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INVESTMENT SERVICES

Weekly Relative Value

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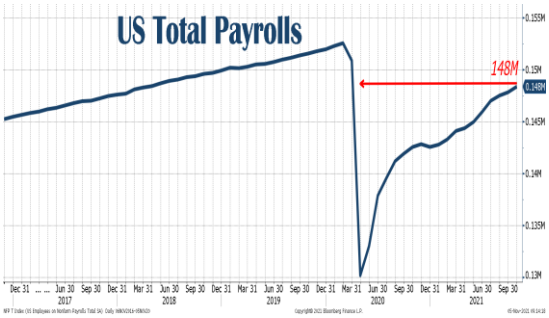
WEEK OF NOVEMBER 8, 2021

October Surprise

After two months of dismal job reports, the Bureau of Labor Statistics (BLS) finally redeemed itself when it reported that in October the U.S. gained some 531,000 jobs – well above the 450,000 consensus expected. Remarkably, the private payrolls print was a stellar 604,000 with government jobs shrinking by 73,000 in October. Just as importantly, the Septemeber print was revised solidly higher, from 194,000 to 312,000, as was August, up from 366,000 to 483,000. With these revisions, employment in August and September combined is 235,000 higher than previously reported.



Looking at the breakdown of job gains, growth was widespread in October, with notable job gains occurring in leisure and hospitality, professional and business services, manufacturing, and transportation and warehousing. Employment in public education declined over the month. In any case, payrolls are now 4.2 million lower than the peak reached before the pandemic and is better than the nearly five million in September.

Validating the solid headline print was the household survey which showed that the number of employed Americans jumped by 359,000 and the unemployment rate dropped from 4.8% to 4.6%. The broad U-6 measure also dropped to 8.3% from 8.5% (it was 9.8% in June) and is the lowest since February 2020.

THIS WEEK

PORTFOLIO STRATEGY

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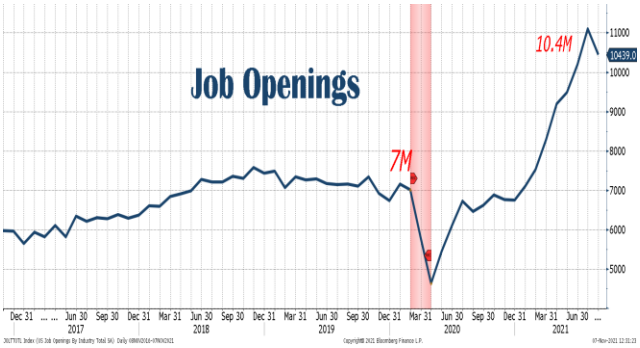
Here's a weird phenomenon: The economy has been monstrously over-stimulated to get consumers, businesses, and governments to spend, and it's creating lots of job opportunities. But millions of people, for whatever reasons, have chosen not to rejoin the labor force, triggering widespread shortages of labor.



Amazingly, since the extremely generous jobless benefits expired two months ago, the labor participation rate has dipped 0.1% and remains stuck at 61.6%. It has not budged one iota in the 18 months. It was 63.4% before COVID-19 struck which means that barely more than 40% of the pandemic-induced decline has been recouped. In total, lower labor force participation has caused the total U.S. labor force to shrink from 159 million pre-COVID to 154 million today, or an aggregate loss of five million jobs.

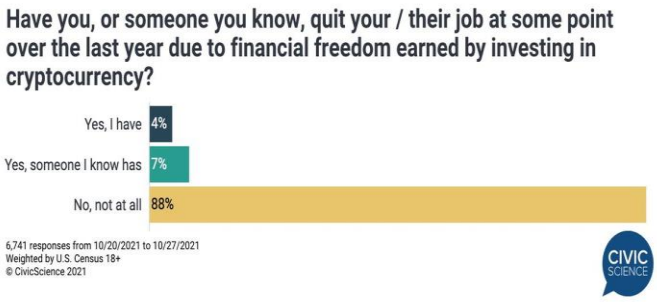
A smaller labor market is troubling because it implies:

- A skills mismatch between employers and job seekers, which is bad because it could mean the participation rate will be slow to recover.
- A lower level of growth, since GDP growth = labor force growth * productivity growth.

