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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JULY 11, 2022

The End of Free Money

"In the late 1990s, the Fed began to use monetary policy as a political tool to make us richer than our economy could grow, inflating home prices and financial asset prices without (they thought) ever triggering wage/price inflation in the broader economy." - Ben Hunt, Epsilon Theory

Since the 1990s, there has been one constant – and that constant is cheaper and cheaper money supplied by the Federal Reserve that created massive and sustained momentum-driven speculation. As rates peaked lower and lower with each cycle, the financial bubbles got larger and larger. In effect, the Fed has greatly distorted the economy and inflated an "everything bubble" from stocks to real estate to corporate debt.

Source: Hedgeye

Take a look at the the graph below. As of December 2021, net assets as a percentage of disposable income have risen to an all-time high of 825%. The historical average is 590%. We are 100% higher than we were at the housing bubble peak in 2007 and 150% higher than we were at the height of the dotcom bubble peak in 1999.

THIS WEEK

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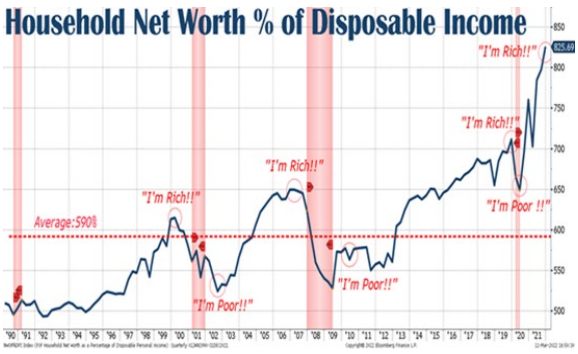


Source: Bloomberg

These inflated asset valuations have nothing to do with economic growth, productivity or corporate fundamentals. It's simply more and more free money being thrown at assets – fundamentals be damned.

In effect, Greenspan, Bernanke, Yellen and now Powell all distorted the markets and a fake economy based on ridiculously unsustainable, ultra-low interest rates. When the Fed drove interest rates to essentially zero, investors reacted to the loss of income by taking greater and greater risks. In today's lingo, they engaged in "yield- chasing". We see it today in stocks, junk bonds, real estate, private equity, venture capital and commodities. We have invented entire new asset classes like crypto for the sole purpose of helping people take more risks in search of higher returns. This yield chasing worked for a while as asset prices soared to stupid levels. Yet people cared little about why asset prices were rising and became brainwashed that asset prices only go up.

Indeed, it's wonderful when bubbles inflate. We feel so "smart" and so "rich". None of this is new. It's happened many times before, going back centuries, and it has never ended well. The problem comes from bubbles bursting when we feel "duped" and so "poor"! This time is unlikely to be different – and far more abrupt and violent than the Fed and its Wall Street megaphones ever remotely imagined. The idea that the Fed had license to print money with reckless abandon will surely rank as one of the great follies of all time.

Now, the Fed is raising rates and draining liquidity. If quantitative easing (QE) and zero interest rates were the primary catalyst for creating the bubble today, what do you suppose will happen as these policies are reversed? In other words, the Great Reckoning has now commenced. As an example, the market cap of the Facebook, Amazon, Netflix and Google (FANG) stocks went from $3.0 trillion to $5.1 trillion and then back to $3.0 trillion, all in the space of hardly two years. This is a consequence of liquidity-fueled bubbles being inflated and then deflated by speculative forces. That's the true economic evil of the Fed's financial repression policies. It causes the financial system to go wildly askew, thereby generating massively falsified financial values, which never last the test of time.

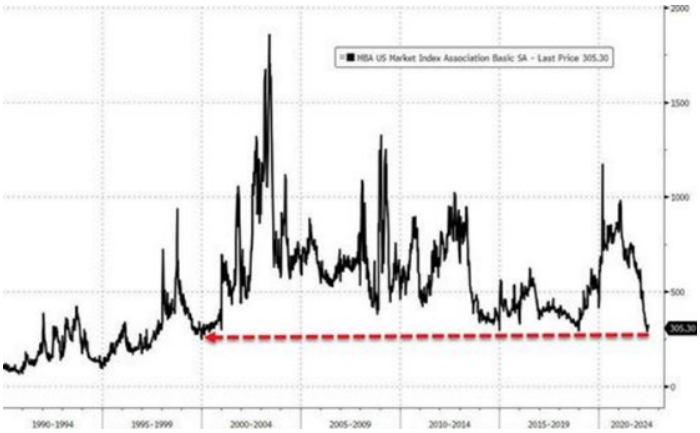
Final words go to Goldman Sach's "Perma Bull" Jesse Abbey Cohen:

