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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JULY 18, 2022

Walking Away

"The slowdown in housing-market competition is giving homebuyers room to negotiate, which is one reason more of them are backing out of deals…Buyers are increasingly keeping rather than waiving inspection and appraisal contingencies. That gives them the flexibility to call the deal off if issues arise during the homebuying process." – Redfin Deputy Chief Economist Taylor Marr

Not so long ago in June 2021, prospective home buyers were waiving contingencies, buying sight unseen. A year ago, the number of canceled transactions equaled roughly 11% of contracts.

In normal times, housing deals can fall through for a variety of reasons. Home inspections may squash a deal or mortgage applications get denied. Sometimes a buyer has second thoughts and simply just gets cold feet.

But today's housing market is anything but normal. Today, the housing market (bubble is a better word) is the least affordable in decades. And with the 30-year conventional mortgage

"Rising mortgage rates are also forcing some buyers to cancel home purchases. If rates were at 5% when you made an offer but reached 5.8% by the time the deal was set to close, you may no longer be able to afford that home or you may no longer qualify for a loan." – Lindsay Garcia, a Redfin real estate agent in Miami

THIS WEEK

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rates doubling to 5.73% from 2.88% a year ago, buyers have more reasons than ever to back out of contracts. Bubble like home prices, combined with higher financing costs have finally slowed the once frantic, sight unseen, "buy at any price" home buyer.

According to Redfin data in June, 60,000 home sales were canceled! That is equivalent to 15% of turnover activity, the highest share since April 2020 when the housing market all but ground to a halt due to the onset of the coronavirus pandemic.

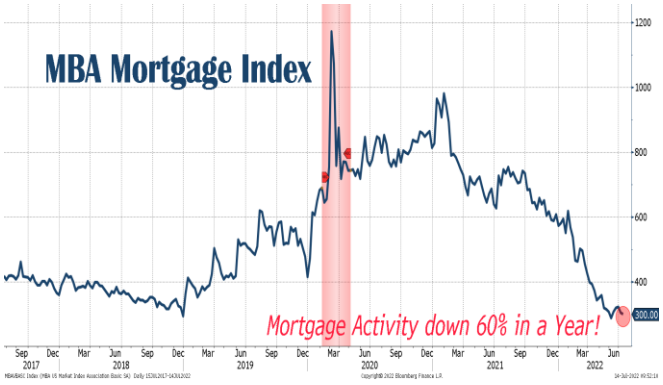
Nick Palacios Jr., Director of Research at John Burns Real Estate Consulting, concisely sums up what's happening in housing.

1) A lot more new home buyers cancelling.
2) Price cuts becoming fairly common.
3) Drop in demand finally cooling construction cost pressures (builder layoffs also happening).

Red hot markets such as Austin and Phoenix have turned sharply. And it's not just the hot markets. The malaise is spreading throughout the country.

"Sales have fallen off a cliff. We're selling 1/3 of what we sold in March and April. Trades are more willing to negotiate pricing since market has adjusted significantly past 60 days…Some builders are already cutting staff. Cancellations are extremely high. Dismal traffic and sales climate." – Austin Home Builder

Given rising cancelations, expect major revisions to new home sales data. The reason being is new home sales are reported at signing and people are walking away from purchase agreements. More importantly, we haven't even come remotely close to seeing all the lags from the Fed's radical tightening program kick into the data. To wit: Every region of the just released Fed Beige Book had something very nasty to say about the housing market, and from the demand side. Higher mortgage rates are biting.



The mortgage application data for the July 8 week were really bad. Down 1.7% in the July 8 week on top of the prior week's 5.4% hemorrhaging – taking the year-over-year trend to an amazing -60% pace. The purchase index is crumbling again after a brief respite, down 3.6% last week and 4.3% the week before to stand 18% below year-ago levels. The housing market is getting crushed by the lagged effects of rising interest rates and affordability issues.

Housing reports provide more strong evidence a recession has already started or is on the near horizon.

