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INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF AUGUST 15, 2022

Goodbye Housing Bubble!

"Rates are going up and prices are coming down. It takes time. We are seeing inventories expand. We are seeing the length of time that homes are on the market expand. We are seeing national homebuilders' inventories increase…We need to be patient and allow the market to reset." — David P. Singelyn, CEO, Americas Home 4 Rent

Americans Home 4 Rent founded during the housing bubble is a real estate investment trust (REIT) based in California that invests in single-family rental homes. In addition to buying houses, in recent years, it has started building its own subdivisions with just rental houses, that are specifically built for rentals. As of December 31, 2020, they owned 53,584 single-family properties in selected markets in 22 states. Its largest concentrations are in Atlanta, Dallas-Fort Worth, and Charlotte.

During its recent earning call, the CEO, David P. Singelyn, said that housing is in a downturn and has slashed its purchases of single-family homes by 80% to allow for home prices to recalibrate and reset.

American Homes 4 Rent is not the only institutional buyer moving to the sidelines. According to Redfin, investors' share of the overall market fell for a fourth straight month in June with double-digit declines in many overpriced markets.

"You can have people on the sidelines, but they also have to be able to afford the offering. And when you think about interest rates rising, and you go with a home mortgage from 3% to 5.5%, it's a significant increase in the payment, reducing affordability."
— David P. Singelyn, CEO, Americas Home 4 Rent

THIS WEEK

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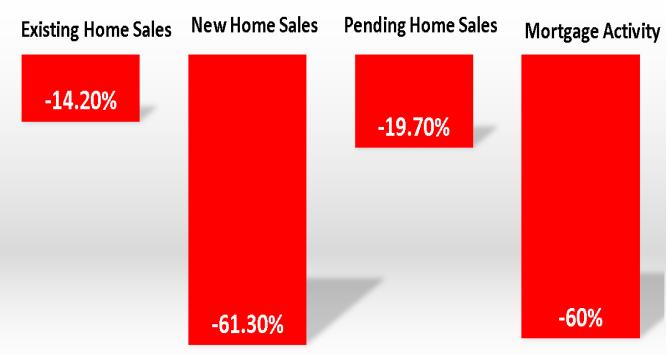
These are the "pros" who are not swayed by emotions or stage of life. They are opportunistic investors and evaluate homes based on whether or not the investment makes sense. And at today's prices and financing rates, it makes no sense. They are largely walking away from the markets.

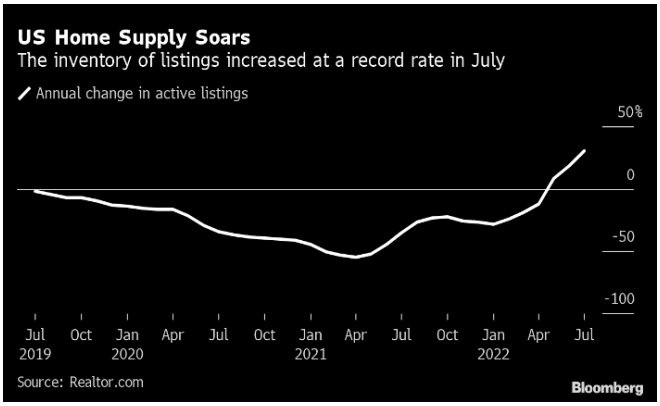
"At these mortgage rates, investors can't make the economics of investing work, whether they're a flipper, small mom-and-pop or institutional investor Institutional buyers are opportunistic. I'm sure they're waiting, thinking they'll get a much better price for these properties in the not-so-distant future."
— Mark Zandi, Chief Economist, Moody's Analytics

As mortgage rates have skyrocketed, the weakness in the housing sector is becoming widespread. Consider the following graph that shows housing and mortgage activity year over year. It's not pretty! New single-family homes have plunged 61%. Previously owned homes have seen single-family homes down 13% over the past 12 months. Mortgage activity is down 60% to the lowest level in over 22 years.



