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INVESTMENT SERVICES

Weekly Relative Value

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Flashing Red!

"Every indicator is flashing red." – Bill Ackman, hedge fund manager

There has been a groundswell of anecdotal information pointing to a wave of early retirement. As I wrote last week, the willingness to sail into the sunset comes from the "wake up and smell the coffee" and "you only live once" attitude. This change in perpsective has been made possible due to years of asset appreciation, especially from the inflated equity portfolio.

So people want to take advantage of their good fortune and kick back and enjoy life. That may be true, but just how long can this last? According to the Fed's survey of consumer finances published in 2019 and ajusting for the recent run up in equity prices (S&P 500 rose 40% over this period), the median value of equities inside and outside of retirement accounts both directly and indirectly in mutual funds are $240K for those aged 45-54 and $340k for the 55-64 cohort. Seriously, you want to retire early on this nest egg?

Furthermore, according to the Consumer Expenditure Survey the typical retiree spends $50,000 per year. So if you retire between 45 and 54, your equity assets will cover your expenses for just over four years. What do you do next?

And if you're retiring in the 55-64 age cohort, your equity portfolio will cover you for seven years.

If you make it to 64, the odds are very high you will live another 20 years. Maybe your pension and Social Security will help, but to think that your bloated portfolio is going to be nearly enough to live comfortably in the years ahead may well end up being a reckless and dangerous proposition.

"Current conditions demand greater forethought and planning than in the past, when lower valuations and loftier yields paved the way to higher future returns." – Morningstar

According to Morningstar, someone retiring with a $1 million portfolio and expected to live another 30 years past retirement should plan on withdrawing 3.3% of their savings a year. This is down from the standard well-entrenched assumption of 4% (based on a portfolios made up of 50% stocks and 50% bonds). That's a a 7.5% decline from $40,000 a year to $33,000.

THIS WEEK

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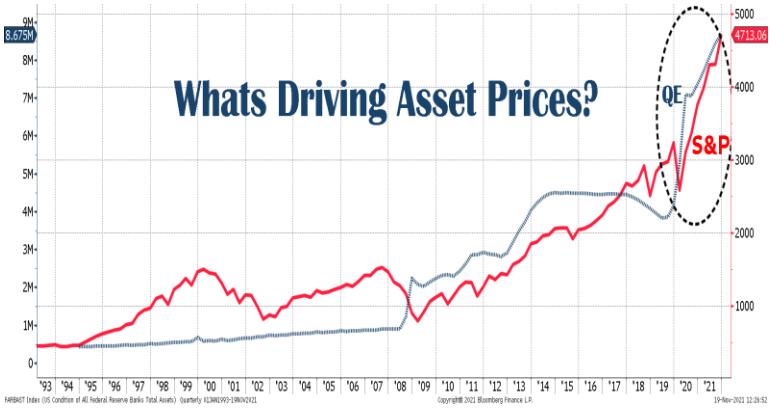
The reason for the lower payout is due to the lower expected returns from assets over the next two-three decades. To wit: Morningstar is predicting that U.S. large cap stocks will deliver an inflation-adjusted return of only 2.74%. Investment-grade bonds are expected to generate -0.11% in inflation adjusted terms. With pensions being a relic of the past and Social Security benefits at risk of being cut, there's not much of a safety net for people who run out of their own savings.

WHAT IF THE "EVERYTHING BUBBLE" BURSTS?

"…Investors need to respect that they're riding a huge liquidity wave thanks to the Fed, and that wave will eventually break as monetary stimulus winds down. ***So investors should keep an eye on the risk of an abrupt shift from a relative valuation market mindset to an absolute valuation one, or an environment in which you stop worrying about the return on your capital and start worrying about the return of your capital****. That's a risk to watch because not only would it mean higher volatility, but also, and most critically, an undue hit to the real economy." – Allianz Chief Economic Advisor Mohamed A. El-Erian*

The reason asset prices have levitated to the bubblicous levels seen today is because of easy money and massive liquidity. This has created a carnival of Fed-induced speculation. For those that believe it's the economy that driving prices higher take a look at the following graph.



