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INVESTMENT SERVICES

Weekly Relative Value

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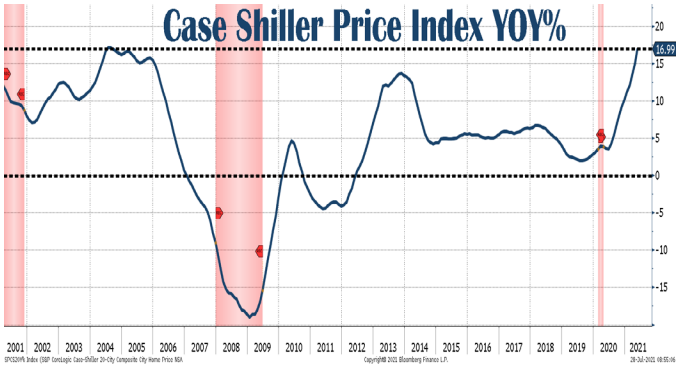
WEEK OF AUGUST 2, 2021

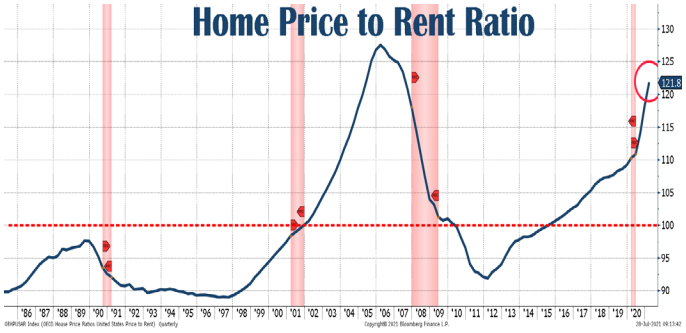
When Will the Shoe Drop?

"Gradually, then suddenly." – The Sun Also Rises, Ernest Hemingway

The spike in house prices is now the largest increase in history based on data going back to 1987. The Case-Shiller home price index soared a record 1.8% in May, taking out the prior surge of 1.5% back in March 2005. The three-month trend is crazy at a 22.1% annual rate. The year-over-year trend went from 14.8% in April to 16.6% in May – again, this takes out the bubble peak of 14.2% in the 2005/06 mania. The pace has accelerated for twelve months in a row. But in some cities, the raging housing mania produced far wilder results.



Adjusted for inflation, home prices have risen to new highs and are 50% above the long-run norm. When you normalize the home price index by income and rents, home prices are off the charts. We haven't seen anything like this since the last real estate bubble fourteen years ago. Memories have faded.



THIS WEEK

- WHAT PLANET IS THE FED ON?
- TRADE DEFICIT EXPLODES
- NO SUMMER OF JOY

PORTFOLIO STRATEGY

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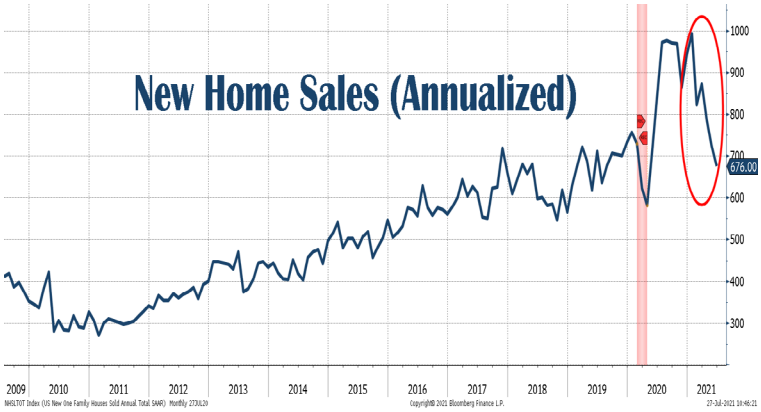
And, while prices skyrocket, sales of new single-family houses in June plunged by 6.6% from May, and by 32% from the peak in January, to an annual rate of 676,000 houses. This was the lowest reading since the economy was caught in the throes of the pandemic-induced lockdown recession in April 2020. Making matters worse, May was revised sharply lower to 724,000 units from 769,000 prior. So off the unrevised figure, the month-over-month decline in June was actually 12.1%.



