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INVESTMENT SERVICES

Weekly Relative Value

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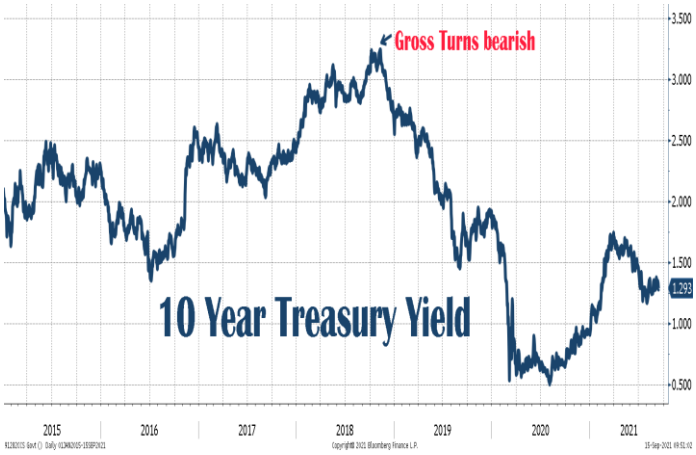
WEEK OF SEPTEMBER 20, 2021

Call 'Em as I See 'Em!

"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

First off, regarding the quote above, Bill Gross (the so-called "Bond King") has been bearish on bonds since 2015. That's a long time to be wrong but hey, maybe he's just "early." In the meantime, the 10-year Treasury yield has been sliced in half with the yield declining from 3% to 1.28%. Enough said.



For the past two months, the 10-year Treasury yield has traded in a relatively narrow range (1.17%-1.35%). If the yield can break through support at 1.12% (it's tried twice and failed in recent months), the 10-year Treasury yield could fall below 1%.

This is quite remarkable since everything and the kitchen sink (massive fiscal and monetary stimulus) have been thrown at the Treasury market. But even as U.S. economic growth continues at a robust pace, Treasury yields remain well below what many market participants expected earlier in the year. Positioning, Fed asset purchases and the Delta variant have all been floated as potential explanations, but none seems sufficient. Clearly, something is preventing yields from breaking out higher the way people like Bill Gross think should be happening.

THIS WEEK

PORTFOLIO STRATEGY

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So, what are bond markets telling us? As I have discussed numerous times, I don't think the market, any market, is fully appreciative of how rapidly the economy is downshifting, and it's not just the Delta variant but also the dramatic withdrawal of fiscal stimulus that's at play.

As shown below, the Citigroup U.S. Economic Surprise Index – which measures the degree to which incoming economic data are either beating or missing expectations – has been mired in a multi-month slump and is at its lowest level since the worst of the COVID-19 pandemic.

Consistent with the Citigroup's Economic Surprise Index, the Bank of America Global Fund Manager Survey shows that only 13% see the global economy getting better, the lowest since April 2020. The difference this time is there is no new fiscal stimulus to save the day.

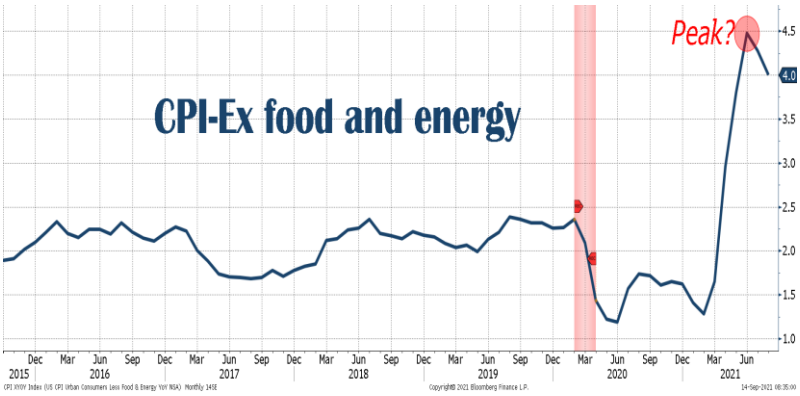
As the data have weakened, the Atlanta Fed's GDPNow model has shown a sharp deceleration in economic growth. This model is best viewed as a running estimate of real GDP growth based on available economic data for the current quarter. There are no subjective adjustments made to GDPNow — the estimate is based solely on the mathematical model. Based on the quarterly data received thus far, the model is predicting growth of only 3.6%. However, it appears that the ever-bullish Wall Street analyst community (Blue Chip) has still not faced this reality and is far too optimistic in its forecasts with the consensus still at 5% in the third quarter (Q3).

