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INVESTMENT SERVICES

Weekly Relative Value

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Bubbles and the Wealth Effect

"Easier financial conditions will promote economic growth. For example, lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending."
– Former Fed Chairman Ben Bernanke

Last week, China's top banking regulator stated that he is "very worried" about risks emerging from bubbles in global financial markets. In making these bold comments he dared go where Fed Chair Jerome Powell was not willing to do so. Powell continues to state, at least publicly, that there are no bubbles.

So why would the arguably two most important financial regulators view asset prices so differently? The Fed has spent years driving asset prices higher via zero rates and money printing to boost the "wealth effect" which in turn led to increased consumption and economic growth. The Fed under Ben Bernanke, Janet Yellen and now Jay Powell explicitly wants investors to take more risk. This is also called "financial repression."

The Fed also knows (even though they won't admit it) that by keeping rates at zero for nearly a decade and injecting monetary liquidity, the Fed has inflated asset prices by the hopes it would spark economic growth. Moreover, Powell knows full and well what happens to consumption and economic growth should the "everything bubble" end up bursting.

THIS WEEK

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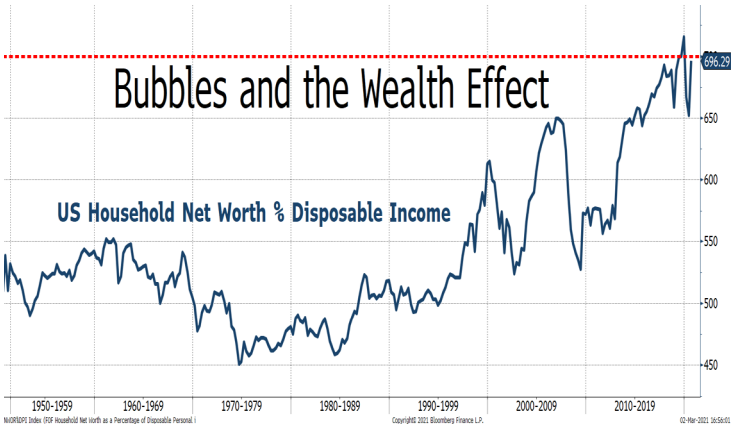
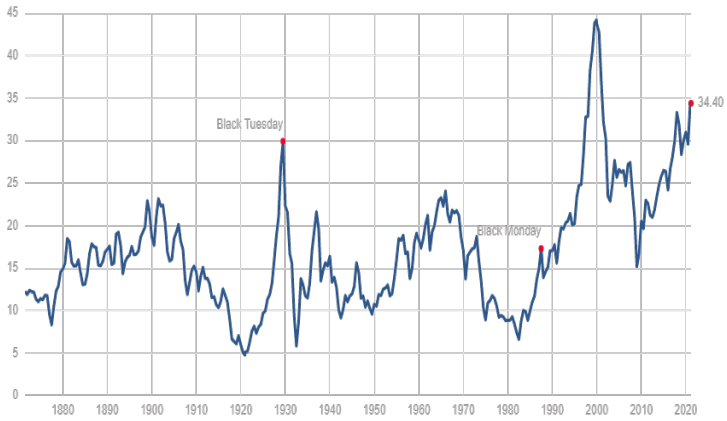
As shown below, personal net worth to income sits at 700% today. This is even higher than the housing bubble in 2007 and the tech bubble in 2000. As such, U.S. households have never been as vulnerable to a reversal in asset prices and net worth as is the case today.

Currently, the top 10% of income earners own nearly 87% of the stock market. The top 20% own over 92% of stock assets. Here's the key point – the top 20% of income earners account for 40% of consumption in the U.S. Thus, should asset prices decline, confidence would likely wane, and the wealthiest Americans will cut spending which in turn will dampen economic growth.



