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INVESTMENT SERVICES

Weekly Relative Value

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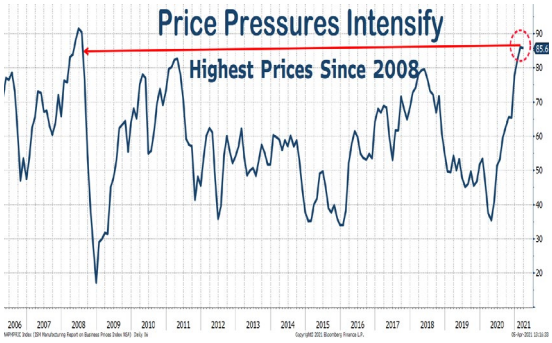
WEEK OF APRIL 12, 2021

The Economy on Wheels

For the here-and-now, there is no doubt that the U.S. economy is in a boom right now. Moreover, the latest incoming robust economic data in March occurred without the latest round of policy stimulus boosting the economy. So, over the next two months it's safe to say that economy will be on wheels.

Last week, the ISM manufacturing purchasing managers' index (PMI) climbed to 64.7 in March from 60.8 in February to hit the best level since December 1983. Sensationally, 17 of the 18 industries reported growth. Notably, new orders rose to 68.0 from 64.8, the best reading since January 2004.

Production ratcheted to 68.1 from 63.2, and there's likely more to come as customer inventories have plunged to the lowest level on record. The percentage of respondents saying inventories are "too low" soared to an all-time high of 45.5% from 39.8%. A mere 5.3% complained about inventories being "too high."



THIS WEEK

- HITTING THE LIGHTS OUT!
- IT'S ALL ABOUT WAGES!
- BANK CREDIT CONTRACTED

PORTFOLIO STRATEGY

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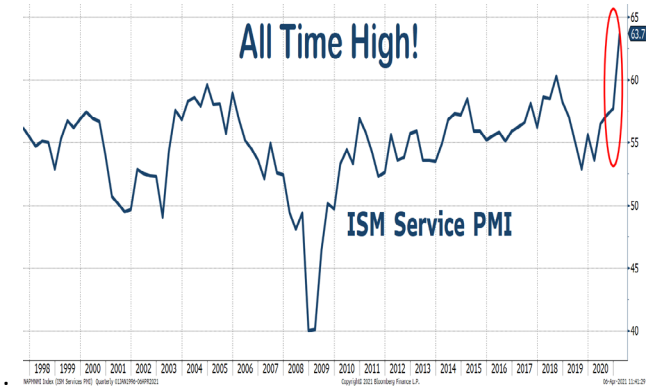
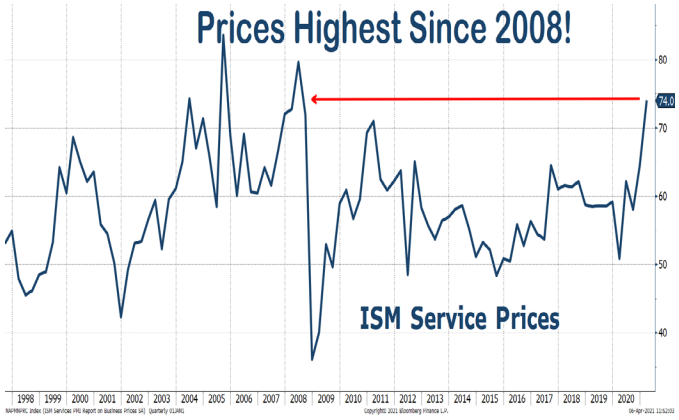
And due to the increased demand, along with bottle necks in the supply channels, manufacturing prices paid remained at a lofty 85.6. Over the past two months manufacturing prices have shown the highest back-to-back prints since June-July 2008. Before that, the previous highs were October-November 1979, and prior to that, July-August 1974. Unquestionably, prices continue to be pressured higher near-term as the system can't handle all the stimulus-fueled demand.

HITTING THE LIGHTS OUT!

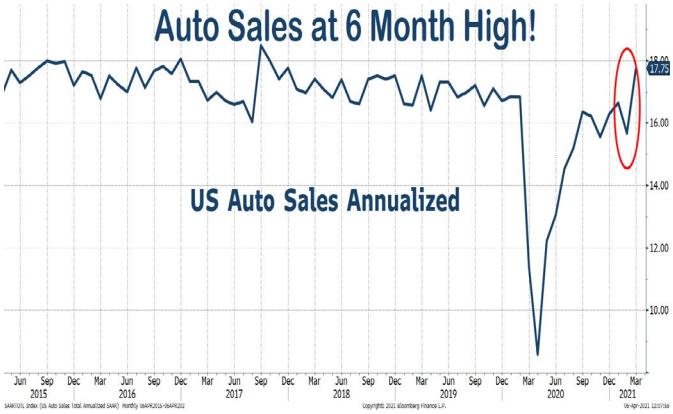
Like its manufacturing counterpart, the March ISM Service PMI index hit the lights out. The index soared from 55.3 in February to 63.7 in March, setting a new all-time high. New orders soared from 51.9 to 67.2, also a new peak.



