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INVESTMENT SERVICES

Weekly Relative Value

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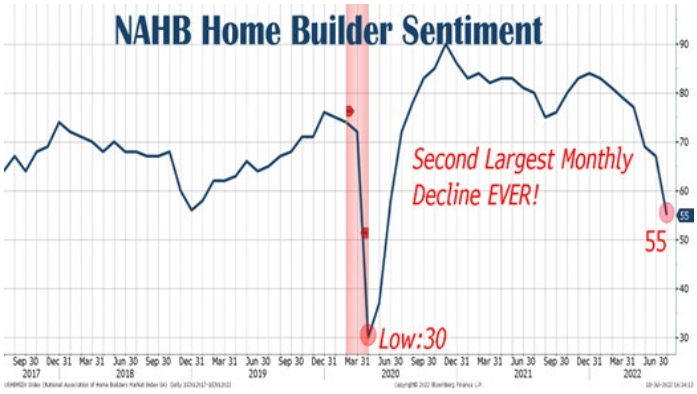
WEEK OF JULY 25, 2022

Housing Comes to a Screeching Halt

"Production bottlenecks, rising home building costs, and high inflation are causing many builders to halt construction because the cost of land, construction, and financing exceeds the market value of the home."
- National Association of Home Builders (NAHB)

Economists just cannot seem to grasp the housing crash that is underway. The Bloomberg consensus is a good example. The consensus forecast was for the NAHB index to come in at 66. That was a big "oops" as the number dropped 12 points to 55 points. In fact, the magnitude of the drop in homebuilder sentiment was, excluding COVID-lockdowns, the largest in history! The NAHB housing market index is now down seven months in a row. In other words, it's been all downhill for builders so far this year.

For some perspective, since the start of the year, the 29-point setback in the NAHB index is larger than during the implosion of the housing market in the lead up to the financial crisis. This speaks to the lagged impact of the sharp rise in interest rates as affordability has deteriorated significantly, leading to a slump in demand.



The weakness was widespread with every region experiencing a decline. With that being said, the greatest weakness was centered in the South (60 from 75) and West (48 from 64), although the Northeast (57 from 62) and Midwest (49 from 55) were not immune.

Adding salt to the wound homebuilders said the future looks worse. Prospective sales in the next six months fell to 50 from 61, the lowest reading since April 2020. And the index for traffic of prospective buyers plunged by 11 points, to an index value of 37, after having

THIS WEEK

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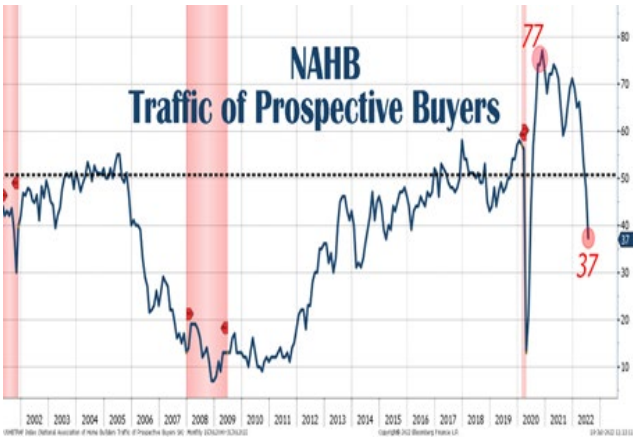
already dropped below 50 in June. The index value of 37 means that more builders rated the market "low to very low" rather than "high to very high," the second month in a row with below -50 reading. That's a real problem going forward. Simply put — buyers have gone on strike and builders are bummed!

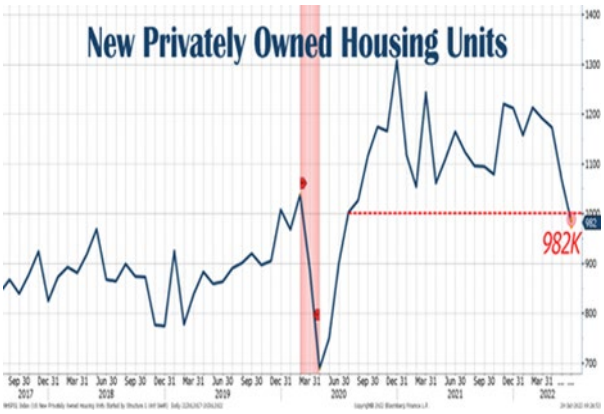


Mind you, there was one piece of "good news" embedded in the report. Due to the meaningful pullback in demand, 13% of builders reported reducing home prices in the past month to bolster sales and/or limit cancellations. This has positive implications for the trend in inflation and is yet another reason to expect that inflation has peaked.

