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INVESTMENT SERVICES

Weekly Relative Value

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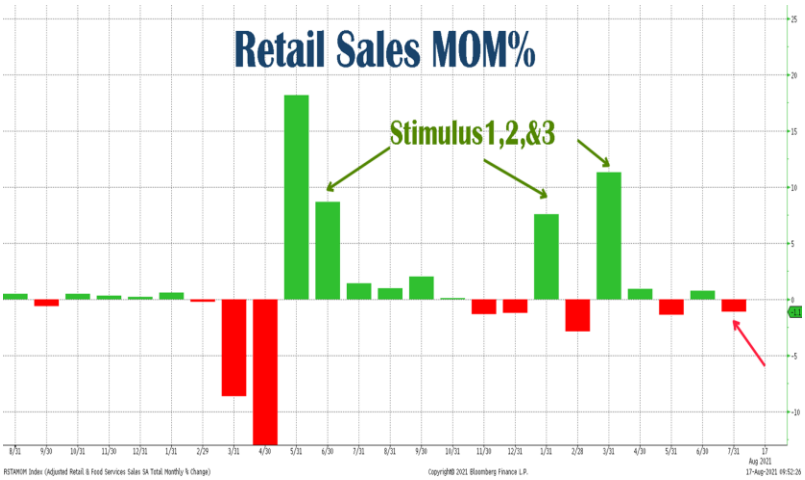
WEEK OF AUGUST 23, 2021

A Summer Chill

In last week's edition of the Weekly Relative Value, I discussed the possibility of a significant decline in consumption. And whether it's due to the end of stimulus checks, the evaporation of savings, or a fresh round of COVID restrictions, it appears that the American consumer is once again on the verge of tapping out.

To be blunt, the July retail sales report was ugly. Sales were down (-1.6% in July) and are now down three consecutive months. There was a mild upward revision to June but that was not enough to prevent this from being a woeful report. Excluding auto sales were off 0.4%, whereas the consensus was +0.2% . This is clearly not just a case of chip shortages and thin motor vehicle inventories. There was a slowdown across virtually all leisure sectors, from airlines to lodging to entertainment, although one can see that spending on durable goods is also starting to take on water.

The all-important "retail control" number, which feeds into the consumer spending section of the GDP report, collapsed 1% in July (5X worse than consensus forecast). Over the past three months, sales have contracted at over a 3% annual rate. This is a very deep hole to climb out of.



Shortly, after the retail sales data, Wall Street took out their machete and slashed their GDP forecasts for the third quarter (Q3) and future quarters. Most notably, the always-bullish Goldman Sachs lowered their Q3 GDP forecast from 8.5% to just 5.5%. For what it's worth, I believe the slowdown in Q3 will be worse than the venerable Goldman Sachs is forecasting.

THIS WEEK

- PEAK HOUSING
- ACCIDENT WAITING TO HAPPEN
- GROWTH SCARE
- THE ENERGIZER BUNNY
- I-N-F-R-A-S-T-R-U-C-T-U-R-E

PORTFOLIO STRATEGY

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How about flat or even a modest negative contraction? Now that would surprise the Roaring 20s crowd!

As vividly shown in the previous graph, this data series has been totally distorted by recurring rounds of stimulus checks. Just look at the monthly pattern of extreme volatility. Government policy of issuing stimulus checks has pulled spending forward, which leaves question marks over what happens now with the bulk of Biden's trillions now spent?

