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INVESTMENT SERVICES

Weekly Relative Value

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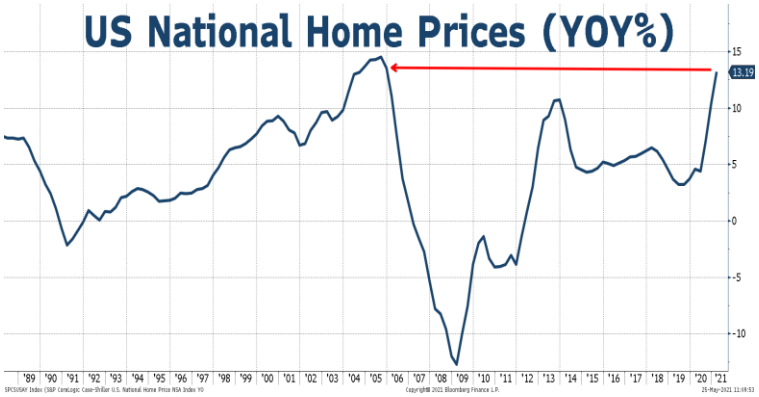
WEEK OF JUNE 1, 2021

The "Boom" is Off the Rose

"In real terms, home prices have never been so high. My data goes back over 100 years, so this is something," – Nobel prize-winning economist Robert Shiller

According to Case-Shiller's latest data for March, released last week, home prices in America rose 13.19% year-over-year – the fastest since 2005. Additionally, the 20-City Composite prices are surging at a stunning 13.27% year-over-year.

As Shiller noted, that is the highest price ever and over 19% higher than the home price index was at the peak in 2006.



Shiller believes the current housing market environment is similar to 2003, five years before the housing market crash in 2008. He also believes that such lofty home prices remove all but the wealthiest from the American Dream pipeline.

THIS WEEK

- PEAK HOUSING
- MIGRATING SOUTH
- PEAK GROWTH?
- SIX MONTHS FROM TODAY
- THE INFLATION DEBATE
- BANKS LOVE BONDS!

PORTFOLIO STRATEGY

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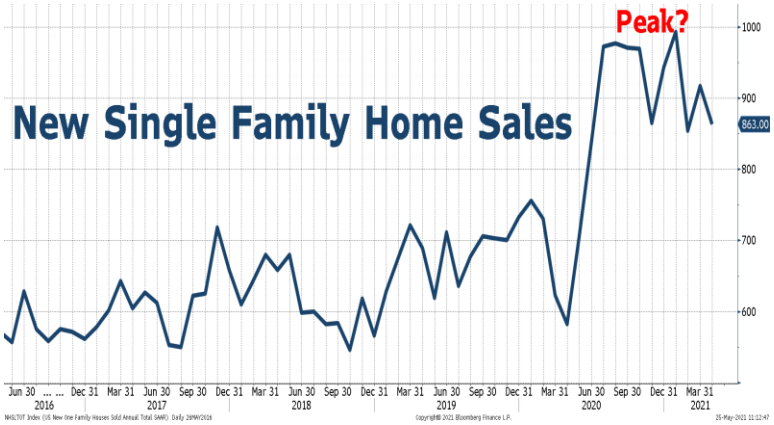
PEAK HOUSING

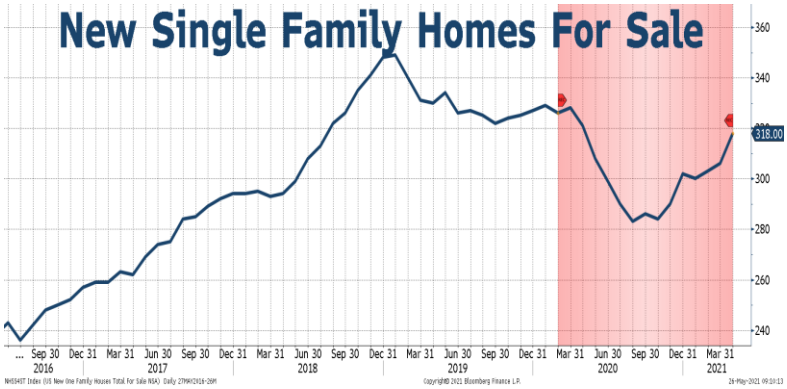
"In my time studying housing markets, I've seen bubbles and I've seen busts…But I've never seen anything quite like this. It's a perfect storm." – Bill McBride, an economics writer who famously predicted the 2007 housing crash

