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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF MAY 10, 2021

Risk and Uncertainty

"Everyone has a plan until they get punched in the mouth." – Mike Tyson

Since the 1980s, an equity culture has taken hold in society as the economy has become increasingly "financialized." The focus has shifted to the net worth of households and on generating asset inflation. In boosting asset prices, the Fed believes that consumer confidence will improve which in turn will drive consumption and economic growth.

Take a look at the chart below. It is easy to see why some may feel that Americans are spending like they're a decamillionaire. The household net worth to disposable personal income ratio has risen to a record high of 750% (nearly 200% above its long-term average).

But also note that when assets have reached such extreme levels in the past the markets have not stayed there for long. And when markets inevitably mean revert, the move is swift

"The net worth-to-income ratio —defined as household assets net of liabilities divided by personal disposable income —provides a valuation metric for a broad set of assets including debt, equity, and real estate weighted by the proportion in which they are being held by households. Similar to the P/E ratio, this ratio tends to revert toward its historical average and does not remain at extreme values, either high or low, for prolonged periods." – Federal Reserve Bank of San Francisco

THIS WEEK

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PORTFOLIO STRATEGY

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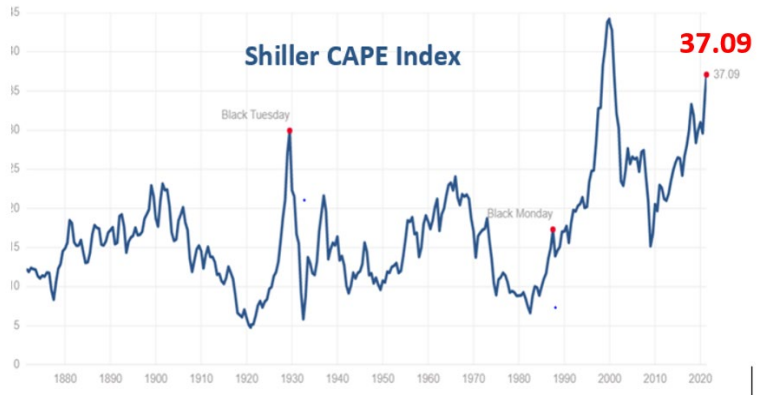
(up by the stairs and down by the elevator). The so-called wealth effect then goes in reverse.

Furthermore, before you all go on your next shopping spree, consider what the San Francisco Fed said in its report titled *Valuation Ratios for Households and Businesses* in 2018.

As mentioned in the quote above, I am keeping a close eye on valuations. Indeed, the cyclically adjusted price-to-earnings (CAPE) ratio for the S&P 500 currently sits at 37.09 – taking out the 1929 peak and is now at the second highest on record.

Note: The S&P 500 Shiller CAPE Ratio is defined as the ratio of the S&P 500's current price divided by the 10-year moving average of inflation-adjusted earnings. Using 130 years of back tested data, the returns of the S&P 500 over the next 20 years are strongly inversely correlated with the CAPE ratio at any given time. In other words, whenever the CAPE ratio of the market is high, it means stocks are overvalued, and returns over the next 20 years will likely be poor. In contrast, whenever the ratio is low, it means the stocks are undervalued, and returns over the next 20 years will likely be good.



Source: Case Shiller

The San Francisco Fed also had this to say in the same report:

> *"Current valuation ratios for households and businesses are high relative to historical benchmarks... we find that the current price-to-earnings ratio predicts approximately zero growth in real equity prices over the next ten years."*

