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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 9, 2021

Take With a Grain of Salt

"Staffing fluctuations in education due to the pandemic have distorted the normal seasonal buildup and layoff patterns, likely contributing to the job gains in July. Without the typical seasonal employment increases earlier, there were fewer layoffs at the end of the school year, resulting in job gains after seasonal adjustment. These variations make it more challenging to discern the current employment trends in these education industries. Since February 2020, employment is down by 205,000 in local government education and 207,000 in private education." – Bureau of Labor Statistics (BLS)

On the surface, the July employment report was solid all around. With consensus expectations calling for a July payrolls print of 858,000 and whisper numbers starting at one million, the BLS reported that payrolls came in at 943,000 in July, comfortably beating the consensus. And June was revised sharply higher to 938,000 from the prior tally of 850,000.

"There's a lot of uncertainty out there these days. Or not. Who knows?"

Confirming the strength in the jobs reports, the household survey showed a whopping 1.043 million runup. Better still, all of these jobs were full-time positions. All in all, we have now recouped roughly 75% of the pandemic-induced job loss.

While payrolls were solid, the unemployment rate was stellar, sliding from 5.9% to 5.4%, beating expectations of 5.7% as the number of people employed according to the household survey soared by 1.043 million to 152.645 million as the number of people unemployed dropped by almost 800,000 to 8.702 million from 9.484 million.

THIS WEEK

- BOOM NOW, BUST LATER
- "INCREASINGLY ALARMED"
- THINGS ARE GOING TO GET WORSE

PORTFOLIO STRATEGY

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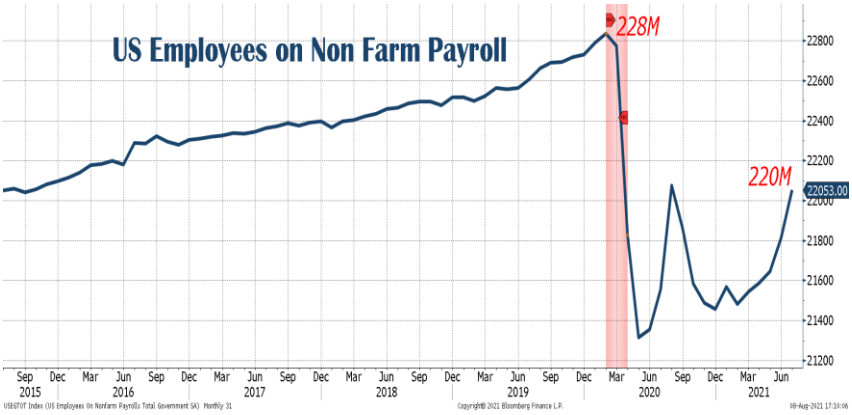
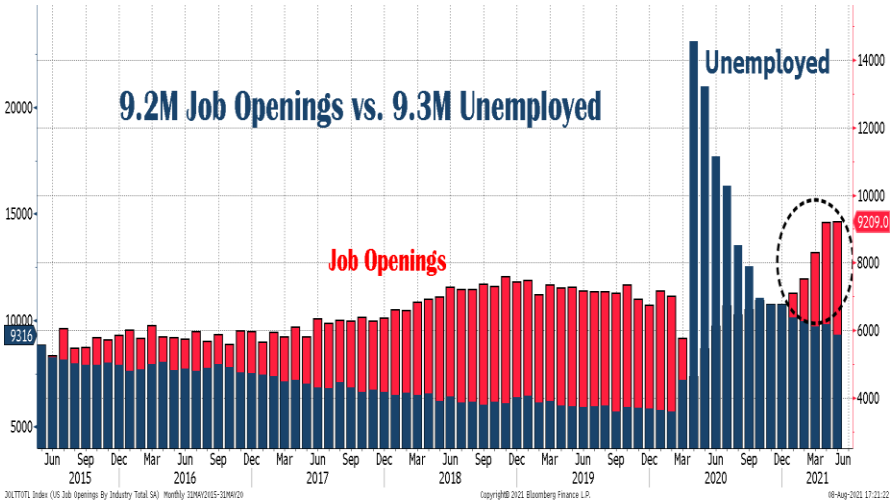
Even still, while jobs are up over 10 million from the low in April 2020, jobs are still eight million lower from the February 2020 pre-COVID high.



