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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JUNE 21, 2022

A Recession Is on the Horizon

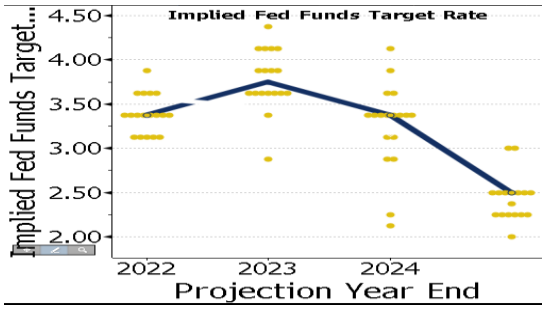
"The odds of a soft landing are pretty darn close to zero, and the reason is we're in an unprecedented environment and the Fed's overwhelming priority is inflation, inflation, inflation. Inflation is a lagging indicator and the fact they are looking for direction as to what to do for current monetary policy that works with a 12-18 month lag, that is almost a guarantee they'll overtighten and cause a recession."
– Stephen Kane, CIO of Fixed Income, TCW

In an attempt to regain its credibility as an inflation fighter, the Federal Open Market Committee (FOMC) voted to hike all policy rates by 75 basis points – the most hawkish move since 1994, with only one dissenting vote (by Esther George, who wanted a 50-basis point hike).

- Federal funds rate target range to 1.50% – 1.75%.
- Interest it pays the banks on reserves to 1.65%.

"Clearly, today's 75 basis point increase is an unusually large one, and I do not expect moves of this size to be common." – Fed Chair Jerome Powell

But Powell also said that at the next meeting in July, another 75-basis point hike might be on the table. Further, Powell said that the Fed will be *"looking for compelling evidence"* that inflation is moving down before *"declaring victory*." This phrase, *"compelling evidence,"* has been cropping up a lot recently among Fed governors. They're looking for more than just a little squiggle in the line before backing off.



Source: Bloomberg

THIS WEEK

- MARKETS ARE ON THEIR OWN
- BACK TO THE BASEMENT
- CONFIDENCE CRUSHED
- SMALL BUSINESSES ARE DEPRESSED
- NO SAIL IN SALES
- PEAK LABOR

PORTFOLIO STRATEGY

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The Fed "dots" showed that all 18 FOMC members who participated in the meeting expected the Fed to raise its federal funds rate to at least 3% by the end of 2022, with 13 members expecting higher rates. The median projection jumped to 3.4%.

This implies the possibility of a 75bps hike in July, followed by a 50bps hike in September and then 25bps at its November/December meetings. However, it could also be interpreted as three 50bps rate rises followed by a 25bps move. The incoming data on inflation is likely to guide officials in July.

The new forecasts see interest rates peaking at 3.75-4.00% in 2023, implying a front-loaded hiking cycle with the prospect of a further two 25bps rate rises next year.

The Fed cut its real GDP growth projections down to +1.7% for this year and next (from +2.8% and +2.2%, respectively). The key is the unemployment rate. The Fed is expecting that unemployment will increase to 3.7% this year, 3.9% in 2023 and then to 4.1% in 2024, which is a recessionary projection.

Also of note, quantitative tightening (QT) has started this month. The Fed confirmed that it is proceeding according to plan. During the phase-in period of June through August, the Fed caps the amount of securities that can roll off the balance sheet at $47.5 billion per month ($30 billion in Treasury securities, $17.5 billion in MBS). Starting in September, the caps will double to a total of $95 billion a month.

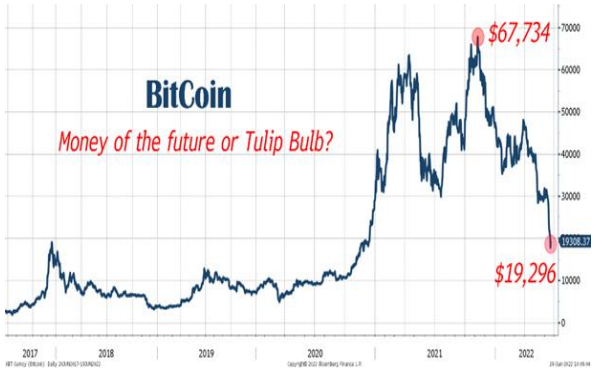
Bottom line: The Fed is frontloading as much as it can. Almost all of the tightening is seen happening this year. The Fed expects this to generate enough slack to bring inflation down materially next year to 5.2% this year (from 4.3% prior), then to 2.6% in 2023 and then to 2.2% for 2024. It makes sense since inflation always declines in a recession, and so do Treasury note and bond yields.