"For the last few years, the fundamentals have mattered less than things like momentum and investor enthusiasm"*…We're now back into a period where it does matter, where it's the fundamentals of earnings, the fundamentals of margins, the fundamentals of inflation and interest rates****..."When money is no longer free, you get to see a better picture of whether those corporate managers and those portfolios managers are actually doing a good job."*** *– Jesse Abbey Cohen, Goldman Sachs*

Indeed!

NOT A PRETTY PICTURE

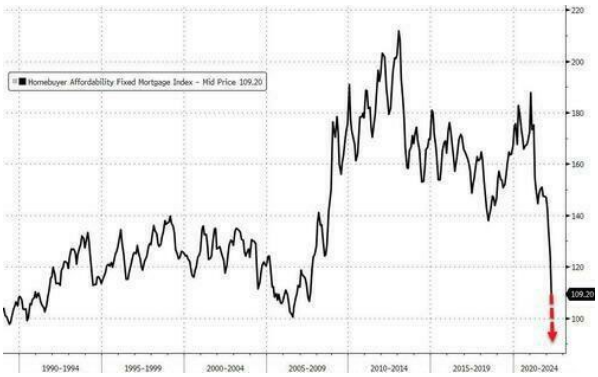
"While the drop provides minor relief to buyers, the housing market will continue to normalize if home-price growth materially slows due to the combination of low housing affordability and an expected economic slowdown."
- Sam Khater, Freddie Mac's Chief Economist



Source: Bloomberg

The laws of supply and demand have once again miraculously reappeared – this time in the home mortgage market. And the mortgage application data for the week of July 1 didn't exactly paint a very pretty picture. Applications sagged 5.4% and were down a huge 51.3% on a year-over-year basis. Applications for new home purchases dropped 4.3% and were off 7.8% on a year-over-year basis. But the real negative kicker is how households are seeing their cash-flow streams robbed by the plunge in mortgage refinancing – hammered -7.7% last week (sharpest decline since mid-May) and now off a huge -76.0% from year-ago levels.

Rates are still up massively from levels a year ago and home prices are at ever higher levels too. Not surprisingly, the eruption of the mortgage rates has sent housing "affordability" into the drink. In fact, housing affordability is now at the lowest point on record going back to the late 1980s. It would actually take a 30% drop in average home prices to reverse the affordability plunge just since the pre-COVID levels.



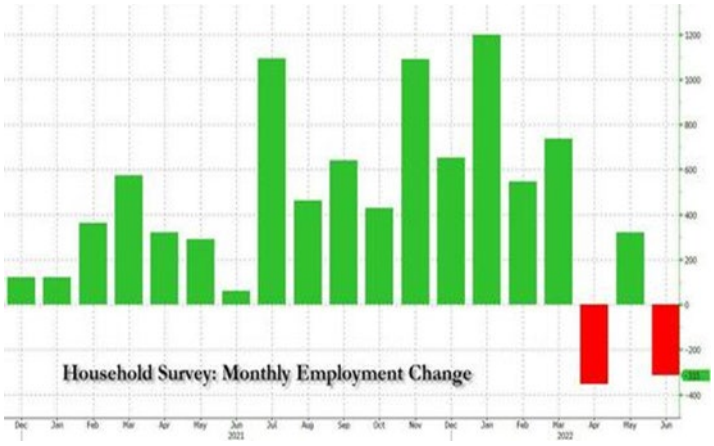
Source: Bloomberg

LESS THAN MEETS THE EYE

The closely followed Establishment Payroll Survey came in red hot, and despite dropping modestly from May, it still printed some 100,000 above the median consensus expectation, printing at 372,000. Wages also rose 0.3% month-over-month or 5.1% year-over-year. On the surface, it was enough for many to conclude that calls of a recession are premature because, after all, you can't enter a recession when jobs are rising by almost 400,000.

True... But something odd emerges when delving a bit deeper into the less closely watched, but more detailed, Household Survey. This month, the Household Payroll Survey showed a striking 315,000 drop, and after the April plunge of 353,000, the June drop was the biggest going back to the March 2020 crash.

