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INVESTMENT SERVICES

Weekly Relative Value

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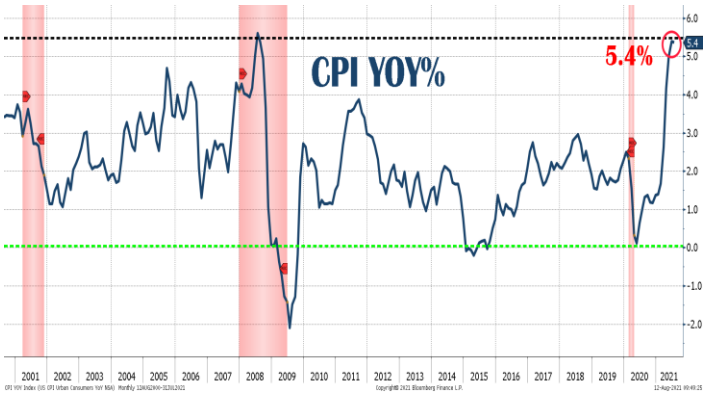
WEEK OF AUGUST 16, 2021

Dodging a Bullet!

For a change, the Consumer Price Index (CPI) data did not provide an upside surprise in July and the bond market took a deep breath of relief. Headline CPI increased 0.5% month-over-month (5.4% year-over-year) in July.

That said, groceries remain a big shock to the household budget as prices jumped 0.7% on top of the 0.8% June jump. At the pump, gasoline prices surged 2.4% after running up 2.5% in June (+41.8% year-over-year). Needless to say, these two categories are a big crunch to the pocketbook and a big tax on the poor. Maybe this is why credit card usage has soared these past two months.



Moving on. Core CPI, which excludes food and energy, rose only 0.3% month-over-month – the lowest reading since March. The year-over-year core inflation rate actually eased to 4.3% from 4.5% in June, ending a four-month string of accelerations.

THIS WEEK

- BOOMING WAGES?
- HAVE COMMODITY PRICES PEAKED?
- REAL WEEKLY WAGES DROP AGAIN!
- TAPPING INTO CREDIT CARDS
- SENTIMENT PLUNGES TO LOWEST LEVEL IN 10 YEARS
- FOLLOW THE LEADER

PORTFOLIO STRATEGY

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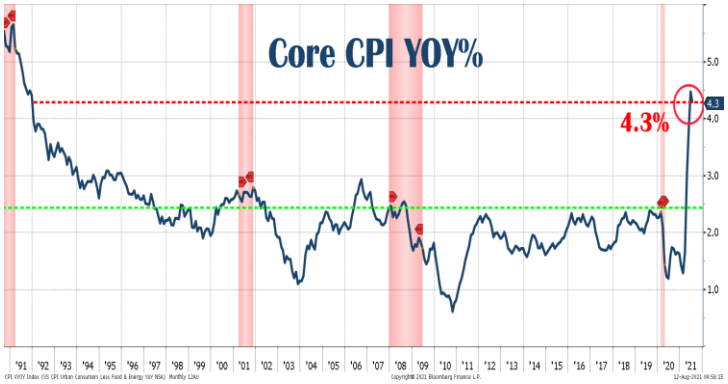
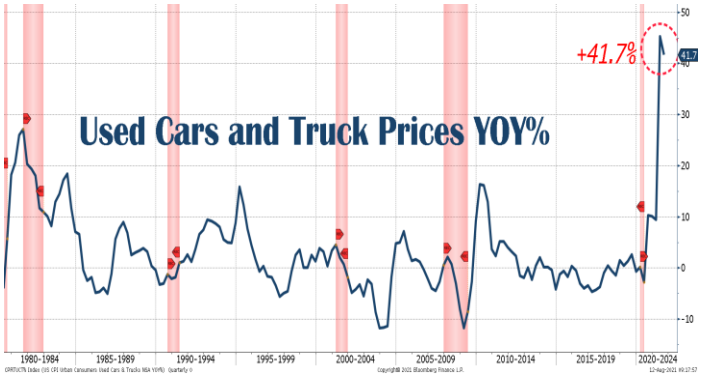
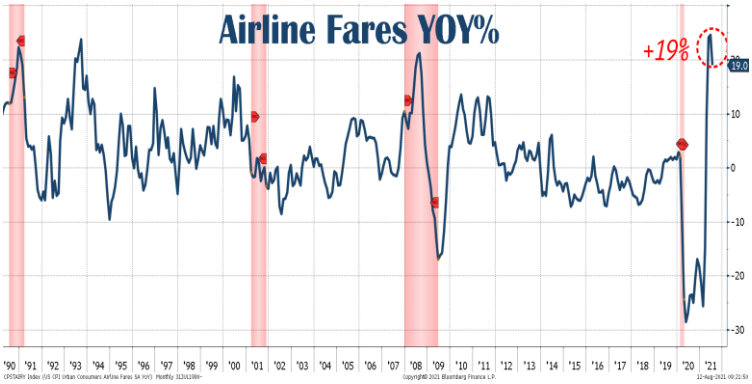
Excluding autos, the core was just +0.2% month-over-month in July, the smallest print since February. The rest of the core index actually only rose 0.2% month-over-month in July and is up a benign 1.1% on a year-over-year basis.



