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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF APRIL 26, 2021

Investors Party Like It's 1999

"For equity markets, the parallels between current conditions and those of 1999 are striking and worrisome." – Tobias Levkovich, Chief U.S. Equity Strategy at Citi, op-ed via The Financial Times

Regarding the above quote, whether it's 1999 or 2007, you get the point. Stock valuations are extended, if not grossly overvalued, but few seem cognizant of the risks. Most investors have thrown caution to the wind and are more heavily invested in equity assets that ever before. As shown below, the Bank of America private client allocation to equities is now at record highs. Investors are currently "all in" on the equity risk pool. Investors continue to increase "risk appetites."

The stock market is currently pricing in a "huge" economic recovery. As noted by Goldman Sachs in a recent report, they now expect economic growth in 2021 to hit levels not seen since the early '90s.

THIS WEEK

- THE BIGGEST BUBBLE
- THE STRANGEST RECESSION EVER!
- SPEND OR SAVE?
- LABOR SHORTAGE?
- TAKING THE JAB
- RECORD HIGH
- CUT PRICES AND THEY WILL COME!

PORTFOLIO STRATEGY

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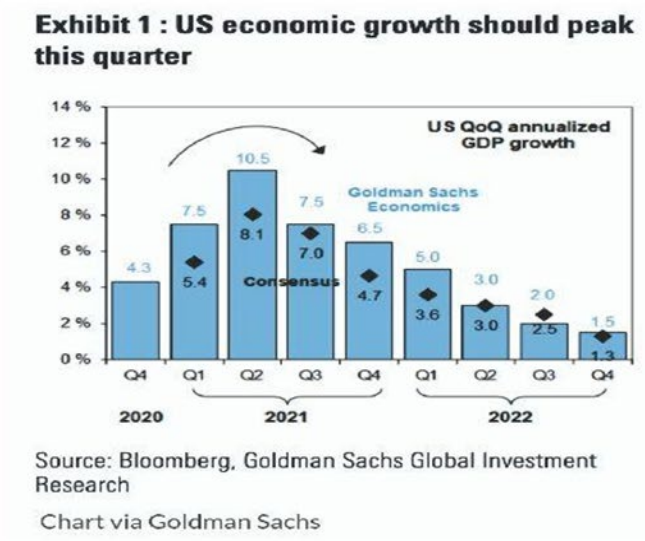
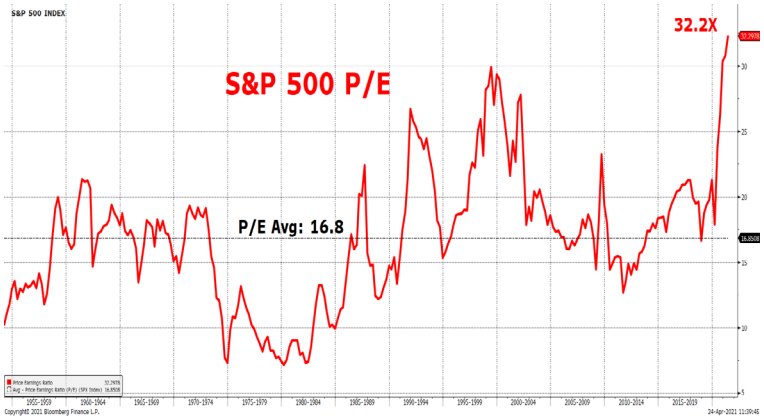
However, when looking at the table below, the key takeaway is after the initial surge of reopening and growth, activity quickly returns to historical norms.