In fact, since March, the Establishment Survey shows a gain of 1.124 million jobs, while the Household Survey shows a loss of 347,000 jobs!

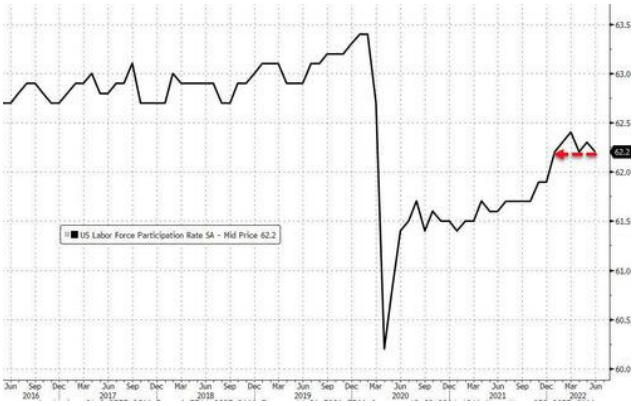


Source: Bloomberg

Maybe most importantly, the Household Survey tends to lead the Establishment Survey in both directions at turning points in the economic cycle. To wit: in January 2020, the Payroll Survey was +339,000, but the Household Survey was -119,000. In December 2007, the Payroll Survey was +108,000 and the Household Survey was -322,000. And then in February 2002, the Payroll Survey rose +91,000 while the Household Survey showed a 166,000-job loss.

And since the Household Survey also feeds other closely watched ratios, such as the labor force participation, it explains why despite the apparent "surge" in June jobs, the labor force participation rate declined and is unchanged since January.

Furthermore, from my perch, it is difficult to draw the conclusion that we really have a healthy labor market on our hands just because of the Establishment Payroll headline, when the Household Survey told us that the employment-to-population ratio receded to a four-month low of 59.9% from 60.1% in May.

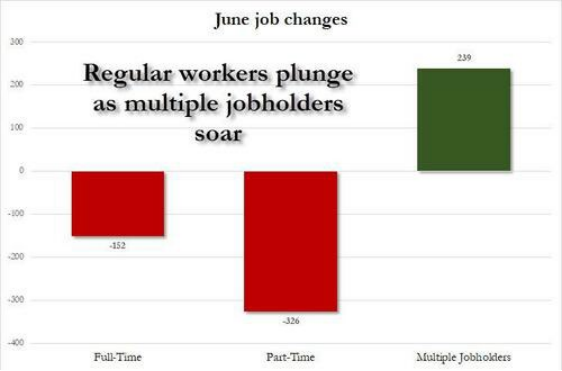


Source: Bloomberg

Wait, there's more. Digging deeper, we find that this drop in Household Survey employment is the result of both full-time and part-time jobs. In fact, as shown below, since March, the U.S. has lost 70,000 full-time employees and 462,000 part-time employees.

The offset? Multiple jobholders, or people who have more than one job**.** While the number of total employees (per the Household Survey) has stagnated, the number of multiple jobholders has been growing steadily. In June alone, the increase was 239,000.

This provides a stark contrast to the decline in individual holders of single part-time and full-time jobs. So, what appears to be going on here is that fewer people are working, but more people are working more than one job, a rotation which picked up in earnest sometime in March.



Source: Bloomberg

Bottom line: Based on the June Establishment (Payroll) Survey, one can argue that the recession is not here yet, but it most certainly is evident in the Household Survey. Full -time employment, real wages and productivity — all are in contraction mode.

MORE CRACKS IN THE LABOR MARKET

The Challenger job cut announcement data surged in June – up +57.0% month-over-month in the sharpest increase since April 2020 and by +58.8% on a year-over-year basis. The 32,517 pink slip announcements were the highest since February 2021. The areas of accelerating layoffs included autos, consumer products, entertainment/leisure, electronics, media, financial services, real estate and industrial products. The list of key cyclical sectors was breathtaking. There were 3,281 jobs let go due to "demand downturn" or over 10% of the total firing volume for the first time in eight months.