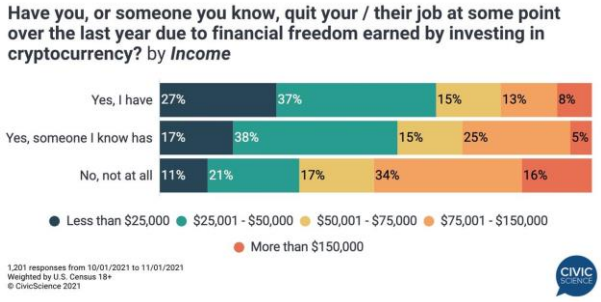
So, what are these five million who have dropped out of the labor force doing?

"Wow 4% of people in the USA have quit their jobs because of crypto gains, and the vast majority made under 50,000. Now we know why so many people quit low paying jobs. And this was BEFORE the current runup." – Mark Cuban, November 3, 2021

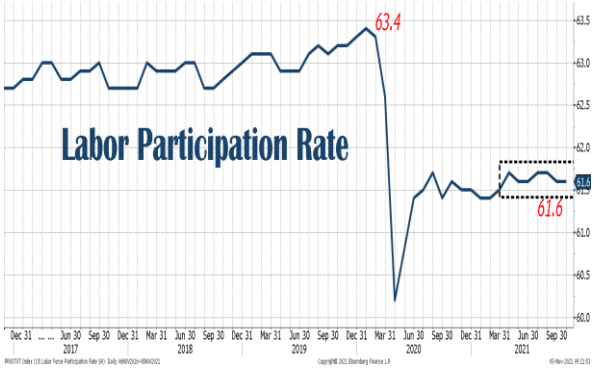
As Cuban tweeted, the vast majority of the day traders quitting their jobs aren't crypto millionaires. In fact, it's just the opposite: Most of those quitting their jobs are in "the lowest income brackets".



Since job openings (especially for lower-paying jobs) are so plentiful – and most in lower income brackets are so used to living paycheck to paycheck (or having little in savings) – they're taking a sabbatical while they play the role of amateur crypto trader. If true, this sounds like dot-com all over again. Remember how that game ended?



It also safe to say that not everybody sitting at home is sitting on a cushion of crypto wealth. Like the dot-com bubble, by the time idle people realize they can't really live off their crypto winnings indefinitely, people will return to the work force, the participation rate will rise and wage trends will get capped as job competition comes back.



Whether demand for work returns gradually, or all at once, will be a key question for markets and the economy going forward. Note: If the participation rate stays low and wage growth continues to accelerate, the bullish call on bonds will end up having a short leash. Labor costs are the key to the inflation story.

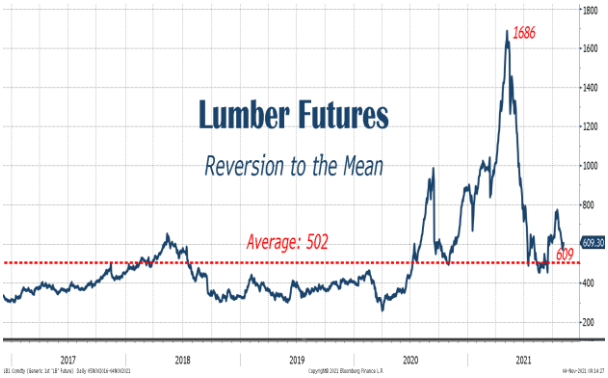
In October, hourly wages rose +0.36% – tied for the softest print since March. The base effect did take the year-over-year trend to 4.9% from 4.6%, but it is a false breakout. If we have two more prints like we had in October by year-end, the year-over-year trend will be down to 4.3%. For perspective, when the pandemic first hit the pace was 3.5%. Digging a bit deeper, wage growth surged 12.4% in leisure and hospitality. The wage inflation in the other 88% of the economy is running at +4%. Is that something for everyone to get all worked up about?

REVERSION TO THE MEAN

"Rule #1: Markets tend to mean revert over time." – Bob Farrell

The hype and hysteria over inflation doesn't cease yet there are many signs indicating the commodity cycle has already turned. Take a look at iron ore futures which have slumped from $240/ton to to a six-month low of less than $100/ton (on shrinking steel output in China). The current price is now very close to the average of $76/ton.

