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INVESTMENT SERVICES

Weekly Relative Value

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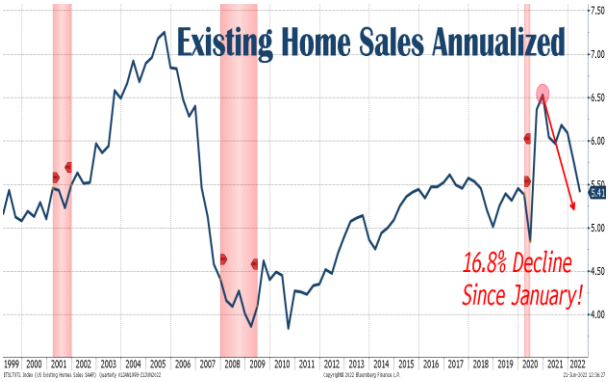
WEEK OF JUNE 27, 2022

The Next Shoe to Drop?

"Further sales declines should be expected in the upcoming months given housing affordability challenges from the sharp rise in mortgage rates this year."
– Lawrence Yun, National Association of Realtors (NAR)

Existing home sales declined 3.4% to a seasonally adjusted annual rate of 5.41 million units. This was the fourth straight monthly decline (and fifth drop in the last six months) in existing home sales and the lowest annualized rate since June 2020. Year-over-year sales are down 10 consecutive months. Sales are down 16.8% since January.



It's important to note that existing home sales are recorded at closing. These "sales" are contracts signed three to four months ago when mortgage rates were about 100 basis points lower than they are now. So these closed because it was time for these buyers to take advantage of their rate lock-ups — and even with that, sales have plunged.

Think about what happens next when the rate impact hits home more forcefully. With mortgage rates up 2.7% this year and doubling from a year ago, this bust is just getting started.

Sales of homes priced below $500,000 have plunged, while sales above $500,000 have surged year-over-year, and these dramatic changes have skewed the median price upward.

THIS WEEK

- CEOs SEE A RECESSION
- STAYCATION (AGAIN)
- CONSUMERS ARE TRADING DOWN
- DEJA VU ALL OVER AGAIN!
- YESTERDAY'S STORY?
- BAD WEEK FOR JOBS!

PORTFOLIO STRATEGY

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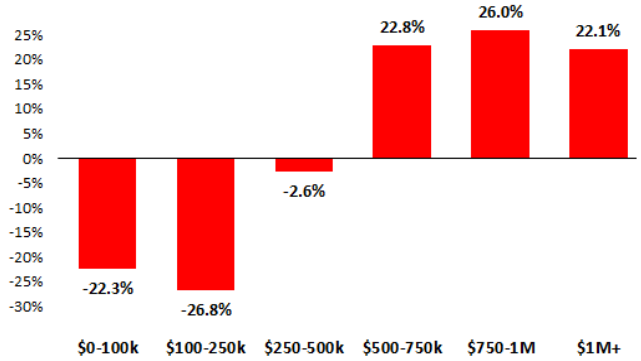
% of Homes Sales by Price



Source: NAR

In fact, the the median price of sales continues to rise (for now), exceeding $400,000 for the first time. Year-over-year home prices have risen 14.8% from a year earlier, to a record $407,600. Prices increased in all regions.The bubble just got bigger!

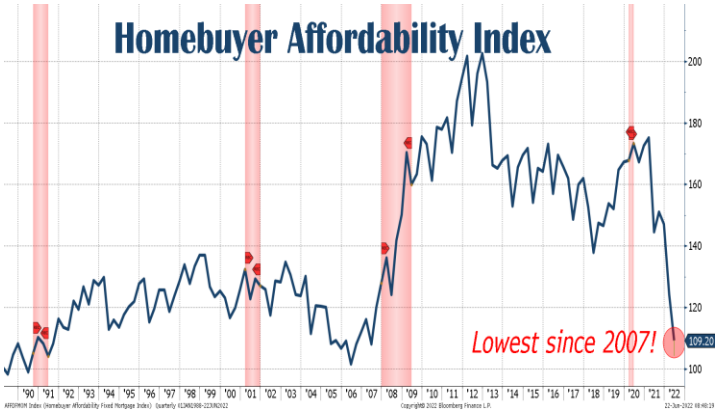
- This marked 123 consecutive months of year-over-year increases, the longest-running streak on record.