The labor force participation rate edged up to a three-month high of 61.7% and the employment-to-population ratio jumped from 58.0% in May and June to 58.4% in July (also the highest since March 2020, but still off the pre-COVID level of 61.1%). It was super encouraging to see the female employment-to-population ratio rise to 53.3% from 52.9%.

While the labor market is expanding, employment growth is running hotter and absorbing the supply of workers — to the point now where the broad U-6 jobless rate has declined to 9.2% from 9.8% in June and 10.2% in May (it was at 6.8% at the end of 2019). Let's hope this continues, but there are some potential headwinds in front of us (mostly the contentious back-to-school season as it pertains to vaccinations).

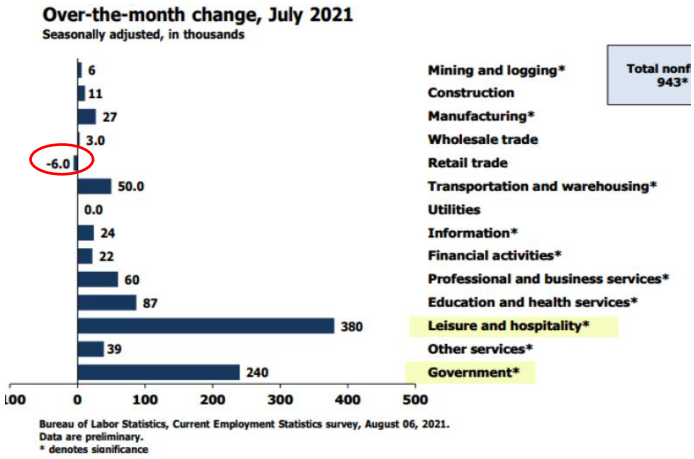


Finally, wages rose less than 0.4%. The year-over-year trend only picked up to 4.0% from 3.7% because of the near-flat base effect from a year ago. Actually, gains were very mild in the overall scheme of things (especially given the horror stories you hear and read about how companies are radically raising wages and salaries to attract labor).

No report is ever without its blemishes. There were a few in this one as well.

The jobs data were skewed by a massive increase (650,000) in leisure/hospitality and teachers.

Outside of these segments, payrolls were up 302,000 — more in line with the more tepid message from the ADP report. This means that almost two-thirds of all job gains came from bartenders/waiters and from teachers.



And not everyone was euphoric.

"The jobs report is sturdy, but not as strong as it looks. In addition to the modest fade in the pace of private-sector hiring (703,000 in July vs. 769,000 in June), much of the July gain occurred in the tenuous leisure and hospitality sector — and that could easily reverse due to Covid-19. This already appears to be evident in metrics such as OpenTable bookings. So if we look at private-sector hiring outside of leisure and hospitality, today's reported gain was 323,000, a bit slower than the prior month's 375,000. This tells us that underlying economic momentum is steady-state, not accelerating." – Carl Riccadonna, Bloomberg Intelligence economist

I think it is worth mentioning that retail sector employment declined 5,500 in July. This was the first decline since April and just the second falloff since last November. The weakness was broadly based. Not just that, but worker hours in this industry were cut 0.3% for the second consecutive month (to a four-month low of 30.8 weekly hours). Insofar as the consumer represents 70% of GDP, what are the nation's retailers telling us about their outlook for spending as they trim their staffing levels and their time at work?

Finally, there was a big divergence between the seasonally and non-seasonally adjusted data. The raw non-seasonally adjusted payroll data actually showed a 133,000 decline! As stated by the BLS at the top of this article, the seasonal factors have all been affected by the pandemic noise in the data. For example: Government education workers plunged 901,000 in the raw data but somehow that translated into a record 221,000 surge in the seasonally adjusted number! Private education services also fell 45,000 on the raw number and yet was +40,000 on the seasonal adjustment.

Staffing fluctuations in education due to the pandemic have distorted the normal seasonal buildup and layoff patterns, likely contributing to the job gains in July. Normally, there are huge seasonal declines in this sector in July, but this time around there were simply fewer of them to leave their job and go on summer vacation. So, this alone created the illusion of there being 270,000 teachers and tutors being added to the data. In fact, in raw non-seasonally adjusted terms, this sector saw a one million decline in jobs.

