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INVESTMENT SERVICES

Weekly Relative Value

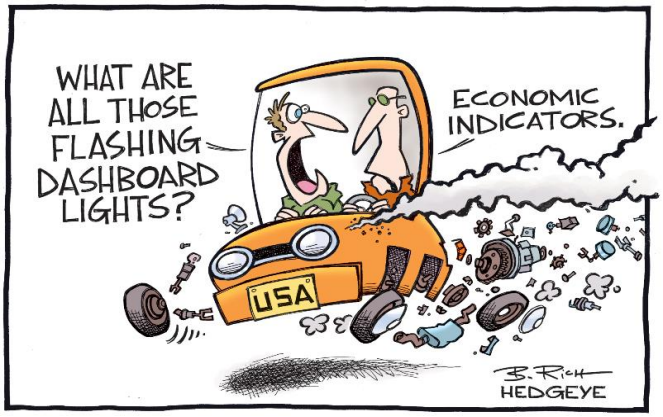
Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF SEPTEMBER 7, 2021

Economy Shifts to a Lower Gear

"There is little to think that the secular disinflationary forces that have been in place for decades have suddenly reversed or abated." – Fed Chair, Jerome Powell

The re-opening and fiscal stimulus led boom in economic activity has come and gone. Most leading indicators of economic growth have now peaked and rolled over. The slowdown under way is evident. We can all quibble over the reasons, but it does not matter.



It's clear that the delta variant is exerting a negative impact on domestic activity with restaurants, hotels and airlines reporting a sudden decline in activity. Unquestionably, the delta variant is in play, but I believe it goes beyond the pandemic to the reality that the U.S. economy is unquestionably slowing.

As highlighted recently, the University of Michigan consumer sentiment index for August showed buying plans for big-ticket consumer durables fell to the lowest level since April 2020. And before that the last time durable order sentiment was so low was in March 2009 and before that September 1982. In other words, a recession-like number.

Auto buying plans have done more than just slam on the brakes but have gone into reverse to levels last experienced in November 1974. Again, this is a recessionary level. Last, but not least, homebuying intentions have slumped to levels we last saw in October 1982.

THIS WEEK

PORTFOLIO STRATEGY

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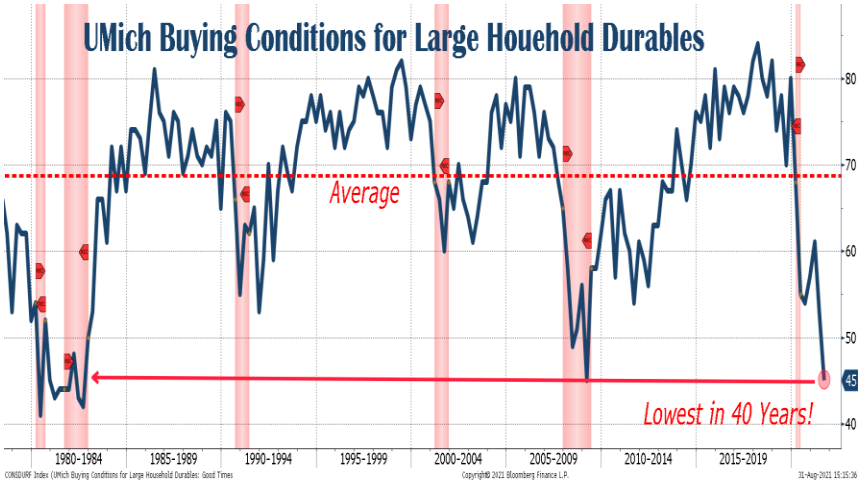
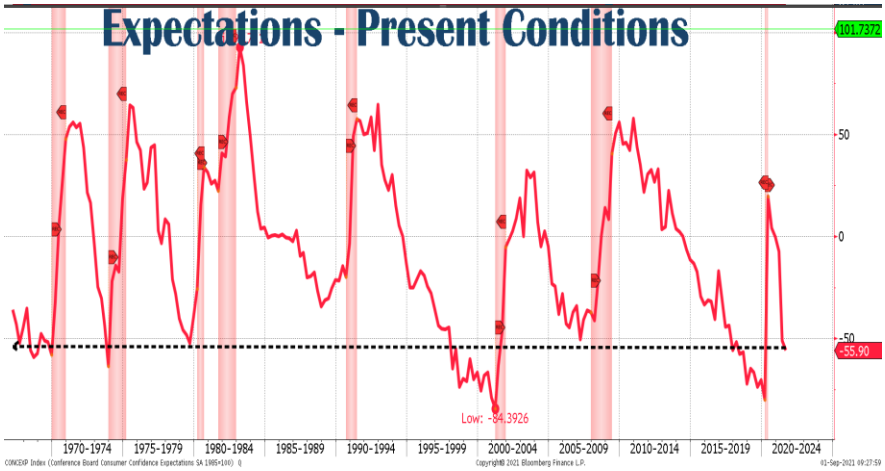


