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INVESTMENT SERVICES

Weekly Relative Value

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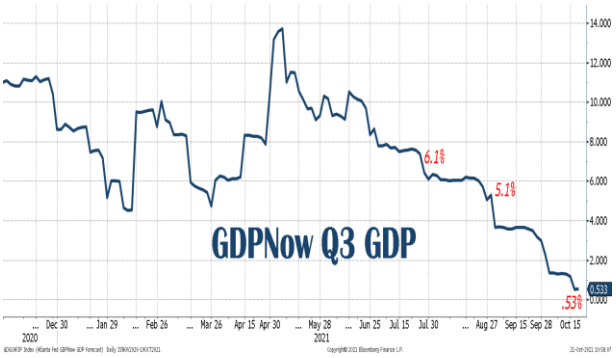
WEEK OF OCTOBER 25, 2021

Stall Speed

The Atlanta Fed's real-time tracker slashed its estimate for real gross domestic product (GDP) growth in the third quarter (Q3) of 2021 to a microscopic +0.5%, down from 1.2% on October 15. At the end of September, the forecast was +3.0%; at the end of August, it was 5.1%; and at the end of July, it was 6.1%. In less than three months, from 6.1% to 0.5%, and we are in a booming economy? Note: The consensus Wall Street forecast is for Q3 GDP to increase 2.8%.



Importantly, Q3 is supposed to show a big positive inventory swing. Indeed. So, strip that out, and the Atlanta Fed model real final sales are down to -1.6% (annualized) for the third quarter. At the end of September, the estimate was +0.1%; at the end of August, try +1.5%; and at the end of July, how about +2.3%. A negative 390-basis-point swing in less than three months. At no point in modern history, back to 1952, have real final sales contracted at a 1.6% annual rate without the economy being in recession.

THIS WEEK

- TAPPED OUT
- JOBLESS CLAIMS DOWN AGAIN
- MISSING WORKERS
- THE WAGE STORY
- HOUSING UPDATE
- POWELL PIVOTS AGAIN
- BULLISH, NOT BEARISH!
- THIS TIME IS DIFFERENT?

PORTFOLIO STRATEGY

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According to the Atlanta Fed economists, "the nowcasts of third-quarter real personal consumption expenditures (PCE) growth and third-quarter real gross private domestic investment growth decreased from 0.9% and 10.6%, respectively, to 0.4% and 8.4%, respectively. "In short, everything is slowing."

Investors see this as transitory (only inflation is permanent) and are expecting a Q4 bounce back. The consensus forecast is for a big surge in consumption in Q4 (and beyond) will come from the spending of "excess" savings.

"When crisis hits, or anything goes out of the norm—your child is sick, for example—you are sacrificing wages." – Avenel Joseph, a vice president at the Robert Wood Johnson Foundation

According to a poll from the Robert Wood Johnson Foundation and the Harvard T.H. Chan School of Public Health, for many Americans, the COVID lockdowns – with nowhere to go and nothing to do – was a time to save. However, many people dipped into their savings to cover child or health care expenses.

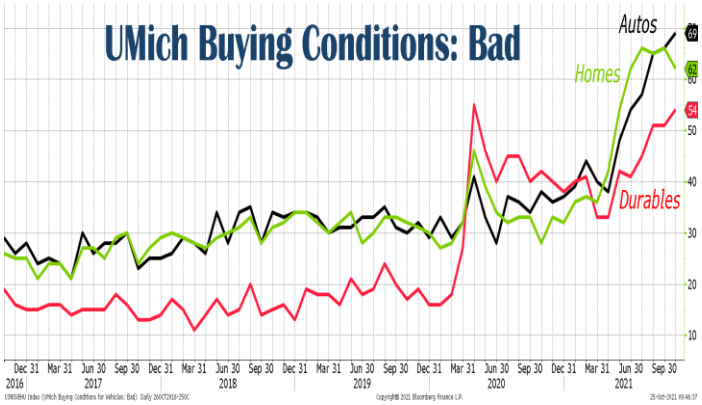
For almost 20% of U.S. households, the pandemic wiped out their entire financial cushion. The share of respondents who said they lost all their savings jumped to 30% for those making less than $50,000 a year. Black and Latino households were also harder hit. While about two-thirds of people surveyed said they received financial assistance from the government in the past few months, 44% said those programs only "helped a little." Almost two-thirds of households earning less than $50,000 a year said they had trouble affording rent, medical care and food.

