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INVESTMENT SERVICES

Weekly Relative Value

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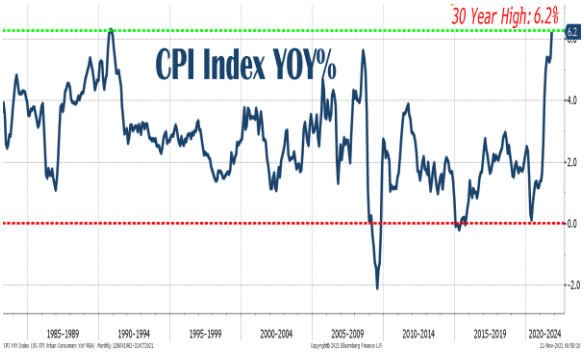
WEEK OF NOVEMBER 15, 2021

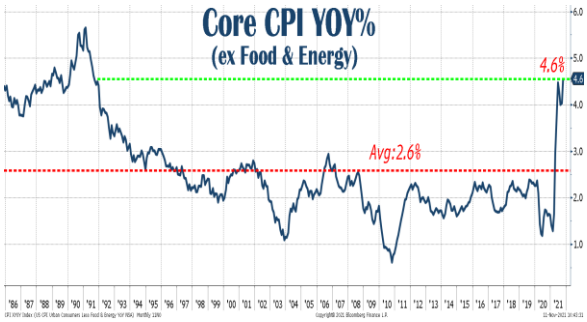
Eye-popping!

"Eye-popping' inflation readings are driven by supply-chain breakdowns and will subside as COVID does, and the Fed's decision not to raise rates in response is the right one… Raising rates now would not solve the global supply-chain issues but could start to bridle growth next year just as inflation pressures are receding and cost the economy both output and jobs." – San Francisco Federal Reserve Bank President Mary Daly

The Consumer Price Index (CPI) in October was super-hot, with the headline spiking up 0.9% month-over-month versus consensus estimates of +0.6%. The year-over-year trend hooked up to 6.2% from 5.4% in September. These are the highest increases since November 1990 (6.3%).



Excluding food and energy, core CPI spiked to its highest since August 1991.



As the pundits and headlines hyperventilate over inflation, the important thing to note is that when you strip out the rent and auto sectors, the "core" (excluding food and energy) CPI was up just 0.2%. Whoopee!

THIS WEEK

- ALL-TIME LOW REAL RATES
- WHAT, ME WORRY?

PORTFOLIO STRATEGY

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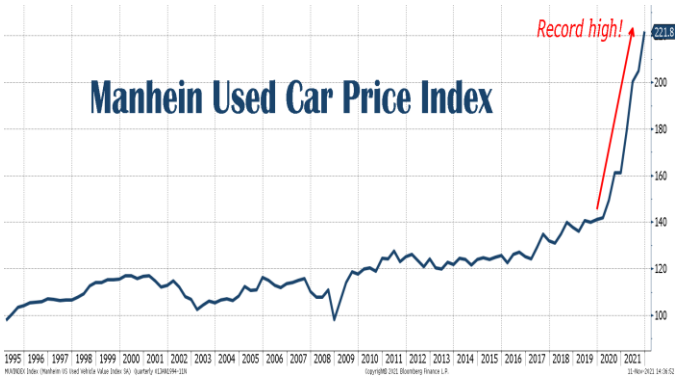
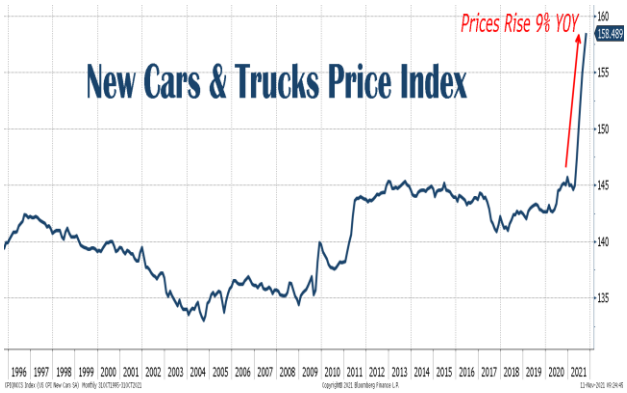
Let's discuss the primary inflation drivers in more detail.