There were also several interesting crosscurrents in the July CPI report. New car prices jumped 1.7% after a 2.0% run-up in June and that took the year-over-year trend up to 6.4% from 5.3%. But people are now resisting the ridiculous pricing in the used car market where prices in July nearly flattened for the first time since February. That said, used car and truck prices are still up 41.7% year-over-year, but the July data showed that the consumer has its limits and is now balking at these stupid-high prices.



Also, perhaps due to Delta-induced fears, airfares dipped 0.1% for the first time since February. Airline prices are still up 19% year-over-year, but that needs to be viewed in the context of a -23.7% year-over-year trend this time last year.



As I have opined previuosly, the COVID-19 pandemic has influenced and distorted pricing in certain sectors of the economy in a very big way. But this far inflation is not widespread throughout the economy. To wit: An index consisting of COVID-19-centric items like autos, airlines, appliances, recreation, hotels, etc. is up a ripping 22% on a year-over-year basis. That index is 14% of the core CPI. But while the COVID-impacted sectors see skyrocketing prices, the other 86% of the CPI index has an inflation rate of just over 1%! Yes 1%!

So, the inflation we are seeing remains confined to a handful of sectors, while the non-distorted components – which represent the majority of the inflation pie – are seeing inflation barely above 1%.

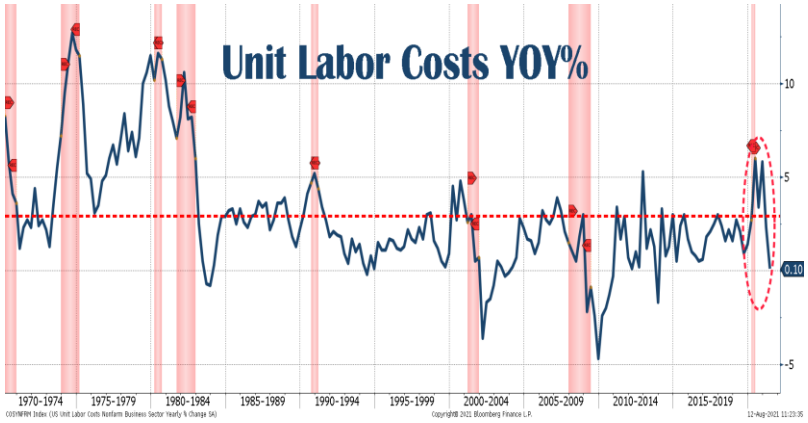
That is the BIG story beneath the headline, and one BIG reason why I have not been sucked into the inflation vortex.

BOOMING WAGES?

Wages are key to the deciphering whether or not we are heading into an extended inflation environment. Yet , for all the talk about booming wages, nominal labor compensation per hour has slowed from 8.5% in fourth quarter (Q4) to 6.4% in the first (Q1) and now to a five-year low of 2.0%.

In real terms, compensation per hour actually contracted at a 4.8% annual rate, dragging the year-over-year pace to -2.7% from + +7.2% in Q4. This is quite a reversal and now the most negative trend in a decade and the second most negative on record. Some red-hot economy.

