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INVESTMENT SERVICES

Weekly Relative Value

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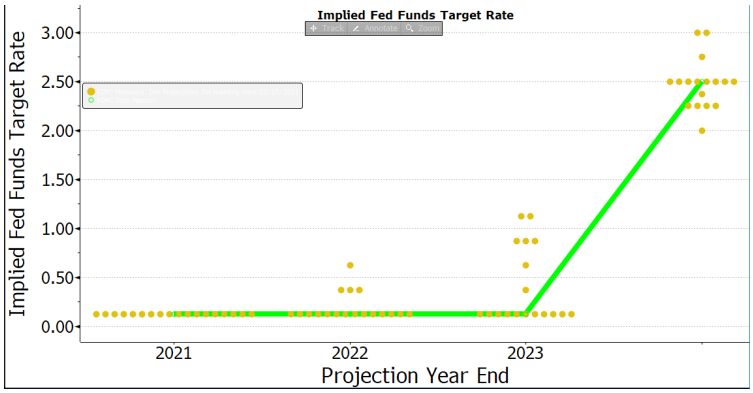
WEEK OF MARCH 22, 2021

Reality Check

"Our view is that inflation will generally remain subdued in coming years, allowing the Fed to point to cumulative shortfalls from its two percent goal to support delaying the start of policy tightening…once we get through the next few months of noise from base effects in the year-over-year numbers" and "the lagged effects of the 2020 economic contraction begin to show up in the cyclical components of core inflation…. In light of our inflation views—and given the recent backup in Treasury yields—we believe that the balance of risks is skewed toward lower bond yields, particularly in the front end and belly of the yield curve."
– Scott Minerd, Guggenheim Investments Macroeconomic and Investment

This past week Fed Chair Jerome Powell was quite adamant the Fed funds rate won't rise until unemployment reached 3.5% and inflation averages 2%. He emphasized that he wanted to see these numbers actualized; see real results. He also made clear they would tolerate the economy "running hot" and inflation above 2% for a period of time. They believe inflation will prove to be "transitory."

Powell confirmed that they will continue to buy "at least" $80 billion worth of government bonds and $40 billion in mortgage bonds monthly. When asked about tapering quantitative easing (QE), Powell said "substantial further progress" toward the dual mandate (full employment and stable prices) was needed. QE is not going anywhere, anytime soon. If anything, the Fed will increase purchases.



Source: Bloomberg

The Fed's dot plot (summary of where the Federal Open Market Committee members see future interest rates) dilemma was resolved. It's unanimous there will be no hikes this year. The Fed is going to look through the sugar high coming to the U.S. economy this summer

THIS WEEK

PORTFOLIO STRATEGY

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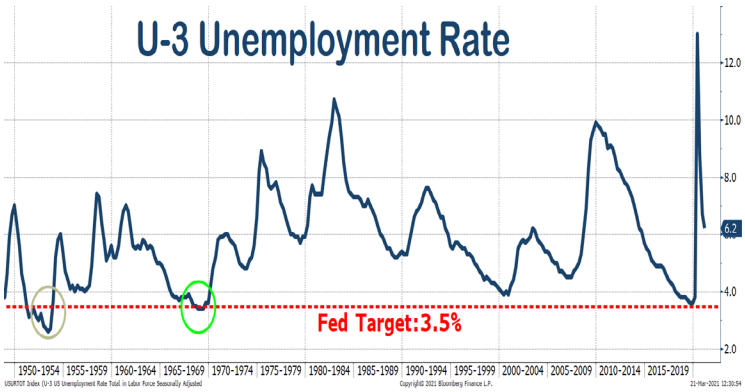
and the monetary policy will not change because of it. And by a 14-4 supermajority there will not be hikes in 2022. There will be no pre-emptive tightening of policy.

Fed officials have laid down the gauntlet: They will let inflation rise because it is "transitory." In fact, the Fed's forecast is for inflation to rise to 2.4% from 1.8% by the end of this year, and then back down to 2.0% in 2022 (from 1.9%) and to 2.1% by the end of 2023. So should inflation data spike due to commodity prices in in the next couple of months, the Fed's policy will not change. Simply put, the Fed is on hold.

