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INVESTMENT SERVICES

Weekly Relative Value

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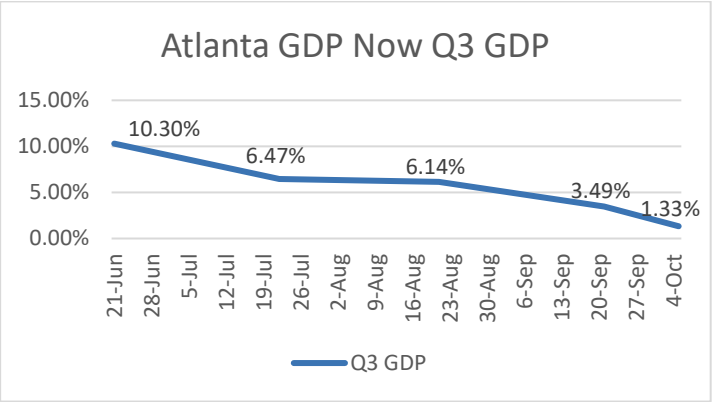
WEEK OF OCTOBER 12, 2021

Slowdown Ahead

The Atlanta Fed GDP Now estimate for Q3 GDP has been sliced and diced all the way down to a 1.3% annual rate from 2.3% just three days ago, 3% at the end of September and over 5.1% at the end of August. That's low and close to stall rate. Meanwhile, Goldman Sachs just cut its GDP growth forecasts for this year. Other firms on Wall Street have followed suit.



But, look closer. According to the Atlanta Fed, real final sales for Q3 is now at -1% (annualized). Real final sales are the true bottom line measure of GDP because inventory changes net to zero over time. Simply put, this means that its GDPNowcast model is "negative" ex-inventories. It should also be noted that with real final sales down this much, the economy has typically been in a recession. Surely the economy must still mean something for stocks and bonds, no?

THIS WEEK

- JUST KEEPS GETTING WORSE
- THE CHINA SYNDROME
- WINTER IS COMING
- "TRANSITORY" STAGFLATION
- EMPLOYMENT UPDATE
- "UNCERTAINTY" IS THE WORD

PORTFOLIO STRATEGY

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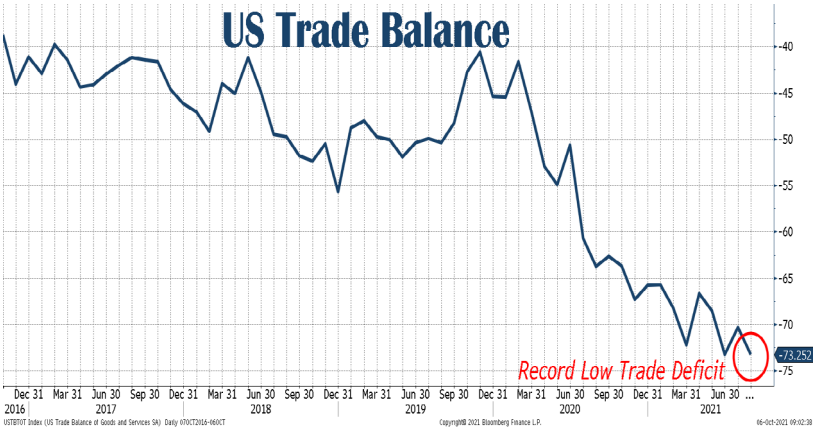
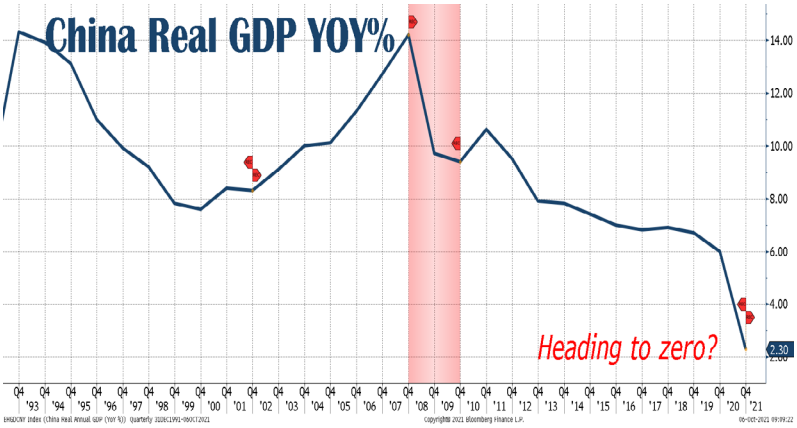
JUST KEEPS GETTING WORSE