Here's another eye-popping stat:

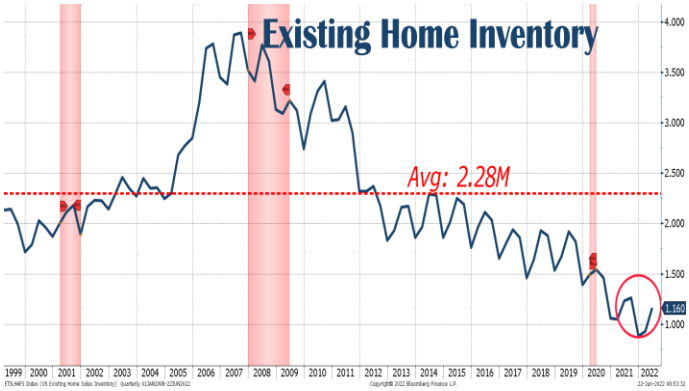
- Adjusting for inflation, home prices are 18% higher than they were at the peak of the last housing boom, in June 2006, when the typical house would have cost about $345,000 in today's dollars.

Indeed, pandemics have been good for real estate but that will not last long. Since March 2020, home prices have risen 38%. Real disposable income is up only 2%! Homeowner affordability has worsened in each of the past seven months and is 29% more onerous than this time last year. In fact, the NAR's Housing Affordability Index has deteriorated to its point of most hardship since July 2007.

The rest, as they say, is history.



In the meantime, the once-super-tight inventory backdrop is loosening up. The inventory of unsold existing homes climbed to 1.16 million, or the equivalent of 2.6 months of the monthly sales pace. This is still low (the norm is four months), but actually represents a 33% increase since February.



"A housing correction will reach from coast to coast in the U.S." – Mark Zandi, Moody Economics

Bottom line: The next shoe to drop may be the housing market, and the bubbliest areas in the U.S. are starting to show some signs of cracking. Sales volumes are in recession, and prices are sure to follow, especially with the inventory backdrop becoming far less tight than it was at the turn of the year. Because homes represent the single largest asset for most Americans, if home prices drop 20% from current levels, it will have a much more significant impact on the wealth effect than the most recent stock slump.

CEOs SEE A RECESSION!

Did you know that the Federal Reserve has NEVER ever forcasted a recession? Going back to every recession since 1970, not once did the Fed economics staff see a recession — even when the downturn began the very next month. Think about that. Former Fed Chair Ben Bernanke denied a housing bubble and a recession after it already started. We see that again right now, by the Fed, by President Biden and by Treasury Secretary Janet Yellen.

Not a single Fed participant forecasts anything less than 1% growth. For whatever reason, Fed officials simply resist what is a natural part of the business cycle. Yet, in the post-World War II era, 14% of the time the economy has been in recession.

Here's the thing. The Fed may forecast economic growth, but CEOs produce it. A Conference Board survey of 750 global business executives conducted in May showed that:

- Over 60% see a recession coming in their regions;
- Of the rest, 15% believe that we are already in a recession.

At the end of last year, only 22% believed a recession was coming. So the number of CEOs seeing a recssion has now nearly tripled. Thus, JPMorgan Chase CEO Jamie Dimon's dire warnings of almost a month ago seem to be resonating: "A hurricane is right out there down the road coming our way."

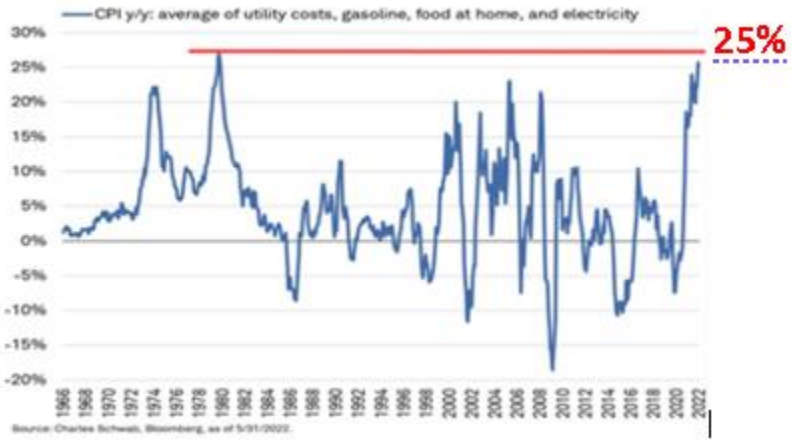
As far as the "rose colored" economist crowd goes, Citigroup just raised their recession odds to nearly 50%. What a bold call. Now imagine an obstetrician telling a mother-to-be that she's half-pregnant. This is what gives economists a bad name — making half a call and pretending that it is helping anyone.