Unquestionably, stocks are expensive by almost any valuation measure. But more broadly, the equity markets are broken. This has been true for some time. This is a stock market in which, much like bonds, prices bear little resemblance to fundamental reality. But valuations have not mattered simply because rates have been kept so low for so long. Wall Street has successfully sold "there is no alternative" (TINA) to the stock market. And investors (institutional and retail) starving for yield (many who don't really want to be in stocks) have plowed into risk assets.

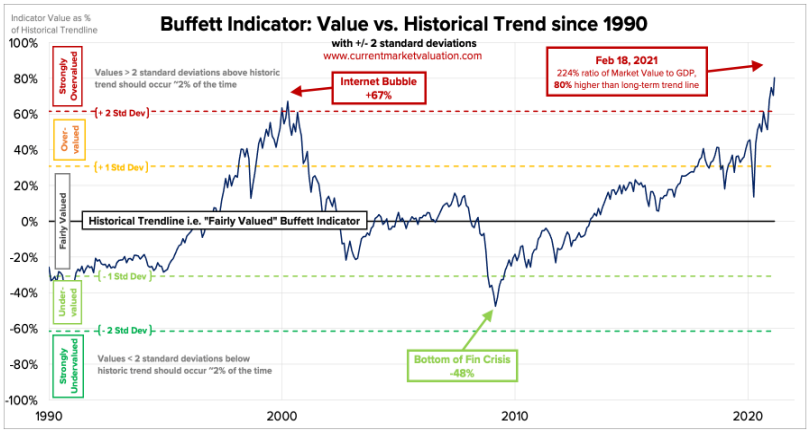
Clearly, these valuation metrics have a poor track record of predicting short-term returns. In other words, they should not be used for timing the markets. That said, they have far greater power as a guide to long-term prospects. Historically, the cyclically adjusted price-to-earnings ratio (CAPE) ratio has had a correlation of -0.83 with subsequent relative 10-year U.S. returns.



Source: Alpha Investing

As discussed last week, the so-called "Buffet Indicator" – the Wilshire 5000 Index (the total stock market) divided by U.S. GDP – now stands at about 195% or 80% higher (see graph below) than the long-term trend. Buffet believes this is the single best indicator for determining whether assets are over/undervalued.

For perspective, this metric peaked at 159% just before the dot-com bubble burst. Back then everything was hunky dory-until it wasn't. At cocktail parties all I heard was that stocks would go up forever. A survey in the year 2000 showed that investors expected future returns from the stock market would be 15% per year. It was the "new economy." Who knew at the time what was coming down the pike? I think current investors have similar expectations. They think stocks only go up, because the Fed will intervene if they don't. Will history repeat?



Source: Case Shiller

And the S&P is not what many people think. Many are investing in passive S&P ETFs or index funds thinking that they have broad diversification across many sectors and companies. But that is now not the case.

In 2020, the S&P 500 Index climbed 18%, and the FAMAG stocks – just five companies out of 500 – contributed 9% (half of the index's total return). Their combined market cap weight has more than doubled from about 8% of the S&P 500 Index in 2015 to 23% today. This means the largest U.S. stocks now account for a larger slice of the market than at the peak of the dot-com bubble in 1999. In other words, concentration risk has never been higher. As five stocks go, so goes the S&P.

Investors seem to think this time is different and that these companies are unstoppable. But the truth is that the bigger they get, the harder it becomes for them to repeat that performance. It is naïve to assume their stock market dominance will continue indefinitely. Cisco, IBM and General Electric are just a few examples of firms that are no longer driving equity returns. In addition, regulation is by far the biggest risk. The bigger these firms get, the more likely they will become more heavily regulated. History is rife with such examples.

Anyone who owns passive index funds will endure a major drawdown at some point. I can't say when, but it's going to hurt.

ANOTHER BUBBLE?

And it's not just the stock market or financial assets. Home prices have been in a roaring bull market over the past 12 months. Year-over-year, the Consumer Price Index (CPI) is only up 1.4% and the Owners' Equivalent Rent (OER) is up 2.0%, but the national median price of existing home sales has risen over 14% to $303K. Thus, home valuations when compared to rent, income or the broad inflation rate are quite elevated.