MARKETS ARE ON THEIR OWN

"When the world goes mad, one must accept madness as sanity; since sanity is, in the last analysis, nothing but the madness on which the whole world happens to agree." – George Bernard Shaw

I have long argued that we are in the "everything bubble." All risk assets (stocks, corporate debt, housing, crypto, etc.) have been pushed into bubble-like levels due to the Fed's reckless attempt to create a wealth effect. As the Fed kept rates too low for too long and printed literally trillions of dollars out of thin air, asset prices became grossly distorted from economic reality and fundamentals. It was "fake wealth" but as long as the Fed printed "free money," asset prices kept going higher and higher.

Investors threw caution to the wind. Fundamentals be damned. “TINA,” “FOMO,” “Buy the Dip,” “Stocks always go up” in the “everything bubble.” Money was thrown at everything from money losing meme and concept stocks to SPACs. And let’s not forget that cryptocurrencies are now worth valued at $2.2 trillion. They were just over $1 billion eight years ago. Is that the bubble of the century like tulip bulbs in the 1600s or is it the money of the future. Well, most readers know or can guess my opinion on this!



Indeed, it worked until it didn’t! As shown above, Bitcoin plunged 25% alone last week (to below $20,000 for the first time since December 2020); and now off 70% from the highs. Suffice it to say, there’s lots of pain in the crypto space, and I say, well deserved. It was never “digital gold,” the “new money” or some “hedge.” It was exactly how Bill Gates just described it: “the Greater Fool Theory.”

In equity land, last week's 5.8% slide in the S&P 500 was the steepest since March 20, 2020. The S&P 500 is now down in 10 of the past 11 weeks and is down 23.4% from the peak. As an aside, the S&P 500 is back to where it was on December 9, 2020, so basically you have picked up nothing but the 2%-ish dividend over an 18-month time span. The Nasdaq is down 32.8% from its peak and is back to where it was in the beginning of August 2020. Many once high-flying tech stocks are down 80-90%! For the record, U.S. equity markets have lost $12 trillion (and over $14 trillion if you include crypto “assets”) in this Fed-fueled “Gong Show.”

In the past, drawdowns of 20% or so the Fed would start putting phrases into its communications that indicated some sort of pivot. The Fed would lower rates or turn on the printing presses. This was the Fed put. This time, however, the Fed isn't holding anyone's hands. There was no mention of asset price drops and the reverse wealth effect in the FOMC minutes or in the press conference that indicated that the Fed is worried.

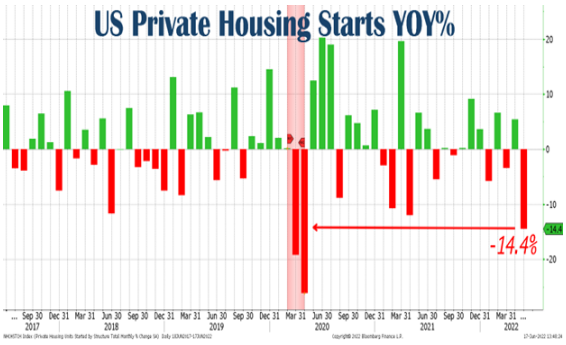
“The only thing confirmed yesterday is that the Fed will to do whatever it takes to get inflation back to target. If that means slowing the economy to a halt and crashing the stock market, so be it.”
– Elan Luger, Head of Trading Desk, JPM

Bottom line: As the Fed is now committed to driving inflation back toward 2%, do not expect the Fed to backstop the markets as they have repeatedly done over the past decade. Let’s face it, the Fed can’t cut rates and print more money without losing whatever credibility they have left. Further, the market sell-off, if sustained, and sustained price declines in the housing market could do some of the heavy lifting for the Fed so that the Fed might not have to raise its policy rates toward the rate of inflation, or even above the rate of inflation to knock down inflation. Seems to me markets are going to have to figure out how to stand on their own two feet amid rising interest rates and QT.

