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INVESTMENT SERVICES

Weekly Relative Value

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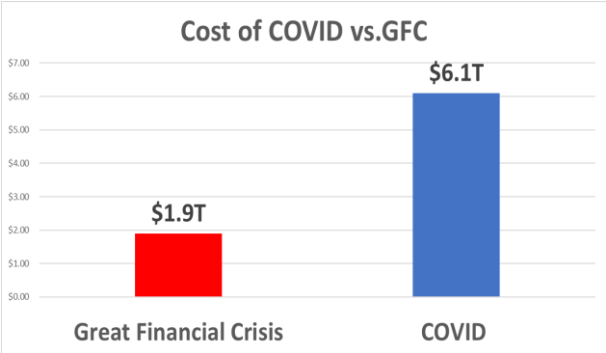
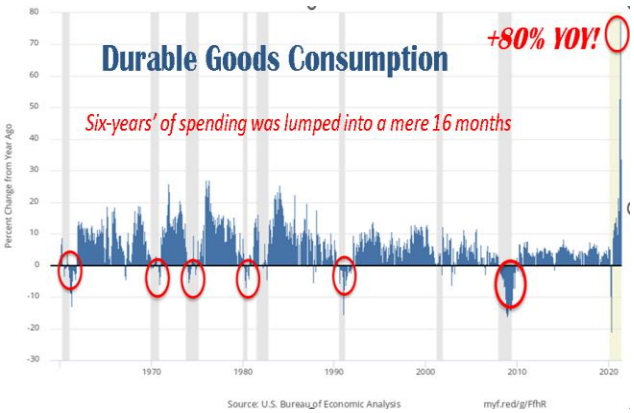
WEEK OF JULY 5, 2022

The Consumer Led Recession

When the pandemic arrived the U.S. economy shut down and entered a deep recession. The Fed slashed interest rates to the zero lower bound and printed literally trillions of dollars via quantitative easing (QE). Uncle Sam followed suit by spending like never before (including three rounds of stimulus checks) to support the consumer and the overall economy. In total, this massive and unprecedented stimulus amounted to $6.1 trillion or 3X higher than the stimulus during the Great Financial Crisis.



The impact from this enormous stimulus can be seen in the graph below. Normally, in a recession, it is durable goods that take the big hit. In fact, in all prior recessions (shaded area) durable good sales fell (see circles). While we were locked in our homes during the Covid pandemic we spent like mad on merchandise. As shown in the graph below, durable goods consumption skyrocketed 80%. Six years of spending occurred in 16 months! How crazy was that?



THIS WEEK

- PENT-UP DEMAND IS EXHAUSTED
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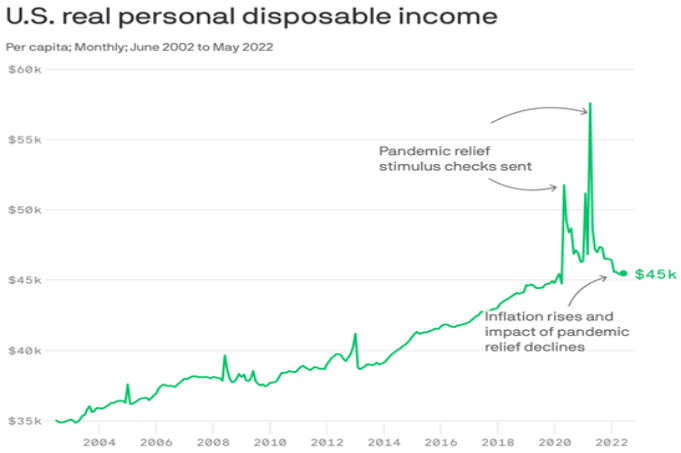
Fast forward. Consumers have spent their "free" money. In fact, real per capita disposable income – the money consumers can spend after accounting for taxes and inflation – has declined steadily for the last 14 months.

Since March 2021 – when the last round of stimulus checks artificially puffed personal disposable income to a record high level of nearly $57,000 – real inflation-adjusted incomes have plunged 20% to $45,490 in May. These levels were last seen in 2019!