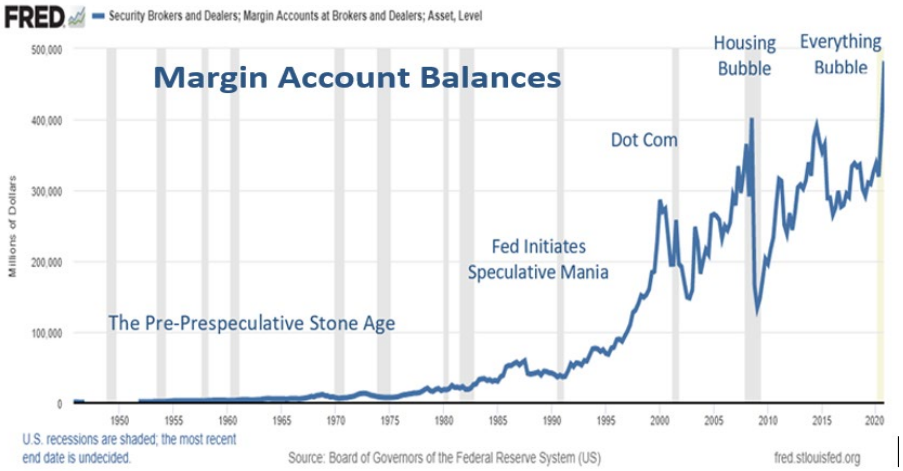
This was two years before the pandemic and, at the time, the CAPE ratio was 33.3x – three multiple points lower than where it is currently. Despite the high multiple, the equity markets have registered impressive returns since 2018. So clearly this index should not be used for timing the markets. However, if the CAPE index is a good "long-term" predictor of long-term returns (as over 100 years of back testing validates), then returns for the coming decade are not very alluring.

IRRATIONAL EXUBERANCE

"…should risk appetite decline from elevated levels, a broad range of asset prices could be vulnerable to large and sudden declines, which can lead to broader stress to the financial system." – from the Fed's semiannual Financial Stability Report

On December 5, 1996, remember when Alan Greenspan mentioned that the markets were showing signs of "irrational exuberance"? Those two words shook the markets to the core and the Maestro had to walk them back shortly thereafter. Well, the Fed's semiannual *Financial Stability Report* released last week was even more direct, and it doesn't seem like there is any walking away from this one. This was not the normal 'modest', 'moderate', 'mediocre' statement we are used to. Notably, the Fed doesn't see the stock market's valuations being justified by low interest rates any longer. What's Jeremy Siegel going to say?

The report specifically talked about SPACs, IPOs, meme stocks and hedge funds – no stone was left unturned. This is irrational exuberance on steroids. And remember, this is a week after Fed Chair Jerome Powell uttered the word "froth" not once, but twice at last week's post-meeting press conference. Is the Fed saying: "Don't say we didn't warn you?"

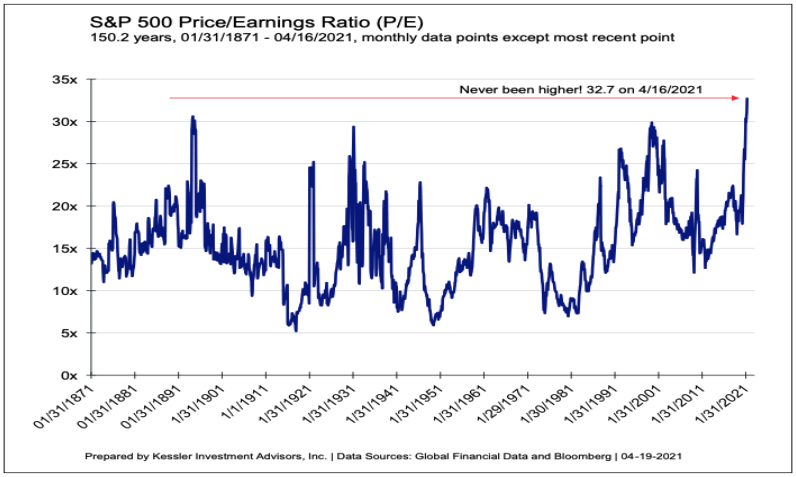


The markets are beginning to think the Fed's annual symposium in Jackson Hole this August will be used to prime everyone for an early taper. Of all the markets vulnerable to any shift, it would have to be the junkiest parts of the credit market, which are priced for fantasyland, as the spread between CCC and B rated bond yields has tightened to 260 basis points, the tightest since 2007. Top of cycle stuff. As Herb Stein famously said, "If something cannot go on forever, it will stop." This is an accident waiting to happen.

What is really interesting is despite these lofty valuations and words of caution it seems the primary risk on investors' minds is FOMO (fear of missing out) of all the fat, juicy guaranteed gains just ahead. The charts of margin debt (loans taken against one's stock portfolio) is at record highs. Pedal to the metal. We have not seen something like this since the second quarter of 2007.

The unprecedented consistency of this bull market has created the appearance of a sure thing – exemplified by the Reddit mantra of "stocks always go up." Risk has never been so forgotten. The problem is that greed has far overtaken fear and investor complacency is running wild.

