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INVESTMENT SERVICES

Weekly Relative Value

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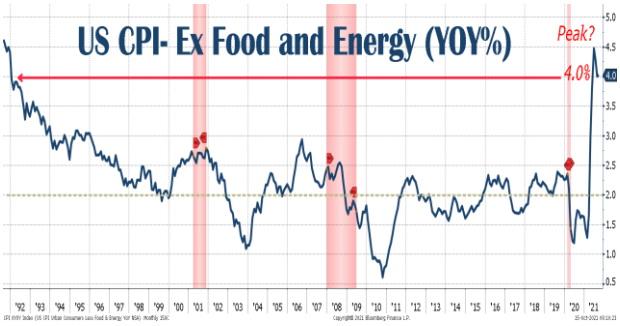
WEEK OF OCTOBER 18, 2021

Itchy Fingers

There were no big surprises in the September Consumer Price Index (CPI) report. The headline came in at +0.4%, with the year-over-year spike edging back up to a 13-year high of 5.4%, thanks to a 0.9% increase in food costs and a 1.3% pop in energy prices. The last time the inflation rate was this high was during the China-led commodity supercycle,which peaked in July 2008. Guess what. A year later the CPI dropped to -2.1% year-over-year.

This is not to say we don't have an inflationary "shock" across the globe; it's obvious we do. But the key message is that these commodity spikes inevitably sow the seeds of their own demise. As they say, the best cure for high prices is high prices.

More importnatly, core CPI (excluding food and energy) was held to an expected 0.2% increase and the year-over-year held at 4.0%, down from 4.5% in June. As shown graphically below, the upward trajectory has collapsed since mid-summer.



Rents are still rising but there are wide swaths of areas related to the reopening theme that showed price weakness last month.For examle: while new cars and trucks are still inflating fast, used vehicles and rentals are peeling off big-time.

THIS WEEK

- ALL-TIME HIGH PRICES
- STAGFLATION HYSTERIA
- THE LONG-TERM SECULAR FORCES
- A WINTER OF DISCONTENT?
- THE FED DOES A 180 (AGAIN)
- RECESSION COMING?
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When push comes to shove, the core CPI rose an average 0.8% month-over-month in April, May and June. In these last three months, the average is +0.2%. Based on all the inflation hysteria, you wouldn't know that the core rate of inflation in the past three months has plunged to a 2.4% annual rate from 10.6% back in June. Put that in your pipe and smoke it!

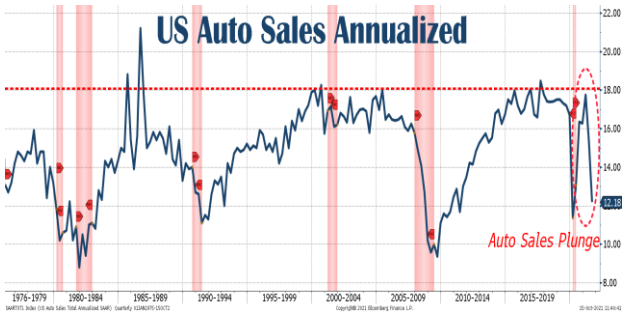
ALL-TIME HIGH PRICES

New car prices hit a new all-time high in September, due primarily due to uber-thin inventories and snarled supply chains. At $45,000, the average transaction price for a new car was up 12.1% (or $4,872) from one year ago in September and monthly up 3.7% (or $1,613) from August.

All-time-high prices come as the entire industry endures a slowdown in sales. New vehicle sales in September plunged by 37% from the free-money peak in March. Total sales last month were approximately a million cars, a 7.3% monthly decrease, and one of the lowest volumes in the past decade.

Dwindling sales are likely a function of three things: 1) a worldwide shortage of microchips that have shuttered many automobile factors, 2) pent-up demand is exhausted, and 3) higher prices are creating demand destruction among buyers. Of note: This is the largest retail category, in normal times, accounting for over 20% of retail sales.

So in a nutshell, fewer cars were sold last month, but prices continue to hit record highs. This may suggest consumers are becoming discouraged to buy because of affordability issues. Again, high prices are the cure for high prices.