Make no mistake, the real estate boom has been built on historically low mortgage rates. Mortgage spreads collapsed in 2009 and 2020 because the Federal Reserve bought truckloads of mortgage-backed securities. Economic fundamentals didn't do this. A committee decided to encourage home purchases and did so by making it cheaper to finance those purchases. The predictable result is a housing boom. Or, in the current case, amplification of a boom that was already happening for demographic and other reasons.

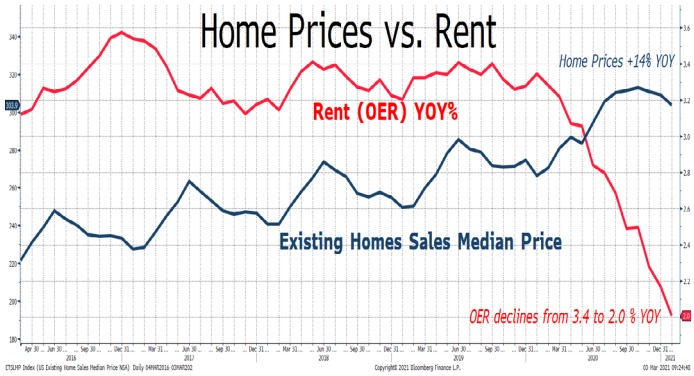
But it also obscures reality. No one really knows what their home is worth.

While the Fed may not be discussing a "tightening monetary" policy, the bond market is doing it for them. At such elevated price levels, if rates continue to back up the implications for the housing markets could be quite significant. After reaching a record low of 2.65% in early January 30-year mortgage rates have risen to 3.21%; the highest level in seven months. While still low from a historical perspective home prices are at an all-time high.

Meanwhile, mortgage applications barely showed a pulse in the week of February 26 and they have plunged over 19% in the past four weeks. This confirms the recent weakness in pending home sales (down in two of the past three months), which are a leading indicator for the housing market.

If one were to assume that stocks and home prices are overvalued by 15-20% the math on the negative "wealth effects" would come to a $600 billion hit to consumer spending. That alone would absorb 70% of the unemployment benefits and stimulus checks from this current fiscal package.

This is the deal. Low rates have been and remain the lynchpin to asset valuations. When pundits tell you that interest rates can back up and everything will be hunky dory, think twice.



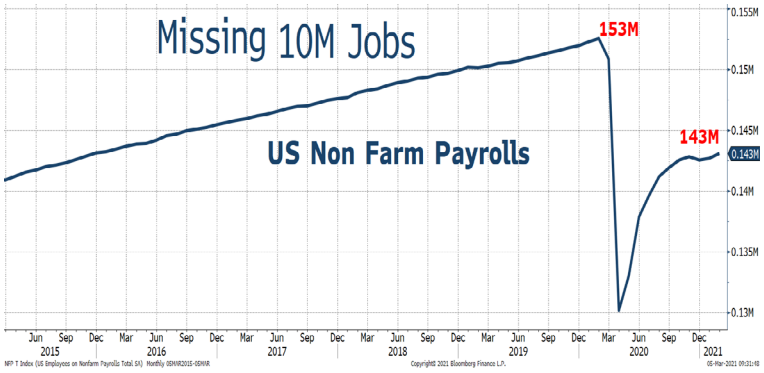
HUGE JOBS BEAT

"All told, nearly 5 million people say the pandemic prevented them from looking for work in January. In addition, the Bureau of Labor Statistics reports that many unemployed individuals have been misclassified as employed. Correcting this misclassification and counting those who have left the labor force since last February as unemployed would boost the unemployment rate to close to 10 percent in January." – Fed Chairman Jerome Powell

The U.S. added a whopping 379K jobs in February, nearly double the 198K consensus estimate. Revisions to the past two months added a net 38K new jobs. The private payrolls number was even more remarkable coming in at 465K jobs – more than double the 195K expected. The unemployment rate dropped from 6.3% to 6.2%, also beating expectations of an unchanged print.