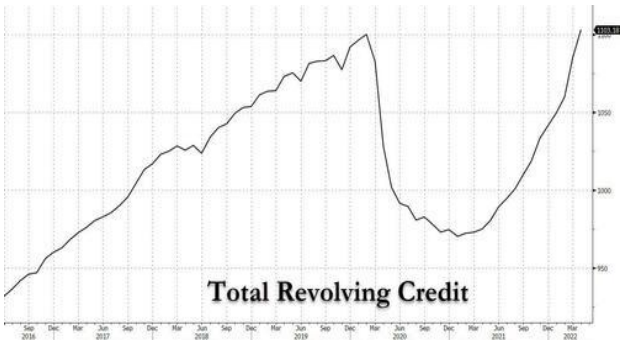


Source: AXIOS

More importantly, according to the most recent Conference Board survey there are now more people who believe their income growth will recede in the coming year than accelerate. In fact, 22% see no wage growth at all. That is a defining characteristic of a tight labor market? I think not. And get this, the mean wage growth estimate for the coming twelve months is down to +1.1%, tied for the lowest since July 2020. Given that consumption represents 70% of the economy, this does not bode well for growth.

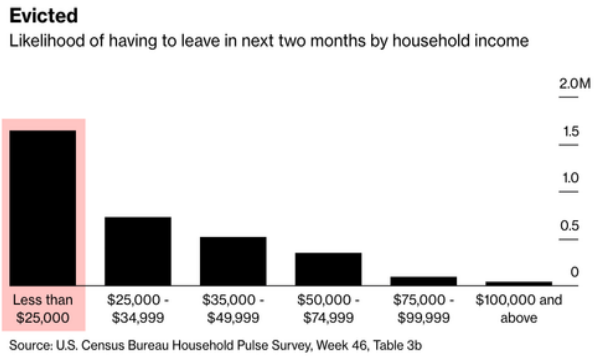
As disposable income crashes, the savings rate is now below pre-pandemic levels. As shown below, the savings rate as a percent of disposable income is down to a lowly 4.4% – the lowest level since 2008 and well below the long-term average of 7.8%. Moreover, higher interest rates have eviscerated the incentive to refinance, thus eliminating extra cash flow. In addition, the consumer is faced with higher costs of everyday items such as grocery and gas bills, and this is putting a dent in their budgets.

Making matters worse, they're footing the bill with their credit cards. Total revolving consumer credit back is back at a new all-time high at just over $1.1 trillion, erasing all the post-Covid credit card deleveraging just in time for those credit card APRs to start moving much higher – first slowly and then very fast.



Source: Bloomberg

Even more shocking is how a very underreported tidal wave of evictions could be imminent as millions of Americans can't pay rent. Bloomberg news reported on a Census Bureau survey discovery that 8.4 million Americans, or about 15% of all renters, who are behind on rent are at risk of being evicted. The survey found that 3.5 million households were at risk of an eviction within the next two months. Most of these folks are of the working poor class and situated in large metro areas from New York to Atlanta where the cost of living, including shelter, food, and fuel, has skyrocketed.



Bottom line: The consumer is tapping out under the weight of inflation, maxed out credit cards, collapsed personal savings and negative real wage growth. In that case, it is an ominous sign for a consumer-driven economy.

PENT-UP DEMAND IS EXHAUSTED

In the newly released revised Q1 GDP data, personal consumption growth collapsed from +3.1% to just +1.8% – the weakest since the Covid lockdown collapse. The pace of spending slowed significantly in May to just +0.2% month-over-month (half the expected +0.4%) while incomes rose +0.5% month-over-month (as expected). In other words, Americans' spending rose slower than their incomes for the first time since December. Adjusting for inflation, spending actually dropped 0.4% month-over-month in May.

Moreover, look at what the stock market is telling you about the frugal future. In a year in which the S&P 500 has fallen 21%, the likes of Campbell Soup is up 11% while Kraft-Heinz has advanced over 7% so far in 2022. General Mills is up nearly 6%. This happens in recessions as consumers hunker down and buy what they need, not what they want.

One can legitimately wonder about the true shape of the U.S. consumer when Bed Bath & Beyond sees its quarterly sales plunge 25% year-over-year as it did over the three months prior to May (and the stock price is down more than 65% this year and 80% over the past three months).

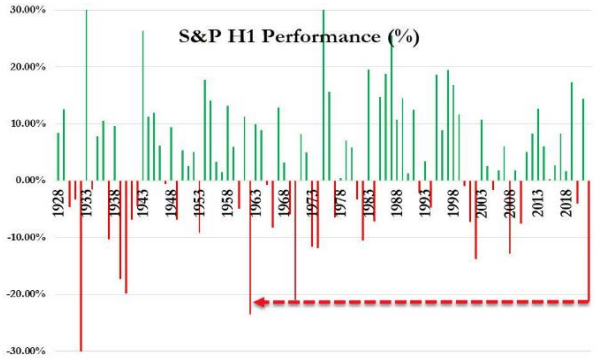
Then look at the various consumer discretionary stocks: Restoration Hardware (-55%); Target (-38.7%); Best Buy (-33.9%); Dicks Sporting Goods (-33.5%); Home Depot (-34.0%); Macy's (-28.1%); Lowe's (-31.9%); Kohl's (-27.3%); Darden (-24.4%). These stocks aren't signaling a consumer-led recession? Really?

