CAPITAL MARKETS *monthly*

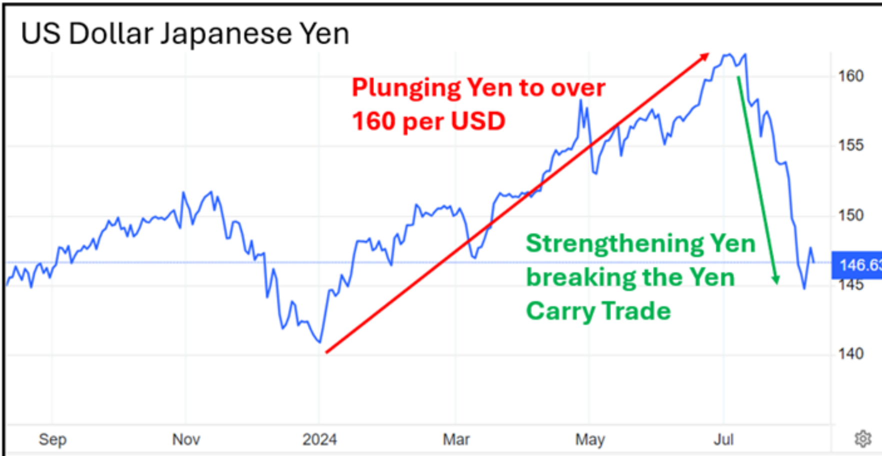
VOL 18 | AUGUST 2024

GENERAL MARKET OVERVIEW

Markets went reeling after a global margin call from a surprise interest rate increase by the Bank of Japan (BOJ) and the subsequent unwind of the Japanese yen carry trade. The trade involves borrowing money from Japan and using it to fund other positions. The Japanese yen enables the trade by the BOJ, leaving rates near 0%, while most global yields rose in other currencies. From there, the yen is converted into another currency (often U.S. dollars) and seeks higher yields. Guaranteed profit, right? Not so fast. The "carry" is a capture of the interest rate differential. The strategy is deployed by banks and hedge funds, as well as everyday retail investors, especially Japanese citizens with an easy borrow of their local currency. Skeptics refer to the trade as "picking up pennies in front of a steam roller."

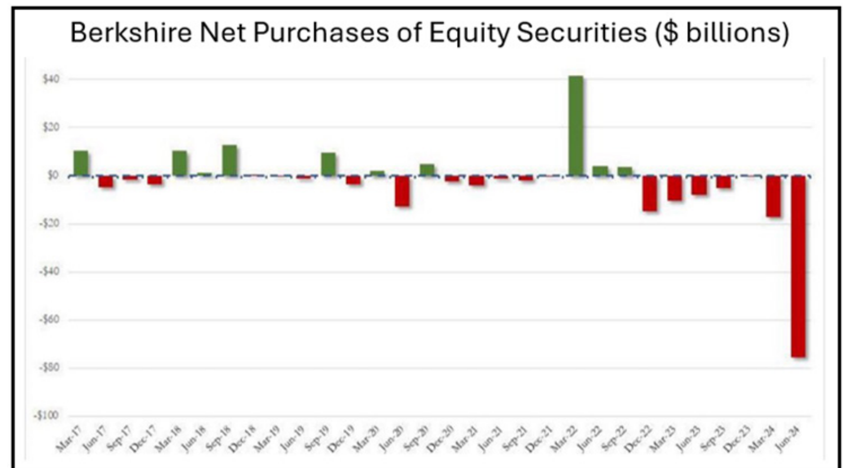
Year-to-date relative weakness in the yen made the trade even more appealing until global investors were reminded of the risk they were holding as the yen violently increased over the past month and then gapped higher when the BOJ surprised markets with their 25-basis-point rate increase. This caused the yen to rise just as speculators are positioning for the U.S. economy to roll over with U.S. rates about to go down. The yen carry trade loses money when the yen yield goes up, the U.S. dollar goes down (in our pair example) or the yen/USD conversion rate goes down. *Continued on page 2*

It seems counterintuitive that a 25-basis-point increase would have such a deleterious effect on risk assets, until you gain appreciation for how much inherent leverage is involved in the trade. When the trade goes wrong, it unwinds fast. Thus, the margin call on risk assets. The turmoil will most likely be short lived as the foreign exchange (FX) market currency pairs realign and central bankers around the globe hold market-calming unscheduled meetings. While risk is being repriced, this is not a redux of the Bank of England sterling crisis in 1992. Financial lore likes to credit George Soros with “breaking the Bank of England,” but there was a mountain of selling against the pound (and not just from Mr. Soros’ Quantum hedge fund).