I should add that the equity markets are telling us that a "hard landing" is coming our way, if not already here. In the past 50 years, every decline in the S&P 500 of 20% or more over a span of five months presaged a recession. That is a fact, not an opinion. Forewarned is forearmed.

STAYCATION (AGAIN)

"The inflation pressures across the board are more significant than anytime I have seen in my career."
– Howard Penney, consumer analyst

The necessities of life – food, gas and utilities – have soared 25% over the past year. This is a huge de-facto tax on consumers, especially for the middle-to-lower income groups. Given that consumers spend more than 30% of their disposable income on these items, there is little discretionary income left. As such, many families looking to break loose after two years of COVID fears are now rethinking their long-awaited vacation plans, if not scrapping them altogether.



Indeed, according to a survey released from Axios, "money" – or lack thereof – is by and far the biggest hurdle for potential vactioners this summer**.** A whopping 45% of Americans who have no summer travel plans this year said that they couldn't afford it, while 33% said they'll refrain from traveling to save money. Meanwhile, just 15% of U.S. non-travelers said that COVID-19 was the reason for staying home this summer.

And its not just vacations that consumers are skimping on. The casual dining sector is also being being hit hard by the current inflationary environment.

"You can see a really significant slowdown in mall visits… that will impact companies that have significant exposure to malls, like Cheesecake Factory and Red Robin." – Howard Penny

CONSUMERS ARE TRADING DOWN

If last week's dud in retail sales didn't confirm the consumers' woes, then the words of the retailers just might. They indicate that there have been patterns of consumers switching towards cheaper alternatives. Even essentials such as milk and meat are being hit. Retailers, including Walmart, report that they have seen shoppers buying a half-gallon of milk instead of a gallon or choosing private label lunch meats and bacon over branded versions.

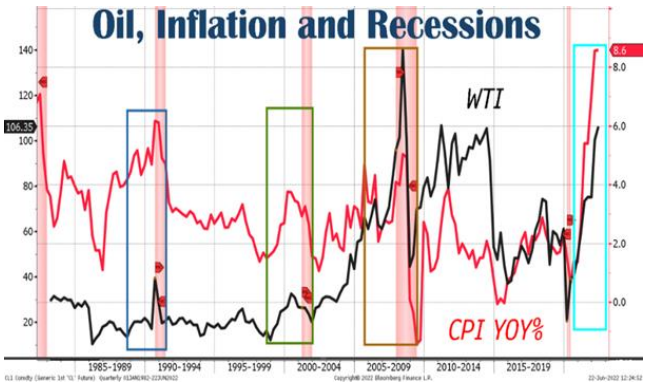
"In earnings calls and investor conferences in recent weeks, several U.S. retailers have flagged that their customers have begun migrating to cheaper products. Others are bracing for more to do so in the coming months... Mentions of 'trade down' and 'trading down' on U.S. retail and consumer companies are now running above the previous peak they hit in the global financial crisis of 2009." – Financial Times

Consumers are now facing a double whammy of high inflation and rising rates. If the Fed aggressively hikes rates in the coming months, this downtrend in spending is set to continue. The U.S. consumer is not as strong as many think. As the consumer goes, so goes the economy!

DEJA VU All OVER AGAIN!

"Every 50% rise in crude has led a recession." – Jim Bianco, President of Bianco Research

While prices have risen and spread to more categories, the inflation narrative hinges on oil prices and all the spillovers through the pricing system. But this is nothing new. As highlighted below, there have been many periods in the past when oil prices skyrocketed.



- December 1986 to October 1990 – West Texas Intermediate (WTI) soared +125%, and the inflation rate rose from +1.1% to +6.3%. A recession took care of that.

- October 2006 to July 2008 – WTI again spiked 125%, and inflation went from +1.3% to +5.6%. Likewise, a recession followed and inflation plumetted!

Fast forward. WTI has soared yet again, up +110% from January 2021 to May 2022, and the headline inflation rate is going from +1.4% to +8.6%.