Consumers are beginning to hunker down. They are driving less, carpooling more and not filling up the tank at the gas stations. A Morning Consult poll showed that over half are also now changing their eating habits and 84% say they intend to dine out less than they had been during the reopening phase. Good for the grocery chains, mind you.

Bottom Line: The driving force behind 70% of U.S. GDP is now in a deep funk! As for the broader implications, from this perch, it sure appears we are headed towards a consumer-led recession, one which has shocked corporate America with its size and speed. This means that the "soft landing" many are hoping for is not in the cards, especially when combined with other parts of the economy that are rolling over visibly, such as housing.

THE REVERSE WEALTH EFFECT

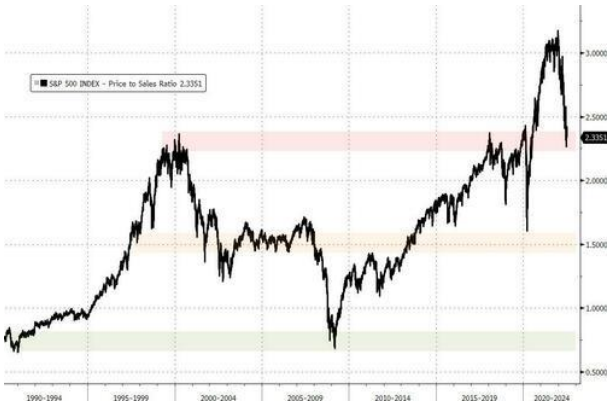
At mid-year, the S&P is currently down 21.22% – the worst period since 1962...60 years ago! The Nasdaq Composite is down 30% to start the year, making it the worst start to a year ever – even worse than the 2002 collapse.



Source: Bloomberg

The most interesting thing in the stock market nightmare figures of the first half of 2022 isn't that it was the worst first half for the S&P 500 since 1970. No, what was really interesting was that every major S&P 500 segment was more or less deeply in the red – led by Consumer Discretionary (-32.8%), Communication Services (-30.2%) and Information Technology (-26.9%). Even the Energy segment cratered in June.

And for those who think *"it can't get any worse"* … be careful. Equity market valuations have only dropped to the same level they were at during the peak of the Dotcom bubble.



Source: Bloomberg

I should note that that global equity and debt capital markets lost a stunning $31 trillion in the first half of the year... a record by a massive margin.

Source: Bloomberg

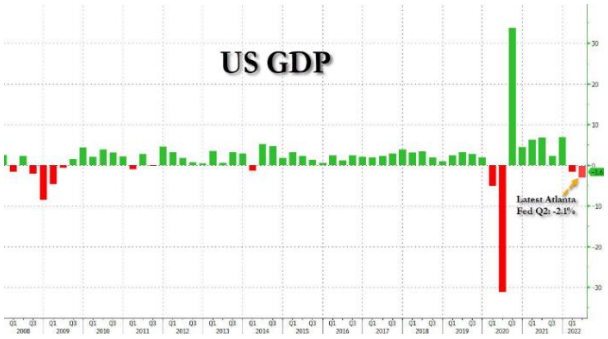
For those believing in the "new" digital money, cryptos were down by about two-thirds. Bitcoin fell 59% in the first half of the year, making it the worst start to a year ever for the cryptocurrency. Ethereum was even worse, falling 72% YTD!

Bottom line: The wealth effect that once drove consumption and economic growth is now in reverse. Going forward, consumption and economic growth will follow suit.

THE ATLANTA FED SAYS…

As Fed Chair Jerome Powell crowed once again how the U.S. economy was strong enough to cope with his hawkish rate-hike cycle (and President Biden told the world that the U.S. economy is the strongest in the world), the Atlanta Fed stole the jam out of everyone's donut as their GDPNow model estimate for real GDP growth in the second quarter of 2022 was cut to a contractionary -2.1%. This is down from 0.0% on June 15; +0.9% on June 6; 1.3% on June 1; 1.9% on May 27.

Thus, the U.S. is on the verge of a technical recession (after Q1's confirmed 1.6% contraction). And the Fed is hiking rates.



