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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 30, 2021

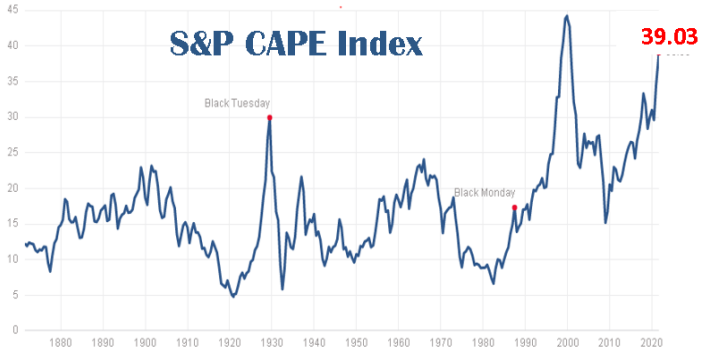
Nosebleed

From the pre-COVID-19 peak, GDP (nominal) has risen just less than 5%, corporate profits are up 12%, and the S&P 500 is up 33%. And get this: In January 2020, just before COVID-19 hit, the consensus projection for 2021 S&P 500 earnings-per-share (EPS) was $193.90. Where is that forecast today? Try $198.50, or only 2.4% higher. And the S&P 500? Well, it is up 40% over that time. To repeat: That is a 40% surge from the time the market was last peaking and with no real improvement in earnings expectations.

The market has been indoctrinated into believing there is no alternative (TINA) and that the stock market is a "protected" asset class (the Fed has everyone's back!). To wit: There have now been no fewer than 13 "buy the dip" episodes where the market dips — dips, not even a correction — to only then have the buyers (computers? algos?) step right in. Frankly, in my 40+ years in this business, the "buy the dips" mentality may be the most ingrained investment phenomenon I have seen. But it has worked every step of the way.

And in contrast to prior cycles, this is no single-market bubble. It is ubiquitous. In the late 1980s, it was commercial real estate. In the late 1990s, it was the dot-com mania. In the 2000s, it was housing. Now, it's everywhere you look and covers trillions of dollars of assets — equities, residential real estate and all forms of corporate credit.

As the equity bubble gets bigger, like the clown at the circus who keeps blowing into the balloon, the valuations have simply gotten out of control**.** The cyclically adjusted price-to-earnings (CAPE) multiple, at 39X, exceeds every single top in the past by a massive amount and is only surpassed by the dot-com craze in the late 1990s**.**



