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INVESTMENT SERVICES

Weekly Relative Value

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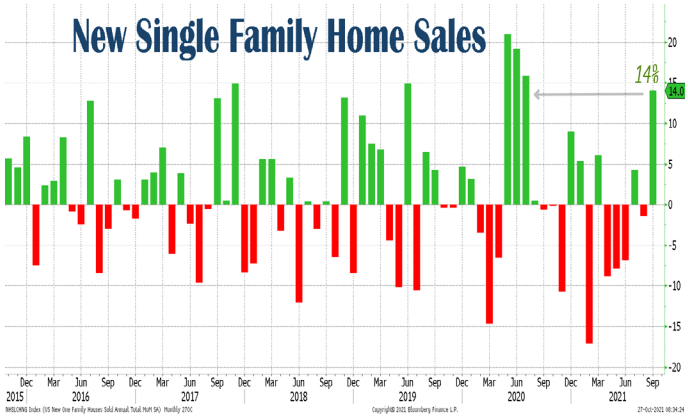
WEEK OF NOVEMBER 1, 2021

The House That Roared

"Persistently strong demand among traditional homebuyers has been amplified by an increase in demand among investors this summer." – Selma Hepp, deputy chief economist at CoreLogic

New home sales in September literally exploded higher. After a downward revision to -1.4% month-over-month in August, September new home sales screamed 14% higher month-over-month – the biggest jump since July 2020.

By region, the Northeast was a beast with a 32.3% surge, followed by the South (+17.5%) and the West (+8.2%). The Midwest saw sales slide 1.5%. It looks as though a lot of fence-sitters jumped into the real estate market in a very big way.



The pricing is nutso. The median new home price rose 18.7% year-over-year to a new record high of $408,800. You know you are into a complete frenzy when a +18.7% rise in price is the "slowest"increase in six months. (The six-month trend is in excess of a 22% annual rate - absolutely unheard of).

These numbers are simply off the charts. Normally, home prices go up with inflation plus 2% – not 15%! This is a bubble of mammoth proportions and has taking out every other peak in the past, including the mania of the mid-2000s when the highest year-over-year trend in that period of insanity was 14.4%.

THIS WEEK

- A LEAK IN THE HOUSING BUBBLE?
- COULD HAVE BEEN WORSE
- THE CONSUMER IS KEY
- THE MOST INAPPROPRIATE MONETARY STRATEGY EVER?
- BUYING TREASURIES

PORTFOLIO STRATEGY

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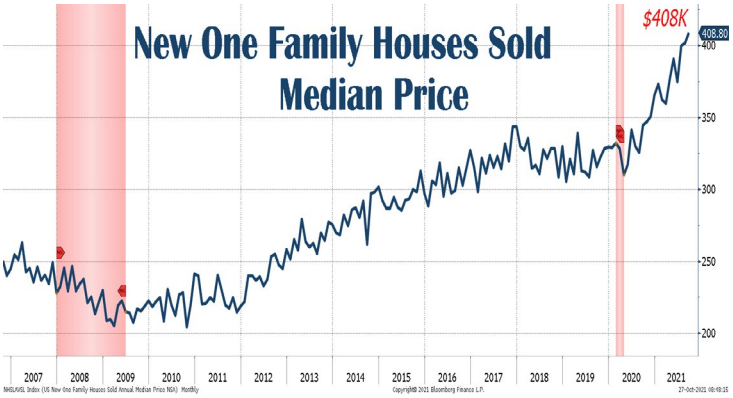
So with home prices now in the stratosphere, it takes more than eight years of income to buy a median-priced home in this country (60% above the historical norm).

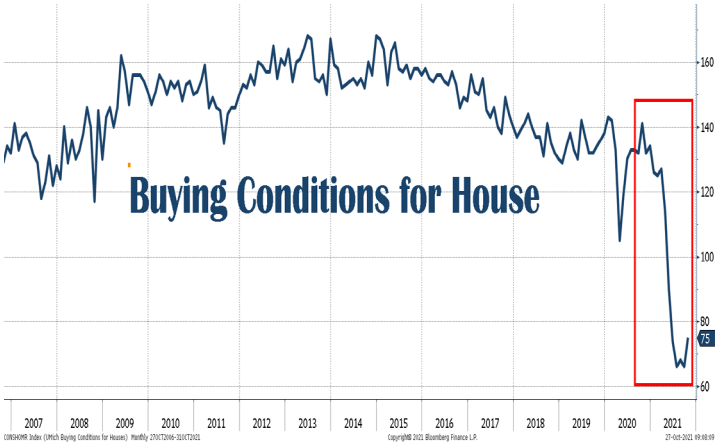


Prices continued to spike as the high end boomed and the low end all but died. In fact, the new home priced below $150,000 has become completely extinct. Just a decade ago, homes in this price range represented 20% of the market (and over 30% two decades ago).