"If you go out three or five years, I could imagine they'd (prices) be substantially lower than they are now, and maybe that's a good thing…Not from the standpoint of a homeowner, but it's from the standpoint of a prospective homeowner. It's a good thing. If we have more houses, we're better off." – Robert Shiller

With home prices soaring at their fastest pace since 2005, and existing home sales unexpectedly tumbling in April, analysts expected new home sales to finally fall prey to the affordability crisis. And sure enough, April new home sales plunged 5.9% month-over-month to 863,000 (losing the one-million-mark once again). New home sales fell in the Northeast (-13.7%), Midwest (-8.3%), and the South (-8.2%), but rose in the West (+7.9% vs -31.8% in March).

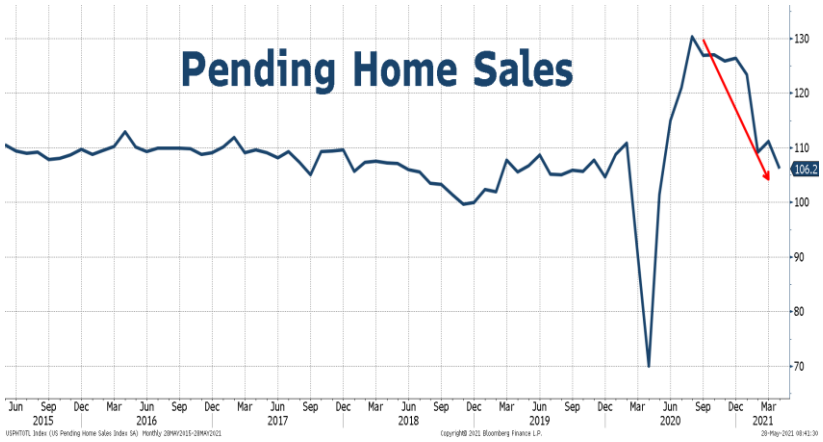


According to an article in the Wall Street Journal, *"Housing Prices Surge on Short Supply,"* home sales were lower due to "lack of inventory." Question: Did these folks actually do more than a cursory glance at the data? In fact, the new home sales data showed the tightness in the housing market beginning to ease up. As shown below, the backlog of unsold new homes has risen to an 11-month high of 4.4 months from 3.6 months at the turn of the year. Yes, still tight but definitely getting better.



Currently, there are 316,000 newly built homes sitting vacant, not far off the level prevailing at the end of 2019. New homes for sale have risen at an 18% annual rate year-to-date. Despite what you hear and read, the residential real estate market has started to thaw out. Sooner or later, prices will react accordingly with a lag.

Finally, pending home sales, the quintessential leading indicator, dropped a hefty 4.4% in April. This metric has been flat or down in seven of the past eight months and is at a 12-month low — back when we all thought COVID-19 was the Black Death and the economy shut down.



MIGRATING SOUTH

It's become quite clear that the housing demand continues to migrate south. For example, in the past decade, home prices in Las Vegas have boomed 125%. Phoenix is up 141%. Miami and Tampa are both up more than 100%. Dallas has soared 92% (imagine what Austin must look like — what an awesome town). In the North, there were a few surprises as Detroit (+116%) and Seattle (+131%) experienced huge price surges. The laggards? No surprise: New York City (37%), Boston (+68%), Chicago (+38%) and Cleveland (+47%).

PEAK GROWTH?