It's not about being pessimistic as much as what risk people are willing to take on at this juncture, with price to earnings multiples some 40% above historical norms and microscopic bond yields can no longer be used as a rationale.



So, what could be the stock market's undoing? Possible candidates include an emerging market sovereign fiscal crisis, a large hedge fund/bank blow-up, fraud, social unrest, or a geopolitical crisis. There is also the possibility that an inflection point won't have an identifiable catalyst but could happen just from a collective realization that asset prices reflect optimism extrapolated further into the future than is realistic. I don't know when or how, but sentiment will change; the boom-and-bust process is as old as civilization.

"Iron Mike's" quote above offers great insight into risk and uncertainty. Where we go from here is up for debate. Bubbles do what bubbles do. Clearly, you can make money trading a bubble, but with stock valuations stretched, complacency everywhere and the market extremely leveraged, we should all be prepared for an abrupt "air pocket" from record extremes – that could punch us in the face.

LITERALLY SHOCKING

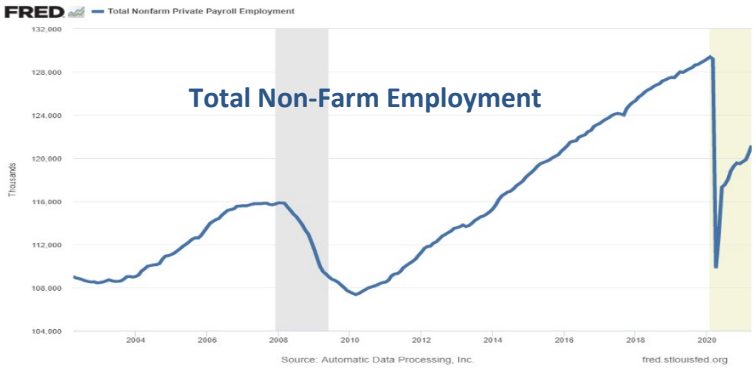
"Let's not just forecast that the labor market will recover, let's actually wait for the labor market to recover. As Chair Powell said a week ago, we've had one great jobs report, let's not declare victory yet."
– Minneapolis Fed President Neel Kashkari

With expectations of April's payroll print soaring, consensus expecting a whopping 700,000 to 2.1 million, few were prepared for a miss (just two forecasters out of 79 were calling for a sub 800,000 print). And of course, the market gods made sure to inflict the most possible pain on as many as possible, with the Bureau of Labor Statistics (BLS) reporting an April payroll of just 266,000 in April (more than 60% below the lowest estimate).

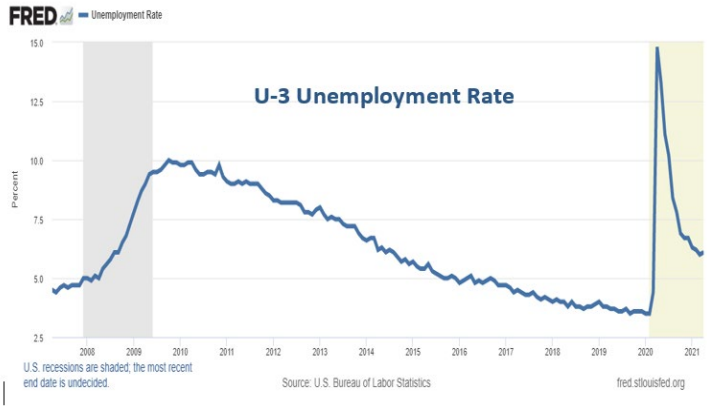
While the change in total nonfarm payroll employment for February was revised up by 68,000, from +468, the change for March was revised down by 146,000. Making matters worse, half of that headline came from the BLS' stab at guessing as to what job gains came from the creation of new business. Back to the drawing board on the extent of this jobs recovery, even as the economy reopens.

Commenting on the data, Bloomberg notes that the payroll data was "literally shocking" with an unemployment rate of 6.1%, and earnings growth of 0.7% "all speaking to a lack of low-skilled job additions."