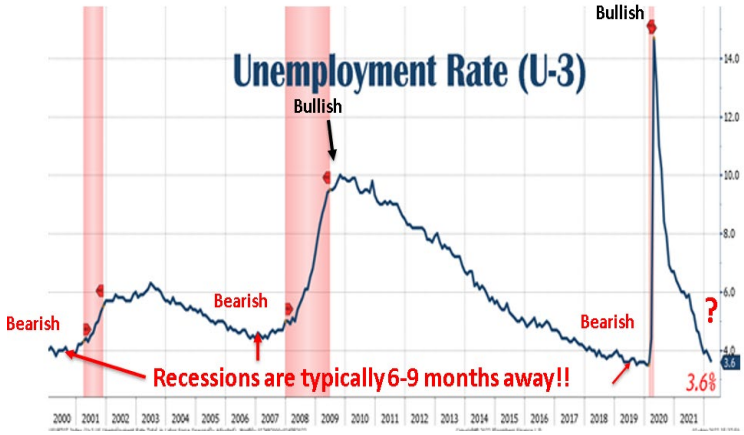
And it's not just layoffs. Hiring announcements shrunk 18.4% sequentially in June and have been down now in three of the past four months – not to mention falling 6.5% on a year-over-year basis. Financial services, construction, retail and transportation services were the major culprits on this score.

JOBLESS CLAIMS ON THE RISE

Initial jobless claims in the week of July 2 rose +4,000 to 235,000, the highest level since January 15 and are now up +69,000 from the nearby low. The key four-week moving average climbed from 231,750 to 232,500 and has risen every week since April 2. Importantly, it is now at the highest level since December 11 of last year and is now up 62,000 from the early-April trough. The average increase from the lows by the time a recession begins is +60,000. So, we are there.

While the unemployment claims are low, it is vital to note that economic expansions always end with claims at a "low level." So, please ignore the noise from the Wall Street shills on bubble vision. It is the change that matters.

Moreover, continuing claims, which is the existing pool of unemployed, jumped 51,000 in the June 25 week, which was the sharpest increase since November – and has been rising now in four of the past five months. At 1.375 million claimant counts, this is a nine-week high, up by a huge +65,000 in the past three weeks. Things on the job market front are changing fast and the clouds are forming.



Source: Bloomberg

A JOLT

Job openings dropped 427,000 after a 174,000 rundown in April — the sharpest two-month setback since the spring of 2020. Let's see if Powell continues to harp on elevated job openings. The 11.254 million level is high, but is now at the low for the year, to date. Notably, manufacturing job openings plunged by a record 208,000.

Also, new hires fell (-38,000) for the third month in a row to four-month low. In manufacturing, hiring activity was down 21,000 on top of the 17,000 slide in April. In the retail sector, new hires slipped 34,000 and were down in each of the past three months and in five of the past six (down 220,000 since February!). Hiring in financial services also declined 45,000 and was down in two of the past three months.

The number of job-hoppers is now finally in retreat. That is great news since it means the up-wage cycle has done its job in satisfying workers, especially in the low-skilled service sector. The number of voluntary quits dropped 37,000 after shrinking 104,000 in May to a four-month low. Retail (-15,000 and down three straight months), financial services (-55,000) and manufacturing (-7,000) played big roles here.

Bottom line: The Job Openings & Labor Turnover Survey was weak right across the board in May. It's a wonder that Powell can't see it. Or maybe he thinks he needs a recession in his zealous quest to kill an inflation that is principally supply-side induced.

The labor market is the next shoe to drop in this game of economic dominoes as the transition from expansion to recession takes hold.

DEMAND DESTRUCTION

On the inflation front, we are now at the point where demand destruction is taking over. This is no longer about supply issues but about a pullback in demand, as recession pressures intensify. The "goods" component commands a 40% chunk of the Consumer Price Index (CPI) and is going to very likely trigger deflation in the coming year. In fact, there are signs of unravelling around the edges on the "goods" front in the May Personal Consumption Expenditures (PCE) report.

- Furniture prices fell 0.2%, the first negative reading since last July.
- Appliances plunged 1.7%, dropping 0.7% in April, which was the sharpest slide since December 2020.
- Recreational goods dipped for the third month running. Sporting goods came in at 0.2% month-over-month and have receded in two of the past three months.
- Luxury items like recreational vehicles and boats tumbled 0.6%, and have retreated in three of the past four months.
- Ditto for watches, down 0.7% in May and on discount in two of the past three months.
- Even in the services sector, telecommunications services have deflated for four months in a row.