Last week, the Conference Board's consumer confidence went from 125.1 in July to 113.8 in August. Given the magnitude of the decline, it classifies as a two-standard deviation event. The Present Situation Index, based on consumers' assessment of current business and labor market conditions, fell to 147.3 from 157.2 last month. The Expectations Index, based on consumers' short-term outlook for income, business, and labor market conditions, fell to 91.4 from 103.8.

Obviously, neither of the individual measures are doing very well, but it is the ratio between the two that offers the most important indicator as it shows the forward momentum indicator for the economy. The spread between what consumers see down the road compared to what they see currently has deteriorated now for six months in a row. At -55.9, this is the largest negative differential since the dark days of March 2020. And as the chart below illustrates, it is not uncommon for such a wide divergence to occur ahead of economic recessions, or at the very least, significant growth turndowns.

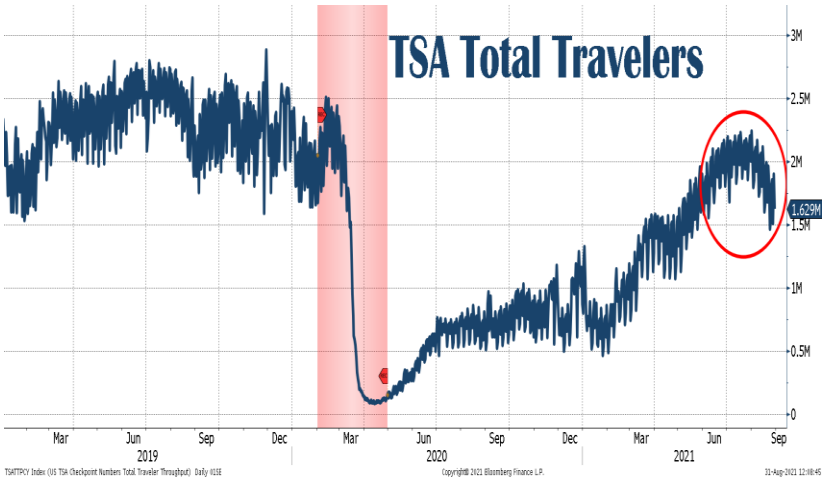


The high frequency spending data are painting a fairly grim picture for the U.S. consumer sector. We are on the precipice of four straight months of negative real retail sales. Keep an eye on the retail sales data for August on September 16th. If it shows a drop in volume spending, it will be the fourth in a row, and this has only in the past happened in recessions. Is anyone brave enough to say, "it'll be different this time?"

Here's an interesting little ditty. In July, the Federal Reserve Bank of Philadelphia conducted a consumer survey on overdraft usage. It showed that over the last 18 months roughly a third of respondents experienced an overdraft on

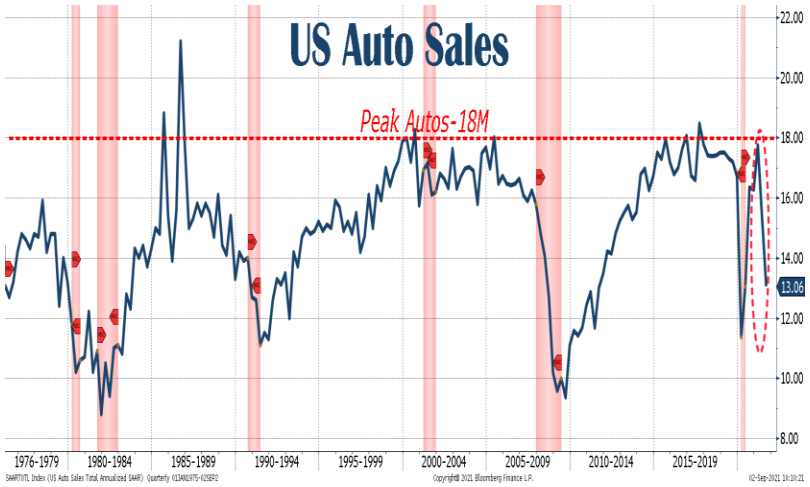
their checking accounts. And more than half of those using overdraft facilities did so intentionally to plug short term liquidity shortfalls. Well, so much for the stimulus checks!