Source: S&P Case Shiller

THIS WEEK

- COVID, COVID, COVID!
- THE WELL RUNS DRY
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PORTFOLIO STRATEGY

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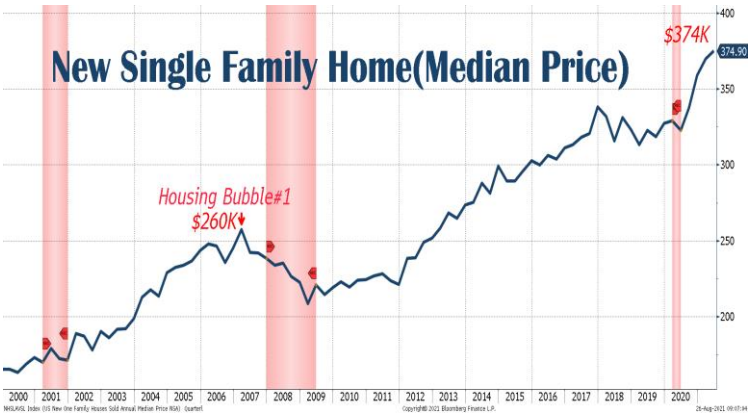
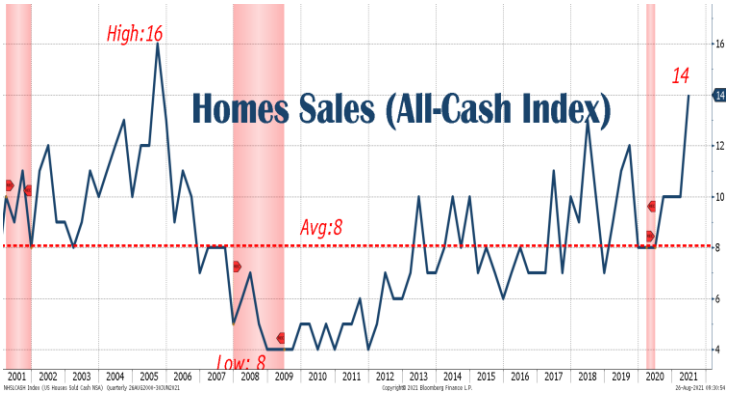
Note: The CAPE ratio is a valuation measure to assessing how a stock's price compares to its value. Unlike the standard price-to-earnings (P/E) ratio, the cyclically adjusted price-to-earnings ratio attempts to better account for long-term trends (10 years). As with the standard P/E ratio, the utmost important point here is that the CAPE ratio can be also applied to get an idea about whether the market is over-valued or under-valued. A high CAPE ratio suggests those prices are extended and future returns may disappoint. Conversely, a low CAPE ratio suggests that the stock market is more attractive and likely to deliver higher-than-expected returns. It should be stressed that this index should not be used for timing the market short-term.

Despite record-high valuation, Wall Street is the most bullish on equities in two decades with 65% of portfolio managers seeing stocks as being attractive. It doesn't get much bigger than that. Only 5% of portfolio managers see Treasuries as being attractive compared to 65% for stocks. Meanwhile, the average Joe investor continues to plow money into equity exchange traded funds (ETFs) and mutual funds with inflows over just the past five months now exceeding cash flows of the prior 12 years! Truly amazing stuff. The level of investor complacency is truly without precedent. Risk management is so passe.

Moving on. The median price of a new home jumped 5.5% in July (+18.4% year-over-year) to a record-high $390.5 thousand; and the average price spiked 3.8% month-over-month to a record as well of $446 thousand (+17.7% year-over-year). This bubble just keeps on getting bigger with each passing month.



The first-time entry level buyer has been totally priced out. The share of new homes sold at a price tag below $200 thousand is now only 1%! A decade ago, this market accounted for half of all new sales and two decades ago, the share was 60%. Now it is down to almost nothing. Meanwhile, the share of new homes priced at $500 thousand or more is over 25%; a decade ago, these comprised 5% of the market.



Even with prices sky-high, sales are being snapped up quickly. And the buyers aren't who you think they are because the number of "all-cash" deals have soared to a 16-year high (back to the 2005 bubble) while sales to people with a conventional mortgage are actually no higher now than they were at the end of 1999! The real estate market is being increasingly dominated by investors mopping up the supply for rental purposes given the tight vacancy rates and rising rents in the apartment space.

It's not just housing and equities that trade at nosebleed levels. Investment grade credit yields 2%. BBB-rated corporate debt is now 2.28%, which is only 33 basis points above long-dated Treasuries, which have no default or call risk. The average yield in the junk bond market is at a record-low of 4.5%. To me, that is nuts relative to underlying default rates. But investors don't seem too concerned about default risk; it's all about a chase for yield. The average CCC-rated bond trades at 7%.

Never have all these asset classes diverged so much from their intrinsic values and been so incredibly hitched to the Fed's money printing experiment and the move to eradicate risk premia. Crazy stuff!

COVID, COVID, COVID!