I expect economic growth to underwhelm in Q3 – especially when viewed in the context of over $6 trillion of stimulus thrown at the economy. The question then becomes: What's in store for Q4? The Foundation for International Business and Economic Research's (FIBER) Leading Growth Index is as good of an inflection point as I've seen in my 40 years in the business and it is now at 1.33% as of the second week of September.

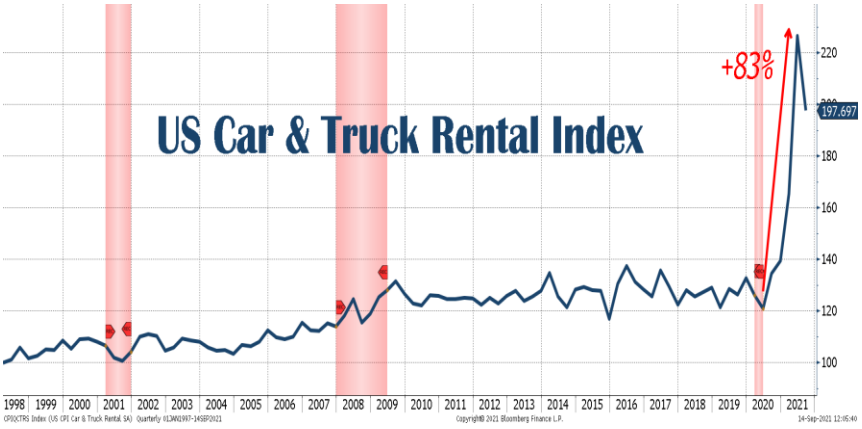
For perspective, it was 4.29% two months ago and 7.67% three months ago. At 1.33%, we are back to where we were in April 2020. Again, the big difference now is that there is no wave of fiscal stimulus staring us in the face, but rather some very critical fiscal headwinds.

INFLATION, WHERE IS THY STING?

The August core Consumer Price Index (CPI) – while still very elevated – slowed from +4.3% year-over-year to +4.0% year-over-year (well below the +4.2% year-over-year expected). We have to remember that 60% of the index actually has an inflation rate of 1.5% year-over-year. Back in the 70s, virtually everything in the CPI was rising. Today, that is simply not true. The sectors and prices most affected have been pandamic related.

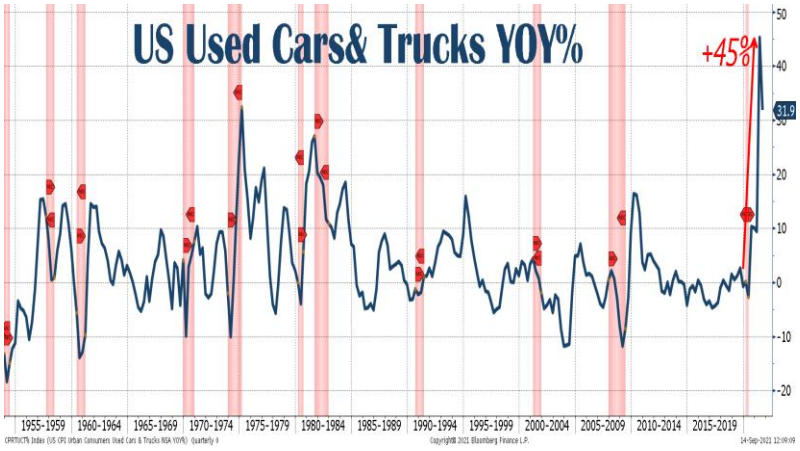


To wit: In the 1970s, we did not have rental car agencies dumping their inventory in a pandemic, to then have everyone scramble to rent a car because nobody wants to take public transit? The rental car CPI is up 83% year-over-year, but come on, this isn't going to last indefinitely and is 100% tied to the pandemic.