Also worth noting is that air-traffic has sagged to a three-month low. Cancellations are on the rise and new bookings for leisure travel have declined precipitously. The delta variant may not be denting investor sentiment but it sure is affecting the consumer sector.



Auto sales for August were also much weaker than expected (-11.1%) coming in at 13.06 million units sold. In June, sales were 15.36 million and in March sales reached 17.75 million units. As shown below, whenever auto sales have spiked to 18 million units this is virtually always a cycle peak. These are the weakest numbers since May 2020. This was the fourth consecutive decline, and the decline is a massive -65%, annualized. Yet, I did not see any reports on this – not a peep from anyone. Keep in mind that the University of Michigan vehicle-buying plan index has dialed back to levels last endured in November 1974, when the economy was knee-deep in an official recession.

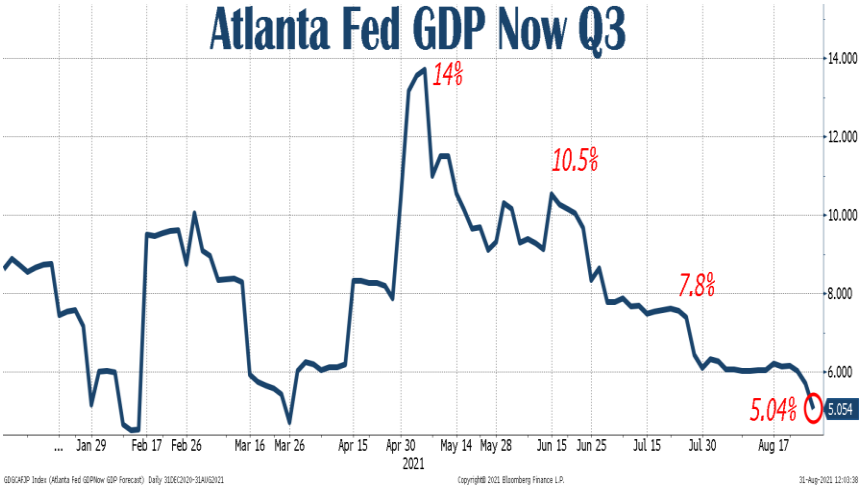
The auto sales with what looks like a flat August reading for chain store sales suggests that real retail sales will decline yet again, for the fourth straight month. While the headlines are plastered with inflation stories, maybe the bigger story is a significant slowdown.



Moving on, durable goods orders clearly peaked at the end of April when the year-over-year growth rate was 60%. Once again – thank you, stimulus checks. But now that the stimulus checks are long gone the bloom is off the rose. Durable goods orders have plummeted from the stimulus driven peak to 16% year-over-year.

This makes total sense. During the past 16 months consumers purchased six years' worth of stuff! Let's face it, how many new appliances, TVs, etc. can one buy? How many kitchen remodels? In other words, there is no pent-up demand for consumer durable goods after the massive 2020 spending spree. There is only pent-down demand.

When adding things up it surely appears that growth is heading lower. To wit: the Atlanta Fed Nowcast third quarter real gross domestic product (GDP) forecast is down to +5.1%, down from 14% in April; 10.5% in June, and 7.8% in July. Not a pretty trend at all. The New York Fed is down to 3.8% from 4.2%. That's it. People forget that the consensus for second quarter real GDP was around 10% and the actual number was 6.6%, which I believe is rather pathetic in view of an economy that was re-opening and also stuffed with near-record amounts of fiscal stimulus.



Other indices are pointing in the same direction. The New York Fed's Weekly Economic Index has also slowed to 7.3%, the weakest it has been since March 20th, 2021, down from 9.0% one month ago and over 10% two months ago.