Let's just say there was no midsummer hiring binge for educators in July, but rather a case of the BLS's seasonal adjustments. Simply put, so many schools were closed or already in limited operation this past academic year, there

were fewer people losing their jobs. What this means, in turn, is that the seasonal adjustment reported was clearly a misleading job run-up.

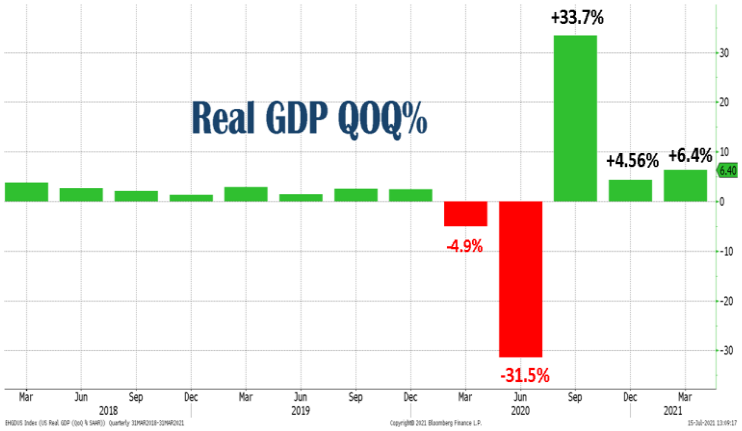
Two areas comprising 20% of the workforce accounted for 70% of the July jobs gain. Outside of teachers and bell captains, employment was up 292,000 in July. That is the story beneath the story. This was one of the most lopsided reports in modern history.

As the saying goes… If it's too good to be true, then it probably is. It would be wonderful to believe the 943,000 surge in July payrolls. However, as noted above the BLS made it crystal clear there were huge distortions coming from the seasonal adjustment process. Perhaps some cause for pause here before fully uncorking the champagne bottle. I believe we should take last week's employment data with a grain of salt. A big grain! Whether Fed Chair Jerome Powell sees it this way remains to be seen.

Let's see what the August and September data hold, given the end of the extended jobless benefits and the Delta wave underway.

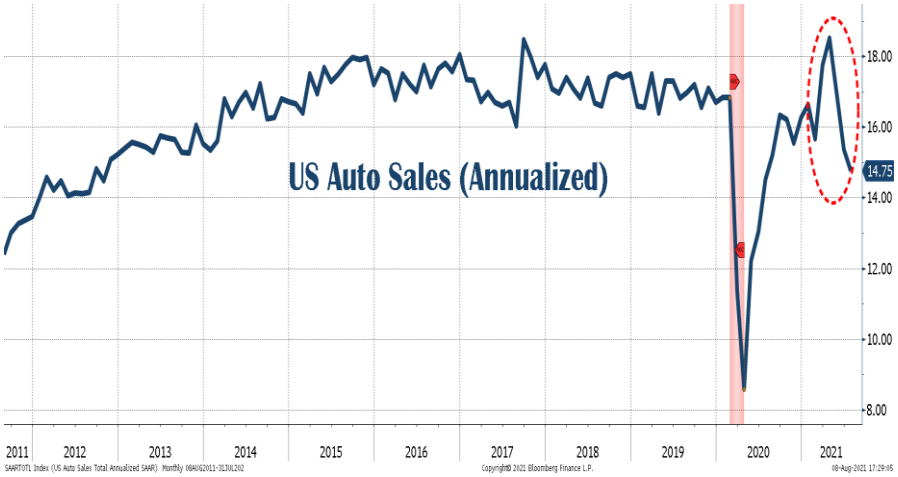
BOOM NOW, BUST LATER

The U.S. economy recovered at a 6.5% annualized rate in the second quarter of 2021, and GDP is now above the pre-pandemic level. This should be viewed as good news until we put it in the context of the largest fiscal and monetary stimulus in recent history.



Don't shoot the messenger**,** but the facts are the facts, and the facts are that in July, auto sales fell 4.5% and the Johnson Redbook Retail Sales Index is flagging a 1.9% decline in chain store sales on the month. So, we head into the third quarter with zero GDP momentum, and a deeper hole for consumer spending in July suggests that we could even see a negative print for the current quarter.