The Fed also acknowledged there is no carryover or multiplier impact from the positive yet transitory fiscal stimulus. To wit: The Fed barely touched its 2022 GDP growth view (3.3% from 3.2%) and actually took it down a tad for 2023 (2.2% from 2.4%). As Billy Joel would say, "is that all you get for your money?" Indeed, short-term stimulus; here today, gone tomorrow.



In essence, the Fed is going to try to hold off on raising rates until they get 2% average inflation (which they have not been able to do for a very long time) and 3.5% unemployment, which has only happened two times in the last 60 years. Good luck!

The longer run is a real hoot. A majority think rates will be 2.5% to 3.0% in the long term. Seriously? The U.S. national debt is over $28 trillion and rising. If the average financing cost were 3% that would equate to $840 billion in annual interest expense. Further, debt is likely to grow considerably in the next four years. In addition to the recently passed $1.9 trillion stimulus package, expansion of the Affordable Care Act (ACA) and a potential infrastructure package (I actually support), debt is likely headed in one direction…up!

According to the U.S. Debt Clock, the federal debt projection (assumes everything continues at today's rates for four more years) is for debt to reach $49.7 trillion in March 2025. The debt-to-GDP ratio is projected at 191% in 2025, up from 129% now. Is that sustainable? Maybe. Japan's ratio is even higher. But Japan also has very low GDP growth. The U.S. is a few years behind Japan, but we are on that same path.

Source: U.S. National Debt Clock

HERE COMES THE TAXMAN

While the Tea Party has long disappeared, it's a sure bet that taxes are going up. The White House will propose $1 trillion worth of new taxes, according to Sarah Bianchi, head of U.S. public policy and political strategy at Evercore ISI.

Here's a quick and dirty synopsis:

- Hike the corporate tax rate to 28% from 21%.
- A global minimum tax on corporations in foreign tax havens.
- Double the capital gains tax on wealthy citizens – long-term capital gains taxes will rise for rich people, perhaps by a lot. Biden wants to raise it to 39.6%, which would put capital gains taxes at pretty much the highest levels ever, going back to the late 1970s.
- Hike death taxes.
- Tax unrealized stock gains at death.
- Hike the income tax rate. The top tax bracket will go from 37% to 39.6%. There is a chance that another bracket, at a higher level of income, is added after that.
- Restore 2009 estate tax policies. The estate tax threshold will be lowered to estates as small as $3 million. Currently, the estate tax affects virtually nobody. But that might not be true for much longer.
- New financial transaction tax.

Everything is on the tax table, except of course spending cuts.

Before I go any further, let's just say that none of these tax increases have anything to do with deficit reduction. This tax package is supposed to raise $2.1 trillion over 10 years. That's $210 billion a year. Last year, our deficit was $3.1 trillion, and it will be even larger this year. It doesn't come close to covering the deficit. In fact, if we raised all taxes on every single person to 100%, it wouldn't come close to covering the deficit.

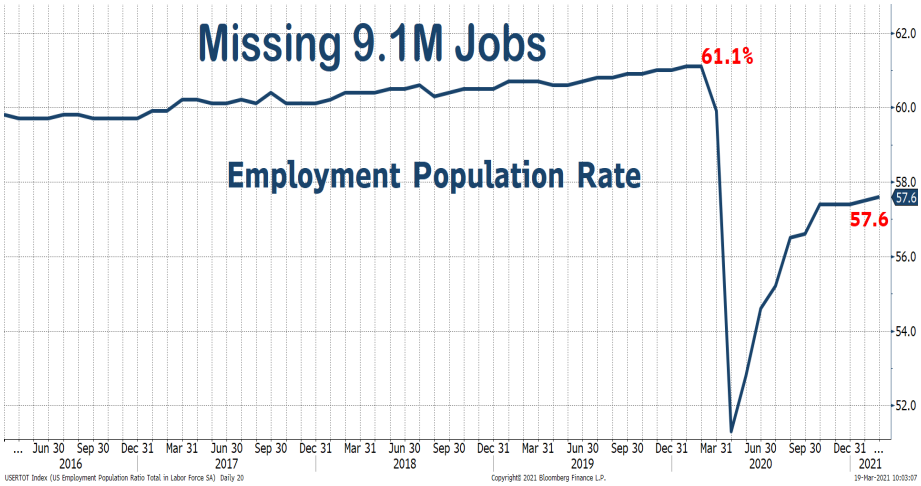
THE JOB HOLE

The worst may be over, but the job recovery is painfully slow and the hole in the jobs market is unmistakably massive. The official unemployment rate is 6.2%. This does not sound bad, however the reason it is low is because over four million unemployed have dropped out of the labor force over the past 12 months. Adjusted for this exodus, the unemployment rate is closer to 9%. Also consider the following:

- Those working part-time for economic reasons has increased 38% to six million.
- Those unemployed after six months has risen to 4.15 million.
- Job losses deemed to be "permanent" has soared 169% to 2.2 million.
- Jobless claims have seemingly stalled. For the latest week, 770,000 people filed for jobless claims (up by 45,000). Jobless claims have shown no improvement since last October.

Adding to the angsts, the California Policy Lab released a report that shows 80% of the unemployment applications in California over the past month were from folks who were laid off early in the pandemic, then went back to work, to only be let go again. Repeat claims are a big issue here and underscore this "stop and go" nature to this economy. Wait till this transitory fiscal stimulus begins to wear off through Q3 and into Q4.

The most important labor metric is the employment-to-population ratio. Before the COVID-19 pandemic, it was 61.1%. Today it now stands at 57.6%. To return to pre-pandemic levels we would need to generate 9.1million jobs. That is the true size of the labor market gap, and that number is so huge that it would ordinarily take (in good times) four years to achieve. So now you know why Powell isn't intent on tightening monetary policy before 2024.

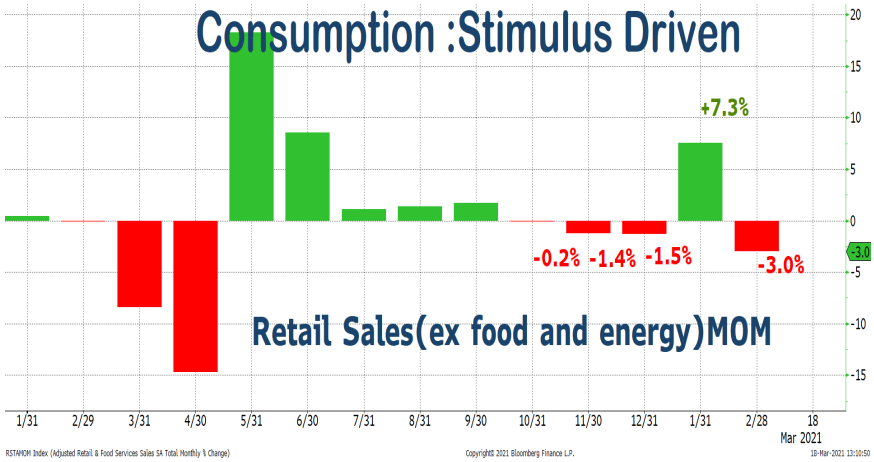


STOP AND GO

Last week the incoming data pointed to a "stop and go" economy heavily dependent upon stimulus. The February retail sales report looked horrible as sales plunged -3.0% in February. The consensus was -0.5%. However, it should be highlighted that it was not as bad as it appeared for the following reasons:

- Adverse weather conditions (cold winter in the Northeast followed by the freeze in Texas).
- The latest massive round of stimulus checks only began to hit consumer bank accounts this past weekend.
- January retail sales were sharply upwardly revised higher to 7.6%.

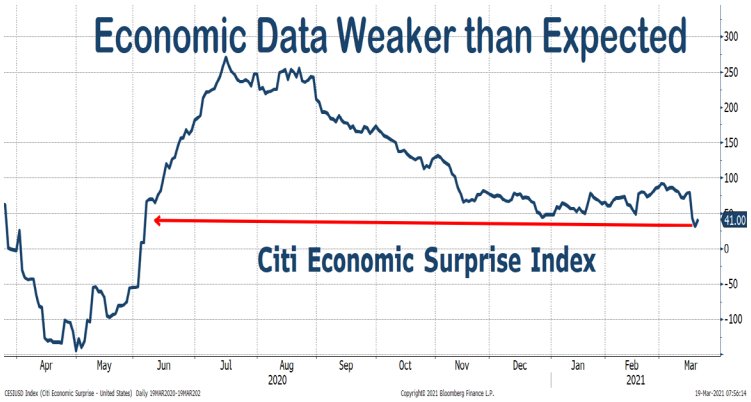
Regardless, the retail sales data suggests we have a “stop and go” economy that ebbs and flows with the fiscal stimulus.