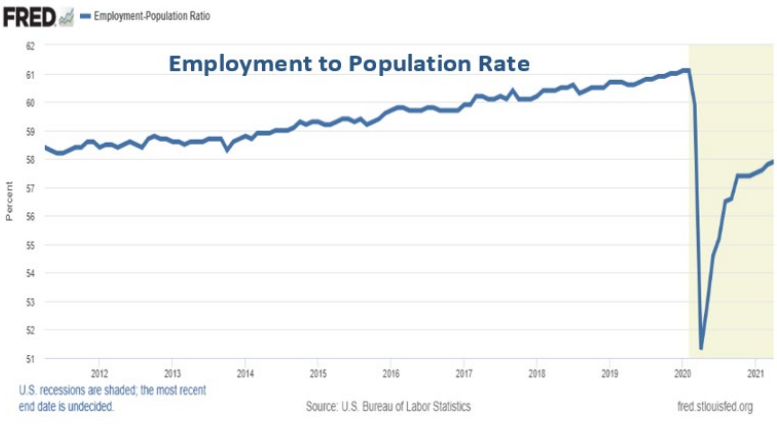
We remain about 8.2 million jobs below the pre-COVID print. At this point, only 63% of the pandemic/shutdown job losses have been recouped. At the pace, it would take 30 months to get back to that old high. The Fed rarely, if ever, embarks on a policy tightening cycle until we recoup all the recession job decline, and that looks to be no sooner than late 2023. Maybe Powell isn't such a dummy after all.



The unemployment rate came in well above expectations and rose to 6.1%. This is exactly where we were in September 2008 when Lehman collapsed, and the economy was in the ninth month of recession. The U-6 stands at 11%.



And as shown below, the employment to population index (arguably, the single most important labor index) has leveled off well below pre-pandemic highs.

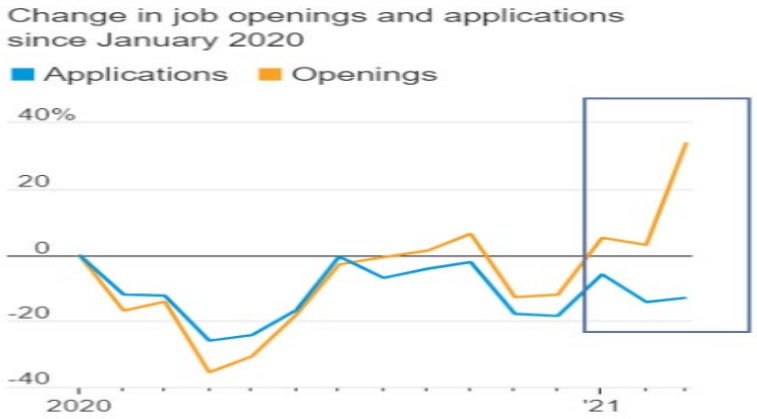


One data point that really stood out to me was the 115,000 plunge at employment service firms. This is only the third time in history (back to 1985) that we have ever seen such a decline at firms whose job it is to go headhunting for businesses. Either companies have given up on their search, which could speak to labor supply, or they have found that they are more productive and simply don't need as many workers as they once did. The blowout Q1 productivity data would attest to that latter view. All in all, this suggests that we may not see a big rebound in the pace of job creation going forward.

WHY WORK?

"Paying people not to work is dampening what should be a stronger jobs market and is hurting the overall recovery."
– Executive Vice President and Chief Policy Officer Neil Bradley of The Chamber of Commerce

Employers are becoming increasingly concerned about the lack of people willing to fill lower-paid positions. Fed Chair Jerome Powell has gone to lengths to point to the low levels of employment recovery among lower-paid workers and minorities this year. Recruiting platform iCIMS has seen more job openings but fewer applications by job seekers.



Source: iCIMS

The list below explains why employers can't find workers:

- Enhanced Unemployment Benefits
- Lack of Child Care
- Fear of Getting COVID

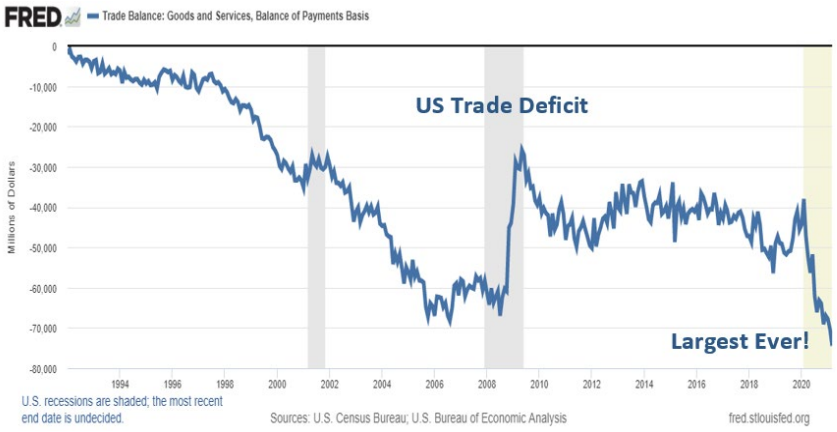
Reason #1 is key. Heck, if one can make more by sitting on the sidelines why rush back to work? According to the Department of Labor yesterday, there are still 16.2 million people who are claiming unemployment benefits under all state and federal programs. The federal government is paying an extra $300 a week on top of the regular unemployment benefits, which allows many lower-wage people to make more money on unemployment than they would earn if they got a job. On top of unemployment insurance, we had three rounds of Covid stimulus, fired in shotgun fashion. Fear of getting COVID is a copout for "I'd rather collect unemployment."

WORST EVER!

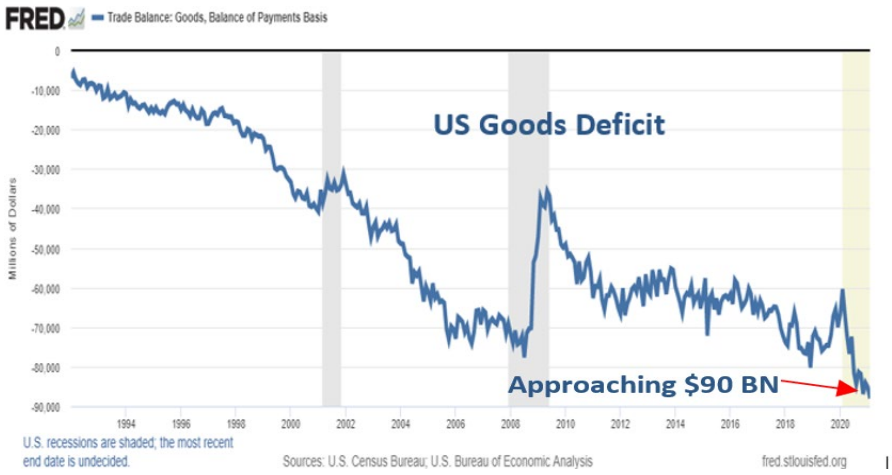
Remember when corporate America promised that globalization was great for the consumer and economy? Fears over the ballooning trade deficit in goods were soothed away with promises of exports of services – such as software, movies,

etc. – would offset the trade deficit in goods. In essence, we'd buy cheap goods made in other countries, and they'd buy our expensive services, and it would all balance out. That was the rationale. Few economic reasonings have failed more spectacularly.

Last week, the U.S. trade deficit in goods and services, after going from record worst to record worst, worsened by 5.6% in March from February to a new worst-ever $74.5 billion. This is 52% worse than in March 2019 and the largest trade deficit in U.S. history. Note that during the Financial Crisis, the overall trade deficit improved substantially.



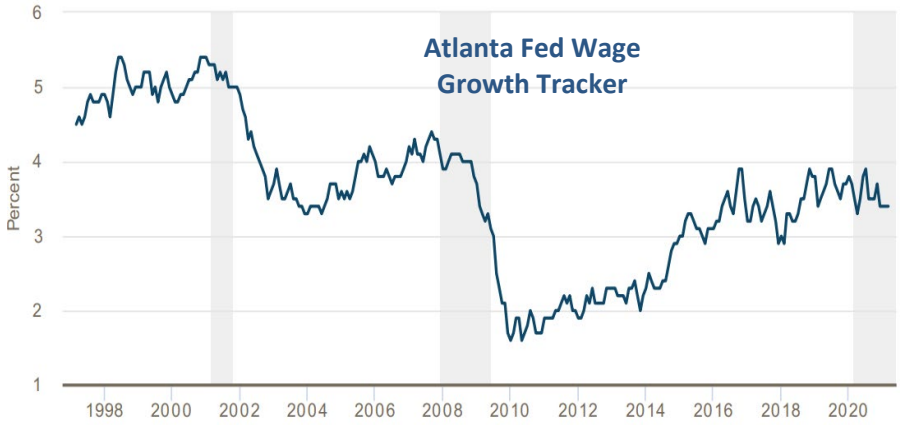
During the Great Financial Crisis, consumers cut back buying imported goods, while the trade surplus of services declined only briefly. The opposite happened during the pandemic. The stimulus checks have fired up consumer demand for imported goods. As shown below, the goods "only" deficit is huge (approaching $90 billion) and has been getting worse.