First, anyone shopping for a used car has been sticker shocked by soaring prices since the pandemic began. There's a global shortage of semiconductor components, which has shuttered auto plants and crimped new car output. Lower inventories at dealerships forced many people onto secondary markets (e.g., used car market), searching for the next best option, pushing prices to record highs. For a bit of perspective, prices for used vehicles actually fell over the 20 years between 2000 and 2020. That has all changed since the COVID pandemic.

Since the pandemic, prices for used cars and trucks have exploded higher. Case in point: The Manheim U.S. Used Vehicle Value Index jumped 9.2% month-over-month in October. This brought the index to 223.7 (a new record high). From a year ago, the index is up a whopping 38.1%.



At the same time, prices for new cars and trucks spiked by 1.4% for the month and by 9.8% year-over-year, the biggest and nastiest price spike since 1975.

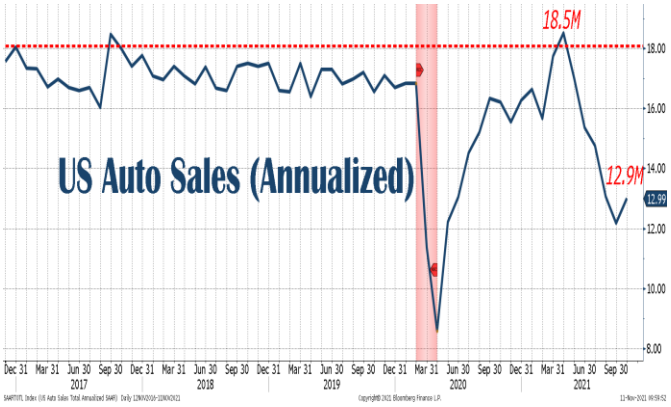


Many say it's the robust demand. Really? If so, why are auto sales at recessionary levels of 13 million units? Is this all about dealer inventory? Or is it possible that the pent-up demand was filled when sales approached classic peak levels of 18 million units in the spring as the fiscal stimulus checks rolled out?

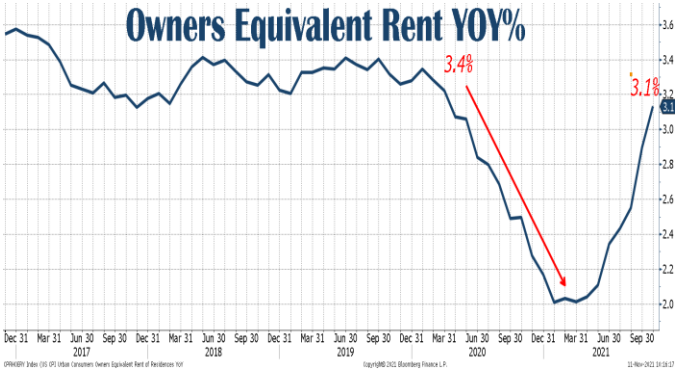
Regardless, as we move forward, the chip shortage seems to be easing, allowing automakers to ramp up production. To wit: Toyota is aiming to produce roughly 1 million units in December, a 30% year-over-year increase. Next year, the automaker is planning to produce 850,000 vehicles per month next year. This will play a key role in easing auto-sector price pressures next year. Yet stories like these receive very little press coverage.

Likewise, General Motors reported last week that it is seeing a better flow of semiconductors.

"Most of its assembly plants in North America are now back to running regular production… In fact, the week of November 1 represented the first time since February that none of our North American assembly plants were idled due to the chip shortage." – GM spokesman



Another big reason why CPI has popped is because of rising rents. During the pandemic, rent had plunged but has since made a V-shaped recovery. "Owner's equivalent rent (OER)," accounts for 23.6% in the overall CPI and is a substitute to track the costs of homeownership, is based on surveys that ask what homeowners think their home might rent for. It rose 0.4% for the month and was up 3.1% year-over-year. Even still, as shown below, the OER is still lower than pre-pandemic levels (3.4%).