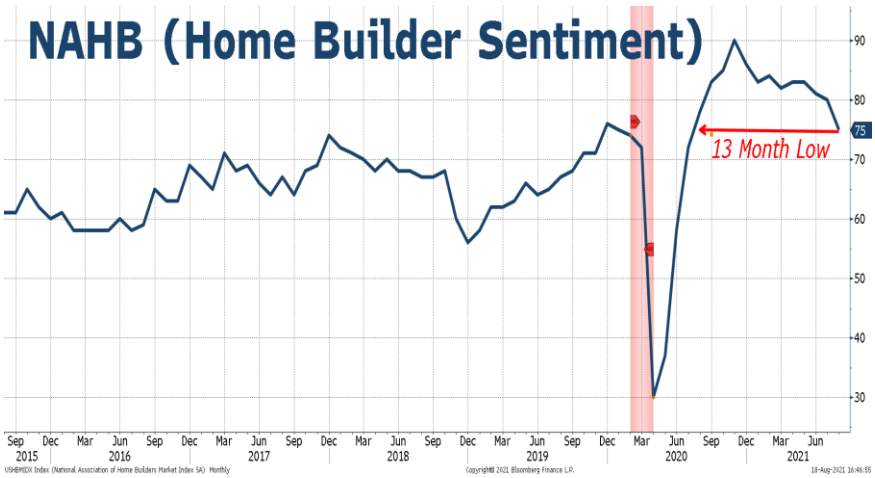
The incoming data shows that consumers are reverting to their pre-COVID spending patterns. Get this. Since the massive fiscally-juiced-up March spending boom, 40% of that spending spree has now been reversed in the past three months. Meanwhile, stimulus checks are now in the rearview mirror.

Frankly, it seems that without the government constantly pumping cash into Americans' pockets (for doing nothing), this "blistering recovery" is just an illusion. One can't help but worry what happens to the U.S. economy when the stimulus checks, deferrals on student loan debt, eviction moratoriums and other emergency benefits finally come to an end.

PEAK HOUSING

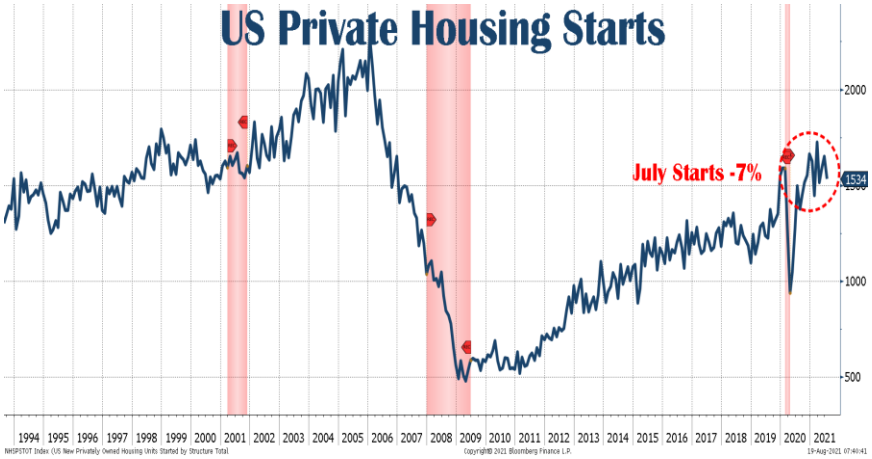
"Our expectation is that production bottlenecks should ease over the coming months and the market should return to more normal conditions."
– Robert Dietz, Chief Economist, National Association of Home Builders (NAHB)

The NAHB Housing Market Index crashed from 80 to 75 in August to a 13-month low (July 2020). The single-family sales index plunged to 81 from 86 last month, and more notably, prospective buyers traffic tumbled to 60 versus 65. To no surprise, the National Association of Realtors (NAR) was quick to shrug off the sentiment slump.

