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INVESTMENT SERVICES

Weekly Relative Value

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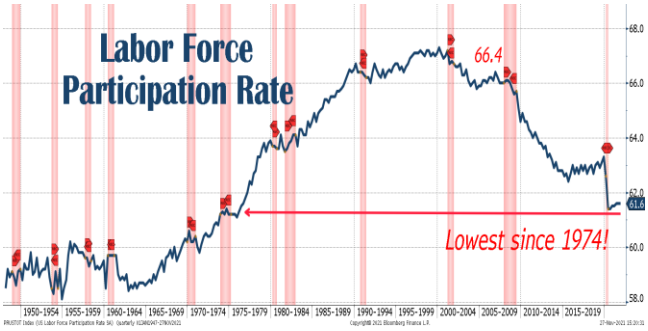
WEEK OF NOVEMBER 29, 2021

Lowest Since 1969!

Let's start the week with some good news.

At the end of February 2020, leading up to the onset of COVID-19, initial jobless claims stood at 216,000. The closing of the economy then drove claims to a peak of 6.1 million in early April 2020. They've since declined as the economy reopened more broadly and Americans returned to work. Last week, it was reported that jobless claims fell by 71,000 to 199,000 in the week ending November 20 – a level not seen since 1969. The drop in weekly initial claims was accompanied by a post-pandemic low in continuing claims as well, which fell to 2.05 million. The latest claims data bodes well for the November jobs report this Friday with the consensus forecasting a gain of 500,000 new jobs.

I think we can all agree that less people unemployed is (obviously) a positive. However, the one important caveat is that the labor force participation (LFP) rate, as shown below, is now substantially lower (61.6) than pre-pandemic levels (66.4).



The only reason why the official unemployment rate is at 4.6%, and not above 6%, is because of the very sluggish performance from the LFP rate.

THIS WEEK

- INFLATION SPIKES TO 30-YEAR HIGH!
- #1 PRIORITY
- THE TAPER COMETH
- WHERE TO FROM HERE?
- BLACK FRIDAY

PORTFOLIO STRATEGY

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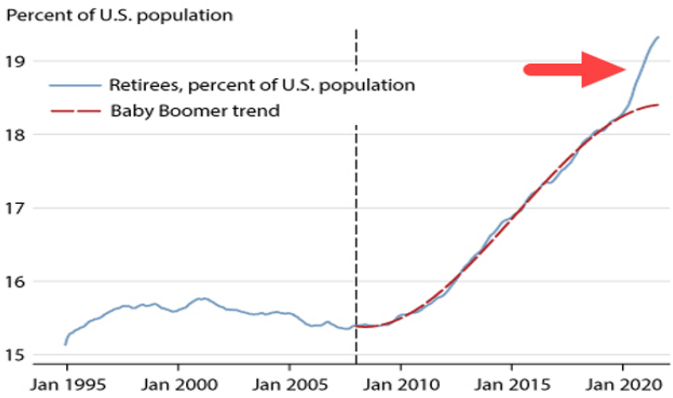
So, what's potentially driving LFP's sideways trudge:

- Fear of COVID – Not all of us are healthy and/or millennials, plus 22% of those with "long COVID" report inability to work due to symptoms.
- Childcare – This remains a serious issue for working parents, especially as COVID cases pick up again in many states and disrupt in-person learning.
- Massive & Unprecedented Stimulus – Raised unemployment benefits and cash checks diminish the need to work.
- Early Retirement – See commentary and graph below.

COVID-19 appears to have motivated a wave of early retirements, which seem to be accelerating. The blue line shows retirees as a percentage of the U.S. population. The red arrow shows the percentage of retirees rising sharply above the previous decade's trend. The percentage may look small, but this divergence represents something like 3 million "excess retirees" above what the prior trend predicted. That's substantial labor force shrinkage.



NOTE: The percentage of retirees is a 12-month moving average, and the Baby Boomer trend is a cubic trend estimated between January 2008 and February 2020.
SOURCE: Current Population Survey and author's calculations.