Another catalyst for a market sell-off comes from the Oracle of Omaha, as Warren Buffet decreased his Berkshire Hathaway equity position in the second quarter by the most in history. The firm is going into cash and now holds a record $227 billion in Treasuries.

Then there was the huge job report miss and unemployment print. July non-farm payrolls grew by just 114,000, far below estimates of 185,000. With five out of the last six payroll numbers revised down, this is causing concerns that the data might not be reflecting how badly the labor market has turned. The unemployment rate ticked higher for the fourth month in a row, reaching 4.3% and triggering the Sahm Rule. The Sahm Rule is a recession indicator when the three-month moving average of U3 unemployment rises 50 basis points relative to the minimum of the three-month averages from the previous 12 months. This indicator has a near-perfect record in predicting a recession has already begun. Fed Chairman Jerome Powell even referenced (though dismissively) the Sahm indicator at the most recent press conference.



On the coattails of the Federal Open Market Committee (FOMC) statement and Chairman Powell’s remarks at the July 31 meeting, market analysts were very much looking forward to the Fed’s next meeting in September. At that time, Chairman Powell said that if the “totality of the data are consistent with rising confidence and inflation and maintaining a solid labor market… a reduction in our policy could be on the table as soon as the next meeting in September.” The Treasury market rallied on those comments, and the swaps futures market showed a 100% probability of a 25-basis-point reduction of the federal funds rate in September and November, which is in stark contrast from two months ago when higher for longer was fully priced into the futures curve.

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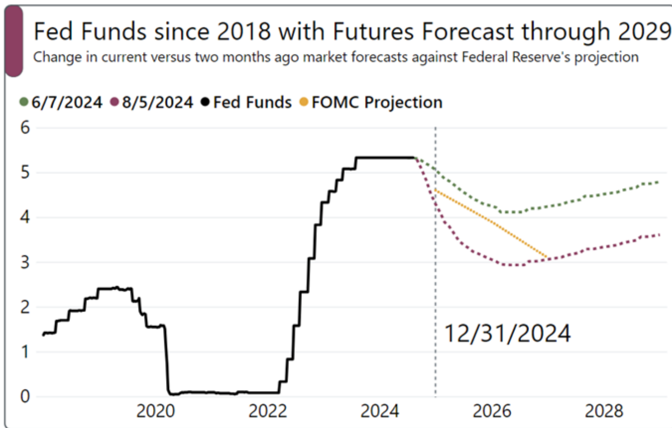
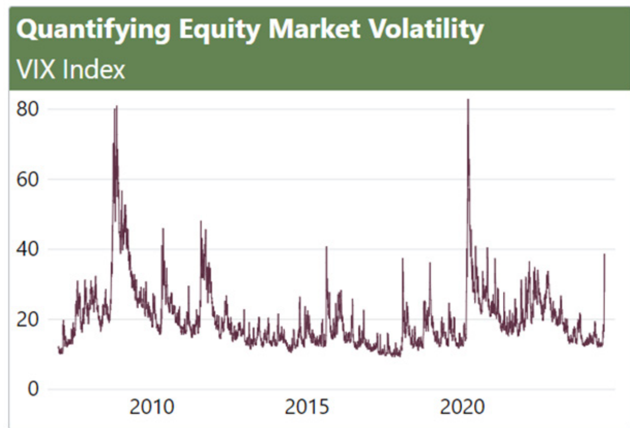
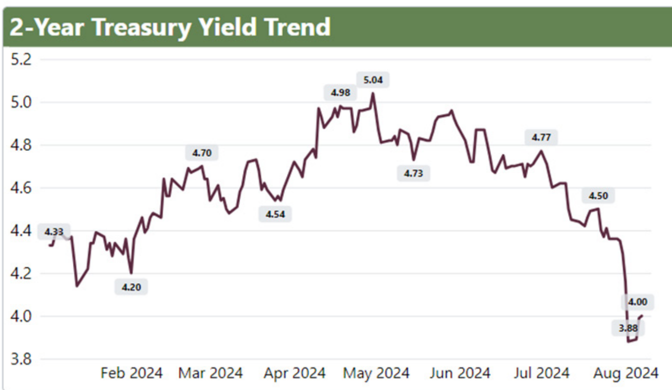
Equity markets experienced their sharpest spike in volatility since the COVID-19 sell-off.