As in the past periods of oil spikes, the Fed is tightening into it, so the recession will come, and the demand destruction will take the oil price back down. Voila! Inflation morphs to disinflation. As Yogi would put it, a case of déjà vu all over again.

YESTERDAY'S STORY?

While prices remain elevated by the standards of recent years, it's the rate of change in prices (not the level) that drives inflation. And to that point, commodity prices have been swooning of late. The Commodity Research Bureau (CRB) index has plunged 10% since early June and levels are back to where they were in February 2020! Doesn't sound too inflationary from my perch.

Take a look at what the following commodity prices have done from their peaks. Do you see Inflation here?

- Oil: -14%
- Copper: -24%
- Natural gas: -33.0%
- Aluminum: -36%
- Steel-27%
- Nickel: -50%
- Lumber: -57%
- Baltic Dry Index: -58%

Suffice it to say, there are tentative signs that inflationary pressures are easing. Yet, inflation remains on the brain as the Fed, and practically everyone else, gazes into the rearview mirror.

Anyway, somebody must get it because the 10-year Treasury yield melted down a sizeable 45 basis points from that very recent high. That is a very big change in direction and not to be ignored.

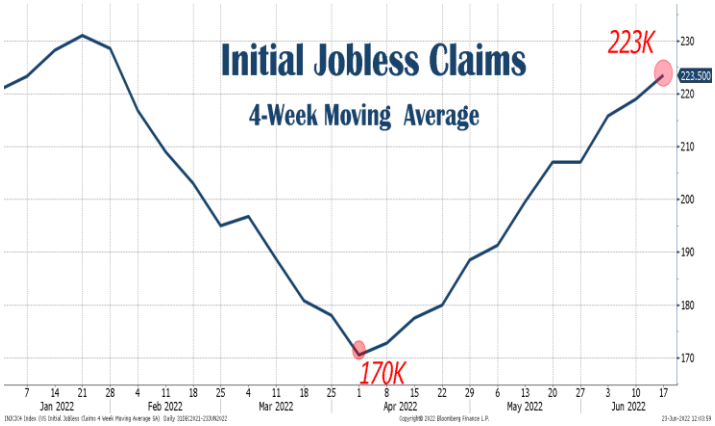
BAD WEEK FOR JOBS!

While employment data are considered a lagging indicator, or coincident at best, it is a further sign of the deterioration in the overall economy in my view, and is set to get worse in the months ahead. Indeed, just look at some of the headlines crossing the wire recently:

- "Tesla Is Laying Off Hourly Workers Across its Organization"
- "Coinbase to Cut About 18% of Jobs, Cites Economic Downturn"
- "Redfin to Cut 6% of Workforce, Citing Market Conditions"
- "Compass to Cut About 10% of Workforce Amid Housing Slowdown"

To be sure, sector-specific reasons (such as plummeting cryptocurrencies and housing markets) are at play in some instances. However, from a macroeconomic perspective, it does not matter what the reasons are. If the trend continues, especially in FinTech/Silicon Valley, as many investors are warning, it is only a matter of time before they begin to weigh on the headline data.

Looking at the weekly unemployment insurance data, the number of Americans seeking jobless benefits for the first time was 229,000 last week, pushing the four-week average to its highest since late-January. Claims are still low but remember, it's the "change" in claims that is the key to the economy, not the "level." Claims are always super low at the tail end of the business cycle. Historically, by the time the four-week moving average is up 60,000 from the lows, the jig is up. It already is up 53,000 from this cycle's trough. That means a recession is staring us in the face. Once the labor weakness shows up in declining payroll data, the game will be over for this Fed tightening cycle.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

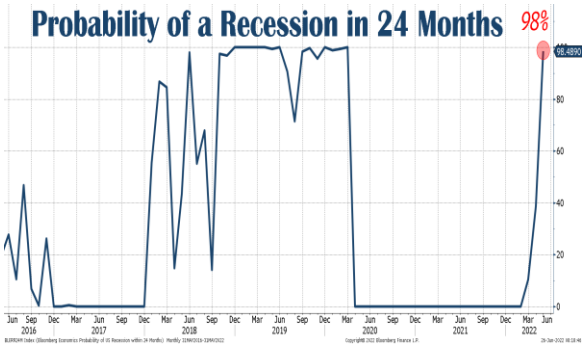
Below I list a number of indicators suggesting that a recession in 2022 is NOT a low probability scenario. Frankly, it would not be surprising if, once the National Bureau of Economic Research revises the data, we are already in a recession.