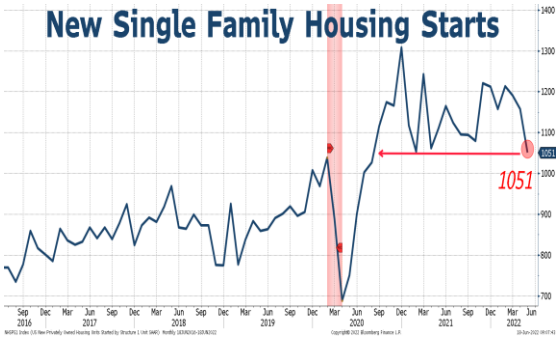
BACK TO THE BASEMENT

Meanwhile, as the Fed was raising rates at the fastest pace in almost 30 years there was a string of disappointing macro data points – from housing to retail sales to manufacturing to consumer and business sentiment in the U.S. economy.

Let's start with the latest housing data. Amid soaring rates and plunging mortgage applications, it was no surprise that the consensus expected a drop in housing starts and permits in May. Not only did housing starts drop, they dropped by an eye-popping 14.4% to a twelve-month low of 1.549 million units (annualized). This was the biggest drop in housing starts since the economy was shut down by the pandemic in April 2020. And the outlook is not that rosy as permits plunged 7.0% month-over-month to their lowest since September 2021.



The single-family market is a complete mess. With interest rates rising sharply and affordability at all-time lows, this most rate-sensitive sector of the economy slid 9.2% to 1.05 million units, which is the lowest since August 2020 when most of the economy was shut down. Single-family permits tumbled 5.5% and are down three months in a row (to 1.048 million units) to the lowest level, yet again, since July 2020.



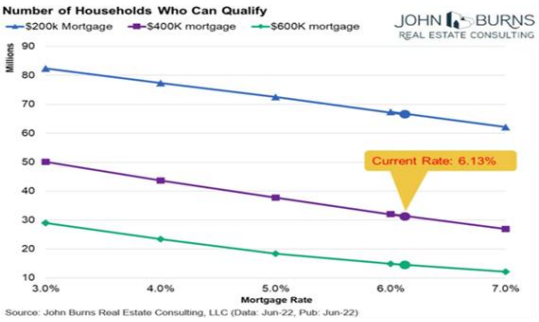
With this backdrop it's hardly any wonder why home builders are gloomy. To wit: the National Association of Home Builders (NAHB) homebuilder sentiment index for May was a complete dud. It fell two points to 67 and is now down six months in a row. And at 67, the headline is down to its lowest level since June 2020, when COVID-19 was in full swing and many parts of the country were still in lockdown mode. This time around, it's for a different reason: interest rates.

After 12 years of money printing and interest rate repression, home prices have ballooned to the point where higher mortgage rates have a very big impact!

In a lighting fast move, conventional 30-year mortgage rates have nearly doubled since the beginning of the year to 6.00%, the highest mortgage rate since April 2009. And each time mortgage rates rise just a little at current prices, they

take a new layer of potential buyers out of the market. Transaction volume sags, homes begin to sit on the market and inventory piles up.

Even in May before the current spike in mortgage rates, inventories jumped in amid price reductions and sagging sales. There is one way for sellers to nail down a deal: cut the price enough to where the next buyers can afford the mortgage. Take a look at the graph below. John Burns' team calculates that the increase since January from 3% to over 6% now means 18 million fewer households can qualify for a $400,000 mortgage. That's a 36% reduction in potential demand.



Bottom line: Something has to give. And it's going to be price.

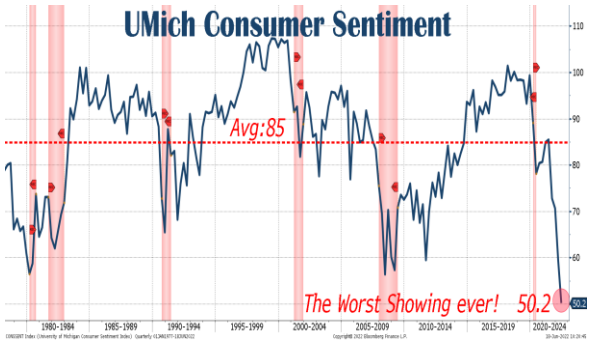
CONFIDENCE CRUSHED

Inflation. Government inertia. Interest rates. Weak job and income outlook. Negative wealth effects. You name it. They all contributed to the worst consumer sentiment report ever!