The Fed's ZIRP and Quantitative Easing (QE) programs have been the primary drivers of asset prices for quite sometime. Since the beginning of the COVID-19 recession the Fed's asset purchases have risen 80%. This essentially mirrors the rise in the S&P 500 over the same period of time. In the meantime, asset prices have totally detached from economic reality and corporate fundamentals. Once again, it's all a liquidity story.

When central bankers drive interest rates too low, yield-starved investors respond by searching for any risky security that will offer a "pickup" in yield. Wall Street responds by issuing more "product," regardless of how sketchy those securities may be. Speculators have their day, and a collapse invariably follows. The Fed should have learned that during the mortgage bubble. The Fed has learned nothing. At every point that the Federal could have acted to limit the formation of a speculative bubble, it has doubled down instead.

Consider the following from famed value manager, Jeremy Grantham:

"The Federal Reserve simply does not understand the risks of asset price bubbles and asset price collapses. It is clear from the data that they don't get it. *Greenspan could never make up his mind whether the market was overpriced – irrational expectations – or whether it was fine. Yellen couldn't. Bernanke couldn't see a housing bubble that was a 3-sigma 100-year event. Where were the statisticians?* ***The answer is that the Federal Reserve statisticians do not do asset bubbles. They are, in that respect, utterly clueless*** *– and we apparently never see that. We are willing to look through the crash of 2000, the housing crash – really dangerous affair – they didn't do their duty, they didn't head it off, they didn't raise the limits for mortgages, they didn't warn anybody, they allowed it to happen. Yes, they did pretty good in the decline. They were pretty good at applying bandages, and stimulus, and support for the wounded. But they sure as hell should not have allowed that housing bubble to occur.*

They don't get it. They don't see the risks, and they don't see them now. And so this time, we don't just have a housing bubble. We have a housing bubble, a stock market bubble, a commodity bubble, and an interest rate bubble. This is going to be the biggest write-down." – *Jeremy Grantham, GMO, August 2021*

Frankly, the only days the stock market doesn't reach new highs is Saturday and Sunday. But the "wealth" that seems to be popping up around you almost daily is not a reflection of a brave new world or the new new thing. It is a speculative wave. I know that most people don't want to hear that. It would mean that what you consider to be "wealth" could simply evaporate as smaller prices are placed on the pieces of paper you own.

Consider these timeless words from economist Kenneth Galbraith:

"No one wishes to believe that this is fortuitous or undeserved; all wish to think it is the result of their own superior insight or intuition. *The very increase in values thus captures the thoughts and minds of those being rewarded.* ***Speculation buys up, in a very practical way, the intelligence of those involved." –*** *Kenneth Galbraith*

And more people are sending warning signals. Last week, hedge fund manager Bill Ackman stated we are in a classic bubble that's "fueled by the Fed."

"We are in a classic bubble which has been driven by the Fed. Every indicator is flashing red." *– Bill Ackman, hedge fund manager*

Even the "uber" bullish Goldman Sach's senior brass is becoming concerned about the current euphoria and greed reigning in the stock markets.

*"**When I step back and think about my 40-year career, there have been periods of time when greed has far outpaced fear -- we are in one of those periods**…My experience says those periods aren't long lived. Something will rebalance it and bring a little bit more perspective." – Goldman Sachs Chief Executive Officer David Solomon*

Yes, yes, maybe this bubble will grow even bigger and bigger. But eventually every bubble bursts! Amplifying a bubble doesn't somehow avoid its consequences – it makes the consequences of the bubble bursting worse.