Like in the manufacturing sector, the prices paid index has indeed spiked again, from 64.2 in January, to 71.8 in February, to 74.0 in March. The last time prices were at this level was in July 2008 and October 2005. While it's tempting to assume that overall inflation will rise dramatically, that has not been the case historically. In the wake of the July 2008 reading, the inflation rate (12 months later) collapsed from 5.6% to -2.1%. After the October 2005, the inflation rate went from 4.3% to 1.3%. In other words, this is a contrary indicator! This index tells you what has already happened. It is purely, and simply, a coincident indicator with no leading properties.

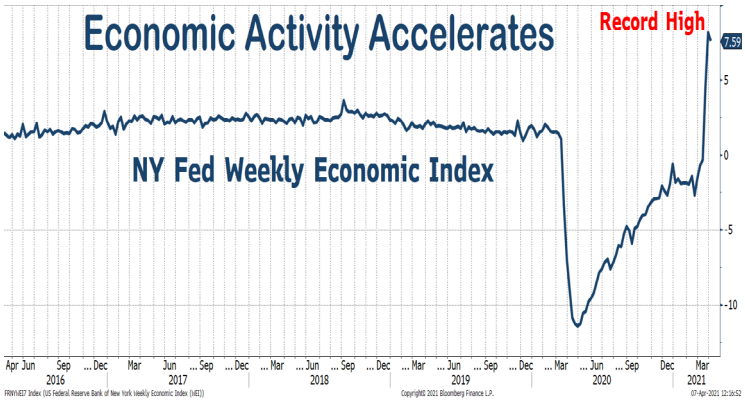


Moving on. Outside the robust manufacturing and service surveys, auto sales soared 13% month-over-month in March to an 18-million-unit annual rate (+56% from depressed year-ago levels) which is the highest level since August 2015.



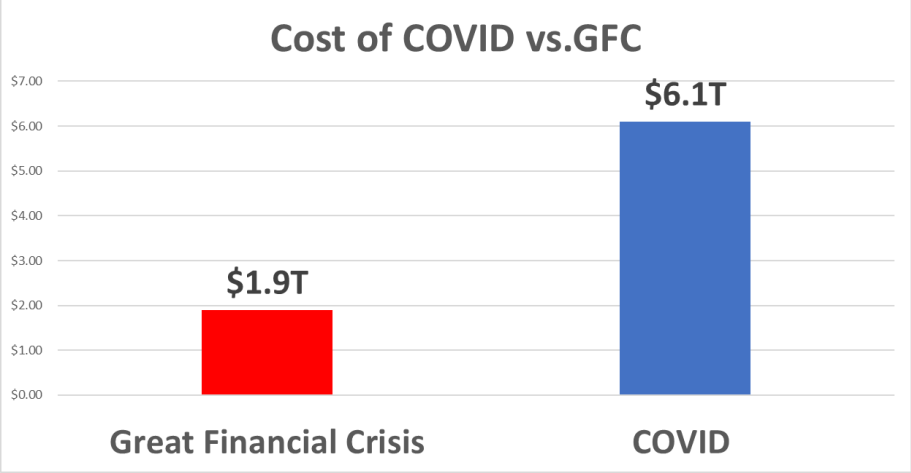
The Johnson Redbook retail sales number is up a record 10.6% year-over-year as of April 3.

Finally, the New York Fed's Weekly Economic Index is up 7.59% year-over-year, also a new all-time high. These numbers are bound to get even stronger through the second quarter, even if a small amount of that big stimulus finds its way into the economy.