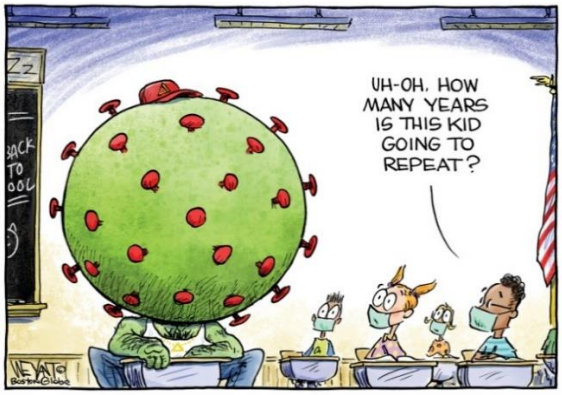
While markets are seemingly unconcerned, the Delta variant crisis is not getting better one iota. U.S. cases topped 130 thousand per day in August, a level not seen since the end of the third wave in February. Hospitalizations are topping 100,000 now for the first time since January. The FDA's "full approval" of the Pfizer vaccine is welcome news, although it's unclear if that will be enough to convince those that remain hesitant about taking the shot. And the White House is aiming to provide "booster" shots to all Americans starting at the end of September, but that does little to persuade the millions who have refused doses one and two. This is bad news for the U.S.

As of mid-August, 28 U.S. states had failed to fully vaccinate at least half of their populations. Southern states, such as Alabama and Mississippi, are at an abysmal 36% fully vaccinated rate, with high transmission rates, increasing hospitalizations and growing death counts. In Texas, hospitalizations reached 13,928 – an all-time high. Likewise, in Oregon, the case count and hospitalizations have soared to record levels. The CDC reported 5,665 deaths from the disease in the week ending Tuesday. In Florida, the death count reached 903 in a single day.

It remains uncertain how severe the current wave of the virus will be, but there are many indications that it could last until mid-November. While virtually no one expects states to lock down, increased social distancing and mask mandates are likely, as are capacity limits on events where distancing isn't possible. This will hold back the recovery in tourism and hospitality in particular.

- OpenTable data show that seated dining activity has fallen 10% below pre-COVID-19 levels; at the end of July, it was -3%. CEO Debby Soo stated that they see, “a pronounced decline in late July and August.”
- Hotel occupancy levels have receded now for four weeks in a row.
- Air-traffic has sagged to a three-month low. Cancellations are on the rise and new bookings for leisure travel have declined precipitously.
- The drive to move employees to the downtown offices has completely stalled out and the level of occupancy is 31.3% of the pre-COVID-19 level. All 25 major urban markets are down year-over-year on office space take-up. This is a disaster, and we haven’t yet seen the worst of it in terms of price and rent deflation.

The spread of the virus also means a delay in re-hiring for a lot of service-oriented positions (which are still 4.2 million jobs below the February 2020 level). Then we need to factor in how schools and childcare centers may not fully re-open as anticipated in September, meaning that parents (mothers, disproportionately) and teachers may not be able to return to their full-time positions as expected.



And sadly, it is becoming increasingly clear that COVID – while likely to fade – will be with us for the long haul. A glut of data released over the past few weeks supports the idea that coronavirus vaccine effectiveness against infection begins to wane over time, although it remains effective against severe disease.

Most of the data suggest effectiveness is on the decline within six months post-vaccination. The U.S. vaccination campaign began in December. So, millions of vaccinated Americans are likely significantly less protected than they were when they completed their shots. That's not even accounting for the possibility that the vaccines are less effective against Delta.

Even after getting the shot, we'll have to live with some level of COVID risk for the foreseeable future.

THE WELL RUNS DRY

Unlike early on in the pandemic, the government fiscal spigots are running dry. And we all know that the key drivers of growth over the past year have been the three gargantuan fiscal transfers to the personal sector that kept the economy afloat.

- $2.2 trillion CARES Act in March 2020
- $900 billion CRRSA Act in December 2020
- $1.9 trillion American Rescue Plan in March 2021

According to the Brooking's Institute, these three programs contributed 14% to 2020 second quarter (Q2) GDP growth and 8% in 2021 Q1. However, momentum has now faded without the boost from stimulus checks, and from here on out, the growth rate will fall well into 2023.