"How high the peak has no bearing at all on what the fair value is. What it does change is the amount of pain that you get to go back to fair value and below." – Jeremey Grantham

"I can show, really precisely, that there are two warranted prices for a share. The one I prefer is based on such fundamentals as earnings and growth rates, but the bubble is rational in a certain sense. The expectation of growth produces the growth, which confirms the expectation; ***people will buy it because it went up. But once you are convinced that it is not growing anymore, nobody wants to hold a stock because it is overvalued. Everybody wants to get out and it collapses, beyond the fundamentals."*** *– Nobel Laureate Franco Modigliani, New York Times, March 30, 2000*

And, if you say there is no alternative to stocks, possibly you should think again. John Hussmann PhD expects that bonds and lowly, dismal Treasury bills will likely outperform stocks over the coming 10-20 years.

"I expect that the coming decade – and possibly even the next 12 months – will be a disaster for the U.S. stock market*… Measured from current extremes, I expect that* ***the unwinding of this bubble will drag S&P 500 total returns below Treasury bill returns for least a decade, and possibly two.****"*

"I know that many of you believe that the current episode of speculative enthusiasm will persist forever –that the Fed will make it persist*... Investors should also consider what might happen if valuations merely touch their historical norms – even 20 years from today – and growth in fundamentals matches that of the past 20 years. The simple arithmetic implies that the S&P 500 would actually lose value on a total return basis."*

Bottom line: Pure speculative psychology and the widespread belief that the Fed will "never" allow asset prices to fall are the only things standing between an hypervalued market that continues to advance and a hypervalued market that drops like a rock.

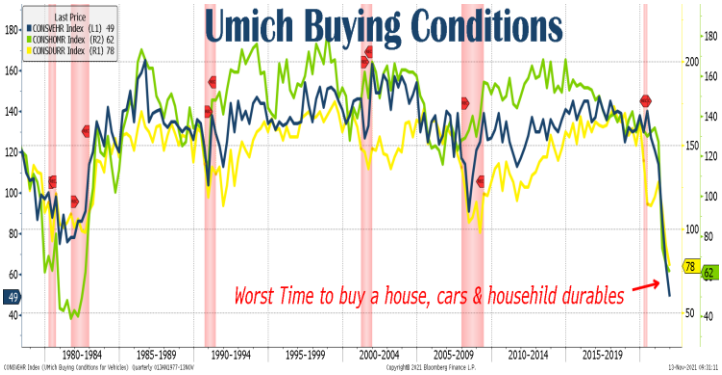
That said, I want to stress that this commentary is not intended to scare people into selling their stock holdings. As many have opined above, the market remains overvalued, overbought, overbullish. In other words, it's a bubble – all the boxes have been checked. Yet, this has been the case for quite sometime and as long as the Fed irresponsibly and imprudently prints money I say emphatically, this bubble can continue.

As economist John Maynard Keynes famously stated: **"The stock market can remain irrational longer than you can remain solvent."**

My real concern is for investors – particularly many retirees (or soon to be retirees) who, as discussed above, may have barely enough to enjoy their retirement if hit by a huge loss (30-40%) in their equity investments.

IT'S WHAT YOU DO THAT MATTERS!

As they say, its not what you say, it's what you do that matters. As discussed last week, the University of Michigan survey showed that consumer sentiment sentiment plunged from 71.7 to 66.8 (way below the 72.5 expected) – the lowest since 2011. The survey showed that demand for durable goods was down to thelowest level since May 1980. Auto buying plans have fallen to a record low. And intentions to buy a home are back to recessionary September 1982 levels.



Yet, with consumer sentiment and buying plans at decade lows, retail sales boomed in October with the headline print coming in at +1.7%, the biggest rise since last March. This was the third consecutive increase in sales (and third consecutive beat).