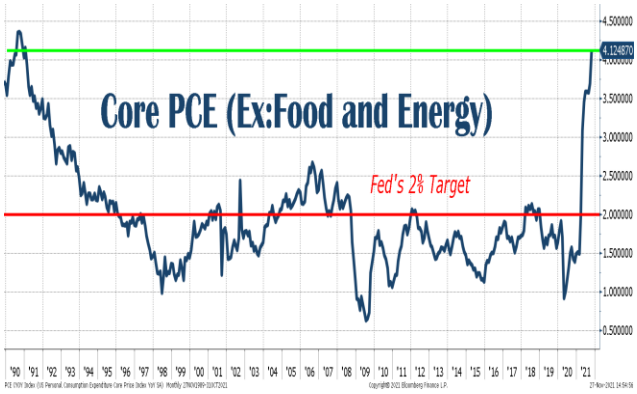
Federal pandemic unemployment benefits ended by September 6 in all states. Even so, millions of Americans are still choosing to sit on the sidelines, frustrating employers who are desperate to fill a near-record number of positions. That said, my view is that this labor constraint will not be long-lasting. People will still come back to work because, in the end, they have to eat. I repeat: People have to eat and pay their bills, and that normally is achieved with a paycheck. The narrative that people will retire in their 50s for good or can live off their "excess savings" indefinitely is wrong-headed, in my view. (See last week's edition of the Weekly Relative Value for more on this discussion.)

INFLATION SPIKES TO 30-YEAR HIGH!

Now the bad news. The overall personal consumption expenditures (PCE) inflation index, which includes food and energy, spiked by 5% in October, the hottest since November 1990. The core PCE, which excludes the now-soaring food and energy prices, is used by the Fed for its inflation target: a 2% core PCE. The core PCE in October, released last week, spiked by 4.1%, more than twice the Fed's inflation target, and the highest inflation reading since January 1991.

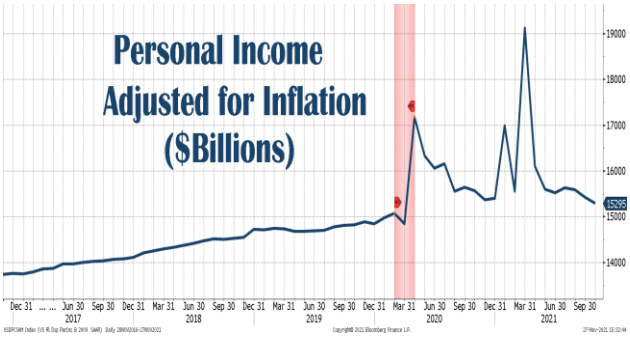
The higher inflation prints of late have eroded the purchasing power of Americans. Adjusted for inflation, consumers' personal income from all sources – wages, interest, dividends, rental income, unemployment compensation, stimulus

checks, Social Security benefits, etc. – dipped by 0.2% in October from September to an annual rate of $17.7 trillion, up by only 0.8% from a year ago.



As shown graphically below, real disposable personal income was rising at a generally steady pace in the years leading up to 2020. Then came the pandemic. Since COVID entered the scene, personal income has gyrated wildly and was grotesquely inflated by the various stimulus payments and special unemployment benefits.

Most of the pandemic-specials have now expired and real disposable income has declined for the past five months. In other words, inflation has eaten up any and all income gains from promotions, hiring bonuses, higher wages paid to attract workers, and higher wages to retain workers, etc.



#1 PRIORITY

"The unprecedented reopening of the economy, along with the continuing effects of the pandemic, led to supply and demand imbalances, bottlenecks, and a burst of inflation. We know that high inflation takes a toll on families, especially those less able to meet the higher costs of essentials like food, housing, and transportation. We will use our tools both to support the economy and a strong labor market, and to prevent higher inflation from becoming entrenched." – Federal Reserve Chair Jerome Powell

In the wake of the higher price data, newly renominated Jerome Powell (Chair) and newly promoted Lael Brainard (Vice Chair) of the Federal Reserve Board of Governors stated that fighting inflation was (all of a sudden) their number one priority.

Powell's first priority is now to "prevent higher inflation from becoming entrenched."

Brainard's first priority is now "getting inflation down":

> *"I am committed to putting working Americans at the center of my efforts at the Federal Reserve. This means getting inflation down at a time when people are focused on their jobs and how far their paychecks will go."*
> – Federal Reserve Vice Chair Lael Brainard

There was no mention of inflation being "transitory" or "temporary," nor about the Fed needing to be patient. Now that both individuals have been renominated, their views on inflation have seemingly taken a U-turn.

Did President Joe Biden explain to the pair that inflation had become a problem, that people are getting frustrated and restless and very unhappy as their wage increases (plus some) are gobbled up by higher prices, that it's hurting people that live off their labor? Did he say that it was time for Powell and Brainard to get off their high horse and do something about these crazy price increases?

