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INVESTMENT SERVICES

Weekly Relative Value

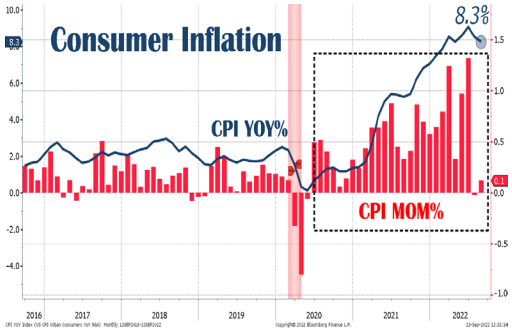
Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF SEPTEMBER 19, 2022

Hotter than Expected

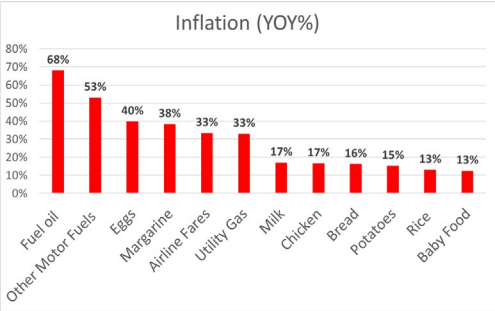
"The economy is braking hard… If the Fed keeps this up, they are going to have a serious recession and people will lose their jobs."
— Barry Sternlicht, Chairman and CEO, Starwood Capital

In August, the headline Consumer Price Index (CPI) came in hotter than expected, rising 0.1% month-over-month against expectations of -0.1% month-over-month. The headline did recede to +8.3% year-over-year from +8.5% — but the market was looking for +8.1% and the "whispered" number was lower than that. Regardless, this was the twenty-seventh straight month of rising inflation.



**Red shaded areas are recessions*

The table below shows the annual increases in prices by expenditure category:



Source: BLS

The energy component of the August CPI fell by 5% month-over-month: the biggest drop since the COVID-19 crash in April 2020. Gasoline was down 10.6%. One would have thought with a 5% slide in energy prices in August (along with the knock-on effects) this would have

THIS WEEK

- MORE CRACKS IN THE LABOR MARKET
- A HIRING FREEZE
- THE EVERYTHING BUBBLE IS POPPING!
- AS THE CONSUMER GOES…
- THE HEARTBEAT OF THE ECONOMY
- THREE IN A ROW?
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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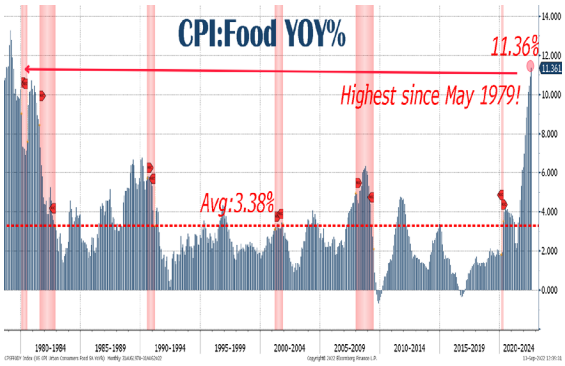
been a much more benign report. But no. The big shock was the food index (13.52% weighting in the CPI), which increased 0.8% over the month and 11.4 % over the last year, the largest 12-month increase since the period ending in May 1979.



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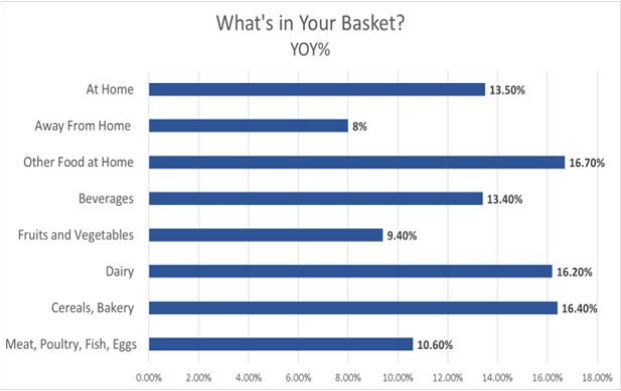
The reasons for spiking food prices include the following:

- Pandemic-disrupted supply chain issues.
- The war in Ukraine (25% of world's wheat exports).
- High energy prices (shipping costs and fertilizer).
- Disease and climate change (droughts & floods).