The slowdown has commenced. Take a glance at the latest data points for April (the "hard numbers"):

- Housing starts: -9.5%
- April jobs: +266,000
- Single-family permits: -3.8%
- Existing home sales: -2.7%
- Core retail sales: -1.5%
- Real average hourly earnings: 0.0%

And the survey data ("soft numbers") for May haven't been anything to write home about.

- Empire State Manufacturing Survey: 26.3% to 24.3%
- Philly Fed Manufacturing Business Outlook: 50.2% to 31.5%
- University of Michigan Consumer Sentiment Index: 88.3 to 82.8
- Chicago Fed's National Activity Index: 1.71 to 0.24

- The Atlanta Fed Nowcast model is "down" to 10.1% real growth (annualized) for Q2, from 13.7% in early May. The St. Louis Fed is down to 7.7% from 10.7% a month ago. And the New York Fed has cut its GDP estimate to just 4.6% from 6.8% a month back.

Yes, today growth is robust but the trend of late suggests that growth has peaked and is decidedly slowing. This is astounding in view of the latest super-sized fiscal stimulus and the reopening of the economy.

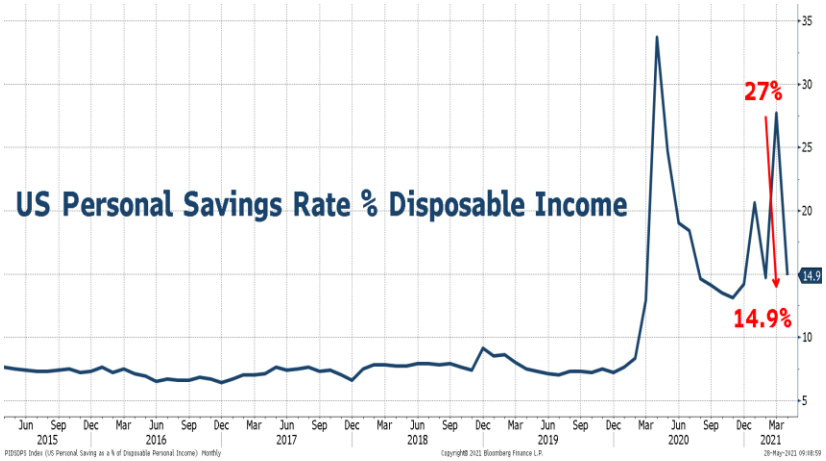
SIX MONTHS FROM TODAY

"Consumers' short-term optimism retreated, prompted by expectations of decelerating growth and softening labor market conditions in the months ahead."
– Lynn Franco, Senior Director of Economic Indicators at the Conference Board

In April, personal incomes crashed 13.1% month-over-month and spending rose just 0.5% month-over-month.

Source: Bloomberg

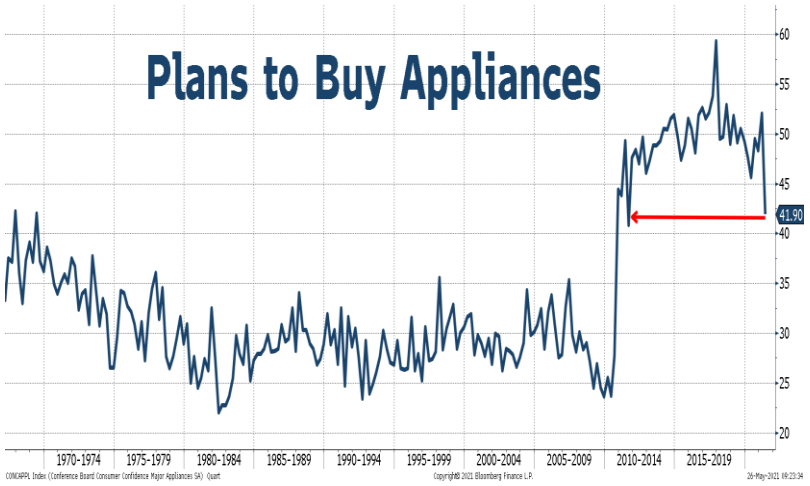
That was the biggest monthly crash in incomes "ever," which sent the savings rate plunging. In essence, the consumer buffer is almost gone as the personal savings rate plunged by 50% as Americans do what they do best and spend their savings.