SMALL BUSINESSES IN A FUNK

"As inflation continues to dominate business decisions, small business owners' expectations for better business conditions have reached a new low…On top of the immediate challenges facing small-business owners including inflation and worker shortages, the outlook for economic policy is not encouraging either."
– NFID Chief Economist Bill Dunkelberg

U.S. small business optimism plummeted in June to the lowest level since early 2013 (down 3.6 to 89.5, well below 92.5 expected) – so, quite the "miss". The index was 98.9 at the turn of the year and just took out the April 2020 recession trough of 90.9. It matches the June 2008 Great Recession level, not to mention taking out the 96.2 reading in September 2001 amidst the 9/11 terrorist attacks and an economy that was seven months into an official NBER-defined recession (at the time, the consensus was convinced that this was a "soft landing").

More disconcerting, a net minus 61% of owners last month said they expect better business conditions over the coming six months, the worst result in the survey's 48-year history.

Inflation continues to be a top problem for small businesses with 34% of owners reporting it was their single most important problem, an increase of six points from May and the highest level since quarter four in 1980. But it wasn't just inflation. All 10 sub-components worsened in June.

Small Business Optimism

Index Component	Net %	From Last Month
Plans to Increase Employment	19%	▼ -7
Plans to Make Capital Outlays	23%	▼ -2
Plans to Increase Inventories	-2%	▼ -3
Expect Economy to Improve	-61%	▼ -7
Expect Real Sales Higher	-28%	▼ -13
Current Inventory	5%	▼ -3
Current Job Openings	50%	▼ -1
Expected Credit Conditions	-5%	▼ -1
Now a Good Time to Expand	3%	▼ -3
Earnings Trends	-25%	▼ -1

NFIB NFIB.com/sboi

Hiring plans fell to 19%-tied for their lowest level since February 2021. Capex plans plunged to 23% in June, which is the lowest since March 2021. Business expansion plans were cut in half from 6% to 3%, the lowest reading since April 2020

and roughly matching what we had on our hands in March 2009. The stock market shouldn't like the fact that expected sales volumes also retreated further from -12% in April to -15% in May and now to -28% in June.

The record low outlook is strongly indicating bad times for the economy to come.

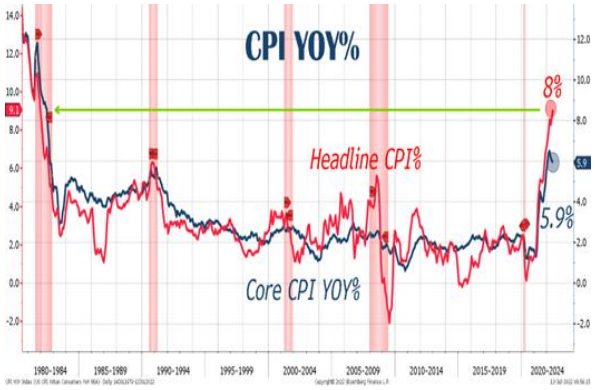
The NFIB concludes rather ominously:

*"**These indicators make a very strong case for a decline in economic activity.** How long and how severe is now the question. It appears that real GDP growth was negative in the first two quarters of the year, some say that is a recession. But employment has yet to yield to the forces of decline, a good sign... However, this plays out, small business owners are bracing for challenging times ahead."*

HOTTER THAN EXPECTED

"What I take from the report, and it was uniformly bad -- there was no good news in that report at all -- is that inflation remains at an unacceptably high level…We at the Fed have to be very deliberate and intentional about continuing on this path of raising our interest rate until we get and see convincing evidence that inflation has turned a corner." – Cleveland Fed President Loretta Mester

The consensus forecast was expecting a jump higher led by food and energy costs. They were right in direction, but it was way worse as the headline consumer price index (CPI) soared 9.1% year-over-year (vs. 8.8% expected and 8.6% prior). The 1.3% month-over-month rise is the hottest since 2005 and the 9.1% year-over-year. The last time inflation ran this hot was 1981, when Ronald Reagan was elected President and NASA launched its first space shuttle, the U.S. Men's Olympic hockey team was fresh off its shocking win over the Soviet Union, and Jeff Bezos was in high school. In other words, it's been a very long time.



