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INVESTMENT SERVICES

Weekly Relative Value

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"Transitory" is the Word

Last week, the Fed acknowledged economic improvements and higher inflation. Even still, the central bank remains extraordinarily dovish and entirely focused on the labor market recovery, especially in some vulnerable sectors.

The Fed emphasized the term "transitory" to describe the current inflation blip. The Fed is going to be patient. It believes there is a temporary mismatch between demand and supply that will create a short-lived inflation bump but will be resolved without persistent inflation pressures.

Maybe the bond traders don't believe it, but that is what the Fed's models are predicting (and I line up with the Fed on this one). One thing is for sure, the Fed is still not allowing the bond vigilantes and talking heads to push it around.

In the subsequent Q&A press session with Chair Jerome Powell, there were 10 key takeaways:

1) Rate hikes will not start until the recovery is complete and that is still a long way off.

"The economy is a long way from our goals, and it is likely to take some time for substantial, further progress to be achieved."

2) Powell stressed the Fed's mandate of achieving full employment and we are still at least 8.4 million jobs shy of the old highs in non-farm payrolls (more like 11.8 million when you consider where employment would have been at the end of this year had the pandemic never happened).

And also, it's going to be a different economy. So, we've been hearing a lot from companies that they've been looking at deploying better technology and perhaps fewer people, including some of the service industries that have been employing a lot of people."

3) The Fed is not talking internally about any taper.

THIS WEEK

- FAKE GROWTH
- INFLATION?
- TWIN DEFICITS
- DOA

PORTFOLIO STRATEGY

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"So we're a long way from our goals, and We don't have to get all the way to our goals to taper asset purchases. We just need to make substantial, further progress. It's going to take some time."

4) Powell repeated that inflation is a process. The Fed is fully aware that inflation is heading higher over the near-term. He is convinced that what we have on our hands is a temporary phenomenon where demand is receiving a boost from reopenings but that the supply constraints will ease at some point and alleviate the current and prospective inflation prints. They're temporary and expected to resolve themselves. Powell also stressed that there is no entity in the country with the extensive network of business contacts that the Fed has and that he is convinced these supply shortages at the current time will not be sustained.

"[...] The other big one I would talk about is bottleneck. So, this is what we're seeing in supply chains in various industries. And we're in close touch with all of these industries. The Fed has a network of contacts that is unequaled in businesses, and in nonprofits for that matter, too. So what do we mean by a bottleneck? A bottleneck really is a temporary blockage, or restriction in the supply chain for a particular good or goods. Something that slows down the process of producing goods and delivering them to the market. We think of bottlenecks as things that in their nature will be resolved as workers and businesses adapt and we think of them as not calling for a change in monetary policy,

5) The Fed is not concerned or surprised about inflation expectations rising above 2%.

Source: Bloomberg

7) Powell also made the point that the primary reason for the recovery at hand is because of the stimulative monetary and fiscal policy stance the Fed is pursuing. He kept saying over and over that "substantial further progress" has to be made on the economic expansion before the Fed will signal any shift in its current posture.

8) He is not that concerned about asset bubbles although he did use the term "froth" twice to describe several aspects of today's financial markets. And he did indicate that asset prices are "high." Dah, no kidding!

*"I know many people just look at asset prices, and they look at some of the things that are going on in the equity markets, which I think to reflect froth in the equity markets. But really, we try to stick to a framework for financial stability so we can talk about it the same way each time and so we can be held accountable for it. So, one of the areas is asset prices, and I would say some of the asset prices are high**. You are seeing things in a capital markets that are a bit frothy. That's a fact."***

9) While Powell seemed delighted with how the economy has been reviving, he did say that the employment recovery has been "uneven" and that the employment "shortfall" is still considerable.

"Notwithstanding that, we're a long way from full employment, [...] payroll jobs are 8.4 million below where they were in February of 2020. We've got a long way to go. And also, it's going to be different.

10) He stressed that there is still far too much excess capacity in the labor market for him to believe that the inflation we are seeing unfold will be "persistent." That is what is important and means he will be very patient. He actually came right out and said, with inflation and inflation expectations above 2%, that the Fed is a "long way from [its] goals."