*"**While strong home price appreciation rates are narrowing the pool of buyers, particularly first-time buyers**, the depth of the supply and demand imbalance and robust demand among higher-income earners will continue to push prices higher." – Selma Hepp, deputy chief economist at CoreLogic*

- Only 2% of new homes are now priced under $200,000. This was half the market a decade back and over a 60% chunk two decades ago.
- In the $200,000 to $300,000 range, only 12,000 homes were sold – 19% of total sales. This is the lowest on record, down from a share of 29% a year ago and from 35% in September 2019.
- The $300,000 to $400,000 range accounted for 24% of total sales. The $400,000 to $500,000 range also accounted for 24% of the sales.
- And the high end, over $500,000 homes accounted for a record 31% of sales up from 12% ten years ago and a 5% share two decades ago.

All of which explains why (according to UMich sentiment surveys), homebuyer sentiment is firmly at record lows driven by price.



Yet, even with homes priced to the moon it took builders a mere 3.2 months to make a sale upon completion, versus 4.5 months a year ago and the long-run norm of five months. So new homes, as expensive as they are, have proven to be priced for sale – and buyers for the time being are not balking.

How is it that homes are both unaffordable and soaring in price? As with so many other things that shouldn't be, the answer can be found at the intersection of Wall Street and easy money. Institutional investors have bought nearly one in four homes. So, if you have been outbid on a home, there's nearly a one in four chance it was to an investor or group of investors.

Last word goes to Robert Shiller:

*"Even at currently elevated U.S. home-price levels, buying still makes sense for those who are set on ownership…**But buyers need to be sure that they can accept what could be a rather bumpy and disappointing long-term path for home values."** – Robert Shiller*

A LEAK IN THE HOUSING BUBBLE?

Pending home sales are a forward-looking indicator of closed sales in 1-2 months. In September, pending home sales were expected to scrape out a modest 0.5% month-over-month rise, but that was a long way off as it tumbled 2.3%

*"Contract transactions slowed a bit in September and are showing signs of a calmer home price trend, as the market is running comfortably ahead of pre-pandemic activity…**Rents have been mounting solidly of late, with falling rental vacancy rates…This could lead to more renters seeking homeownership in order to avoid the rising inflation."** – Lawrence Yun, chief economist at NAR*

month-over-month. That is the third monthly drop in the last four months and leaves pending home sales down over 7% year-over-year. Signings declined in all four U.S. regions from the prior month, led by a 3.5% drop in the Midwest.

There is no denying that rents are rising. In total, across the 100 largest markets, the median asking rent for 1-BR apartments increased by 11% in October compared to October 2020, and by 11.8% compared to March 2020, according to data in Zumper's National Rent Report.

But, is Mr. Yun (in the above quote) saying if you can't afford to rent, you can afford a million-dollar starter-home? Sure thing.

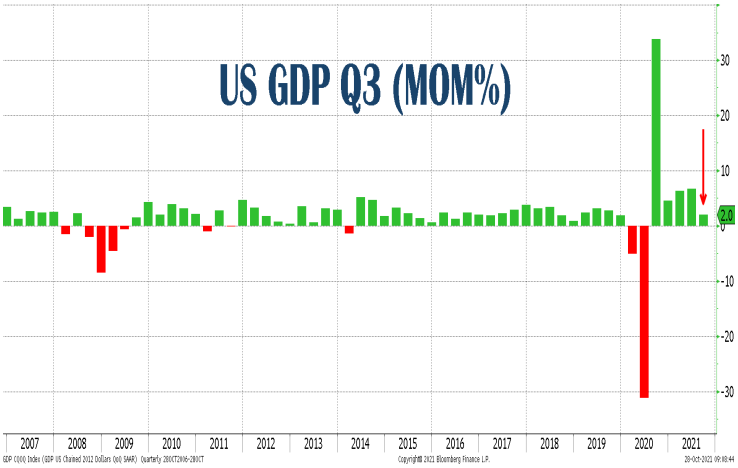
COULD HAVE BEEN WORSE

The Q3 GDP number was bad, but not nearly as bad as it could have been. At 2%, it did indeed miss the 2.6% consensus by a lot, but it could have been far worse**.** Of note, the Atlanta Fed GDPNow cast was expecting a miserly .19% gain.