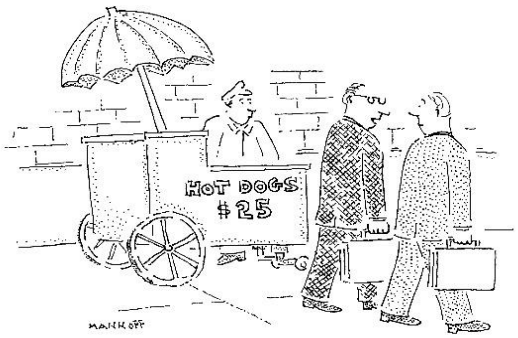
Under the hood, energy and food costs dominated the rise. The energy component of CPI (gasoline, natural gas and electricity) spiked by 7.5% in June from May and by 41.6% from a year ago.

Meanwhile, food prices soared. The CPI for "food at home" – food bought in stores and at markets – spiked by 1.0% in June from May, and by 12.2% year-over-year – the ugliest spike since 1979!

Look at a sampling of major food-at-home categories, and the percentage change from a year ago:

Food Prices Year-Over-Year %	
• Cereal: +15.1%	• Fish and Seafood: +11%
• Pork: +9%	• Eggs: +33.1%
• Poultry: + 17.3%	• Dairy products: +13.5%
• Fresh Fruits +7.3%	• Juices and Nonalcoholic drinks: +11.6%
• Coffee: +15.8%	• Baby Food: +14%

I should add that people in the lower part of the income spectrum spend most of their money on necessities, with a relatively big portion of their income goes to food, and they're getting absolutely crushed by food inflation.

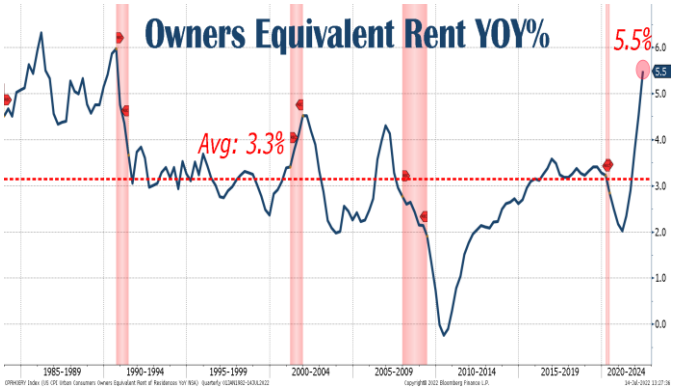


"I told you the Fed should have tightened."

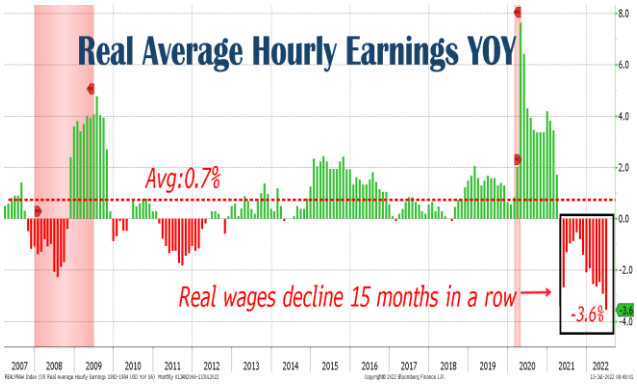
CartoonStock.com

Services prices are the real story though. They are now up 6.2% year-over-year, the highest since 1991. Rent accounts for 32% of total CPI and is the largest component. It attempts to measure housing costs as a service (not as an asset to be purchased). And in June, housing inflation alone contributed 2.4 % to service inflation over the last 12 months. The Owners' Equivalent Rent index rose 0.8% over the month, the largest monthly increase since April 1986 and is up 5.5% year-over-year.