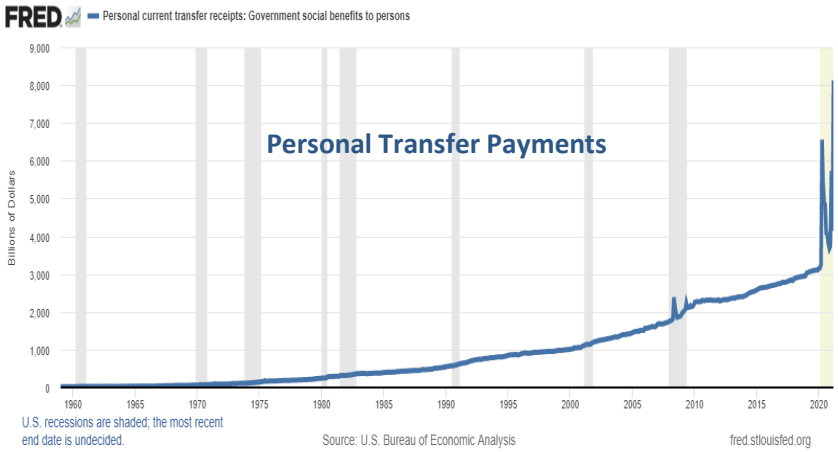
The so-called official unemployment rate is 6% (really closer to 11% when you add in all the idle labor such as the part-time workforce wanting to work full-time and those not in the labor force but would gladly take a job if offered one).

The bottom line is that inflation has to prove to be persistent. Don't let a financially-speculative-induced rally in commodity prices fool you; these cycles come and go like the wind. Ultimately, the Fed will only be convinced of this once full employment is reached, which likely means a return to a 4% unemployment rate. Given the number of people not in the labor force that will return over time, this process is likely to take several years.

FAKE GROWTH

First quarter (Q1) inflation-adjusted GDP was reported at "only" 6.4% – all funded of course by trillions in fiscal stimulus. This was an improvement from the 4.3% in Q4 but missed consensus expectations of 6.6%, and certainly missed the whisper numbers some of which were even in the double-digit range.

Would real GDP really have come in with a +6.4% annual rate pick-up in Q1 if not for a surge in government benefits? I am referring to "Personal Transfer Payments," which are essentially government sourced income such as unemployment benefits, welfare checks, and so on. In March, this number exploded to a mind-blowing $8.1 trillion.



Excluding the $8.1 trillion surge in government transfers, personal income excluding government handouts would be virtually unchanged from a year ago level at $16 trillion. That's correct. "Organic" personal income stagnated.

Personal consumption soared 10.7% in Q1 and contributed more than 100% of the final GDP print. This was the second biggest jump in consumption since the 1950s with just the stimulus-fueled Q3 2020 coming in higher. Then again, if you give away free money, people spend it.

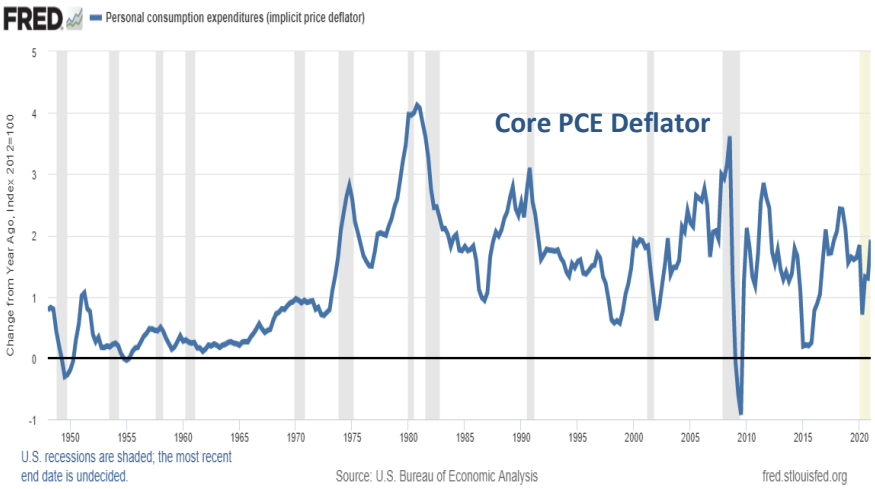
Let's look at the situation for what it is. A record 34% of all household income now comes from the government. Putting that number in perspective, in the 1950s and 1960s, transfer payment were around 7%. This number rose in the low teens starting in the mid-1970s. The number then jumped again after the financial crisis, spiking to the high teens. And now, the coronavirus has officially sent this number to a record 34%!

In summary, we have reached a situation where the economy is totally reliant on Uncle Sam's wallet. And there has been no U.S. economic growth barring the government's relentless support. Yet, we have the illusion of an economic boom.

INFLATION?