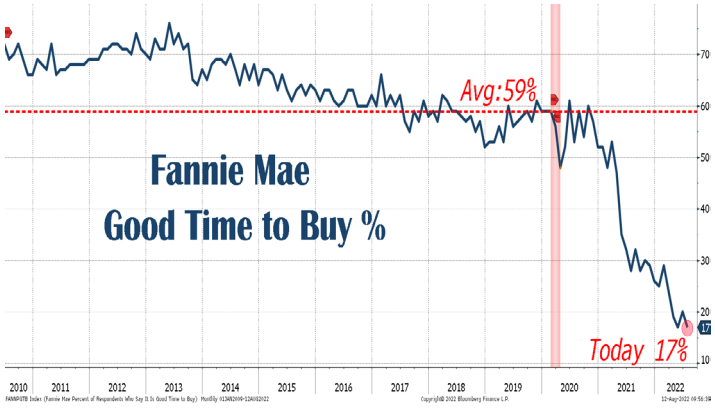
Source: Bloomberg data

Realtors are complaining about plunging foot traffic, which is now down to levels seen since the COVID pandemic and pent-up supply is now showing up in the market as unsold homes have doubled year-over-year. No surprise there. It happens every time when the housing market turns. For years there were claims of housing shortages. And then voila, there's plenty of supply. And this supply keeps coming out of the woodwork just as buyers have evaporated. According to a report last week by Realtor.com, the number of active home listings nationwide jumped by a record 31% from a year earlier. In some markets listings have jumped by 50%!



Bidding wars are gone. There was competition for just 44% of homes in July, the sixth straight monthly decline and a steep drop from the beginning of the year, when 70% of offers written by Redfin agents faced competition. It was also the lowest percentage posted since April 2020.

As shown below, Fannie Mae's Home Purchase Sentiment index fell 2 points in July to 62.8 — an eleven-year low. Only 17% said it's a good time to buy. The Redfin data also show that the average number of days on the market (23) is the longest since April 2021. We are heading into a buyers' market.



**Red shaded areas represent recessions*

So as reality sinks in, sellers are increasingly responding by reducing prices to make a sale. According to Realtor.com, price reductions rose 60% year-over-year. Meanwhile Redfin said roughly 8% of listings on the market are seeing price reductions each week, the highest share on record. Prices have to go to where the buyers are. And with mortgage rates doubling over the past year that means prices need to go lower.

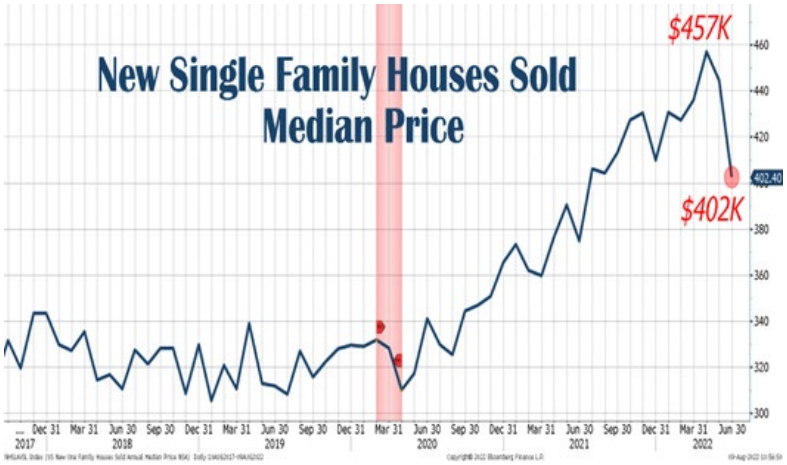
As shown below, there is now a huge supply of new single-family inventory – 9 months of supply, or almost twice the long-term average of 5.8 months. In fact, this is the highest inventory since 2007! Adding to the inventory woes, according to real estate consultant John Burns, home builder cancellation rates have spiked to 18% (double vs. last year) and even worse than what was seen during the COVID lockdown.