While the staggering social divide is truly sad, and largely a byproduct of the Fed's policies in the past decade, it does bring up an important point. While much has been said about the $2 trillion or so in excess savings created during the COVID pandemic, most if not all of that has not already been spent to fund the massive household spending in the U.S.

As shown in the graph below from Morgan Stanley, only a third of the $2 trillion in excess savings has gone to the bottom 80%. And the bottom 80% has long ago spent its "excess savings" and only the top 20% has any residual money left from the trillions in COVID stimulus. Unfortunately, this "top 20%" has a far lower likelihood of spending its money. In short, the consumer – that 70% driver of GDP growth – may be about to hit reverse.

TAPPED OUT

After the repeated rounds of fiscal stimulus at the end of 2020/early 2021, so much spending on durable goods was pulled forward. With the amount of spending that was pulled forward earlier in the pandemic, the consumer continues to show signs of being tapped out. To wit: The October release of the University of Michigan Survey of Consumer Sentiment showed that buying conditions continues to trend lower and lower. Given that sentiment often leads spending activity, the lack of consumer enthusiasm increases the downside risks to growth.



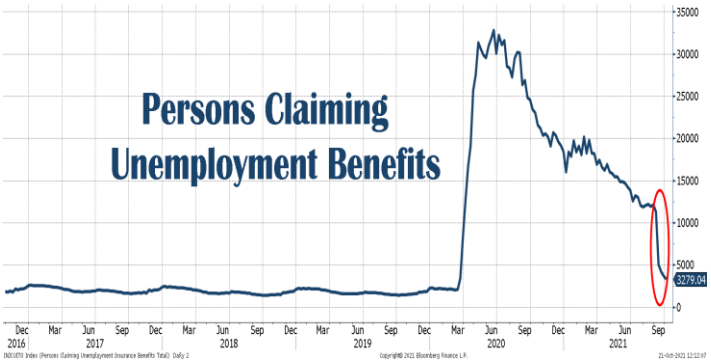
And this is evident beyond just the survey data. Last month, new car sales month fell to their lowest level since May 2020; housing activity has peaked and rolled over; and real retail sales came in at a -8.8% annualized rate for Q3. Add to that the fact that the latest Energy Information Administration (EIA) estimate that half of U.S. households using natural gas to heat their homes can expect an average increase to their bills of 30%.

JOBLESS CLAIMS DOWN AGAIN

Initial jobless claims fell in the week ending October 16 to a new post-pandemic low of 290,000 from 296,000. They have now come down 74,000 in just the past three weeks. Continuing claims also fell 122,000 (down four straight weeks) to 2.481 million for the week ending October 9 after dropping 124,000 the prior week.

MISSING WORKERS

The most recent jobless claims data show that 8.5 million Americans fell off all of the various generous jobless benefit programs in September. At the same time, employment only rose 526,000 (household survey) and those not in the labor force expanded 338,000.

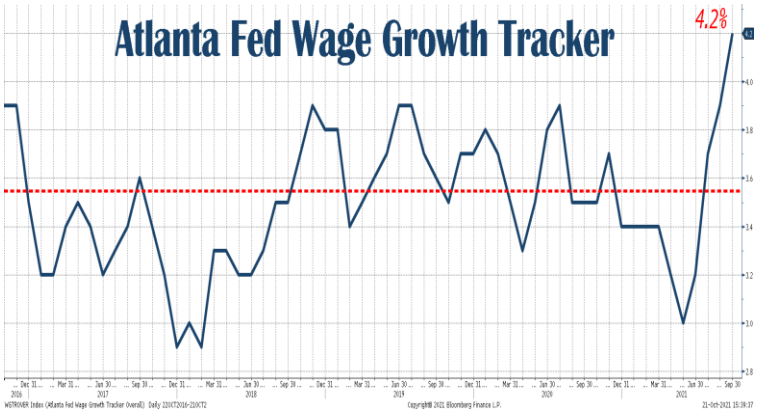


So where did the rest of the 7.6 million go?