Obviously, there is little the Fed can do about rising food prices. Jerome & Co. will not don blue jeans and plant corn or soybeans. More importantly, higher food prices are primarily a delayed reaction to higher energy costs and supply problems, so they can be expected to retreat at some point. As John Maynard Keynes may have said, on a long enough timescale everything is transitory.

The table below shows the annual increases in prices by food category. Unquestionably, high food prices are forcing many consumers (especially those in the middle-lower income brackets) to cut back on discretionary spending.



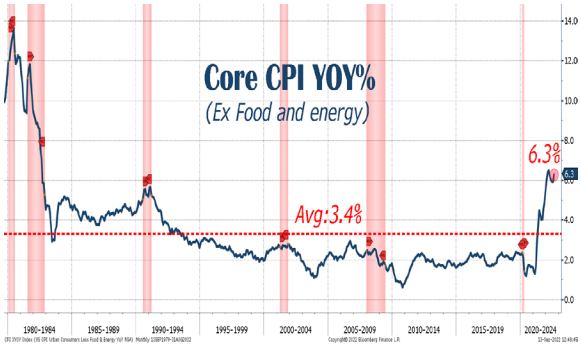
Source: BLS

But the real kicker was the "core" CPI (food and energy) surging +0.6%. On a year-over-year basis, core inflation picked back up to +6.3% from +5.9%. While used car prices fell 0.1% on the month, new car prices continued to rise.

Surprisingly, the core goods index jumped +0.5%, which begs the question: where is the price erosion from all the retail sector inventory liquidation?

The service component of CPI (restaurants, haircuts, hotels etc.) spiked +0.6%. Healthcare is another big one, which rose 2.4% and is now up 24.3% for the year. But housing is actually the biggest service category. You pay rent, your landlord "serves" you by putting a roof over your head. If you own your home, you pay imputed rent. In either case, housing is the biggest single expense for most households, and its price has been rising steadily.

Rent and Owners' Equivalent Rent (OER) account for a 7.25% and 23.65% weighting, respectively, in the CPI. Together, these two price inputs constitute about 31% of the entire CPI. Month-over-month OER rose +0.7% (6.24% year-over-year), a big jump from July's 5.69%. This surpassed the previous high from August 1990 of 6.1%. Rent inflation, meanwhile, hit higher highs, rising to 6.74% year-over-year, a print which only can be found going all the way back to the early 1980s!



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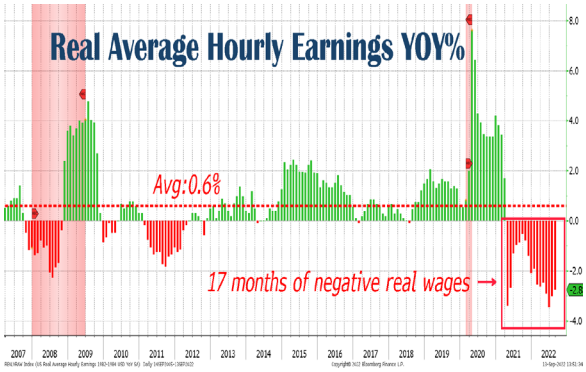
Side note: The rent portions of CPI (both actual rent and OER) come from surveys asking people about their housing costs. They don't ask the same people every month, and they rotate through different regions every six months. The findings are averaged into CPI over time, not immediately.

That's why we see housing inflation in the August number, even though we can look at the current data and see that housing and rents have seemed to peak. August data doesn't reflect what actually happened in August but is an average of what happened over the last 12 months.

Finally, for the seventeenth straight month, Americans' wages lost ground relative to the cost of living. Not good!



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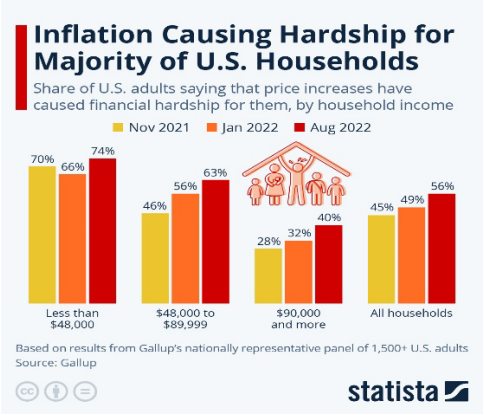
According to a survey conducted by Gallup in August, 56% of adults say that price increases are causing financial hardship for their household, with 12% describing their hardship as severe, meaning it might affect their ability to

maintain their current standard of living. Another 44% of households face moderate hardship, meaning that price increases affect them but don't threaten their standard of living.
Unsurprisingly, inflation woes affect lower income groups disproportionately. These households are more likely to face higher rent inflation and be more impacted by higher food and energy costs. In fact, 74% of low-income households (less than $48,000) are now facing severe to moderate hardship due to inflation. However, 40% of high-income households ($90,000 or more) now say they're facing financial hardship due to inflation, up from just 29% in November 2021.



