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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 1, 2022

The State of the Consumer

"I look at my bills after going to the grocery store and wonder who stole my credit card?"
— Alexandra Peña, 27, of Brooklyn, NY

As the consumer goes, so goes the U.S. economy. And all is not all is well with the U.S. consumer. This has become more than apparent in recent months following data releases such as declining real wage growth, the surge in consumer credit and slowing retail sales volume. With real incomes being pressured lower as inflation remains high, mostly due to soaring food and energy costs, the consumer is becoming more selective and frugal.

**Red shaded areas are recessions.*

Indeed, anecdotes of households cutting travel, driving less, and paring back on other forms of discretionary spending are ubiquitous.

"Concerns about inflation -- rising gas and food prices, in particular -- continued to weigh on consumers…Looking ahead, inflation and additional rate hikes are likely to continue posing strong headwinds for consumer spending and economic growth over the next six months."
— Lynn Franco, Senior Director of Economic Indicators, The Conference Board

"They're store-hopping, cutting back on expensive items and using more coupons. Plying the meat counter staff with homemade banana bread for favors is not out of the question."
— "As Prices Surge, Consumers Push Back by Cutting Back", The Wall Street Journal (WSJ)

"Extremely frugal families are coping with record-high inflation by doing what they always have done: not spending money."
— "Campbell Serves Up Reassurance", WSJ

THIS WEEK

- **HOUSING JUMPS OFF THE ROOF!**
- **NOTHING PENDING HERE**
- **THE REPO MAN COMETH**
- **LAYOFFS START**
- **MARKET OUTLOOK AND PORTFOLIO STRATEGY**

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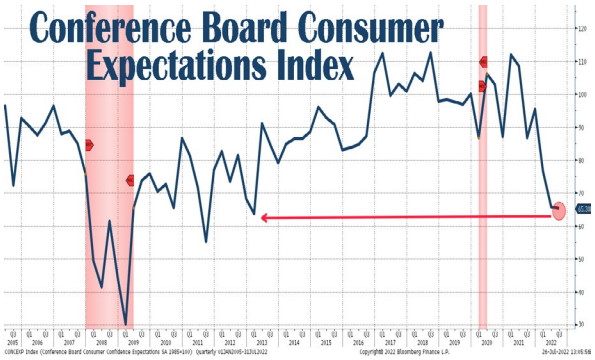
The same message is appearing in corporate reports. Walmart, the Nation's largest retailer, cut its outlook for the second time this year — citing inflation affecting consumer spending behavior and excess inventory it needs to clear. Walmart is widely watched as a consumer health indicator. Its sheer size and national scope reveal a lot about the economy. People are spending more on food and fuel but spending less on things like apparel, furniture, and other non-essential goods. Worse, those happen to be the same goods that had been scarce due to supply chain snarls. Now that they're finally on the shelves, people don't want (or can't afford) them. Retailers are overstocked and cutting prices on slow-moving goods even as they raise prices on others. The point being consumer preferences are changing.

Other companies are seeing a similar trend. McDonald's, UPS, 3M and PulteGroup all added their own examples into the state of the consumer. The examples below are representative of the slowing in economic activity and corporate profits we can expect in the second half of the year.

- McDonald's: Lower-income customers trading down to value items
- UPS: Sinks after package demand falls more than expected
- PulteGroup: Uptick in cancellations has been in last 30-60 days
- 3M: "Broad-based inflation is having an impact on consumers' purchasing power. We're seeing softening trends in consumer electronics especially in TVs…"

One can see the consumers psyche as the Conference Board's consumer confidence expectations index has fallen to the lowest level in nine years. This index has now contracted for four consecutive months. Whenever this has happened in the past a recession has occurred 100% of the time. No guarantee, but who wants to take the other side?