The U.S. goods and services trade deficit widened from $70.3 billion in July to $73.3 billion in August, as imports rose 1.4% in August while exports rose only 0.5%. The net impact was the widest monthly net deficit in history. How much longer this setup can continue before it blows up in a currency crisis, war with China or some other major economic disruption remains a key mystery. Regardless, this trade data is bound to keep Q3 GDP downgrades on a downward path. What we don't hear anymore – "Trade deficits do not matter."



THE CHINA SYNDROME

The Evergrande fiasco is a contained financial event within China since most of the debt is held onshore, but it is also a huge negative macro event for the world's second largest economy and could send China into a recession. This has serious global ramifications since China accounts for nearly 20% of global GDP and still consumes half of the world's basic materials. As such this story is going to have global macro knock-on effects that we haven't seen yet. The bottom line: economic growth forecasts are coming down in the two largest economies on the planet!

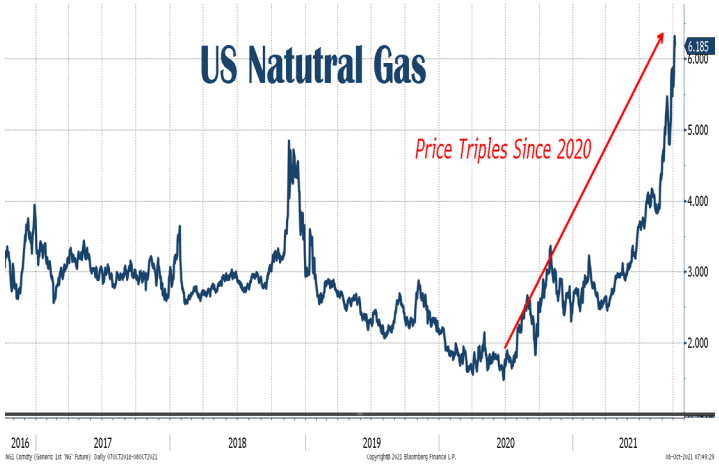


WINTER IS COMING

Energy prices continue to surge globally. West Texas Intermediate (WTI) is up to a fresh, seven-year high of $81.60bbl.

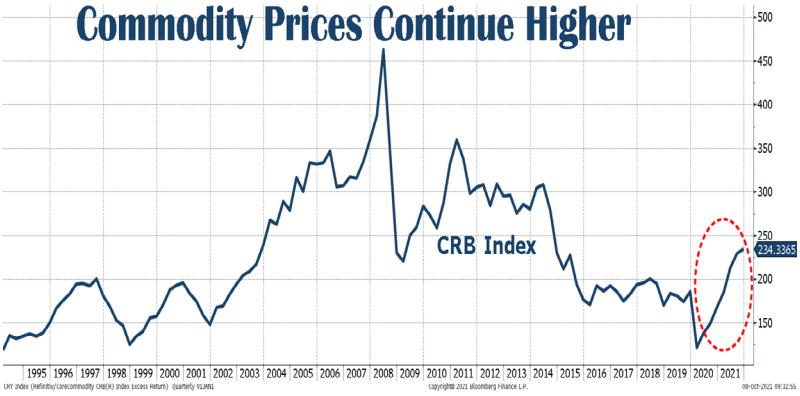
Natural gas has jumped by 25% in Europe in just past the past two weeks. The U.S. hasn't seen gas prices rise this fast but, as shown below, they have moved substantially higher over the past year. Natural gas supplies are running low after

a freeze in Texas earlier this year drove up demand and Hurricane Ida forced nearly all of the Gulf of Mexico's gas output offline. Heating oil has surged 68% this year alone.