STAGFLATION HYSTERIA

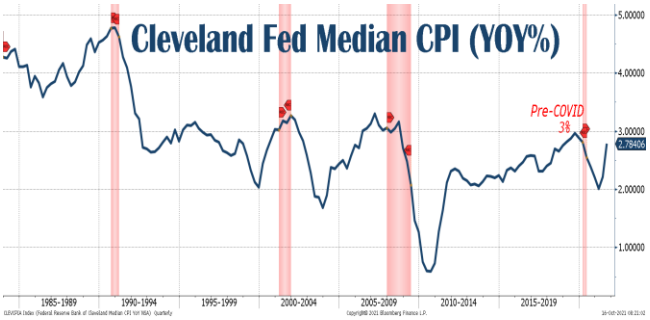
"There are no new eras — excesses are never permanent." – Bob Farrell

With the inflation rate at its highest point since the summer of 2008, and prospects of a sharp deceleration of economic growth in the third and fourth quarters, talk of stagflation has been gathering month-over-monthentum. The "flation" part has a lot to do with the 5% increase in the CPI rate since the trough of May 2020. The "stag" part, in contrast, is what many are expecting considering that real GDP has grown more than 10% annualized since May last year.

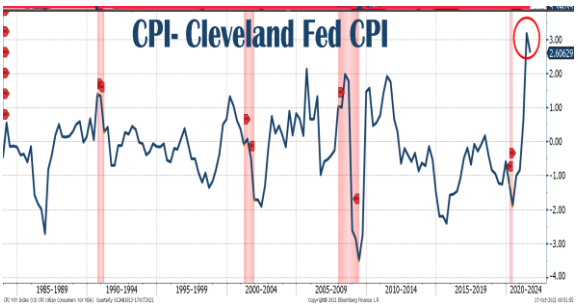
I would agree that U.S. GDP growth is about to soften drastically. In fact, this narrative has been fleshed out in this space more than a few times.

That said, I disagree with the pundits that the recent high inflation rates – because of the reopening of the world economy and clogged bottle necks, etc. – is sustainable.

To better understand the underlying inflation trends, take a look at the Cleveland Fed median CPI. According to the Cleveland Fed, this index "can provide a better signal of the underlying inflation trend than the all-items CPI." As shown below, that metric has risen but it is still below where it was before the pandemic hit.



As the graph below demonstrates, the spread between the CPI index and Cleveland median index is at a record gap of 3%. This means that the price increases are concentarted in just a few categories. As I have discussed previously, if you strip out autos (whose prices have soared in part due to shortages of semiconductors), the annual inflation rate is roughly 2%. Really scary stuff. Right?

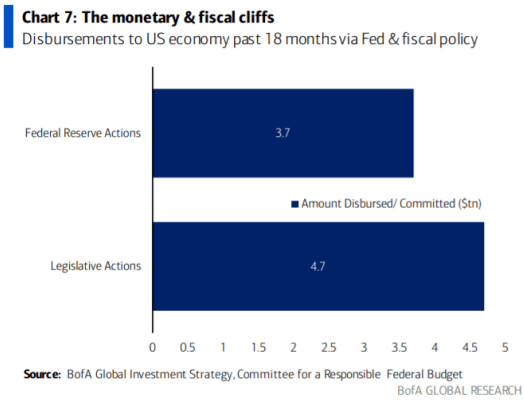


We all know the reason prices have soared in a select basket of goods. In this monstrously overstimulated ($5 trillion in deficit spending and by $4.5 trillion in money printing by the Fed since March 2020) economy, demand for goods has surged, triggering all kinds of shortages that are now rippling through the system, as global supply chains and transportation systems have been buckling for a year.

This is not to say we don't have an inflationary shock across the globe. It's obvious we do. The global supply chain is impaired indeed, and based on everything you read, it may even get worse before it gets better. Those supply shortages will linger a while longer and challenge the economy for the next several months. But there is no reason to believe this won't be resolved. Either that, or demand will crater and that settles the issue.