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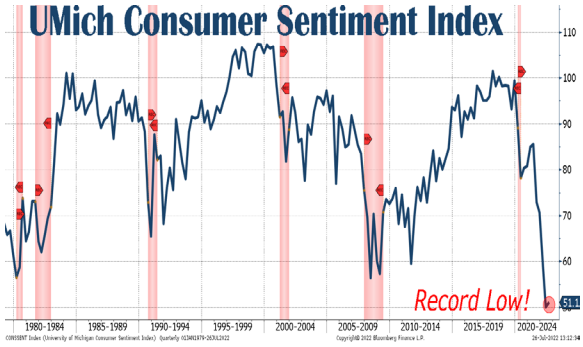
And let's not forget the University of Michigan's pulse on consumer sentiment is flashing an even more dire signal — hovering near record lows at 51.1 in July. Indeed, the message is consistent. Suffice it to say that consumers are bummed and plans of future consumption remain depressed.



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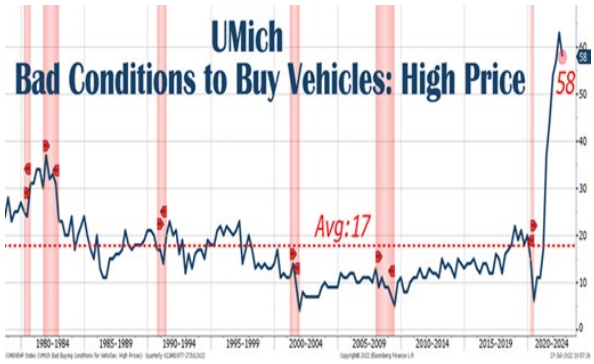
In the U.S., housing and vehicle sales are key drivers of growth and that my friends is a problem. Vehicle-buying conditions are at rock-bottom levels due primarily to ridiculous prices and higher financing rates. The share citing that it is a "bad" time to purchase a new set of wheels because of high prices remains at nosebleed levels and the highest reading since…well ever!



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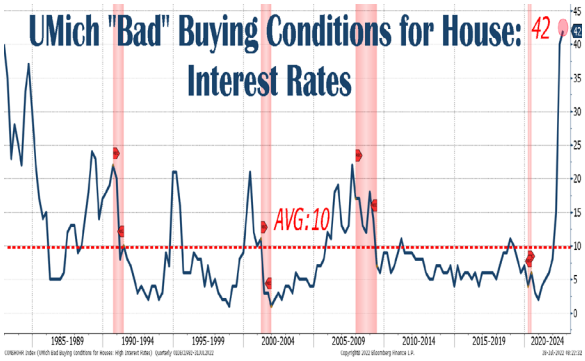
Like autos, the Fed, in its quest to crush inflation, has also crushed affordability for wannabe home buyers. As prices ease, which obviously helps, higher rates and tighter financial conditions have provided an even bigger offset on the hurt front. Get this — the share saying that it is now a "bad" time to buy a home due to rising interest rates has skyrocketed to 42%. The highest this share got to in the housing and mortgage market crunch in October 2008 was 24%. It is now 42%, the highest since November 1982! At the same time, rates have crowded out auto purchase plans the most since October 2008. No recession? Sure thing, Janet and Jerome.



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Let's not forget the wealth effect on consumer sentiment. The S&P 500 has rallied off its recent lows but is still down 15% from the nearby peak. Moreover, investors remain uncertain about the prospects of the market. Not to mention the added hit to confidence not if but when the housing prices adjust to the new paradigm of higher interest rates. Ultimately, this means that the outlook for real spending, which represents a dominant 70% share of GDP, may well embark on a prolonged weak trajectory.

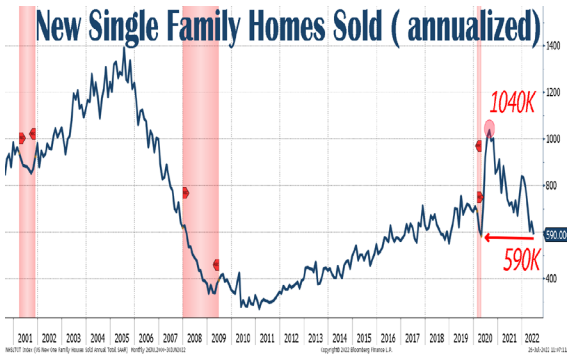
So, despite pundit cries that the labor market is "strong" and that the economy is in "good shape" it would appear that weakness lies ahead for the consumers. The downward trend could very well kick into higher gear in the coming quarters as the negative consumer sentiment compounded by the uncertain economic outlook and unfavorable equity and housing shocks weigh on spending.