The University of Michigan consumer index for June rang in the woeful level of 50.2, down from 58.4 in May. This sentiment index is now lower than the past 11 recessions, including the real estate crisis of the early 1990s, the 9/11 terrorist attacks, the tech wreck, the mid-late 2000s bursting of the housing and credit bubble, and even the worst part

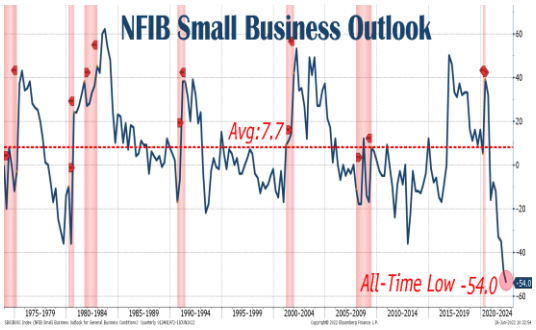
of the 2020 pandemic/lockdown phase. No stone was left unturned. This was the worst showing ever and widespread across age groups, income cohorts and regions. That says a lot.

Bottom line: Consumers are telling you the recession has arrived.



SMALL BUSINESSES ARE DEPRESSED

It's not just the consumer. Small business owners – the backbone of the economy – are none too optimistic today. The National Federation of Independent Business (NFIB) small business sentiment index inched down to 93.1 in May from 93.2 in April. This index has been flat or down five months in a row to the lowest level since April 2020. But what was truly revealing was the metric that assesses economic expectations which plunged to a record low of -54 in May.



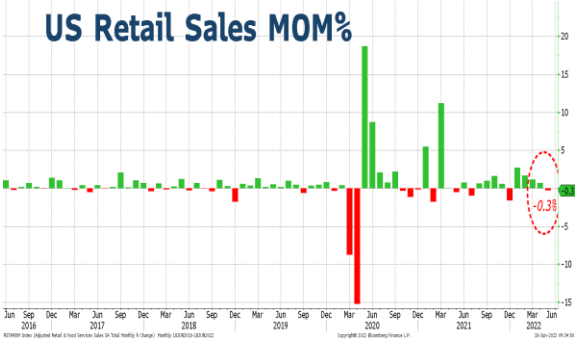
NO SAIL IN SALES

"Frugality is definitely in fashion right now." – Amanda L. Goodman

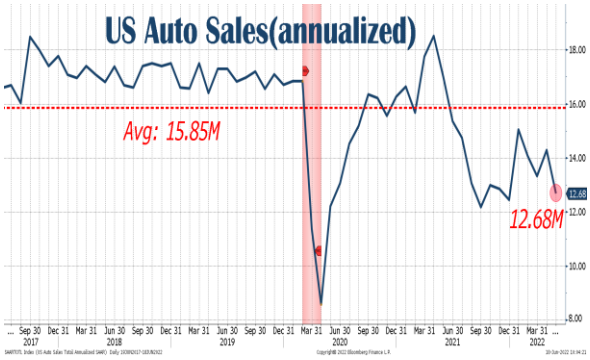
Extremely frugal families are coping with record-high inflation by doing what they always have done: not spending money. Amid record low consumer sentiment, crashing asset markets and tumbling savings rates, it is no surprise that May retail sales were a disappointment, but the 0.3% plunge was remarkable relative to a 0.1% expected rise and downwardly revised 0.7% month-over-month rise in April. In fact, the May decline of -0.3% month-over-month was the first negative print since December 2021.

The key "core control" number that feeds directly into the consumer segment of GDP printed a blank (0.0% month-over-month) compared to the +0.3% consensus view; and, again, April's +1.0% previously reported gain was revised sharply lower. Additionally, the control group retail sales data from April was revised dramatically lower from +1.0% month-

over-month to +0.5% month-over-month suggesting Q2 GDP could be heading into contraction and the dreaded 'technical' recession looms.



Meantime, spending at gas stations rose 4% and are up 43% on a year-over-year basis. Groceries jumped 1% and are up nearly 8% year-over-year. Together they rose a sharp 2.5% month-over-month and 22 % year-over-year. Spending on these necessities facing sharply higher prices is draining spending on the more economic-sensitive sectors. Excluding food and energy, retail sales rose 0.1%, the smallest gain in five months. Auto sales sagged 3.5%, the biggest drop since last July, and are at -3.7% year-over-year.



Remember, retail sales data is “nominal,” so an inflationary impulse is actually “helping” put some lipstick on this headline pig. Real (inflation adjusted) retail sales are factored into GDP and on this note endured their worst showing of the year to date, with a -1.2% decline. May was the third straight month of declines for real retail sales.

Finally, as a reminder, the myth of the “strong consumer” is dead as Americans are surviving by eating into their savings and piling up credit card debt as inflation sends the cost of living to the moon.