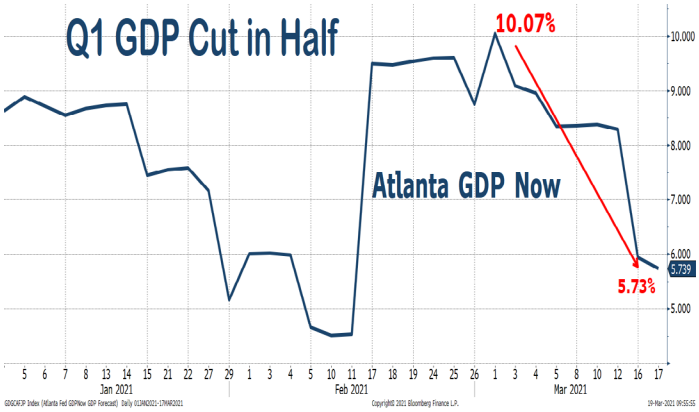
PRODUCTION PLUNGE

Industrial production dropped -2.2% in February. Manufacturing activity slumped 3.1% in February versus expectations of +0.2%. The capacity utilization rate dropped to a four-month low of 73.8% from 75.5% in January. Simply put, the capacity utilization rate is akin to the unemployment rate for the production side of the economy. When the capacity rate declines it leads to more “excess capacity.” We are still light years away from reaching full capacity. This in turn means less, not more, inflationary pressure.

In the wake of or hefty setbacks in retail sales, industrial production and housing activity, the Citi U.S. Economic Surprise Index has dropped to its lowest level since June.

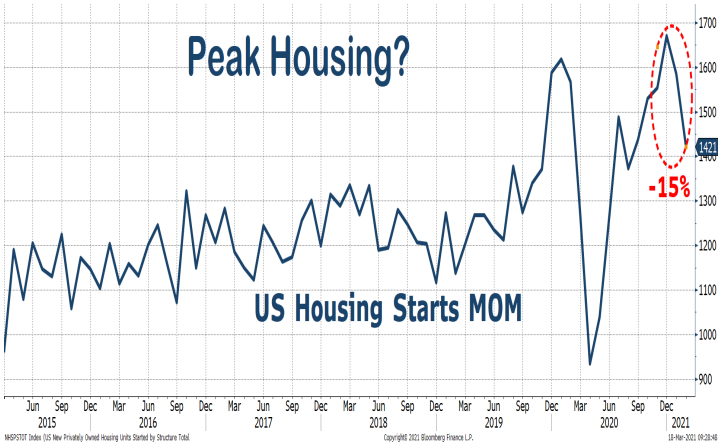


And the Atlanta Fed’s GDPNow model sharply downgraded the Q1 growth projections.

