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INVESTMENT SERVICES

Weekly Relative Value

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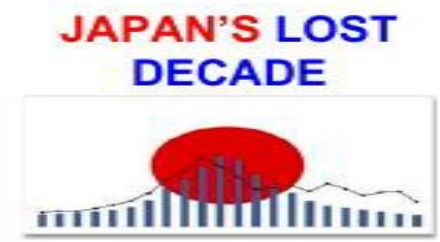
WEEK OF APRIL 5, 2021

On the Road to Japan?

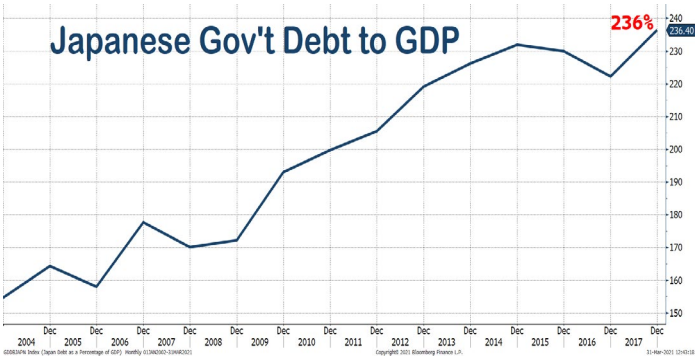
"It's shocking that households with $150,000 of income and three children will get $6,000 from the government... This looks a lot like a monetizing experiment." – Jeffrey Gundlach

In the 1970s and 1980s, Japan was the envy of the world with the world's second-highest GDP and ranked #1 in GDP per capita worldwide. But all of that ended in the early 1990s when its stock and real estate bubble burst and the economy stalled. At that point, Japan embarked on a new experiment of central bank financed government largess.



Source: *Japan's Lost Decade: Origins, Consequences and Prospects for Recovery*

Massive government spending, huge public debt and deficits, and ongoing central bank accommodation has been the norm for three decades in Japan. Today, Japan holds the title of having the industrial world's heaviest public debt burden with a debt/GDP ratio of about 240%. In other words, its debt is more than twice the size of its $5 trillion economy.



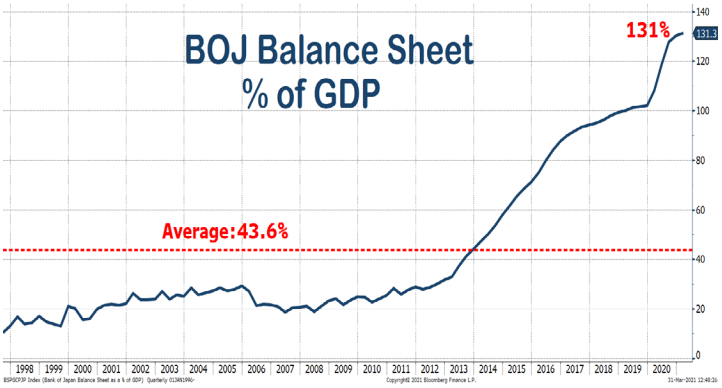
THIS WEEK

- COMING TO A THEATRE NEAR YOU
- GIDDY!
- MARCH MADNESS
- THIS IS NOT THE 1970s!