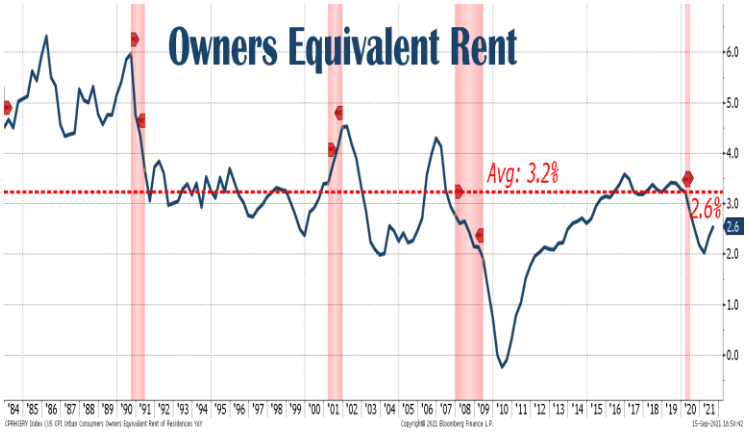
Meanwhile, used car prices are up 42% year-over-year. Outside of the automotive sector, the core rate of inflation is 1.8%. That's your big inflation story. But nobody seems to care or believe the simple fact that there has been no broad-

based inflationary run-up. So, all those pundits who compare today to the 1970s really don't know what they are talking about.



Of course, the bond bears are still clinging to the view that we are about to see a surge in rents because of the impact of the surge in home prices.

The CPI for Owners' Equivalent Rent (OER) of residences, which stands in for the costs of homeownership and weighs nearly 25% in the overall CPI, inched up just 2.6% year-over-year. As shown below, that is less than the average of 3.2% since 1984.



That said, the OER doesn't track actual home prices, but is based on surveys that ask homeowners what they estimate their home might rent for. So, the CPI for OER of residences is a measure of rent as seen by the homeowner.

Meanwhile, apartment (condos and housing) rents have been surging. There are many areas in this country that are seeing rents up 20% or more in the last year. Get this. Rents in New York City are are rising as much as 70% from pandemic lows. Yet, the OER went up only 2.6%. Bottom line: CPI would be running much, much higher if it reflected true housing and rental costs. However, it does not and until the Fed revises the CPI index they will continue to base monetary policy on the current construct of the CPI index.

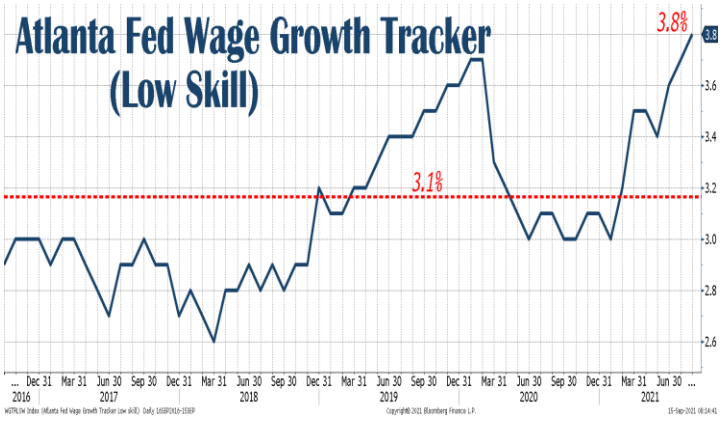
FADE THE WAGE HYSTERIA (PLEASE)