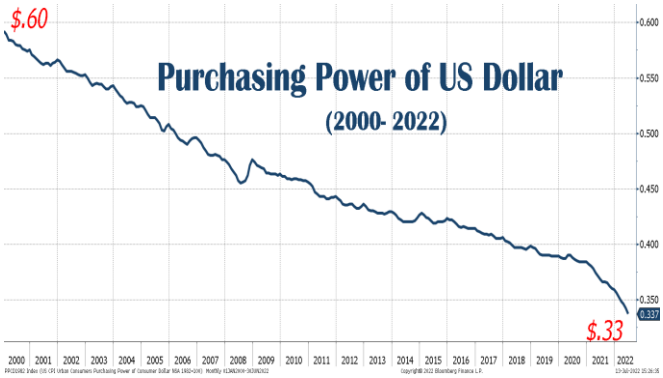
From the rental data, it is clear now more than ever that the Fed is going to have to prick the housing price bubble. And it won't be a pretty picture for the consumer as it faces a double-whammy "negative wealth effect" on spending from real estate and the equity market. No, it won't be as bad as 2007-09 and will not trigger widespread financial failures. But it's still going to be bad for the average American consumer.



Bottom line: This is the sort of number that crushes incomes and spending in 'real' inflation adjusted terms and recessions are based on 'real' inputs. In fact, as shown graphically below, Americans' purchasing power fell by a record 3.6% year-over-year in June – the 15th month in a row of declines. Such declines in real income have been seen only in recession years.



Another way of looking at the impact of inflation on disposable income and spending is by looking at the purchasing power of the U.S. dollar. As shown below, in June, the purchasing power of the U.S. dollar dropped to $0.33 in June 2022. In 2000, the same U.S. dollar's purchasing power was equivalent to $0.66. In other words, the U.S. dollar buys 50% less than it did in 2000. Suffice it to say, a buck is not what it once was. No wonder American are in a rotten mood!



RUNNING DRY

"The report implies a very negative inflation-adjusted number on goods consumption, and the real-time GDP nowcasts are likely to be marked down significantly." – Mizuho Financial Group U.S. Economist Alex Pelle

Despite collapsing consumer sentiment (and real wages slumping), headline retail sales rose 1.0% month-over-month (ahead of the +0.9% expected) – the best month since March. Excluding autos and gas, retail sales rose 0.7%. Most importantly, the control group sales – which feeds directly into GDP – rose 0.8%.

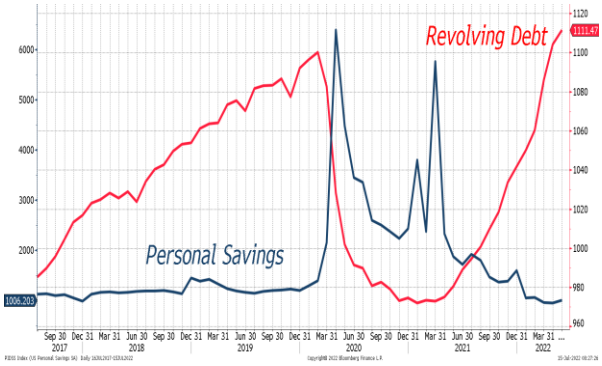
As a reminder, retail sales are 'nominal', not 'real'. While adjusting the headline retail sales print for inflation (via CPI) is rough, it gives us some idea of the 'real' state of the American consumer's appetite for buying more stuff (or less). Real retail sales contracted by 0.3% in the month and have declined at a 0.9% annual rate for Q2.

Bottom line: Recessions are based on 'real' variables and the retail data solidified the case that the consumer downturn has arrived.

With real disposable incomes at all-time lows and the personal savings rate near a five-year low, consumers appear to be tapped out. But American love to shop. To fill the void from declining income and savings, consumers are pulling out their plastic. But how long can consumers keep spending with revolving (aka credit card) credit at the highest level in decades?

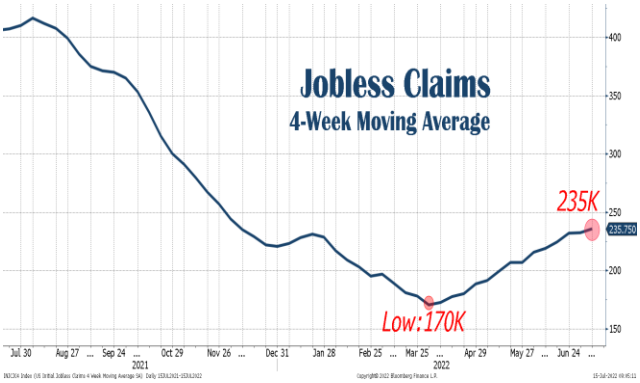
Lower income + lower spending + lower savings + more debt is not a winning formula for a consumer-based economy.