Bottom line: Housing starts are a leading indicator of housing activity. And keep in mind housing leads the overall economy — so if this critically important sector is knee-deep in recession, you can be sure that the rest of the economy will follow suit.

HOUSING STARTS STOP

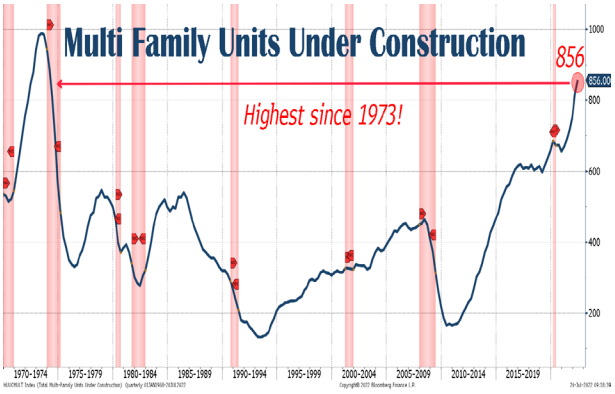
With homebuilder sentiment collapsing at its fastest rate on record in July (ex-COVID lockdowns), it was more than apparent that residential construction is struggling. Indeed, June housing starts confirmed those struggles with a 1.559 million annualized print, a 2% monthly decline coming after an 11.9% crash the prior month. So, in just two months, all the gains made since September 2021 have vanished.



But the headline print hides the real details as single-family starts sank another 8% to 982,000 in June, the first time in two years that this sector of the market has been below one million units. And the damage is far from over based on the 9% decline in single-family building permits, which are now down for four consecutive months — the lowest since June

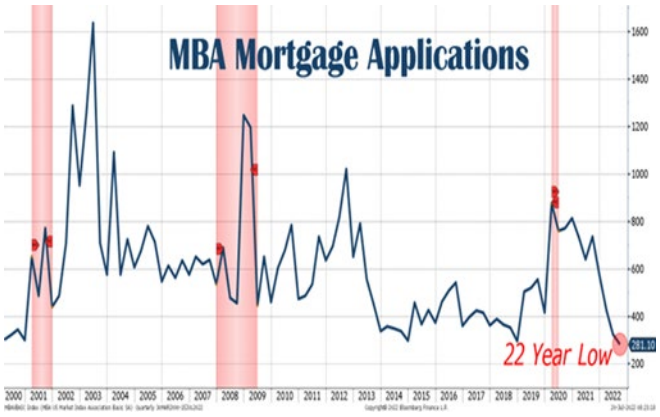
2020. With higher building costs combined with higher mortgage rates, it should not really be surprising that this rate-sensitive sector of the economy is taking it on the chin.

Meanwhile, multi-family starts rose 10.3% to 577,000 in June and multi-family permits jumped 13.1% to 666,000, which is the highest since December 2021! Multi-family units under construction jumped to 856,000 (the highest since 1973) and are now up +23.9% year-over-year. So, look for a surge in the supply of rental units in the second half of the year, which could come close to doubling the demand for apartment living. That is bound to bring down rental CPI and overall inflation.