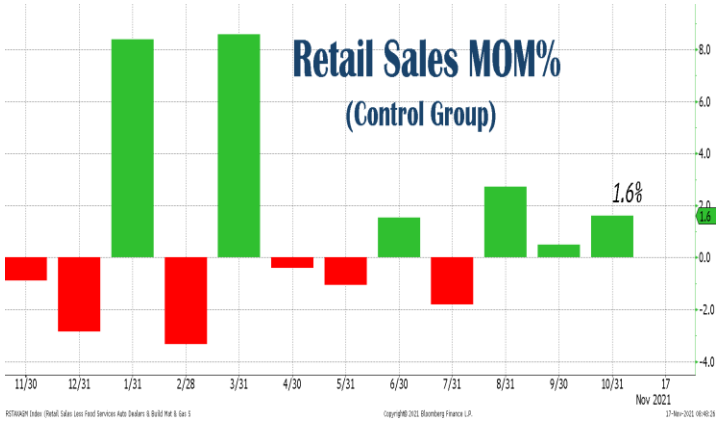
Ex-autos, sales soared 1.7% month-over-month (far hotter than the +1.0% month-over-month expected) and ex-autos, building materials, and gas stations sales rose 1.4% month-over-month and are up 12.9% year-over-year. Very heady numbers indeed!

And the key core 'control' measure – which feeds through to GDP – surged 1.6%, which was more than triple the 0.5% month-over-month rise in September and far above expectations.

But it was the breadth of the report that was most impressive. Even with gasoline siphoning 4.0%, the rest of the retail sector enjoyed a hefty 1.5% bounce. Only two sectors – clothing and accessories – saw sales drop.

So why the disconnect between sentiment and actual spending?

Possibly consumers got spooked about the supply-chain bottlenecks and stories about how retailers would not have inventory for the holiday season and decided to get a head start on their shopping? We will find out soon enough, but if true, this is simply a case of pulling sales higher now at the expense of later on.



It is also crucial to remember that retail spending is 'nominal' dollars not 'real'. To better understand this point, let's look at a couple of reports from major retailers last week.

Lowe's revenues increased +2.7% year-over-year, but unit sales were down -7.5% year-over-year. The average price per transaction was +9.4%. Likewise, Home Depot reported that sales revenue grew 5.5% year-over-year, but transaction volume declined -5.5%. Once again, higher prices saved the day with the average transaction price up 12.9%. Simply put there were few shoppers, but those that shopped paid higher prices. As for Walmart, revenues were up +4.3% year-over-year, but food sales accounted for over 60% of the overall sales growth.

Simply put, when sifting through the data you'll find that much of the retail sales gains in October were driven by "inflation" which masked the rot in the real volume. Thus, spending could be driven as much by accelerating-inflation and not confidence.

Regardless, unless there are serious downward revisions ahead this was a solid number and paves the way for a growth rebound in Q4 after a dismal third quarter. In fact, based on the incoming data thus far, the Atlanta GDPNow scorecard is at a hefty 8.2% rise for Q4.

FILLED TO THE BRIM!

For all the doomsday warnings about logjams and unloaded shipping containers off the coast of California, many companies seem to be managing just fine. In fact, the largest retailers – Target, Home Depot and Wallmart – have stocked their shelvesto the brim.

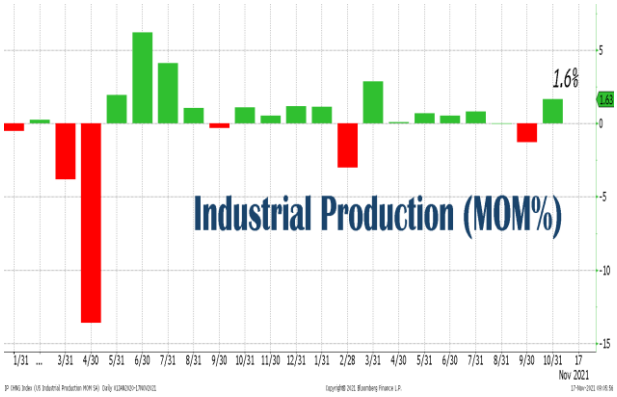
Target reported $2 billion of additional inventory – an increase of 17.7% from year-ago levels. Meanwhile, Home Depot reported that inventories have increased a whopping 27.4% year-over-year. And finally, "Where America Shops", Walmart's stockpile are up 11.5%. So, what about all of the shortages we read and hear about?

This build up of inventories may have some significant impacts on the growth and inflation as we move into next year. It would appear that retailers – hook, line and sinker – have bought into the Wall Street narrative that "excess savings" will be spent on an upcoming holiday spending binge. Remember: 97% of what people spend comes from cash flows – not savings.