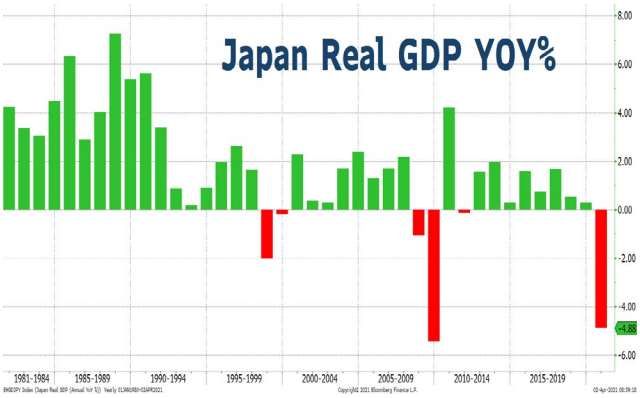
PORTFOLIO STRATEGY

SUBSCRIBE

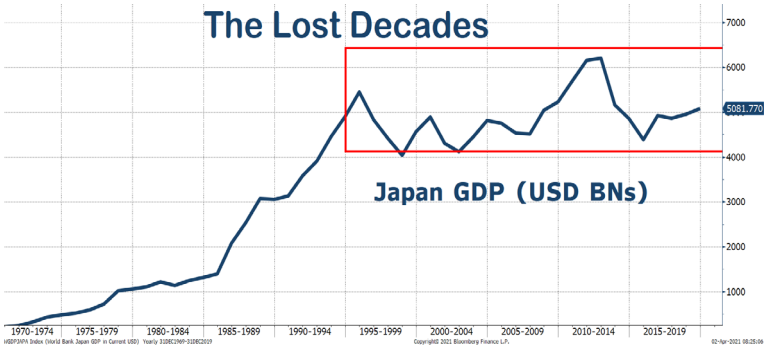
As the government was issuing debt, the Bank of Japan (BoJ) was buying the debt and expanding its balance sheet to 131% (15x in thirty years) and the money supply tripled in size.



Due to added stimulus and central bank intervention there have been many quarters of growth exceeding 4%, but there were also 40 quarters of negative GDP prints. In other words, since the start of this government-central bank relationship, all it created were the conditions for a boom-bust, stop-and-go economy.



As shown in the graph below, the country's GDP is no higher than it was in 1990! The term "lost decade" was used to describe the 1990s. Even decades later the country continues to struggle with deflation, zero interest rates, adverse demographics, and periodic bouts of negative growth. And there is no end in sight. In the end, Japan remains a sclerotic economy with little vitality and vigor. Issuing massive debt to prop up the status quo is a flawed prescription for future growth that will never work.



COMING TO A THEATRE NEAR YOU

Is the Japanese experiment coming soon to a theatre near you?

Many of the policies that have failed in Japan over the decades are now being played out across the world. After the largest decline in GDP since 1946, personal incomes rose sharply for the first time due to massive doses of stimulus checks and extended/enhanced jobless benefits. In fact, personal incomes rose to $19.7 trillion – $1.1 trillion more than what would have been realized had the pandemic not occurred.

In addition, the Biden Administration – in a move designed to help millions of renters who had fallen behind on their monthly "nut" – announced a new three-month extension to a nationwide eviction moratorium. According to the Urban Institute the amount of unpaid rent now exceeds $52 billion (the average household that has fallen behind on rent owed $5,586). The reality is that millions of renters have been unable to pay some or even all of their rent since March 2020.

So, thanks to the generosity of Uncle Sam, consumers have added a lot of extra income to spend since the pandemic began. For sure, everyone loves all that cotton candy from Uncle Sam. And why not? It's income that you don't even have to earn!

There is no doubt that March data will be absolutely spectacular. But then again Uncle Sam doled out $1.9 trillion the very same month. And it comes three months after the prior $900 billion handout. The consensus view on real GDP for the 2021 has ratcheted higher from 2% a year ago to nearly 6% currently. It is amazing what $5 trillion (14% of GDP) of painkillers can do to the economy.

So we will have a boom, almost exclusively because of the stimulus checks. Even if much of the stimulus gets saved or used to trade GameStop, the windfall was so big that even a small part going to the economy will provide a sharp boost to consumption and overall growth. This party will likely continue through the spring and summer.

But here's the thing. Without the government, real GDP would actually have contracted this year! In other words, the vitality of the economy really boils down to the recurring rounds of federal government spending. Big Brother is watching out for you! Karl Marx, Vlad Lenin and Leon Trotsky must be smiling in their graves.

And once we are past June and July, we are going to face a huge fiscal cliff. And don't expect another round of stimulus checks. And without stimulus the economy will repeat what happened in the last three months of 2020 in this stop-and-go-and-then-stop-again economy. This is the lesson for those who crave a free lunch, pseudo-MMT experiment.

GIDDY!