As such, the expected recession-induced inflation comedown should provide support for the bond market, meaning now is as good a time as any to add long duration Treasuries to the portfolio.

HOUSING JUMPS OFF THE ROOF!

Amid a plunge in homebuilder confidence, record low affordability, tumbling single-family starts and permits and multi-decade lows in mortgage applications, it is no surprise that analysts expected a 5.9% month-over-month plunge in new home sales.

Indeed, the consensus was right in direction but off in magnitude as new home sales plunged 8.1% month-over-month in June and the 10.7% surge in May was revised down to just +6.3% month-over-month. New home sales have fallen for five of the last six months and the last few months have seen a one-way street of downwards revisions. The new home sales annualized has tumbled to its lowest since the nadir of the COVID lockdowns in April 2020.



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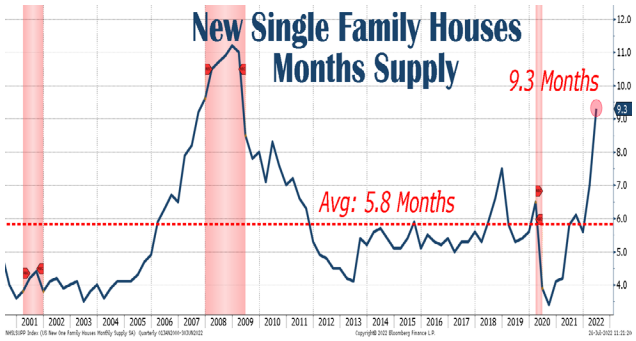
New home sales plunged in every region compared to June last year, but plunged the most in the Northeast -37.9% ,West: -32.9%, Midwest: -22.1%. South: -8.7%.

This new home sales print comes on the day that Pulte Homes admits buyers have hit a wall and is "dialing back" its spec-home-starts, noting that the homebuilder's cancellation rate more than doubled to 15% in quarter two from 7% in the year-ago quarter, as soaring home prices and mortgage rates hinder affordability. Most notably perhaps was Pulte's admission that the uptick in cancellations has been in the last 30 to 60 days, perhaps mirroring the plunge in homebuilder confidence (and Walmart) as the "strong American consumer" appears to have pulled back into its shell.

A potential silver lining is that inventory is finally on the rise with 9.3 months of supply seen in June, up from 8.4 in the prior month.



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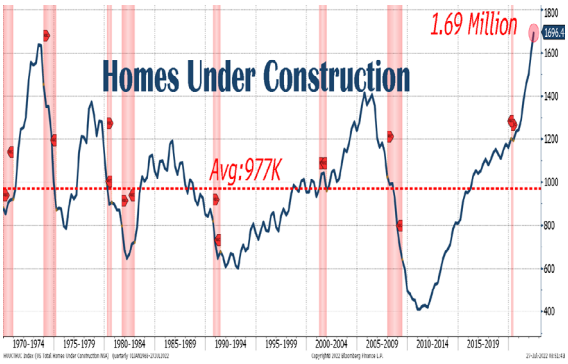
I should also add that there are 1.7 million homes under construction. This is a record supply. And those are real numbers, not annualized numbers. So, is there a housing shortage turning into a housing glut?