Today, a crackdown on inflation would mean a quicker end to quantitative easing (QE). It just now reduced the amount of its asset purchases from $120 billion in October, to $105 billion in November and to $90 billion in December. Even still, they are still printing money! If one is to believe the statements above, I expect that asset purchases will end sooner than the previously announced timeframe through mid-2022.

THE TAPER COMETH

> *"So the bond supply narrative is that there's a lot more bonds coming. More supply brings the intuitive view that the yield will have to go up… I don't see any empirical evidence of that playing out. Frankly, I find that view is nonsense."*
> – Steven Major, HSBC's head of fixed income research

The Fed has purchased more than $4 trillion of Treasuries and mortgage-backed securities via its QE program since the pandemic began. Now investors are fretting over the prospect of a "Fed taper." In theory, tapering should lead to higher interest rates because the Fed is reducing purchases of securities, and in turn increasing the supply that must get absorbed by the market.

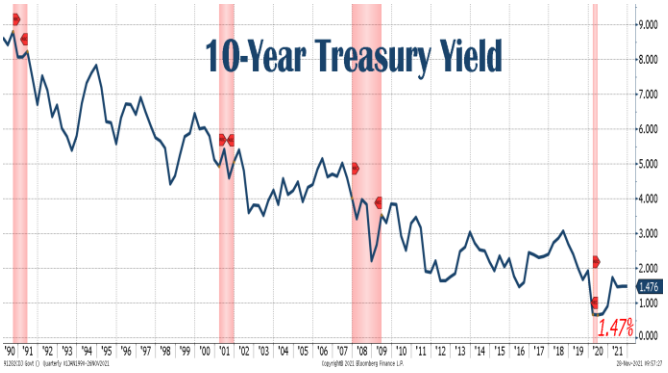
While market punditry continues to say that yields will soar once the Fed exits stage left, that view is based on a lack of historical experience or perspective. In fact, history shows that the opposite happens. As shown below, when the Fed is

buying bonds (shaded area represents QE programs), yields actually "rise." When the Fed stops buying bonds, yields actually "fall" on average by over 100 basis points.

Here's why: As the Fed was printing money and increasing liquidity, investors rotated out of the "safety of bonds" back into equities (risk-on). But as soon as the liquidity flows slowed or stopped, the equity market buckled as the risk-on trade reversed. Treasury bonds – the asset that everyone hates – have been the primary beneficiary.

So, 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).

Moving on. At the same time the Fed is tapering its bond purchases, the proposed new fiscal stimulus packages (Build Back Better) will add much more debt with deficits expected to approach $4 trillion.



On the surface, this seems troubling and bearish for bonds. However, I suggest you look at the graph above that shows the long-term secular decline in 10-year Treasury yields. Over the past 10+ years, there have been repeated rounds of fiscal stimulus, a significant spike in inflation, record stimulus-driven growth, the reopening of the economy and the Fed's taper. Yet, the 10-year Treasury yield is below 1.5% today! For perspective, at the depths of the Great Financial Crisis (12/31/08), the 10-year Treasury yield was 2.24%.

So, what does the bond market do for an encore? All the bad news for bonds is already out there. This is telling you a lot about the resilience of the bond market. We're not at the bottom of a recession with clear skies ahead. We're coming out of this best part of the growth, with inflation likely peaking.

WHERE TO FROM HERE?

"What matters are not this week's [gross domestic product] print or the next [consumer price index] print, or the next Fed meeting, the fundamentals are what drives the longer run."
– Steven Major, HSBC's head of fixed income research.

The broad consensus is that the first global pandemic in a century has suddenly turned the economy into some inflation-prone basket case and that the entire inflation mindset of consumers and businesses has changed.

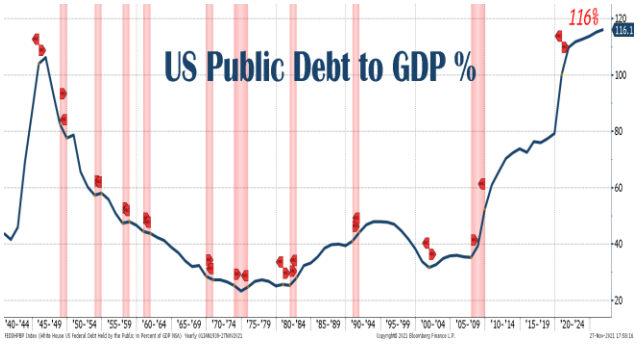
Even still, I continue to take a contrarian stance and believe that the long-term secular deflationary forces, such as aging demographics, excessive debt and disruptive technology (productivity and labor-saving automation), which have outlasted all the other inflationary forces over the past two-plus decades, are still intact and will win the war.