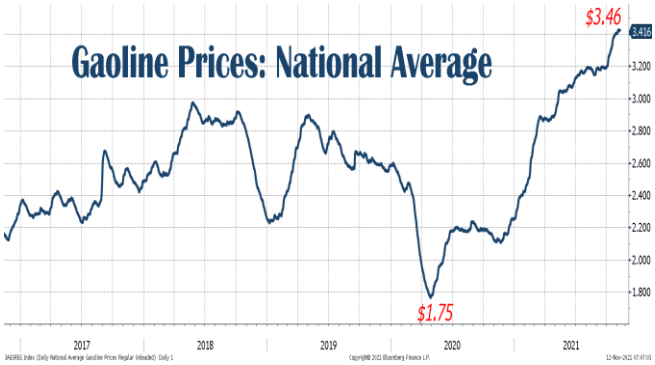


This is primarily a supply issue. Multiple-unit completions are down 30%, which caused this dive in the vacancy rate and huge growth in rental inflation. Now there is a boom in new supply from multi-family housing starts and permits. Not to mention there has been an ever-rising inventory of single-family housing that will be rented out. Supply cometh and rental rates will reverse course before long.

Moving on. Energy costs, which account for 7.3% in the overall CPI, spiked by 4.8% for the month and by a whopping 30% year-over-year:

- Gasoline: +6.1% for the month, +55.6% year-over-year
- Utility natural: +6.6% for the month, +28.1% year-over-year
- Electricity: +1.8% for the month, +6.5% year-over-year

Think about this. Oil prices are about 30% higher now than before the pandemic even though gas expenditures are down 0.9%; miles driven are down 6%; and air travel is down 19%. So, this isn't about strong demand one bit. Once again it is a supply problem. Domestic energy is still 6% below pre-pandemic levels, and petroleum import volumes are down 5% because of stinginess by the Organization of the Petroleum Exporting Countries (OPEC+).



At the grocery store, food prices have jumped quickly. Food costs, 14% of overall CPI, jumped 0.9% for the month and 5.3% year-over-year. Prices for meats, poultry and fish spiked by 11.9% year-over year, with beef spiking by 20%. Assuming you can find a turkey, this Thanksgiving dinner could be the most expensive ever.

But what can the Fed do about the price of food unless Fed Chair Jerome Powell & Co. want to become farmers? Once again, all fingers point to the supply-side in the agriculture sector as food production is nearly 2% lower now than before the COVID-19 crisis. The Fed has no control over the culling of herds, droughts, floods and supply shortages from disrupted supply chains. I should also add that relief may be on the way as the commodity futures space is already pricing in lower prices with the Commodity Research Bureau's (CRB) foodstuffs down 6% from the highs.

Regarding the all-important labor market, as of the October payroll report, the U.S. economy remains 4 million jobs shy of its pre-pandemic level. What are these people doing? For some, the health risk of COVID-19 remains a key reason to stay on the sidelines. So, these people could come back quickly as the virus subsides.

For others, the willingness to sail into the sunset comes from the "wake up and smell the coffee" and "you only live once" psychology. This change in sentiment has been made possible due to multiple years of asset appreciation, especially the inflated equity portfolio.

But here's the thing. When you're 55, and look at the life expectancy table, you realize that you're going to live another thirty years. So, to treat the portfolio as something that can replace a paycheck to fund "early" retirement lifestyles may lead to tremendous regret for the millions.

It may be true that people can – for a while anyways – just stay home and play video games, live off their crypto winnings or equity portfolio gains. I don't believe that will last long. Rest assured that the next bear market will usher a wave of employees back into the workforce.

And if these folks decide they will have to re-enter the workforce, they are likely to face another reality, which is that their old job has been automated away as the "return of labor power" will be quashed. One of the best Wall Street Journal reads of the week was "Sales of Robotics Increase With U.S. Labor Shortage."