*"**It is the labour market, however, that central bankers are watching most closely for any signs that temporary bottlenecks and shortages are leading to a more permanent increase in prices**. For the moment, while truck drivers and others in certain high-demand professions are enjoying their first "pricing power" in decades, there is little sign yet of wider increases in pay. It is unlikely that workers today have the same sort of ability to restrict supply that their more heavily unionized predecessors enjoyed in the 1970s, the last period of sustained inflation in many rich countries." – The Many Faces of 'Pricing Power,' Financial Times*

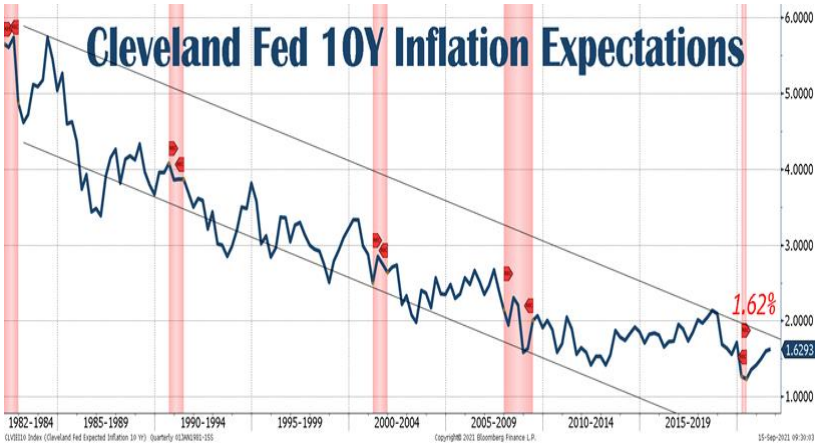
Wages are the key to whether or not inflation is transitory or long-lasting. For inflation to have any staying power, wages must rise steadily month-over-month and year-over-year. This occurred in the 1970s primarily due to the lobbying power and influence of unions. Today, only 10% of workers in the U.S. belong to a union.

Anyway, despite all the anecdotes and surveys, there has been no breakout in wages. Yes, due to the labor shortages. The youth, females, unskilled and uneducated workers in the leisure/hospitality and education/health are experiencing wage gains. These two sectors have the highest level of public interface and obviously may be hesitant to come back to work for health concerns (though everyone has their price). But what happens now that jobless benefits have expired for roughly 10 million people? Go back to work or starve?

Also it should be noted that while the unskilled are seeing wage increases (that's a good thing), they represent 20% of the workforce; the other 80% are seeing wage trends stable in the aggregate for many months now. In wide swaths of the economy, such as financial services, manufacturing, public administration, trade/transportation or even construction, there are zero signs of any wage breakout. It's truly a mystery because the narratives and anecdotes are all about a wage boom — and yet it's not in the data. I say to the "inflationists"out there: Stop hyperventilating and chill a little.



Finally it should be noted that the Cleveland Fed's 10-year inflation expectation measure, which is model-driven and highly dependent upon the labor market, is at 1.6%. Thus, despite all the protestations and warnings from Larry Summers and Bill Gross, inflation expectations over the next 10 years are no higher today than they were in April. So, who should you believe? My money is on the Cleveland Fed.