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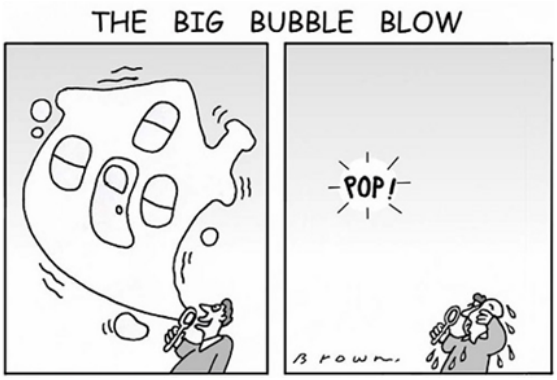
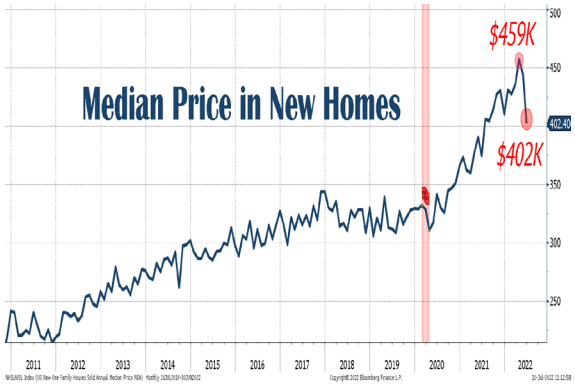
And the best news of all - the median new home price tumbled 9.5% month-over-month to $402,400. This was the biggest month-over-month drop in the median new home price since September 2014. Potential buyers are now having second thoughts, given the spike in mortgage rates, and homebuilders are responding to this decline in demand and the surge in cancellations by piling on incentives and cutting prices.



The pandemic housing boom may not turn into a crash, but it has room to soften quite a bit, and seems to be in the early stages of doing so. It's definitely showing in new home sales and in prices. And as discussed last week, similar drops in sales occurred with "existing" homes (previously owned houses, condos and townhouses) where sales plunged 14% in June from a year ago. Particularly noteworthy with existing sales was California's 21% plunge in closed sales and the 40% collapse in pending sales. Note that housing drives many other segments like furniture, paint, appliances, etc. These also suffer when home sales drop.

"The market is adjusting to a new reality, with much lower sales volumes and far more inventory. Prices, therefore, have to adjust to the downside, likely quite substantially."
— Ian Shepherdson, Chief Economist, Pantheon Macroeconomics



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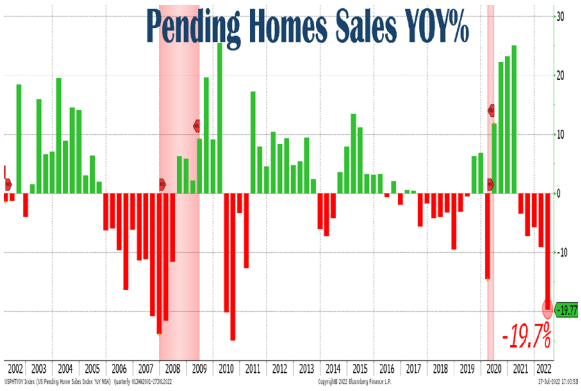
Bottom line: Folks, the "housing shortage" is yesterday's news and double-digit price markdowns over the past two months is good news for those who have waiting for lower new single family home prices. Even still, prices are still too high! Nothing goes to heck in straight line, but home prices have peaked and substantial declines of 20% to 30% are quite possible if not probable. The silver lining is there is now some hope that younger folks whose lunch hasn't been eaten by inflation will finally get a crack at homeownership.

NOTHING PENDING HERE

As I have been highlighting, housing has fallen off the cliff above and is in a complete state of disarray. And making matters worse, the lags from the Fed's aggressive policy tightening haven't even fully kicked in yet. If you think a housing bottom is close, think again. Pending sales (based on contract signings, rather than when a contract closes like existing-home sales) is the bellwether leading indicator of demand and this metric collapsed 8.6% month-over-month in June, making a mockery of the -1.0% consensus forecast. The seventh slide in the past eight months. I would call that a trend.



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This was the steepest decline for any month since April 2020 — the depths of the pandemic. The year-over-year trend of -19.8% (from -12.0% in May), once again, is the worst showing since April 2020.