While everyone focusses on the here and now one has to wonder what happens when these container ships finally get unloaded. To wit: 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, inventories will skyrocket (inventory recession?) and inflation will be the last of our worries. In other words, higher supply is set to put a ceiling on prices.

Furthermore, the economy has remained on fiscal and monetary stimulus. Since the pandemic began there has been over $8 trillion of fiscal and monetary stimulus thrown at the economy. That tide has now turned. The fiscal cliff could knock GDP down by 2.5-3% for 2022. This also means that demand will slow below supply and that in turn will snuff out this inflation bulge we see today.



THE LONG-TERM SECULAR FORCES

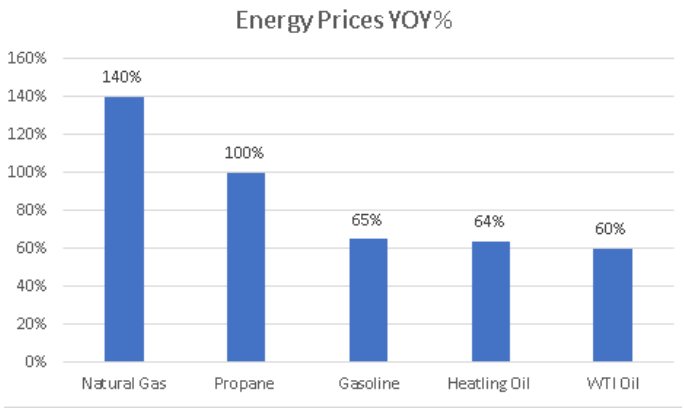
From a longer-term perspective, I have a difficult time seeing a repeat of the staglationary 1970s. Today's economy, unlike the economy in the 70s, is geared towards deflation rather than inflation. This is due to massive debt levels across all sectors of the economy, technological innovations, globalization, an aging population (which reduces demand) and rising income inequality, all of which translate into secular downward forces on inflation. And unlike the 1970s, wage growth – while rising in some sectors – remains subdued thanks to the absence of cost-of-living adjustments (i.e., COLA clauses, which were ubiquitous in employment contracts 50 years ago).

Once the COVID dust settles, these long-term secular trends will reassert their downward forces on inflation. As such, the current inflation situation won't last for an extended period of time.

A WINTER OF DISCONTENT?

Oil prices have risen for eight straight weeks,the longest stretch since April 1999. Natural gas made it to a December 2008 high and is up nearly 120% for the year. Surging oil prices have trickled down to consumer energy products such as heating oil and gasoline (both seeing prices soar more than 60% over the past year). Natural gas and propane prices have also exploded amid lower-than-normal inventories for this time of the year.

The EIA expects that the near-half of U.S. households who warm their homes with natural gas will see their heating bills this winter soar an average 30% —and by 50% if the weather turns out to be just 10% colder than average. If so, the home heating bill for the consumer this winter is going to act as a huge constraint on spending. This is all happening at the worst possible time, as governments worldwide are paring back measures that helped support household disposable incomes during the recent recession.



Data Source: Bloomberg

That raises risks for a severe global economic slowdown, if not an outright recession. Note that the last seven U.S. recessions were preceded by an energy price surge. A recession has a higher probability if the energy crisis results from a supply shock and the government responds with tighter monetary policy (e.g., the back-to-back U.S. recessions of the early 1980s). Will we make the same policy mistake this time around?

THE FED DOES A 180 (AGAIN)

The Fed is now backing off its "transitory" view of inflation and is starting to get nervous and appears to have an itchy finger. I truly find it Interesting how this esteemed collection of economists make decisions.