Elsewhere, West Texas Intermediate (WTI) crude has seen a drawdown from the highs to more than 20%. Yet, the Fed is consumed with inflation with oil in a bear market – go figure that one out. And it's not just oil. Natural gas is down 25%. Wheat prices are down 25%. Base metals are down 12%. Meanwhile, the 10-year Treasury Inflation-Protected Security (TIPS) breakeven is down to 2.30%. Surely the 10-year and the Fed must have Bloomberg terminals, wouldn't you think?

Finally, the dollar is soaring and there is a 90% plus positive correlation between the dollar and CPI goods inflation.

Bottom line: Nobody seems to be able to see beyond the tip-of-their-nose reinflation. All that most market pundits do, and they do it well, is extrapolate the most recent experience.

THE FRUGAL FUTURE

"Take Gina Palmer, who runs She Salon on Atlanta's busy Northside Drive, west of downtown. 'When people look at their budgets, the first thing they cut is self-care. I've seen my clients go from having weekly appointments to bi-weekly, and my bi-weekly clients are now coming in every six weeks.'"
– Excerpted from a Bloomberg News Column: "Already Feels Like a Recession for Weary Consumers"

Frugality was alive and well in the May consumer spending report. Consider the following highlights form the May PCE report:

- Luxury items like jewelry, watches and sports vehicles/boats have been hit hard by the bear market in financial assets.

- The boom in "stay-at-home" spending that has propelled the economy for much of 2020 and into 2021 has turned to bust.
- Furniture spending was down 0.8% in May and is now off for three months running to a five-month low (and -9.5% year-over-year). How many sofas and coffee tables do we need after that pandemic/stimulus check-induced spending spree?
- Home improvement expenditures dove 1.1% in May, down for each of the past four months and in five of the past six. Who needs an addition on the addition?
- Motor vehicles are down 16.4% from year-ago levels and are nearly down to recessionary May 2020 levels.
- Recreation/sports vehicles declined 3.1% and are down in five of the past six months.
- Games and toys: the rage during much of the pandemic, but no longer. Spending in this category fell 0.4% in May and has receded in three of the past four months.
- Restaurants posted a 0.1% dip, ending three months of gains.
- Speaking of eating, grocery store sales fell in May, down four months in a row and -4.6% year-over-year.

Interestingly, spending on cabs has been up in five of the past six months. Meanwhile, bus riding jumped nearly 4%– the largest spike in over a year. Apparently, people are leaving the car in the garage and grabbing a cab/bus Instead.

People may be driving less but, amazingly, are still flying more despite the exorbitant cost, massive delays and headaches. Flying has been riding a four-month winning streak. Where people are going is anyone's guess as hotels/motel expenditures were down 2.8% in May – the sharpest decline since the turn of the year. Further, my "moles" in Vegas tell me the casinos and hotels there are half-filled. When households cut back their spending on casinos, you know we are in a hunker-down mode.

Thanks to *Top Gun*, people are spending more on fun things such as movies, live entertainment and sporting events. To wit, movies experienced a +22.5% increase.

However, in a weird and sad twist, spending on utilities, gas and food are being reduced in the household budget to make room for alcohol. The family budget has less room for bread but more for booze. I suppose this makes sense given 401K statements these days!

Bottom line: Consumers are trading down, driving less and eating out less, being more selective on utilities and groceries, and focusing on the necessities, while hanging onto some fun items like movies, entertainment and sporting events.

The data were for May before the bear market was confirmed. More frugality is coming our way.

WATCH WHAT THE FED DOES, NOT WHAT IT SAYS

Karine Jean-Pierre, Press Secretary, said the following last week: *"We are stronger economically than we have been in history*." Come on now!

Bending the truth isn't isolated to the White House. For example, the Federal Reserve just spent the last year and a half telling us that inflation was "transitory." The Fed didn't drop the term "transitory" until inflation had already hit 7.1% towards the end of 2021.

In a shocking bit of truth-telling last week, Christopher Waller, Fed Governor, spilled the beans when asked, *"How did the Fed screw up so much last year?"*

> *"We didn't do a good job of risk management. We bet the farm on inflation coming down. We should have been asking, 'What if it doesn't come down?' We had to do an abrupt and fast pivot to try to catch up."*
> *- Christopher Waller, Fed Governor*

Last week, Fed officials, Christopher Waller and James Bullard, stated that the odds are high that a recession will be averted and that the economy will easily withstand a move in the funds rate to 3.5% (Bullard's call). Though with quantitative tightening (QT) tacked on (more than $500 billion slated for this year), the total tightening in Fed policy for

> *"We're going to get inflation down […] that means we are going to be aggressive on rate hikes and we may have to take the risk of causing some economic damage." - Christopher Waller, Fed Governor*

this year would come to roughly 450 basis points. A tightening of this magnitude occurred only in the Paul Volcker era back in the early 1980s. There you have it. So now, the Fed is aggressively tightening monetary policy to catch up to inflation risks they dismissed during all of 2021. The disconcerting bit is what the Fed is saying now. They're aggressively hiking rates while insisting they don't see a recession on the horizon.