Also worth highlighting, unit labor costs were very well contained at just a 1% annual rate in Q2, and Q1 was revised sharply lower to -2.8% from +1.7%. This means that the year-over-year trend in unit labor cost is a miniscule +0.1%. In the 1970s, it was running closer to +10% annually.



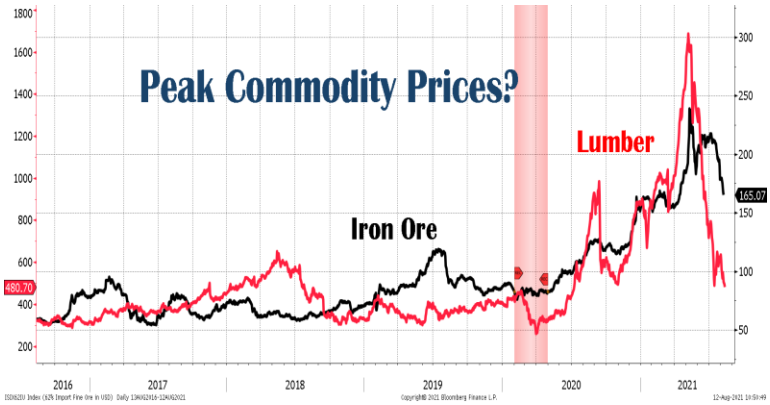
HAVE COMMDITY PRICES PEAKED?

"The reflation story is still very much alive." – Portfolio Manager

The above statement came from a portfolio manager who was quoted in a Financial Times article on reflation.

Hmmm. Let's see about that. From the nearby peaks, this is what these commodities have done:

- Lumber: -69%
- Iron ore: -29%
- Corn: -29%
- Platinum:-25%
- Soybeans: -14%
- Palladium -13%
- Oil: -12%
- Copper: -10%



REAL WEEKLY WAGES DROP AGAIN!

The pandemic has created a temporary environment where inflation is running at the highest level since 2008. This, in turn, has reduced inflation-adjusted (real) wages. In fact, real average weekly earnings have declined four consecutive months.

This is not what would be considered "normal" for an economy in recovery mode. Actually, it is more characteristic of an economy that is slowing down as declining real wages affect consumption, which makes up about two-thirds of GDP.

If wages remain depressed, the durable goods sectors at the greatest risk of being negatively impacted would be sporting equipment and vehicles, furniture, jewelry and watches, household tools and equipment, and new autos.

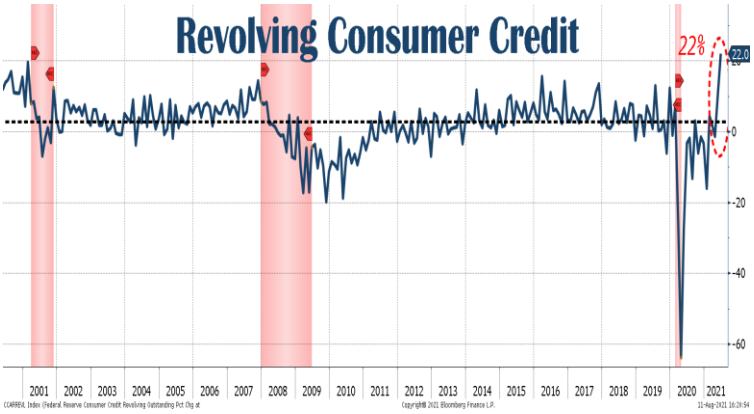
For the services sector, spending on travel, theaters, hotels, air and rail transportation, casinos, live entertainment, and household maintenance could be ripe for a pullback if real wages continue to decline.

The above items are considered highly discretionary spending, and these are also categories that are very susceptible to changing public health measures so they could doubly pull back if the Delta variant keeps surging.

TAPPING INTO CREDIT CARDS

Just as the stimulus checks dry up, the household sector is tapping credit at a rate that we haven't seen in a decade. And it is the credit card that is being tapped big-time – soaring at a 22% annual rate, which comes atop an 11.3% annualized surge in May, and the fastest growth seen since April 1998.