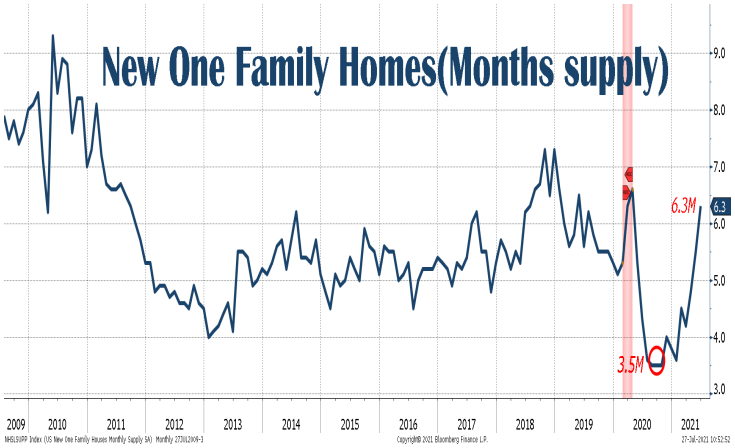
What's going on? Practically nothing was sold in the under $200,000 price category. Between $150,000 and $200,000, the sales share in June was a mere 2%! A decade ago, this segment took up around 30% of all new sales. The under $300,000 price category accounted for only 28% of total new house sales, down from 39% in June last year. That's where the volume used to be, but people willing and able to buy a new house under $300,000 are out of luck – prices have moved away from them. And facing those higher house prices, they went on buyers' strike.

"The moderate slowdown in sales is largely due to the huge spike in home prices…Buyers are still interested and want to own a home, but record-high home prices are causing some to retreat."
– Lawrence Yun, Chief Economist at the National Association of Realtors

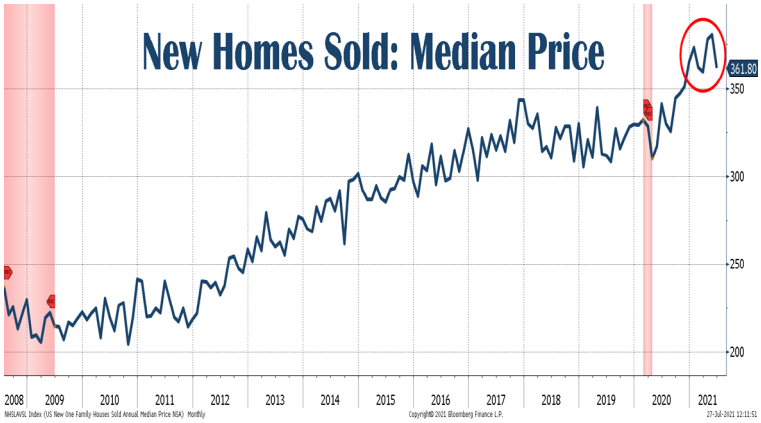
At the high end, there was no buyers' strike in June. In fact sales are booming at the high end (where the money is) in the category of people that have the full and undivided love and support of the Fed through its dogma of the Wealth Effect. We have never before been in an environment where, for every sale of a new home priced less that $200,000, there were seventeen priced in excess of $500,000. Houses with a price of over $500,000 accounted for 28% of total sales in June, up from a share of 23% in May and 14% in June 2019. And get this, the portion of sales that were made "with cash" rose to the highest level since 2005!

But because there aren't that many potential buyers in the high end, overall demand fell off. In addition, there is the whole issue of the shift to working from home that caused many people to go buy a house in a different location, a larger house to accommodate one or two home offices, and that trend may have run out of steam by now.

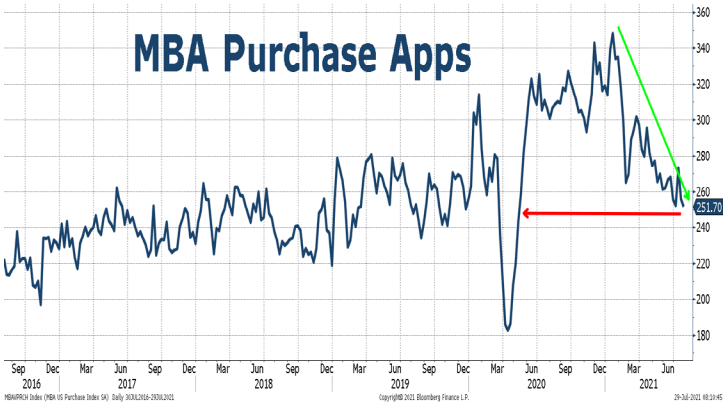
Despite the lower demand, homebuilders are building (that's for sure), even if more homes are now sitting on the market. Supply jumped to 6.3 months at the current rate of sales. Unsold spec homes for sale jumped to 353,000 houses the most since December 2008.