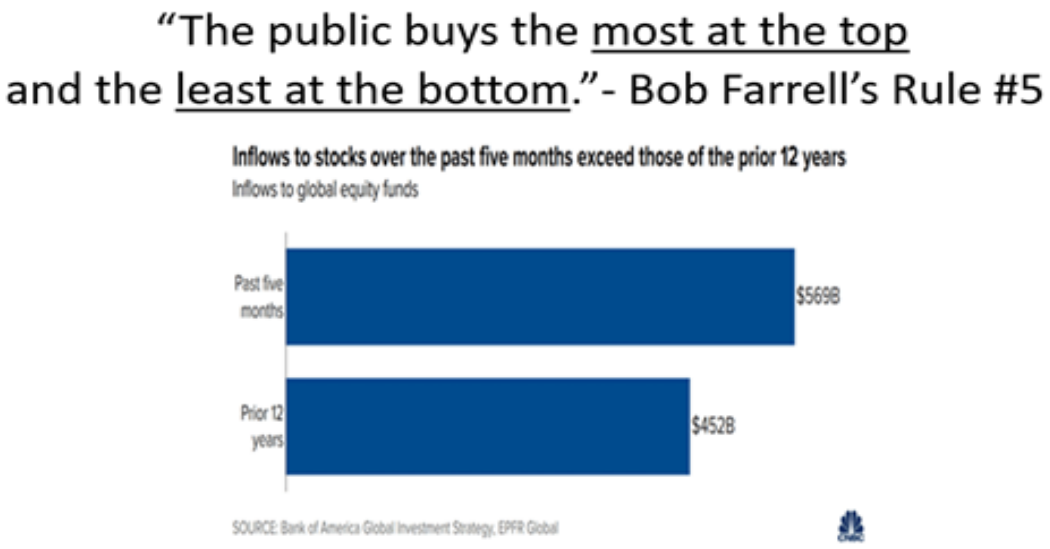
The S&P 500 is supremely expensive and priced to perfection with a trailing P/E of 32. Amazingly this multiple has expanded more than 10 points in the past year even as 10-year Treasury yields rose by nearly 100 basis points. With the 10-year Treasury note yield above the S&P 500 sub-1.5% dividend yield we don't hear TINA or "There Is No Alternative" any longer.

Of course, "valuations" have nothing to do with market prices in the short-term. They do, however, have everything to do with long-term returns. If economic growth fails to achieve "peak" expectations, the reversion could be pretty extreme. Here is some math. If, for any reason, the price-earnings multiples "normalize," that would imply a 30%-40% correction in the stock market. But we won't go there, right?



I have said time and time again you cannot time bubbles. They have a mind of their own and can reach silly levels. But over the long run, prudence and risk management will always win out over recklessness. Yet as is the case with human nature, investor psychology is overtaken by temptation to play the momentum game.

Surveys show that over 50% of individuals receiving stimulus checks have purchased stocks and have become stock "traders" playing the price momentum game. It's an attractive "side hustle." Take a look at the table below. Equity inflows into stock funds over just the past five months exceeded $569 billion which exceeded inflow of the prior 12 years ($452 billion). Truly amazing stuff.



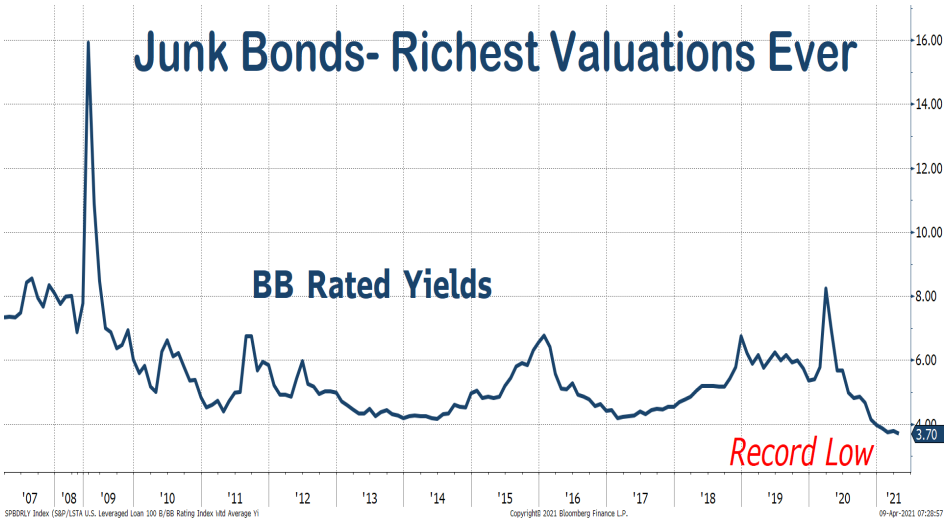
However, even with extreme valuations, not only did they increase exposure to equities, but investors have also leveraged their portfolios to take on even more risk. Historically, these episodes have not ended well for investors.