As such, the risk is that the retailers have over-prepared. As mentioned above, Q4 is going to see a strong growth rebound from the anemic Q3 performance. However with retailers fully stocked, the stage is set up for a renewed weakening in economic activity in the first quarter of 2022. This could also force the retail community to begin to discount prices again (remember those days?), thus depressing the incipient investor inflation expectations embedded in the Treasury market.

BOTTLENECKS ARE IMPROVING

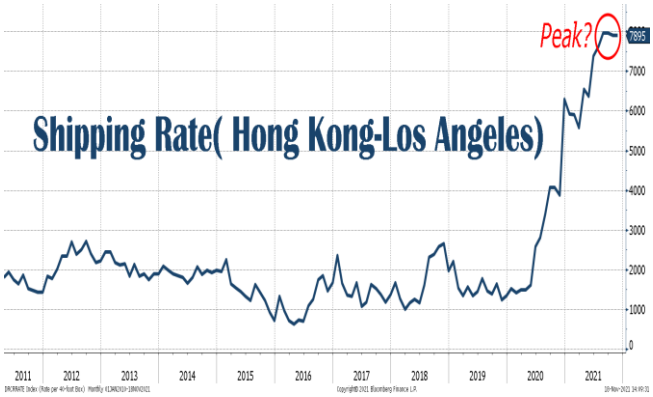
Industrial production rose a healthy 1.6% in October, the best performance since last March. Manufacturing output gained 1.2% (ending two months of decline). Of special note: semiconductor production jumped 1.9% and is now up a rock-solid 10% increase year-over-year. It should also be noted that this data does not include the booming imports from Asia seen in recent months. To wit: Korean exports ripped 27.6% through the first 20 days of November following a 24.0% October surge. Oh, and as for chip exports? Try +32.5%. As a result, motor vehicle production has ramped up big-time – soaring 11% month-over-month suggesting that even the automotive industry, hit hard by the semiconductor shortage, is navigating the supply crunch. As discussed last week, October marked the peak of the chip crunch at Toyota and GM. Bottom line: This report was terrific news for the "supply bottleneck" story. (Yes, believe it!).



Let's face it, over the past two years – from massive stimulus driven demand, extreme weather events and even a container ship getting stuck in the Suez Canal - just about anything that could go wrong with global supply chains has gone wrong. But incoming evidence suggests that the U.S. is slowly but surely making progress in easing freight congestion and supply shortages.

As shown below, the benchmark shipping rate for the Shanghai-to-Los Angeles trade route remains at extremely high levels ($7,895 per full 40-foot box), but appears to be leveling off. Meanwhile, the number of containers lingering for longer than nine days at the Port of Los Angeles has dropped by about a third.

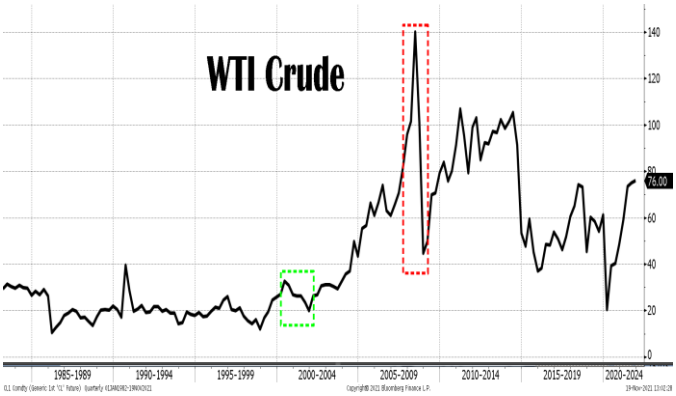
To be sure, a peak in supply-chain stress doesn't mean it's over. The number of container ships waiting to enter the ports of Los Angeles and Long Beach have declined but still remain historically high. And Black Friday is coming this week and there's probably stuff on those 80 waiting boats that some people would prefer to have. But for the supply-chain crunch to get better, it first needed to stop getting worse. That at least appears to have happened.