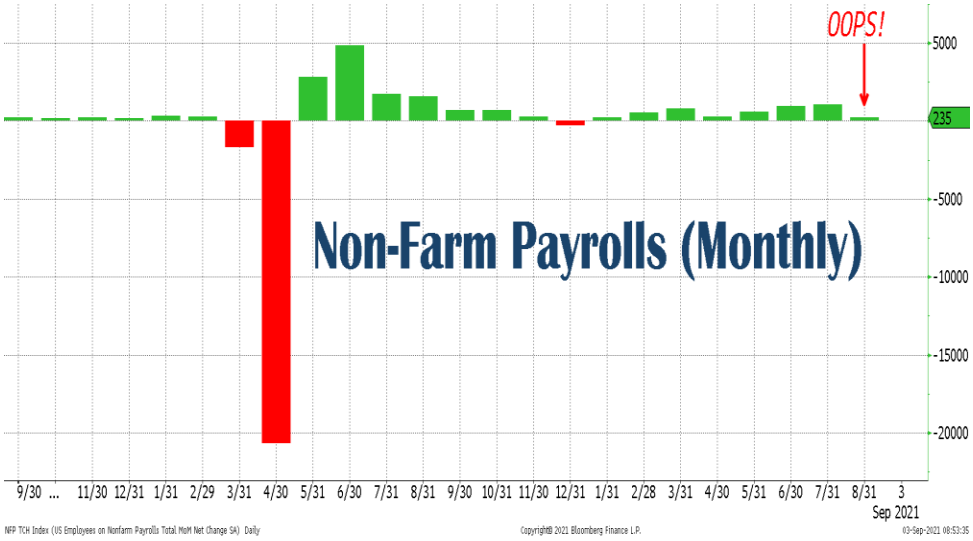
The FIBER leading economic growth index has declined for 13 weeks in a row to 1.16%, down from 2.03% one month ago, 6.07% two months ago, and 8.33% three months ago. We haven't seen a number this soft since March 2020.

Notably last Thursday, Morgan Stanley followed in the steps of Goldman Sachs and lowered its third quarter GDP from 6.5% to just 2.9%. Citing the sharp slowdown in spending and consumer confident, Morgan Stanley noted that *"motor vehicles sales in August was the latest data point to miss to the downside, with a fourth consecutive decline in annualized unit sales following the stimulus-related surge in April (highest rate since 2005)."*

OOPS!

The consensus for the August payroll print was 725,000, a drop from last month's 943 thousand. The whisper expectation was for a number decidedly lower. And sure enough, the U.S Bureau of Labor Statistics (BLS) reported that in August just a paltry 235 thousand jobs were added, far below the 725 thousand expected, and a huge drop to last month's upward revised 1.053 million. The unemployment rate fell from 5.4% to 5.2%. Also, wages rose an impressive 0.6% in August (4.3% year-over-year).

While the pundits will quickly blame the resurgence of covid in August, manifesting itself in zero jobs added in leisure and hospitality, the reality is that the U.S. economy is rapidly slowing and putting the Fed's tapering plans squarely in doubt.

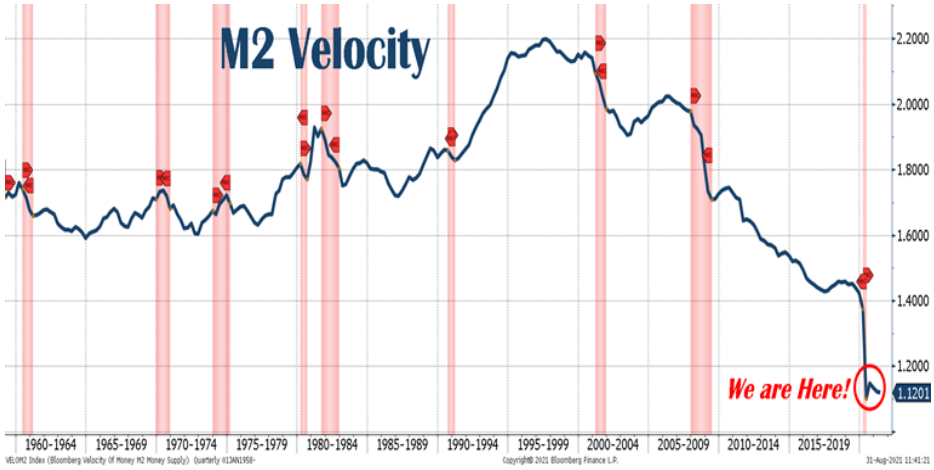


WHAT ABOUT INFLATION?

