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INVESTMENT SERVICES

# Weekly Relative Value

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WEEK OF JUNE 14, 2021

## What a JOLT!

*"The COVID-19 pandemic has disrupted the U.S. labor market, causing unprecedented deviations from the normal historical relationships among a wide range of labor market variables. Indicators related to the manufacturing and small business sectors as to overall labor turnover suggest there is less slack in the labor market than is reflected in the unemployment rate. By contrast, measures of labor force participation and the duration and reasons for unemployment all show more slack in the unemployment rate." – San Francisco Federal Reserve*

The Job Openings and Labor Turnover Survey (JOLTS) for April showed job openings increasing almost one million in April to an all-time record-high of 9.286 million. Year-to-date, 2.5 million new job positions have been posted.


However, it's one thing to have an open position and quite a different thing to fill that position. To wit, new hirings in April only rose 69,000. In other words, only 7% of the new job openings were filled. In fact, year-to-date only 26% of the postings have been filled. As shown in the following graph, there are still 15 million Americans (7X the pre-pandemic level) collecting at least one jobless benefit. How messed up is that?

Either workers are staying at home until their juicy jobless benefits end in early September, job seekers are pricing themselves out of the market, companies can't find qualified candidates or they need new HR departments. Take your pick.

### THIS WEEK

- PEAK HOUSING
- INFLATION FEARS ARE OVERBLOWN
- NO MORE CASH PLEASE
- BONDS HAVE MORE FUN

### PORTFOLIO STRATEGY



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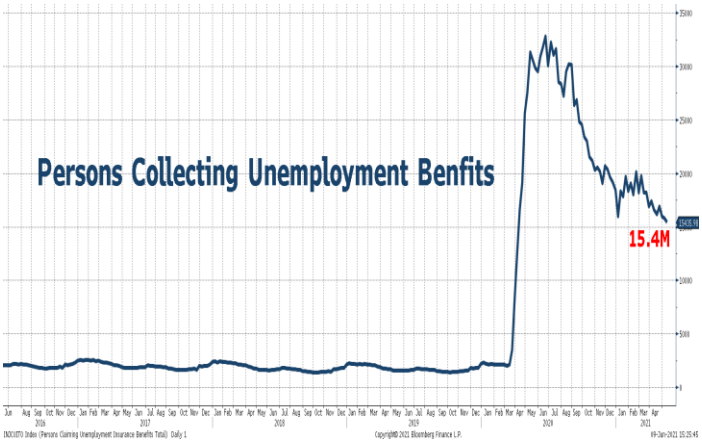
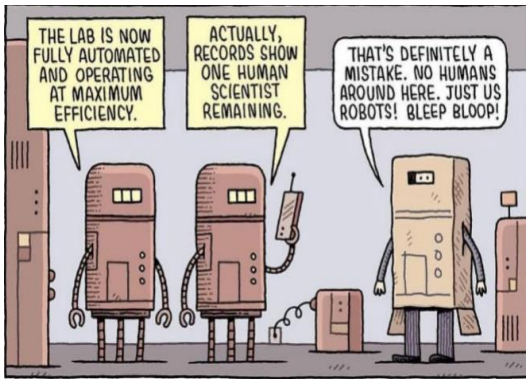
At any rate, the barriers in terms of attracting idle labor are likley temporary. This will will become crystal clear by the fourth quarter when the disincentives to work expire and people's comfort levels rise to re-enter the workforce (especially for women).




Meanwhile, as potential workers continue to couch-surf, businesses are increasing tech spending to fill the void left by idle workers choosing to stay at home and collect their benefits. See the Wall Street Journal article, *Technology Fills the Gap as Jobs Lag GDP.* As companies invest in more productive technologies to increase efficiencies and profitability, these couch surfers may find that they are no longer needed.