They didn't get jobs. They didn't leave the workforce. Were they all "double dipping"? None of this makes sense. It is a compete mystery. It's hard to believe that those who have chosen not to work because of early retirement – because they have a stash of savings from government handouts, have made a fortune from trading meme stocks, or didn't like their prior low-skilled/low-pay jobs – will be able to stay out of the workforce indefinitely. And if they do, one can reasonably expect that before long, their spending patterns will also be affected as much as their lack of a paycheck.

THE WAGE STORY

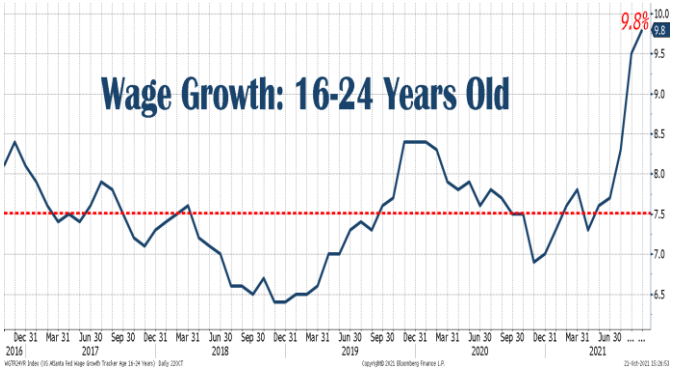
The Atlanta Fed wage tracker showed that the pace of wages picked up for the fourth month in a row in September to 4.2% from 3.9% in August.



While wage growth, on average, has risen, the details are quite interesting and revealing:

- The sectors showing wage accelerations are in leisure/hospitality and education/health.

- Females experienced wage gains of 4.9% (20-year high) from 4.3%. Note: Most females tend to be employed in health/education and need to be enticed to come back to the workforce. On the other hand, wages for males slowed to 3.4% from 3.5% in August.
- Job hoppers are having fun now as they see that they can switch jobs quickly for higher pay. How long employers are willing to continue to play this game remains to be seen. Be that as it may, the wage tracker showed a notable acceleration for job switchers in September to 5.4% from 4.8% in August. Job stayers lagged behind with wage growth eking out a smaller acceleration — from 3.3% to 3.5%.
- Oh, to be young again. Those aged 16-24 saw their wage tracker explode to the upside in September to 9.8% from 9.5% in August. This is the fastest trend since March 2001. Oh, if you're 25-54, your wage growth has been stagnant at 3.7% for five months in a row!! For those of us 55 and up, try 2.0% from 1.9% in August.

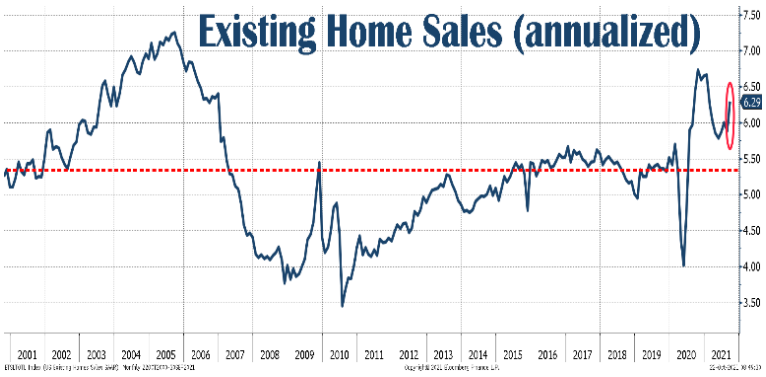


- Those with a high-school education saw wages rise 3.9% (a 20-year high). People with a bachelor's degree or higher saw their wage growth stuck at 3.2%. Historically, wages grow faster for those with a formal education. In the COVID world, no longer. In fact, low-skilled wage growth, at 3.7%, is beating high skilled wage growth that is at 3.5% and is going nowhere.