"Inflation is always and everywhere a monetary phenomenon." – Milton Freidman

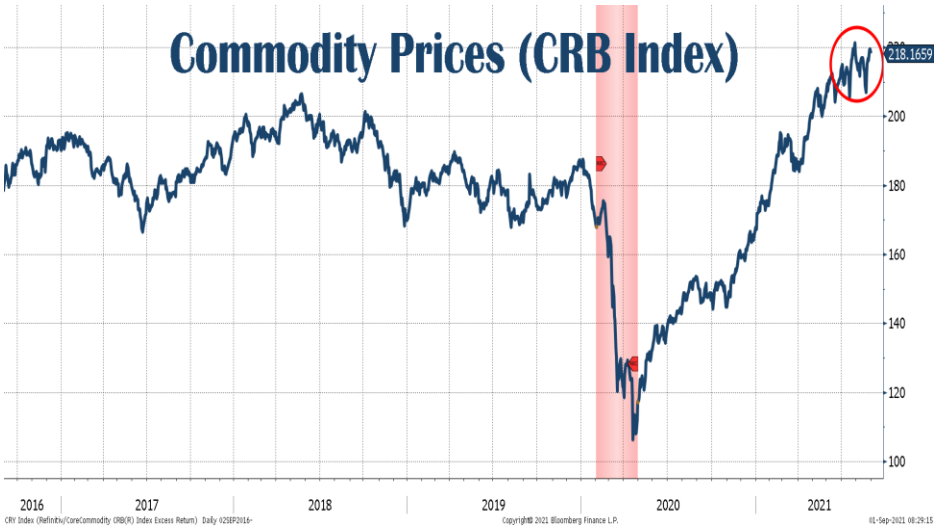
It seems lost on a whole lot of folks that M2 growth has stagnated over June and July and the year-over-year trend has throttled back from 27% in February to 12%, currently – back to where it was in March 2020. M1 has slowed down precipitously as well.

At the same time, money velocity is barely showing a pulse as bank lending has continued to contract (mostly due to C&I loans and mortgage credit) at a 1% year-over-year rate. The fastest growing assets on commercial bank balance sheets? Try cash (+43% year-over-year) and Treasury securities (+24% year-over-year).



Meanwhile there are signs that, at least from the commodity markets, inflation may be peaking. Many commodities have been under serious downward price pressure of late. From the peaks, lumber is down 70%, iron ore is down 40%, and copper is down 10%. In the agricultural complex, corn is down 25%, wheat -14%, and soybeans -24%. Crude oil -9% remains well below their prior highs, too. The Commodity Research Bureau (CRB) commodity appears to have pulled off a classic double peak in early and late July. So much for the 'super cycle.'

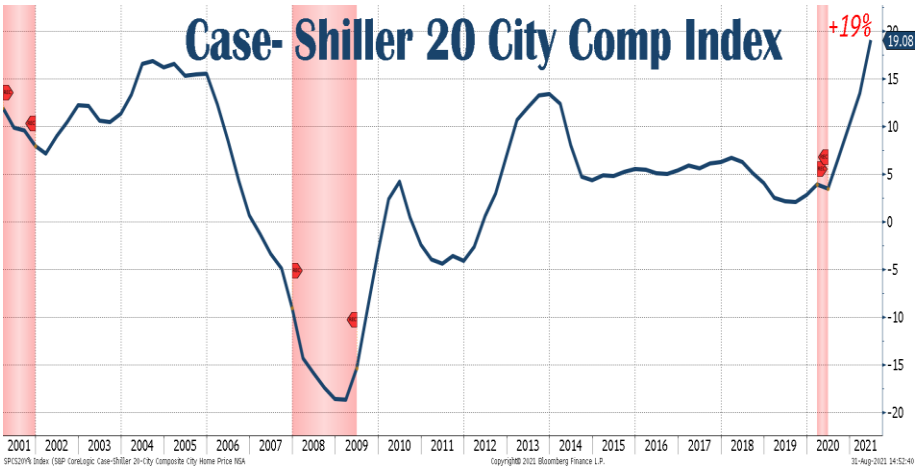
And there is no sign in the labor market, outside of the low-end worker, that wages are taking off. Not one shred of evidence; just anecdotes. We are going to either have a lot of competition from idle workers for the jobs listed out there once the extended benefits expire on September 6th, or we will be seeing a contraction in personal incomes if they choose to remain unemployed. Either way, we are likely heading into some wage compression.



KISS OF DEATH?