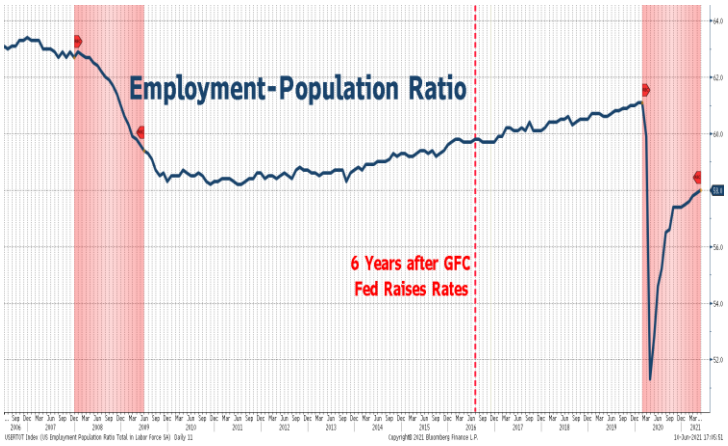

Source: Cagle

Back to the JOLTS report. Layoffs dropped 81,000 and have now declined for five months running. While virtually every sector is reducing layoffs, there was one noticeable exception: construction where "pink slips" rose 7,000 (think: peak housing).

The number of job hoppers has expanded now in each of the past three months. Voluntary "quits," rose 384,000 in April to a new high of 3.952 million. But yet again, the only outlier was construction, where the number of quits fell 22,000. This could be the fly-in-the-ointment as the housing market is one of the best leading indicators for the overall economy.

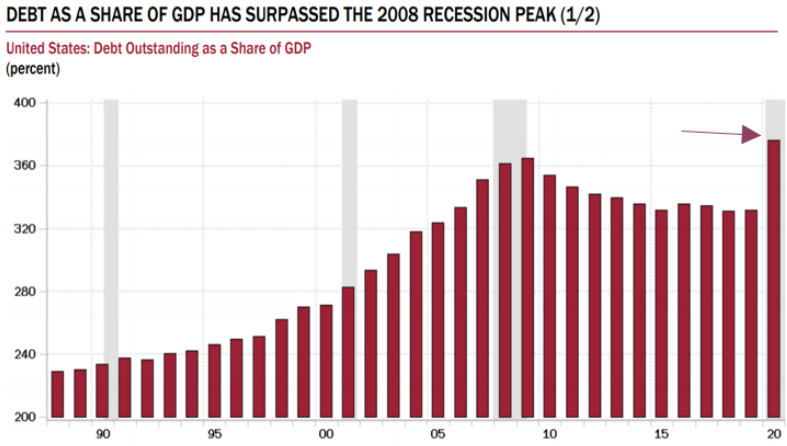
**Bottom Line:** There is tremendous noise in the employment data. From the peak of employment 15 months ago, after the first rounds of aggressive monetary and fiscal stimulus, a year into the reopening phase, and seven months post-"Pfizer Monday," employment is still 5% shy of the pre-pandemic peak. The employment-to-population ratio is only 58%.

In case you're thinking about the Fed and interest rates, remember that the central bank has a dual mandate — a healthy labor market is one of them, and we are still in the early innings of the job market recovery. The last time employment levels were so weak was coming out of the Great Financial Crisis (GFC) over a decade ago. It is a rare day indeed when the Fed starts to hike rates before employment has recovered to previous highs. Based on the current progress, that could easily be two to three years down the road. Heck, who knows? Maybe longer. Remember, it took six years after the GFC ended before the Fed raised rates. Put that little tidbit of Fed history into your back pocket.




Finally, to "save the system" the all-economy debt ( government, business and consumer) debt-to-GDP ratio has soared 40% to an all-time record-high of 370%. Remember: Debt has brought forward consumption and, as such, debt is future consumption denied.