INFLATION UPDATE

"…do such bottlenecks pose a risk to overall recovery? Do they mean that policymakers need to pull back? No. The overwhelming lesson of the past 15 years or so is that short-term fluctuations in raw material prices tell you nothing about future inflation, and that policymakers that overreact to these fluctuations —like the European Central Bank, which raised interest rates in the midst of a debt crisis because it was spooked by commodity prices —are always sorry in retrospect." – Paul Krugman

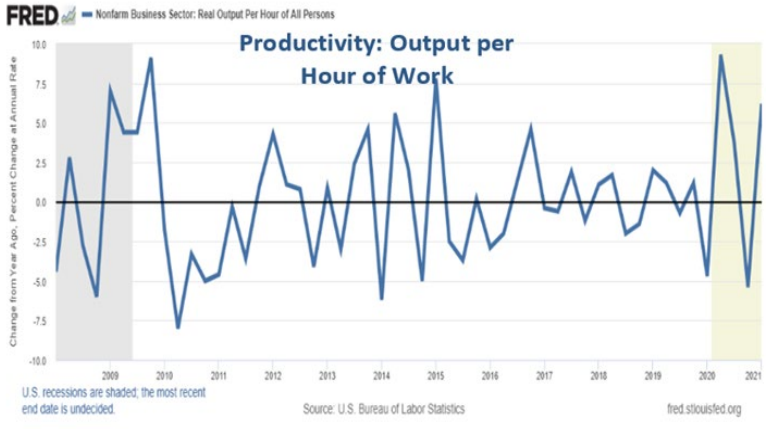
Despite the inflation hysteria, there has been no breakout at all in the Atlanta Fed wage tracker, which is the gold standard for forecasting labor compensation growth. And it is rising labor costs that creates an inflation cycle.



Source: Atlanta Fed Wage Growth Tracker

Nonfarm business productivity for the first quarter expanded at an impressive 5.4% annual rate – its highest productivity growth in 10 years. GDP fell 3.5% in 2020, while employment fell 5.5%, revealing that far fewer workers were needed to produce somewhat fewer goods and services. In 2020, the worst year for the economy since 1946, business spending on software and IT was 6%. Productivity is more powerful than the CRB index. Rising productivity is an inflation killer.

As for businesses, the NFIB survey showed that only 4% cited inflation as their top concern in April. Don't these people read the newspapers? Or Wall Street research? Meanwhile, 17% said taxes were their number one worry and 10% stated the sales outlook.

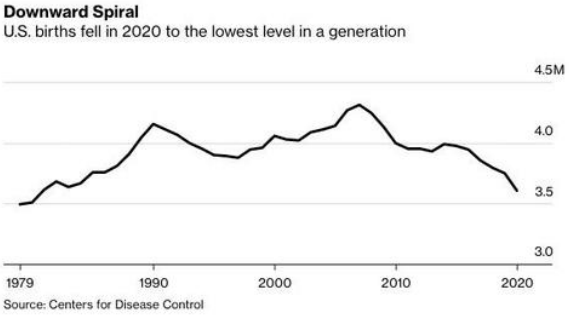


BABY BUST

"There are several factors that go into family planning, and an entire ecosystem of support that enables and empowers parents and parents-to-be…In 2020, nearly all of those factors were turned on their head, and many of those support systems came crashing down." – Paris Wallace, CEO of Ovia Health

One of the biggest deflationary threats looming over the global economy is China's shrinking population, as deaths outpace births for the first time. A shrinking population is bound to create serious challenges for China's debt-fueled economy. But it is not just China. The deflationary trend of a falling birth rate continued last year in the U.S.

U.S. births have now dropped for the sixth consecutive year. In 2020, U.S. births dropped 4% to only 3.6 million births – the lowest level since 1979. This recent drop seems to have been supercharged by the pandemic. According to surveys by Ovia Health, fears of contracting the virus while pregnant, or while in hospital to give birth, combined with job insecurity and measures limiting social contact and business activity, dissuaded Americans from having babies.