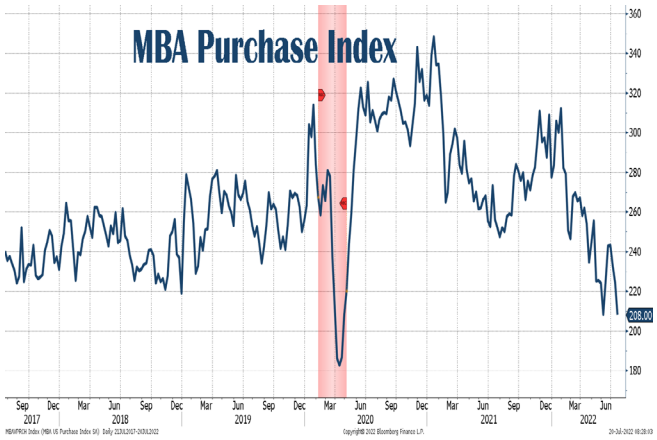
MORTGAGE ACTIVITY IN THE BASEMENT

The affordability constraints from elevated prices and rising mortgage rates continue to weigh on the overall mortgage industry. Mortgage volumes fell to a fresh 22-year low, with the Mortgage Bankers Associations (MBA) Mortgage Applications Survey (as of the week of July 15) showing a decline of -6.3%. As shown below, mortgage activity has contracted to the lowest level since 2000 and is a 60% fall-off from year-ago levels.



Moreover, with the Fed expected to continue hiking rates, and recession risks rising, this trend is expected to continue and will also spill over to other parts of the economy. For example, mortgage originators are being let go (JP Morgan, Wells Fargo, and others have announced layoffs), and consumers will find they have less spending power as there is no more rush to refinance at lower rates (now nearing 6%).

Purchase applications declined (-7.3%; worst week since May to hit a post-pandemic low) and refinancing apps fell (-4.3% to the lowest level since December 2000).



CRACKS IN THE FOUNDATION

"Falling housing affordability continues to take a toll on potential home buyers… Both mortgage rates and home prices have risen too sharply in a short span of time."
- Lawrence Yun, Chief Economist, National Association of Realtors (NAR)

On the heels of ugly homebuilder sentiment, tumbling single-family home starts and permits, and mortgage applications, the last housing release of the week was existing home sales. And like every other housing report it was ugly as sales slumped 5.4% month-over-month in June —the fifth straight month of existing home sales declines. Year-over-7-year home sales are down a stunning 14.2%!

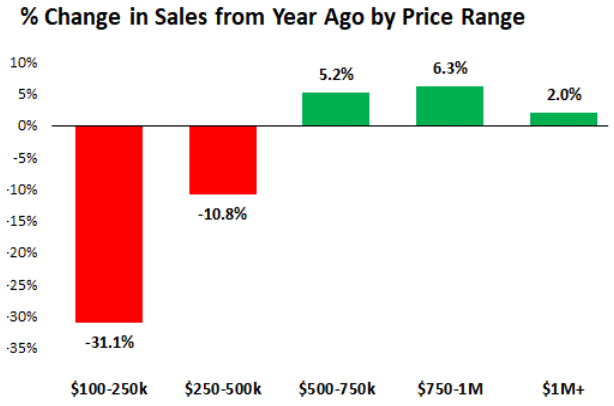
And the clearest sign of how potential homebuyers are staying on the fence and balking at current bubbly home price offerings, 60,000 existing-home contracts ended up being canceled in June — the cancellations amounted to a huge 15% of activity (was 12.7% in May), which was the highest since April 2020. No recession? Sure thing.

It is also important to remember that the sales data represent transactions agreed upon two or three months ago — when 30-year mortgage rates were some 50 to 100-basis points lower than the current 5.5% (highest since 2008). Put differently, the re-adjustment of the real estate market is not complete and has yet to be fully reflected in the data. The

question becomes, how much longer can the Fed continue to keep hiking before the cracks in the foundation ultimately break, making the housing market the next shoe to drop with the impacts spilling over across the U.S. economy.