The concept of selling overpriced new houses to everyone is running into trouble. In June, the median price of new single-family houses sold fell by 5% in June from May, to $361,000, the lowest since March, having thus unwound part of the majestic spike that occurred starting in the summer last year. Home prices are still up up 6.1% year-over-year.



The high frequency data shows that housing may be beyond the "peak." The Mortgage Bankers Association (MBA) mortgage purchase application index sank in the week ending July 23 and dropped 1.6%, on top of the 6.4% plunge in the week ending July 16. So far in 2021, purchase apps have plumeted by 21% and is now at the lowest point since the economy was staging an attempt to move away from the sharp two-month pandemic lockdown recession (back on May 8, 2020).

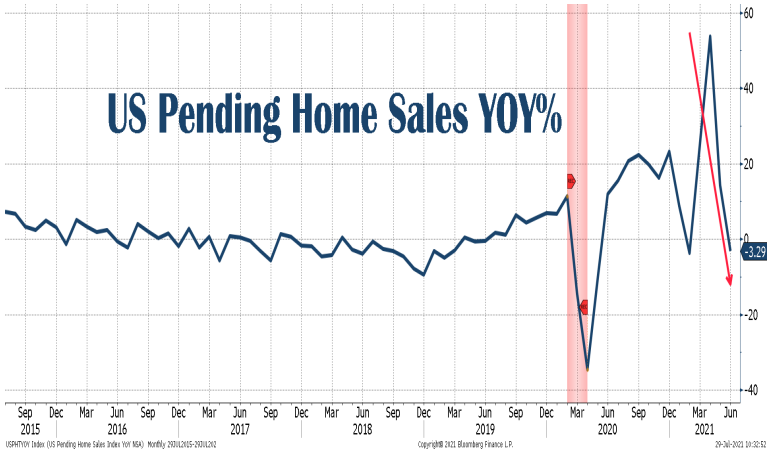


And last, but not least, pending home sales – a leading indicator of future housing demand – dropped 1.9% month-over-month, pushing pending home sales down 3.29% year-over-year. The consensus was expecting an unchanged number, but no such luck. This was the second decline in the past three months and the fourth in the past six. All regions saw sales slow as pending home sales decreased in the South and West, and rose 0.5% in the Northeast and 0.6% in the Midwest last month. The biggest drop was in the West with a decline of 3.8%, the most since February. The South retreated 3%.

This is what Fed Chair Jerome Powell had to say about the housing market:

"The housing sector remains very strong."

I can't believe he said that with a straight face. I'm still chuckling.



If housing data is starting to weaken now, imagine what happens when the Fed starts to taper... or, heaven forbid, raises rates. The first casualty is housing. But it won't end with housing. Real estate valuations are approximately $34 trillion. For perspective, at the prior housing bubble peak real estate valuations were $24 trillion. So, imagine if home prices drop 25% and revert to the mean. That would cause household net worth to plunge by $8.5 trillion. And when household net worth drops consumer spending follows. Like the prior bubble in 2006, it is impossible to time. But know that it is out there. This shoe will drop.

WHAT PLANET IS THE FED ON?

"With progress on vaccinations and strong policy support, indicators of economic activity and employment have continued to strengthen." – Opening comment from the Federal Open Market Committee (FOMC) Minutes

Real GDP for Q2 came in at 6.5% (2% below expectations). Here's the rub – you have to go back to the 1930s to see an economy so dependent on government support. Without it, GDP would be more than $1 trillion, or 5%, lower than it is today. And now these massive on-again/off-again rounds of fiscal stimulus are in the rear-view mirror.