Lumber futures have also normalized as prices are heading back down and are now off 65% from May's peak. Yet there is nary a peep anywhere about this reversion to the mean.



In the commodity complex, the S&P/Goldman Sachs industrial metals index has been down six of the past eight days to its lowest level since September 30. The agriculture index is down more than 6% and nary a word about this anywhere. Corn has plunged 28% from the May peak. Aluminum and zinc are down -20% and -15%. No mention of it. Ditto for soybeans as prices are off 29% from the May peak. Eggs and wheat are down -36% and -10% respectively. Nary a word on this and dare I say, pork bellies are down 38%, hogs are down 33%...shhhhh.

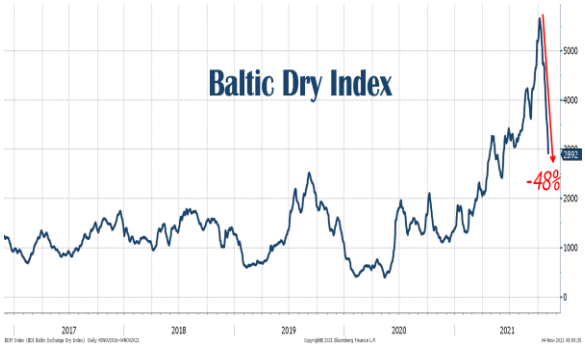
Yet, everything I read tells me that commodities – all commodities – are exploding higher. Whoever is writing that stuff should invest in a Bloomberg terminal and see the charts of the exhaustive list of commodities that have cascaded lower.

Moving on. The Baltic Dry Index is down 50% from the peak of a month ago. But I have not heard a peep from anyone.

For the bond bears, the rise in shipping costs was a posterchild to support their inflation views until, well…it wasn't . This index is a measure of what it costs to ship raw materials – like iron ore, steel, cement, coal and so on – around the world. As such, the Baltic Dry Index is a leading indicator that provides a clear view into the global demand for commodities and raw materials. A decline in shipping container prices is one of the first signs of easing supply chain issues.

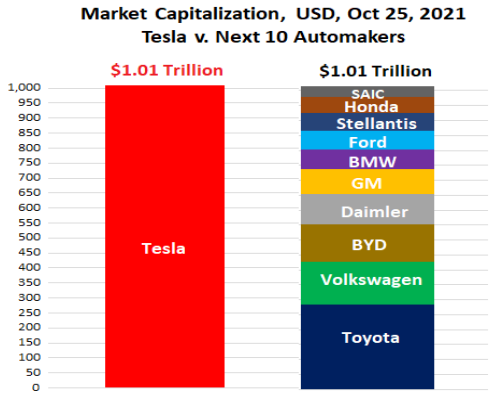
Here's an interesting side note: Did you know that the unprecedented backlog of container ships ready to be unloaded and ease the inventory shortages in the U.S. is already taking hold and may be accelerating? That's because the ships off the ports of Long Beach and L.A. are moving to Florida where the seaports are open and labor and environmental policies are far less restrictive than in California. A very interesting development indeed.

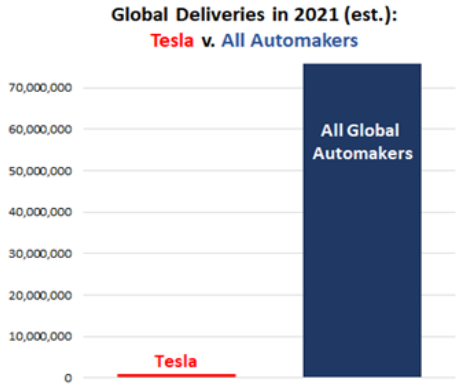
And think about this. Some U.S. companies have switched their production model from just-in-time (JIT) to just-in-case inventory (JICI). JICI allows companies to store more inventory and will help ensure future orders are filled. But what if companies order too much merchandise and and leads to a massive inventory gluts. In other words, ordering too much could be the next big headache for U.S. companies if supply chain stress continues to ease.



WALKING ON WATER

Tesla joined Apple, Microsoft, Amazon and Alphabet as one of the U.S. companies worth more $1 trillion. As seen in the graph below (left) from Wolf Richter, the market share of Tesla is now equal to the largest auto companies combined. Next stop: $2 trillion? Its a mad, mad, mad, mad, mad, mad, mad, mad world.