PEAK OIL?

Regarding commodity prices, oil is the key to the inflation story. Oil has a 75% correlation to the headline inflation rate like. Metals? Try 30%. Agriculture? Try 40%. Textiles? Try 25%. And that is because oil is a critical input into all the items of the consumer price index (CPI), not to mention what energy does to transportation costs and all the spinoffs that entails.

Over the past 12 months, oil has risen 106%. Based on prior episodes of a doubling in the oil price within a year, the following twelve-month period isn't so kind.



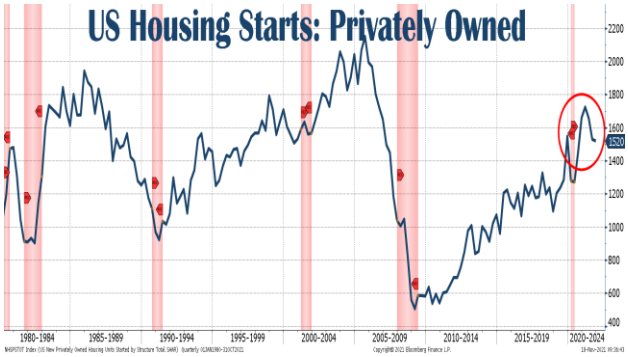
The wonderful thing about high prices is they bring on more supply (U.S. energy production is now 10% above year ago levels) which then pressures the price lower.

And for all the talk about booming demand did you know that gasoline usage (volume terms), miles driven or air travel, are all below where they were pre-COVID-19. Yet on the supply side, OPEC crude oil production is more than 6% lower now than it was in January 2019. U.S. oil production is also 12% lower now that it was before the pandemic struck. So this is not about roaring demand-led inflation.

In any event, if history is any guide, betting on more inflation coming after a twelve-month doubling in the oil price is not a good bet to make. So as oil goes, so goes inflation.

A WELCOME SLOWDOWN

In the NAHB (National Association Of Home Builder) sentiment index, homebuilders signaled confidence, yet housing starts declined 0.7% decline last month – which followed a 2.7% falloff in September. This decline was more pronounced in the single-family sector, where starts fell 3.9% month-over-month to 1.039mm (annualized) – its lowest since August 2020. This data series is negative for four straight months. For perspective, we have not experienced this kind of a losing streak since late 2018 (when the Fed's next move certainly wasn't to tighten policy!). Hopefully, the slowdown will help take pressure off current home prices.



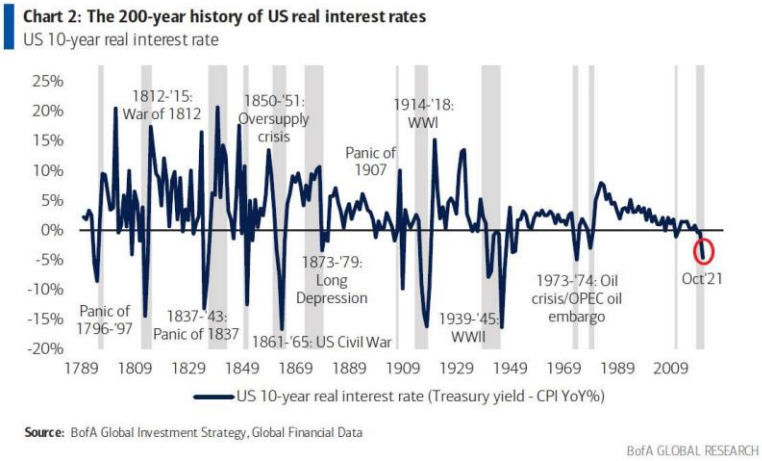
Moving on. The big story in the housing data is that rental construction is now booming. Multi-family (rental) starts jumped 6.8% month-over-month to 470,000 (annualized) and have now risen +37% over the past year. Also of note, multi-family unit permits rose 6.6% month-over-month so the pipeline of multi-family units that will hit the market in the next 6-12 months have expanded to the best level in 47 years. This development should temper the the rental effect on inflation over the next 3-6 months.