Even still, the third quarter GDP was far below Q2 GDP of 6.7% and the pandemic stimulus driven growth rates of the past four quarters. But hey, those were special. In the decade from 2010 through 2019, annual GDP growth averaged 2.3% and never reached 3% in any single year. So 2.0% is in that normal range for the U.S. economy which was the lowest since the COVID collapse quarter of Q2 2020 when GDP crashed more than 30%.

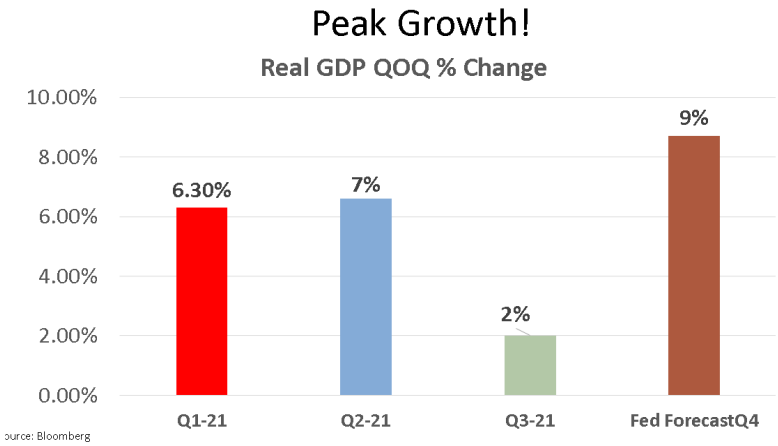
Summary Highlights:

- After the stimulus-powered gigantic gains in Q1 and Q2, the consumer spending spree has slowed as consumer spending dropped to 1.6% from 12.0%. Consumer spending accounts for 70% of total GDP.
- Growth in Q3 was further marred by a huge record massive blistering trade deficit, which is a negative for GDP. Exports add to GDP; imports lower GDP. The balance (exports minus imports), or "net exports," worsened by $67 billion, or by 5.4%, to a record worst of -$1.31 trillion annual rate.
- Commercial fixed investments shifted into neutral.
- Meanwhile, investment was a positive contribution, thanks mainly to businesses restocking depleted inventories.
- Government was a marginal factor, as it has been in recent quarters.



In summary, GDP rose entirely due to an inventory build and the "pandemic recovery" led by consumer spending spree has softened. Overall, the report was stronger than I expected. Nonetheless, this was a weak report.

The question now is how much further will subsequent revisions shrink the initial print and whether Q3 marks the lowpoint for U.S. GDP or will Q4 be even worse. Even if there is room for some optimism over a Q4 growth pick-up, the Fed is implicitly forecasting +8.7% for fourth quarter GDP. Good luck with that one.



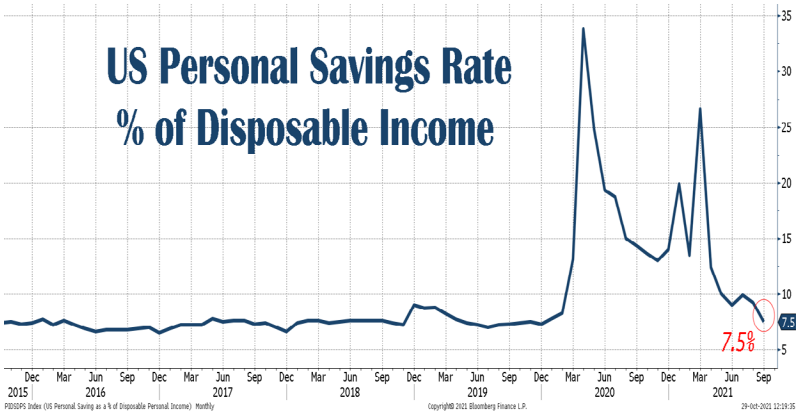
THE CONSUMER IS KEY

When looking under the cover of consumer spending, there was one breathtaking statistic: the nearly record plunge in spending on autos. The contribution of personal consumption of motor vehicles and parts to the overall GDP growth number was a whopping -2.4%, the second-worst print on record after 1980.