The Conference Board's expectations index is a handy forward-looking momentum indicator for what the consumer is thinking. It has receded four months in a row to the lowest level since March 2020. All of this makes total sense. The stimulus bonanza will end and that means Americans soon will have to live again within their means. In fact, buying intentions (six months from today) as measured by the Conference Board, have cratered across the three major spending categories: homes, automobiles and major household appliances.

Home-buying plans have dialed back to an eight-year low (the decline in May for home buying intentions, as an aside, was the steepest ever recorded). Likewise, the University of Michigan survey showed home-buying is all the way down to a 38-year low.

Plans to buy an appliance are at the lowest in a decade and second lowest since January 1995. The drop in May amounted to the biggest one-month drop in intentions to purchase appliances.

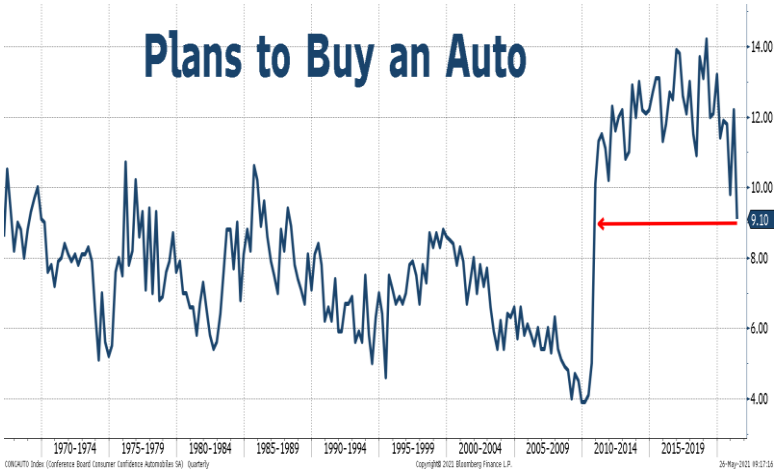


And auto-buying plans fell to their lowest level since April of last year (when the economy was in the eye of the pandemic storm) and before that, try March 2010.

One cannot help but get a gnawing feeling that the spending spree of the past year is completely tapped out. If not today, then certainly six months from today when President Biden's trillions in stimulus will have been long spent.

Oh, and for those saying wage hikes may be permanent, I have some bad news: employers know very well that the extended unemployment benefits bonanza ends in September, at which point millions of currently unemployed workers

will flood back into the labor force. And with all that, a lower wage rate. This is why, instead of raising base pay, most employers offer one-time bonuses, which – as the name implies – are provided one-time.



Just wait until October when everything reverses, Uncle Sam is no longer pays more than the private sector, and wages slump. The Conference Board survey recognizes this, because "income expectations" declined in May to a four-month low.

What does that mean for the economy? Well, all those producers and retailers who got used to bumper demand and pushed their prices sharply higher, will face a stark choice: either drag prices right back down, or sell far fewer goods and services. That, or just await the next bailout.

One thing seems all but certain: six months from today, the U.S. economy is heading for a significant slowdown. Yes indeed, the "boom" is off the rose.