Is the U.S. economy really strong enough to cope with any more rate-hikes?



CRACKS WIDEN

Initial jobless claims came in at 244,000 in the week of July 9 from 235,000 the prior week, the highest since November 2021, and up +78,000 from the March 19 cycle low. The four-week moving average has risen six weeks running to 235.75K from 232.5K, and this is the highest number since December 4 of last year. Yes, claims are still low but it's the change, not the level that matters. This is another sign that we are beyond peak labor and raises the probability of a recession.

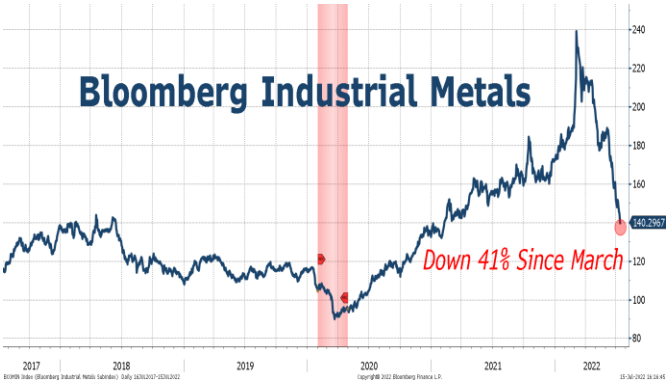


YESTERDAY'S STORY?

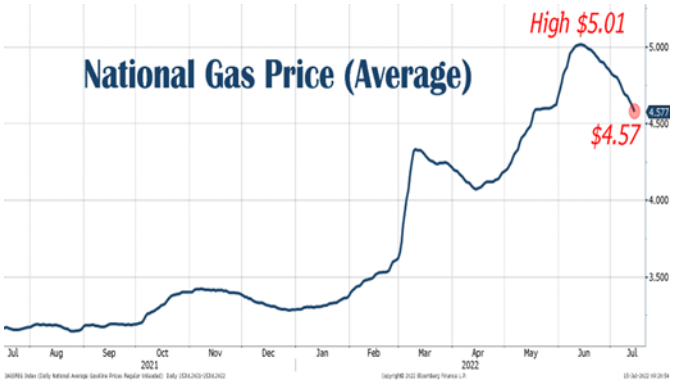
"After May's upside surprise across all major categories, this report is the second in a row that shows inflation pressures continuing on a broad basis…But The outlook points to some inflation deceleration from here. In particular, energy price inflation is likely to reverse sharply in July on the back of falling commodity and retail gas prices, which points to a substantial drop-off in sequential headline inflation next month."
– Morgan Standley Chief Economist Ellen Zentner

If inflation is the clear and present danger, someone forgot to tell the commodity market.

In the base metals complex, copper is down -36% from the peak – never a good sign for economic prospects – and back to pre-pandemic levels. Lumber is down 37% from its all-time highs. Silver has plunged -31% from the peak. Nickel? How about down -60%! Steel is down 34% from the highs. All in all, the industrial metals index is down a whopping 40% from the March peak.



In the energy patch, West Texas Intermediate (WTI) has plunged a whopping 20% since June! Demand destruction for gasoline has now turned into a crescendo during peak driving season, including the 4th of July holiday weekend to boot. The U.S. national average price of gasoline has declined every day since mid-June and is down 8.8% over the period to $4.57 per gallon. And get this… I filled up my tank at Costco this weekend at $4.07 per gallon!!



In the agricultural sector, wheat prices are now down 48% and are now amazingly back to pre-Ukraine invasion levels. Corn has plummeted 27% and soybeans are down nearly 20%. Elsewhere in the commodity complex, I should add that lumber is off 56%. All in, the CRB index is down 16% from its nearby high. Now tell me: do you see inflation in these numbers? Because all I see is deflation. Yet everyone still has inflation on the brain. Have they unplugged their Bloomberg terminals? We had inflation – had. We had a price shock that lasted fifteen months. It's over.