To be sure, it wasn't just autos where spending imploded: it was **all** goods that showed the weakness. Spending on furnishings and durable household equipment slumped at a 10.3% annual rate, a negative reading not seen since the first quarter of 2009. This spending – or lack thereof – wiped off 2.7% of growth last quarter.

Of course, many will merely deem this to be "transitory". The conventional wisdom continues to push the supply-side weakness as the explanation for the plunge in spending. But could the weakness also be that pent-up consumer demand has been exhausted at the same time we are entering a phase where consumption is falling off a cliff for two reasons: the end of extended unemployment stimmulus and the end of "excess" savings.

Income drives consumption and consumption drives growth. In Q3, labor compensation rose at a 9% annual rate with job gains and the wage pick-up. But there was a huge offset from the pullback in government handouts. In fact, the $240 billion increase in wages and salaries was almost completely offset by a $222 billion reduction in government fiscal transfers. Tack on higher prices, and the really big deal in Q3 was the 5.6% decline in real personal disposable income – following a 30.3% slide in Q2 (and -1.7% year-over-year).



I hear from the Wall Street crowd that households are sitting on "excess savings" of roughly $2.5 trillion. And the view is that this is "dry powder" for future spending. First and foremost, it's income growth that drives consumption – not savings. Second, the "excess" savings that Wall Street raves about is not excessive anymore. In fact, the absolute personal savings currently has declined by 50% since the beginning of the year and is just $1.336 trillion, the lowest since January 2020. It's best to fade these simplistic narratives.

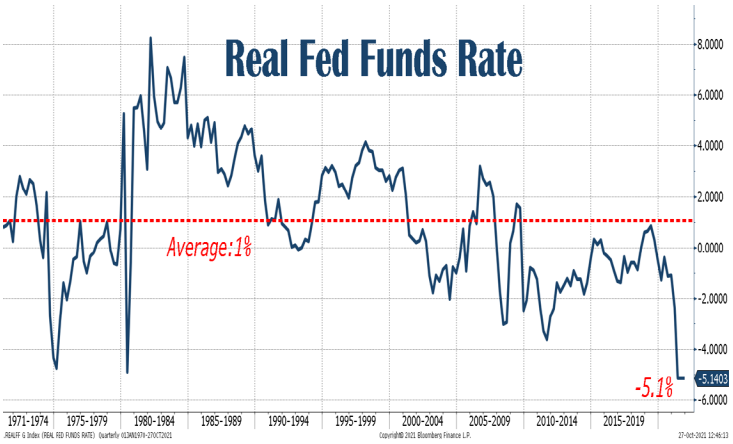
And the savings rate (percent of disposable income) has plunged down to 7.5% from 9.2% and is now below the 8.3% level prevailing before the pandemic. The pent-up demand from the fiscal stimulus is yesterday's story. In other words, we borrowed $5.7 trillion and this is the net result. Easy come, easy go!

THE MOST INAPPROPRIATE MONETARY STRATEGY EVER?

"The most inappropriate monetary policy that I've seen maybe in my lifetime." – Paul Tudor Jones

The Fed has kept the real inflation adjusted Fed funds rate well below the economic growth rate since the Financial Crisis. Today, the real Fed funds rate (inflation-adjusted) is a "negative" -5.1%.

