alloya
INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF SEPTEMBER 13, 2021

Asking the Wrong Questions

"There is always risk, since trying to predict the direction of interest rates over the short-term is very difficult. But we have conviction that the 40-year bull market for bonds is over, inflation risks will prove more than transitory, and rates will be higher by the end of the year." – Portfolio Manager

If I had a dollar for every time I heard the for 40-year bull market in bonds is over, I would be penning this piece from the south of France. (Or maybe in my 20,000 square foot home adjacent to Tom Brady's water front estate.)

Anyways, every year, the bears come out of the woodwork and proclaim the end of the bull market in bonds. In the early 1990s, it was the stock market boom that would unravel the Treasury market. In the 2000s, the housing and China-led commodity boom would drive interest rates higher. I heard the same narrative throughout the last decade for the following reasons:

- Endless QE.
- Years of zero policy rates.
- Massive infrastructure spending.
- Restrictions on immigrant labor.
- Tariff hikes and trade barriers galore.
- A huge tax cut with a 50-year low 3.5% unemployment rate.

Did I miss anything?

THIS WEEK

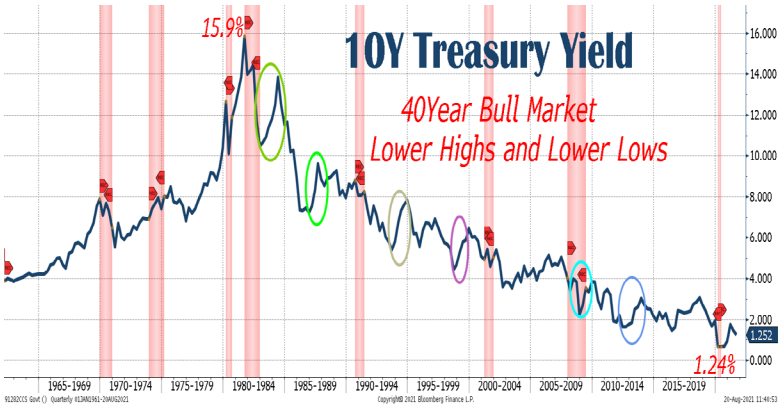
- RULES TO REMEMBER
- WEALTH INEQUALITY SLOWS GROWTH

PORTFOLIO STRATEGY

SUBSCRIBE

And yet even with all of this the U.S. economy grew at a miserly 2% and inflation remained below 2%. The 10-year Treasury benchmark yield closed the decade at a whopping 2%.

If you take a step back and look at the big picture, the long-term graph of the 10-year Treasury benchmark yield shows very clearly that the secular bull market remains fully intact .That's a strong statement when one considers what the bond market has endured: massive fiscal stimulus; unprecedented money supply growth; the best growth in decades; a stock, housing and commodity boom of epic proportions. What do you do for an encore?



Let's review some recent history. Nobody in the 2003-2007 bull market in equities ever thought the 10-year Treasury yield would retest the 2003 yield low (4%). But it did. And nobody thought the 2008 yield lows (2%) would ever be retested. It did and it happened without a recession in 2016 when yields declined to 1.50%! Nobody thought we would ever retest those lows again, but by the end of 2019 yields ended up going to new lows (.62%) in the spring of 2020.

Today, virtually every economist, strategist, analyst, and media pundit is in full contempt and still calling for a bond bear market. It's all about central banks, supply chain issues and the impact of the pandemic. Yes, yes yes, interest rates could be pressured higher periodically for whatever reason (markets do not move in a straight line), but this will quickly collide into the massive debt levels which will continue to retard economic growth. I've said it before and I'll say it again, too much debt means interest rates have no staying power. End of story.

Now let's imagine where the yield goes when the stock market, God forbid, reverses? Or when the next recession inevitably occurs?

RULES TO REMEMBER

Bob Farrell was the dean of technical analysis on Wall Street (Merrill Lynch). He penned his *Ten Market Rules to Remember* in 1998. They have shaped my thinking for many years.

1. Markets tend to return to the mean over time.

2. Excesses in one direction will lead to an opposite excess in the other direction.

3. There are no new eras — excesses are never permanent.

4. Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.