As I have constantly highlighted in this space, our debt levels are ridiculously high. The total debt-to-GDP ratio in the U.S. is over 350% today. This unprecedented debt bubble can only be financed at extremely low interest rates. Interest rates cannot back up much without inducing a destabilizing run-up in debt-servicing costs.

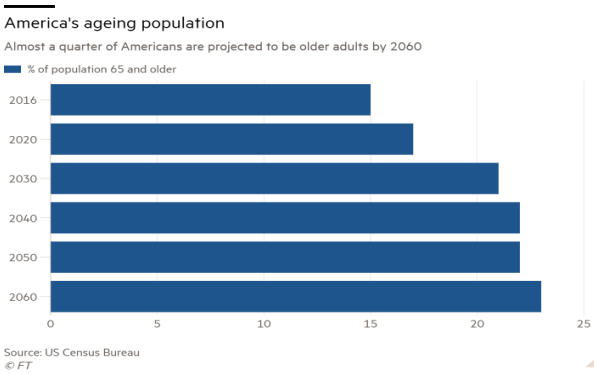
And there are bubbles everywhere: residential real estate, equities, corporate credit, cryptos. Without doubt, the valuations are crazy, and there will be a day of reckoning. It's just not clear when. However, if bond yields really ratchet-up the bull market in equities, then almost everything else that is considered risk is going to come under a serious correction if not an outright bear market.

Remember what happened when Powell was hell bent on raising rates to 3%? Well, it didn't happen. The Fed raised rates to a whopping 2.5% and the next thing you knew, equities dropped 20%, the credit market froze up, and as a result, Jerome did the famous "Powell Pivot."

Here's a question for the bond bears. How does one explain that the U.S. economy with the tightest labor market in 50 years, a massive tax reduction, a record-high (at the time) fiscal shortfall, a quintupling in the stock market and the longest economic expansion in recorded history, and even with all that, the Fed could not raise rates above 2.5%?



In addition to the excessive debt, aging demographics support U.S. government bonds. The argument is based on the premise that Americans approaching retirement will increasingly shift into low-risk investments that provide consistent income streams over a long-time horizon, such as Treasury bonds. As shown below, this cohort is expected to grow rapidly in the coming years, with the proportion of Americans 65 years and older rising from about 17% in 2020 to 21% in 2030.



Finally, regarding increased productivity and labor savings technology, one of the best recent reads was *"Desperate for Workers, Restaurants Turn to Robots"* from the New York Times. These bots can cook, mix drinks and clean toilets, and they don't complain, and they don't job hop. Maybe the Job Openings and Labor Turnover Survey should start to include them. Here's the point. Unlike the 1970s, when labor-saving tech spending was less than 1% of GDP, that share is now 8% and still rising. This will temper labor costs and hence inflationary pressures.

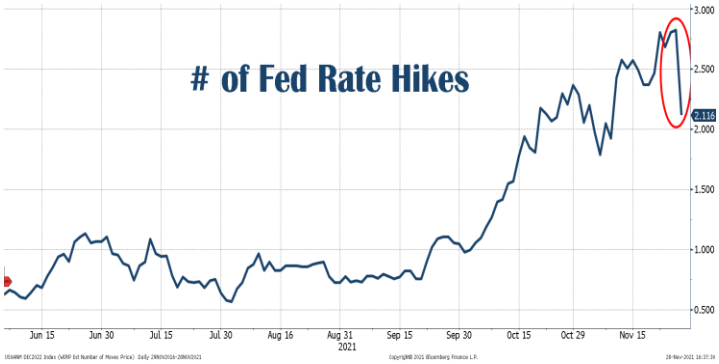
These long-term drivers are going to continue to be a force for lower rates in the future.