Source: Federal Reserve, Chicago Mercantile Exchange





At the beginning of this month, the Department of Labor reported weaker non-farm payrolls for July. Treasury yields continued to fall and it seemed that lower yields would hold. A few days later, stocks sold off worldwide on lower tech earnings. Treasury yields fell and the 2-year Treasury, which is a measure of inflation expectations and a future federal funds rate, continued its descent. The flight to quality trades pushed the 2-year Treasury at one point to a 3.67% yield. As of this writing, stock prices have rebounded and initial jobless claims for the week of August 3 were lower than expected, tempering concerns over the labor market. Now it's the reverse with the flight back to risk assets (stocks). The 2-year Treasury is again trading above 4.0%. See above for the rollercoaster ride of the 2-year Treasury. Expect more of the same volatility into the fall.

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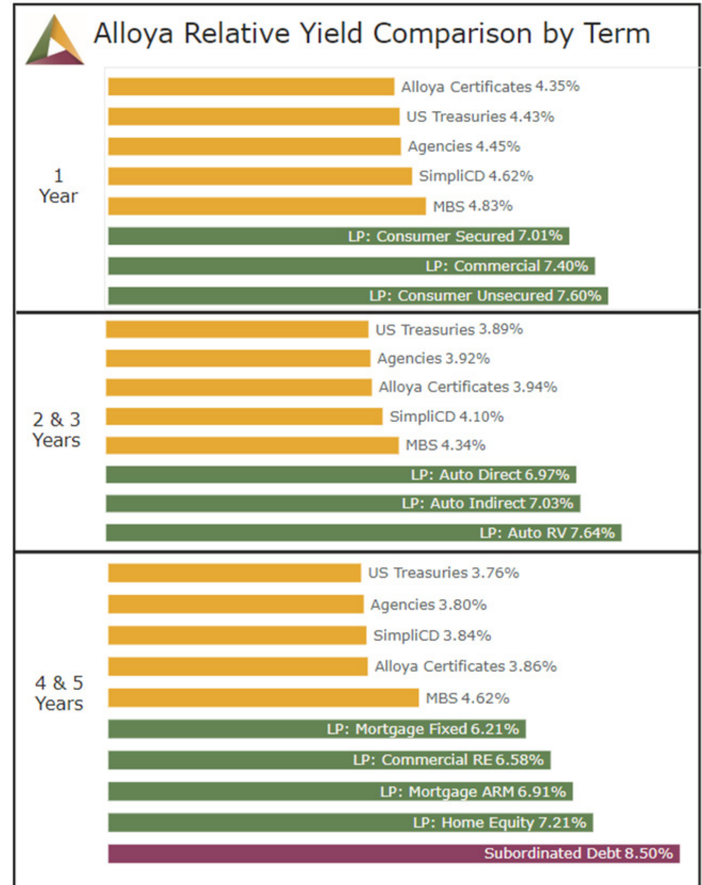
LP MARKET OVERVIEW



Last month, we began offering readers enhanced visibility into loan participation investor net yields. To the right is a chart showing the relative value of various loan participation asset types compared with other typical investments credit unions hold on their balance sheet. Asset yields are falling across all assets and durations. Notice that loan participation net yields are holding up nicely offering additional spread income. Recall that the loan participation net yield estimates prudently include an embedded annual loss estimate. Soon these yields will likely drop as credit unions adjust their pricing of new loan originations.