On the surface the report was fantastic. But let's dig a little deeper.

1) There was a big catch: leisure/hospitality alone added 355k jobs or 94% of the total run-up. It is encouraging to see these depressed areas come back as the economy re-opens (let's hope not too early).
2) The unemployment number does not reflect reality and is artificially low. You count as "unemployed" if you actively look for work. In February, 13.3 million people reported they had been "unable to work because their employer closed or lost business due to the pandemic." I think millions want to work but for various reasons haven't been looking. So, they don't count.
3) The broader U-6 measure (includes discouraged workers no longer seeking jobs and part-time workers seeking full-time employment) didn't budge at all at 11.1%.
4) Additionally, there are still about 9.5 million, or 6.2%, fewer jobs than the pre-pandemic level in February 2020.



The workweek declined to 34.6 hours from 34.9 hours in January. That, my friends, is equivalent to a job decline of over one million! In other words, if the workweek was held at the January level, payrolls would have plunged 700k!

Average weekly earnings slid 0.6% in February, the first decline since June (but don't worry...more fiscal stimulus checks are coming!).

Long-term joblessness is getting worse as the number of people unemployed for 27 weeks or longer swelled 125k last month to 4.15 million.

There are now 3.5 million Americans who consider themselves to be "permanently" unemployed – 170% higher than a year ago. For those economists waxing about the great jobs report, I would suggest not sharing their views with these people. You might get punched in the nose.

This was a very lopsided report, centered mostly in areas of low-skilled and low-wage sectors of the economy. Yes, yes, more help from Uncle Sam (President Joe Biden) is on its way, but the message from this report is that there are still big holes in the labor market to fill. This means that Jerome and Company will remain accommodative for some time to come.

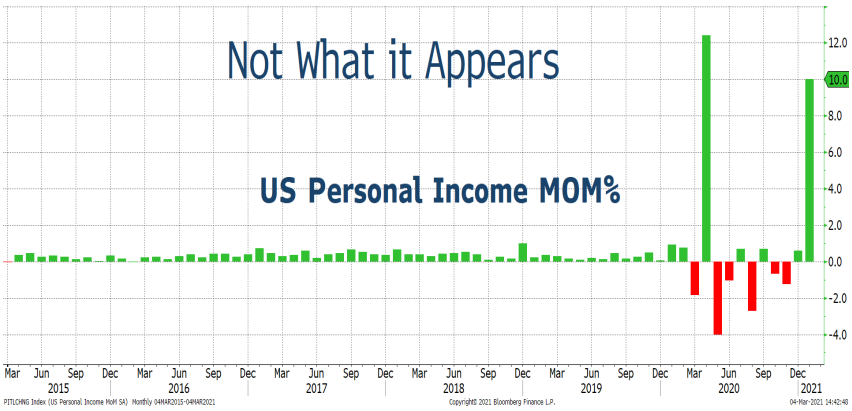
INCOME IS NOT WHAT IS APPEARS

The January personal income report showed that personal incomes soared 10% ($1.95 trillion). Indeed, a monster number, but government transfers soared $1.97 trillion. That means that real income, excluding government transfers,

declined 0.5%, the third decline in the past three months. For the three months ending January, organic income has contracted at by 5.3% annualized rate.

To be sure, the Biden team is going to be doing ever more and it will be bigger. The Senate passed the $1.9 trillion package, and it will be soon signed into law by President Biden. The package includes $1,400 checks for Americans making under $80,000 per year and couples earning less than $160,000, and extends unemployment benefits. It also waives tax liability for up to $10,200 of UI benefits. This significantly reduces the negative tax surprise many individuals would have faced when filing 2020 tax returns. It now heads back to the House to incorporate Senate amendments into the final bill, after which it will go to President Biden's desk for a signature before several programs are set to expire on March 14.