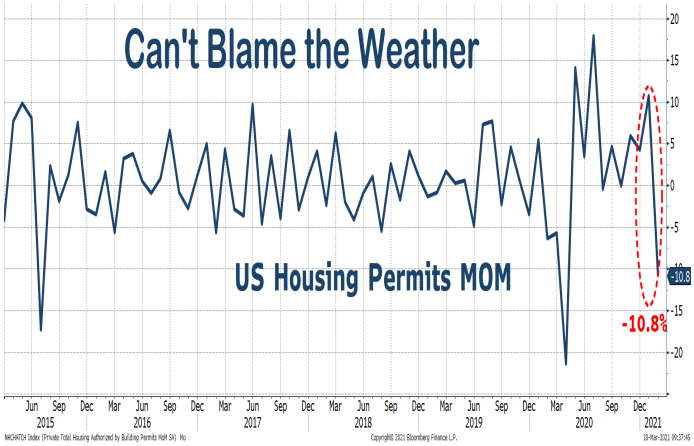


PEAK HOUSING

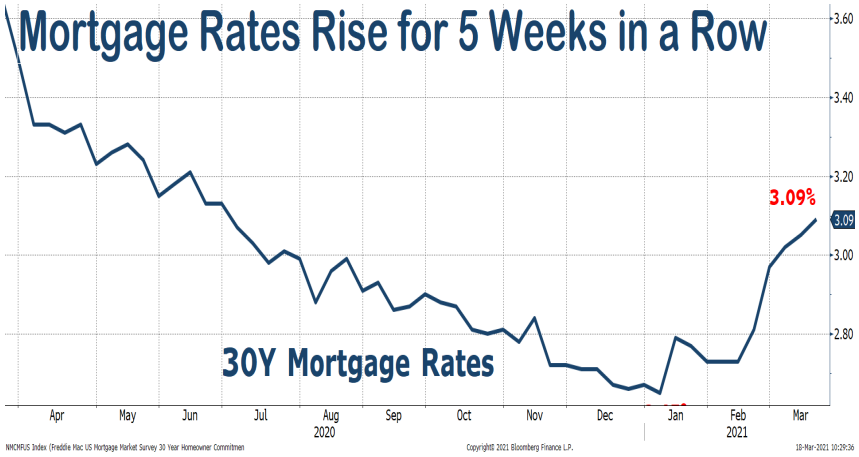
In the wake of a 5.2% slump in housing starts in January, starts collapsed an additional 10.3% month-over-month in February. As shown below, starts are now down 15% since year end.



Building permits (not affected by weather) plummeted 10.8% to a three-month low of 1.682 million. Single-family permits cratered 10.0% and multi-family permits were down 12.5% and have declined now in two of the past three months.



The housing demand has slowed as well. In the March 12th week mortgage applications fell 2.3%. Since the end of January, applications for a purchase have tumbled 12.0% while refinancing (until recently, a source of homeowner cash flow) has nosedived. The culprit? The 36-basis point jump in mortgage rates since the end of January to a seven-month high (of 3.28% for the 30-year fixed rate).



WHAT ABOUT THE STIMULUS?

"It's worth highlighting that a large amount of the upcoming U.S. stimulus cheques will probably find [its] way into equities…Behind the recent surge in retail investing is a younger, often new-to-investing and aggressive cohort not afraid to employ leverage." – Jim Reid, Deutsche Bank.

We don't know yet how much effect the stimulus will have. Will people save most of it like they did last time? Will they put it in stocks? Will consumer spending and supply chain problems push prices higher?

But we do know that much of this stimulus is going to state and local governments, plugging revenue holes where they exist. A ton of this money is going to colleges and universities so that they won't hike tuition fees. There's also a bulk going to vaccine distribution, which hardly has a recurring impact on economic growth directly. Of the $1.9 trillion, $800 billion (half) will be used for unemployment insurance benefits which will go into rent, utilities and food, and then the other half to households in the form of stimulus checks. The New York Fed reported that 20% of this goes into spending and the other 80% goes into debt repayment and playing the market.

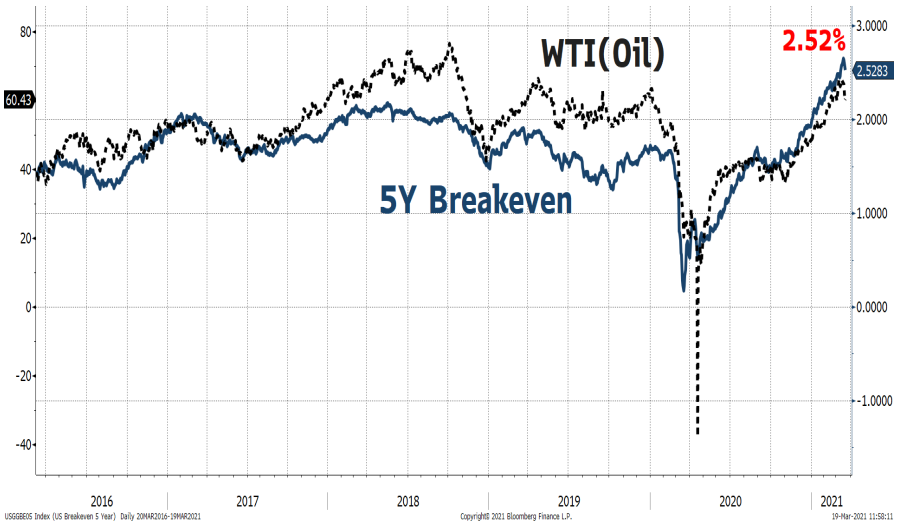
A Deutsche Bank survey found that of those folks receiving the $1,400 stimulus checks (not including all the credits for children), 37% of the recipients intend to use the proceeds to play the market. Likewise, a recent Household Pulse survey indicated that about 15% of the people who received a stimulus payment in the previous seven days were already busy putting at least some of the money towards savings or investments.