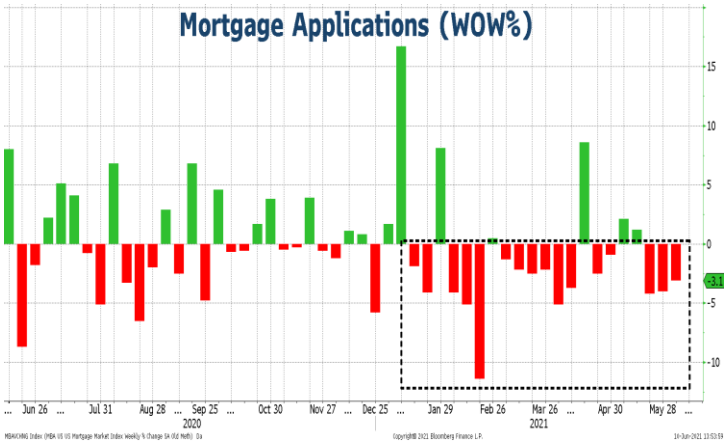
Following the GFC, debt levels soared and acted as a constraint on economic growth. As we move forward, debt will prove to be a more pervasive headwind on growth, on inflation and on interest rates. As I have higlighted numerous times in this space, the U.S. economy has never been so leveraged and exposed to interest rates. This is a big reason why any normal cycle of higher bond yields or Fed tightening is practically impossible without creating an environement for a new recession and, yet again, a meltdown in Treasury yields.



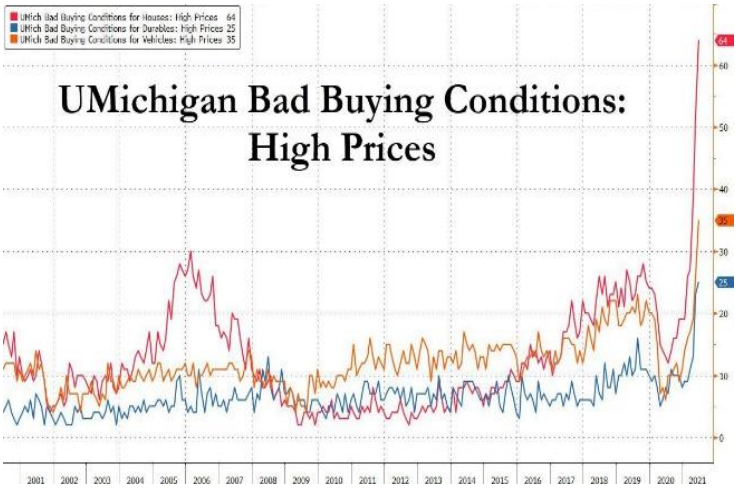

Source: Rosenberg

## PEAK HOUSING

It's unanimous. Everyone says we are in a housing boom that shows no end in sight. Yet, the incoming housing data suggests otherwise. For the week ending June 4, mortgage applications fell 3.1% on top of a 4% turndown the prior week. Applications have now declined in five of the past seven weeks. Over this period, mortgage apps have plunged 11% and are down 41% (annualized) year-to-date. Mortgage app volume is now back to where it was when the pandemic hit in February 2020.




While home prices have soared over the past 16 months, they now look pretty "toppy." In fact, according to the University of Michigan survey last week, the unfavorable (too expensive) perceptions of prices has reduced overall buying attitudes for homes to their lowest point since 1982. This can be seen in the following chart showing record highs for "bad buying conditions" due to high prices for houses (the same is true for vehicles and durables). In other words, due to soaring prices, America is going on a buyers' strike.