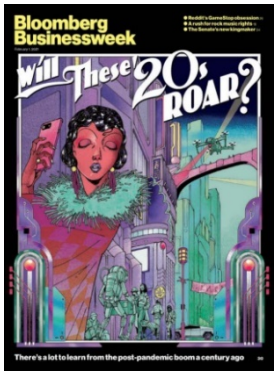
But alas, it is just temporary income. By the summer, this stimulus will be gone.



SELL THE FRONT-PAGE NEWS

"Sell the front-page news and buy the back page news on the way to the front page." – Don Coxe

There are now three magazine covers talking about the "Roaring Twenties."



From my perspective, this is akin to a fairy tale by Wall Street for the benefit of their clients.

Outside of a health crisis, there are no other relevant comparisons between the 2020s and the 1920s. Let's take a look at 1920 vs. 2020:

1) In 1920, World War I was ending as the Spanish flu was spreading. Due to the mass destruction in Europe, by default the U.S. became the manufacturer of the world. U.S. exports and industrial production boomed.
2) During the Spanish Flu people lived with the disease. The economy was not closed, and welfare and unemployment benefits were non-existent. Churches, community and charity were the safety nets in the 1920s. Nobody expected Uncle Sam to save the day.
3) Yes, the economy collapsed, but the big difference is the U.S. government did not blow its brains out on debt. At the end of the Spanish Flu, U.S. government debt-to-GDP was 10%. Today, we are at 10 times that level.
4) The U.S. government CUT taxes in the 1920s. The corporate tax rate was cut to 11%. Likewise, individuals received a huge tax break as the highest rate declined from 58% after the war to 24% by 1929. Does anyone think taxes are going to be coming down in modern day U.S. any time soon?
5) The homeownership rate was 25% back then versus 64% today. This was the beginning of the American Dream as people shifted from renters to homeowners. Housing fueled the economy.
6) The economy in 1920 was manufacturing based and was centered on industries and companies that were "essential" (that could not be closed down). Manufacturing represented over one-third of the workforce compared to less than 10% now. Today, about 70% of the U.S. economy is deemed "non-essential" (that could be shut down) whereas one hundred years ago it was less than 10%.
7) In the 1920s, the population was much younger with a median age of the population at 29 years. Today, it is 38 years. In the 1920s, the percentage of the population over the age of 65 was 7%. Today, we are on the precipice of hitting 20% for the first time in recorded history. Retirees are savers, not spenders. Demographics is destiny.
8) Corporate America was less focused on financial engineering in favor of improving efficiency and profitability. Manufacturing productivity rose 5% in the 1920s.
9) Productivity was high as the working-age population grew by around 2% annually in the 1920s. And productivity growth was over 1%. As such, real GDP growth averaged over 3% in the 1920s. Over the next decade, the growth of the working population will be a historically low 0.5% per year. Thus, it would be nearly impossible for the U.S. economy to average 3% growth over the next decade.
10) In the 1920s the Fed tolerated mild deflation. Today, inflation is seen as a desirable outcome because today's central bankers are consumed with bailing out debtors and penalizing savers.

Long after the stimulus sugar high fades, and as we move forward into the next decade, the outlook for demographics, productivity, debts and taxation are so vastly different than the 1920s. In other words, do not expect a repeat of the economic boom experienced in the "roaring" 20s.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

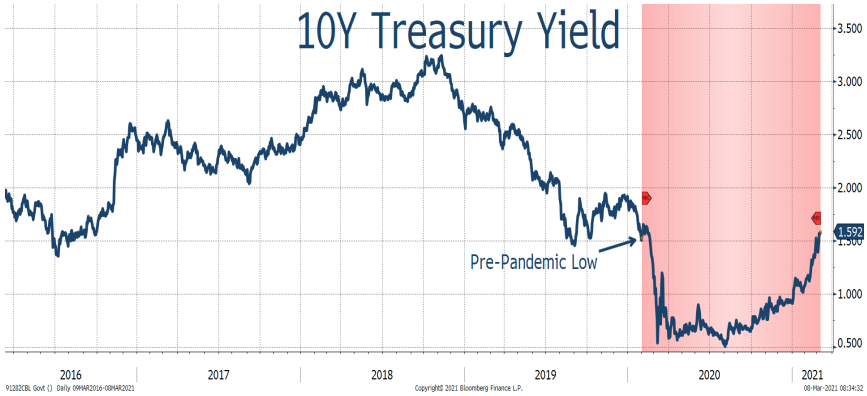
"As interest rates rise, the odds of Operation Twist 3.0 increase. The Twist can arrest rate increases without altering the current QE pace of $120 billion per month. The alternative option, increasing the amount of QE, might cause rates to climb further due to the inflationary implications of such actions. The Twist allows them to manipulate markets without increasing their footprint." – Michael Lebowitz