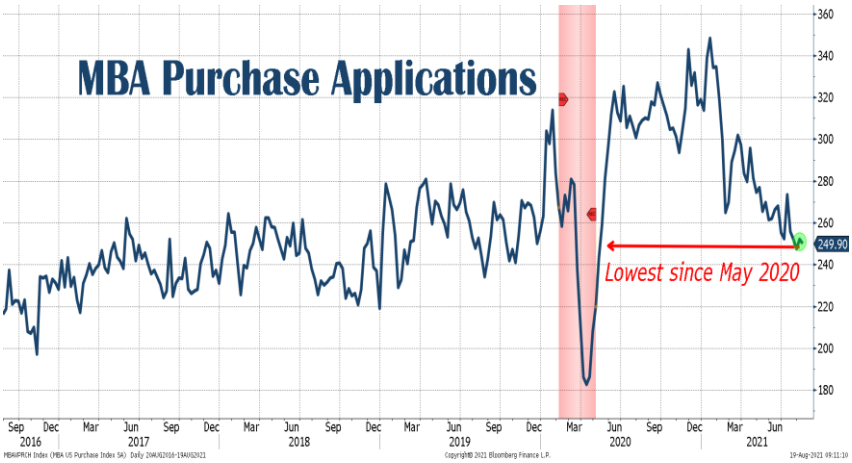


Moving on. July housing starts collapsed 7% month-over-month (vs. -2.6% expected) to a three-month low of 1.534 million units (annualized). The plunge in starts was dominated by multi-family units. Single family units were down 4.5% and multifamily units down 13.6%.

Year to date, starts are running at a deep -12.8% annual rate. Single-family starts are down at a 25% annual rate from December. Not only are single-family housing starts down a whopping 25% year-to-date (at an annual rate) but permits are down 24.3%.



Not only did housing starts slump to a three-month low, the high-frequency weekly data also shows that things are going from bad to worse. The Mortgage Bankers Association's (MBA) mortgage application volume index retreated 3.9% in the week ending August 13, declining in two of the past three weeks. Notably, the application index for home purchases dropped 0.8% and is down in four of the past five months. This level is lower than it was in mid-May 2020 when the economy was emerging from the worst downturn in the post-World War II era.



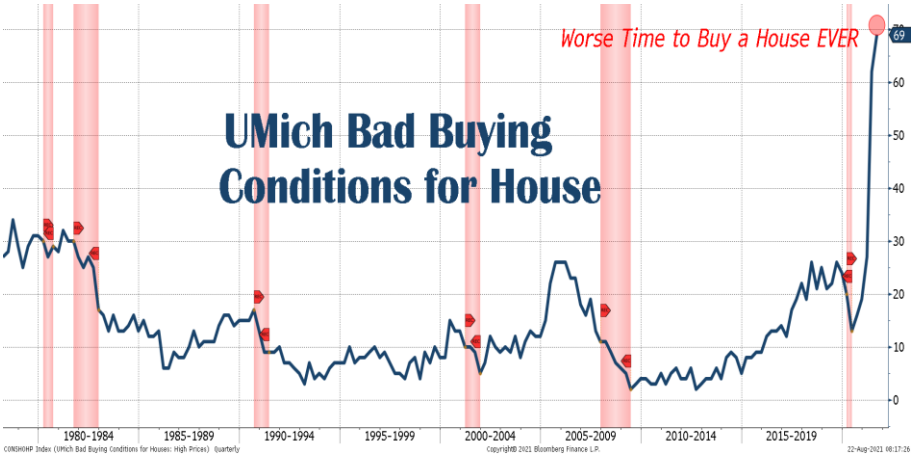
ACCIDENT WAITING TO HAPPEN

"If something cannot go on forever, it will stop." – Herb Stein, American economist

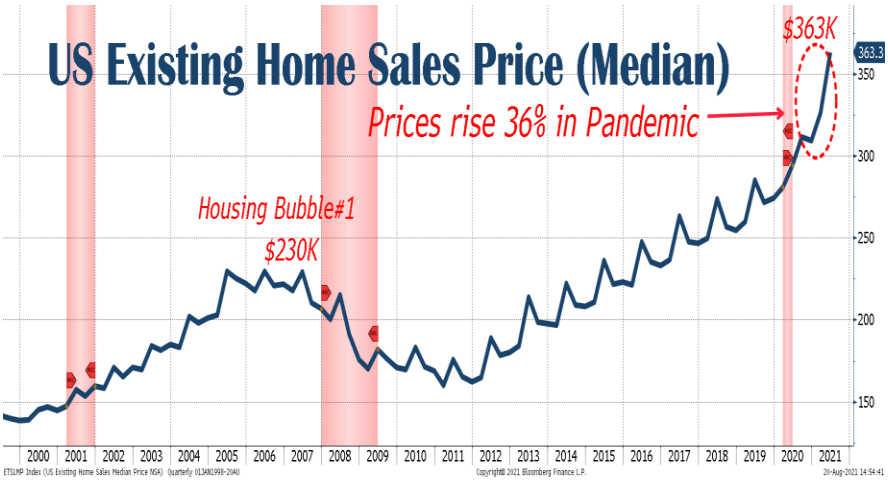
Home prices – when benchmarked against all the fundamental factors that drive valuations – are in the stratosphere. On average, prices nationwide are 25% overvalued relative to residential rents and income. In inflation-adjusted terms, housing prices are nearly 50% above normalized levels. This is an accident waiting to happen.