Source: Bloomberg

## INFLATION FEARS ARE OVERBLOWN

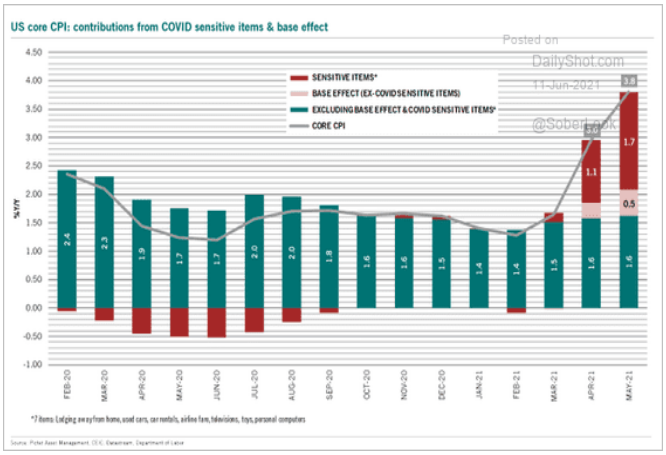
*"Contrary to the conventional wisdom, disinflation is more likely than accelerating inflation. Since prices deflated in the second quarter of 2020, the annual inflation rate will move transitorily higher. Once these base effects are exhausted, cyclical, structural and monetary considerations suggest that the inflation rate will moderate lower by year-end and will undershoot the Fed Reserve's target of 2%. The inflationary psychosis that has gripped the bond market will fade away in the face of such persistent disinflation." – Dr. Lacy Hunt*

The Consumer Price Index (CPI) print for May had been heralded as the arbiter of "is it transitory or not?", with some even suggesting we are nearing a period of "transitory hyperinflation." Well, only time will tell but the answer for now is: Inflation's still accelerating as headline CPI soared 5% year-over-year (hotter than the +4.7% expected). That is the highest level of inflation since August 2008. Core CPI soared 3.8% year-over-year, the hottest level of inflation since 1992.

Much of the extreme inflation is in reopening sectors and supply channel issues (e.g., air fares, movies, sports events, theater, restaurants, autos, car rental, hotels and motels). This has been much discussed, but it is true. In the past six months, this COVID-19-impacted share of the CPI index (20%) jumped 2.2% in May. Without going too far out on the limb, I would say this is not sustainable. Used cars on their own account for about a third of the increase in core inflation. Demand for used cars has been driven by the global chip shortage that has slowed new auto production. But the pressue should be abating as auto buying intentions have have fallen to their lowest level in 39 years. Also, whether we are talking about accommodation, sports, clothing or airlines, prices are still lower than they were pre-pandemic. Is closing the price gap really a long-lasting source of inflation?

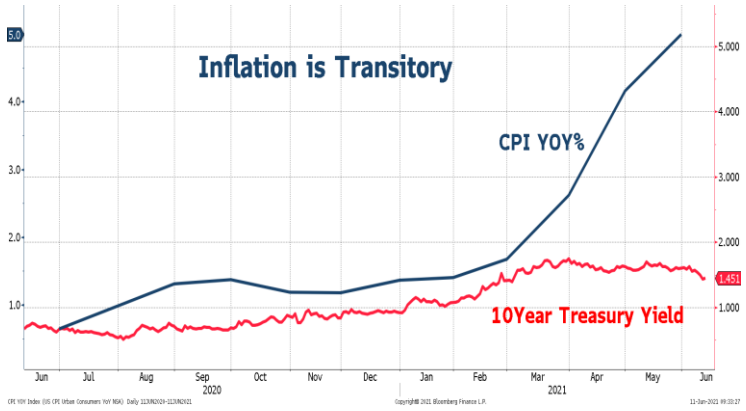

At the same time, 80% of the sectors of the economy that were not as affected by the pandemic rose a modest 0.15%. As such, this better represents the true underlying trend of inflation. And when you do the math, this equates to a sub-2% annual rate. In other words, four-fifths of the economy is operating below the Fed's inflation comfort zone.

So yes, there are plainly elements of this inflationary episode that owe everything to the pandemic; however, without the COVID-sensitive items (including the auto manufacturing disruptions) and the base effect, the core inflation remains relatively stable. As far as the markets are concerned, this supports the Fed's "transient" inflation narrative.




One more point. I have read lots of articles that posit that we are returning to the inflationary days of the '70s. But this is nonsensical. The economy in the 1970s was largely unionized and COLA clauses institutionalized the wage-price spiral. Constantly rising wages are the key to an inflationary cycle. As noted, the economy is saddled with so much debt and the population is much older than fifty years ago. Ugh! Let's talk technology – another inflation slayer. In the 1970s, technology was a transistor radio and a Polaroid camera. Today, tech spending has never been higher and this increased tech spending will enhance productivity – the antidote to higher inflation. What about trade and global competition? Global free trade didn't exist in the '70s. Today, it is here to stay and this, too, is disinflationary. Finally, it is important to undersatnd that the inflationary '70s were an outlier – an anomaly in the context of financial history.