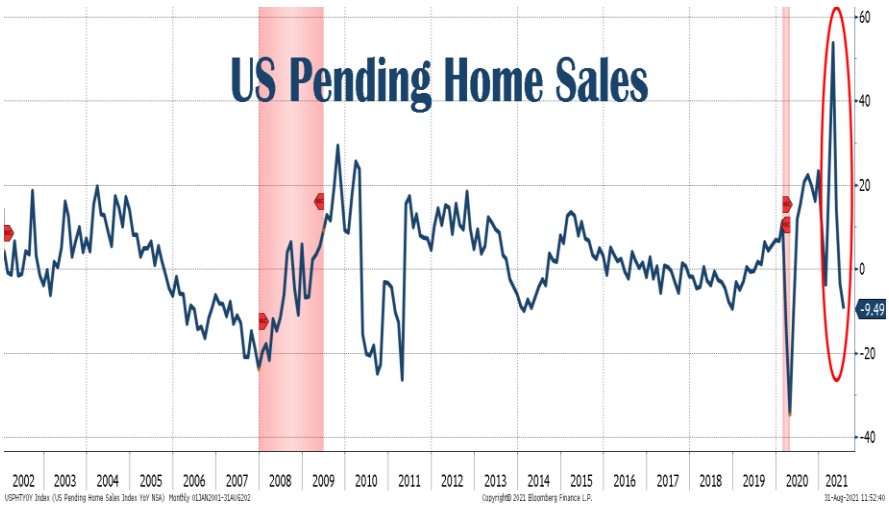
"I think we're settled into a long-term secular housing market." – CEO of Toll Brothers

One of the lead stories in this last week's Barron's magazine was the CEO of Toll Brothers saying, *"I think we're settled into a long-term secular housing market."* Kiss of death, perhaps? Remember that it was Robert Toll himself who said in June 2006 that *"I think you're going to see a very strong housing market again."* Who knew it was going to take four years? No U.S. housing bubble? Even as home prices today absorb eight plus years of wage growth!



According to the Case-Shiller indices, home prices in America's 20 largest cities have exploded at 19.08% year-over-year in June – up from 17.14% in May, and the highest pace on record even surpassing the housing bubble days of 2005-2006 when prices rose at 17.1%. So, if it was a bubble then why is it not a bubble today with the current price trends actually surpassing those prior peaks?

When you look at home prices in inflation-adjusted terms, when compared to rents, or income, they are at least 25% above the historical norm.



Undoubtedly, bubbles can get even bigger, and it is nearly impossible to time them, but it's also true that bubbles never correct by going sideways. If the Fed is ever forced to tighten policy, there will be a day of reckoning. If so, do not be surprised to see new lows in long-term Treasury yields.

Meanwhile, it may be happening already. Pending home sales, the quintessential leading indicator for new resale activity (near -70% in correlation to new home sales activity), retreated 1.8% in July. The year-over-year trend eroded to -9.5% from -3.5% in June and the level in July was 12.4% below what was prevailing at the end of 2020.

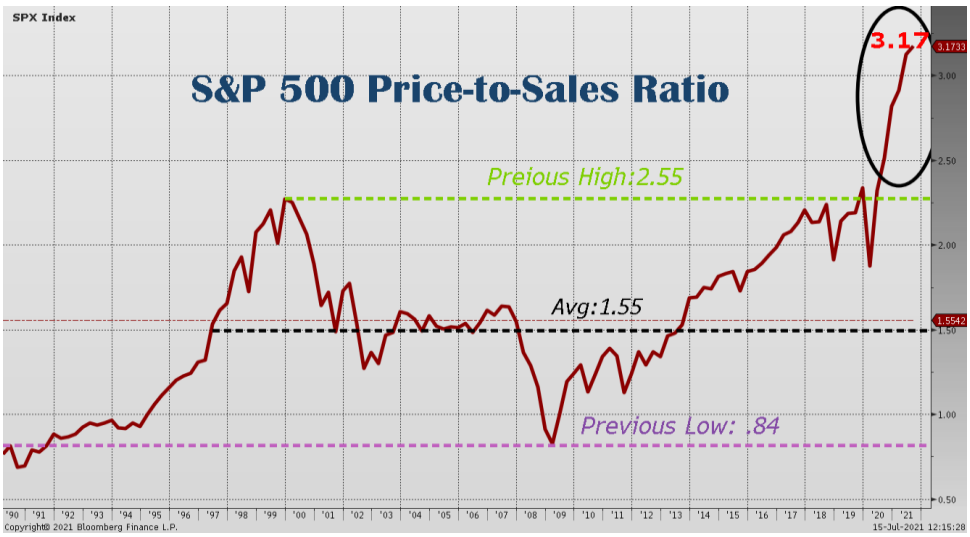
The downward trend in pending home sales is unmistakable, declining in three of the past four months and in five of the past seven. On a regional basis, the Northeast weakness was most pronounced. But even the once-hot Southern region has cooled off significantly these past two months. The West has hung in comparatively well, but still down 5.7% from year ago levels.