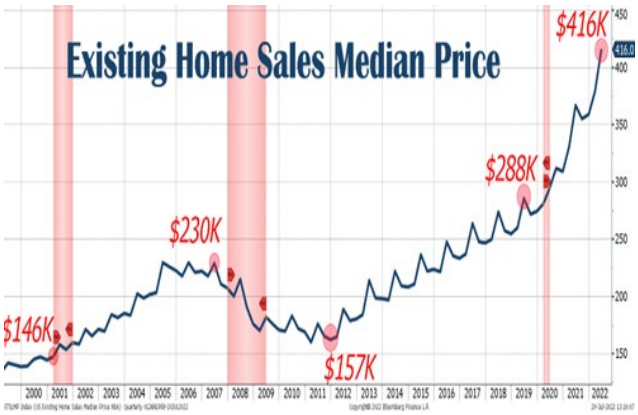
Interestingly, despite hopes that prices would start to roll over, helping with affordability, the median selling price rose 13.4% from a year earlier to a fresh record of $416,000 versus $367,000 a year ago. So, for the time being sellers are refusing to accept the new reality of a Fed-induced erosion in affordability and sharply reduced demand. But it's only a matter of time.

It's also important to note that the median price is skewed by changes in the mix, and there has been a huge shift in the mix to the higher end. Take a look below. The bottom has fallen out in sales of homes priced below $500,000, which accounted for 62% of total home sales in June. But sales of homes above $500,000 have increased year-over-year. Sales of homes in the $500,000 - $750,000 range accounted for 20% of total sales, homes in the $750,000 - $1 million range accounted for 7% and homes of $1 million and over accounted for 8% of sales.

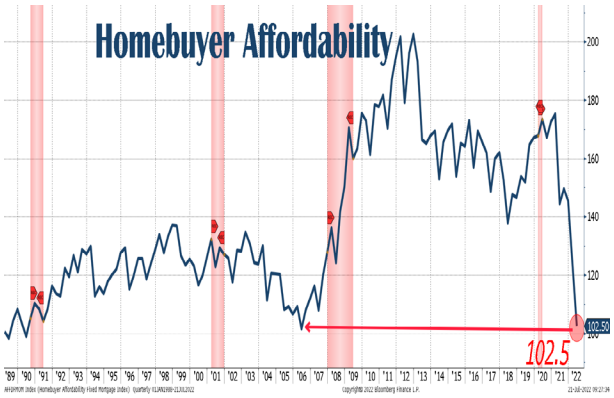


Source: NAR

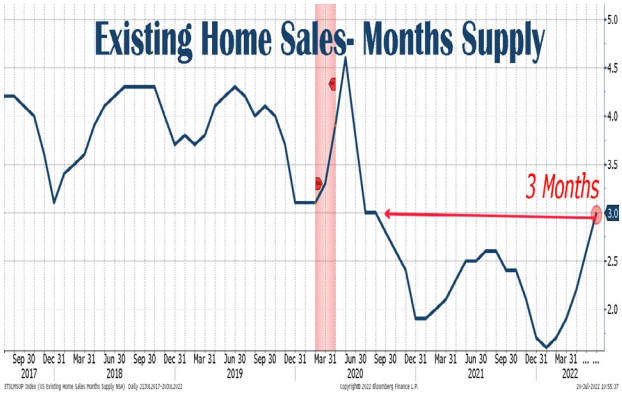
And this big change in the mix, with fewer homes selling in the lower half and more homes selling in the higher half, skewed the median price upward.



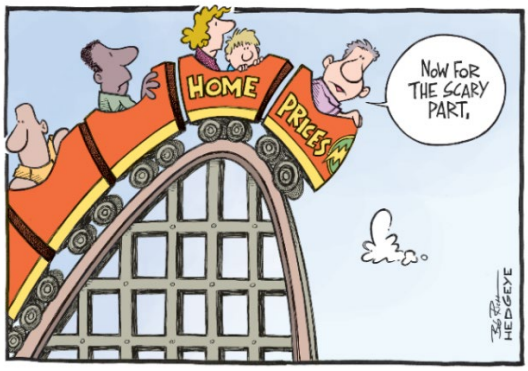
Regardless, the NAR affordability index has now sunk to levels not seen since the height of the housing boom in 2006.



The good news: The number of homes for sale rose for the first time in three years on an annual basis to 1.26 million, the highest since September and marking the fifth straight rise in months' supply. At the current sales pace, it would take three months to sell all the homes on the market. This is a considerable improvement, but still more work is required to get to an "average market" of four to five months of supply.



As buyers continue to walk away combined with rising inventory, house prices will be pressured lower. In fact, it's already happening. According to Redfin, 25% of listings have seen price drops already. Look for this trend to continue as the ridiculously high home prices adjusts to a new economic reality. In other words, home prices have peaked!