And it may not even take Fed action or even higher rates, although that would definitely impact home prices. The best cure for high prices is high prices. As the University of Michigan survey shows, households have pared their homebuying intentions to four-decade lows — they are balking.

As shown below, consumers believe that buying conditions for houses are the worst ever!



The demand destruction will ensure that prices mean-revert. I believe this is the greatest economic and financial risk. It's not about the banks this time, but the shadow banking system. And, if home prices do mean-revert, the ensuing hit to household sector balance sheets and the negative wealth effect on consumer spending is likely to be spectacular.



GROWTH SCARE

Ugly retail sales, and the weakest homebuilder sentiment in 13 months, adds up to a "growth scare" as U.S. macro data are declining/disappointing at the fastest rate since March 2020. As a reminder, the Citigroup Economic Surprise Index does not indicate whether the economic data are strong or weak. Rather, it simply speaks to how the data are coming in relative to expectations.

As shown graphically below, there have now been 15 straight days of negative readings in the Citigroup Economic Surprise Index. This suggests if not confirms that the consensus forecast for economic growth is too optimistic about the future and has not properly discounted the complete lack of momentum that has occurred with the fiscal stimulus fading into view, as well as rising COVID-19 cases.

Here's the scoop. Real sales and housing starts are a proxy for what is happening to three-quarters of the economy, and they are in a deep hole at the moment. Over the past six decades, whenever final sales and housing starts have been so weak in tandem, the average real GDP print was -1.6% (annual rate). On the Q3 GDP score, the economic consensus is still near 7%. Frankly, I see that as next to impossible given the weakness in sales and housing. I guess economists are expecting a huge inventory build to offset the weakness elsewhere. Good luck to you and the Red Sox on that! I believe it is only a matter of time before growth expectations are slashed. Will this be the moment when Wile E. Coyote begins to look down?

THE ENERGIZER BUNNY

COVID is like the Energizer Bunny. It keeps going and going. A U.K. study has shown that COVID-19 shots are less effective against the Delta variant and the protection from vaccines wanes after 90 days. While vaccination will stave off the majority of infections, people who had been inoculated were shown to carry the same viral load as those who had not been, raising doubts of achieving herd immunity.

All anyone has to do is look at what is happening in Israel. This country has one of the most vaccinated populations and now one of the highest infection rates on the planet. The daily rate of confirmed new virus cases has more than doubled in just the past two weeks; restrictions are being reimposed; and the government is considering a new lockdown. Much of the rest of the world is back in restriction mode, and that includes several of China's major ports.

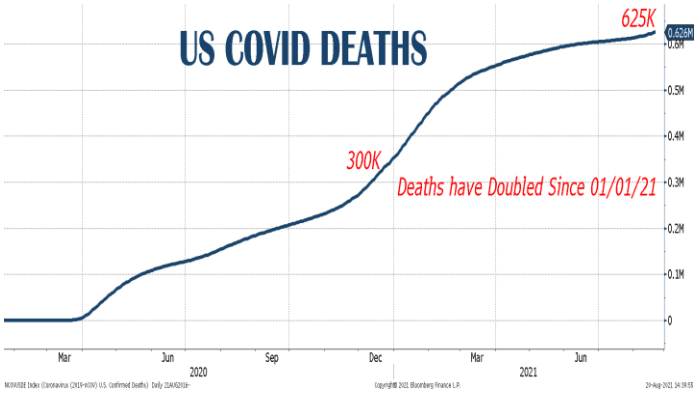
In the U.S., confirmed new cases have skyrocketed and hospital rooms are filling up. One in five intensive care units throughout the U.S. had at least 95% of beds occupied last week. The number of people dying in hospitals with COVID hit the highest since February.