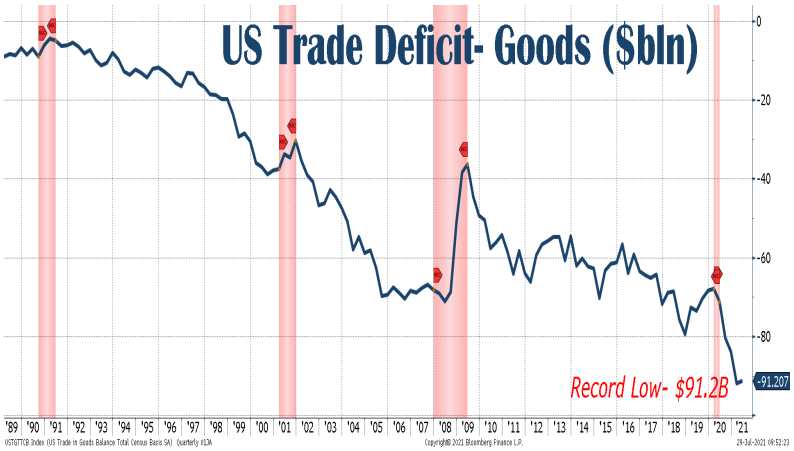
The Atlanta Fed GDP model has lowered its GDP forecast to 6.0% from 10% in mid-June. Likewise, the New York Fed's has been lowered to 4.19%. And, surely 12 men who occupy the Eccles building are aware that the Citigroup economic surprise index from meeting to meeting has tumbled from 44.90 to -19.00.

Meanwhile, the consensus for Q3 real GDP is still at 7.1%. Looking at the negative momentum in consumer spending, production, capex and housing activity, I believe the consensus will be very disappointed.

TRADE DEFICIT EXPLODES

Speaking of negative economic surprises data, the U.S. trade deficit on goods surged to $91.2 billion in June versus a $88 billion gap. Suffice it to say that that is a very deep hole and it is happening in the same quarter when the huge fiscal support fades away.

This is why: Americans get about half of what they buy from foreign producers. And because Uncle Sam stuffed the pockets of Americans with stimulus checks, imports soared at five times the pace of exports.



NO SUMMER OF JOY

As for COVID-19, there is no "summer of joy." Only 56.7% of Americans are fully vaccinated and only 500,000 shots are being administered daily, which is an 85% plunge from an average of 3.4 million per day in early April. Notably, the potent new Delta Variant has created a tragedy in Red States where it combined with anti-vaxxers, COVID deniers, conspiracy theorists see vaccine defiance as patriotism.

At the same time, the COVID-19 case count and hospitalizations are back on sharp rising trend. On top of this, the CDC warns that even those who are vaccinated can carry the delta variant.

And if Dr. Scott Gottlieb is right, this next leg of the virus is going to soar and not peak until October. You don't need a lockdown to slow growth down. All you need is enough parents to believe that their kids won't be going to school this fall. Not to mention the fear of returning to work in general for those people employed in public facing sectors of the economy. For example: an expanding list of restaurants are requiring vaccination proof for indoor diners to get a table. Not to mention the fact that a growing list of companies, including Apple, are reinstating mask mandates. This says all you need to know.

At the margin, virus fears may discourage people from going to restaurants, bars, hotels and travelling, especially to destinations (like Florida) with high transmissions. This is happening at a time when, in early September, the throngs of idle workers collecting a generous extended jobless benefit will be coming into the labor market expecting to return to his/her old job, which may now not be there.

So here's the deal. The unvaccinated are going to set the country on fire once again. Yes, those of us who are vaccinated will be protected from getting horribly sick, but this surely is cause to be wary of sky-high growth forecasts ahead.

I'm assuming the hawks on the FOMC read the daily newspapers. So count on growth downgrades with the delta variant breakout. Also keep in mind that Powell has said all along that the path of the economy and policy will hinge on the path of the pandemic. As such, expect more Fed tightening to be removed from euro futures and the Treasury market. Lower for longer indeed!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"T.S. Eliot once wrote, 'Only those who risk going too far can possibly find out how far one can go.' It seems the U.S. financial system is bound and determined to find out." – John Hussmann, July 29, 2021

The U.S. is at least eight to nine months away from attaining herd immunity and that is an optimistic assessment as the vaccination campaign sputters. As such, the economic road ahead is bumpy and is likely to now be a series of lower-case w's after the V-shape we saw in Q2.