THE BIGGEST BUBBLE

The biggest bubble may be in the market for junk bonds. There was an article in the Wall Street Journal – *Corporate-Bond Measure Hints at an Upbeat Outlook*. It should read *High Yield Market Prices in No Default Risk*. The average yield on non-investment grade corporate credit is a 4.03%. BB-rated debt yields are at a mere 3.70%.

The high yield market now trades at a thin 250 basis point spread to 10-year Treasuries – which is the tightest since 2007! Remember what happened in 2007? Take a look at the graph below.

Like today, in 2007 everyone believed we were in a new era as it pertained to the credit and housing markets. Risk being mispriced to this extent is classic top-of-cycle stuff.



THE STRANGEST RECESSION EVER!

"Ask not what you can do for your country, ask what your country can do for you." – President Joe Biden (paraphrased)

Real GDP collapsed 3.5% in 2020 and employment cratering 5.7%. These are the worst number since 1945 – the mother of all recessions. Yet look at the following data:

- Real personal income: +4.9%.
- Equity returns: $51 trillion; gain in global equity market cap since Mar'20 lows (fastest/largest rally all-time).
- Home prices: U.S. house prices +17% year-over-year (highest ever).
- New home sales: +20.1%.

Aided and abetted by on-and-off fiscal and monetary policy stimulus we experienced the worst recession and largest unemployment since the Great Depression, yet incomes rose because Uncle Sam stuffed people's bank accounts with recurring rounds of stimulus checks. Government transfers to individuals were up a record 36.6% last year.

Government spending soared 49.7%, which is unprecedented in the post-WWII era. Putting this number in perspective, government spending rose 41% during Lyndon B. Johnson's Great Society largess.

Finally, central banks cut interest rate cuts 201 times since February 2020 (989 since the global financial crisis (GFC)) and have purchased $1 billion of financial assets every hour since February 2020 ($21 trillion since GFC).

Overall, there has been $30 trillion of global policy stimulus in '20 & '21 ($17 trillion fiscal + $13 trillion monetary).

Let's assess the situation for what it is. There is no U.S. economic growth barring the government's relentless support. If not for the massive surge in government expenditure in 2020 nominal GDP would have collapsed 16% instead of contracting over 2% to its lowest level in six years. This should put any recovery into perspective.

One cannot help but wonder if the government and central banks have proven it can eliminate the business cycle? History would suggest no.

Remember: everything in life ends up coming with a price. Speaking of paying the price, all of a sudden, investors are realizing someone is going to pay for all the fiscal largess. President Biden will tax capital gains for taxpayers who earn more than $1 million at the personal income tax rate, which he also wants to raise to 39.6% from 37%. Add the 3.8% Obama Care tax on investment, and you get to 43.4%. And that's merely the federal rate. Rates would be even higher in many U.S. states due to state and local capital gains taxes. Add 13.3% in California and 11.85% in New York (plus 3.88% in New York City), which also tax capital gains as regular income, and you are heading toward the 60% rate range.

Will this pass? Doubtful in its current form. However, after a long period of bickering, I do expect a more modest increase in taxes than what we see on the table now.

Any increased tax rates on corporate America could cost the stock market especially with the current inflated "P/E multiple" discussed above. Don't worry though, Wall Street strategists are saying the hit to the market would be only temporary.

SPEND OR SAVE?

The latest $1.9 trillion stimulus bill continues to make its way through the system, but according to the New York Fed the impact on consumption may not be as powerful as widely believed. There are two points worth highlighting.

First, the majority of the checks will go towards savings (41.6%) or used to pay down debt (33.7%). Only a quarter will be spent. Second, this is a transitory sugar high that just exacerbates the stop-and-go nature of this economic recovery.

Stimulus	Round 1	Round 2	Round 3
Avg. Share Saved	29.20%	25.50%	24.70%
Avg. Share Spent	36.40%	37.10%	41.60%
Avg. Share Used Toward Debt	34.50%	37.40%	33.70%

Thus, there may not be as much true fundamental support underpinning consumer spending as the economic consensus believes. Further, it begs the question: once we are into the summer and fall, with the economy open and the stimulus checks gone, what happens to growth beyond these points?