All I hear is about how the level of everything is still above where they were pre-COVID. So what? The level of the CPI isn't what goes into the calculation of Old Age Security payments. It's the rate of change. Here is an example: Did Tall Paul Volcker manage to get the oil price back to pre-1973 embargo levels of $3.50 per barrel? WTI was sitting at about $20 per barrel the day he left the Fed in 1987. This was still 6x higher than where it was before the initial shock fourteen years earlier. Yet inflation plummeted! But the things I read and hear and even the questions I field show that there are far too many people hung up on levels when what matters most for the economy is growth, not levels, and for the markets, the change, not the level.

Bottom line: Inflation is undoubtedly and unacceptably high, but it's important to understand that inflation is a classic lagging indicator and peaks six months into recessions on average. So far, the runaway strength in the U.S. dollar and the dive in commodity prices have yet to kick into the actual data. This is important because 40% of the CPI will be directly affected in the future from these developments. The recession is staring us in the face, and it won't be long before the inflation data reverse course – a backdrop that has historically been bullish for Treasuries, particularly at the long end of the curve.

BUCKLE UP…

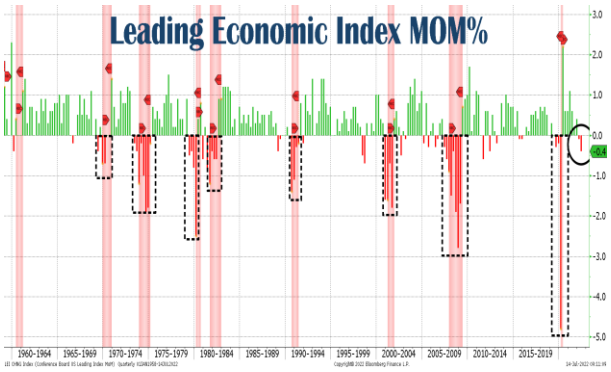
Because it looks like things are about to get even bumpier. Perhaps the most-notable development of last week's market price action was the aggressive inversion of the U.S. yield curve. The curve dynamics were turbocharged by week's

hotter-than-expected U.S. inflation readings, which have prompted traders to jack up bets on just how quickly the Federal Reserve will need to raise rates. That's pulled up rates in the shorter-end and belly of the curve. At the same time, concern that might crater growth is helping to fuel a bid for longer bonds, sending yields there plummeting.

The 2s/10s Treasury curve inverted more than 21 basis points, which was the most since 2007. As a sidenote, the recession began in December of that year. Yet, it took the "wise men and women" at the NBER a full twelve months to declare that the economy was in recession. Seriously… I mean, there's such a thing as showing up to the party late and then showing up after everyone's gone home.

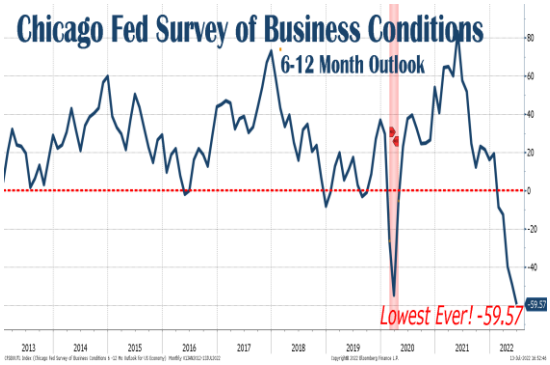
Historically, a negative spread between the 2-year and 10-year Treasury yield has resulted in a recession… wait for it… 10 out of 10 times!!! No guarantee, but would you want to bet against those odds. And if the curve is indeed prescient, look for a recession to follow and a continued rally in the Treasury market as yields have historically fallen 150 basis points in recessions.

And it's not just the yield curve that is pointing to a recession. The Conference Board leading economic indicator is on the verge of declining four consecutive months. Since 1959, any such decline has presaged recession 100% of the time. This is why, as aggressive as the futures strip is in predicting big rate hikes into the fall, it has gone ahead and priced in three rate cuts in 2023. Bullish for bonds.