The prices are disconcerting and winter is coming. But this is not about demand, with Q3 real GDP growth closing in on a stall-speed of +1% for Q3 and in China down near to 0%. Soaring energy costs at a time when the pandemic has not ended is not good for anyone. For consumers, this is a huge de facto tax; for businesses, a huge margin squeeze.

Frankly, it seems a little unusual for the commodity rally to be sustained given how the U.S. economy is slowing to stall-speed growth of near 1% in Q3, China is basically flat and Japan now looks to be in modest contraction. Europe is facing an acute energy crisis that could tip its economy back into recession as well. (In other words, 70% the global economy is now stagnating.)



Here's the key point. Monetary policy cannot fix unprecedented disruptions, delays, shortages and bottlenecks that the pandemic has created across transportation, semiconductors, food and fuel sectors of the economy.

That said, market seers and pundits are calling for the Fed and central banks around the world to tighten monetary policy – and fast. The one thing we know about Fed tightening cycles is that 75% of them are followed by recessions.

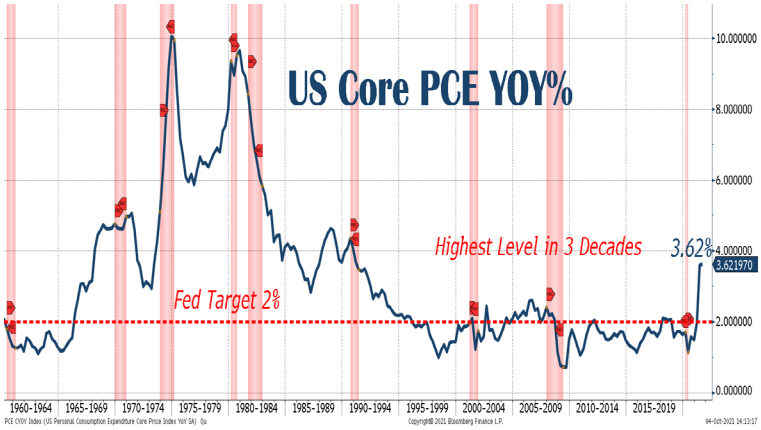
All I can say is that tightening monetary policy into a supply crunch-led inflation(as opposed to a demand-led inflation) could very easily put all of us back in a recession next year.

Be careful what you wish for.

"TRANSITORY" STAGFLATION?

> *"Even if transient, higher inflation has already decreased living standards, further damage is anticipated as just 18% of all households anticipated income gains would be larger than the expected inflation rate."*
> *– Richard Curtin, Chief Economist of the University of Michigan*

On the inflation hysteria file, the personal consumption expenditures (PCE) core index rose to 3.6% year-over-year – a three-decade high. But we have to bear in mind the causes of this sort of inflation. It's all pandemic induced. Strip out autos and inflation is basically at 2% on the nose. In the 1970s, for comparison, everything was going up double-digits. Not at all the case today. Just because Hershey's raised its chocolate prices the other day it does not mean that "stagflation" is here to stay.



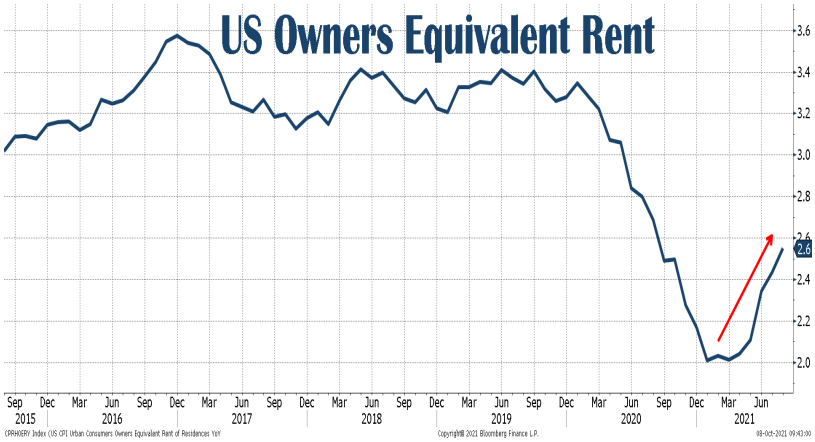
Stagflation is recession coupled with inflation. This is a chronic illness and not something that lasts a few months or quarters. The last time we experienced this condition was in the 1970s and it permeated the macro landscape for more than a decade.