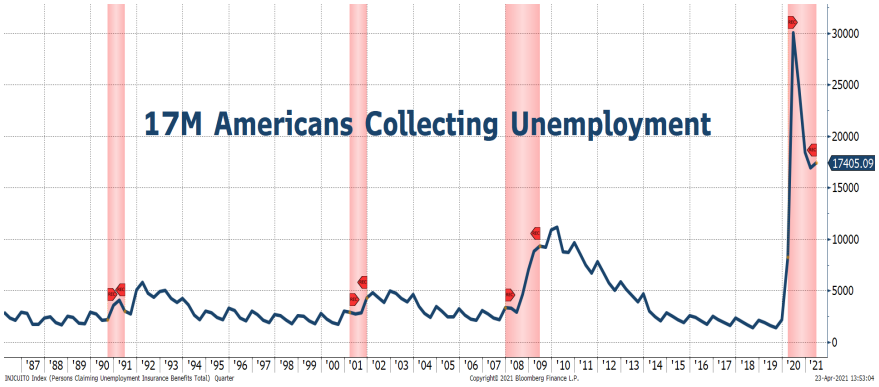
Oh, and as for the ballyhooed "infrastructure" plan, the Senate Republicans have come up with a plan of their own at $568 billion, nowhere near the $2 trillion boondoggle that the Biden team has proposed (and even lower than Obama's spending package of $800 billion in 2009).

LABOR SHORTAGE?

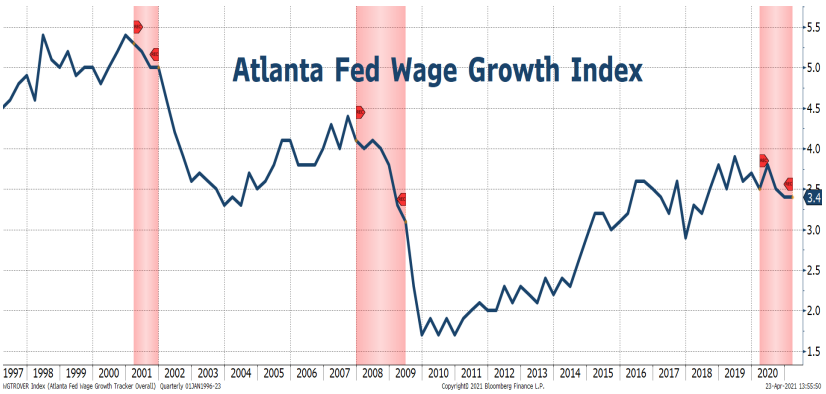
We have the vaccines, the re-openings, and the mountain of policy stimulus, but we have a ton of idle labor. Let's take a look. There are 9.7 million Americans who are officially unemployed, another 6.9 million who are not counted in the labor force, but would take a job if offered one, and 5.8 million working part-time. but actually want a full-time job. This comes to a total pool of available labor of 22 million.

At the same time, there are over 7 million job openings as per the latest Job Openings and Labor Turnover Survey (JOLTS), which is where they were pre-pandemic. The bottom line is that if just one-third of the idle labor resources were put to work right now, every one of these posted job openings would be filled.

We have 17 million Americans now on at least one jobless benefits program. Before the pandemic, this number was barely more than 2 million. Again, this speaks to abundant labor supply. Maybe people are scared to go back to work because of the lingering virus and mutations. More likely, it is the extreme generosity of the extended jobless benefit schemes and a belief that this gravy train will never end.



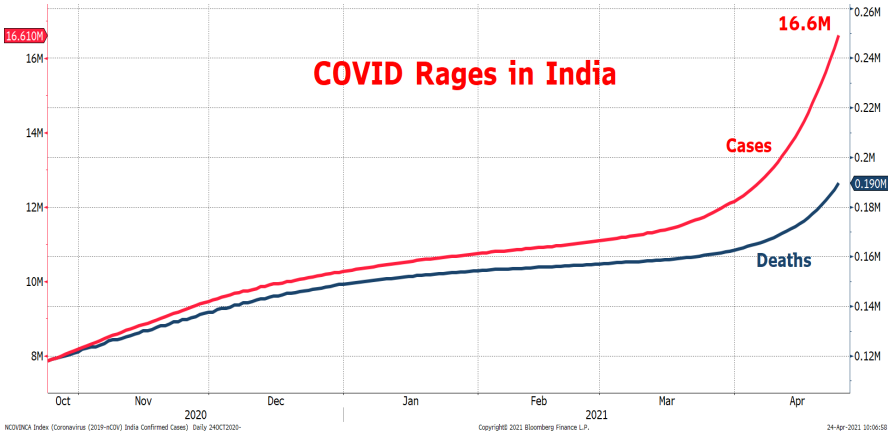
Finally, the truth is generally in the price. While there is a lot of talk about wage hikes accelerating, this still isn't evident. Take the Atlanta Fed wage tracker. The latest reading is 3.4%, which is lower than it was before the COVID-19 pandemic struck.