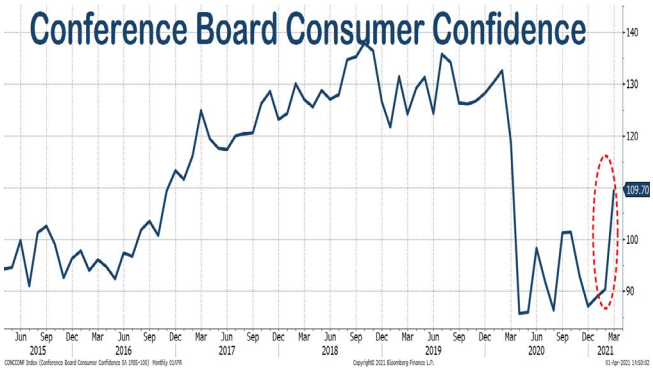
American consumers were downright giddy in March as consumer confidence exploded from 90.4 in February to 109.7 in March – the highest since March 2020.

The underlying components also smashed expectations:

- Present situation confidence rose to 110.0 versus 89.6 last month.
- Consumer confidence expectations rose to 109.6 versus 90.9 last month – the highest since July 2019.

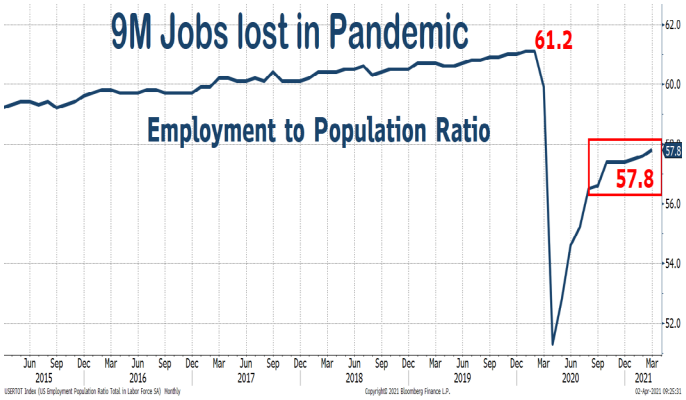
Still, putting these levels in context, they are still dramatically below the pre-COVID levels of confidence.

Maybe with just a few more trillion dollars of helicopter cash, that Main Street confidence will catch up?



MARCH MADNESS

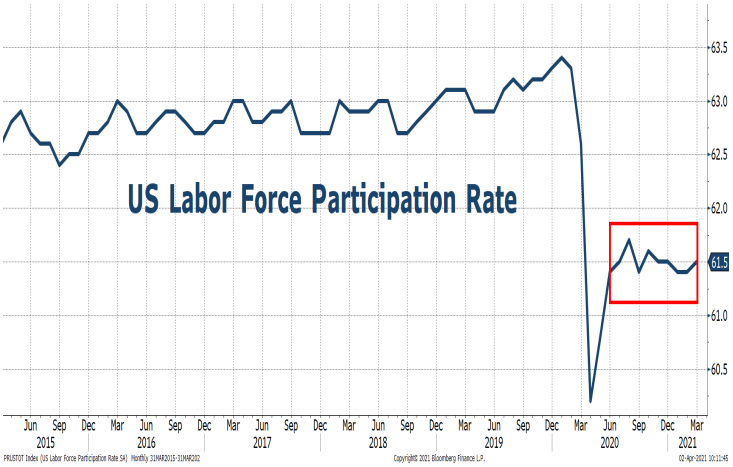
In March, the U.S. added a total of 916K jobs, smashing expectations of 660K, nearly triple the original February print of 379K and was the strongest payrolls report since last August. With January and February jobs being reviewed higher by 156,000 then we easily get a whopping one million plus change in payrolls. The job increase was concentrated where you would expect it with the vaccinations gaining momentum and wider swaths of the economy re-opening. The largest gains occurring in leisure and hospitality, public and private education, and construction.