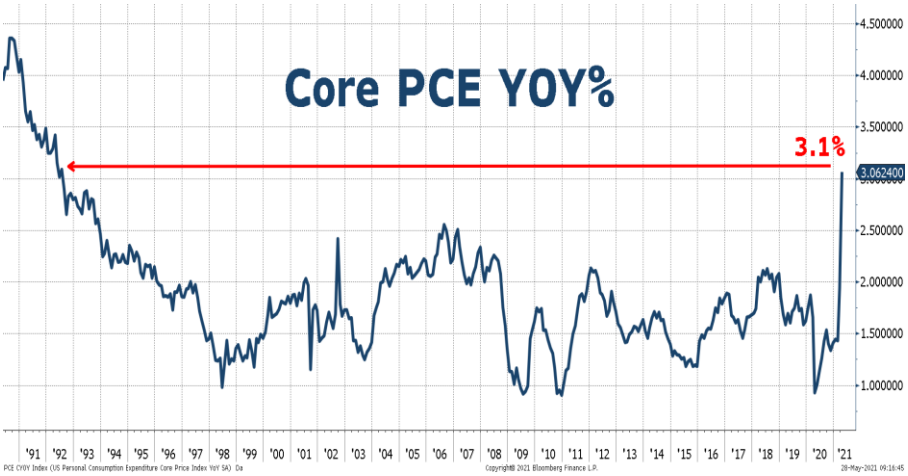
THE INFLATION DEBATE

"It seems as though, out of the blue, we have gone from talking about deflation to inflation. From depression to an economic boom. From the Bubonic Plague to the 'Roaring Twenties'…" – David Rosenberg, President and Chief Economist & Strategist of Rosenberg Research & Associates, Inc.

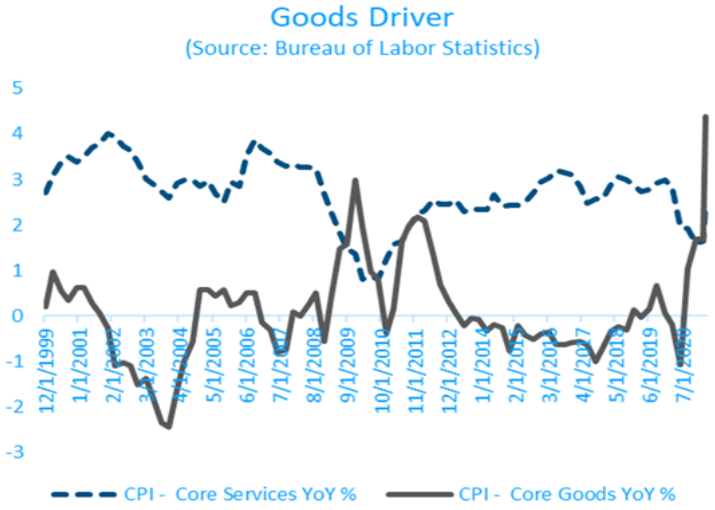
While Americans' income and spending is normally the headline-making data, all eyes were on the Fed's favorite inflation indicator: the personal consumption expenditures (PCE) deflator. The headline PCE deflator rose 3.6% year-over-year, the fastest rate of price increases since 2008. Even more notably, the core PCE index soared 3.1% year-over-year and the hottest print since May 1992. I'm sure to many people, these numbers were shocking. And I think that the core inflation will stay in the 3% range for the next few months on a year-over-year basis.

That said, the inflation reports of late are as distorted now as they were when prices were declining in the spring of 2020. The recent inflation numbers are very much supply-chain oriented. Car rental, transportation costs, and so forth. We've never seen such serious supply chain issues as we're seeing now. Think about it. A year ago, the economy effectively just shut down. This was cold turkey. Businesses cut off all orders, and the consumer saving rate soared to 35% as consumers had very few places to spend. Goods. Goods were the spaces to spend, right? Durables and non-

durables, especially for the home and so forth. And that's where consumers spent a disproportionate amount of their budget.



Here's a chart from Avalon Advisors on the year-over-year core services and core goods inflation. Notice the steep rise in core goods.