Only the Treasury market seems to realize that this inflation bump is due to special factors related to all the noise from the last traces of the pandemic and the reopenings that have created a temporary imbalance between demand and supply. To wit: We've now had two huge CPI releases and the 10-year Treasury yield is down more than 20 basis points since just before the April surge. The market agrees with the Fed's view that inflation is transitory and is pricing in sub-2% inflation and economic growth. Furthermore, over the next two quarters, the year-over-year rate of change will slow (the "base effect") as the economic "shutdown" is removed from the calculation. Even still, all I hear is the incessant pundits hyperventilating over the coming inflation explosion. My advice: Fade these folks!



## NO MORE CASH PLEASE

Some banks, awash in deposits, are encouraging corporate clients to spend the cash on their businesses or move it elsewhere. It's a strange case of "No More Cash Please." Companies do not know what to do with the profit boom that has generated a ton of cash, and this cash is going into the banking system. And the banks are, in turn, either plowing the funds in deposits at the Fed or buying Treasury securities as if there is no tomorrow.

Bear in mind that the Fed, via quantitative easing (QE), has been stuffing banks with cash for a year at a rate of about $120 billion a month. Not only do the banks have no use for it, it's starting to cost them money.The Fed's solution, using the word loosely, is to do reverse repos to drain banks of cash.

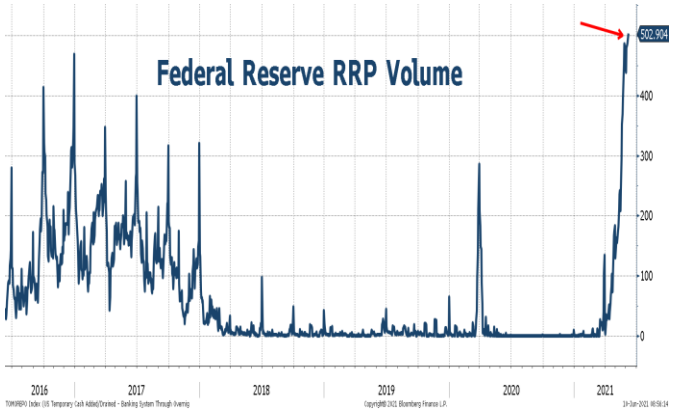
***Note:*** *"Reverse repos" are the opposite of "repos." They drain cash from the market and are liabilities on the Fed's balance sheet – money the Fed owes the counterparties.*

The Fed offers these reverse repos to keep the reverse repo rates from falling into the negative as the tsunami of liquidity needs to find a place to go. The Fed's offering rate currently for overnight reverse repos is 0%, meaning that counterparties are handing their cash to the Fed, and get Treasuries as collateral, for 0% return. By having drained $503 billion in cash from the market via these overnight reverse repos, the Fed has undone the liquidity effect of 4.2 months of QE.

New York Fed President John Williams emphasized repeatedly that the reverse repo system "was working really well," and that there were "really, no concerns about that. We expected that to happen. It's working exactly as designed."

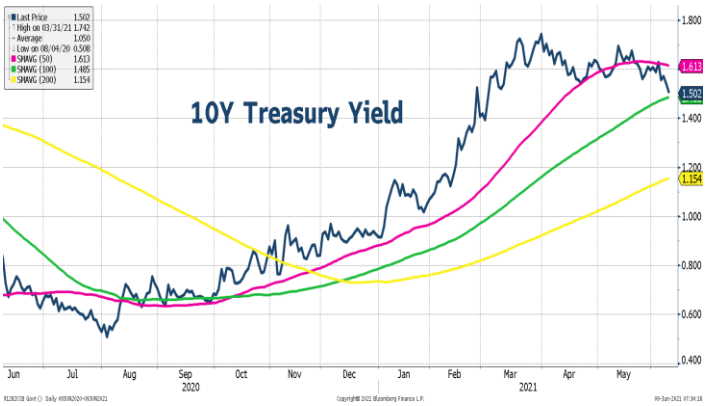
Amazingly, the Fed crams half a trillion dollars down banks' throats. Banks tell corporations "no more deposits" because they are losing money on them. Alternatively, banks have to raise capital. So corporations turn to money market funds. The money market funds do not know what to do with the cash either. So the Fed is forced to take a half trillion dollars back. This was "expected" and is "working exactly as designed"? Sure thing.