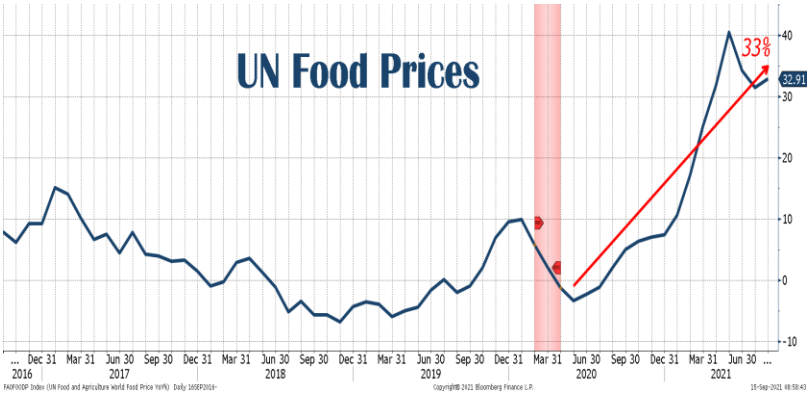


SCREWFLATION

"Food is more expensive today than it has been for the vast majority of modern recorded history."
– Alistair Smith, senior fellow at Warwick University in England

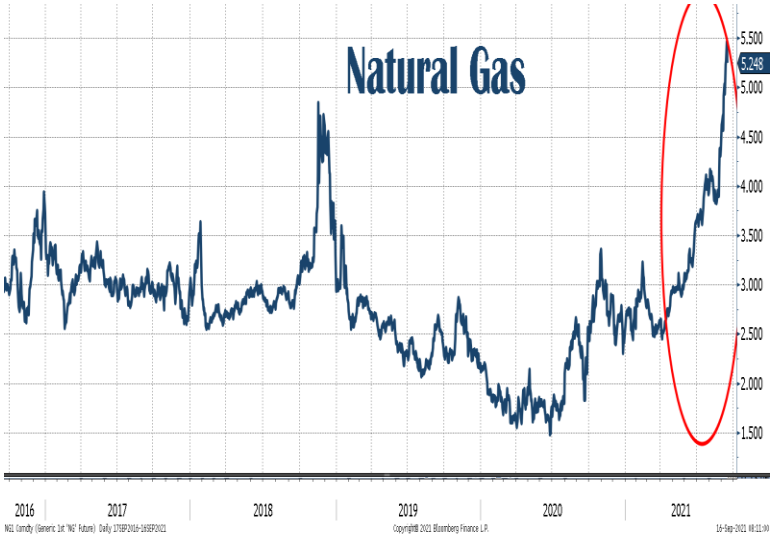
I've been on the "transitory" side of this year's inflation debate. While prices will likely remain high and distorted until the dust settles from the pandamic, I still think we will avoid long-term sustained severe inflation.

But here in the real world, "transitory" doesn't mean "inconsequential." Because of supply-side issues (weather, supply chains), global food prices have soared 33% year-over-year as of August, and this poses huge problems for many importing countries, especially in the Developing World, and is a huge tax on low-income households everywhere. Central banks have little influence over these items. How does monetary policy solve a crop shortage brought on by a draught? It doesn't. That's why monetary policy is based on the "core" indices.



It's not just food. Natural gas remains on a tear – surging by 250% since March 2020 and now near seven-year highs.

These supply-shock price increases in food and energy are a huge tax on the consumer, especially at the low end. As such, this promises to be a rough winter for many folks, even if the pandemic subsides.



While the headlines scream "inflation," it's more like "screwflation," since wages have no chance of catching up. Please give a read to the Wall Street Journal article, *Inflation Erases Low-Wage Workers' Gains.* While you're at it, see how the pandemic has totally turned the economy upside down in, *Incomes Declined Last Year As Virus Took Toll*. Note: High-end income earners are less affected, but their day of reckoning lies ahead from the taxman (see *Taxes Would Rise for High Earners*).