"'Transitory' has become a dirty word." – Atlanta Fed President Raphael Bostic

In summary, the overwhelming consensus is that the inflation genie escaped the bottle and will not be put back in. I take the contrarian stance. Undoubtedly, the inflation situation has surprised a whole lot of people, including me, but I think that it's explainable in the context of the pandemic and the global supply chain problems, which were exacerbated by massive and unprecedented fiscal stimulus. But the stimulus is in the rearview mirror. As such, demand will slow, supply will catch up and prices will then subside. In other words, the recent spike in prices should prove to be "transitory."

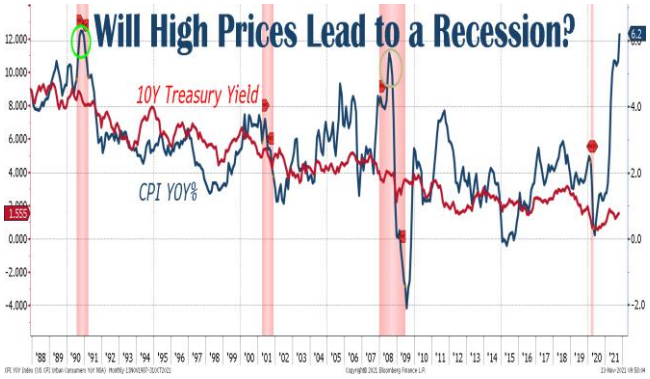
That said, it's difficult to know how you define "transitory." Is it months, is it quarters, is it a year? Most likely, high inflation readings will remain in place for a few more months. But unequivocally, this is not the 1980s when inflation was driven by demand, or the 1970s when it was a combination of supply and demand. This is all about supply. And it has little to do with central bank policy. The Fed can't influence supply. Powell is not going to grow corn or wheat, or drill more oil, or build semiconductors.

"Soon enough we'll be back to that situation in which we had, for more than a decade, forces pushing inflation down, not pushing inflation up." – Federal Reserve Bank of San Francisco President Mary Daly

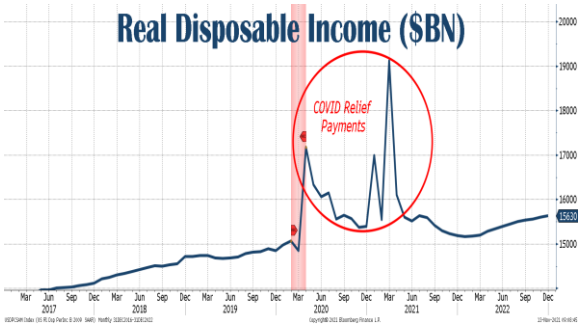
Finally, here's something to think about. Inflation is back to where it was in October 1990 and July 2008. Guess what? The economy was recession-bound both times, the Fed's next move was "not" to raise rates and Treasury bond yields plunged in the coming 12 months (and by a lot!). The reason being that inflation sowed the seeds of its own demise in terms of crushing real purchasing power. Bob Farrell's Rule #9 reigns.

Rule #9: "When all the experts and forecasts agree – something else is going to happen" – Bob Farrell

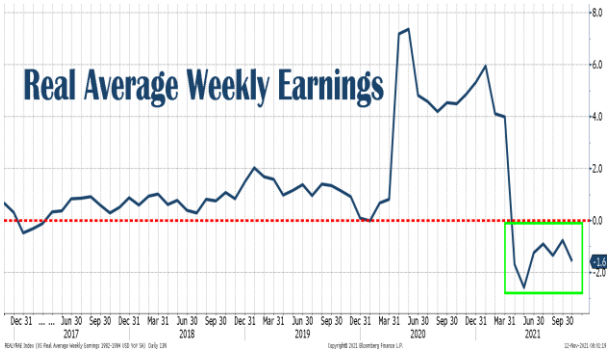
The same thing is happening now. Take a look at the graphs below showing real disposable income and real average weekly earnings. The economic growth we've seen came not from the Fed and from the massive fiscal stimulus. This in turn led to the current inflation.



For those that believe the $2 trillion of "excess savings" will be spent, think again. The data show that 97% of the time savings remain well…savings. Consumers spend cash flow, and that comes from income. As the fiscal taps dry up, consumption will sputter as it did in the third quarter.