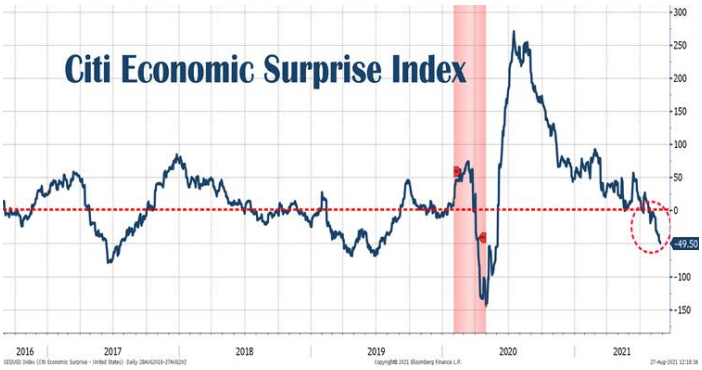
The expiration of extended jobless benefits coming up on September 6 will put a huge dent in the pool of nearly 12 million Americans continuing to rely on federal assistance. Not all benefits will expire immediately, but in general, there should be much less of a deterrent to work among those who were being incentivized to stay home rather than search for a job. This should also increase the labor supply and reduce the pressure on rising wages.

I should add that assuming the visions of added fiscal stimulus, including a huge "human capital" endeavor, are also unlikely to morph into reality. The House agreeing to a "framework" is much ado about nothing and Democratic moderates are nowhere close to accepting a $3.5 trillion spending boondoggle.

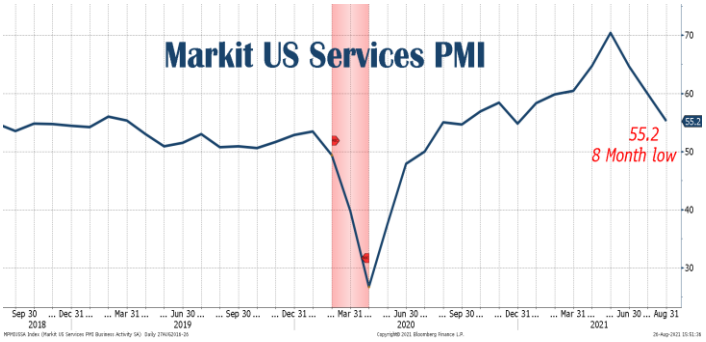
But even should the American Jobs Plan ($1.2 trillion infrastructure bill) and American Families Plan ($3.5 trillion social spending bill) make their way through Congress, their impact won't be felt immediately as was the case with the stimulus checks to households. Spending for these new bills is spread over the next decade and, I should note, comes with an additional tax burden.

THE MACRO STORY

You can see the culmination of benefits and stimulus and the spread of the Delta variant on incoming data. Notably, the Citigroup Economic Surprise Index has crashed into negative territory.



And, most importantly, consumer sentiment and spending are being negatively impacted. The latest University of Michigan survey of consumer sentiment hit a pandemic low in August. Last week, the service component of the Markit Purchasing Managers' Index (PMI) slid to an eight-month low of 55.2 from 59.9 (consensus was 59.2).