Year to date, Tesla sold 627,000 vehicles globally. For the full year 2021, deliveries might approach 900,000 vehicles. On the other hand, total deliveries globally of vehicles by all automakers combined will be close to 75 million vehicles. If Tesla can deliver 900,000 vehicles and all automakers globally combined can deliver 75 million vehicles, then Tesla's

global market share would surge to a record breath-taking dizzying 1.2%. (See graph on right above). I repeat: 1.2%! So, Tesla's global sales have soared from nearly nothing to very little.

Here's the thing. The boring "old' car manufacturers are priced on day to day sales and earnings. Tesla's valuation is priced on hope. Yes, I think everyone will agree that the future for EVs is bright. But does anyone really think that there will be sufficient growth to pay $332 for a $1 in earnings that "justifies" Tesla's market cap? Or how about competition? Going forward, consumers will be able to buy and EV from the old car makers as well.

But for now, Tesla has a cult-like following and Elon Musk is the modern day equivalent of Thomas Edison. In the eyes of many, Elon walks on water.

NO TAPER TANTRUM (YET)

According to Fed Reserve Chair Powell, the tapering of asset purchases will start later this month and wind down completely by mid-2022. The Fed also said it is "prepared to adjust the pace of purchases if warranted by changes in the economic outlook." In other words, it confirmed that tapering begins in mid-November with a $10 billion drop in Treasuries and $5 billion in MBS, then declining by $15 billion every month unless something "breaks".

Powell also stressed that inflation is not due to a tight labor market, but rather supply bottlenecks. For all the hyperventilating in the markets, Powell sees no sign of a wage-price spiral and emphasized that productivity is strong. He also commented that "our tools cannot ease supply constraints," which is a dagger in the heart of those predicting rate hikes to come sooner rather than later, if at all (it will all come down to how the economy performs).

Perhaps the most important comment from Powell was about the jobs market:

"There is still ground to cover to reach maximum employment. The inflation that we're seeing is really not due to a tight labor market."

If that is in fact the case, then inflation, by definition, is not going to become a persistent and insidious problem despite what the consensus economics community believes.

"Inflation is elevated, largely reflecting factors that are expected to be transitory. And the comment that "supply and demand imbalances have contributed to sizable price increases in some sectors." – The FOMC Statement

Powell seems certain that the supply chain issues will be resolved with only timing being the issue. He sees inflation lingering, but then coming down. Bang on!

As for rate hikes, they are not on his radar screen, Powell went to some lengths to emphasize that the pace of tapering does not imply there will be a rate hike any time soon.

JANET SAYS…

Treasury Secretary Janet Yellen says inflation is "COVID-linked and transitory." Take note that Janet Yellen still has close ties to the Fed. You know what that means, right? It means that Powell is hardly likely going to do anything without Janet's blessing.

Here is what the Treasury Secretary had to say:

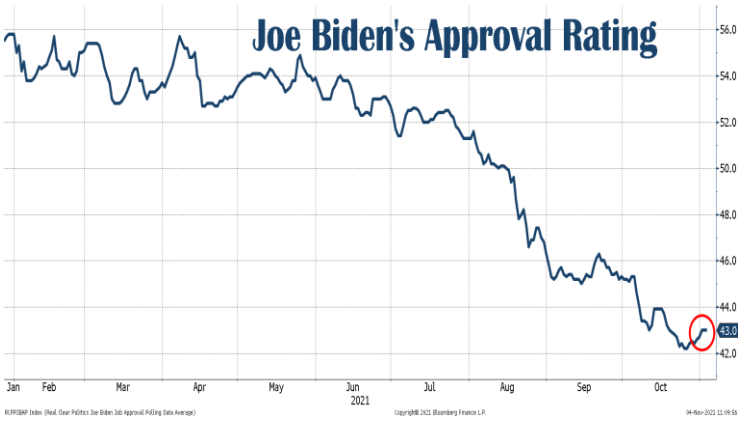
"We are experiencing inflation that's higher than we have seen in a number of years. Again, I think this is pandemic related. In the U.S., demand for durable goods has surged by more than 30 percent and that is combined with pandemic closures in parts of the world where we are reliant for supplies of semiconductors and other products.