And even in July the "Windy City" has a chill in the air. A Chicago Fed survey on the outlook for the U.S. economy decreased to minus 60 in June, the worst reading since the survey began and worse than at the depths of the COVID lockdowns in 2020. In the same vein, according to *The Wall Street Journal*, a JPMorgan survey of CEOs shows just 19% of business leaders are optimistic on the U.S. economy compared to 75% this time last year. Do you really think that will lead to a 'soft landing'? To even imagine a soft landing reveals a Jiminy Cricket wishing upon a star mentality.

Is there much more to be said? Only the Fed and Wall Street economists don't see a recession.

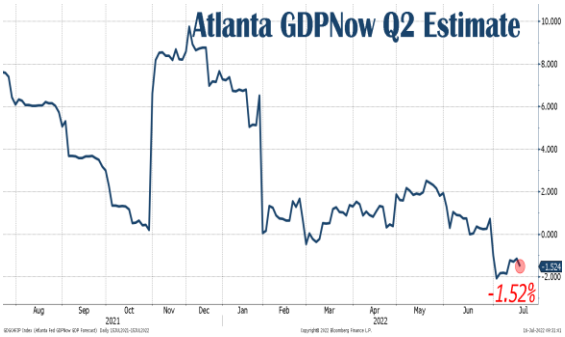


MARKET OUTLOOK AND PORTFOLIO STRATEGY

The characteristics of a realistic "soft landing" would be for a slow rise in unemployment towards 5% while inflation declines at a moderate pace to below 3%. It's possible, but unlikely. A recession is still very likely, and leading indications of a recession are saying it is certain to occur "soon."

"We're going to react to the incoming data and appropriately." – Federal Reserve Chair Jerome Powell

As shown below, the Atlanta GDPNow estimate for Q2 is -1.52%. If you recall, Q1 GDP was -1.6%. If this Q2 estimate comes to fruition, that would be the second consecutive quarterly 'negative' reading in GDP. In other words, a technical recession.



In terms of monetary policy, last week, FedSpeak managed to talk down the odds of a 100bps hike in July from 75% to around 30%.

To wit: Fed Governor Waller stated that a 75 basis-point hike is "huge" and that if the Fed opts for such a move, it wouldn't mean officials are failing to confront price pressures.

"Don't say because you are not doing a 100 you are not doing your job… you don't want to really overdo the rate hikes." – Federal Reserve Governor Christopher Wallace

Meanwhile, Bullard suddenly suggests 'neutral' rate is at 2.25% (basically done after a July 75bps hike).

Bullard went on to say the following:

"So far, we've framed this mostly as 50 versus 75 at this meeting. I think 75 has a lot of virtue to it" because it brings the benchmark rate to roughly the neutral level as seen by policy makers…As of today, I would advocate 75 basis points again at the next meeting." – St. Louis Fed President James Bullard

Did the Fed Pivot?

"I've said it would be a good idea to get to 3.5% this year, and that would put downward pressure on inflation. A lot of that's already been priced into the markets, so we've already got the market pricing we need."
– St. Louis Fed President, James Bullard

The next Federal Open Market Committee (FOMC) meeting is two weeks away on July 27. And while the Fed remains extremely data dependent never before has the Federal Reserve tightened (not to mention by 75bps) into a yield curve inversion, a runaway U.S. dollar, a bear market in equities, seemingly back-to-back negative GDP quarters, and a 20%+ pullback in most commodity prices.

So, what happens after the Fed hikes 75bps in the last week of July (assuming it does, of course)?

The Fed will be cutting long before Q4 2023, and indeed, as of this moment the Eurodollar market is pricing in almost one full rate cut in Q1 2023!

In terms of portfolio strategy, with short-intermediate term yields near 15-year highs, we encourage credit unions to invest 'excess' cash further out the curve. Because of the higher volatility environment, we advocate that credit unions maintain a "dollar averaging" discipline while maintaining a fully invested risk appropriate ladder strategy. Sell-offs provide an attractive entry point.

In terms of sectors, U.S. Treasury securities, and high-quality bank notes offer attractive risk return profiles. For credit unions looking to increase loan exposure, select loan participations (i.e., autos) are now attractively priced and offer generous yields and spreads versus comparable duration Treasury counterparts.

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.