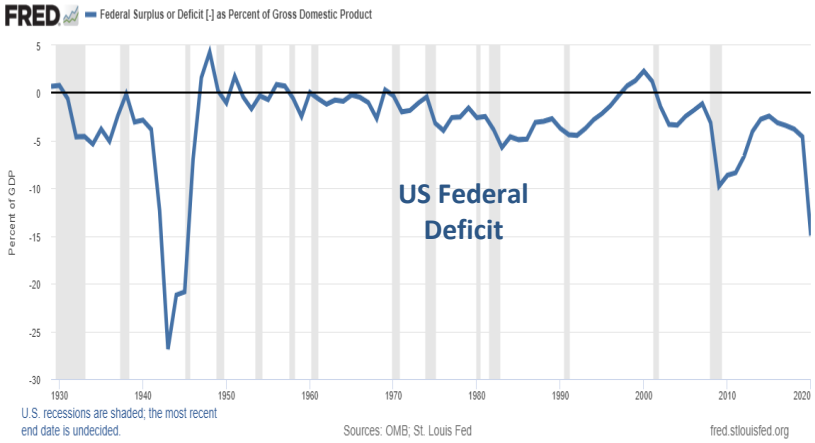
Amidst the inflation hysteria the core personal consumption expenditures (PCE) deflator rose at a 2.3% annual rate, and the year-over-year trend nudged up to +1.6% from +1.4% in Q4 of last year. At the same time, in March 2020, core PCE deflator was +1.8%. Two years ago it was +1.7%. Three years ago it was at +1.8%.

Today, the deflator is at a whopping 1.6% year-over-year. Think about it. In the past year, the Commodity Research Bureau (CRB) Index soared 30%, base metals have ripped 54%, textiles are up 18%, and raw industrial prices have boomed 29%. And at this point, the core Producer Price Index (PPI) is 3.1% year-over-year while the core PCE deflator is 1.6%.



TWIN DEFICITS

I started in the business in 1981. In those days "twin deficits" sent shivers down the spine of the investment community. The monthly trade data was almost as important as payrolls in moving the market. Today, nobody seems to care. In any event, as we are all painfully aware, the fiscal budget deficit is approaching a record all-time high $ 2 trillion – or 15% of GDP.



Meanwhile, the U.S. trade deficit in goods with the rest of the world exploded by 25% in March 2021 from March 2019 and by 38% from March 2020 to $91 billion. Another worst-ever milestone, in a long series of worst-ever milestones. Year-over-year imports have jumped 21.3%; roughly doubled the pace of exports. Over the past three months alone, imports have soared at a 35% annual rate to another huge worst-ever level of $233 billion. Imports are a negative in the GDP calculation and are a drag on GDP. But they do stimulate the economies of other countries. So the stimulus checks were put to good use stimulating the manufacturers in other countries and the offshore entities of Corporate America.

So the once-feared trade deficit expanded 4.5% in March to a record $90.6 billion. Trade deficits are not a sign of a growing economy, or any kind of economic strength, but a sign of rampant offshoring of production by Corporate America of consumer and industrial goods to cheap-labor countries.

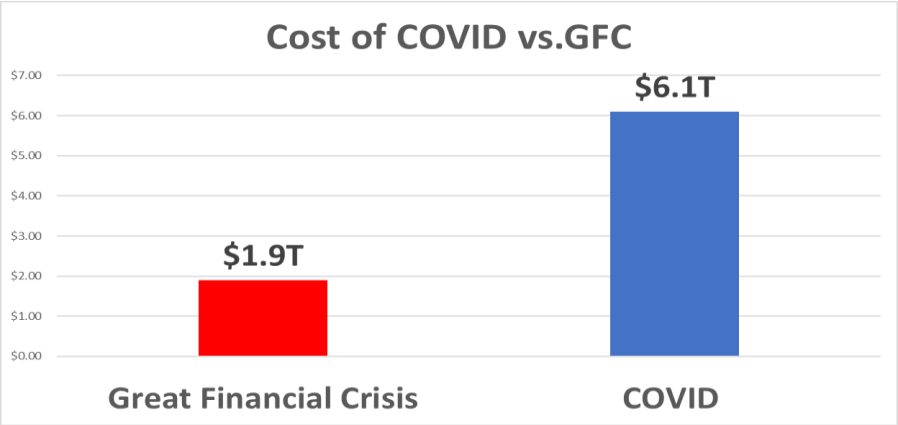
Trade deficits are a drag on GDP: The ever-widening trade deficit may be one of the offsetting wrinkles to the ever-bullish growth consensus forecast.