What are people doing with this new debt, considering consumer spending has significantly cooled off these past few months? Autos and housing, arguably the most credit-sensitive sectors, are floundering. And credit card debt is the highest cost debt to boot. This is most likely not an act of economic enthusiasm but rather one of distress.



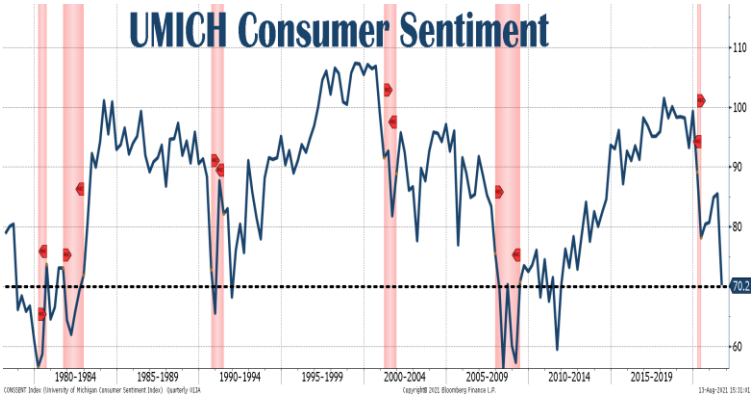
SENTIMENT PLUNGES TO LOWEST LEVEL IN 10 YEARS

"There has been a U.S. consumer goods demand surge, as consumers have spent the savings they acquired against their will. ***Once those savings have gone, U.S. consumers' demand will be based off incomes, plus whatever credit they can get.*** *But the real spending power of U.S. income is now falling, as headline inflation exceeds income growth. This limits the power of future demand to push up prices indefinitely."*
– Paul Donovan, Global Chief Economist, UBS Wealth Management

The University of Michigan Consumer Sentiment Index was a painful eye-opener. Sentiment crashed in early August with the headline plunging from 81.2 to 70.0. That is weaker than the April 2020 COVID crisis lows.

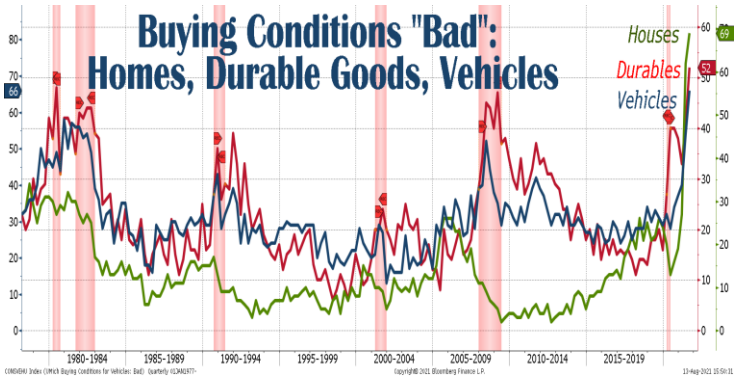
Over the past half century, the University of Michigan Consumer Sentiment Index has only recorded larger losses in six other surveys, all connected to sudden negative changes in the economy. The only larger declines in the Consumer Sentiment Index occurred during the economy's shutdown in April 2020 (-19.4%) and at the depths of the Great Recession in October 2008 (-18.1%).

Furthermore, the sentiment shift wasn't confined to just one demographic; the losses in early August were widespread across income, age and education subgroups and observed across all regions. Moreover, the losses covered all aspects of the economy, from personal finances to prospects for the economy, including inflation and unemployment.