Consider the following: *"Reopening Is Inflation's Cure, Not Cause"* in the op-ed section of the Wall Street Journal, authored by Jason Thomas, the head of global research at the Carlyle Group. Mr. Thomas uses the 38% growth in motorcycle sales during the pandemic alongside a lagging 14% pace of production as a sign of the mismatch between the forces of demand and supply caused by the pandemic. As the article asserts, inflation "really is transitory" because

"If 38% were to represent the new trend rate of growth in demand for motorcycles, inflation would be a genuine concern. Motorcycle production capacity isn't sufficiently elastic to adjust in the short term; additional factories, equipment and trained workers would be needed. But if, as is far more likely, this growth rate represents a one-time boom occurring in very unusual circumstances under which consumers paid for goods to replace live events and travel, then motorcycle sales will likely moderate in future quarters, production will return to pre-pandemic levels, and price pressures should dissipate."

"it is predicated on expenditure patterns unlikely to persist." How simple. How succinct. And how logical. But why do so many "pundits" believe this is a permanent condition?

Goods represent only one-third of consumption in the GDP. Services are two-thirds. What I think is going to happen now is businesses are scrambling like crazy to keep up with demand. They can't. They got way behind. They're double and triple and quadruple ordering. And at the same time the consumer is about to shift the mix back towards services, maybe disproportionately. I think we're going to end up with a massive inventory problem towards the end of this year or into next year. This could lead into a deflationary period after this supply chain related and base effect related bounce in inflation.

Also, commodity prices – driven more by speculation than demand – are high and at risk of a major reversal. When commodity prices do start to fall, expect a major reversal in inflation sentiment. Furthermore, expect momentum to become as self-reinforcing on the way down just as it was on the way up. This is what the bond market is already pricing in.

One more point. Whatever you think of Jerome Powell or Ben Bernanke or Janet Yellen, they did their best to create inflation. So did Obama. So did Trump. Now the pundits are saying that the first global pandemic in over a century will manage to do what nobody else could manage to do over the last two decades. I don't buy it. The secular dynamics of excess debt, aging demographics and disruptive technologies have not gone away one iota. As such, longer term inflation pressures will subside.

BANKS LOVE BONDS!

Who needs quantitative easing (QE) when banks are buying bonds? And in droves.

Bank CEOs are telling everyone that the economy is booming, yet the fastest growing sector on their balance sheet is... well, it's Treasury securities. In another definite sign of "peak housing," residential mortgage balances dropped $8.6 billion in the week of May 19 — declining now in five of the past six months. Commercial and industrial business lending fell $2.1 billion and is down in four of the past five weeks. At the same time, in that week of May 19, bank Treasury holdings jumped $12 billion, and that followed a $7.8 billion addition in the week of May 12 and $14.5 billion on May 5. So, in three weeks, banks have purchased $34 billion of Treasuries (59% annual rate).

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"There are reasons why we should be seeing higher price levels today. The question is: Wow enduring is it going to be? Right now, I am not seeing it is going to be enduring." – Atlanta Fed President Raphael Bostic

"A very important part of inflation dynamics is longer-term inflation expectations and those have been extremely well anchored, implying that if we saw some development pushing inflation up, I wouldn't expect that to get embedded in the ongoing inflation rate." – Fed President Lael Brainard

We come off a very interesting few weeks in which the boil of U.S. economic data ends with clear signs that the housing market is rolling over and that the effects of the stimulus checks are beginning to subside. We also have had some ripping inflation statistics, which transcend just base effects and also why it is that the Treasury market is hanging on so impressively well. Interest rates peaked a couple of months ago, suggesting economic growth will weaken in the months ahead. I boil that down to the downward revisions we are now seeing to second quarter GDP growth estimates.

The one thing I will continue to say about the Fed is that it is not letting the bond vigilantes and inflationists push it around and is also making it clear that short-term gyrations in inflation are not going to trigger a policy shift.

In terms of portfolio strategy, credit unions with excess liquidity should continue to earmark funds in the belly of the yield curve (4-7 years) in order to maximize income. In terms of sectors, we continue to advocate underweights in CDs and traditional agency debt. Credit unions should overweight the Treasury and MBS sectors.

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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 30 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.