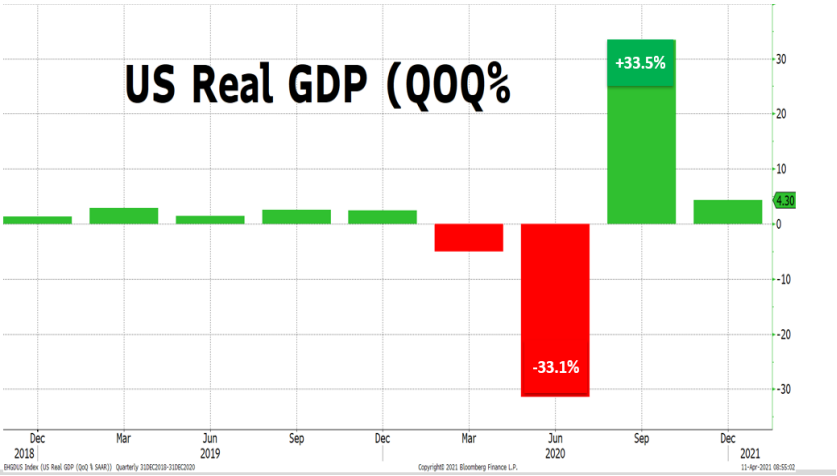
Yes, the economy is booming. How could it not? Look at the chart below. Since the pandemic commenced, the U.S. has spent $6.1 trillion to support the economy. This is three times the support during the Great Financial Crisis. I should add that the $6.1 trillion does not include the potential $1.5-$2 trillion from the proposed Biden infrastructure plan.

"Stimulus cheques are lifesavers for poor households and will be spent on goods and services. But the fiscal multiplier is likely to be small when a worker making $70,000 a year uses his cheque to invest in cryptocurrencies. Retirees, now who saw abatement in their incomes, are also unlikely to spend windfall cheques."



As shown in the chart below, in Q3 the inflation-adjusted GDP surged 29.91% from the Q2 reading of -35.94%. As stimulus ran out, Q4 GDP only increased by 3.95%. If we assume that Q1 will increase by the Atlanta Fed GDPNow estimate, GDP will show an 6.2% advance. That advance is the result of the $900 billion stimulus bill in December.

As I have stated previously, beyond stimulus there is no real vitality to the economic backdrop. Everything we have seen thus far is based on massive stimulus. It's not sustainable and its transitory. Frankly, no one knows what the real economy will look like in a post-COVID-19 steady state where policy stimulus is no longer providing so much medication. We will have a better reading past mid-year once the vaccinations are done, the economy re-opens, the euphoria party runs its course and the stimulus checks run out.

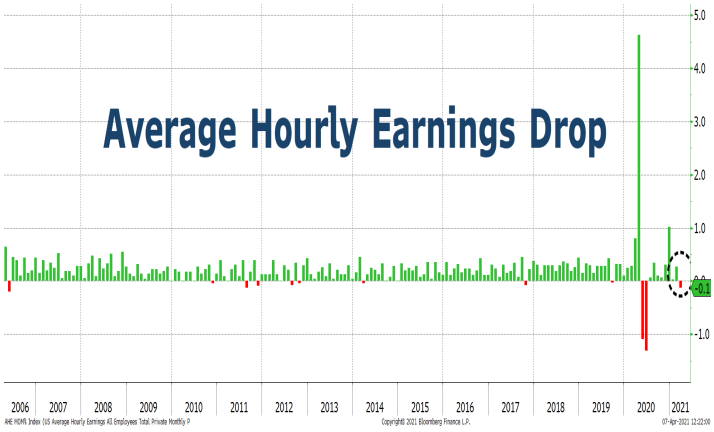


IT'S ALL ABOUT WAGES!

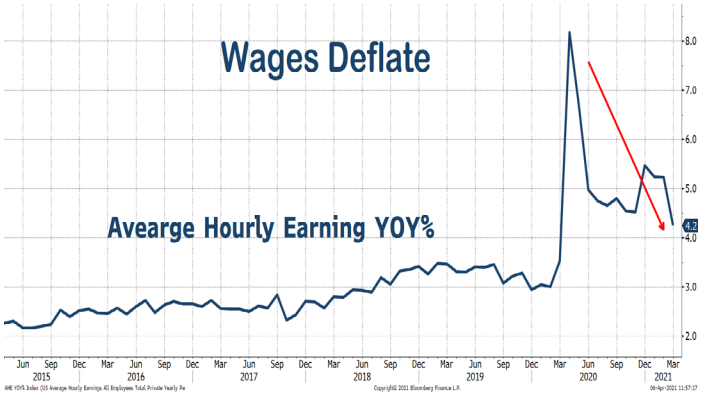
Last month we saw record gains in employment. This is clearly welcome news. That said, while a whole lot of workers came back into the workforce in March, average hourly earnings fell 0.1%, which was the first decline since June when the economy was in disarray. This does not happen very often. As shown below there are very few monthly declines in earnings. In fact in the past, we have we only witnessed an outright wage decline about 8% of the time in any given month.

Wages are unlikely to rise significantly anytime soon. The reason being is labor is abundant.