In summary: If you are young, unskilled, uneducated, and work in a public-facing industry, the world is your oyster. If you are middle-aged, skilled, have an education and and don't work in the leisure and hospitality sector, then you're out of luck (maybe you should stop showing up at work like these other folks).

HOUSING UPDATE

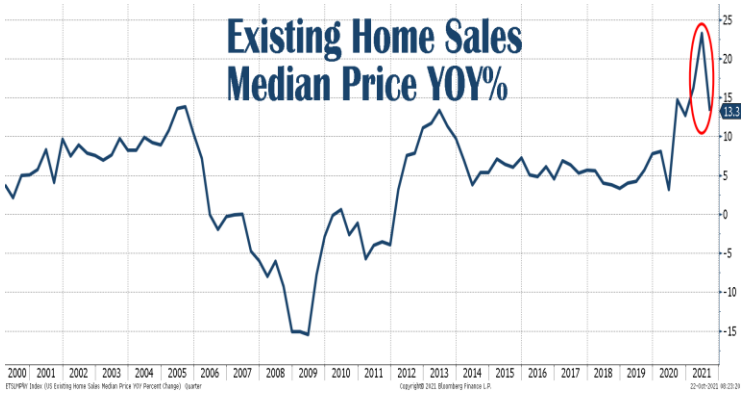
U.S. housing resale activity jumped 7.0% in September to an eight-month high of 6.29 million units (annual rate).



Keep in mind that this is somewhat of a lagging indicator as these "sales" reflect closings only; the contracts were signed months ago when mortgage rates were falling, not rising.

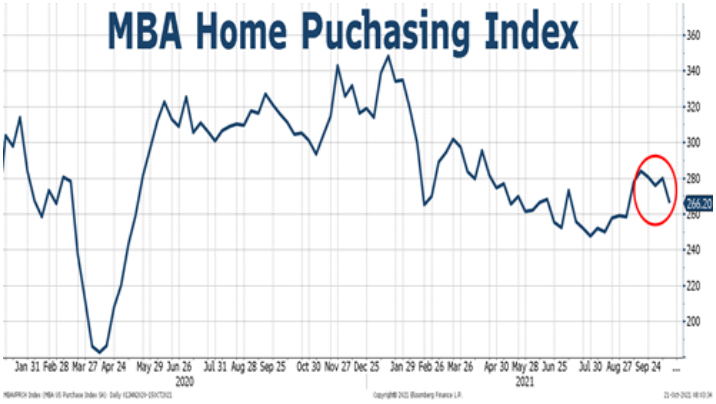
And even though the unsold inventory tightened up to just 2.4 months' supply (the lowest in five months), from 2.6 months' in August, there seems to be a thaw occurring in the runaway home price inflation theme. The year-over-year trend in median real estate prices peaked in May at 23.6% and has since been cut in half to 13.3%. Even still, the median home prices have now risen for 115 consecutive months. So for the time being, people have become convinced that prices only go up and no price is too high to pay.

As many as 25% of homes are now being bought by yield-seeking funds that will rent them. Low interest rates are of limited help to first-time homebuyers when the average price goes from $380,000 to $420,000 in a little over a year. The first-time buyer share went down even more, to 28% from 29% in August, 30% in July and 31% in June. This is what happens when government, in this case the Federal Reserve, meddles in the market. Now, if you already own a house that's rising in value, you are not upset. But if you are trying to buy one, the Fed is making it harder on you.



Moving forward, the Fed has now made clear that it will taper its asset purchases after the Federal Open Market Committee (FOMC) meeting in November, and end quantitative easing (QE) entirely by mid-2022. There are already Fed governors that are considering speeding up the pace of tapering to make room for sooner rate hikes.