Bottom line: It is likely that Delta won't peak until October or November and while no one believes we will have another lockdown, it is safe to say that increased caution will have an economic impact. It's already evident in the data. Notably, consumer spending plans are hooking lower with a pullback in air travel, hotel bookings and now restaurant reservations.

Source: GIPHY

Companies are being forced to delay their back-to-office strategies. Apple just announced that it is delaying its return-to-the-office work date to January 2022. Lest anyone think we are heading back to "normal" any time soon, I suggest a read of the front-page WSJ article titled Delays to the Office Set Bosses on Edge. The chilling conclusion is right up front in the first paragraph —"offices may be closed for nearly two years."

But the really big question, now that summer is drawing to a close, is what happens to the back-to-school season? Delays, quarantines, switches to "virtual" education, mask requirements, etc. Very quickly, this is now a big issue in the southern states. Florida, Mississippi and Louisiana have thousands of school children and teachers under quarantine. Kentucky and Georgia are reshuffling their reopening plans. And South Carolina is shifting to remote learning. These are disruptive economic forces, even if necessary.

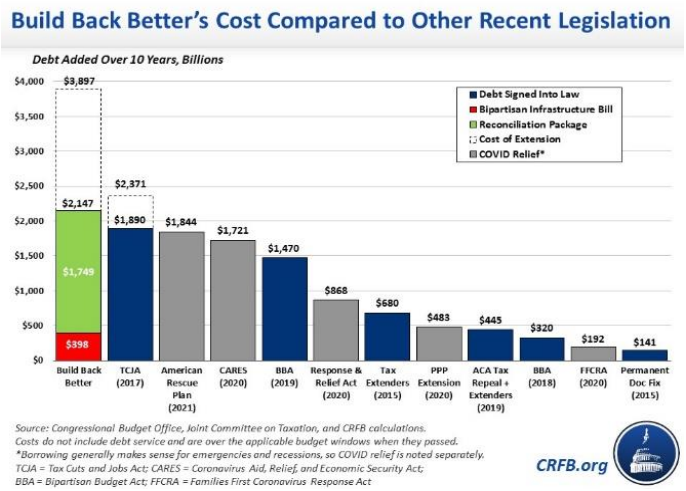


As for the potential booster, there is lots of uncertainty as to the efficacy around mutations. It seems like herd immunity now seems harder to achieve, and a gnawing realization is that we may all, at some point, get the COVID-19 virus and the "new normal" is we simply learn to live with it. Oh, in the process, maybe we won't die, or even have to be hospitalized (hopefully). But does anyone want to get that sick that they lose 15 pounds? This is not a disease you want to get.

I-N-F-R-A-S-T-R-U-C-T-U-R-E

The 14-letter word everyone wants is infrastructure. We need it. A long list of CEOs recently signed a petition to Congress to get it done! But nobody wants to pay for it. The timetable for the infrastructure bill is in doubt. Even still, House Speaker Nancy Pelosi may get her left-leaning troops in line and get the plan passed. If so, as laid out today, the total cost for both packages (including the "human capital" package) is estimated to be $4 trillion (without offsets). If so, debt would rise to 114% of GDP by 2031.

The non-partisan Committee Responsible for Federal Budget shows that the Build Back Better program would be more than 60% larger than the Tax Cuts and Jobs Act (TCJA) of 2017 (with extensions), more than twice as large as the Coronavirus Aid, Relief and Economic Stimulus (CARES) Act, and more than 2.6 times as large as the Bipartisan Budget Act of 2019.