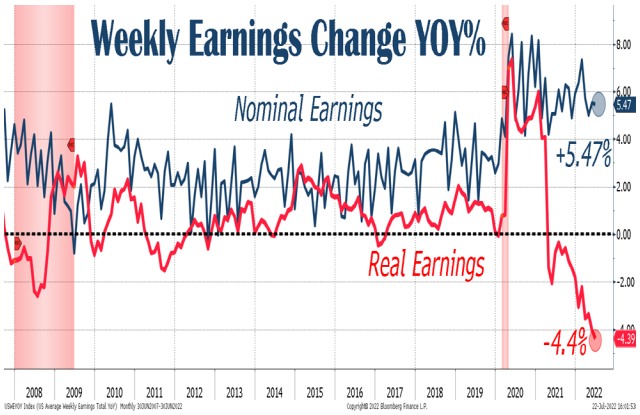


The weakness in residential construction could be enough to push an already-vulnerable economy in recession. Recall that consumers (nearly 70% of the economy) are currently being flattened by declining real incomes and job losses (according to the household survey which at this point in the cycle is more reliable than non-farm payrolls). Should housing slow and house prices drop say 20-30%, it will only exacerbate the declining wealth effects from the recent decline in stock portfolios.

Bottom line: The housing market is the primary engine of the economy. Hate to say it, but it's coming to a screeching halt. Question: How high do you think rates will go with housing, a key driver of the economy, now clearly rolling over?

THE DRAG ON REAL SPENDING

As has been discussed in this space numerous times, the inflation spike over the past 15 months has led to declining real incomes. As shown in the graph below, nominal wages have risen 5.47% year-over-year and when adjusted for inflation wages nominal wages have actually declined 4.4%!



Like wages, spending also rose over the past year. Americans are spending more because of high prices, but adjusted for inflation, they are actually consuming less. With the exception of spending on eating out (e.g., restaurants and bars), real sales are down on a year-on-year basis for all retail categories. That's yet another warning to those folks still counting on consumers to steer the U.S. away from recession this year.

Meanwhile, the Fed's actions have acted to push homeowner affordability down to its worst levels since the bubble peak in 2006. Remember what happened next? And the same in the auto sector, consumers have never paid more to finance their cars. The surge in auto prices along with financing costs has pushed average monthly payments to a record, high of $700, up 13% above a year ago. Average monthly payments on used cars are near a record. In June, they averaged $554, up 12% from a year ago. And the impact of what the Fed has already done is still to be felt months down the road. Not to mention what it still intends to do.

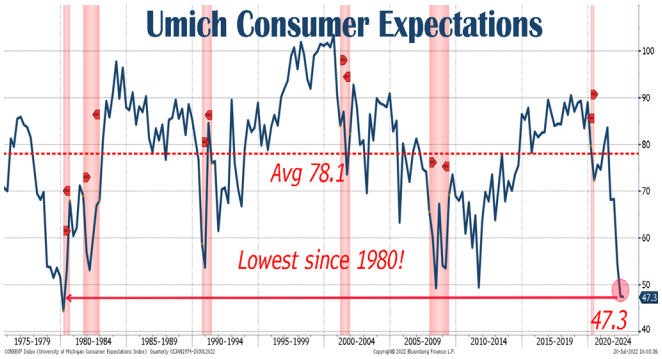
And as shown graphically below a growing share of people are paying much more. Amazingly, a record 12.7% of new car buyers have a monthly payment of at least $1,000. up from roughly 7% a year earlier and 2% in June 2010. I guess some say…Go big or go home!

In some ways, the car market mirrors the dynamics in the housing market, which has been upended by pandemic related supply-chain problems and a shortage of new vehicles, which means sticker prices are much higher than they were two years ago. Interest payments are higher too, thanks to the Fed's rate-raising campaign against inflation. Financing rates on new car loans last month averaged 5.2%, up from 4.4% in February before the Fed began raising rates.