PEAK LABOR

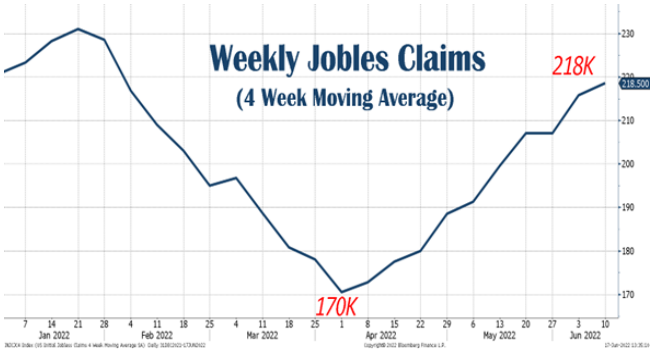
The U.S. has regained 90% of the jobs lost. Such certainly sounds robust until you realize we are not creating NEW jobs to absorb a growing population but only rehiring for the job vacancies created by the shutdown. However, more notably, near record-low unemployment is also a recessionary warning sign.

Keep an eye on the unemployment rate. Some people will say, can we really have a recession with the unemployment still so low? Indeed, we can. Check out 3.5% in February 2020, 4.4% in May 2007 and 3.8% in April 2000. And each time, a recession was only months away.

Unemployment is a lagging indicator. Bottoms in the jobless rate are classic late-cycle developments and are followed by recession an average of six months later. If you want to be bullish do so at the unemployment rate peaks. While such seems counter-intuitive, it isn't.

Powell confirmed in the press conference that the Fed is unlikely to be able to get inflation back to 2% without deliberately slowing the economy and raising unemployment. The Fed raised its projections for unemployment rates, with the median projection rising from 3.7% at the end of 2022, to 3.9% at the end of 2023 and to 4.1% at the end of 2024. Rising unemployment would obviously end the "labor shortage" and untangle some of the inflationary and supply chain issues that came with it.

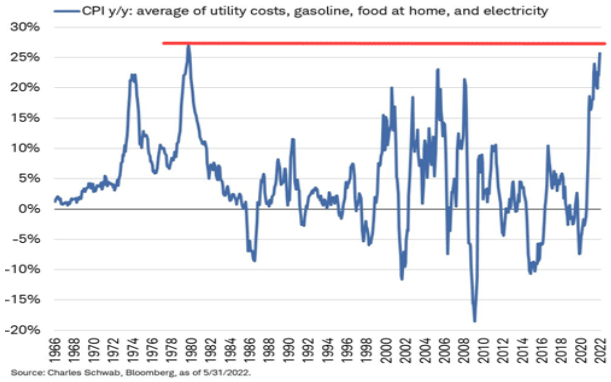
Last week, the number of Americans filing for first time unemployment benefits was practically flat at 229,000 for the latest week, but the trend is clear from the chart below. Initial claims are trending significantly higher as a turn in the labor market is clear. The four-week average of initial claims is now at its highest level January 2022. All in all, the claims data is low but it's the change that matters and the trend is moving towards a weaker labor market.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

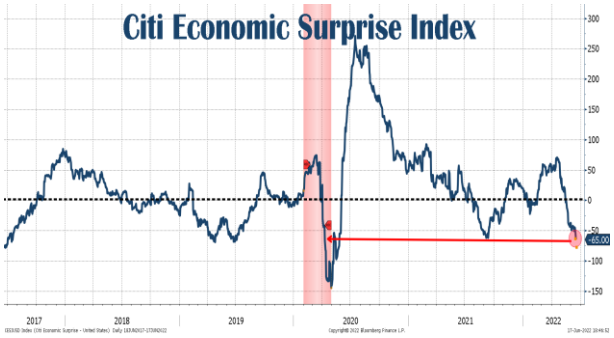
"The next time an unelected official, like the head of the Federal Reserve, tells you there are no signs of an economic slowdown, you better walk right out there wrapped in an American flag and yell 'Bull----!'" – Keith McCullough

Personal consumption is 70% of the U.S. economy. As the consumer goes, so goes the economy. The graph below shows the average CPI change for four categories a typical household has little ability to control: utilities, gasoline, food at home and electricity. On average, these costs have risen by 25% over the past 12 months! Today, wage growth is being totally overwhelmed by higher prices, leading to constant erosion in real consumer spending power.



Yet despite weak manufacturing, flat real retail sales, a housing market in a visible downturn, and record low consumer and small business sentiment, Chairman Powell, in a very poor performance in front of the cameras, extolled the virtues of the U.S. economy.