Here are some of the highlights from the Federal Open Marekt Committee meeting minutes:

On Inflation: *"Many participants noted the substantial rise in one- and three-year measures (of inflation expectations) in the Federal Reserve Bank of New York's Survey of Consumer Expectations or in the one-year measure in the University of Michigan Surveys of Consumers. A few participants remarked that these survey measures tended to be sensitive to movements in actual inflation, or that the recent rise was consistent with previous historical relationships between such measures and actual inflation."*

On "substantial" further progress: *Most participants remarked that the standard of 'substantial further progress' had been met with regard to the " Committee's price-stability goal or that it was likely to be met soon."*

On QE withdrawal: *"All participants agreed that it would be appropriate for the current meeting's post-meeting statement to relay the Committee's judgment that, if progress continued broadly as expected, a moderation in the pace of asset purchases may soon be warranted. ... The path featured monthly reductions in the pace of asset purchases, by $10 billion in the case of Treasury securities and $5 billion in the case of agency mortgage-backed securities (MBS). Participants noted that if a decision to begin taper in purchases occurred at the next meeting, the process of tapering could commence with the monthly purchase calendars beginning in either mid-November or mid-December."*

To sum it up: Based on the latest FOMC minutes, the committee members sounded hawkish and look prepped to taper their bond-buying stimulus program in November, and to possibly end the asset purchases entirely by the middle of next year.

This is a key point. The Fed's plans are contingent on its economic forecast coming to fruition. And we know from past history that the Fed has a fondness to grossly overestimate just how strong the economy is going to be. This is an intentional, self-serving institutional bias.

RECESSION COMING?

"U.S. monetary & fiscal cliffs ahead as $8.4 trillion emergency stimulus by Fed & Treasury ends."

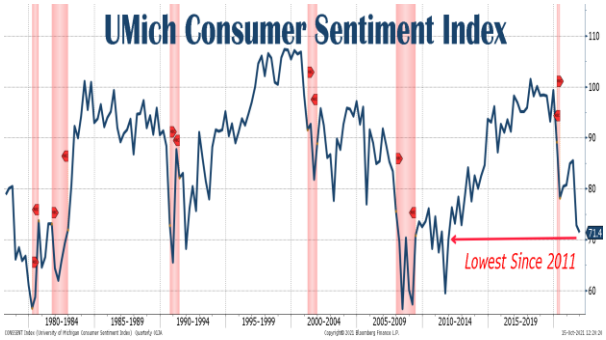
Demand-pull inflation is what central bankers can control. What we are dealing with today, however, is not the sort of inflation you can fix unless Fed Chair Jerome Powell learns how to grow food, build semiconductor plants, pump oil, and unload filled container vessels. Tightening to reduce demand, especially in light of less growth-friendly fiscal and monetary policy, may well lead to consequences that these central bankers live to regret.

If the answer to this sort of pandemic-induced supply squeeze is for central banks to tighten policy, as several are threatening, then there is little doubt that a recession will be coming sooner, rather than later.

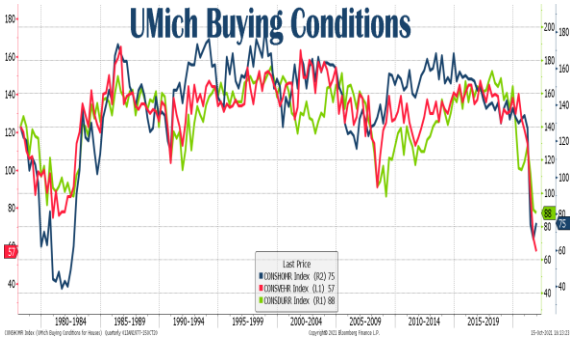
SURVEY SAYS…

"When asked to describe in their own words why conditions were unfavorable, net price increases were cited more frequently than any time since inflation peaked at over 10% in 1978-80."
– Richard Curtin, Director of Consumer Sentiment Surveys at University of Michigan

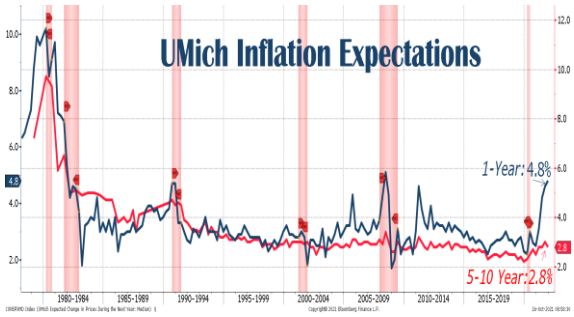
The University of Michigan Consumer Sentiment Survey faltered to71.4 in October from 72.8, and marking the second lowest reading in a decade.