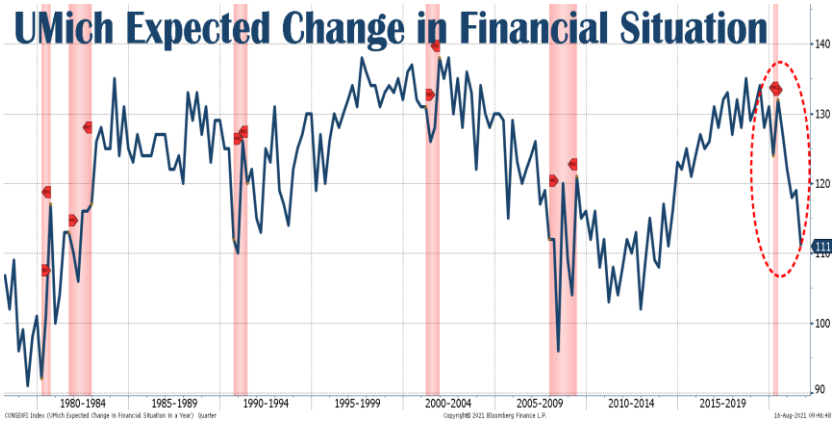
Consumer expectations collapsed, too, with fewer consumers saying the year-ahead prospects for the economy could be described as good (31%, down from July's 50%) the majority (57%) now expect a renewed downturn over the longer term. And even with record job openings, just 36% of consumers anticipated a decline in the jobless rate, down from 52% last month. This reflects an anticipated slowdown in the year ahead, as just 32% of consumers thought that the economy would improve, well below last month's 45% and the 50% in June.

The University of Michigan also noted that reactions to market prices on purchases for homes, vehicles and household durables were the most negative ever recorded in the long history of the surveys, with a record number of respondents remarking on the bad buying conditions for virtually every category.



Regarding houses, nearly 70% of respondents say that now is a "bad time to buy," the greatest share recorded since August 1982 when the economy was mired in recession. Even during the depths of the pandemic lockdowns this share remained below 50%. The same can be said for vehicle buying conditions —a 66% share say now is a bad time to buy, an all-time high and taking out the previous peak of 61% in May 1981. High prices for both are killing off demand — 69% of respondents suggested now is a bad time to buy a house due to high prices while 45% reported the same concern for vehicle purchases, both far surpassing historical highs.

Frankly, none of this is surprising given that expectations that personal finances will deteriorate over the next year have spiked —over a fifth of respondents expect their financial position will be worse in 12 months, the greatest share since December 2012.



Whatever optimism Americans had toward the economy has vaporized. But what is scarier is that, according to the latest Bank of America debit and credit card spending data, this is already starting to manifest itself in actual spending, which is slowing and will have an adverse impact on overall economic growth (as a reminder, 70% of U.S. GDP is derived from consumer spending).

With the benefit of stimulus checks now long gone, and consumers having burned through much if not all of their pandemic savings, American consumers now are choosing to become more cautious in their spending patterns. Bank of America's proxy for services spending – which includes airfare, lodging, entertainment, restaurants and bars – continued to slide in the most recent week to a two-year growth rate of 5.7%. This is down from the recent high in late-June of 14.6%.

The biggest deceleration continues to be in spending on airfare, which reflects concerns over the Delta variant. Also of note, the weekly average of seated diners tracked by OpenTable has dropped back down to levels that are 8% below the

pre-COVID-19 norm (back in late June, dining-out activity had surpassed 2019 levels, so consider this to be a significant negative reversal).

This also means that the upcoming retail sales report, where consensus expects a 0.2% print excluding autos, will be a major disappointment. We know that auto sales fell 4.5% in July. We also know that the Johnson Redbook flashed a 1.9% slide month-over-month in chain store sales activity. The Weekly Index of Retail Trade, published by the Chicago Fed, showed a 0.1% dip in retail sales in July. This would then mark four out of five months with flat or negative readings in real retail sales, which is typically a streak saved for recessionary episodes in the economy.

Moving on. The commercial real estate sector is now considerably more uncertain as to whether workers will return to the office in the volume and the timing that was planned just three months ago. Facebook became the latest major employer to push back the return-to-office date. This is how quickly the virus, and all its various mutations, can change things. Oh, by the way, did you know that only 15% of the global population is fully vaccinated??

Finally, the Biden administration may have delayed evictions and bankruptcies due to an increase in cases linked to the Delta variant, but they are inevitable. Despite the two-month extension, 11 million Americans are at risk of being evicted much sooner than they expect.

What about Infrastructure? We certainly do need it, but there is no evidence that this type of spending, stretched out over long time periods, has any impact on the business cycle.