We don't need massive new borrowing to "Build Back Better." Given the current state of the budget and economy, it's time to say enough is enough. If Congress does pass this plan, they had better identify additional offsets for the cost. Yes, that means higher taxes – possibly to the tune of $2 trillion.

One more comment. Many are hoping that this infrastructure spending will fill the void left from the expiring stimulus checks and drive economic growth forward. Here's the thing. In terms of economic growth, even if this passes there would be no reason to ramp up GDP expectations anytime soon. Remember: GDP is all about spending and the spending is over a 10-year time frame whereas the tax bite likely comes first. As for the spending on transportation networks and "greening" of the economy, the history of prior infrastructure plans is that they are never "shovel ready" and typically take two years to go from planning phase to actual spending.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The latest minutes from the July meeting of the Federal Open Markets Committee (FOMC) showed that most officials agreed they could start slowing the pace of bond purchases this year. As a reminder, the Fed is buying $120 billion per month of debt ($80 billion of Treasuries and $40 billion of mortgage-backed securities).

Many expect Fed Chair Jerome Powell to strongly signal at this weekend's Jackson Hole confab that the Fed is ready to lay the groundwork for tapering its bond purchases. The thinking is that the Fed would then announce a formal plan at

its next policy meeting, which starts September 22, and then start tapering after the next meeting, which starts November 3.

That said, Fed Chair Powell – the only voice that counts – may be worried about the more than six million Americans who are still out of the workforce because of the pandemic. If so, he would probably rather wait until the September policy meeting to lay the groundwork for a tapering. By then, he would have seen the August jobs report, another Consumer Price Index (CPI) report, how the return to school is going and whether the highly transmissible COVID-19 Delta variant had come under control.

We should find out sooner rather than later which path the Fed takes. However, it's becoming increasingly clear that it's not *if*, but *when* the Fed will begin the tapering process.

So, what if the tapering is announced?

If the Fed does taper, the effect is likely to be seen in the MBS sector (and housing) as the Fed has been purchasing $40 billion monthly purchases of MBS. So, it is mortgages that are at greatest risk. The Treasury market has already adjusted with 10-year Treasury yield rates rising from 0.5% to 1.75%. That is in the rearview mirror. But mortgage spreads are drum-tight as is the case—now at 57 basis points; they were 80 basis points pre-pandemic, and the long-run norm is 112 basis points. So, the question is: Will the Fed reduce its support for the mortgage sector just as the housing market is rolling over?

It should also be noted that when the Fed has tapered in the past, equity prices have fallen. And with equity prices extremely stretched, the decline could be significant. If so, Treasury yields could decline in a flight to safety. This is usually coincident with a "risk-off" rotation from the equity markets.

Finally, while there has been much "taper talk," Treasury yields have been dropping since March. Why? Well, it's not about the Fed. It's the realization that with plunges in consumer sentiment, retail sales and housing starts, the U.S. economy is slowing. The slowdown is occurring while fiscal stimulus is being withdrawn and the Delta variant surges.

It's not just the U.S. China's July retail sales, industrial production and investment all surprised to the downside, confirming weaker growth momentum. This probably reflects the setback from COVID lockdowns, disruptions to fixed-asset investment from severe flooding in central and eastern China, and softer exports. The same slowdown is occurring in Japan. So, we now have the largest three economies in the world slowing down at the same time.

So, a great time to taper, right?

Anyway, bonds have seen the whites of the eyes of the post-stimulus check economy. The 10-year Treasury yield is down to 1.25% – about 10 basis points below where it closed on non-farm Friday in the wake of that allegedly "ripping" employment report, and 50 basis points below the recent high of 1.75% in March.

In terms of portfolio strategy, we continue to believe that "excess cash" on the balance sheet will negatively impact net interest margins. As such, credit unions should continue to maintain a fully diversified, risk-appropriate investment portfolio. Excess cash should be reduced to a minimum. From a tactical perspective, volatility could increase if the taper process is announced. And given the recent sharp decline in yields, the bond market could retrace. Any bond sell-offs should be viewed as an opportunity to lock in higher yields.

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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.