WARS, PANICS AND DEPRESSIONS

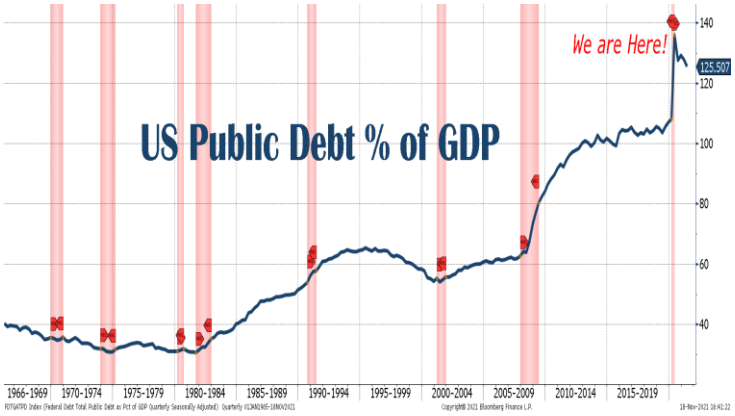
Currently the 10-year real Treasury yield adjusted by core CPI is at a "negative" 3%. The decline in 10-year Treasury real yields at a time of rising inflation and the announced commencement of tapering is a conundrum to many.

According to Bank of America global research, real yields have been this low only three times in the past 200 years: during the Civil War, the Great Depression and the aftermath of WWII.

So what gives?



The one thing in common for all of these periods is the high debt to GDP ratios. As a result of the pandemic, federal debt outstanding rose by over $5 trillion in a little more than a year. As a percentage of GDP, the current deficit is 125% of GDP, which is more significant than during the Civil War, WWI, Great Depression and the Financial Crisis. Only the deficit funding WWII surpassed current levels. This is not about whether the government should have supported the economy, and if so, to what degree. The question is whether the recent economic activity is sustainable or just a flimsy façade that will erode in short order.



Before the pandemic, the level of government debt was already at record highs and climbing faster than economic growth. If the Fed tightens policy, the Treasury's job becomes much more complex and costly. The only way to keep such a scheme going is to maintain lower interest rates to manage the federal interest expense.

Without financial repression (i.e., without the Fed manipulating rates to be artificially depressed through constant backstops) real yields would likely be consistently positive given the weight of debt supply. But given the record global debt pile, that would strongly increase the probability of debt crises across the world. So, with an epic pile of debt to pay off, could it be that rates will remain lower for longer? It may not be appealing and arguably not capitalism, but it may be the only way forward.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Just when everyone seems to have determined that inflation is not transitory and is here to stay consider the following passages from San Francisco's Mary Daly from a speech given last week.

"Monetary policy is a blunt tool that acts with a considerable lag. So, raising interest rates today would do little to increase production, fix supply chains, or stop consumers from spending more on goods than on services."

"As fiscal support rolls off and many households move their savings back to historically normal levels, demand will likely become more in sync with the overall strength of the economy. Production and supply chains should also catch up and repair, reducing bottlenecks and easing the pressure on prices."

"I come down on the side of waiting to gain greater clarity.[...]it's much harder to unwind a preemptive action that turns out to be wrong."

It goes without saying that I agree with Ms. Daly's view. This is why I take the contrarian stand and believe that the aggressive Fed rate hike moves embedded in the Treasury market at the current time are overdone.

As such, selloffs continue to provide attractive entry points for credit unions sitting on excess cash.

HAPPY THANKSGIVING!

Despite the division and friction in our country today, we all need to take a step back and look at the "big" picture. We have truly been blessed in so many ways. Let's take some time to reflect on those many blessings while sharing some quality time with friends and family. By the way, did you know that calories don't count on Thanksgiving? Yes, that is based on solid scientific evidence. Enjoy!

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.

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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.