5. The public buys the most at the top and the least at the bottom.

6. Fear and greed are stronger than long-term resolve.

7. Markets are strongest when they are broad and weakest when they narrow to a handful of blue-chip names.

8. Bear markets have three stages — sharp down, reflexive rebound and a drawn-out fundamental downtrend.

9. When all the experts and forecasts agree — something else is going to happen.

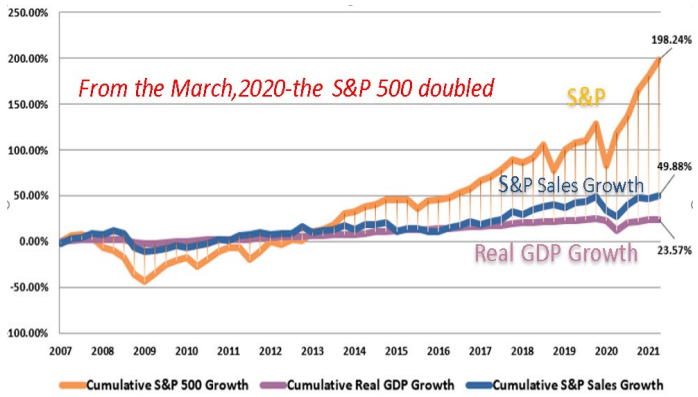
10. Bull markets are more fun than bear markets.

While all of the rules are significant and applicable today, I believe the most relevant and timely rules are #1, #4, and #9.

Rule #1: Markets tend to return to the mean over time.

Currently, the S&P 500 has ridden the massive liquidity cycle and has doubled in the market price in barely over a year. Since 2007, the stock market is up nearly 200% – which is more than twice the growth in GDP and nearly four times the growth in corporate revenue. In other words, the stock market does not reflect corporate fundamentals or economic reality. This disconnect is a function of the nearly $8 trillion increase in the Fed's balance sheet, hundreds of billions in stock buybacks, PE expansion, and ZIRP.

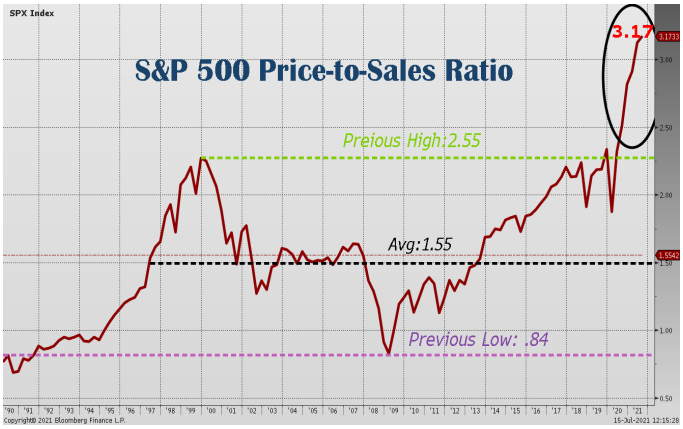
"History teaches that when valuations are extreme, "mean reversion," a move towards historical norms, is likely. Once value stocks turn, the recovery can be fast and intense." – Robert D. Arnott



"Reversion to the mean is the iron rule of the financial markets." – John C. Bogle

At current levels, the market is extremely stretched if not grossly over valued by virtually every valuation metric. The market up nearly 40% since the beginning of 2020 even with 2022 earnings expectations no higher now than it was then.

The CAPE multiple is at a sky-high 38x. Below is the price-to sales ratio of the S&P index. As you can see, the P/S ratio of the S&P is now 3.17 – the highest level ever and two times the long-term average of 1.55. Obviously this does not mean that the market cannot go higher still, but it does speak to how stretched the market has become. The question has to be posed as to what exactly isn't priced in at this point?



Rule #9: When all the experts and forecasts agree – something else is going to happen.