All major regions were pathetically weak: the Northeast -6.7% month-over-month and -17.6% year-over-year ; the South -8.9% month-over-month and -19.2% year-over-year; the West -15.9% month-over-month (!) and -30.9% year-over-year (!!); and the Midwest -3.8% month-over-month and -13.4% year-over-year .

THE REPO MAN COMETH

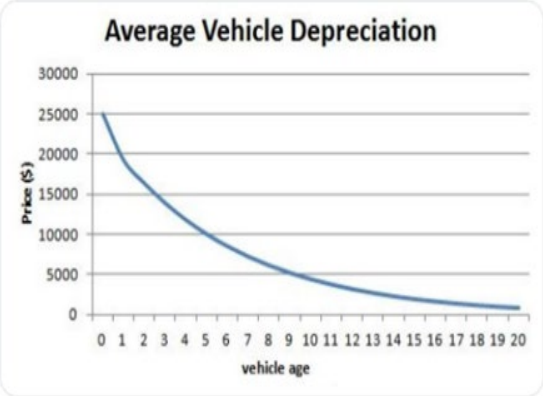
"I expect to be super, super busy… technology has streamlined the process of assigning and finding repo vehicles."
— Mark Lacek, Florida Repossession Worker

Normally, as shown below, most cars follow an inverse exponential curve, with most cars losing its value in the first one to three years. In fact, the minute you drive a new car off the lot it loses 10-15% of its value. But the pandemic changed that. During the weird pandemic cars, instead of depreciating as normal outperformed most stock portfolios.

Consider this: In 2020 the average new car was $38,000. The average used car was $20,000. Prices for used cars and trucks rose 43% June 2020 to August 2020 to $31,000. New vehicles, prices rose 25% over the same period to $48,000. Just nuts!

And we all know the story. Global supply chain issues caused chronic shortages in many key auto parts, including microprocessors — the heart of modern cars. With production of new vehicles slowing used-car prices experienced an unprecedented increase.

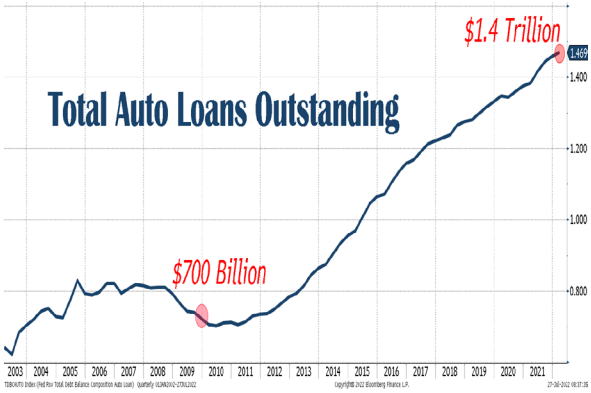
Limited supply combined with literally free money caused many people to start buying any car that could "fit into their budget". It's "only $800 a month" right? To make the numbers work dealers extended the average car loan to 72 months — an increase of about 33% since 2010 (48 months).



Source: Doug DeMuro

But the era of free money is over. Today, people are financing their car at much higher rates. Imagine paying 5-6% interest on a 7-year loan for a car. The average monthly payment on a used-car loan today exceeds $500. It's about $650 for new vehicles, with one out of eight borrowers on the hook for $1,000 or more a month! Subprime car buyers are paying 9-20% according to the Consumer Financial Protection Bureau. People are literally paying hundreds of dollars in interest per month for their car.

This is a huge deal, because more than 85% of cars are financed. Today, Americans owe more than $1.4 trillion on auto loans (the highest in U.S. history and a 75% increase from 2009). Dealerships have morphed into lenders but unlike banks and credit unions, car dealers have no federal oversight. As such dealers have lent to higher risk borrowers. Consider an investigation in late 2021 found that the income and employment verification only happened 4% of the time. If that is not a smoking gun… I don't know what is.