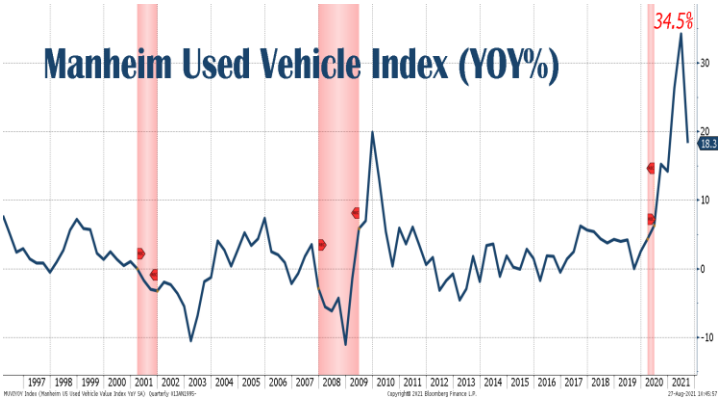


We are also seeing a pullback in retail sales (Johnson Redbook chain store sales are down 0.6% month-over-month) and a pullback in auto sales. Finally, real sales (40% of the consumer spending pie) are on track for a fourth consecutive month of negative readings. In the past, a losing streak like this in has coincided only with recessions. Not once did it occur in an economic expansion.

Bottom Line: Even once the virus begins to subside, the on-again/off-again spread and fears of contagion combined with end-of-stimulus will have a dampening effect on growth and inflation through the second half of 2021. The consensus GDP forecast for Q3 is 7%. Based on the recent data, I believe that is nearly impossible. Look for a 2-3% quarter-over-quarter GDP reading that will stun the Wall Street crowd. A word to the wise.

USED CAR PRICES IN REVERSE

The Manheim Used Vehicle Value Index went into reverse by 2.6% in July after sliding 1.3% in June. It appears that the fun and games are over, and consumers are no longer willing to be fleeced. In June, the year-over-year was 34.5% and, as shown below, is now 18.3% in July and slicing lower. This will play a key role in the coming benign Consumer Price Index (CPI) prints seeing as automotive accounts for over 9% of the core index (no other country has such a high concentration of autos in the consumer price indices, and this explains a lot of why the U.S. headline and core inflation rates look so high on a relative basis).



WAVE OF EVICTIONS COMING?

"The moratorium has put… millions of landlords across the country, at risk of irreparable harm by depriving them of rent payments with no guarantee of eventual recovery… Many landlords have modest means. And preventing them from evicting tenants who breach their leases intrudes on one of the most fundamental elements of property ownership—the right to exclude." – U.S. Supreme Court

The most important aspect of the national eviction moratorium is that it came on top of the extra $600 a week in federal unemployment benefits last year and an extra $300 a week this year, on top of the regular unemployment benefits. And let's not forget the stimulus payments. These programs were specifically designed to give people enough money even if they lost their jobs to pay rent and health insurance and other stuff. There was money everywhere and anywhere.

Many people made more money under these programs than before, and it triggered a historic spike in retail sales. But with the eviction moratorium in place, people didn't have to pay rent anymore, and could just spend all this money they got to pay for rent. And they did.

Last Thursday, the U.S. Supreme Court lifted the CDC temporary eviction ban, set to expire on October 3, 2021. The Court said that the ban exceeded the CDC's authority to combat diseases, and that it forced landlords to bear the costs of the pandemic

It's easy to feel sorry for the plight of those tenants. But those tenants already got paid the extra unemployment benefits from the federal government, on top of the state unemployment benefits, on top of the stimulus, so that they could pay their rents. But the eviction bans allowed those tenants to buy big screen TVs and new appliances with this money instead of paying their rents.

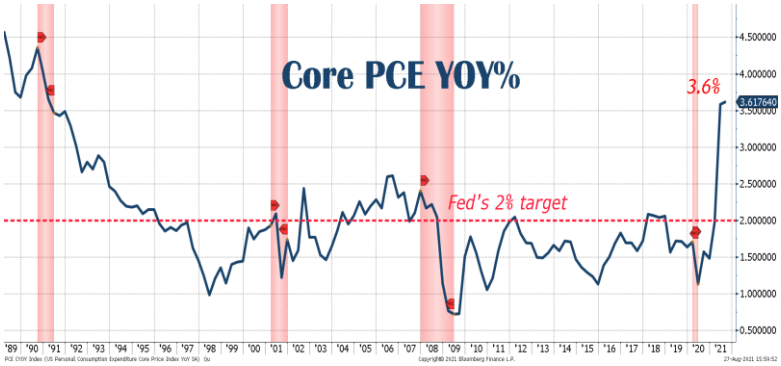
And now the taxpayer is paying $47 billion to landlords to make them whole and to get the tenants off the hook, in an economy where no one has to pay for anything anymore. The whole idea of the eviction ban was that consumers don't have to pay their debts and other obligations, such as rents, with the money that they received from the government precisely to pay those debts and other obligations, and that they could use that money to buy other things.