BLACK FRIDAY

"It's terrible news…The new COVID variant could hit the economic recovery, but this time, the central banks won't have enough margin to act. They can't fight inflation and boost growth at the same time. They have to choose… We now have a new COVID variant that's 'very' different from the ones we knew so far, rising inflation, and a market bubble… The only encouraging news is the easing oil prices, which could tame the inflationary pressures and give more time to the central banks before pulling back support." – Ipek Ozkardeskaya, market analyst

On a day that "all" Americans were supposed to be spending their hard-earned dollars or stimulus checks, markets experienced a mini panic over fears of the new Omicron COVID strain. The Dow closed down 900 points (-2.53%) and the S&P closed down 2.3% – its biggest drop since February.

The potential shift in air-travel views prompted a massive 13.1% drop in West Texas Intermediate (WTI) on Friday, to just over $68 per barrel, and that was the steepest descent since April 2020. WTI now finds itself in a sudden bear market.



The flight-to-safety response supported Treasuries, with yields rallying 14 to 18 basis points across the curve. The 10-year Treasury has plunged 16 basis points to 1.47%; the 5-year slipped a sharp 18 basis points to 1.16%. Fed fund futures, so confident the Fed would make its first rate hike as early as next June (and was 50-50 for May), are now pushing that back to September 2022.

The market reaction on Friday was on thin volumes and could well have been a big over-reaction, but there are a lot of questions that will have to be answered in the coming weeks. The key will be to determine the severity of the Omicron variant and the extent to which the current vaccines will be effective. That said, the U.S .economy is hardly likely to ever shut down and there is going to be a lag before we see the first cases show up here. Also, this isn't likely to crush holiday shopping but, at the margin, there will be a more cautious approach towards spending.

I should add that the Omicron variant won't stop the Fed from its taper, which has already started, but rate-hike expectations have moved from 3-4 moves in 2022 to 2-3 moves. I expect more of that to come out of the market going forward.

The new threat adds to the wall of worry investors are already contending with in extremely high valuations, elevated inflation, monetary tightening and slowing growth.

Keep in mind that, unlike early 2020, this is all coming at a time when central banks are tightening policy or hinting at starting the process, so don't expect the monetary authorities to step in and hold your hand as readily this time around.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Inflation rates are higher today than I would have thought several months ago. However, the price pressures are still narrowly confined to rent and automotive, basically anything with a microchip attached to it. In other words, this is still very much part and parcel of all the distortions we've seen through the entire pandemic. Simply put, the inflationary episode we are experiencing today is not inflation, it is price distortion caused by acute supply imbalances. And whether it takes a while longer to alleviate all the port congestion or for people to return to work, it doesn't mean it's not going to happen.

Meanwhile, this time next year, demand is going to be quite a bit weaker and the economy should begin to cool down with GDP reverting to its longer-term growth rate of 2%. At the same time, supply bottlenecks will ease as more capacity is built up everywhere. And that means inflation should come down.

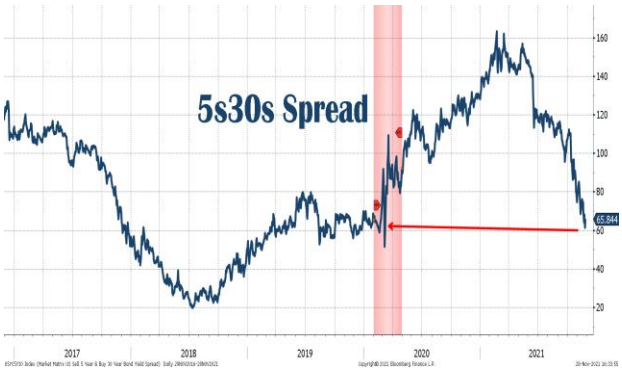
Regardless, the Treasury market is now pricing in quite a few Fed hikes. But we have seen this before. Shoot first, ask questions later. Remember the Bernanke "green shoots," the "huge" $1-trillion Obama infrastructure package (maybe in today's environment that isn't so huge at all), endless QE and negative real rates, and guess what? Rates initially rose but then reversed and ended lower. The fact of the matter is that these hiccups in rates come and go — but these, too, are transitory. The onerous debt-servicing burden ends up sowing the seeds for the demise of these mini rate back-ups.

Another best read of last week goes to *"Mortgage rundown: Higher interest rates will bring lower interest rates"* from The Globe and Mail.

The real risk is that if the Fed tightens next year as the futures markets are 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, and 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 moves to its flattest since pre-COVID.

In terms of portfolio strategy, unless you are a market timer and/or trader, the best advice is to maintain a fully invested, risk-appropriate laddered portfolio.



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.