- There are still 8.4 million less jobs than before the pandemic struck (only 62% of the pandemic job loss having been recouped).
- 1.6 million additional workers are working part-time but want full-time work.
- 2.1 million whose jobs have been lost permanently.
- 3.1 million have been unemployed for 27 weeks or longer (43% share of the jobless ranks).
- Finally, the unemployment data doesn't include the four million people who left the labor force these past thirteen months.

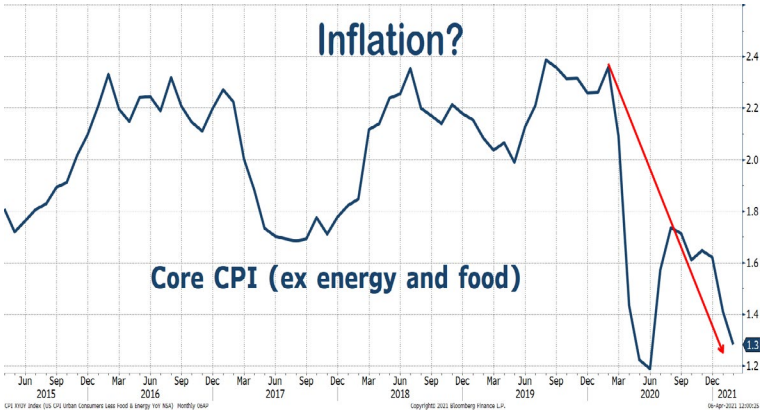


So in summary, there are six million outside the labor force who would take a job if offered one. Another six million underemployed in the sense that they are working part-time but would prefer to have a full-time job. In total, the pool available labor is approximately 17 million, which is 50% above the pre-pandemic level of 11 million.



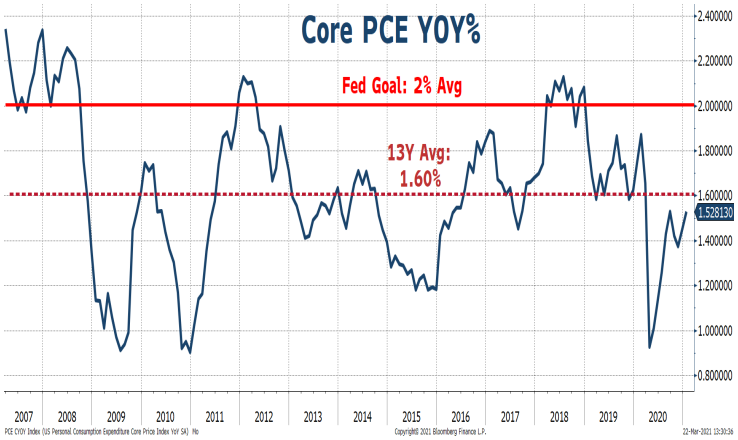
There is much talk about wage growth and that companies are going to be boosting wages to attract workers. But that is clearly not happening. The year-over-year trend shows average hourly earnings appearing to have peaked at 4.2%. And it now appears that wage momentum is subsiding fast. The six-month trend is +3.1% at the annual rate and a mere 0.7% over the past three months. This inflation narrative of companies being forced to boost wages to attract labor seems off base. With so much labor capacity, why would businesses be raising their compensation plans unless they suddenly feel charitable?

The funny thing is, so many people are freaking out about inflation at a time when both average hourly earnings and the core consuper price index (CPI) are running at the grand total of a 0.7% annual rate. Hysteria versus reality?



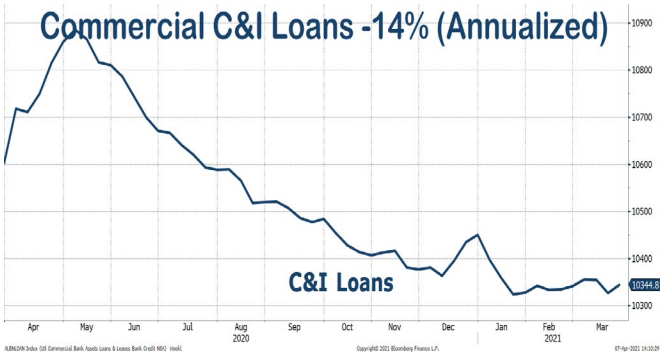
Boston Fed Senior Economist Viacheslav Sheremirov had this to say about inflation:

"On Wall Street about the prospect of runaway inflation are so far misplaced because there is still ample slack in the economy according to a wide range of key metrics. … Core PCE inflation also suggest little inflationary pressures."