Source: Bloomberg

THE NEW YORK FED SAYS…

We are heading for a recession, disinflation and return to lower interest rates.

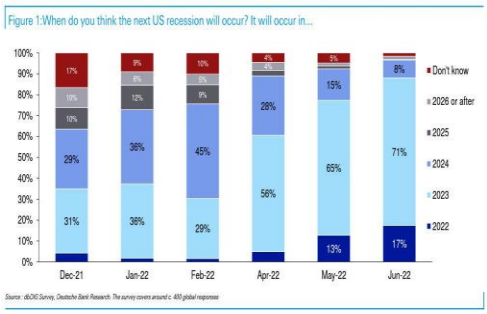
"It projects inflation to remain elevated in 2022 at 3.8 percent, up a full percentage point relative to March, and ***to decline only gradually toward 2 percent thereafter*** *(2.5 and 2.1 percent in 2023 and 2024, respectively)."*

"According to the model, ***the probability of a soft landing****—defined as four-quarter GDP growth staying positive over the next ten quarters—****is only about 10 percent****. Conversely, the* ***chances of a hard landing****—defined to include at least one quarter in the next ten in which four-quarter GDP growth dips below -1 percent, as occurred during the 1990 recession—****are about 80 percent.****"*

*"****The real federal funds rate implied by these forecasts*** *quickly approaches the natural rate of interest,* ***which is around 1 percent, reaching it in 2023*** *and modestly overshooting it for the rest of the forecast horizon."*

THE ONLY QUESTION IS TIMING

When does the recession begin? According to a DB survey of 400 money managers, the risk of a U.S. recession by the end of 2023 is at 88%, up from 78% last month. Interestingly only 17% believe the recession starts this year, but this is up from 13% last month and virtually 0% in February. That said, of these respondents, over a third (6% of the total responses) believe the recession has already started.



INFLATION TAKES BACK SEAT

The inflation market metrics are reversing course in a major way. Commodities are well off its peak. Wage growth is moderating, and the high-frequency data are showing a slowing from the frenetic pace of rental rate increases and a rise in national vacancy rates. And, as demand shrinks, it's only a matter of time before we get a deflationary tsunami for most non-food and energy goods and services.

Source: Bloomberg

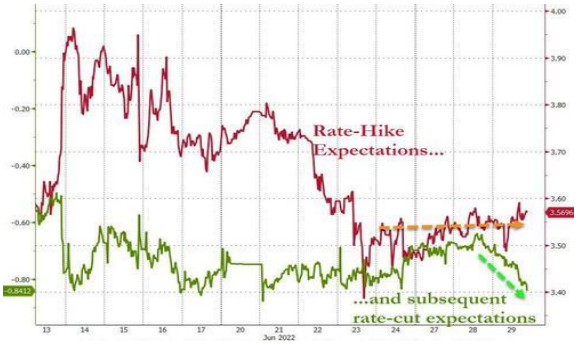
As shown above, the market-implied inflation breakevens are tumbling as recession/growth fears dominate the inflation narrative. The 10-year TIPS breakevens are down over 100 basis points from the April highs to levels before the Russian invasion of Ukraine. Finally, for the bond bulls, I should add that a record 17% share of respondents in the latest University of Michigan survey in June expect DEFLATION in the next five years. Now put that in your pipe and smoke it!

The inflation narrative has become tired and stale and completely overdone, but Powell and crew either don't see it or don't believe it.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Peak growth. Peak inflation. Peak rates.

If the stock market is right, there is little chance that Powell and his pals will get close to hiking as much is currently priced into the Treasury curve. In fact, as shown below, the market is now expecting rate-cuts to start in Q1 2023 and pricing in more than three rate-cuts to address that recession.



Source: Bloomberg

As the bond market begins to price in the oncoming recession, Treasury yields have plunged from their recent highs. To wit: the 10-year Treasury yield experienced its biggest weekly drop since March 2020 and has now fallen a whopping 85 basis points since June 15. Likewise, the front end and belly of the curve have seen significant yield declines over the same period. Yields on the two- and five-year Treasury benchmarks have declined 53 and 60 basis points to 2.92% and 3.0% respectively.

Source: Bloomberg

In summary, inflation concerns are now taking a backseat. A set up of weaker economic growth and reduced concerns about inflation is bullish for Treasuries. We strongly encourage credit unions to capitalize on the year-to-date selloff in the Treasury market and lock in some of the highest yields in over a decade while maintaining a fully invested, risk appropriate ladder strategy.

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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