If these surveys prove to be accurate, the consensus may have too much spending in the forecast even as the economy re-opens.

MORE ON INFLATION

The headlines constantly focus on soaring inflation based on market expectations. These expectations are expressed in five-year Treasury Inflation-Protected Securities (TIPS) as breakeven levels have soared to 2.5%. As discussed last week

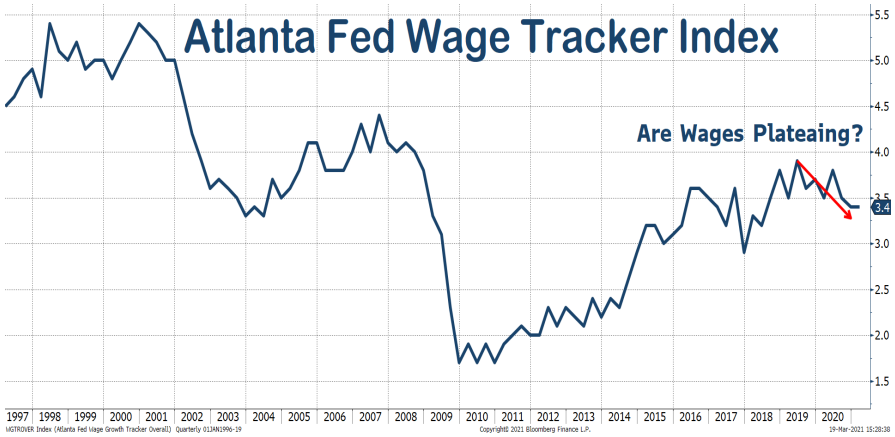
these "breakevens" are driven primarily by commodity prices and, more specifically, oil prices. There's your inflation story. We are no longer living in the times of Davey Crocket. Commodities are little more than 10% of the final price in the goods sector. In the past seven decades, there have been 10 of these commodity cycles. But they never last.



While the five-year TIPS breakeven inflation levels have soared, the core inflation rate has done nothing but go straight down – from 1.6% in December to 1.3% in February. Over the past three months, the core Consumer Price Index (CPI) has slowed to a mere 0.7% annual rate.

Higher prices are primarily driven by labor costs (70% of final prices). Until we return to full employment and see sustainable wages increase it will quite be challenging for overall inflation to rise in a sustainable manner. Moreover, given the effect of lower-paid workers returning to their jobs in restaurants, bars, hotels, theme parks and airports, the trend in average hourly earnings is going to be down in a very major way in the months ahead.

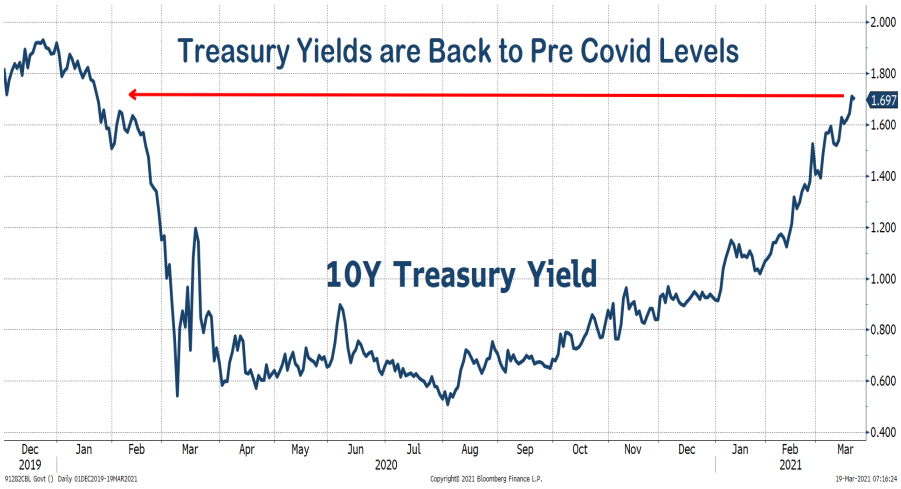
While everyone is focusing on headline inflation rates bumping up in the coming months, look for the trend in hourly earnings to do the exact opposite.