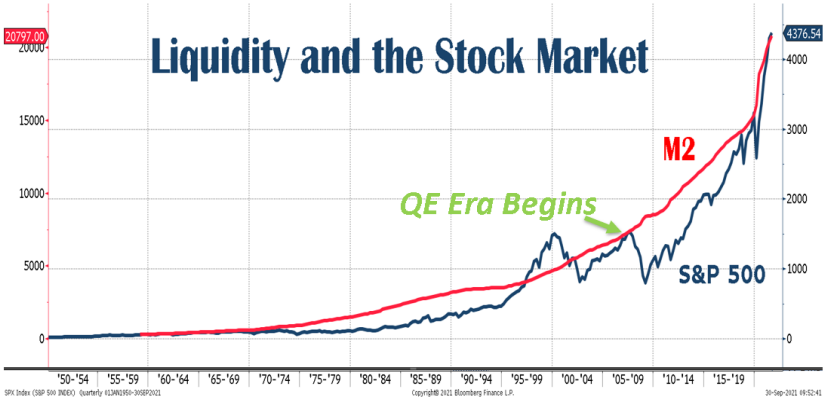
In addition to keeping interest rates negative for the past 12 years, the Fed has been agressively buying securities via their quantitative easing (QE) policy. According to ex-Fed Chair Ben Bernanke, every $6–$10 billion of excess bank reserves (the QE money) is roughly equivalent to lowering interest rates one basis point. So using the "Bernanke adjusted" federal funds rate, Powell and crew have taken the real Fed funds rate it to an unheard of -10%! You read that right – negative 10%.



So why does the Fed continue to maintain "extreme crisis" level policy?

First, the Fed's asset purchases served mainly to pump up stock prices. The graph below tells the story as as the equity market has moved in tandem with the Fed's money printing operations and their unprecedented liquidity injections (M2).

A Picture is Worth a 1000 Words!



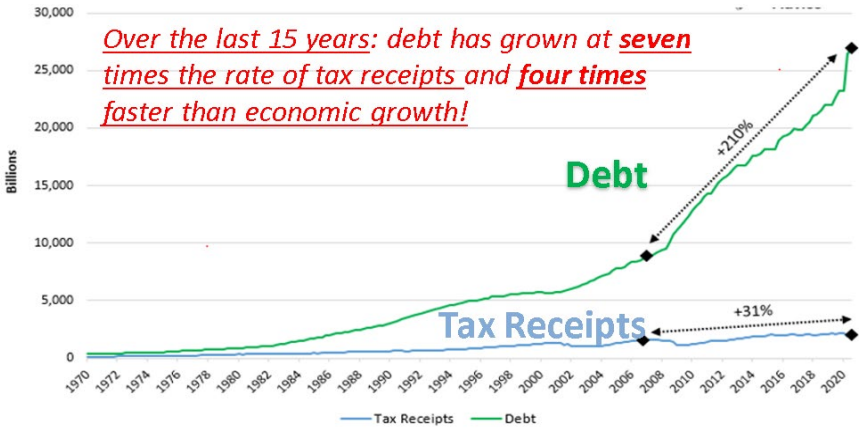
The Fed's stimulus created asset inflation. This has helped investors but done nothing to spur GDP growth. The S&P 500 is up 34% since the pre-pandemic highs. However over the same period, real GDP has grown less than 1%. Since QE commenced in 2008, the stock market is up nearly 200% – more than twice the growth in GDP. Historically, stock market gains have tracked real GDP growth. This disconnect is a function of the nearly $8 trillion increase in the Fed's balance sheet and ZIRP.

Here's the thing. The Fed does not want pop a bubble, especially since they created it. If the bubble does burst, the wealth effect will go in reverse and consumption and growth will decline.

Second, we all know that fiscal prudence is a joke. Debt was egregiously high prior to the pandemic. However, since March 2020, U.S. government debt has skyrocketed over 24% ($5 trillion) to $28 trillion. The fiscal deficit has soared to $4 trillion – 13% of GDP and $4X the average of 3%.

When debt grows much faster than the ability to pay for it, it becomes problematic. Since 2006, U.S. debt has grown at 210% whereas tax receipts have risen only 31%. Over this period debt growth has been four times economic growth.

And the hole is so deep and getting deeper by the day. According to the U.S. Debt Clock, the federal debt projection, debt is expected to reach $50 trillion in March 2025. Debt-to-GDP ratio is projected at 189% in 2025, up from 129% now. Is that sustainable?



The Treasury needs low interest rates and consistent buyers of their debt to keep such an unsustainable pace going. Currently, the government's interest expense is less than 8% of total expenditures. That is the lowest percentage since at least 1947. However, if rates rise to say 2% interest expense on debt would be close to $1.3 trillion.

This economy, stock and credit markets are wedded to low rates staying low. Without extremely low interest rates to make the new and existing debt affordable, economic growth would disappear, the stock market would collapse and financial defaults would be plentiful.