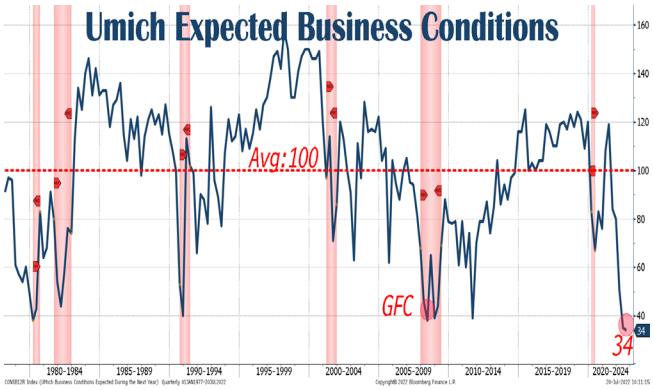
This is a warning about the potential hollowing out of the U.S. economy because of eroding affordability of everything from houses to cars, a threat to the sustainability of growth over the longer term.

SENTIMENT TURNS TO SEDIMENT

The July University of Michigan sentiment came in at 51.1, barely better than the all-time low of 50.0 in June. It's a slight improvement but still at recessionary levels. More importantly, the key "expectations" segment dipped from 47.5 to a dreary 47.3 — the lowest since 1980! And it is "expectations" that drive future spending.



Expected business conditions for the next twelve months are down to the lowest level since the Great Recession in February 2009.

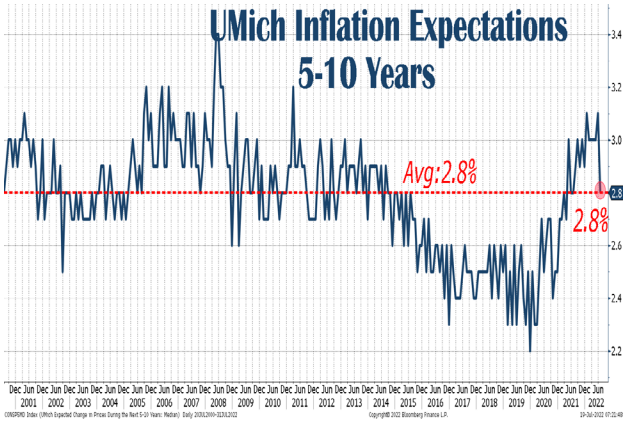


Interestingly, as for the labor market:

- The share seeing rising unemployment in the next year climbed from 23% to 39% in July — last there in April 2020.
- Surprisingly, given the so-called job openings, only 16% see labor market improvement (a six-year low).
- A -23% point gap between those who see higher as opposed to lower unemployment is a shot across the bow, to say the least.
- The probability of losing a job in the next five years went up to a six-month high of 17.2% from 15.9% in June and 14.8% in May. It was +2.6% three months ago — which is something last seen since May 2020.
- Household income expectations sagged to their lowest level since April 2020. And the average income growth for the next twelve months has gone down to +0.6%. Point-six? That's all you get with a 3.6% headline unemployment rate? What happened to worker power?

Possibly the most important consumer view was the drop in longer-dated inflation expectations. The median five-year consumer inflation expectation measure fell from 3.1% to 2.8%, which is tied for the lowest reading since April 2021 and is essentially at the 20-year long term average. Thus, concerns about inflation expectations becoming unanchored have eased and consumers are signaling a return to disinflation. And remember it's the consumer which does all the shopping in the economy. And yet, interest rate views are at their second most hawkish level on record!

In summary: The macro view is very downbeat. Households see increasing labor market slack ahead while income expectations are declining. Not good for a consumer driven economy! The consumer is telling the Fed that it is on the precipice of a huge policy misstep. To be sure, it wouldn't be the first time.