Bottom Line: The public interest is not served by allowing freeloaders to squat in property for what is now going on 18 months. States were warned in June by the Supreme Court and did nothing about it. Heck, half of this money to assist renters was available in March of 2020 then Congress added to it. The government is paying a second time for the same thing, this time to make landlords whole, in an economy that has gone nuts.

If tens of thousands, hundreds of thousands or even millions are evicted and become homeless, do not blame the landlords or the Supreme Court. Blame the states for not distributing the allocated funds and Congress for the rules regarding funds disbursement

TAPERING IS NOT TIGHTENING

As shown below the Fed's preferred inflation index (core personal consumption expenditures) rose to 3.6%, the highest since 1992. The only question now is how much of this inflation is "temporary" – surely, some of it is – and how much of it is persistent and how much new inflation can come along.



Fed Chair Jerome Powell, in his virtual Jackson Hole speech, pointed out why inflation has spiked so enormously in durable goods: a historic spike in stimulus-fueled demand that no one was ready for. And some of those price spikes, such as the ridiculous price spikes in used vehicles, are surely in part temporary because these prices are just too outlandish to persist. And when those prices tick down, they pull down the inflation index.

"The spike in inflation is so far largely the product of a relatively narrow group of goods and services that have been directly affected by the pandemic and the reopening of the economy." – Fed Chairman Jerome Powell

He's right, and nothing the Fed does with monetary policy can fix those supply-chain disruptions, which have nothing to do with an overheating economy. Would a less accommodative stance open the ports in China that have been hit by COVID-19 outbreaks? Would it solve the semiconductor chip crisis that has curbed the production of autos and sent used-car prices soaring? Would it reverse the five-fold increase in shipping-container costs? Would it lower food prices that have soared because of droughts and worker shortages? Would it address the shortage of truckers that have led to higher transportation costs? The answer to all these questions is no.

"I was of the view, as were most participants, that if the economy evolved broadly as anticipated, it could be appropriate to start reducing the pace of asset purchases this year… the timing and pace of the coming reduction in asset purchases will not be intended to carry a direct signal regarding the timing of interest rate liftoff, for which we have articulated a different and substantially more stringent test." – Powell at the Jackson Hole confab

The biggest takeaway from the Powell speech at Jackson Hole is what we already knew from the Federal Open Market Committee (FOMC) minutes. Powell said the economic recovery has progressed enough such that the central bank could begin reducing its $120 billion of monthly bond purchases this year, though it won't be in a hurry to begin raising interest rates thereafter.

In other words, the familiar, trite slogan from 2013: "tapering is not tightening." Simply put, this means rates will remain "lower for longer."