"It has led to a series of bottlenecks, boats lined up at ports; shortages of semiconductors have constrained vehicle production and it has led to price increases. But I believe that as we get beyond the pandemic that these pressures will ease and, in that sense, I believe the inflation is transitory and we don't have an economy that is in a longer run sense overheating."

RED WAVE COMING?

In wake of President Biden's 43% approval rating (which has plummeted 10% since the summer), there is a high likelihood that we start to hear more about a "red wave" coming in the midterms next November. Let's just say that the GOP's strong success in Tuesday's local elections shows that the public, even in blue states like New Jersey and Virginia, is getting fed up with these left-leaning policies that President Biden "never" campaigned on.

A likely GOP electoral victory in the 2022 midterms will take us back to an era of fiscal restraint as opposed to fiscal recklessness. The era of fiscal largess is over and few realize that it was such largess that has caused the level of GDP to be 5% higher than it would otherwise be.

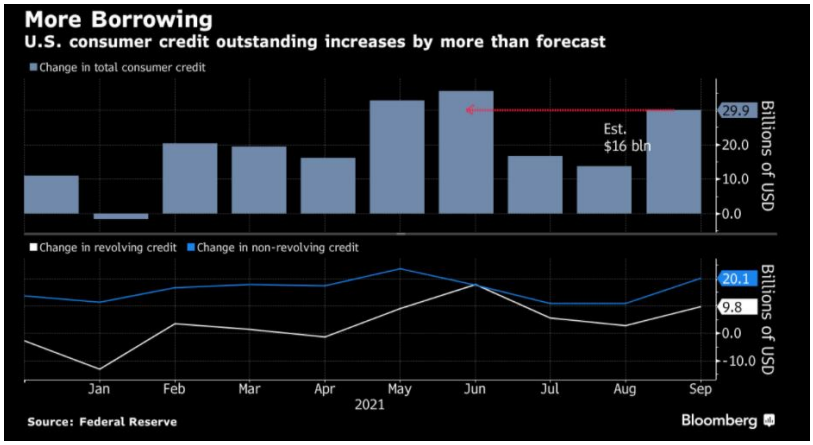


EXCESS SAVINGS RUN OUT

The latest consumer credit data confirmed that total consumer credit soared by $29.9 billion, almost double the $16 billion expected, and well more than 100% higher compared to August. Notably, after shrinking for two consecutive months, credit card debt soared by just shy of $10 billion – the second highest this year – and pushed the total revolving credit outstanding back over $1 trillion for the first time since April 2020.

In short, after revolving credit shrank and then barely grew in the aftermath of the COVID pandemic, it now appears that things are largely back to normal with credit cards serving as the primary source of discretionary funding for most

Americans. I bring this up just in case you hear from some Wall Street pundit proclaim that America's middle (and lower) class still has trillions in "excess savings" left, which they clearly don't.



WHAT IS THE YIELD CURVE SAYING?

The spread between the 10-year and two-year yields is a good predictor of economic downturns. As shown in the graph below, the yield curve has flattened with the two-year yield rising amid heightened expectations of Fed rate hikes, while the 10-year yield has dropped well off the highs. As such, the bond market seems to be saying that Fed rate hikes are coming, but the inflation problem will fade and growth will slow down.

Another key point: Solid demand from investors has also supported long bonds and kept their yields lower than would otherwise be the case. Note that the bid-to-cover ratio for the 10-year and 30-year Treasuries bond auctions so far in 2021 has, on average, exceeded that of the prior five-year average. The opposite is true for two-year and five-year bonds. So perhaps it is the case that “transitory” is lasting longer than expected, but the nature of the bond market movements suggest that it is also far from “permanent.” So while inflation is accelerating, it will ultimately settle back down to the low levels seen over the past few decades.

That said, it the curve is comfortably in positive territory. Thus, the likelihood of a U.S. recession over the near term is low, at least according to the yield curve. However, the risks rise once/if the Fed begins the process of rate hikes in mid-2022, as the futures curve is now discounting. Remember that Fed tightening cycles have been followed by recessions 75% of the time in the post-WWII era. Furthermore, if prior QE tapering episodes are any guide, look for the recent curve flattening to continue towards an eventual inversion. And then the next recession.