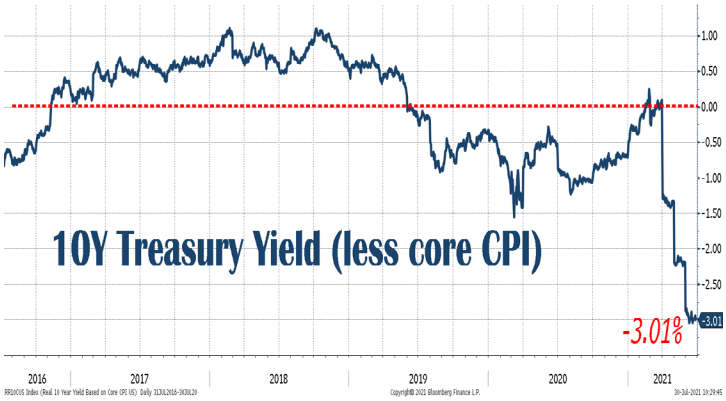
The fiscal boom and monetary stimulus part of this recovery is over. The stimulus money is going to run out soon. Infrastructure and child tax credits aside, all the macro risks are to the downside. Eviction notices will start coming out in

August and September (unless the moratorium is somehow extended, but then how does that help a severely impacted real estate industry?).

Do you really expect Powell and crew to start tightening financial conditions in this environment? Patience is required now given all the uncertainty and the recent weak tone to the incoming data flow.

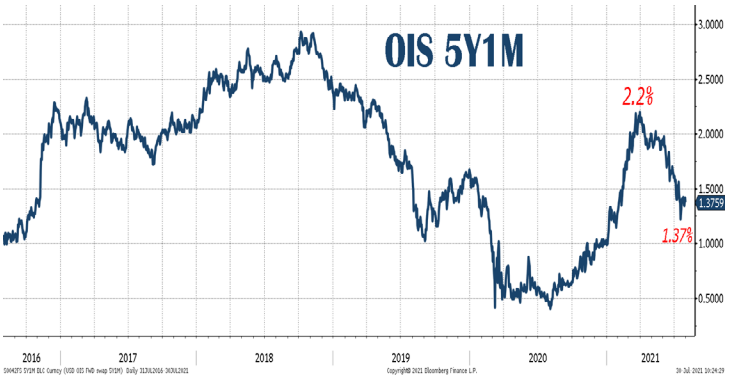
On the inflation file, the bond bears like to talk about the CRB hitting record levels, but the lion share of the rising prices of late are due to the food complex. Extreme weather across the globe has sharply boosted the likes of coffee and sugar to multi-year highs. What can the Fed do about the worst frost conditions in Brazil in two decades, scorching heat in North America and torrential rains in Europe? How can monetary policy cure climate conditions? Well…it can't!

The bond market had already figured this out before most economists, strategists, and pundits. The real 10-year Treasury note yield is down six basis points so far to a record-low of -3.01%. That is the bond market giving a tip-of-the-hat to the second-half GDP growth downgrade and transitory narrative.



This past week's Fed statement was another non-story. They are simply thinking about whether they should start discussing the possibility of making a plan to begin tightening when conditions are right. I also think Fed believes the economy is still very fragile, and that if they began to even modestly normalize monetary policy, it runs the risk of pushing the economy into a more fragile condition.

Shown below is a closely watched market proxy for where policy rates will stand at the end of the entire tightening move. One-month rates traded five years forward at about 1.4% – well below the Fed's forecast for their long-run rate at 2.5%. In other words, so much for the dots.



On the longer end, the 10-year Treasury yield sits at 1.22%. A month ago, it was 1.48%, and it was 1.62% two months ago. At the end of March, the benchmark yield sat at 1.80%. It's come a long way, but it could still go much lower as we move forward.

For the bond bears who can't understand what's happening, it's all about how views of peak growth and inflation and downside risks from the delta variant have conspired to trim future Fed rate expectations by over 100 basis points. (See OIS 5Y1M graph above.) It's not much more complicated than that. This unwinding process may have further to run.

As has been discussed consistently in this space, the Fed funds rate is likely to stay lower for longer. If so, excess cash will continue to negatively impact the balance sheet and portfolio. We continue to advocate reducing excess cash and investing in a fully diversified laddered investment portfolio. We also encourage credit unions to capitalize upon periodic market declines. Simply put: Buy the dip!

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