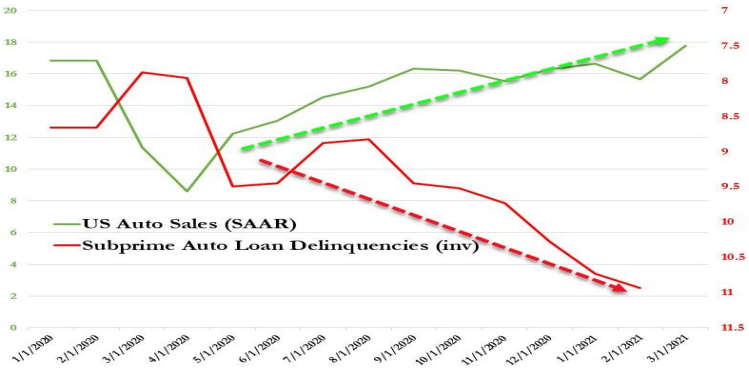
BANK CREDIT CONTRACTED

U.S. bank credit declined 0.3% in the week of March 24, following a 0.6% pullback the week before. In that same week, commercial and industrial loans shrank 1.1%, and this came on the heels of a 1.4% fall-off the previous week. The four-week trend is now running at a -14.3% annualized pace.



The weakening in the housing market is also underscored by bank-wide residential lending, which has contracted at a 3.6% annual rate over the course of the past four weeks. The same goes for commercial real estate as CRE credit has fallen at a 1.0% annual rate over the same timeframe. Credit card borrowing has been trimmed again in the past week at -0.1%.

Auto lending is the only segment of banking sector credit that has been expanding in recent months. In the past month, auto loans increased at a 7% annual rate. This explains the surge in vehicle sales in March to a six-year high of 18 million units.



Source: Bloomberg

However, 10.9% of these debtors are now at least 60 days behind on their payments (from 8.7% a year ago). This is the highest figure on record, back to 2005. Amazingly, nearly 20% of all the auto loans were to subprime borrowers the last year. And now the delinquencies are mounting.

Car payments represent the largest monthly debt payment for many borrowers who are in the subprime designation, and who may be in service industries such as restaurants or bars (and thus, need wheels to get to work).

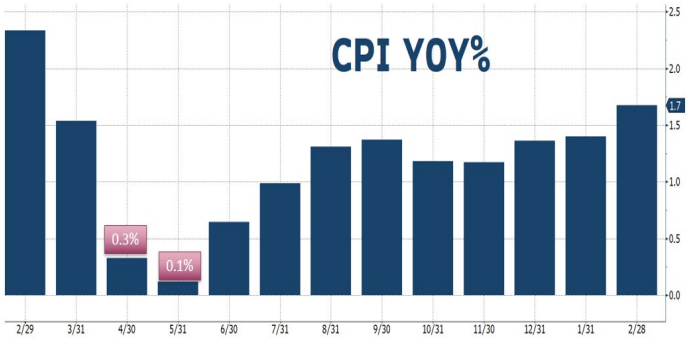
With the rising delinquencies, the fact remains that borrowers are juggling, and perhaps triaging different expenses – not an easy task when 60% of U.S. individuals and families live paycheck to paycheck.

So inquiring minds are wondering if the next White House bailout is for subprime auto loan borrowers.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The fact that the Treasury market has withstood the storm from the latest round of fiscal stimulus, all the chatter about a big, bold infrastructure plan, and the ripping March employment data (as well as last week's record-setting service sector ISM) is good news.

On the inflation front, incoming year-over-year comparisons may produce very large numbers. It's not that inflation will be rampant. Rather, it's the impact of year-over-year comparisons, goosed by a huge Covid-related dip in energy prices in April and May of 2020. As you can glean from the graph below, in March 2020 CPI was 0.3%. In May 2020, CPI bottomed at 0.1%. The forthcoming March and April CPI data for 2021 will be compared to these pandemic depressed inflation rates.



Source: Bloomberg

Furthermore, there is a whole lot of inflation and Fed rate hikes embedded in the current yield structure. With the Fed emphasizing patience and waiting for actual progress amid a long road to full recovery, we believe there is room for the

market to push back the hiking cycle. Despite the rally last week, the belly (4-7 years) of the yield curve continues to offer good value. There is plenty of room for rates to fall further.

As an aside, even with the Fed no longer allowing the banks to buy government bonds without any capital requirements, they have once again been stepping up their buying of Treasuries. Perhaps taking advantage of a market that has already priced in peak inflation and peak Fed funds in barely more than three months' time. In the past two weeks, the commercial banks have purchased a net $49 billion of Treasury securities.

We continue to advocate a fully invested, risk appropriate ladder strategy to managing excess cash reserves. Excess cash should be minimized.

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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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