MARKET OUTLOOK AND PORTFOLIO STRATEGY

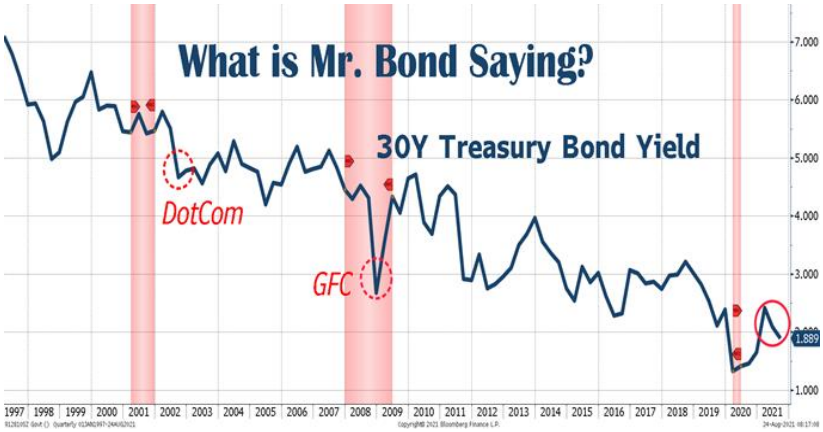
"I know I'm going to be very regretful if we claim victory on averaging 2%, and then we find ourselves in 2023 with about a 1.8% inflation rate sustainable going forward… I'm probably more nervous than almost all of my colleagues." – Chicago Fed President Charles Evans

In a nutshell, Mr. Evans thinks the pre-pandemic dynamics – in which inflation, interest rates and global growth were historically low – will eventually reassert themselves. He sees core inflation returning to around 2.1% at the end of next year. This has been my story for quite some time.

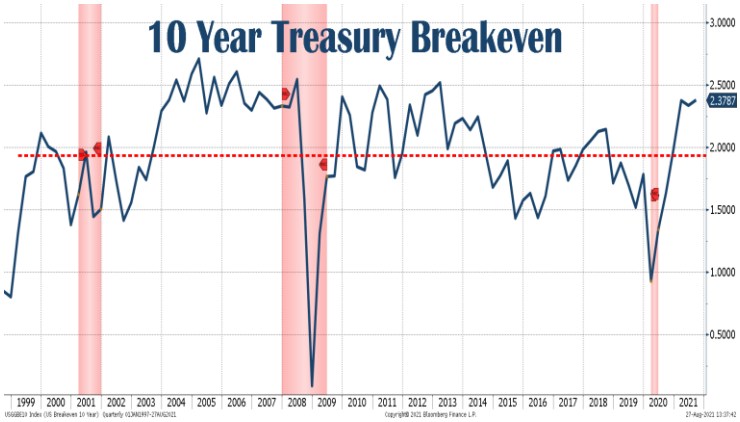
Meanwhile, there are signs that, at least from the commodity markets, there is a break in the inflation action. From the peaks, lumber is down 70%, iron ore is down 40%, and copper is down 10%. Corn and crude oil remain well below their prior highs, too. And there is no sign in the labor market, outside of the low-end worker, that wages are taking off. Not one shred of evidence; just anecdotes.

Maybe that is why the 30-year long bond yield at 1.92%? During the Great Financial Crisis, the lowest point it reached was 2.53%. During the tech wreck two decades ago, the lowest the yield got was 4.79%. Everyone says it's the Fed. Come on. The Fed's quantitative easing (QE) program has been concentrated in 10-year notes and shorter maturities. Only 15% of the Fed balance sheet is in maturities over 10 years. Long bond holdings on the Fed balance sheet are less than 6% of outstanding federal marketable debt. So, it's not about the Fed. It's a message from the back end of the

curve that inflation is going to come right back down before long and that whatever "new normal" we enter, it is not going to entail an acceleration profile for economic growth.



I also find it interesting that after throwing everything including the kitchen sink (and all the appliances), the 10-year Treasury Inflation-Protected Securities (TIPS) breakeven level is below 2.3%. (Note: The TIPS breakeven is the difference between the real yield on TIPS and the nominal Treasury yield. The result is the implied inflation rate.) This has been the case 75% of the time in the past two decades and, as shown above, it is not nearly a breakout. Yes, expectations have moved higher in the past year, but this is not going to be the 1970s on the inflation file any more than it will be the "Roaring Twenties."



In terms of portfolio strategy, stay the course. Reduce excess cash and maintain a risk-appropriate ladder strategy. Periodic sell-offs provide an opportunity to lock in higher yields.

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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.