Buying conditions for homes rebounded very modestly from 40-year lows, but buying conditions for vehicles and appliances pushed to new record lows...



And finally, inflation expectations for the next year surged to their highest since 2008 (as longer-term (5-7 years) inflation expectations dipped). In fact, inflation expectations are still lower than during the Great Recession of 2008-09, according to the University of Michigan's consumer sentiment measures (e.g., expected inflation rate in one year). Those expectations are clearly being held down by the Fed's credibility, which was arguably not the case when Arthur Burns led the Fed in the 1970s



CRYPTO MANIA

"I personally think that bitcoin is worthless,"
– Jamie Dimon, Chair and Chief Executive Officer, JPMorgan Chase

Bitcoin has made a round trip to just below $60,000, where it was in April, on news that the U.S. Securities and Exchange Commission is poised to allow the first U.S. bitcoin futures exchange-traded fund to begin trading. Also, Russian President Vladimir Putin said he accepted crypto's role in making payments.

As for the cryptocurrency mania, Tobias Adrian, the director of the Monetary and Capital Markets Department of the Intrnational Monetary Fund, came right out and said the obvious for those of us watching this craze take hold in this period of bizarre financial history: "With limited or inadequate disclosure and oversight, the crypto ecosystem is exposed to consumer fraud and market integrity risks."

For an in-depth and interesting discussion on bitcoin and crypto currencies click on this link.
https://www.currentaffairs.org/2021/04/why-cryptocurrency-is-a-giant-fraud

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Wall Street economists talk about how strong the economy is. Wait,w hat? If "demand" is as solid as they say, then why is it that Preisdent Joe Biden's approval rating on the economy is down to 39%? And his disapproval rating is at 55% (as per the latest Quinnipiac survey)? The President's total public approval rating is at a Trump-like 38% right now (with a 53% disapproval rating). Doesn't sound like a very robust macro environment.

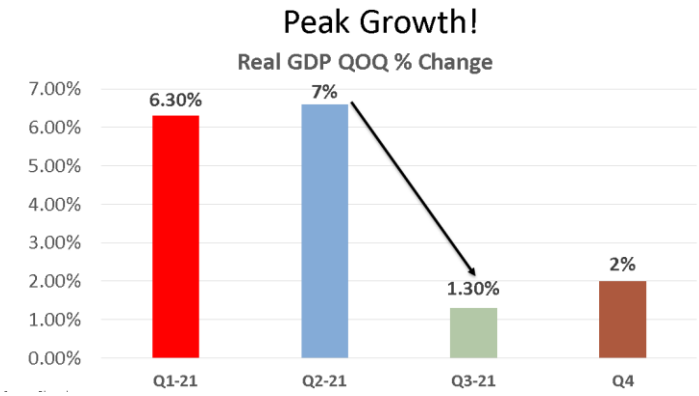
The data tells the story. In the third quarter, economic growth slowed sharply, registering a fraction of the growth rate in the first half.

The Atlanta Fed is calling 1.20% annualized growth for the third quarter (Q3). In other words: stall speed. Remember, this estimate was 3.0% at the end of September and 5.1% at the end of August. Real final sales also were trimmed to -1.2% at an annual rate from -1.1% (this was +1.5% at the end of August).

I expect Q3's weakness to continue over the balance of this year and into 2022. To wit: the FIBER leading inflation index is now foreshadowing sub-1% real GDP growth for Q4 (the same Q4 that the Fed is implicitly forecasting at 7%+!).