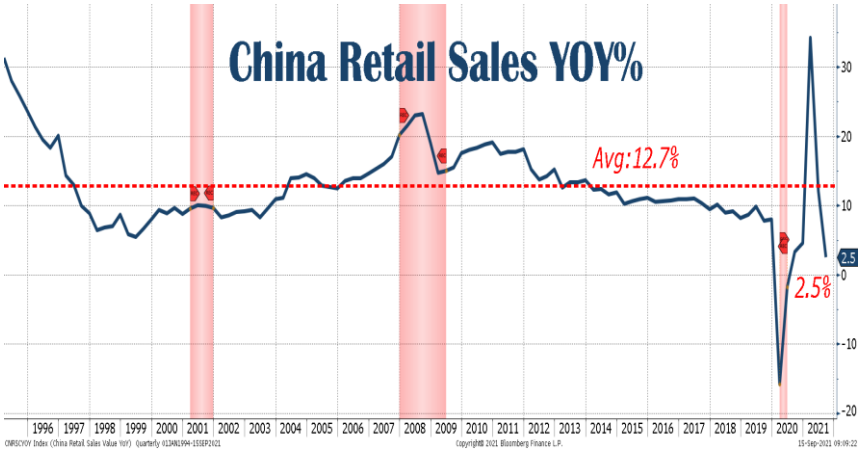
CHINA SLOWS

The Chinese macro data reported last week were disturbingly weak. Retail sales growth throttled back to +2.5% year-over-year in August, way below consensus estimates of +7.0%; and a huge haircut from +8.5% in July. The three-month sales trend is running at a -27.2% annual rate! This is worse than anything experienced in the 2008-09 global recession.

Construction investment has contracted 3.2% year-over-year through the first eight months of 2021. Industrial production was down 0.4% after the 1.3% slide in July and is down in five of the past six months. The three-month production trend is running at a -5.6% at an annual rate.

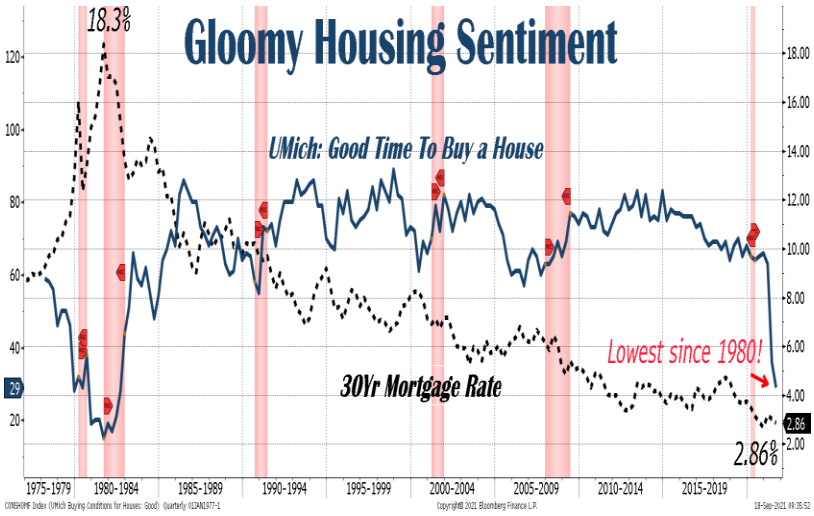
Christophe Barraud (Market Securities, LLP) has cut his real GDP growth forecast to near 0% for China. I should add that China is the biggest consumer of raw materials.

The gurus are lamenting constantly about inflation and nary a word about how the world's second largest economy is not just slowing, but contracting. Yet, to the typical strategist and market commentator, the turndown here and in the U.S. is transitory; only inflation is deemed to be permanent. Give me a break.



HOUSING BLUES

Last week, the University of Michigan Consumer Sentiment Index showed that the share of people who think now is a good time to buy a home fell in September to 29%, extending the plunge from March when the proportion was more than twice as high. The last time Americans were this turned off by the U.S. housing market, borrowing costs were over five times the current rate. Back then, the average for a 30-year fixed rate mortgage topped 18%. That compares with today's measley 2.86% rate.



We know why. Prices have skyrocketed, with year-over-years gains on existing, single-family homes exceeding 20% and surpassing the inflation-fueled increases seen in the late 1970s and early 80s. This massive housing price appreciation has overwhelmed prospective buyers (especially first-time home-buyers), which has more than offset the cheap borrowing.