- Falling retail sales
- Existing home sales in freefall
- Plunging demand for durable goods (i.e. appliances, cabinets, landscaping, paint, furniture)
- Rising inventories
- Fed hiking rates/quantitative tightening (QT)
- Highest mortgage rates in 15 years!
- Reverse wealth impact of declining stock market
- High oil and food prices
- Labor markets cracking

Despite the 24/7 focus on inflation by the media, there are signs that the inflation narrative is changing. Indeed, as discussed above, simply staring at the price of energy and other materials suggests a peak looks to have been put in. Yes, prices are high by recent standards, but the direction is key — and they are trending lower!

Meanwhile, economic data has been worsening at the fastest rate in two years while the Fed is tightening — not good. If, as Shakespeare said, "past is prologue," the risks of a Fed policy misstep are non-trivial. If so, this would exacerbate demand destruction in the process.

Further, as shown below, the probability of a recession over the next 24 months (according to Bloomberg Economics) has ratcheted higher to a 98% probability. Thus, growth concerns will begin to dwarf the current inflation obsession. Needless to say this would be a bullish signal for Treasuries as investors shift from inflation concerns to growth fears while dragging yields lower.

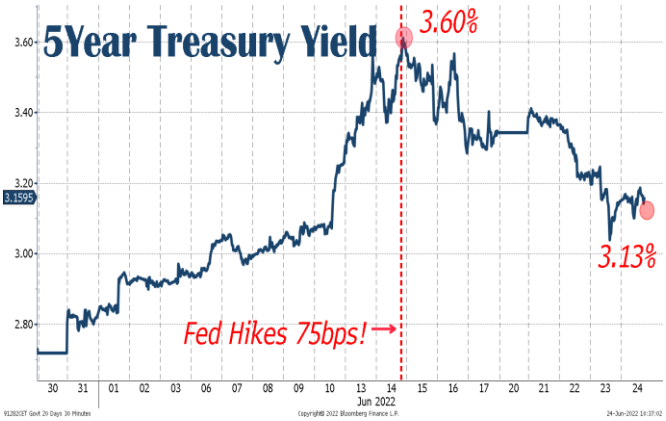


For all those credit unions concerned about investing because they think rates are going higher, please consider that since the Fed raised rates by 75 basis points, Treasury yields have absolutely cratered across the curve. Reason being is the bond market had fully discounted an aggressive rate hikes. (Sell the rumor and buy the fact!) Further, bond markets are saying that the higher the Fed hikes rates, the slower the economy and lower the inflation rate will be. That, in turn, will lead to a pause, followed by rate cuts. Indeed, another Powell Pivot! Finally, it's a vivid reminder of why credit unions should avoid timing and maintain a risk-appropriate ladder strategy in managing their excess cash reserves.

The table shows the Treasury yield declines across the curve since the Fed hiked rates on June 14.

Treasury Yields	Basis Point Change	Yield %
2-Year	-37bps	3.066%
3-Year	-45bps	3.149%
5-Year	-41bps	3.1875
10-Year	-43bps	3.134%
30-Year	-26bps	3.261%

I should add, if the Fed is done after the July meeting, rest assured the Treasury market will undergo a bull steepening. If so, the best risk-reward segment of the curve is likely to be the 5-year maturity. Though the long bond will deliver the strongest return, you are taking on much greater duration risk.



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. As such, rates cannot rise in a sustained manner without crashing the economy, housing and equity markets.

In managing excess cash reserves, we advocate 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 risk-management discipline.

HAPPY FOURTH OF JULY!

Finally, next Monday, Americans will celebrate our nations' 246th birthday with fireworks, concerts and, of course, barbecuing with family and friends. Sadly, on Tuesday, many people will go back to being angry and divided. A national holiday will not heal our ugly political discourse, selfish instincts or deeper divisions, but it could well be a catalyst to set us off down a better path together. As we celebrate Independence Day this year, let's remember what's at risk if we continue on our current path and let's resolve to put aside the malice and "talk" to each other about our differences. As Abraham Lincoln warned: "A house divided against itself cannot stand." Indeed!

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.