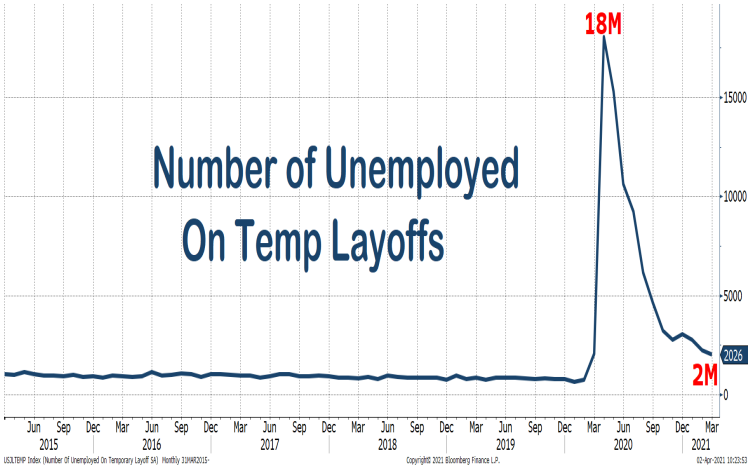
If the economy is re-opening and in view of state and local governments just receiving a huge check from the Feds, why wouldn't we see a big jobs spurt? With this March madness, we have now recouped 62% of the pandemic job loss. Even still, the hole is so big that we are still short over nine million jobs from where we were before the pandemic. And at the current pace, experienced so far in 2021, it will take 20 months to reach pre-pandemic employment levels.

As a result of the burst in new hiring, the unemployment rate dipped from 6.2% to 6.0%, in line with expectations.

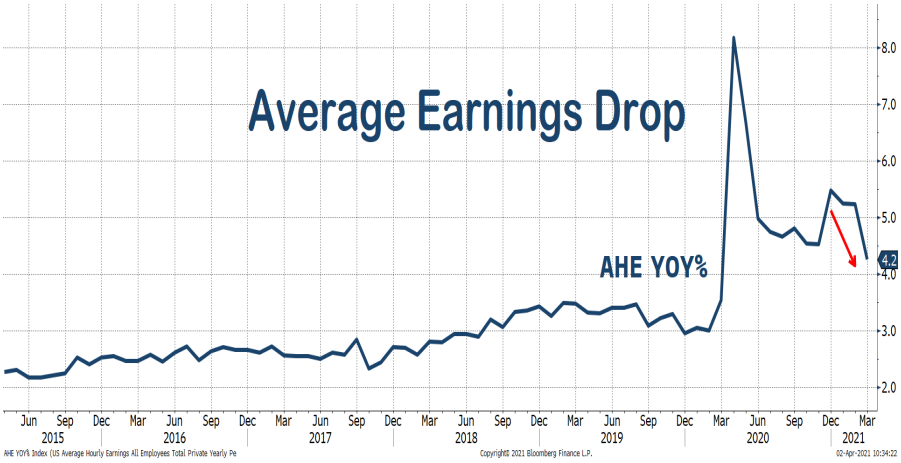
The participation rate resumed its modest increase, rising to 61.5% from 61.4% last month. The number of people not in the labor force remained above 100 million, or 100,445,000 to be precise, of whom 6.85 million want a job now.



The closely watched number of unemployed people on temporary layoffs declined again, if more modestly, from 2.229 million to 2.026 million. The smaller number of workers left on temporary layoff reduces the scope for the rapid pace of gains seen last summer, but it remains a positive factor relative to the pre-coronavirus pace of job gains.



There was some disappointment on wages with average hourly earnings declining -0.1% month-over-month, or by four cents to $29.96, compared to a 0.3% increase last month. Annual earnings growth rose 4.2% also missing the 4.5% estimate and down from 5.2% last month. However, lower wages were offset by a longer work week – increasing by 0.3 hour to 34.9 hours in March, following a decline of 0.4 hour in the prior month.



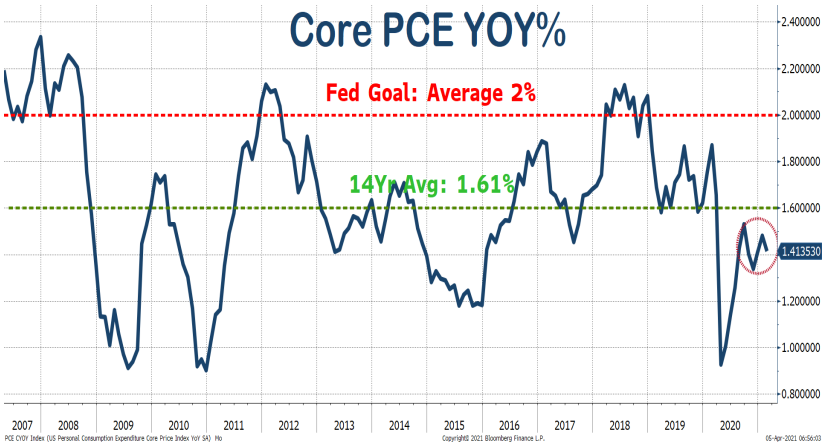
THIS IS NOT THE 1970s!

