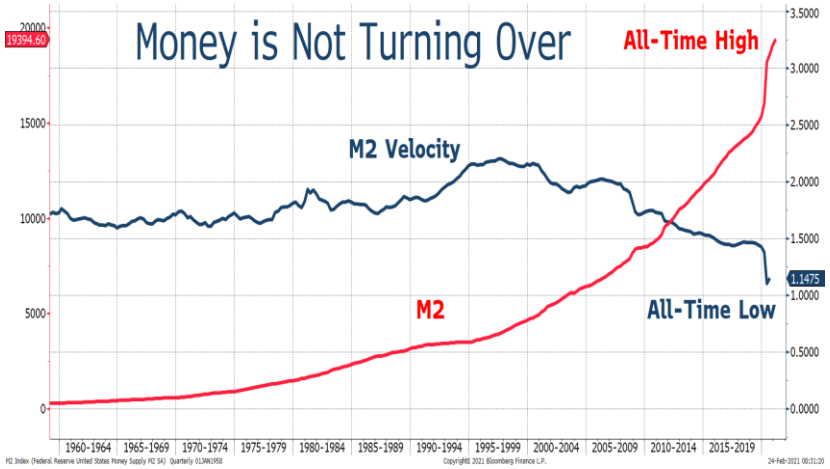
But the Fed has options:

- Reduce the amount of agencies and increase their Treasury debt purchases, thus influencing the bond market.
- Increase the amount of quantative easing (QE) (which, given the deficits that the government is running, may actually be necessary to control interest rates).
- Extend out the yield curve to the 10-year sector.

Bottom line: This economy and asset prices (housing to stocks to high yield corporate debt) are highly dependent upon rates staying low. If rates rise too far too fast, something (or many things) may break. So a message to the bond bears: be careful what you wish for.

MONEY IS WHAT MONEY DOES

Money supply, as measured by M2, has rocketed higher at the fastest pace ever due to massive and unprecedented federal stimulus and central bank liquidity. However, for this "money supply" to impact consumption and prices, it has to "turn over." Currently, that is not happening. Should velocity re-accelerate, inflationary pressure will increase as too much money chases too few goods.

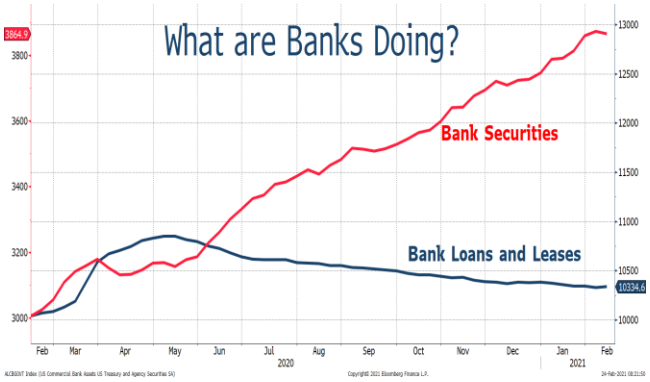


So far this year, credit demand has slowed, bank credit has contracted at a 3.9% annual rate. Commercial and industrial loans (-11%); mortgages (-3%); commercial real estate lending is flat; and other consumer lending (-6%). As such, loan-to-deposit ratios have declined throughout the bank and credit union universe.

Meanwhile, cash balances have soared. Rather than lending, the banks are putting the proceeds into investments, which, as shown below, have been rising at nearly 10x the pace of bread-and-butter loan growth.

- Year-to-date, banks have increased their Treasury holdings by 36.6%, or $44 billion.

- In the past year, bank Treasury holdings have risen 39% ($350 billion).
- Treasury holdings now sit at a record high $1.2 trillion.
- Bond holdings ($1.2 trillion) are now nearly as big as the entire book of consumer loans!

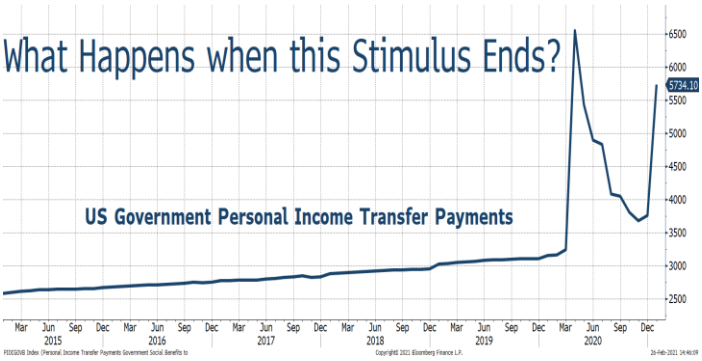


At the same time, bank stocks are rising rapidly due to higher rates and more importantly a steepening yield curve, which increases income and enhances net interest margins (NIM). So in essence, the bonds that were being sold have caused the bank stocks to soar are the same bonds that the banks are adding to their balance sheet at a near-record pace. Gold star to the pundit who can explain this anomaly!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Fears that central banks withdraw support too fast may be overdone given persistent rhetoric, with the Fed holding firm on its accommodation." – Nema Ramkhelawan-Bhana, strategist at Rand Merchant Bank

The debate rages whether the overheating of the U.S. economy is transitory – and thus any burst in inflation can be ignored as it will quickly reverse – or the strength will be permanent. There is no doubt that the economy is booming now. GDP is likely to be very strong for the first two quarters at least. But much of that growth is artificial and due to the massive and transitory fiscal expenditures. Take a look at the graph below. Government transfer payments boosted personal income 10% in January, with spending up 2.4%.



Unquestionably, some of this stimulus may find its way into the economy. Thus, coupled with the collapse in COVID-19 cases and hospitalizations and deaths, the resultant burst of economic strength, it is hardly a surprise. Yet, millions of people are unemployed and many of those jobs will not be coming back. They will need to retrain and make career changes. Transitions are never easy or swift. The Fed is keenly aware of this.

From a longer-term perspective, a bigger question is: what happens to the economy after the next Biden stimulus hits? More importantly, what happens 3-6 months later when the economy hits a fiscal reversal, and the current overheating goes into reverse? In other words, will the boom be followed by a bust?

I realize that the market is not focused on 2022, but everyone should be aware that the $2.8 trillion of fiscal stimulus injected this year will roll off. For perspective, $2.8 trillion would equate to a 14% decline in GDP. In other words, without the sugar-high from stimulus, just how robust is the real economy?

Near-term, the Fed has made it clear that job growth is JOB #1. As such, the Federal Reserve is committed to low rates and easy monetary policy at least until 2023, even with a growing economy. The bond market vigilantes want higher rates, but the Fed doesn't. Who do you think will win?

Expect further bouts of volatility as the markets grapple with a lot of unknowns. And to be clear, despite the above commentary, rates can go higher still. So for those that feel they can time the markets, I say go for it. Possibly, you will find a better entry point.

Then again maybe not.

As stated last week, "stuff happens" when you least expect it, and rates could quickly reverse. Consider what would happen if the Fed increased QE and extended purchases. What if consumers save more of the stimulus checks rather than spending them? What if the housing market slows? What if the stock market bubble "finally" does burst?

Yes indeed, a lot of "what-ifs."

All that said, unless one has a crystal ball, the best, most prudent and "tried and true" course of action in managing excess cash reserves is to maintain a risk-appropriate, diversified ladder strategy. Reduce/minimize excess cash levels, avoid timing, and continue to dollar average into sell-offs. Applying this risk management discipline, combined with the recent sell-off in bonds and the steepening yield curve, will enhance income and margins and prove to be a rewarding strategy over time.

Discipline is the greatest strength to risk management.

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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.