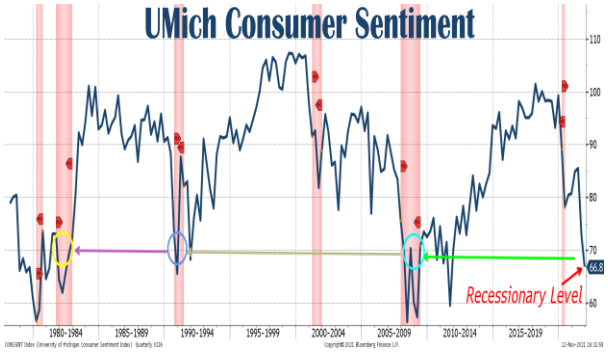


Real weekly earnings have turned negative since March and are now running at a -3% annual rate.



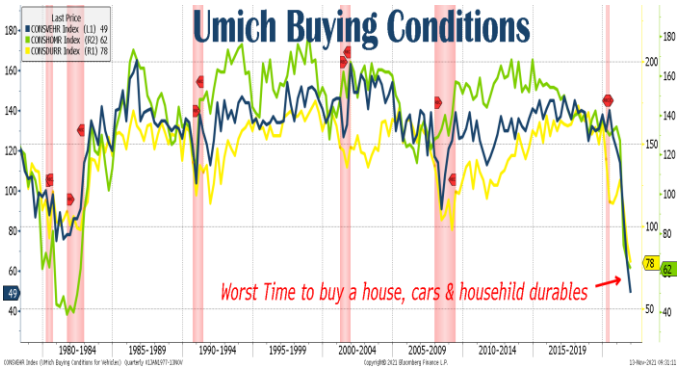
In the University of Michigan Consumer Sentiment Index report, the household assessment of the future jobs market was tied for the weakest in nine months; and the expected income growth for the coming year eased to 2.0% from 2.6% in October. So much for the anticipated wage explosion you read about in the morning papers and the daily blogger.

Also, the UMich headline consumer sentiment plunged from 71.7 to 66.8 (way below the 72.5 expected). That is the lowest since 2011.



The survey showed that demand for durable goods was down five months in a row to the lowest level since May 1980. Auto-buying plans have fallen for seven straight months to a record low. And for housing, intentions to buy a home are back to recessionary September 1982 levels. The proportion of households who expected to be worse off financially stood at 24% in November; the last time a higher figure was recorded was in June 2008.

As they say, the best cure for high prices is high prices. It is against this backdrop that I retain the view that once these global supply issues get resolved, it will nip the current inflation cycle in the bud.



ALL-TIME LOW REAL RATES

"What markets are seeming to price is a return to secular stagnation, or Japanization," – Former U.S. Treasury Secretary Larry Summers

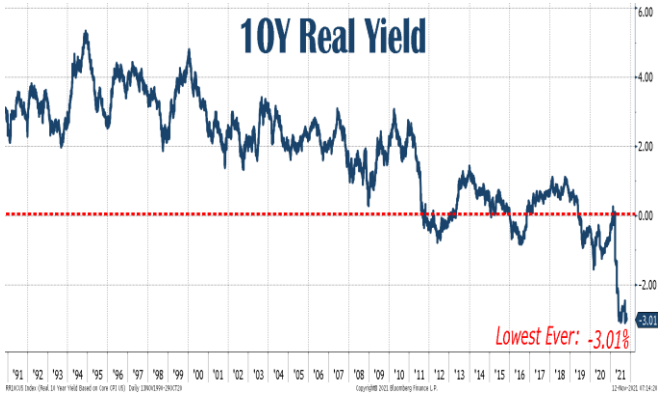
Rather than the outlook for inflation, the most important question for the market is identifying the driver behind incredibly low negative "real" (inflation-adjusted) rates. Indeed, as shown below, the real 10-year Treasury yield has continued to slide despite the Fed's formal announcement of a taper. Currently, it is negative 3.01%.

What is the cause?

If the answer is too much savings and liquidity, it implies front-end yields will have to go much higher to tighten financial conditions.