People like to compare what's happening today to the 1970s. Well, I actually remember those days quite well (well, most of them) and I can say that the '70s were a unique period of time in many ways. But from an economic perspective history union ran the show. Cost of living adjustment (COLA) clauses were ubiquitous. As a result, wage and price inflation became institutionalized.

The recent inflation run-up – which began last summer – is due to the run-up in commodities due to clogged supply channels and higher freight rates. But understand that a sustainable inflation cycle is not caused by rising commodity prices. As I have highlighted previously, rising wages are the key to higher prices. And wages and salaries, as of the February personal income and consumption report, are running at 0% on a year-over-year basis.

Inflation is a process where companies raise prices in an accelerating and frequent pattern. Wages have to absorb the higher prices, or the demand goes down and with that...prices. Price inflation needs wage inflation like how a fish needs water to survive. Simply put, there is no inflation without a rising wage cycle.

As shown below, the Fed's preferred inflation metric (Core PCE) has actually receded of late and stands at 1.4% year-over-year.



That said, we will most assuredly see higher inflation prints (consumer price index (CPI)) over the next three months. This is due to the "base effects." Indeed, when the forthcoming year-over-year headline inflation data is published it will be based off of a pandemic induced 0.5% reading from March 2020, -0.3% in April and 0.1% in May.

But beyond May, the inflation data will be calculated off a June 2020 CPI boost of 0.5%, +1.0% in July and then +1.4% in August.

Thus, after a baked in the cake hook-up in the year-over-year price trends in March, April and May, we will likely witness a sharp reversal in June, July and August. Moreover, this future decline in inflation may be occurring alongside downward GDP growth revisions as fiscal stimulus wanes.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"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

The pace of vaccinations and re-openings in America continues at an impressive clip, and the markets are looking well past the pandemic to a world of massive fiscal support. The focus is squarely on the U.S. where President Joe Biden is pushing hard for a $3 trillion infrastructure plan and the $1.9 trillion that just passed is only beginning to percolate.

As such, investors are increasingly embracing the reflation/inflation view and bonds are being sold in an accelerating fashion as Treasury yields have moved into a new and higher range of growth and inflation expectations. Surprisingly, the Fed, as of now, has not resisted the back-up in yields. This strikes me as being odd because the Fed is openly predicting lower growth and inflation (see table below) than the market is seeing.

Federal Open Market Committee (FOMC) members seem to be encouraging investors to take on a different view than the central bank thus egging on the bond vigilantes even more. Bond market vigilantes continue to posit that the Fed is behind the curve, tapering will take place and the Fed will have to raise rates long before their dot plot suggests.

	2021 Est.	2022 Est.	2023 Est.	Longer Run
Real GDP central tendency:				
March 17, 2021	5.8% to 6.6%	3.0% to 3.8%	2.0% to 2.5%	1.8% to 2.0%
Dec. 16, 2020	3.7% to 5.0%	3.0% to 3.5%	2.2% to 2.7%	1.7% to 2.0%

Source: Bloomberg

I continue to believe that the bond market is deeply oversold and represents good value, but near-term it is obvious that this herd mentality is unbelievably strong. We may have to wait until the stimulus gas runs out of the tank in the second half of the year to see a sustained rally.

That said, as highlighted a few times in the 2009-2019 cycle, there were ten episodes of these bond yield surges. Even with repeated QEs, zero policy rates, tax cuts, huge deficits, two mini-cycles of surging commodity prices, infrastructure and tariff hikes staying the course proved to be the right strategy for the entire cycle.

From a portfolio perspective, with the Fed on hold, excess cash will continue to negatively impact income and margins. As such we continue to advocate that credit unions move further out the curve (five to seven years) to realize greater income potential to enhance margins. A disciplined buy program of dollar averaging into market selloffs – while maintaining the appropriate risk profile – remains the most prudent risk management approach.

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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.

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