And it's not just dealerships. Credit unions have seen booming growth in used-car loans. Here are a couple of examples in the credit union space. As of March, Pentagon Federal Credit Union has a $3.6 billion portfolio of used-auto loans. That's up a whopping 80% from a year earlier. Credit unions now account for about a third of the vehicle credit market in the country! In Orange County at Westminster-based LBS Financial Credit Union, for example, autos make up 70% of its total loans. Mike Schenk, Chief Economist at CUNA, says about 25% of credit union borrowers have below-prime scores. Not good! And some credit unions have lots of subprime exposure. To wit: Pentagon Federal Credit Union has a $3.6 billion portfolio of used-auto loans. That's up a whopping 80% from a year earlier. As of March, delinquencies of 60 days or greater has more than doubled from a year ago to about $45 million.

"You do see some financial institutions, including credit unions, pretty deep in subprime autos, and should that market turn suddenly and viciously, they'll find themselves on the wrong side of a speculative bet,"
— Aaron Klein, Senior Fellow, Brookings Institution.

As real disposable income has declined and savings depleted, more consumers are beginning to fall behind on their car payments. To wit: pre 2020 auto loan delinquencies hovered at 2% to 3%. Today that number is exploding with nearly 25% of auto loans in default in Washington D.C. It's not just D.C. though. California and Texas have approximately 10% of auto loans in delinquency. The best-performing state is Utah with 4.5% of loans in default. Not surprisingly, consumer car loan delinquencies are higher for subprime debtors – long troubled by discrimination and unsavory practices.

Once payment is more than 90 days late, the lender can repossess your car. Data for this year isn't available, but many involved in auto collection and auctions say that repossessions are rising notably, particularly for used cars.

But this is when the story gets potentially ugly. As the car market normalizes — and it will — new and used car inventory will rise significantly. And when that happens cars will once again, begin to depreciate like they always did. Those who bought a used vehicle at a 30% to 40% premium will find themselves significantly underwater on a car they financed for seven years! Top it off with a potential recession and layoffs, and you get a really messy situation within the car market.

LAYOFFS START

Hiring freezes and layoffs are now nearly daily in the news. Here's a list of tech companies who are issuing hiring freezes or laying off employees: Microsoft, Apple, Facebook, Vimeo, Salesforce, Tesla, Alphabet, Netflix, Twitter, Rivian, Shopify, Uber, Carvana, Gopuff and many others.

It's not just tech. Ford Motor announced last week that it has too many employees is planning to cut as many as 8,000 jobs. And as housing slows, every major mortgage lender has started laying off hundreds of people including the biggest such as Rocket Mortgage, which includes the former Quicken Loans, Lending Tree, Loan Depot, Wells Fargo, PennyMac, and many others. Elsewhere, throughout the crypto and blockchain space, there have been waves of layoffs.

What all these companies had in common was that they were intoxicated by the trillions of dollars in stimulus money for consumers, companies, and state and local governments and by the money-printing and the interest rate repression. They expected the "fake" growth to continue. They hoarded employees, like people hoarded toilet paper when the word "shortage" started circulating. In effect, these companies made the labor shortages much worse, and they contributed to this immense overhang of job openings.

Source: Cagle

Now all that is over. A sense of reality is returning to the business world. And it's kind of sobering. Reality has that effect, after a drunken binge. Money printing has turned into quantitative tightening. Interest rate repression has turned into rate hikes and the economy is in a recession.

So now, that they're coming to grips with reality, companies are reducing some of those job openings, and they're looking at places where this hiring binge might have led to overstaffing and concluding that they need fewer not more bodies.

We still haven't seen the mass-layoffs that we see during a real recession but we're seeing jobless claims steadily rising to 256,000, the highest level in eight months. Remember, claims are always extremely low ahead of the recession further it's not the level of initial jobless claims that matters; it's the change. Initial jobless claims are now up +90,000 from the cycle lows (+54%), which is a recession signal.

Likewise, the four-week moving average continues to ascend and is now at its worst level since November 2021. As shown above, the four-week moving average, at 249,000, has risen each and every week since April 9 and is up nearly 80,000 from the cycle trough. Historically, a move off the lows of 60,000 provided the recession signal. If so, we "got there" in the week of July 9. Watch this data closely, as it will help determine the recession's severity.
This is why claims are likely to rise going forward.