To be clear, it's not as if inflation can't come back. Supply chain disruptions, material shortages and base-effects from a year ago will likely take the headline inflation rate up to over 3% by May. Once we get past this transitory speculative-driven bounce in commodities and the "base effects" on headline CPI prints, inflation is going to come crashing back down again. In other words, don't confuse a short-term blip in prices with a persistent acceleration of prices.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

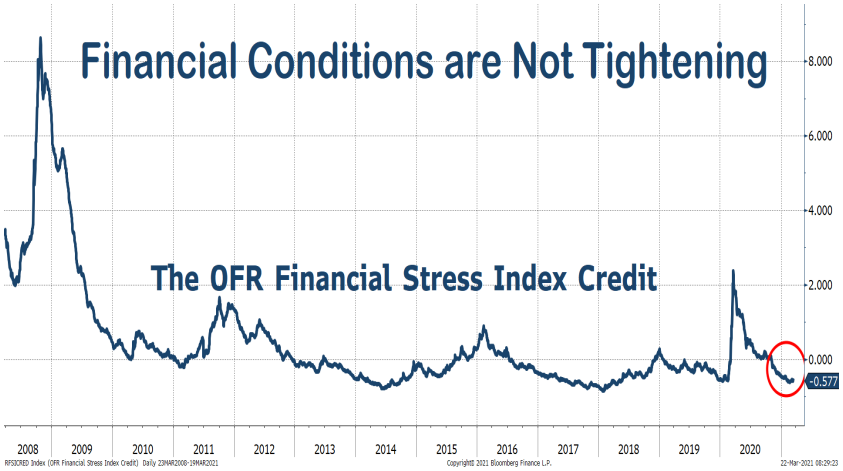
The next few months could be extremely volatile, as the stimulus money hits, and inflation rises due to low annual comparisons (base effect). Growth expectations have been ramped higher. The consensus GDP is 7% to 8% growth for this year and 4% to 5% now for 2022.



The massive fiscal package has been priced in very quickly. On the fears of an overheating economy and higher inflation, long-term rates have shot higher in a short period of time. This isn't the first time that things have happened quickly, and the question is when it is overdone. The long bond touched 2.5%, last week. The last time yields were this high was July 2019. At that time, core inflation was 2.2%, the unemployment rate was 3.6%.and and the funds rate was 2.375%. While rates could continue higher at current levels, a whole lot is already priced in. Do you really believe that the first global pandemic is the event the world needed to generate a decade ahead of inflation and economic escape velocity?

Will the bond vigilantes continue to pressure rates higher? If so, how will housing perform? What about the stock market? Or the credit markets? How high will rates go before the Fed says enough is enough and cap rates at some level via "yield curve control" or "operation twist?"

I believe the Fed will intervene when higher Treasury rates spill into other markets and generate an unwelcome tightening in financial conditions. That said, the Office of Financial Research (OFR) measure so far has shown just a modest 25 basis point tightening. So maybe we will have to wait a bit longer before the Fed says enough is enough.



From a risk management perspective, only fools try to pick the top or bottom and timing these moves is next to impossible. Nonetheless, I believe we are closer to the end of selling rather than the beginning. With so much excess liquidity (more coming) and the Fed on hold (cash will underperform) we continue to advocate a disciplined buy program of dollar averaging into market selloffs. As always, maintaining the appropriate risk profile is paramount.

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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

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