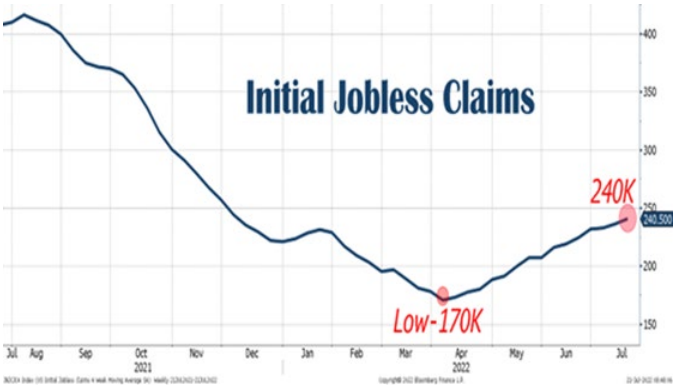
PEAK LABOR

"What had been universally positive labor market news is certainly less so now. The anecdotes are starting to stack up of companies laying off workers or freezing hiring or limiting job postings."
- Liz Ann Sonders, Managing Director and Chief Investment Strategist, Charles Schwab.

Initial jobless claims came in at an eight month high of 251,000 the week of July 16 (up from 244,000 the previous week) and exceeded the 240,000 that consensus was hoping for. Claims are now +85,000 higher than their March low and above the +76,000 historic average off the lows into a recession.

Don't like the headline claims number? The four-week moving average trend is not painting any better of a picture of the economy — it continued to hook up for the fifteenth week running, up to 241,000 from 236,000 last week and is +70,000 above the cycle low.

Historically, by the time a recession sets in, this measure typically increases +60,000 from the lows. So, if history serves as any guide, jobless claims are signaling that the economy is slowing and faster than those on Wall Street think. And unfortunately, this Fed continues to ignore obvious signals that the labor market is cracking, and by the time they pivot, it will already be too late.



"Things have slowed down — in some places, pretty sharply" …"There's nothing right now that looks like we're experiencing a recession, but at some point we can easily tip into rising layoffs and unemployment. The range of [layoff] anecdotes and where they're coming from is getting broader."
- Guy Berger, Principal Economist, LinkedIn

Meanwhile, many other market bellwethers are tightening their belts.

- Apple plans to slow hiring and spending growth next year in some divisions to cope with a potential economic downturn.
- Microsoft blamed soft guidance updates on FX and said it would decelerate the pace of hiring based on current economic conditions.
- Alphabet and Meta announced similar hiring plan slowdowns.

Also, on the labor file active job listings in the U.S. dropped 2.8% in June. That's on top of 4.2% and 3.1% decreases in May and April. In the economics world, three in a row can make a trend. Declines in job listings were seen nationwide, with 94% of states seeing a decline in help wanted ads. Deleted job listings rose 6.9% across all industries from tech, to advertising, to health care, to finance and law. Remember: companies initially decrease hiring to maintain revenues and profitability. After that, layoffs become a risk.

Bottom line: Judging by the initial claims data the tightening of the labor market is only just beginning. Weakness in labor markets and housing will surely make the Fed think about their rate trajectory. Frankly, I would not be surprised if

after they hike rates on July 27 they pause. If so, the front end and belly of the curve would rally dramatically. This is yet another reason why credit unions should continue to reduce "excess" cash and lock in some of the most generous yields in well over a decade.

PEAK INFLATION

Inflation still on the brain? All I hear and read about is inflation, but I continue to believe that is yesterday's news. We had a price shock. Emphasis on the "had". It's over.

To wit, there have been significant declines in nearly every commodity since recent peaks. Gasoline prices have fallen around 15 % from their mid-June high point of $5.02 a gallon. Lumber futures are down 65% from the May 2021 peak. Wheat futures prices have fallen by 37% since mid-May and Corn futures prices are down 27% from mid-June. The cost of shipping goods from East Asia to the U.S. West Coast is 12% lower than a month ago.

And the stock market seemingly agrees as two "inflation-centric" sectors are in or on the cusp of a bear market. To wit, energy stocks have plunged (-20%) and materials are down (-18%). Last week, Broken Hill Propriety Company (BHP), the world's largest resource company, warned of slowing global growth. You see? It was transitory all along!