This rule is very timely. The universal consensus is that stocks are the only place to be and interest rates have nowhere to go but up. In fact, despite obscene valuations, "professional" money managers are the most bullish they have been in two decades. Sixty three percent of the assets are allocated to equities; it doesn't get much bigger than that. Only 5% of portfolio managers see Treasuries as attractive. Citigroup Research concluded that long positions on the S&P 500 now outnumber shorts by a 10-to-1 ratio. On the retail side, equity inflows into stock funds over just the past five months exceeds cash flows of the prior 12 years!

I should add, that one of the most defining features of any bubble is how the investing public reacts to rising equity (and real estate) values. Investors have thrown caution to the wind and are seemingly more afraid of missing the next 5% move higher rather than a 20% sell-off. This is what FOMO (fear of missing out) is all about. Such is human nature. This speaks to the impact of "crowd behavior" on market cycles. But as the public becomes more and more fully invested, the market becomes more vulnerable to a decline.

Rule #4: Exponential rapidly rising or falling markets usually go further than you think, but they do not correct by going sideways.

When markets move in the "exponential"phase they become devoid of fundamentals, as is the case today. Emotion (greed) takes over. However, once these parabolic moves have taken place, they inevitably reverse in an extraordinary fashion and result in crashes. As I like to say, markets go up by the stairs and down by the elevator.

The recent move in lumber prices is a classic example of Rule #4. Lumber prices surged from $350 per thousand board feet at the 2020 lows to $1,700 per thousand board feet this past spring.

Today, the price is now nearly back to where it was at the lows – a virtual round trip in just three months.

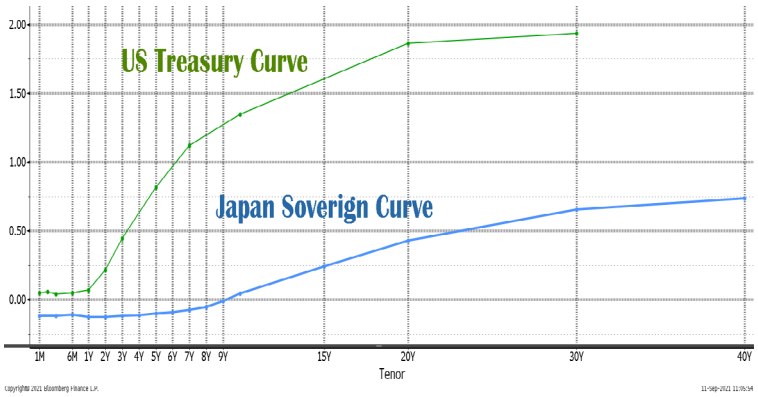
The most important aspect to Rule #4 is that there are no exceptions. As mentioned above, the S&P 500 has doubled in a record-short time frame. In the real estate world, million-dollar-plus homes sell in a matter of minutes and with multiple offers. Junk bonds are yielding 4% less than the historical default rate.

The consensus is overwhelming that the Fed will start to raise rates, never mind just taper the asset purchases. In 2022, something else is going to happen, that seems sure. And if it's not a hike, then it's either stand pat or ease in the face of a downshifting economy. Treasuries aren't priced for these latter two prospects.

Yet, everyone is asking the same questions: "How high can stocks go?" "How high will my home price go?" "How high will bond yields go?"

But when thinking about Rules #4 and #9, the real questions should be: "How low can stocks go?" "When will the housing bubble burst?" "How low can bond yields go?"

The stimulus is over. I believe that we have seen peak growth and peak inflation. Now go back to the graph above plotting the 10-year Treasury yield. As the dust settles from the pandemic, I believe the big story will be how Treasury yields continue in their secular long term downtrend and eventually converge towards Europe and Japanese yields . As an FYI, currently, 10-year Japan and German soverign yields are .042% and -.033% respectively.