The 'inflation' we are experincing may be proving to be less 'transitory,' but it is clearly linked to the global supply squeeze which in turn is linked to the ongoing pandemic. This is not a demand-led inflationary process. As for the supply crunch, help is on its way. The chip industry is on a major investment binge. So, once again, this is not the 1970s. Meanwhile, at last count there are an epic 497 large container ships outside the major ports in Asia, Europe and North America waiting to be docked and unloaded. The day that happens, inflation will be the last of our worries. This is a future source of supply which nobody seems to discuss.

My advice: Take a chill pill. These supply shortages will not last for years even though they do pose a very important challenge to the economy and financial markets for the next several months. Typically, what happens is this supply-side inflation ends up crushing demand and by crushing demand, sows the seeds for its own demise.

As for wages, the labor union strikes defined the wage-spiral of the 1970s. It was also a decade that was devoid of global competition and productivity growth. The bottom line is there is no wage-price spiral in the cards.

Finally, there is no doubt that the rental component of the CPI has hooked up. But the builders have responded in kind, as multiple family starts and permits have soared of late. This rental story is one you can only rent.



EMPLOYMENT UPDATE

The ADP private sector employment number was above expected at +568,000 in September versus consensus views of +430,000. Even though August jobs were revised lower to +340,000 from +374,000, this was the best tally in three months.

From the big picture perspective, ADP shows that private payrolls are still down 5.5 million, or 4.3%, from the pre-pandemic peak. This places the labor market recovery where it was in August 2011. The good news is we have now retraced 72% of the recession job loss.

On the other hand, the all-important September payrolls report showed that the economy added just 194,000 jobs – well below expectations of a 500,000 print. In fact, the number came below the lowest of all but one of the 71 economist forecasts. This is the first back-to-back monthly drop in payrolls this year and the lowest print of 2021. At this pace, it would take until the end of 2023 to get back to the pre-pandemic employment peak.

A good chunk of the payroll weakness reflected a 123,000 slide in state and local government employment (ratified by declines in education/health). But even accounting for that, private payrolls (at +317,000) were still weak when benchmarked against the +450,000 consensus view. Conveniently forgotten is that we have had two duds in the past two months and that at the current pace, the pandemic job loss won't be recouped until the end of 2023.

On the bullish side, the workweek jumped to a four-month high of 34.8 hours. Aggregate hours worked spiked 0.8% after a flat August – the sharpest run-up since last March. This surely blunts the downbeat message contained in the headline number alone.

There was some "wage inflation" as average hourly earnings perked up 0.6% (consensus was +0.4%), though a downward revision to August means the year-over-year trend came in as expected at +4.6%. Also, the run-up in wages was centered in two areas, retail and education/health, which account for 30% of private payrolls. Now, as for the other 70% of the economy, wages only edged up 0.3% last month.