So, after the Fed said inflation was "transitory" for all of 2021, we're supposed to trust them that there's no risk of recession today? Meanwhile, the Atlanta Fed's own "GDP Now" forecast just moved lower to -2.1% in Q2 growth. In other words, the Atlanta Fed is forecasting… wait for it… a recession!! (Back-to-back, quarter-over-quarter negative GDP prints is the traditional measure of a recession. The actual Q1 2022 GDP print was -1.6%.)

It's important to note that the Fed has always played the role of economic cheerleader. Not only that, but, as shown below, the Fed's forecasting abilities are not good. In fact, they are pathetic. One would have better odds by flipping a coin. Yet for some unknown reason, investors treat the Fed forecasts as the gospel truth.

Fed's forecasts over the past 10 years:

- Funds rate: accurate 37% of the time
- Core inflation: accurate 29% of the time
- Unemployment rate: accurate 24% of the time
- Real GDP growth: accurate 17% of the time

Historically, the Fed has been biased towards a higher funds rate and stronger economic growth than what comes to fruition. In fact, only 7% of the time in the past did the Fed predict lower rates, and two-thirds of the time it is too optimistic on growth. So, in the bond market, it is perfectly safe to bet against the Fed's forecasting ability, and especially when it comes to the one thing the Fed can control, which is the policy rate itself!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Economists have their heads in the sand. The Bloomberg Economics model is at a mere 38% odds for the R-word coming to fruition in 2022. And Goldman Sachs is at a mere 30% odds… what a joke!

And according to the New York Fed forecasting model, the chances of a recession occurring over the next ten quarters are at about 80%. And the Atlanta Fed Nowcast now puts its estimate for Q2 real GDP growth at -2.1%, which means that Q2 is set for another contraction. Every time this has happened in the past, we had an official National Bureau of Economic Research (NBER) defined recession.

Remember, a recession is a haircut in real spending and incomes, and that is already happening. It's just a haircut, but that is all it takes. Nothing goes to zero! Even the most severe recession sees little more than a 2% or 3% contraction in GDP. It's all about the change. But recessions have serious market implications because change for the financial markets is always at the margin, and it just takes small deviations to generate big bear markets in stocks (risk assets in general) and big bull markets in Treasury notes and bonds.

This is no time to become emotional or dogmatic. The Wall Street promoters and the Fed will always say we can avoid a recession. Maybe so, but recessions are part of the economic cycle – they do happen. In fact, we have had twelve recessions since 1950, or 14% of the time. As such, it makes no sense to pretend recessions don't exist and, in fact, they are inevitable just as expansions and bull markets are. The good news is that recessions don't tend to last much more than a year.

Meanwhile, it is clear that consumers see the recession, and they represent 70% of the same economy that economists are supposed to be predicting. A Civic Science survey of 2,581 American adults from June 24 - 26 found that 71% see the recession as being a 2022 story – 35% believe it has already started! And according to a Wall Street Journal (WSJ) column, the consumer says this recession is the worst ever. My Lord – "ever" surely covers a whole lot of recessions. See WSJ: Consumers Say 2022 Is Worst Economy Ever.

Meanwhile, the Fed is tightening into an inverted curve, a bear market in stocks, melting commodity prices, a massive widening in credit spreads, a screaming dollar with consumer sentiment at an all-time low and a recession staring it in the face. Even Tall Paul Volcker would be blushing over this one.

The fact that the rates futures market is now pricing in two to three Fed rate cuts next year attests to the view that the plurality of investors in this space can sniff out a policy misstep. Or maybe the Fed is deliberately going to send the U.S. economy into a recession in its zealous quest for that 2% inflation holy grail.

While interest rate volatility will unlikely subside near term, we encourage credit unions to continue to "dollar average" into the market while maintaining a fully invested risk appropriate ladder strategy. Sell-offs provide an attractive entry point.

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 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

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