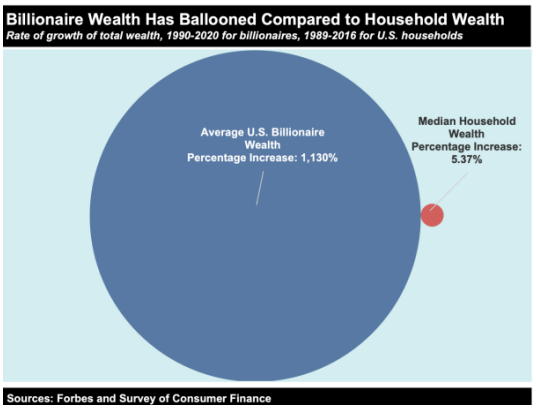


WEALTH INEQUALITY SLOWS GROWTH

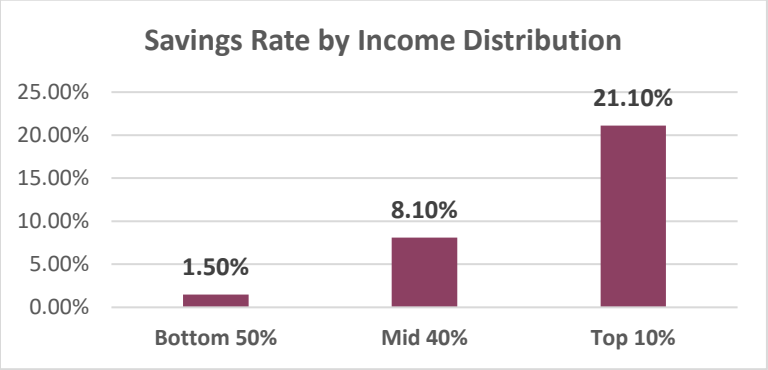
Through the end of 2020, the stock market has returned almost 135% from the 2007. Unfortunately, the "wealth effect" has only benefited a relatively small percentage of the overall economy. The top 10% of income earners own nearly 87% of the stock market. The bottom 50% own less than 1%.

The pandemic has only made a bad situation even worse. Both income and wealth distribution has become even steeper. The concentration of wealth at the top contrasts starkly with median household wealth. Even before the current economic crisis, a growing number of U.S. households had zero or negative net worth (meaning they owed more than they owned).

A new paper presented at this year's Jackson Hole Economic Policy Symposium by Atif Mian, Ludwig Straub and Amir Sufi used microeconomic data from consumer surveys to estimate savings rates and shifts in incomes across age and income groups. They concluded that income inequality is a better explanation than demographics at explaining the savings glut over the last 40 years and hence the trend decline in interest rates.

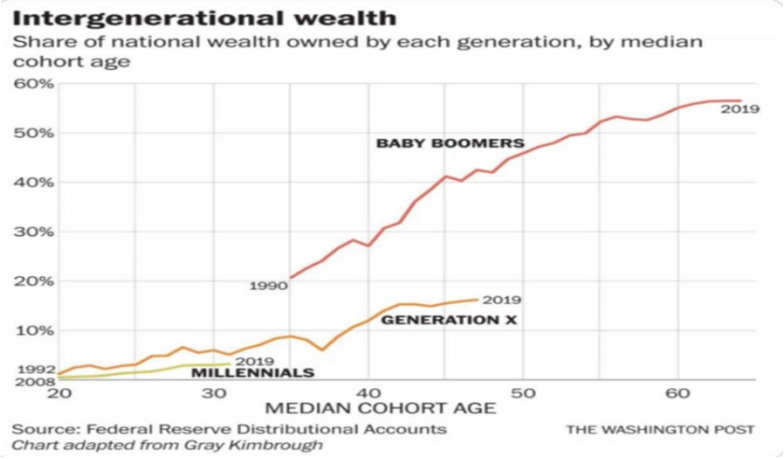


This should not be that surprising. Rising income inequality hurts the economy by restraining consumption. Those at the top end of income distribution have lower propensities to consume and save more than lower income households. This means that the skew of income distribution towards the wealthy tends to increase overall savings and pull back consumption more than would otherwise be the case.