**Red shaded areas represent recessions*

Take a look at the following graph. New homes under construction sits at a new record high. The waitlists for new houses are gone. And buyer traffic to homebuilder websites and sales offices had plunged to the lowest level for the month since 2012, according to the National Association of Home Builders. Traffic is an indication of interest by buyers

and buyers have lost interest at current prices. PulteGroup and D.R. Horton have warned investors of slowing orders and increased cancellations.

Builders have got to hit goals and make their profit, and they don't like inventory just sitting on the ground and are now taking a cleaver to house prices to move inventory. As shown below in four months new single-family home prices have plunged 12% from $457,000 to $402,000. Builders are also applying for fewer building permits, which for single-family homes fell in June to a two-year low.



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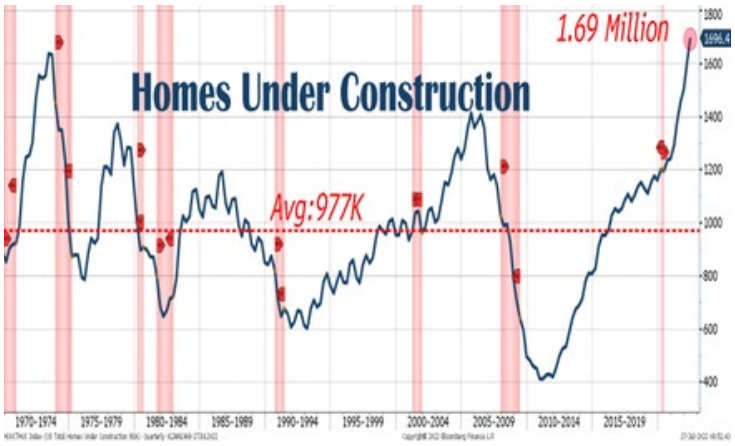
Not every market is cooling fast. As they say real estate is local. But the change is stark especially in the pandemic boomtowns where builders piled in to meet demand for out-of-state arrivals, who often bid up prices beyond the reach of locals.

"The movement from out of state caused a false market. We have to accept things for the way they are. It's going to get tough." — Corey Barton, President, CBH Homes



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We've seen this movie before. The U.S. housing market blew up in 2006-2007, after a similar period of euphoria. And for more than a decade for home prices to recover to the previous peak prices in 2006-2007. Once buyers realize the bubble has burst, they're not eager to blow a new one. Once burned, twice shy.

A lot of people made a lot of money by flipping places during the pandemic craze. But that game is over, and that is a good thing. But many sellers do not accept this new reality and figure if they just sit tight long enough, the market will turn foolish again and they can still get their big payday.

"The market is wildly different than it was a few months ago… Six months ago, buyers were taking any house they could get." — Alexis Malin, Redfin Agent who represents buyers in Jacksonville, Florida

Here's an example: My neighbor owns two homes in the Sarasota, Florida, area and is now concerned home prices have peaked. He is listing one home at 40% more than he paid in March of 2022. Again, 40% more in just 5 months! Five or six months ago, this home probably would have sold at the current asking level. But times have changed and buying interest is non-existent at theses price levels.

Yet, my neighbor refuses to reduce the price. He believes that prices will rebound. It could be a long wait as housing inventory rises sharply, and buyers are now in charge. Buyers figure, heck if prices have dropped $50,000 in six months, they might drop another $50,000 down the road. In the meantime, why offer more than you have to?

Bottom line: The real estate business is a great game when it's working in your favor. But many people keep making the mistake of thinking it's guaranteed money. Price always goes up. They don't! Yes, over time, property generally grows in value. But excess euphoria, unreasonable prices and expectations often leads people into buying at extreme levels and then getting burned.