So there is no doubt the data show that soaring prices for homes (and autos) have sharply curbed demand. But there is also the fact that so much spending was already pulled from the future into the present (now the past) during the prior period when fiscal freebies were running rampant. But the one thing that caught my eye in the report was how credit tightness emerged as a constraint on spending — up to an 8% share – which said as much for both autos and housing (from 4% in July). This is brand spanking new and worth monitoring.

WHAT HAPPENED TO THE TEA PARTY?

"Thus, we face a long-term existential question: will governments eventually be ***forced to unleash sky-high inflation to reduce that debt?*** *Will there be* ***widespread debt forgiveness in the future to avoid a political or social explosion?*** *That may seem hard to imagine now, but as the late anthropologist David Graeber described in his book Debt the First 5000 years,* ***jubilees — debt forgiveness by leaders — have sometimes occurred in history to avoid a social explosion.*** *Or will there be* ***mass defaults and a financial crisis?*** *Or could the 21stcentury* ***instead turn into a period when interest rates remain so low for so long that we learn to accept eye-popping debt numbers as the inevitable corollary of high asset prices, expanded money supply and a frenetic financial system,*** *and ignore them?* ***Will debt just feel to investors and policymakers like the unread emails in our inbox****: an issue which is scary and huge, but so constant that it is easy to ignore? We may not find out until rates rise." – Global Debt is Soaring – And We Need to Talk About It, Financial Times*

Before the pandemic, the world was awash with ungodly amounts of debt. Today, it's much worse. According to the Institute of International Finance (IIF), global debt is destined to hit a record $296 trillion by the end of 2021. At the peak of the 2008 credit bubble, global debt-to-GDP was at 280%. That ratio is now north of 350%. None of the options mentioned above – inflate the debt away, debt jubilee, debt default) of redressing this tourniquet on future growth (and primary source of global financial instability) look appealing. Especially given the aging demographic trends.

And there is no end in sight. The President simply does not see this run-up in debt as an issue (then again, neither did his predecessor). Now Congress is considering a pair of infrastructure bills that will add trillions of additional debt. Some of

"Not only is our out-of-control debt fiscally irresponsible, but it's unethical to put that debt on the backs of the next generation. It's time to get serious …" – Rep. Dave Brat (R-Va.), Tea Party

it will be "good" (productive) debt, spent on public works projects (we really do need). But, as usual, most will be "bad" debt spent on less productive programs. The part that isn't debt-financed will be paid for with tax increases, which, depending on exactly who and what is taxed, may also depress growth.

Bottom line: Politicians are using this pandemic as an excuse to keep borrowing and spending as if there's no tomorrow. The problem is — there is a tomorrow!

History shows that there is a day of reckoning from this extreme debt explosion. When exactly? Who knows? But it's out there.

Where has the Tea Party gone?

MARKET OUTLOOK AND PORTFOLIO STRATEGY

I have long argued that rising debt will cap inflation by holding back the velocity of money, thereby reducing GDP growth. This will reduce demand for housing and consumer goods, bringing prices back down. No more inflation. And I believe that is what Mr. Bond is saying. The low Treasury yields reflect expectations that the post-COVID world will look similar to pre-COVID, as the U.S. returns to slow growth and faith that the Fed will keep a lid on inflation.

At the same time, at a minimum, the fiscal cliff in 2022 will come to a 3% subtraction from the underlying trend in real GDP, which is even, according to many forecasters, now no higher than 3%. So it's either an actual recession or a growth recession in which the output gap widens with aggregate demand growth receding below supply, and that means the consensus "inflation" narrative dies out.