This is the story as I see it. Pent-up demand for housing at these exorbitant levels is exhausted. Let's not forget that at the beginning of the year, new home sales had surged more than 30% year-over-year to nearly the 1-million-unit mark for the first time since the latter stages of the housing mania in 2006! Likewise, existing home sales rose by more than 25% on a year-over-year basis and also touched a near 15-year high of 6.7 million units. Peak housing is here!

CLIMBING THE WALL OF WORRY!

I have to admit the equity market has withstood downward growth projections, disappointing retail sales, the regulatory clampdown in China, the Afghanistan fiasco, delays on the infrastructure bills, the spread of the delta variant, the relentless inflation hype, and weeks of 'taper' chatter from various Fed officials. The S&P 500 comes off its 53rd record close of the year – valuations be damned! Only ten other times since 1963 has the S&P 500 gone more than 200 days without so much as a 5% dip, and speaks to the momentum, liquidity, and speculative aspects to the market.

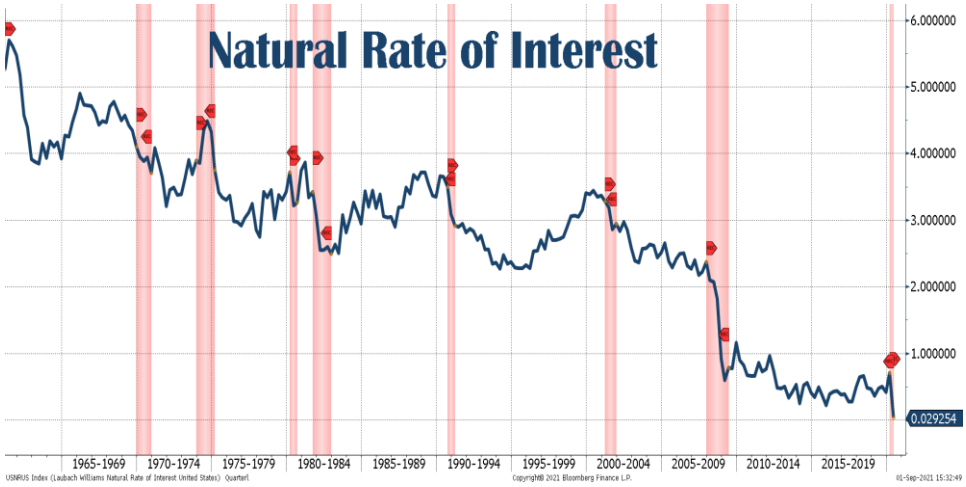
But make no mistake, global economic activity is cooling of. Global stock markets are merely wed to central bank policy as has been the case now for many years. This is a Fed-led rally, not at all a fundamental-based rally.



WEALTH INEQUALITY – THE "R-STAR"

Through the end of 2020, the stock market has returned almost 135% from the 2007. Unfortunately, the "wealth effect" has only benefited a relatively small percentage of the overall economy. The Top 10% of income earners own nearly 87% of the stock market. The bottom 50% own less than 1%. So, as equities soared during the pandemic, the pandemic has only made a bad situation even worse. Both income and wealth distribution has become even steeper.

The share of income being diverted to the top 10% of earners is 45%, up from 30% five decades ago. As the rich get richer, the savings glut gets even deeper. This is pushing the r-star rate (the real short-term interest rate expected to prevail when an economy is at full strength and inflation is stable) lower because those at the top end of income distribution have lower propensities to consume and a desire to hold more assets. This has gone on for decades – since the Reagan era, but has been the case with Clinton and Obama as well. This wealth inequality combined with globalization, accelerating technology, aging demographics and the like argue for a sustained era of depressed natural rate of interest rate.