Source: Bloomberg

The declines were steeper in states that were hit the hardest by COVID-19, such as California and New York. And the exodus from crowded urban centers exacerbated the drop in birth rates in places like New York City, where the constant ambulance sirens over the summer likely made it difficult for couples to get in the mood.

This is why it matters. Without a growing population, the U.S. has two options: either increase the inflow of immigrants or risk a blowout in the per-capita level of America's exploding debt.

BONDS HAVE MORE FUN

Did you know that for the past 40 years the yield on the 10-year Treasury yield has declined in all four recessions as well as in all four expansions? And did you know that yields have declined more during expansions than in the recessions? This happens because the rates have already risen in anticipation of accelerated growth and as is always the case, just a little too much inflation gets priced in too early. And this is where the “sweet spot” is for those bond investors who spend more time looking at the forest past the trees instead of the trees only.

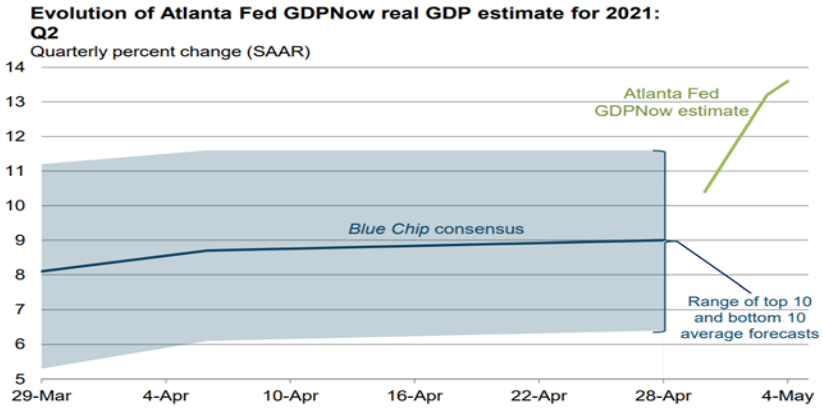
Why Treasuries can still rally:

- Peak funds rate and inflation are already priced in.
- The yield curve is super steep.
- Auto sales at highest levels since July 2005, new home sales at the highest level since August 2006, and housing starts at highest level since June 2006 suggest that we are at peaks in these two critical sectors.

- Less than 25% of the stimulus checks are being spent. Consumers remains focused mostly on debt deleveraging.
- The generous jobless benefits will end by the end of Q3 will help solve any perceived labor shortages.
- Powell and the Fed made it very clear that he is willing to take on the bond vigilantes. Lower for longer.
- Biden latest spending proposals may not happen this year.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

That Treasuries can be flat when U.S. is set to borrow $1.3 trillion in next two quarters and the Atlanta Fed's "Nowcast" model now predicting a 13.2% surge in Q2 real GDP from an already hot 10.4% attests to what is already priced into Treasuries. Perhaps the bond market understands that such debt dynamics are disinflationary because, they act as a constraint on economic growth.



Source: Federal Reserve Bank of Atlanta

The sugar-high is now, the debt overhang is later. At some point, investors are going to be confronting a different reality – otherwise known as the fiscal cliff – in the second half of the year. Ultimately, while the large amounts of fiscal and monetary policy have helped blunt the impact of the pandemic, they have also helped to provide an illusion of growth. In reality, all that has been accomplished is that the future has been robbed to reward the present.

This is not an organic recovery. We were in a modern-day depression. Checks in your bank accounts replaced soup lines.

There will be a relapse in sluggish growth in the second half as the economy returns to the "old normal" of secular stagnation that characterized the previous decade. The Wall Street consensus is that GDP will expand at 5% in the final quarter. This diverges dramatically from the Fed's prediction of 2% growth in those last months. So with that said, beware of a Q4 slowdown. I'm betting that growth will be much weaker as the massive volume of fiscal stimulus falls out of the data.

On the inflation front, prices have been driven up by a combination of fiscal juice, but that's transitory. Investors are likely to be surprised when the conditions for modest deflation reassert themselves by year's end. The supply chain disruptions currently being experienced by the global economy simply are likely to be short-lived. People will be surprised when supply catches up with demand going into the fourth quarter.

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 (four to seven years). As for sector exposure, we recommend underweighting traditional agency debentures and CDs and overweighting agency MBS/CMO, and bank notes.

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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.