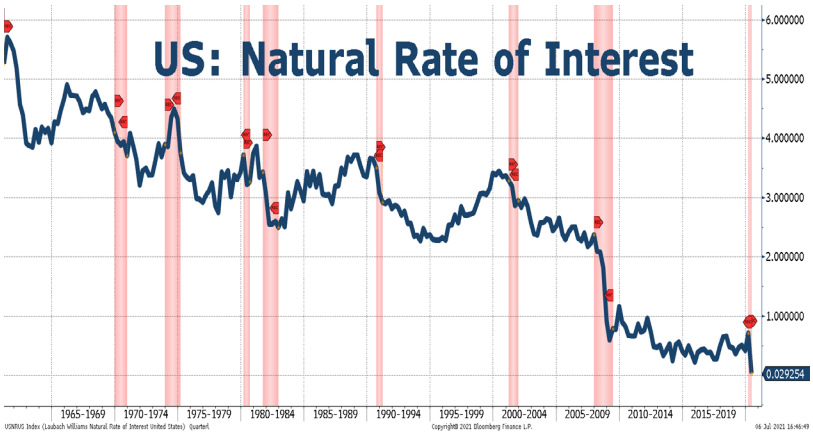


This wealth and income disparity has also become an intergenerational problem. As shown graphically below when comparing the wealth of boomers versus the wealth of Gen X and Millennials by age cohort, the gap has widened significantly. These two generations are way behind the boomer generation in terms of wealth.

But recognition of the problem does not mean something will be done about it. Addressing the problem of income and wealth inequality head-on requires political courage from Washington, a rare commodity which is likely to become even rarer amid increasing polarization among voters.



In the meantime, the combination of rising income inequality combined with other long-term structural forces at play — demographics, debt, technological change, globalization – are driving rates lower and suggests that we could be in for an era of persistently low interest rates. This is reflected in the long-term downward trend in the r-star rate (natural rate of interest). Real short-term interest rate is expected to prevail when economy is at full strength and inflation is stable. Has been declining for quite some time.



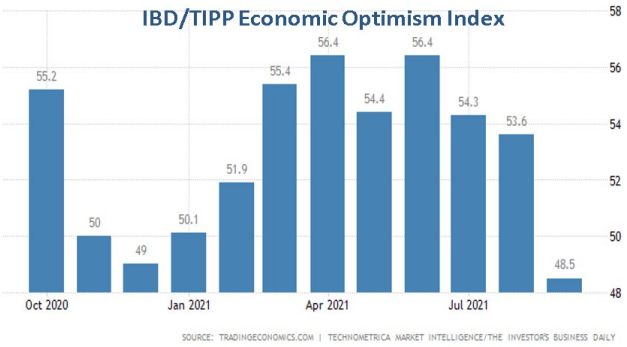
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"[T]he failure by the U.S. to bring Covid-19 cases under control is scrambling business expectations of a rapid economic revival, forcing companies to reset plans and revise forecasts as they also grapple with a new federal vaccine mandate." – Financial Times

The delta factor is ever present. According to Market News International, leisure travelers in the U.S. are canceling vacation plans amid rising COVID-19 cases. This has caused businesses like hotels and restaurants to cut back on hiring. Roughly 69% of the 2,200 adults surveyed between August 11 and 12 said they were planning on taking fewer trips and 65% said they were likely to take shorter trips due to fear of exposure to COVID-19. About 42% said they would cancel existing trips with no plans to reschedule, and 55% said they would postpone existing travel plans until a later date. Restaurant reservations, airline travel, hotel bookings and movie theater visits plunged by more than half from mid-July to the end of August. Ouch!

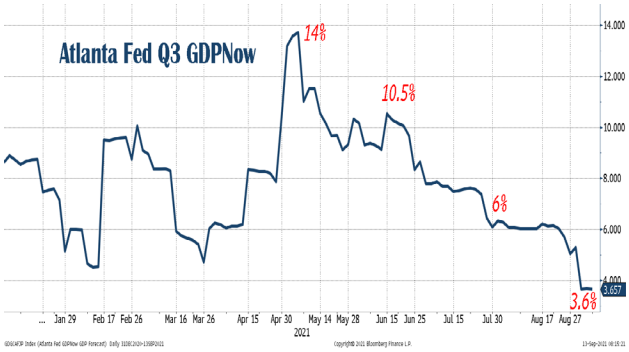
Moving on – offices in 10 major U.S. cities were just 33% occupied at the end of August. Those hopes of employers enticing or forcing their workers back to the downtown office towers have been derailed. On the labor front, 1.5 million Americans have stopped looking for work in August because of the delta variant; and there are still 5.3 million fewer employed today compared to February 2020.