DOA

"Twenty million Americans lost their jobs in the pandemic… [while] the roughly 650 billionaires in America saw their net worth increase by more than $1 trillion… They are now worth more than $4 trillion. My fellow Americans, trickle-down economics has never worked… It's time to grow the economy from the bottom and middle-out."
– President Joe Biden

Since COVID arrived, we have seen three massive fiscal expansions in four months. We are now six trillion dollars and counting. Yet, last Wednesday, President Biden laid out his new mega-trillion-dollar tax-and-spend package which will be split into two packages for Congress to pass. The first $2.2 trillion package will focus on infrastructure investments specifically. The second $1.8 trillion package will focus on funding domestic policy areas of Democratic concern, such as education, childcare and paid time off for workers, food stamps and school meals for needy kids. Biden added climate change, a $15 minimum wage, right to organize, gun control, paycheck fairness, defense spending, charging stations, even a goal to cure cancer.

As for how to pay for the plan, Biden's main priority will be to raise the corporate rate from 21% to 28%. In addition, Biden's proposal would impose a global minimum tax on profits from foreign organizations, increasing capital gains taxes for the wealthy, and returning to the Bush-era individual rate of 39.6 percent for those making over $400,000.



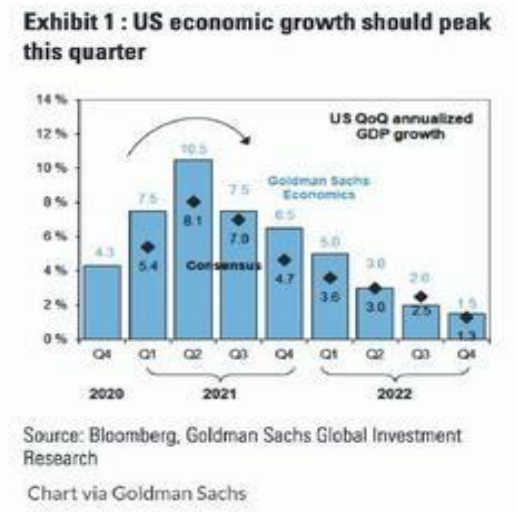
Senator Joe Manchin (D-WV), a pivotal centrist lawmaker, said Congress should focus on raising revenue by enhancing enforcement for existing tax levels.

"It intrigues me to understand that we have 400 billion to a trillion dollars that people have stated that we haven't collected; don't you think we ought to look at that first?... I've been very clear on 25% corporate, but I want to see basically where our loopholes are and why we're not collecting and why the IRS has been eviscerated."

The reality is, his plan cannot possibly pass the Senate as is, and I rather doubt it can even make its way unscathed through the House. Biden cannot even corral the Democrats. And the whole plan is so overreaching that it's possible nothing passes. That said, ultimately, I expect Biden to rally the troops and settle for whatever, but it will be a huge struggle.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Who could have ever predicted that a global pandemic would be the catalyst for unbridled economic optimism, accelerating growth and inflation? Should we pray for another pandemic?



Source: Bloomberg, Goldman Sachs Global Investment Research

Chart via Goldman Sachs

The jump in GDP growth in 2021 reflects an artificial stimulus. The most overwhelming fiscal policy withdrawal in post-war history should take hold in the second half of the year. This will lead to deflationary or disinflationary consequences. As Goldman Sachs recently showed, economic growth will quickly return to 2% growth trends as the “artificial” support fades.

Economists are predicting 6+% growth and higher inflation in 2021. Yet Treasury yields are no higher than they were pre-pandemic. In other words, the bond market is sounding the alarm, suggesting that economic growth will revert back to the old normal of slow growth, low inflation and lower yields.

Here’s the problem, and it started in 1990 and has a lot to do with the basic economic laws of diminishing returns: too much debt. We are now back above 370% debt to GDP. Some say that the debt is affordable because interest rates are so low, but it’s just the opposite. Because the debt situation is so onerous, interest rates are forced to stay low so the economic and financial system don’t collapse.

Since 1990, we have had three economic cycles, each becoming slower and slower, and the last one from 2009-2019 was the weakest ever. We have reached a point where incremental increases in the debt-to-GDP ratio end up creating the conditions for weaker economic growth in the future and lower Treasury yields.

In terms of portfolio strategy we continue to recommend an underweight in excess cash. Credit unions should continue to maintain a fully invested, risk appropriate investment portfolio. In terms of yield curve exposure, we advocate an overweight in the belly of the yield curve (4-7 years). In terms of sector exposure, we recommend underweighting traditional agency debentures and CDs, and overweighting agency MBS/CMO and bank notes.

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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.