TAKING THE JAB

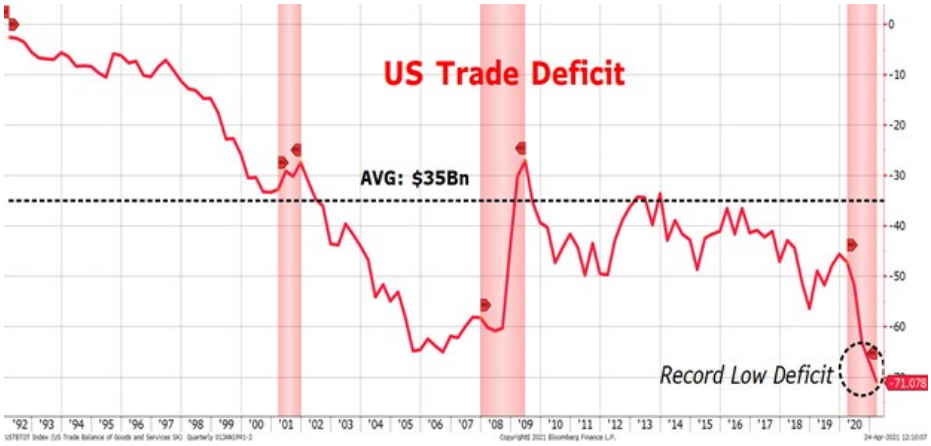
On the COVID front, Americans have been vaccinated at an impressive rate. As shown below, over 222 million Americans (67% of the population) have received at least one dose vaccination. Those considered fully vaccinated are now at 91 million, or 28% of the population. Globally, one billion COVID-19 vaccines have been administered as of April 24, 2021.

Even as Americans take the jab at an accelerated pace, much of the rest of the world is lagging well behind. India reported a world record one-day jump in cases at 314,835 last Friday amid reports the country's health system is close to collapse.



The World Health Organization (WHO) also warned on increasing infections in Argentina, Turkey and Brazil. Globally, the case count just passed the 145 million mark, and this virus resurgence is definitely a threat to this world growth momentum. One thing is certain and that is the pandemic isn't over until it's over globally. More than 3 million people have died, and daily deaths have averaged 12,000 over the past two weeks. And with test positivity rates skyrocketing in some jurisdictions, it's likely that these figures underestimate the true scale of the tragedy unfolding.

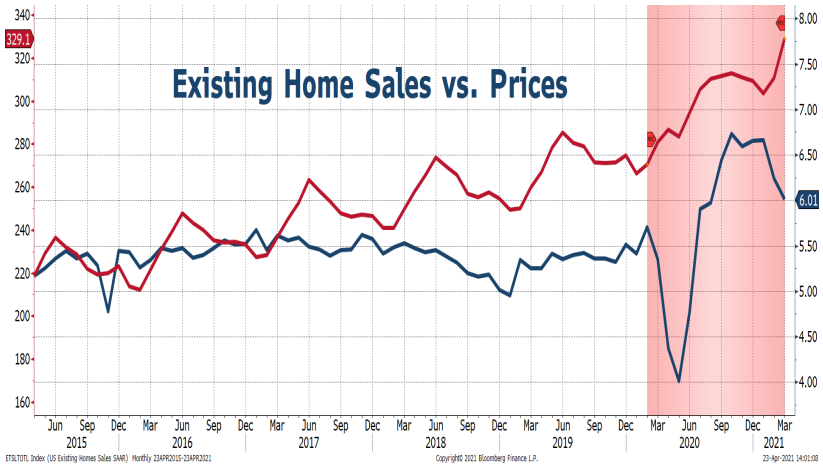
And just remember that U.S. exports are a $2.5 trillion chunk of GDP and already have contracted 10% over the past year as the trade deficit follows the fiscal deficit into the stratosphere.