The headline ISM non-manufacturing PMI declined in August to 61.7 from 64.1 in July, now down to a six-month low. The key "business activity" index sagged to 60.1 from 67.0 – the steepest descent since April 2020. Orders were trimmed to 63.2 from 63.7. Bookings are not affected by supply-side issues. Meanwhile, the employment subindex was trimmed to a six-month low of 53.7 from 53.8.



Likewise, the IBD/TIPP economic optimism index faltered badly in September – down to 48.5 from 53.6 in August, 54.3 in July and 56.4 in June. This is the lowest print since September 2020. The six-month outlook cratered to 41.3 from 50.2, to stand at the lowest level since August 2020. Aside from that, Mrs. Lincoln, how was the play?

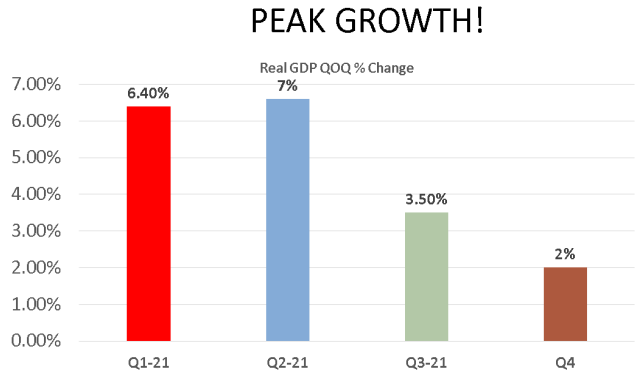
Finally, the Atlanta Fed's GDPNow forecast for Q3 has been revised lower yet again. It's not really a forecast. Rather, it's what the model says would happen with the data we have now if the quarter ended now. As shown below, as economic data has deteriorated the forecast has been steadily revised lower from 14% in June all the way down to 3.56%.



Recent economic growth has been linked to stimulus, which is temporary. After the last round of stimulus checks, Q2 GDP grew 6.56%. Is that all we get from over $6 trillion of stimulus? Anyways, the question now is how bad will the hangover be now that the stimulus has ended.

On the inflation front, are you aware that 60% of the components of the CPI are running with an inflation rate below 1.5%? The inflation story is primarily from the automotive sector, which is acutely sensitive to the chip shortage and to areas in consumer services like airlines, hotels an entertainment, which had been making up lost ground after the price carnage in 2020. So, when people say that this is the same Fed that ignored food and energy at its peril in the 1970s, the

reality is that virtually every component of the CPI was surging back then, year in and year out. That is hardly the case today where 10% of the index is the cause of this entire "inflationary" backdrop.



The bond market understands this all this too well. Last week's Treasury auctions were resoundingly strong. The 10-Year Treasury auction was a blockbuster, closing down over three basis points on the auction and last seen below 1.29%! And the 30-year Treasury bond was nothing short of spectacular. Printing at a high yield of just 1.910%. So, make no mistake, for whatever reason the bond market remains convinced that after the current period of "transitory" inflation ends, economic growth has peaked, and the world will slide right back into deflation.

As we move forward, credit unions are likely to continue to see contracting NIMs well into 2022. As such, we continue to advocate that credit unions reduce excess cash levels and either make quality loans, buy loan participations, or invest in high quality investments further out the yield curve to enhance yield and income. From a tactical perspective, any temporary selloffs in the bond market provide an opportunity to deploy excess cash.

LOAN PARTICIPATION PLATFORM

At Alloya, we have made it our mission to make loan participations simple so you can grow your loan portfolio or free up liquidity with ease. So, if you hear "loan participations" and think "time-consuming hassle," forget what you know and reimagine loan participations.

Think fast, easy, and convenient. Think full transparency, trusted service and reliable support. Whether you are a seasoned loan participation professional or new to the process, we are here to help balance your credit union's loan portfolio through the purchase and sale of loans among the largest credit union network in the industry – all in a matter of a few clicks from the convenience of the internet.

Visit www.alloyacorp.org/participateonline or contact your Alloya representative to learn more and get started.

MORE INFORMATION

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.