Sadly, no one wants to solve the deficit problem because the cost of fixing it involves short-term economic pain and lost votes. And there is simply no way to grow out of this deficit. Some combination of higher taxes and reduced spending is

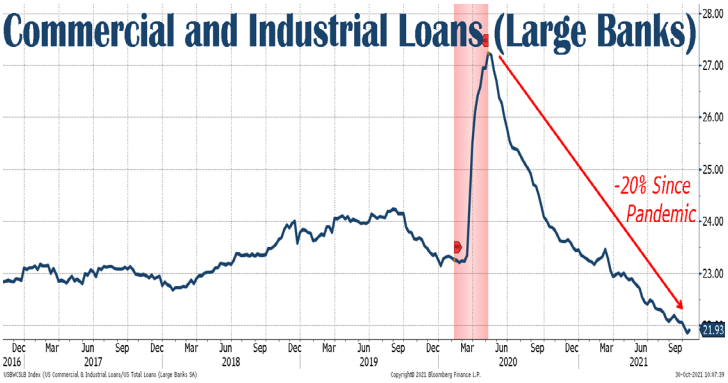
obviously required. The politicians on the other hand seem to think that more debt will fix the debt problem. So they continuously kick the can down the road time and time again.

"Perhaps the real framework is anything that justifies not tightening?" – William White

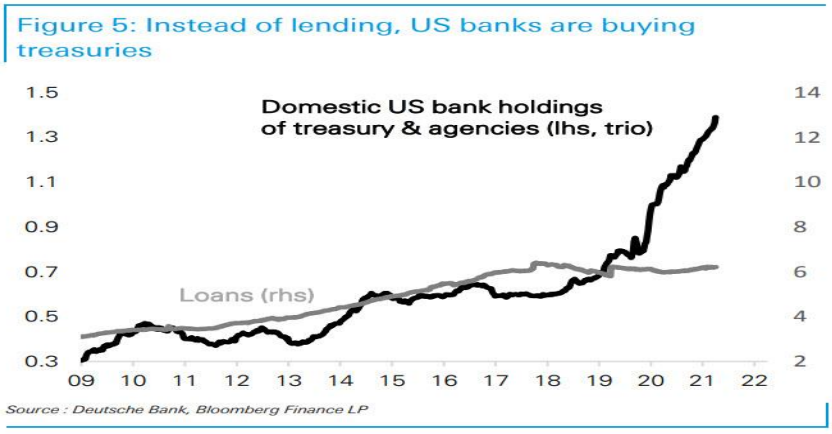
The Fed's official mandate is to maintain full employment and price stability. However, in reality they may be hiding their real agenda. The Fed does not want to prick the asset bubble it created or force the Treasury to pay normal market interest rates.

BUYING TREASURIES

The Federal Reserve is not the main cause of the inflation we see right now. Yes, they've pumped up the money supply, but most of the new money is trapped in the financial markets. It can't escape unless banks lend it to someone. Their willingness to do so has been shrinking, not growing.



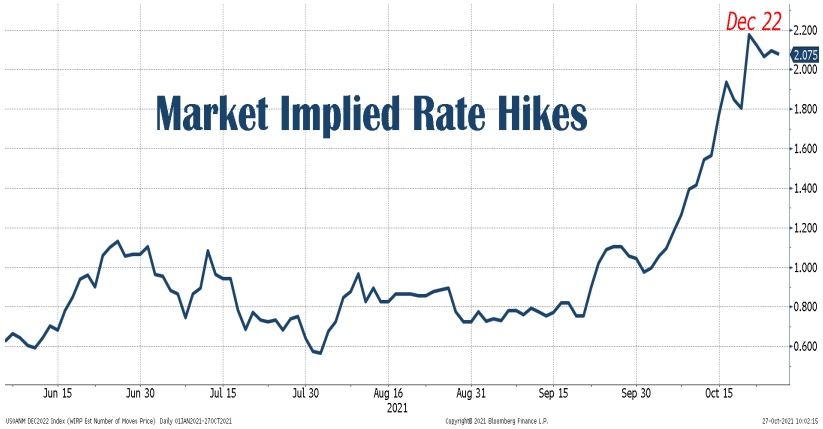
So what are banks doing? America's largest banks are sitting flush with liquidity but rather than increasing loans they are buying Treasuries. Since 2020 Treasury holdings have doubled from $700 billion to $1.5 trillion. In macro terms, Americans' excess cash is not going into consumption, but deposits. Banks, in turn, prefer funneling liquidity back into the domestic bond market rather than extending credit as consumer demand for loans is not as attractive. The U.S. economy is proving Japanese than thought.