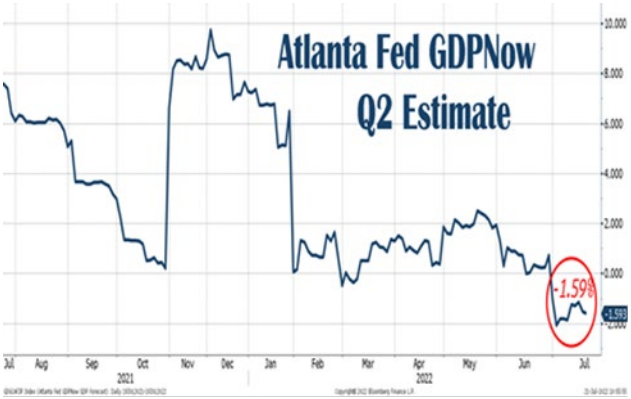
Clearly raw commodity prices are just one factor in overall pricing. Labor costs are a key component of finished goods, and labor costs are still rising. That being said, labor weakness will likely thwart future wage gains. Also, rent (31% of Consumer Price Index (CPI)) seem to be plateauing and as home prices decline and significant rental supply hits the market later this year look for rents to decline.

Year-over-year Inflation has likely peaked. And given the steep plunge in gasoline prices, the CPI for July may be "negative"!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

While U.S. Treasuries have been under pressure from high inflation and the Federal Reserve's policy tightening, including quantitative tightening, the outlook is about to change markedly.

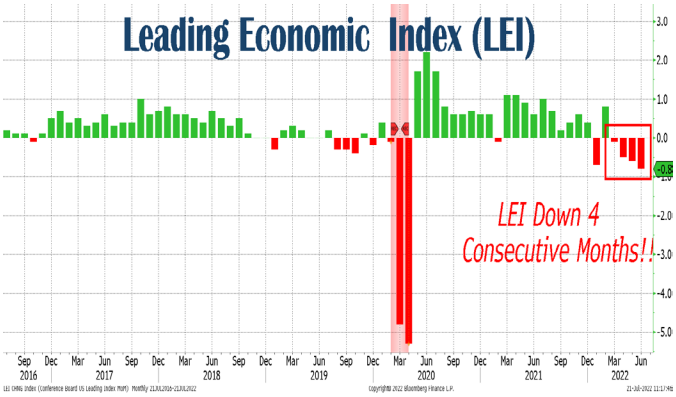
The U.S. housing market weakness is pronounced and likely to worsen, consumers are tapped out and based on the Atlanta Fed's real-time estimates the U.S. economy is on the cusp of the second consecutive quarterly decline in gross domestic product (GDP) (aka recession).



Rising initial jobless claims to the highest level in eight months, the most inverted 2s/10s curve since the Fall of 2000, and four straight negative readings in the Conference Board's Legal Entity Identifier (LEI) (Note: since 1959 four monthly declines in the LEI have presaged a recession 100% of the time) suggest a recession is here or on the doorstep. Don't fight history, please.

Elsewhere, Europe in an economic and political mess and a region bigger than the U.S. economy recession bound. Then consider China, the world's second largest economy — where real GDP contracted at a 2.6% annual rate in quarter two, which more than wiped out the +1.4% first-quarter uptick.

On the inflation front, deflationary forces are already gathering momentum, as evidenced by declining commodity prices (energy and metals) and global transportation costs. As the labor market peaks deflationary forces will spread through reduced pressures on wages and weaker consumer spending at a time when supply chain issues are easing. Meanwhile, massive stockpiling forebodes heavy discounting by wholesalers and retailers ahead (more Amazon days coming our way!)



On the fiscal side, Treasury issuance, courtesy of a fast-shrinking federal budget deficit will reduce supply by an estimated $1.2 trillion in 2022. This is three times the expected $400 billion reduction of the Fed's balance sheet.

Lower Treasury issuance, coupled with deflationary forces gaining momentum — currently being ignored by economic consensus and media — should help put downward pressure on bond yields. This will become more apparent as the Fed tones down its hawkish rhetoric later this year in response to recessionary conditions.

Also worth noting, is that long term Treasury yields historically peak six months in advance of a recession. As shown below the 10-year Treasury benchmark yield has declined 75-bps from its recent peak of 3.5% to 2.78%. History tells us that the inability of for long term rates to maintain an upward trajectory in the face of monetary tightening is a precursor to a recession.

In terms of sectors, short to intermediate (two to seven years) 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.