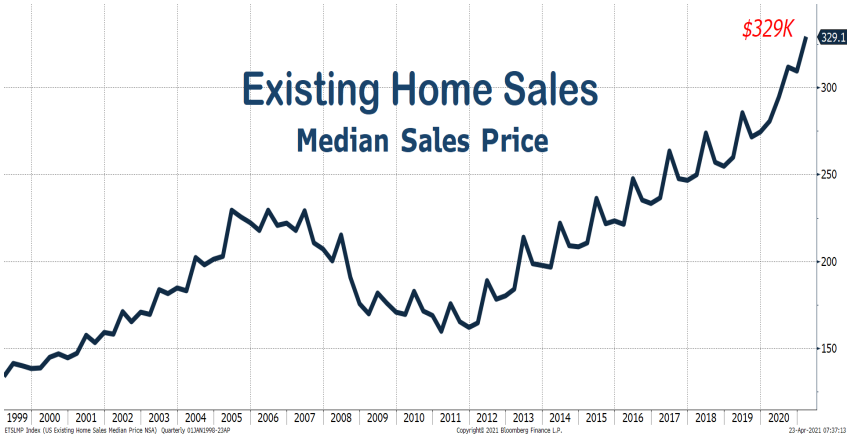
RECORD HIGH

"We know that home prices have been rising, mortgage rates inching higher, housing affordability becoming much more challenging, however I would say the softening sales activity is not due to demand going away… Demand remains strong, it is simply the severe lack of supply that is holding back sales conditions."
– Lawrence Yun, NAR's Chief Economist

After unexpectedly plunging in February (exaggerated by weather conditions), analysts expected existing home sales to continue to slide in March as affordability (inventories and rates) squeeze the marginal panic-buyer at record high prices. Yes indeed, existing home sales were worse than expected, tumbling 3.7% month-over-month (for the second straight month). This came on the heels of a 6.3% plunge in February to mark the first back-to-back drop of this magnitude since April-May 2020 when the economy was backsliding. And while sales are up over 12% year-over-year, the recent plunge in sales has been dramatic.



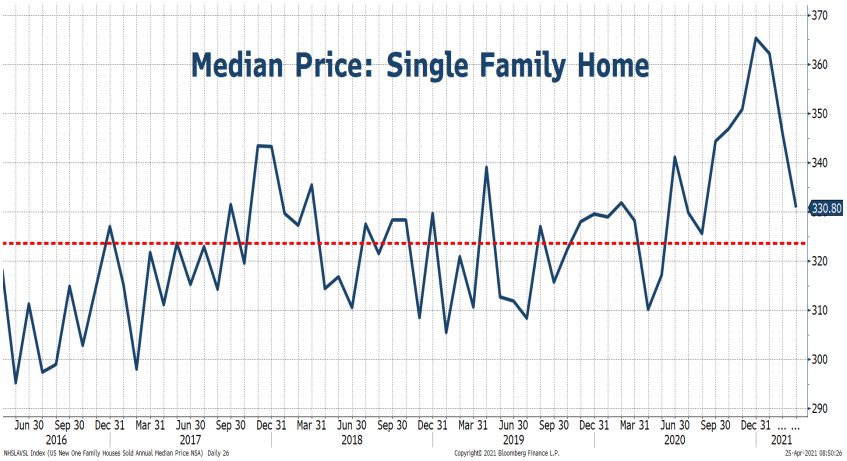
There were only 1.07 million homes for sale last month, down more than 28% from a year earlier. For the listings that exist, fierce competition has pushed prices to new highs. The median selling price jumped 17.2% from a year ago to $329,100 in March, the highest in records back to 1999. This takes out the October 2005 bubble peak when the year-over-year median house price trend was 16.6%. Thing is, back then, wages and salaries were rising at a 5% year-over-year rate versus 0% today. Yes, yes, rates matter. But so do incomes.