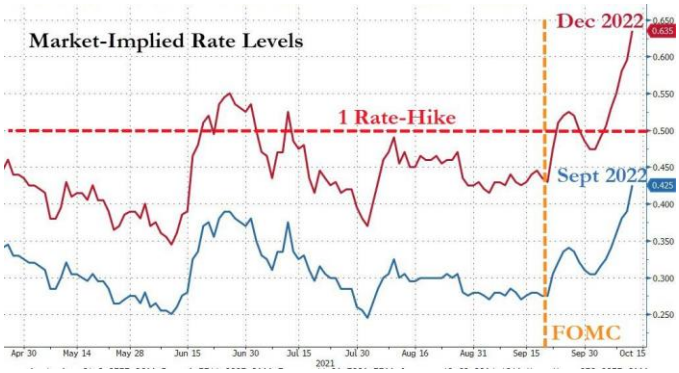
While Wall Street is praying for another stimulus program to save the day, at this writing, the Democratic Party's $3.5 trillion infrastructure bill was still stuck in Congressional limbo. And even if by some miracle it does pass Congress, spending will be spread out over years, as we've seen in the past with infrastructure spending.

And nobody seems to care about the global demand implications from the dramatic slowing in Chinese economic growth, as real GDP weakened sharply in Q3 to 4.9% YoY from 7.9% in Q2. The spreading property and credit crisis will only exacerbate the softening trend. The QoQ pace slowed to a +1.6% annual rate from +7.7% in Q2 and the lowest print, outside of 2020 Q2, since 1999Q1 (the worst quarter we saw in the Great Recession was +4.2% in the fourth quarter of 2008)



Data Source: Bloomberg

As economic growth appears to be falling, markets have priced in the first rate hike to take place by the end of 2022. The futures markets is pricing in a 90% chance of a September 2022 rate-hike (and a July 2022 end to the taper), followed by another hike becoming more priced-in for December 2022.



Source: Bloomberg

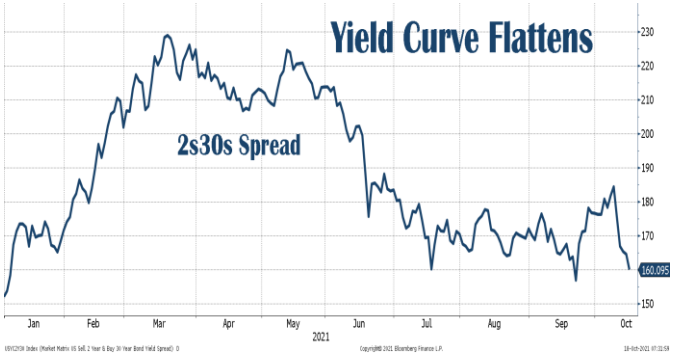
Meanwhile, the yield curve is beginning to price in a massive policy error by the Fed. Just look at the price action on the long end of the yield curve. The 10- and 30-year Treasury benchmark yields dropped 10-13 basis points, repectively, to close the week at to 1.51% and 2.015%. I should add that the Treasury sold $24 billion in a 30-year auction last week that was nothing short of spectacular.

Think about this. The 10-year Treasury yield hit a low 2.08% on December 18, 2008, in the aftermath of the Lehman collapse. Today, the yield is 1.55%, in the midst of what the experts say is the biggest economic boom since the Reagan years and the most pronounced inflation breakout since the Carter era.

Maybe it's because everything is priced in: best economic growth since 1984; run-away inflation; the commodity supercycle; skyrocketing housing prices; record equity markets; endless gobs of fiscal stimulus; vaccines for everyone;the taper; shortages of everything.

Tell me what is not known at this point? Also what will drive the 10-year yield back to the recent March high of 1.75%, let alone 2% and up? I can't think of anything.

I've always argued that the long bond is the single best indicator of economic growth and inflation. And with every tick higher in short-term rates, the yield on the long end has dropped. So what is Mr. Bond saying today? Maybe, just maybe, the Treasury market is seeing something that most economists and strategists are missing (and it wouldn't be the first time). As shown below, the curve is beginning to flatten and then invert ahead of the coming recession which the Fed appears ready to tighten right into. Note: 75% of the time, a recession commences after a Fed tightening of monetary policy.



In terms of portfolio strategy, given the amount of COVID "noise," volatility is likely to increase as we move into year-end. Rather than trying to "trade" and/or "time" the market moves, we continue to advocate that credit unions maintain the tried-and-true discipline of maintaining a risk-appropriate ladder strategy. From a tactical basis, sell-offs may very likely prove to be ephemeral and provide an attractive entry point to invest "excess" cash.

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 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.

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.