Going into 2022, the Fed was saying we should expect real GDP to expand 4% this year. Then, in June, that view was downgraded to 1.7%. And as we sit here today, it looks like 0% growth for the year, or quite possibly negative. What about all those companies who accepted the earlier forecasts, pre-ordered like mad and built inventories in light of that bullish forecast? They are stuck with far too much supply on the shelves and now are forced to liquidate. And the amount of hiring had been off the charts. Now, companies which have shown productivity declines will have to cut jobs… yes CUT. Some pundits have estimated two million jobs will be eliminated in the coming year. Not a disaster, but it won't be pleasant.

How long before the payrolls data catches up to reality? Keep your eyes on this week's payroll report on Friday morning. Once the labor weakness begins to show up in the payroll data, look for Powell and his fellow fortune tellers to pause and then pivot!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Doesn't see U.S. in recession," and takes the first estimate for Q2 GDP … "with a grain of salt."
— Jerome Powell, Chairman, Fed

U.S. real GDP came in at -0.9% at an annual rate in quarter two, below consensus views of +0.4% but very close to the Atlanta GDPNow forecast. This follows the -1.6% contraction in quarter one. Of course, back to-back quarterly declines in real economic activity are not part of the National Bureau of Economic Research (NBER) determination of a recession but the reality is that never has been two consecutive negative prints in GDP without there being a recession. (See graph below). Recessions don't mean the end of the world as we know it, they merely are part and parcel of the business cycle. This is a time to be disciplined, not emotional.

The Federal Reserve and White House are denying that we're currently in a recession. And Brian Deese, National Economic Council Director, said Thursday, "*virtually nothing signals this period in the second quarter is recessionary*." Frankly, waiting for the NBER to make the official declaration is nutty, since it generally waits more than six months after the downturn started when it publishes the announcement. This is akin to your doctor telling you that you are not well at your funeral.

**Red shaded areas are recessions*

The deniers simply have their head in the sand, and that includes Jerome Powel and Janet Yellen. But the Treasury market surely understands what going on. As shown below the ten-year Treasury yield has plunged 85-basis points since its recent June high of 3.49%. With all due respect I'll take the word of Mr. Bond over Mr. Powell and Ms. Yellen every day of the week!

Anyways you decide. Here is how the domestic economy looked in quarter two (annualized):

- Real retail sales: -0.9%
- Real capital spending: -1.5%
- Housing starts: -14.9%
- Existing home sales: -37.9%
- New home sales: -61.3%

Not a recession Janet and Jerome? Okay, I get it. Maybe we'll just call it a "banana" like Gerald Ford did in the mid-1970s.

The economic decay is evident, and the labor market is the next shoe to drop. At some point in the not-too-distant future, all of this will be obvious to investors (like how inflation was not, in fact, "transitory"). But by that time, it will be too late.

Bottom line: I think a continued slowdown in economic activity is likely into the back half of 2022. Why? Consumption growth simply can't sustain itself in an environment where…

• Lower income consumers are being squeezed by sky-high inflation. Food, energy and shelter make up more than 60% of consumer spending for the bottom 40% of incomes. That's 10% higher than it is for the nation's top 5% of income earners.

• Meanwhile, collapsing asset prices hurt the uber wealthy. The top 10% of Americans by wealth own 88% of equity market assets.

Furthermore, Jerome Powell, Fed Chair, is no longer pre-committing, and any rate move in September will be "data dependent." Decisions now are on a "meeting by meeting basis." Of course, they will be because he knows the odds are high that headline inflation is going to collapse in these next two months, and there is a very high risk of a decline in non-farm payrolls. So how can Powell pre-commit to rate hikes anymore? What if the data do end up forcing the Fed to press the pause button?

This is why I remain a long-term bull on the bond market and why credit unions should maintain a fully invested risk-appropriate investment portfolio. Periodic sell offs are opportunities to put excess cash to work.

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 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 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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