The 10-year Treasury yield has risen by over 60 basis points since early August, to 1.68%. Mortgage rates, which generally lag Treasury yields, have risen 32 basis points since early August, to 3.09%. But mortgage rates remain extremely low, with a lot of room left to rise.



But, even with the minor uptick in rates – combined with extremely high prices – the housing market is already being impacted. In the latest week, mortgage applications to buy a home have plunged 4.9%. Purchase apps are down in three of the past four months and to their lowest level since early September. Also, refinancing is down 7.1%, which is the third consecutive week of decline (also down in six of the past seven weeks) to the lowest level since July 2. This is a loss of consumer cash flow at a time when all those "excess savings" are being siphoned into the gas tank.

I wonder what would happen to housing market when and if the mortgage rates are 5-7% instead of 3% today?

POWELL PIVOTS AGAIN

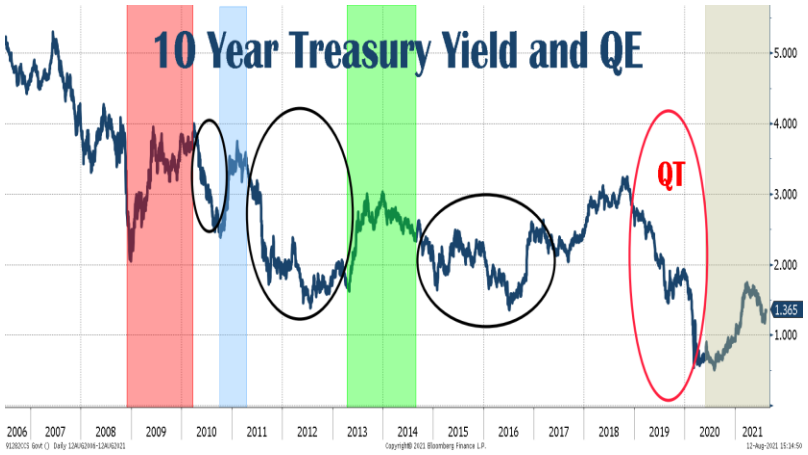
"The risks are clearly to longer and more persistent bottlenecks and thus to higher inflation."
– Fed Chair Jerome Powell, October 22

Fed Chairman Powell has done it again. Pulled a pivot. He did this in early 2018 when he said he was going to aggressively pursue a tightening cycle that would take the funds rate above the 3% neutral funds rate estimate at the time. Didn't come close. After hiking and staying hawkish in December 2018, he then began a process of cutting rates three times in 2019.

In just the span of two months recently, he has moved from"temporary" to "persistent"on the inflation call... in two months! It was quite interesting and a tad humorous to see the Treasury market rally with Powell's more hawkish tilt. Mr. Bond may be thinking that in two or three months, Powell may well be pivoting again. Or possibly, the market thinks a lot of the Fed is already priced in. After all, the futures market is discounting 70% odds that the first rate hike comes by the mid-point of 2022.

BULLISH, NOT BEARISH!

The widely held consensus view is that, when the Fed begins to taper its bond purchases, yields will move higher. While this makes sense in theory, the reality paints a different picture. Indeed, during QE periods (shaded areas below) the yield of the 10-year Treasury has increased by 62 basis points on average. And when QE ended, yields declined by over 125 basis points. So, while it is logical to think that as the Fed stops buying, yields will rise, the opposite happens.



Here are two key takeaways.

1) Demand for Treasuries is strong, even without the direct support from the Fed. Indeed, foreign holdings of Treasury securities have increased by a net $4.5 trillion since the Fed started QE in 2008, a gain of 150%. This makes sense because Treasuries currently offer a yield premium (even after accounting for hedging) versus other major government bonds yields. What's more, even with the recent rate back-up, there is still $12 trillion worth of negative-yielding government debt globally. By comparison, a 10-year Treasury yield of 1.63% looks very appealing.