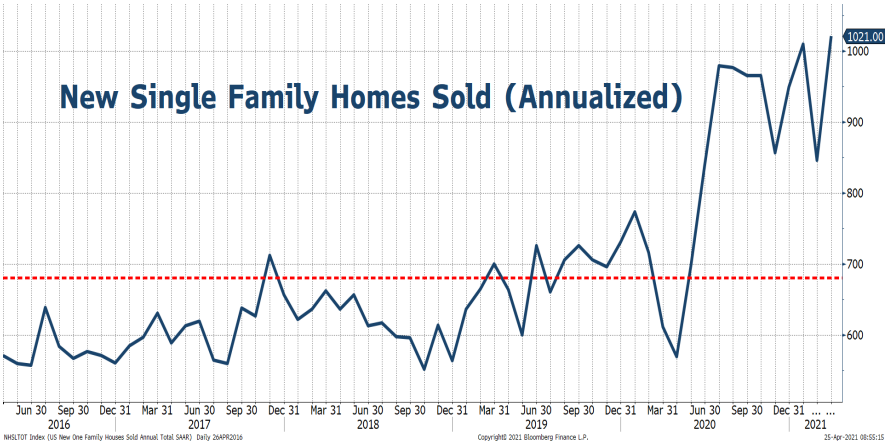
All regions posted sales declines in March, led by an 8% decrease in the West and a 2.9% drop in the South. Though it's clear that the South is a regional leader at the expense of the Northeast as New Yorkers continue to flock to the sunnier weather and better tax climate in Florida. The Northeast saw a 1.3% sales fall-off and is down in each of the past three months and in four of the past five. Sales in the West sank 8.0% and are down in three of the past four months. People in Texas will tell you they are seeing a whole lot of Golden State license plates in the parking lots.

CUT PRICES AND THEY WILL COME!

Unlike what's happening with existing homes, the median price of new single-family houses sold in March fell by 4.4% from February, to $330,800. Since the beginning of the year, new home prices have seen a three-month drop of 9.4%, the biggest three-month drop since 2009.



At the lower price points, sales of new homes bounced back in March to a seasonally adjusted annual rate of 1,021,000 houses, eking past the total in January and up 46% from March two years ago.



For now, the housing market is showing that the shift of the Pandemic continues, from high-rises in urban centers to single-family houses in the suburbs. There were speculations early on that this trend was a knee-jerk reaction and would soon reverse, and it may eventually reverse, because who knows, but it hasn't happened yet,

Amid this trend, the issues of commuting to the office are being overtaken by the issues of working from home, such as space requirements – a particular issue with couples where both used to work in an office, and now both work at home. Marriage counseling must be booming. Or is there an app for that?

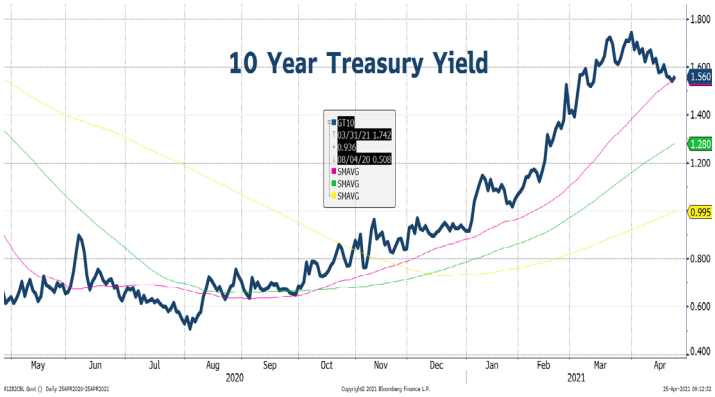
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I'm not too concerned about inflation moving too high at this point[...] all those factors that held inflation down are still in place[...] as the supply chains get fixed – and that may take several months – we're going to see supply pick back up, and then I think we're going to see inflation stabilize." – Cleveland Fed President Loretta Mester

Recent economic data has been stronger than expected. Likewise, inflation data has come in hotter than forecast. Yet, since March 31, the 10-year Treasury yield has declined almost 20 basis points to 1.56% and is now flirting with its 50-day moving average. If the yield breaks through this support, yields could head very quickly lower.

So what gives?

The bond market may be signalling that once we get through the transitory sugar high, there will be a return to "normal." The inevitable return to low growth, low inflation and low bond yields under the crushing demand-constraining effect of excessive indebtedness, which has become more excessive coming out of this crisis. And this current round of inflation, caused by supply shortages and commodities, will be long forgotten once we get into the summer and fall.



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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.