On the other hand, if it is a very low terminal rate (neutral interest rate, consistent full employment and stable prices), it implies the tipping point towards slowing growth is closer than assumed. In other words, the Fed is tapering – and tightening – into a recession.

As 2022 comes in to view, assessing the relative importance of the two is going to be critical for the market outlook.



WHAT, ME WORRY?

"Asset prices remain vulnerable to significant declines should risk sentiment deteriorate, progress on containing the virus disappoint, or the economy recovery stall."

Last week, the Fed released its latest semi-annual Financial Stability Report (maybe it should be called "instability" report). For the first time, this report contained an entire section on how the financial markets have become infiltrated with neophyte investors, and the dangers that lie within.

Of course, the ultimate irony is that much of the extreme market valuations are a product of the Fed's own policies.

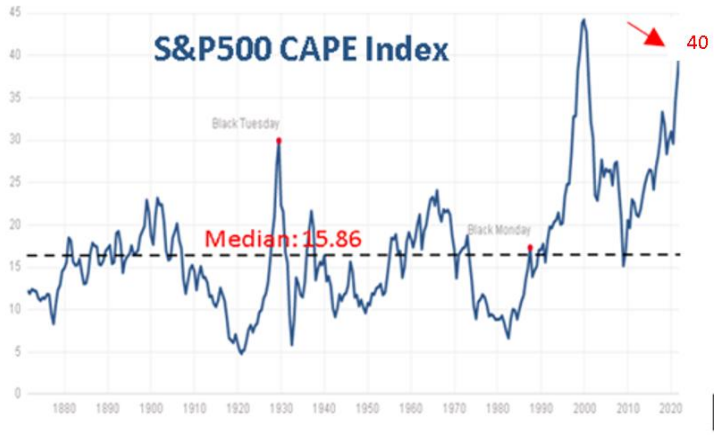
*"Across most asset classes, **valuation measures are high relative to historical norms.** Since the May 2021 Financial Stability Report, equity prices rose further. While this increase is due, in part, to improved earnings expectations, **the ratio of prices to forecasts of corporate earnings stands at the upper end of its historical distribution…***

"Prices of risky assets keep rising, making them more susceptible to perilous crashes if the economy takes a turn for the worse. Asset prices remain vulnerable to significant declines should investor risk sentiment deteriorate, progress on containing the virus disappoint, or the economic recovery stalls." – Bloomberg

Here's the point: Asset values are more hitched to the Fed than ever before. And the economy is more sensitive to financial assets and real estate than ever before. Meanwhile, valuations across equities, real estate and corporate credit are at nearly unprecedented nosebleed levels. The S&P forward P/E (price-to-earnings) multiple, at 21.5x, is at a 17-year high. The CAPE (cyclically-adjusted price-to-earnings) ratio is now over 40x for the first time in two decades. Margin debt is up 38% year-over-year, and in the past two months, has topped $900 billion for the first time ever. Leverage is huge! Gambling has become a totally acceptable way to treat your finances.

The market is highly overvalued, yet caution has been thrown to the wind. (Then again, throwing caution to the wind has worked wonders over the past 20 months.) Complacency is everpresent and sentiment is wildly bullish as equity portfolio managers are all in with razor thin cash ratios of 2%.

We are living through the largest asset bubble in modern times: stocks, real estate, corporate credit and cryptocurrencies. (Did you know that the crypto currency market is now valued at over $3 trillion, six times the $500 billion a year ago?). These are dangerous times but have been camouflaged by massive and repeated doses of policy stimulus. While markets seem calm and healthy, valuations portend they are incredibly risky. Less liquidity and higher rates will bring the party to an end. The Fed knows this.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

Are there currently risks to the bond market to be concerned about in the 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 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.”

The real risk is if the Fed tightens next year as the futures market is now pricing in; the impact on dampening already-soft demand will coincide with the pandemic morphing into an endemic and the supply-chain issues getting resolved. Deflation will come rearing its ugly head again.

What’s interesting is that the bond market, for the most part, has this figured out. And that is what the yield curve is signaling as the 5s/30s spread is at its flattest since pre-COVID.

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.