As shown below, the economic surprise index shows incoming data below expectations. Indeed, the index continues to fall off a cliff, dropping to -65 from 0.0 a month prior and +69.9 at the nearby peak back on April 19. The index is now down to the levels seen in in the depth of the COVID lockdown. Thing is, the Fed was busy easing, not tightening, policy back then.

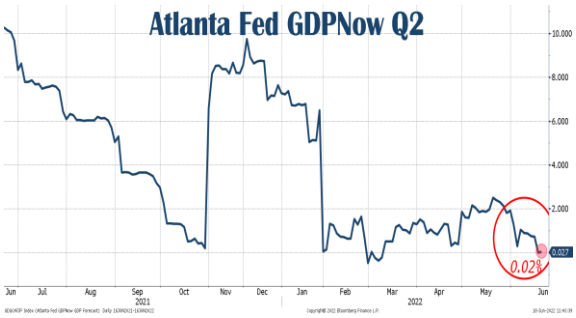


As the incoming economic data continues to come in below expectations, the Atlanta Fed's real growth tracker – GDP Now – is predicting 0% growth in GDP. As you will recall, Q1 was negative, so the bottom line is we are within one basis point of having two negative quarterly prints. That's called a RECESSION.

And yet, the Fed's implicit growth forecast is 4%-plus for the second half of this year. Does anyone else not think that Powell and his team are somehow completely out of touch with reality?

Meanwhile, President Biden is pushing the Fed hard to raise rates, somehow oblivious to the fact that by the time the midterm rolls around on November 8, he will be confronting a recession crisis instead of an inflation crisis.

Heads or tails, he loses.



Finally, over the past fifty years the S&P 500 has never, not once, been down this much for this long without there being a recession.

"Every 10% decline in the S&P 500 has the potential to shave off 1% of real growth." – Josh Steiner, Macro Analyst

Yes, that's a big deal. With pre-2022 real GDP growth rate of 2.5%-3% and a more than -20% decline in equities, the wealth effect impact alone puts us within spitting distance of recession.

Big picture: As everyone focuses exclusively on "inflation," the real economy is heading towards contraction. Demand is set now to decline hard while consumer sentiment and small business economic expectations just fell hard, in tandem, to their lowest levels in recorded history. Right in time for the November midterms, the Democrats will be seeing the inflation crisis being replaced by a recession and rising unemployment, one problem replaced by another. Then a GOP sweep sets us up for even more fiscal contraction. So yes, I remain patient and steadfastly constructive on the detested Treasury market.

The Fed is going to crush demand to get inflation down. And it will be successful because it has the tools, as painful as this process will be, to accomplish their disinflation objectives. Remember, there are 12 more rate-hikes priced in from here. Also, keep in mind that Fed policy affects the economy with a lag, so just as inflation falls and gives real wages room to improve, the policy-induced move to push the unemployment rate higher will create an offset.

In conclusion, the household sector is now, and likely through the summer and fall, confronting a price shock compounded by an interest rate (and negative wealth) shock. While most economists are predicting a recession for next year, it is this year's story.

Next year, we should be through the worst of the biting inflation and liquidity squeeze by the Fed, so 2023 will be the rebirth. Most likely not till the second half of the year. Once the economists call the recession, and once all the market bulls are carted out on the stretcher, I will be turning very positive on the outlook.

In terms of portfolio strategy, by the time the Fed finally pulled the trigger on its 0.75% rate hike, it was old news to the bond market. This explains why rates didn't go any higher after the Fed announcement. In fact, they fell.

As shown below, the short end of the Treasury market has already priced in a higher Fed Funds rate policy. Since the beginning of the year, the 5-year Treasury yield has jumped over 200 basis points to 3.34%. In fact, the 5-year Treasury yield is currently at the highest yield in over 15 years!

Big Picture: The U.S. is the most leveraged and asset dependent economy of all time and is sustained only by low rates remaining low. Yes, rates could continue to rise short term, but rates cannot rise in a sustained manner without crashing the economy, housing and equity markets. Should the economy end up in recession, inflation will subside and the recent rise in rates will reverse. As such, the recent sharp selloff provides an opportunity to lock in the highest yields in well over a decade. As such we continue to recommend that credit unions scale into the Treasury market while maintaining a risk appropriate ladder strategy. Over a full market cycle, credit unions will likely be well served by this tried-and-true approach to risk management.

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.

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