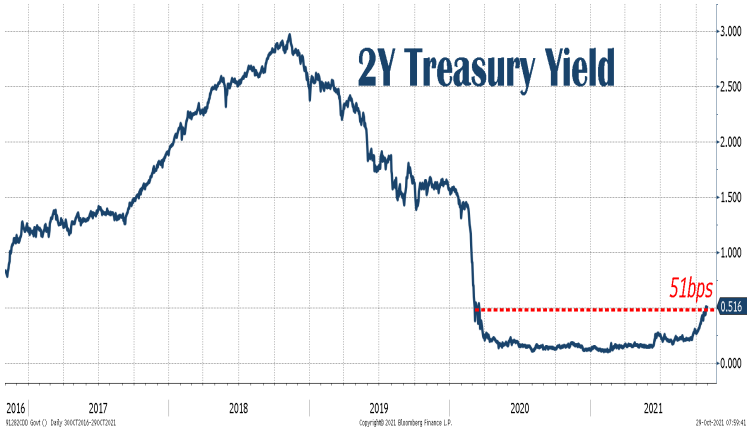
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Everyone in the market seems to think inflation is running away and the Federal Reserve is going to act aggressively to bring it down. That's not our view…There was a significant downshift in consumption in the third quarter, and a big part of that is coming from the service side of the economy." – Michael Brown, principal economist at Visa

The market now is not just pricing in two hikes next year, but assigns an 80% probability to a rate hike in June 2022, up from 15% a month ago (90% odds for September of next year versus 27% a month back).



In turn, the front end of the yield curve (which is highly correlated to the Fed funds rate) has taken it on the chin, with the two-year Treasury yield rising 30 basis points in October to above .51% for the first time since March 2020.



Expectations for rate-hikes are being pulled forward by the market. Yet, several factors suggest the market is overstating the inflation risk. Rising prices are being driven more by supply bottlenecks than a surge in demand. And that's a problem that interest-rate increases won't solve. As noted above excess savings have been depleted. As for wage growth, workers risk pay cuts as inflation outstrips their raises -- which could sap consumer spending. Simply put, if inflation is up and wages up less, workers have gotten a pay cut.

And that is what Mr. Bond is signaling. As yields have risen sharply on the front end, the long end of the yield curve has seen yields decline. Amazingly, despite all the talk and near hysteria over hyperinflation, and the hawkish rhetoric from the central banks, it was fascinating to see the long bond yield dive 14 basis points to 1.93% last week. The 10-year

Treasury yield dropped eight basis points to 1.555% over the past week! Think about this: The long bond yield, at 1.93%, is below the lows of the prior two recessions (2.53% in 2008/09 and 4.79% in 2000/01). It really says something that the yield is some 70 basis points lower now than it was at the worst point of the Global Financial Crisis more than a dozen years ago.

So, what's going on? Long Treasuries and the yield curve are not convinced of this inflation story and are not convinced that the U.S. economy is moving to a new higher, sustained level of growth or higher, sustained level of inflation. It's also telling us the Fed is going to be tightening policy, and that as they do so, that's going to flatten the curve. As shown below, the 5s/30s spread is below 80 basis points for the first time since March 2020.

Going forward, the two forces driving inflation – supply disruptions and so-called base effects -- will dissipate in time. Irrespective of whether it takes six months or more than a year, bottlenecks should be ease as supply increases.

The three rounds of fiscal stimulus are waning. That stimulus and the wealth impact from the stock market is what kept consumers spending. Meanwhile, the economy is slowing, mortgage rates rising, and tax hikes are on the way.

And investors remain dramatically underweight bonds. According to the BAML global investor survey – an unprecedented net underweight position of 80% for the government bond market, a net overweight of 26% for equities and a net 28% overweight for commodities. This is a wonderful setup to go the other way. Any shift in sentiment could lead to a spirited decline in yields. In other words, the 40-year bull market in bonds is far from over!

In terms of portfolio strategy, we continue to advocate that credit unions avoid timing the markets while maintaining a risk appropriate diversified ladder strategy. From a tactical perspective, any weakness in the bond markets provides an opportunity to invest excess cash.

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.