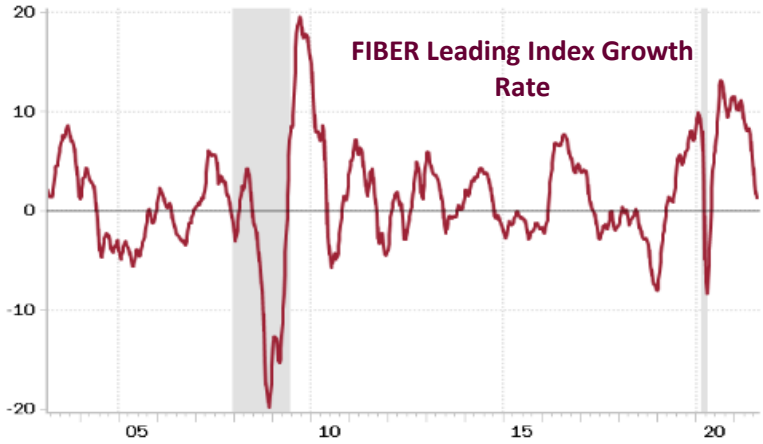
And all of this is happening at a time when stimulus checks are in the rearview mirror and extended jobless benefits come to an end in early September.

No matter how one slices the data, the bottom line is that consumer optimism is collapsing and starting to depress spending, whether it's due to the Delta variant or surging inflation. Incidentally, early last week, small-business confidence plunged to its lowest level since early spring, as the rise in COVID-19 cases due to the highly transmissible Delta variant put a damper on expectations, while surging prices fanned fears about plunging margins.

FOLLOW THE LEADER

The Foundation of International Business & Economic Research (FIBER) leading indicator – a composite time series that has a strong tendency to reveal the direction in which the economy is going – is pointing to below-potential economic growth, starting this quarter. This is what sets the stage for a renewed disinflation cycle once the pandemic distortions ease up. The leading index, in absolute terms, is visibly rolling over, as the chart below illustrates. It hasn't been this low

since May 2020, but back then, we had the vaccines, the reopening phase and an endless stream of stimulus checks. Hardly the case today.

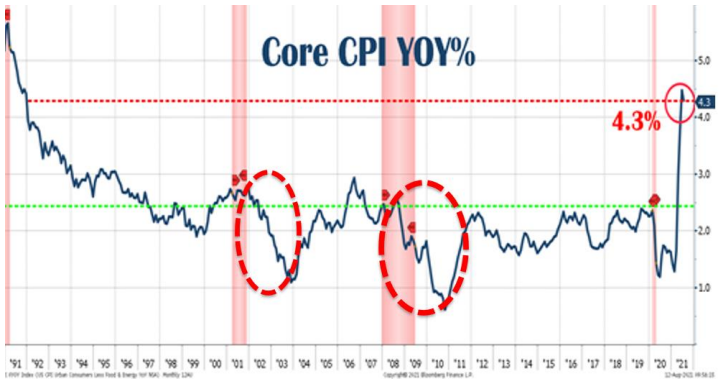


Source: Haver Analytics

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I get uncomfortable when I can't understand what's going on in the markets, and I'm not really happy with my explanation for the weirdness of the Treasury market over the past few months. Given that pretty much everything else rests on Treasuries behaving sensibly, my level of discomfort is high." – Excerpt from 'Something Is Awry in Treasury Market' by James Mackintosh, Wall Street Journal

After rising from a six-month low, the upward pressure on the 10-year Treasury benchmark yield has abated after last Friday's monster rally that saw the yield melt eight basis points to 1.28%. It should be noted that even as Congress tries to advance a mammoth package of infrastructure spending, this past week's auction of 10-year Treasury notes was one of the strongest on record. While pundits and columnists throw their hands up in the air saying rates at current levels don't make any sense, the reality is that they are flashing a signal of future deflation, and that the current state of the inflationary world will come and go much as it did in 2000, 2008 and 2010. As I like to say, the bond market tends to get the story right more times than not.



In terms of portfolio strategy, credit unions should continue to reduce excess cash reserves, maintain a disciplined laddered portfolio strategy and, from a tactical perspective, look to invest on short-term dips in the market.

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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.