The Fed could get a handle on this liquidity phenomenon by tapering asset purchases and eventually reducing its balance sheet. According to Fed watchers, the reverse repo offering rate is now getting lined up for what the Fed calls a "technical adjustment" – say an increase of 10 basis points. The Federal Open Market Committee (FOMC) may also hike the IOER. The Fed is currently paying the banks 0.1% interest on cash they put on deposit at the Fed. Those "reserves" now stand at a whopping $3.8 trillion. In doing so, this would help raise the floor of the effective federal funds rate so that it trades closer to the middle of the Fed's target range, (0.00% to 0.25%). The effective federal funds rate has been around 0.06% when it should be around 0.12%.



## BONDS HAVE MORE FUN

The really big news of late has been the strong performance of the bond markets. Last week, the 10-year Treasury yield tumbled 10 basis points – the biggest weekly drop since last June and the fourth consecutive weekly drop in a row – leaving the key benchmark yield 1.46%.




The 10-year Treasury yield has now sliced below the 50-day moving (pink) at 1.61% and the 100-day trendline (green) at 1.48%. The 200-day (yellow) could be next in line at 1.15%. Remember, about a month ago, the 10-year yield was sitting at 1.64%. The consensus was that 2% was the next stop and many were at 2.5%-plus. Instead, we are at 1.46%.

Who would've thought? Based on the headlines this should not be happening. Right? But it is.Think about all the bad news for bonds there has been: massive inflation chatter, narratives of how stupid the Fed is, huge increases in commodity prices, a weak dollar, unprecedented fiscal juice, record money supply growth, double-digit GDP growth, visions of infrastructure stimulus, widespread reports of wage increases, booming producer and consumer price data, the vaccination process coming so early and the economy pretty well reopened. Could it be that all the bad news has been discounted. In other words, "it's in the price." What isn't in the price is a second-half growth relapse in the economy.

Oh and by the way, the same technical narrative holds true for the five-year Treasury benchmark. If we break the 100-day moving average, yields could plunge all the way down to 0.54%.

## MARKET OUTLOOK AND PORTFOLIO STRATEGY

Given that the "stimulus" effect is fading, and the pull-forward of consumption is mostly complete, economic growth is likely to peak in the second quarter (Q2). On the inflation front, inflation pressures are expected to be transitory. But the question is the rapidity of the retreat. After all, the "base effects" that are helping make inflation look horrid today will be completely the opposite in 2022. Simply, the deceleration of inflation could be one of the more surprising developments of late 2021 and 2022. Regardless, the bond market – arguably the single best predictor of inflation – continues to suggest disinflation, if not deflation, is the more significant threat even though CPI has spiked to the highest levels since 1980.

We continue to argue excess cash will generate suboptimal returns as we move forward. As such, credit unions would be best served by maintaining a fully invested, risk-appropriate investment portfolio.

In terms of portfolio strategy, with the effective fed funds rate at a mere six basis points and the front end of the yield curve tethered to the Fed's zero rate monetary policy, the yield pick-up in the two- to three-year sector is not significant. The front end of the curve offers little value. However, given the current fears of higher inflation, the yield curve has steepened significantly since the end of 2019 and is now almost 3X steeper than it has been over the past seven years and rewards investors for curve extension. The belly of the curve (5-7 years) offers a generous yield pick up to cash without taking excessive duration exposure.

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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.