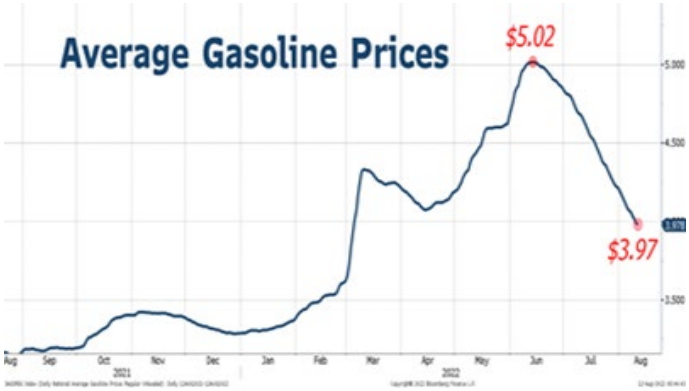
Goodbye housing bubble! Watching the froth evaporate will be a healthy adjustment.

FINALLY, SOME RELIEF!

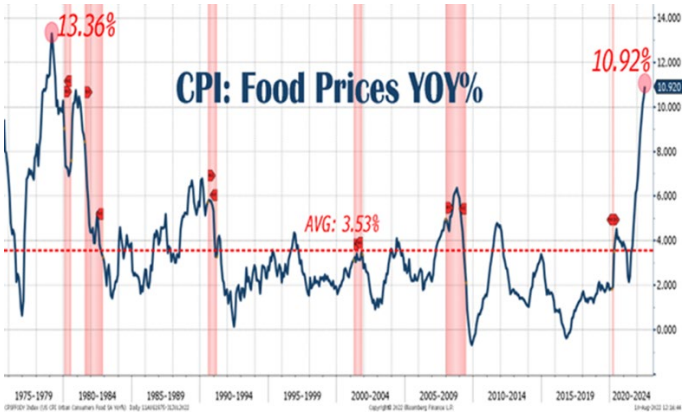
"This is a necessary print for the Fed, but it's not sufficient…We need to see a lot more… Fed officials have said they want to see months of evidence that prices are cooling, especially in the core gauge. They'll have another round of monthly CPI and jobs reports before their next policy meeting on September 20-21."
— Michael Pond, Head of Inflation Market Strategy, Barclays PLC

Inflation might finally be cooling. The consumer price index was unchanged in July. There was 0% inflation month-over-month, down from a 1.3% increase the previous month. This ended a 16-month streak of month-over-month gains. Energy prices tumbled month-over-month with fuel oil (-11%). Utility prices fell 3.6% from June, the most since May 2009. And there were declines in education/communication, used vehicles, appliances, clothing, airfares, hotel/motel rates, and rental cars.

Of note: Nationwide, gasoline prices have fallen below $4 per gallon ($3.97) for the first time since March and are off more than 20% from the mid-June peak of $5.02 per gallon (not to mention declining now for 43 consecutive days). This is a big deal for a country where 91% of the population has at least one vehicle and which accounts for 20% of global oil consumption even though it commands just a 4% share of the world population. Thing is — it has been demanding destruction and not new supply that has brought the price back down.



Food costs, however, climbed 10.9% from a year ago, the most since 1979. Droughts in the Southwest and the war in Ukraine have pressured food prices high. But get this. Once food is stripped out, the price level fell 0.2% in July.



**Red shaded areas represent recessions*

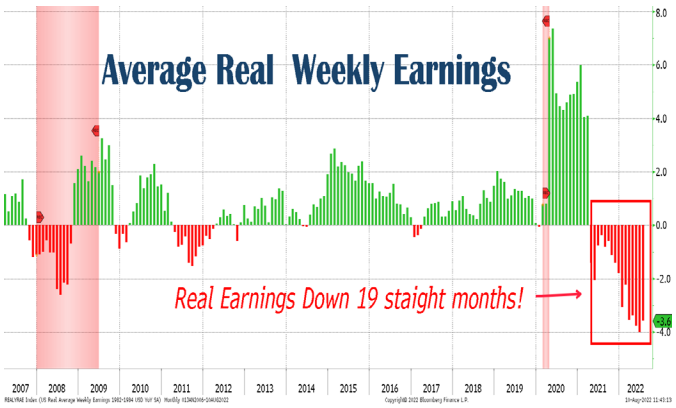
On a year-over-year basis, headline U.S. Consumer Price Inflation was expected to slow from +9.1% year-over-year to +8.7% year-over-year in July, but it actually slowed significantly more than expected to +8.5% year-over-year**.** The problem with looking at the year-over-year number is not that it's wrong, it's that it's all entirely things we already knew. Yes, we know that prices are really high, we know that the trajectory of inflation has been way too fast. None of this is up for debate. What's up for debate is how quickly or how soon we're going to get inflation back to trend. And so, are we going to see a change in trend? You have to look short term. And July's, CPI data was encouraging and may suggest peak inflation.