Meanwhile, wide swaths of the commodity complex are breaking down. Copper is down 13% —five months of no change. Non-energy commodity prices, in general, are down 8% and are flat since April 21st. Even oil, through the peaks and valleys, is flat since mid-June. Wheat is down 9% from the highs; soybeans are off 24%; corn is down 33%. Livestock prices are down nearly 10%. Lead is off 10% and once-strong nickel is down 5%. Yet, the inflationists continue to act like dogs in need of a bone. I have a little secret —deflation remains the principal risk**.**

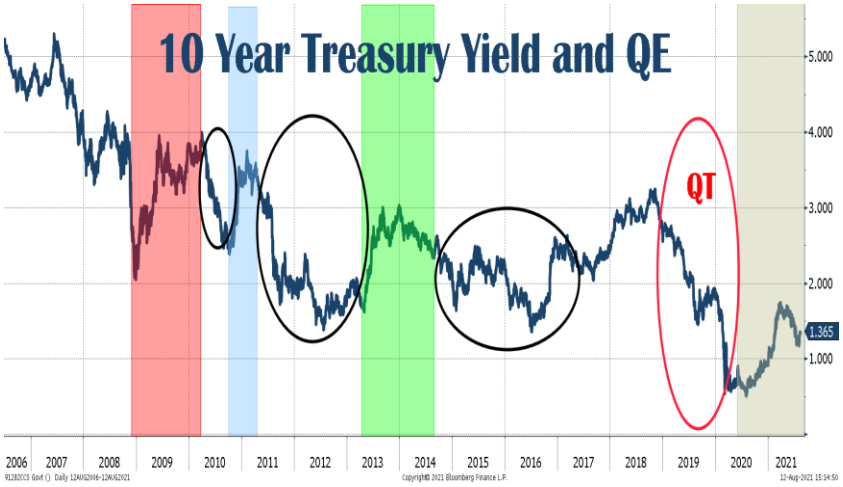
The Federal Open Market Committee (FOMC) meets for two days starting Tuesday and will issue a policy statement at 2:00 pm Wednesday. The tapering debate will be a central question for the FOMC. The policy group is expected to hold rates near zero and continue monthly purchase of $80 billion in Treasuries and $40 billion in mortgage securities. The majority of the Wall Street economists think the Fed will announce a reduction in their bond buying program (QE) starting in November.

I realize that there is some angst and anxiety over the prospect of the Fed pulling a taper by the end of this year. Okay. What if? Everyone thinks QE helped the bond market, but it had a much more dramatic effect on investor risk appetite and "animal spirits." During periods of QE-1, 2 , 3 and 4 (shaded areas), yields actually rose. And when QE ended, yields declined. On average, when QE ended, the Treasury market rallied, and yields declined by over 100 basis points.

This is why. After more than a decade of monetary interventions, the Fed has created a "psychological" link between QE and the equity markets. As a result, the liquidity creates an asset preference of "risk-on" assets, equities, versus "risk-off" assets, bonds.

Let me highlight two examples: From September 2012 to December 2014, the Fed expanded its balance sheet by 60% to $4.5 trillion — and yet, the 10-year Treasury yield "rose" 50 basis points to 2.2%. And then, when the Fed took the balance sheet down nearly 20% from September 2017 to August 2019 (to $3.7 trillion), guess what happened? The 10-

year yield "plunged" 60 basis points to 1.6%. This is the direct opposite of what most market pundits yak about. Do these people actually do any research?



Bottom line: If you think a taper is going to alter my bullish-bond view, think again. The day that happens will most likely occur the day that Bill Gross turns constructive on Treasuries, Jeremy Siegel turns bearish on stocks, and Ed Yardeni takes the "Roaring" out of the "Twenties."

In terms of portfolio strategy, credit unions (and banks) have experienced deposit growth that has far outpaced loan growth and Net Interest Margin (NIMS) remain under pressure. This pressure on NIMS will likely continue well into 2022. As such, we continue to advocate that credit unions reduce excess cash levels and make quality loans, invest in loan participations, or invest in high quality investments further out the yield curve to enhance yield and income. From a tactical perspective, any temporary sell-offs in the bond market, for whatever reason, provides an entry point to deploy excess cash.

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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.

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