U.S. Treasuries Fully Hedged vs. Foreign Domestic Securities			
Hedged Instrument	Percent (%)	Instrument	Percent(%)
U.S. 10-year yield JPY-hedged	1.2%	Japan-10-year yield	0.1%
U.S. 10-year EUR- hedged	0.8%	Europe 10-year Yield	-0.1%
U.S. 10-year GBP- hedged	1.6%	U.K. 10-year yield	1.2%

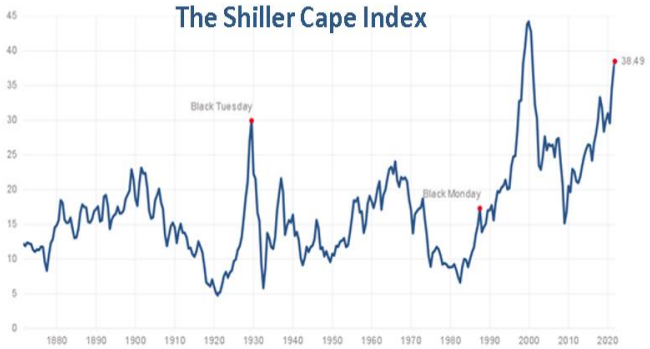
2) After more than a decade of monetary interventions, the Fed has created a psychological link between QE and the equity markets. As a result, the liquidity creates an asset preference of "risk-on" assets (equities), versus "risk-off" assets (bonds). When investors see the Fed directly supporting the market, this gives them confidence to rotate out of safe havens (like Treasuries) into riskier assets (such as equities). Thus, QE periods are best characterized as a "risk-on" market backdrop (which has not historically been favorable for the Treasury market). The opposite is true for non-QE periods.

Bottom line: As we move forward, the Fed is expected to gradually wind down QE. But as this happens, don't be surprised to see yields fall rather than rise. As such, the recent rate back-up has provided a very nice entry point for credit unions. Should yields continue to rise, I would continue to gradually add duration exposure, fully aware that this is a contrarian view.

THIS TIME IS DIFFERENT?

The cyclically adjusted price-to-earnings ratio (CAPE) is a valuation measure. It is calculated by dividing the current price of a stock by its average inflation-adjusted earnings over the last 10 years. The ratio is used to gauge whether a stock is undervalued or overvalued by comparing its current market price to its inflation-adjusted historical earnings record. Using average earnings over the last decade helps to smooth out the impact of business cycles and gives a better picture of a company's sustainable earning power.

In the past three months, the CAPE multiple on the S&P 500 index has expanded from 36.7x to 38.3x. For perspective, the only time it was higher (45x) was during the dot-com bubble in 1999-2000. At the 2007 bubble peak, the peak was and 27.6x. During the October 1987 crash, the multiple was 18.3x. In September 1929, as Irving Fisher was telling everyone stocks were at a permanently new higher plateau for equity valuations, the multiple sat at 32.6x. Of course, nobody seems to think valuations matter (not until they do, that is). "This time is different." All I can say is please, do not throw away your history books. Not now.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

On the inflation front we are facing demand-driven inflation as a consequence of misguided monetary policy and misdirected fiscal stimulus. The $6 trillion in high-powered Fed money plus fiscal stimulus spending went directly into consumers and some businesses. At the same time, we are dealing with major supply chain disruptions. In other words, we want a lot of stuff that the supply chain cannot handle.

Until the stimulus and supply chain issues work out, until we figure out how to entice potential employees back to work, we're going to have to deal with uncomfortably high inflation. To bring everything into balance, prices will rise until enough demand is destroyed to bring everything into line with the limits of the supply chain. This might be happening now as Q3 growth expectations are crumbling as prices are soaring.

That said, when the COVID dust settles, the U.S. economy will eventually revert back to a slow-growth, disinflationary environment. Due to massive debt and aging demographics, I believe that real GDP will average 1% for the rest of this decade.

In terms of portfolio strategy, we continue to advocate that credit unions maintain a risk-appropriate, diversified, ladder strategy. From a tactical perspective, any weakness in the bond markets provides an opportunity 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.