The so-called core CPI, which strips out the more volatile food and energy components, was expected to re-accelerate (rising from +5.9% year-over-year to +6.1% year-over-year in July), but instead it too continued to decelerate to 5.9% year-over-year. Shelter costs — which are the biggest services' component and make up about a third of the overall CPI index — rose 0.5%from June and 5.7% from last year, the most since 1991 and accounts for about 40% of the total increase in all items less food and energy.

**Red shaded areas represent recessions*

Finally, and perhaps most importantly, real average weekly earnings continue to plunge, now down 16 straight months as inflation eats away at any wage gains. The impact of inflation on wages has started to dent spending, with the pace of personal consumption growth decelerating between the first and second quarters.

As such, the consumer will be the cause of the next recession. The lower income consumers are squeezed by sky-high inflation. Food, Energy and Shelter make up more than 60% of consumer spending for the bottom 40% of incomes. Meanwhile lower asset prices hurt the uber wealthy. The top 10% of Americans by wealth own 88% of equity market assets.



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What about the Fed? Is this drop in CPI big enough to signal a Fed pivot? Apparently not. The biggest "dove" on the Fed, Neel Kashkari from Minneapolis, came out and said that his vote right now is for the funds rate to close the year at 3.9% and head to 4.4% in 2023.

The idea that we're going to start cutting rates early next year, when inflation is very likely going to be well in excess of our target, I just think it's unrealistic." — Neel Kashkari, Minneapolis Fed President

His Chicago "dove" counterpart, Charles Evans, added that "we must be increasing rates the rest of this year and into next year".

"I expect that we will be increasing rates the rest of this year and into next year to make sure inflation gets back to our 2% objective…while the inflation report for July showed improvement relative to the prior two months, inflation remains unacceptably high." — Charles Evan, Chicago Fed President

PRODUCTIVITY PLUNGES

"Focus on being productive instead of busy." — Tim Ferriss, American Podcaster, Author and Entrepreneur

Real non-farm business output per hour worked contracted at a -4.6% annual rate in quarter two after the -7.4% slide in the first quarter. As it stands, through quarter two, productivity has decayed in three of the past four quarters. The year-over-year trend, at -2.5%, is unprecedented. Productivity is now at the lowest level in 47 years.

Apparently, corporations are hiring folks to sit on their hands. Consider what's happening at United Airlines. They reported that they need to hire 4–5% more workers just to cover absentee and sick workers. There are other stories that essentially saying the same thing. That's terrible for many reasons, and it won't be good for earnings, as productivity has been the driver for much of the earnings growth for the last 40 years.

**Red shaded areas represent recessions*

Unit labor costs rose at a booming +10.8% annualized pace in the second quarter and that followed a +12.7% first quarter surge. Current labor costs are now running at four times the average of 2.0%. Normally, companies begin to rein in labor when it gets this pricey and when labor becomes this unproductive. Is the fear of not being able to hire people really so extreme that you're willing to cannibalize your business? Interesting way to run your company. What sort of economy is this?

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Bottom line: The weakness in productivity and the depressing impact on profit margins is enemy number one if you are investing in equities. Sadly, the price to be paid will be on MainStreet because correcting this situation will require companies reducing their labor costs. You can see evidence of this in job openings and hours worked both declining. Next will come the actual pink slips.