The one thing recent history teaches us is that the Fed tends to over do it in both directions. So, if the Fed does indeed start to tighten the vast over-indebtedness, cycle after cycle, this means that rate spasms get truncated as the economy cannot withstand the higher debt-servicing costs.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Fears of serious, durable inflation, aggressive central bank action and subsequent financial market chaos are still wildly premature. The violence of the recent short-term bond sell-off looks like it has been exacerbated by hedge funds being forced to liquidate trades. Notably, longer term government bonds remain sedate. That reflects the view that inflation is accelerating but will still ultimately settle back down to the low levels seen over the past few decades. "After all, the forces that have battered down inflation since the 1980s – such as globalization, technology, demographics, debt burdens and the weakening bargaining power of labor – are unlikely to reverse.

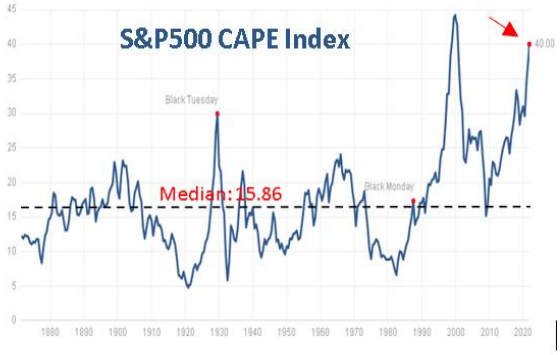
The Fed sees a link between employment and inflation. Indeed, while such a link ebbs and flows through time, it has been strong in the post-Great Financial Crisis era. So, in the eyes of the Fed, the fact that the participation rate has made no progress in nearly 18 months is one strong data point that would suggest to the Fed that inflation is "transitory". If inflation is "transitory" then there is no need to tighten policy aggressively.

Meanwhile, investors are extrapolating today's inflation environment into the future. As such, the rate-hikes are being pulled forward by the market. Yet, several factors suggest the market is overstating the inflation risk. Rising prices are being driven more by supply bottlenecks than a surge in demand. And that's a problem that interest-rate increases won't solve. Raising rates will not fix congested ports, logistical bottlenecks, selective labor shortages or under-investment in energy infrastructure.

Simply put, it is very difficult for me to believe that the first global pandemic in over a century will be the one single event to prompt a future wave of permanent inflation. Yet many people believe it!

Are there currently risks to the bond market to be concerned about near term? Yes. The current spike in inflation will likely last longer than expected due to the break of supply lines. Furthermore, rates tend to rise when the Fed begins to discuss "tapering" their bond purchases as they are doing now.

However, both of these issues will resolve themselves going forward. Eventually, the supply chain disruption will mend and inflation will decline as supply comes back online. More importantly, when the Fed does begin the process of "tapering" their bond purchases, yields historically fall as investors' "risk-preference" shifts from "risk-on" to "risk-off."



As shown above, the latest CAPE ratio for the S&P 500 Index is 38x. That's pretty close to the all-time record, which was 44x back in 2000. For those with a short memory, that was just before the dot-com bubble burst and stock markets (particularly tech) crashed hard. Valuations, by themselves, are a terrible timing metric. However, they tell us a great deal about expected future returns and current market psychology. And for now, investors have "no fear" as they believe the Fed will continue to back stop the markets.

However, with the equity market grossly overvalued there is little upside to the equity market given current valuations, slowing earnings growth, a weaker economy and less liquidity. Whenever the next recession approaches, yields will once again likely approach zero.

Got bonds?

The bond market has done a big reset since the last FOMC meeting on September 21 and 22. The two-year Treasury yield had doubled from 0.22% to 0.44%. The five-year yield had risen 60 basis points to 1.21% and the 10-year Treasury yield has jumped nearly 30 basis points to 1.70%.

But last week, the bond market saw a big reversal. The 10-yearTreasury yield has now dropped 23 basis points to 1.478%. The long bond is down 23 basis points to 1.904%. In the belly of the yield curve, the five-year Treasury yield fell 16 basis points from 1.241% to 1.085%. Even on the front end, the two-year Treasury yield fell eight basis points to .428%.

A new monetary regime is starting but the reality is that it will probably look uncannily much like the last one. Lower for longer.

In terms of portfolio strategy, we continue to advocate a fully invested, risk appropriate ladder approach to managing excess liquidity.

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.