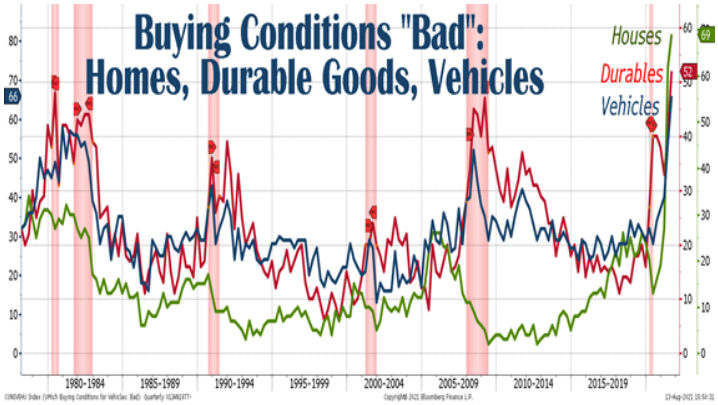
Possibly the biggest takeaway, was that the labor force shrank 183,000. The participation rate fell to a four-month low of 61.7%. The delta variant was likely at play here (the female participation rate – down to a seven-month low of 55.9% from 56.2% in August).

All in all, this report had many crosscurrents. There was something for bulls, bears, inflationists. We'll find out soon enough if the labor market after this report fits the Fed's definition of "substantial further progress."

"UNCERTAINTY" IS THE WORD

According to the University of Michigan survey, there are those saying buying conditions for homes, autos and durable goods are the worst ever. Why the downcast mood? It's not just high prices. There is something much more insidious. I believe it's a general loss of economic confidence.

And what is driving this? “Uncertainty”. Uncertainty over taxation and tariffs. Uncertainty over energy prices. Uncerainty over supply chain woes. Uncertainty over the prospect of future health crises. Uncertainty over inflated asset bubbles.



The pandemic has likely changed spending and savings habits of Americans, and not in a good way for the economy. Also, an increasing awareness among households about work-life balance and heightened concerns about the future could raise precautionary savings. Did you know that 78% of Americans are not prepared for retirement?

Consumer confidence has dropped three months in a row and sits at a seven-month low. And the latest consumer credit data is a sign that Americans in fact becoming more cautious. Consumer credit for August rose $14.4 billion versus a consensus $18.1 billion. Notably, consumers continue to shun credit card debt. Revolving debt is below the pre-pandemic level of $1.098 trillion. This is more strong evidence of a weakening economy.

This is important because much of the bullish case for the U.S. economy for this year and 2022 rests on consumers, which many believe will bounce back as they dip into their savings. That argument, however, would fall apart if American consumers were to become more frugal. Recall that the American consumer accounts for about 70% of GDP.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Fed is forecasting 3.8% growth in 2022. If consumption does sputter, U.S. economic growth will underwhelm. By the way, that means the Fed will not only have to downgrade its rosy forecasts but keep monetary policy accommodative for longer than what it signalled in September.

Furthermore, let’s keep in mind that the economy remains extremely reliant on fiscal and monetary stimulus and the tide is turning. The fiscal cliff could knock GDP down by 2.5%-3% for 2022. This means that demand will slow below supply and that snuffs out this inflation bulge that we see today.

The U.S. political backdrop is toxic and there still isn’t any movement on the infrastructure file as voting in the House continues to get delayed. And both the debt ceiling and government shutdown files are issues that have only been delayed a couple of months, not resolved.

And keep your eyes on asset prices, which have been grossly inflated via the Fed’s generosity. Monetary policy is about to become much less market friendly and this in and of itself may be catalyst enough for the markets to mean revert, to remedy the gigantic 20%-25% bubble in housing and equity prices.

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 recommend that "excess" cash reserves be reduced to reduce the negative income drag. To drive home the point, take a look at the table below that shows comparative historical returns of cash (< 1 year) versus longer duration sectors over the past 13 years (12/31/08 thru 08/31/21). I believe the numbers speak for themselves. As Jim Cramer (Mad Money) would likely say, cash is in the "house of pain." This simple table also clearly demonstrates and validates our ongoing recommendation as to why credit unions should minimize excess cash and maintain a fully invested, risk appropriate investment portfolio.

Total Return Comparison
(12/08 thru 08/31/21)

Duration (years)	Total Return %
Cash (<1 year)	11.14
1.00-2.99	21.72
3.00-4.99	46.88
5.00-6.99	72.07
7.00+	100.72

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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 40 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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