CAVEAT EMPTOR!

I'm amazed that so many pundits — including the Fed — treat the non-farm payroll data as gospel. Did you know that the non-farm payroll report is the least accurate data released by the U.S. government? Did you know that this data is often revised and many times significantly.

So, let's review the June payroll report which showed jobs apparently surging by over 500,000 jobs. Sounds really impressive. Then ask yourself if there was anything going on in the economy to support such a huge increase?

Here's what you need to know. The payroll survey includes the birth-death model (that adds an estimate of new businesses created in any given month). Heading into recessions, this report overestimates net new business creation and the skews the jobs data higher. The opposite occurs when the recession swings to expansion. So, within the 528,000 jobs supposedly added in June more than 150,000 (28%) of the jobs came from the "birth-death" model even though business creation has contracted by 8.5% from a year ago. Go figure!

Looking further back. In the 2008-2009 Great Financial Recession, over 90% of the months were ultimately revised down! Once the final tally was in, employment was revised lower by one million when compared to the initial estimate! One million!

Likewise, during the pandemic/lockdown recession. The March 2020 payroll number today stands 672,000 lower than the initial "take" by the BLS!

And finally, the process of downward revisions is already underway. From March to May, payrolls have been revised down 97,000 from the first estimate — but not a peep from Wall Street! So as everyone gushes over how strong the labor market is — keep in mind how these "adjustments" can mask the true picture underneath the surface.

This is what the Fed stakes its ground on and what traders react to? I realize traders have to trade, but come on now.

Total nonsense. Caveat emptor.

Meanwhile, the Household survey has flashed successive declines in full-time jobs and a spike in multiple job holders, which is a classic counter-cyclical indicator. Jobless claims have trended higher and already flashed the recession signal. Remember: Whenever initial claims have risen by over 60,000 a recession has occurred every single time. It's not about the level, it's about the change. It's a tried-and-true leading economic indicator that has presaged the past seven out of seven recessions.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"On average the yield curve inversion occurred 10 months before a recession… This indicator tends to be reliable predictors of a business recession." — St. Louis Fed

The Treasury yield curve as defined by the widely watched spread between the 10-2-year Treasury yield is now -40 basis points and has now remained inverted for 31 consecutive days. Moreover, today the yield curve is inverted from six months to 30 years. The deeper and the longer negative yield curves persist the higher recession odds rise. In fact, yield curves as inverted as the current one has always predicted a future recession. Always.

What makes this curious, and a little more difficult to predict, is that we already have a stagnant/negative growth with two straight quarters (if revisions show quarter two still negative) of declining GDP.

Inversions typically precede recession by anywhere from a few months up to two years. The yield curve is usually back to normal by the time recession actually arrives. But nothing about all this is "typical" so maybe this time is different.
Or more likely, the real recession is still coming.

**Red shaded areas represent recessions*

Still not convinced that a recession is here or coming. Take a look at the chart below. This is one of the most alarming charts that you're going to see. This is the Small Business outlook on Sales for the next three months. Currently, the pace of decline is worse than the Financial Crisis. Remember, 98% of American businesses are small businesses.

Bottom line: The Great Financial Crisis started on Wall Street and ended on Main Street. This one is on Main Street already. It will end on Wall Street and the Fed will be the last one to figure that out.

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What should credit unions do? In the current environment it is tempting for credit unions to stay in cash all but knowing for certain that the Fed will raise rates again. But as the Fed raises rates the economy will continue to weaken, demand destruction will cause inflation to decline, and if history is any guide, "something" will break. The Treasury market is forward looking and has already begun to discount these scenarios as the yield curve continues to plunge into deep negative territory.

Today, yields are close to 15-year highs. Yes, they may go higher still. But eventually higher rates will drive the highly leveraged U.S. economy into the ground. While "timing" is next to impossible, I believe the most prudent approach to managing excess liquidity is to maintain a risk-appropriate ladder strategy. Periodic selloffs provide attractive entry points.

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.