THIS IS GROSS

"Cash has been trash for a long time, but there are now new contenders. Intermediate to long-term bond funds are in that trash receptacle for sure, but will stocks follow? Earnings growth had better be double-digit-plus or else they could join the garbage truck." – Bill Gross

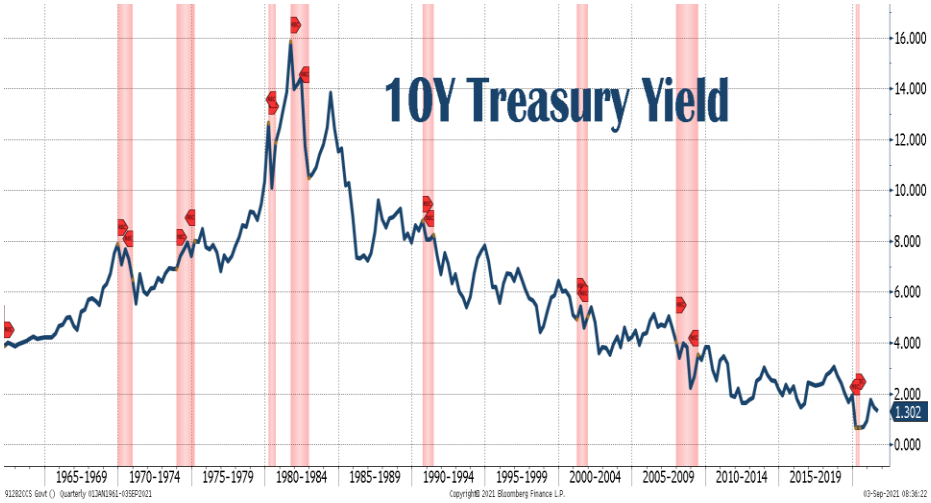
Last week, Bill Gross commented that bond yields *"have nowhere to go but up."* The so- called bond king is calling for a 2% yield on the 10-year Treasury. But here's the thing… this guy has been so wrong for so long it's not even funny. Yet, one more reason to take the contrarian side

Take a look at the following graph.

For years Mr. Gross along with many other economists and bond gurus have been calling for the end of the bull market in bonds.

Seriously! Yes, one day he may be proven right, but his track record is abysmal – with a capital "A"!

Remember when nobody ever thought the Global Financial Crisis (GFC) low in the 10-year Treasury yield of 2.4% would ever be seen again? It reached 1.6% at 1.6% in the spring of 2012 and touched that level again in the winter of 2016. And in 2020 it touched an all-time low of 0.5%. So despite the "experts," forecast history shows that the best days for the bond market may still lie ahead, and again confounding the skeptics in the process.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

What's left to be fretting about? Well, there is a looming rental eviction crisis now that the Supreme Court has struck down the ban (landlords are people too). Another risk ahead getting very little attention is the upcoming fight in October over the debt ceiling (Deja vu?). And keep an eye on China beyond just its regulatory campaign against Big Tech, as the U.S. faces this quagmire in Afghanistan, Beijing has increasingly been more aggressive in its approach towards Taiwan (this has always been a 'red line' for U.S. administrations). In other words, expect the Biden team to continue to be tested on the international front.

On the domestic policy agenda, Senator Manchin muddied the outlook for President Biden's $3.5 trillion tax and spending package by demanding a "strategic pause" on the proposal. Manchin argued that rising inflation and a soaring national debt necessitate a go-slow approach and a "significantly" smaller plan. Have a look at "Why I Won't Support Another $3.5 Trillion" of the Wall Street Journal. Manchin is a linchpin vote in the evenly divided Senate. Also, Arizona's Kyrsten Sinema seems to be in agreement with her West Virginia compatriot as well.

So, no more fiscal stimulus, risk of a Fed taper and the ongoing challenges of the COVID-19 variants would all seem to pose quite a bit of downside potential for GDP growth. Let's think a about this for a minute. Outside of the prior stimulus checks and the re-opening trade, what vitality does this economy really have going for it?

Powell definitely believes to this day, that the inflation run-up has been concentrated and by its very nature, is still transitory. He believes that the Fed is making ground on achieving its dual objective, but that we are still quite a bit away on the employment front.

Yet, 68% of Wall Street economists and pundits see higher interest rates and only 7% are "bond bullish." One big reason why I am willing to take the contrarian side.

In summary, interest rates will likely remain lower for longer. In order to minimize the downside to the Net interest margins (NIM) credit unions should continue to reduce excess cash while maintaining a risk appropriate and diversified investment portfolio.

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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.

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