Just remember that all the fiscal policy stimulus is temporary. "Spend at any cost" policies generate a very short-term sugar rush followed by a long-term trail of debt and zombification. You cannot print and spend your way to prosperity. All the government has done is create the conditions for a boom-bust economy. Boom now, bust later.



"INCREASINGLY ALARMED"

Joe Manchin, Democratic Senator from West Virginia, sent a letter to Fed Chair Jerome Powell in which he, after the required good-job and thanks-for-saving-the-universe-as-we-know-it, hammered on Powell to get off the money-printing binge.

"With the recession over and our strong economic recovery well underway, I am increasingly alarmed that the Fed continues to inject record amounts of stimulus into our economy by continuing an emergency level of quantitative easing (QE) with asset purchases of $120 billion per month of Treasury securities and mortgage-backed securities,"

"The record amount of stimulus in the economy has led to the most inflation momentum in 30 years, and our economy has not even fully reopened yet,"

"I am deeply concerned that the continuing stimulus put forth by the Fed, and proposal for additional fiscal stimulus, will lead to our economy overheating and to unavoidable inflation taxes that hard working Americans cannot afford,"

"I urge you and the other members of the Federal Open Market Committee (FOMC) to immediately reassess our nation's stance of monetary policy and begin to taper your emergency stimulus response."

"[I]t is imperative we begin to understand that long term policy responses tailored for an economic depression, like the Great Depression and Great Recession of 2008, may not be what is required for today's economy and could result in higher than desired inflation if not removed in time."

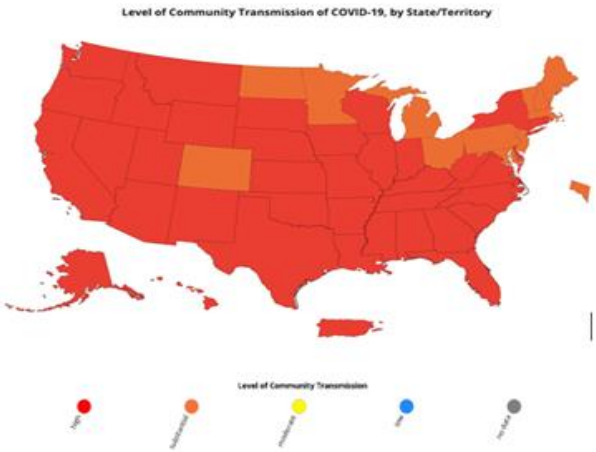
A Democrat calling for a policy tightening? Not to mention the fact that many FOMC members are now feeling emboldened to go public with their own "taper" views and are clearly at odds with the Fed Chairman.

THINGS ARE GOING TO GET WORSE

"Remember, just a couple of months ago, we were having about 10,000 cases a day... I think you're likely going to wind up somewhere between 100,000 and 200,000 cases." – Dr. Fauci

Again, don't shoot the messenger. That isn't from me. It's from Dr. Fauci, as the Delta variant runs rampant at a time when more than 90 million Americans, or half of the adult population, have yet to be fully vaccinated. About 30% of the adult population in the U.S. has not received at least one dose, and roughly 33% of eligible children aged 12 -17 have yet to receive a shot. The infection rate has topped the summer 2020 peak in terms of new daily cases. Experts now estimate that the U.S. needs a 90% vaccination rate to reach herd immunity, with Delta's ability to spread quickly and easily. While the COVID-19 vaccines in use appear to work well against current variants, "there could be a variant that's lingering out there that can push aside Delta," according to Dr. Fauci.

The CDC bases "community transmission" on the number of cases per 100,000, and the number of positive tests, for the last week. As shown below the delta variant is spreading fast across the country



The average seven-day case count is currently higher than last summer's peak, before vaccines were in use. The seven-day rolling average of daily cases was 86,650 on August 2, versus about 59,521 new cases per day exactly this time last year. I recommend a read of *Companies Readjust as Cases Rise* as well as *Confusion Reigns Over School Mask Policies* on the front page of today's Wall Street Journal. Another good article is *Movie Theater Recovery in a Holding Pattern*- also0 in the Wall Street Journal.

Here's the scoop. The economy will not go back into lockdown, but the reality is that the Delta variant could take a toll on the economy. In this period of rising case counts, consumers may become more hesitant to engage in close-contact activities, even among the vaccinated.