Last week was something of watershed moment in the U.S. Treasury market. After a period of relentless selling that pushed longer-term yields to their highest levels in a year, Federal Reserve Chair Jerome Powell had one last opportunity to quell investors' nerves before the central bank's self-imposed blackout period. Instead, he said that he's not too bothered by the moves and that traders are on their own.

I noted last week that the long-lost "bond vigilantes" are trying to rise from the dead. Inflation expectations have risen, and the bond market has priced in an earlier return to a tightening cycle. Undoubtedly, the markets have sold off hard and fast. The benchmark 10-year yield low was just 0.51% on August 4 and now the 10-year Treasury benchmark is 1.62%. Year-to-date, the yield is already up 66 basis points. Looking forward, the immediate outlook is excess fiscal stimulus plus booming economic data (10% GDP, 4% CPI in Q2) which could force bond yields even higher, possibly to 2%, 2.5% or even 3%?

It's certainly possible that this economic recovery will be different from the last one because of supportive fiscal policy and the central bank's new monetary-policy framework. Economic growth this year will be good – and perhaps spectacular. Pent-up demand and savings could revive long-dormant inflation and get the Fed away from the zero-lower bound within the coming years.

But let's get a grip. Just because Powell didn't sweet-talk markets doesn't mean there are no brakes on Treasuries. It's easy to forget that even though 10-year yields have tripled since August, they're barely 20 basis points higher than their pre-pandemic record low. Meanwhile, 30-year yields haven't yet tested 2.5%.



I do not believe the Federal Reserve or other central banks will let the bond vigilantes take control of the bond markets. Given that economic growth is debt-supported, rate increases have an almost immediate negative impact. The Fed is keenly aware that rising interest rates will choke off the fledgling economic recovery.

If they take their hands off the controls, the everything asset bubble will implode. That will deflate consumer confidence, spending and overall economic growth. In addition, according to the CBO, a 1% rise in yields adds a remarkable $9.7 trillion to deficit between 2021-30 (10 times the annual U.S. defense budget of $0.9 trillion).

I firmly believe that at some point the Federal Reserve will begin to buy large quantities of longer-dated securities, taking interest rates down and driving a stake into the heart of those who want higher yields. When and what level…I do not know. The best indicator will be the stock market and high yield credit spreads. If equities drop, say 20%, and credit spreads widen dramatically, look for the Fed to jump in.

Finally, historically long -term interest rates have a 90% correlation with short-term rates. And the Fed has pledged to keep rates low and not raise rates until the recession job losses are recovered. As discussed above, that could take some time.

Thus, the Fed is likely to stay on hold and returns from excess cash will remain painful. With the Fed on hold and more deficit financed stimulus coming our way there is still pressure for yields to push higher near-term. As such, maybe it's tempting to wait for higher rates before investing. Conversely, we have seen ten such market rate hiccups in the 2009-

2019 cycle where the Treasury market rapidly moved from overbought to oversold. Are we approaching that point again? The bottom line is no one really knows when the turn will come…but it will.

In this heightened market volatility, I believe the most prudent approach to managing excess cash reserves is to systematically dollar average into the market. With liquidity levels sky high and likely to increase further, the recent sharp uptick in rates and a steepening yield curve, credit unions can better maximize income and improve net interest margins by investing further out the curve in a risk appropriate manner.

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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.

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