CAPITAL SOLUTIONS MARKET & SPREAD OVERVIEW

Credit unions have always worked together by investing in the certificates of deposit (CDs) of other credit unions' CUSOs. Now is the time to consider investing in other credit unions' subordinated debt as well (previously known as secondary capital).

Although the NCUA does not guarantee a credit union's issuance, they are involved with the entire process and every aspect of due diligence for the issuer. The total approval of sub debt issuance rests solely with the NCUA. No other investment in a credit union's portfolio requires such due diligence; not a mortgage-backed security, a corporate bond or a municipal bond. Your board of directors must approve all loans to other credit unions per the Federal Credit Union Act and the issuing credit union must be well capitalized.

Why do we mention this now? In the coming months, Alloya's Capital Markets group will have sub debt offerings available from very well-capitalized credit unions. So, why not consider introducing sub debt into your investment or loan portfolio? The interest yields are highly attractive, and Alloya's Capital Markets group is here to assist you and your board throughout the process. By getting board approval now, you will have complete access and due diligence to review future sub debt offerings. *Continued on page 5*

Getting started is easy and free, but now is the time to get your board "on board" with sub debt investing:

1. Sign broker-dealer agreement
2. Sign one-time non-disclosure agreement
3. Create subordinated debt policy (can be included in investment policy and Alloya has a sample)

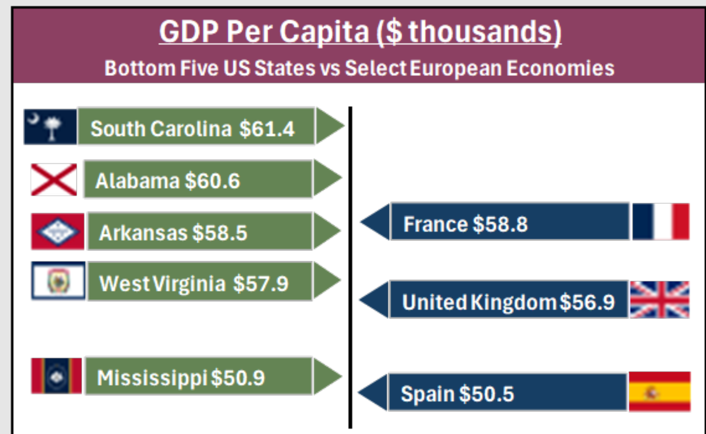
Want more information or need additional assistance to get started? Please contact Alloya's Subordinated Debt Specialist, Parker Hausknecht at **parker.hausknecht@alloyacorp.org**.

Current Market Sub Debt Issuance Rates

Issuance Size	IG Egan Jones	Kroll BBB-	Kroll BBB	Kroll BBB+	Unrated
50MM	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	8.500%-9.000% +/-
50MM-100MM	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	-
100MM+	8.500% +/-	8.500% +/-	8.500% +/-	8.500% +/-	-

FINAL THOUGHTS

While Asian markets are experiencing their worst investor returns in decades, domestically there is much to be positive and optimistic about. Capital continues to flow into the U.S. as energy, healthcare innovation, technology, burgeoning AI and infrastructure revitalization propel the broad economy. The yen carry trade unwind is a technical, short-term, left-tail event that flushed some unhealthy leverage out of the global system. As Robert Shiller observed, "After a stock market decline, people may perceive more risk than before when, in fact, the decline may have taken some of the risks out of the market." As markets worry about recession, it's important to keep the strength of the U.S. economy in perspective. Stories of rising BRICS nations and shade on the U.S. dollar are greatly exaggerated. The U.S. is home to both the world's healthiest consumer and producer. See the accompanying chart that compares the bottom five U.S. states by GDP per capita with select notable European economies to see just how productive the U.S. is.



The GDP per capita of France is on par with Arkansas, the third lowest U.S. state. Notice, the United Kingdom ranks below West Virginia, the second-from-bottom state in the U.S. by GDP per capita. Finally, if Spain were to hypothetically join the U.S. as the fifty-first state, it would become the lowest GDP per capita state in our great nation. Let us not forget about this strength and resiliency as headlines turn more and more bearish over the coming months.