If the Delta spread does worsen, lookout for governments and/or businesses to mandate vaccine passports in order to engage in certain activities. New York City has already headed that way for restaurants and gyms. We also are seeing a long list of companies announce delays to their back-to-office strategies — Amazon being the latest.

Finally, this is a global issue. Many countries overseas are being forced into new restriction measures. China is noteworthy for cancelling all large public events for August, which will reinforce the economic slowdown already underway.

With this bog of uncertainty, why is there relentless pressure on the Fed to begin tapping on the brakes?

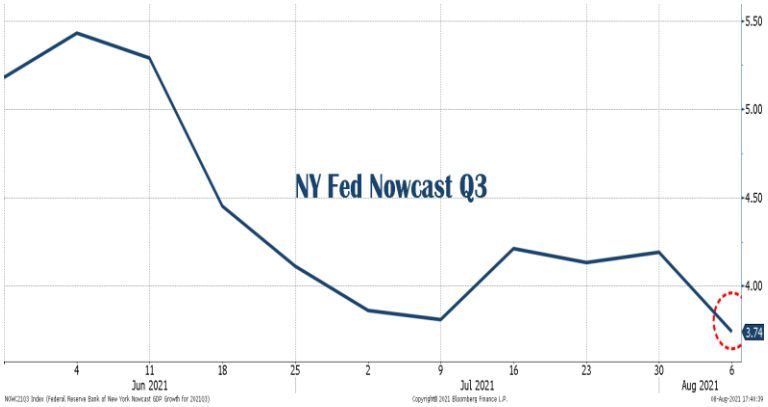
MARKET OUTLOOK AND PORTFOLIO STRATEGY

The economic outlook is clouded to say the least. The end of the fiscal stimulus is upon us. The extended jobless benefits term out in a month. The child tax credit, pound for pound, will not offset the loss of the extended jobless benefits next month.

The first $1 trillion leg of the infrastructure plan is progressing through the Senate, but it is still in limbo. Even if passed, it will take years to have any meaningful impact and since this spending is spread over a decade or so, these sorts of "stimulus" never do have an influence over the contours of the business cycle. The spread of Delta will curb spending growth even with no lockdowns. The momentum heading into the third quarter across a myriad of economic indicators points to a stagnant quarter of real GDP growth at a time when the consensus is stubbornly at 7% (at an annual rate).

The New York Fed's weekly economic indicators have been in a steady decline since this past March.

Meanwhile, the New York Fed's GDP for the third quarter continues to be lowered. Since June, expectations have declined from 5.4% to 3.74%.



On the inflation file, the author of the front-page story in the current Money Week publication titled, “Hold on to your wealth: Why inflation is here to stay” clearly doesn’t realize that copper and oil prices have peeled off 9% a piece; corn is off 28%; soybeans have come crashing down 12%; iron ore has plunged 27%; steel has not made a new high since early May; and nickel is no higher today than it was in mid-February. Not to mention lumber is down a whopping 67% from this 2021 peak

Even still, bond markets have shifted to a defensive posture. Just as it seemed that the 10-year Treasury benchmark was set to break below a key technical juncture, it has popped to 1.25%. It appears that Treasury traders are dialing up their bets on higher rates into 2023 and 2024 after this week’s seemingly hawkish comments from Fed Vice Chair Richard Clarida and Joe Manchin’s open letter to Jay Powell to start the process of tapering.

Keep in mind that when you look at what job growth has been doing so far this year, we do not get back to the pre-pandemic level of the employment-to-population ratio until May 2023. Judging from the Fed’s cadence in the past, it would be unusual to begin the policy tightening process before this threshold is met.

As for the here and now, the Treasury market will probably remain jittery. The 10-year Treasury yield had the chance earlier last week to break below a key technical barrier of 1.125%. But it could not. Now the yield is at another key technical level of 1.30%. Keep an eye out for 1.30%. If the Treasury yield closes the day and the week above that level, it would be a near-term bearish signal.

To be clear, I am not abandoning my fundamental bullish bond view. As I like to remind everyone, nothing moves in a straight line and the facts are the facts. Very suddenly, the Treasury market hasn’t been behaving well. In the near-term, expect more volatility and potentially higher yields. For credit unions with excess cash, we recommend systematically buying the dips.

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