Bottom line: This was a disappointing report and cements another +75 basis points out of the Fed on September 21. Even still, the slope of the year-over-year CPI is now negative (heading lower). You also must remember the lags from the strong dollar and plunging commodities haven't kicked into the CPI. This is why inflation is a lagging indicator and invariably peaks months after the recession begins.

There were several strange anomalies in the CPI report as well. New and used motor vehicle price trends typically are highly correlated, but in August, the former rose sharply while the latter fell. Likewise, furniture and appliance prices have historically trended together, but in August, they too went their separate ways (former up, latter down). And there were also the unusual spikes in healthcare and education (which have nothing to do with the economy). Meanwhile, there was either flat pricing or outright deflation in air fares, delivery services, restaurants, recreation services, apparel, used vehicles, car rentals and even legal services!

That being said, the Fed is relying on "old" data to make their decision, and the Fed wants "demand destruction" to throttle inflation. And they will get "demand destruction" come hell or high water and, of course, a recession.

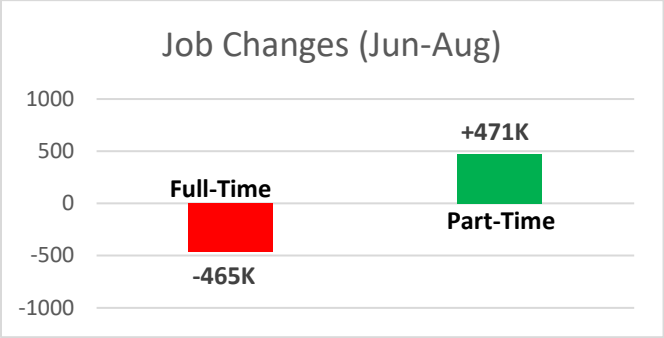
MORE CRACKS IN THE LABOR MARKET

"Quiet quitting means remaining in one's workplace while not actively going above and beyond."

The only thing that is holding this economy up is the labor market, but cracks are already surfacing. Forget the silly non-farm payroll survey — it has been totally skewed by the generous seasonal factors and a birth-death "new business creation" addition that is out of touch with reality.

There is still a lot of slack in the leisure and hospitality sector, but it's increasingly likely that alleged job strength is a mirage of part-time second jobs. Remember: the headline non-farm payroll numbers treat all employment the same, but all jobs are not created equally. A part-time job is different from a full-time job. And over the past three months,

465,000 full-time jobs have been lost and replaced with +471,000 part-time positions. How's that for a Powell-defined "strong" labor market?



Source: BLS

At the same time there have been layoff announcements out of the tech, financial and auto sectors (yet these receive little attention). And according to PricewaterhouseCoopers (PwC), 50% of companies are reducing headcount or plan to, and 52% have implemented hiring freezes. Meanwhile, companies are also responding to the weakening economy by cutting the workweek and overtime hours dramatically this year. That doesn't show up in payrolls or the unemployment rate. And what we know from history is that hours come first, bodies come second.

A HIRING FREEZE

Despite what one hears about record job openings (two jobs for every opening, etc.), small businesses are now implementing hiring freezes and, in some cases, laying off people. Last week, Alignable — an online network of small businesses — released its September Hiring Report. Based on a poll of 5,618 small businesses, the results showed that nearly two out of every three (63%) are putting their hiring on hold, and 10% of those surveyed are laying off workers. So, after struggling to find help, small businesses are now forced to cut workers loose. This is yet another example of the "weirdest" economy of all time.

The primary reason for the drop in hiring among small business owners centered around rising labor costs, rising rents and higher utility costs. In fact, the majority (58%) of poll participants said that labor costs are at least 50% higher than they were prior to the COVID-19 pandemic. But it's not just the skyrocketing costs. Only 23% of small business owners say they have fully recovered financially from the COVID-19 pandemic. Amazingly, 51% of all small businesses generated half or less of their pre-COVID-19 monthly earnings.

The following table shows hiring intentions by sector in September and the percentage change from July. Given the state of housing, it's not surprising that 69% of real estate practices are no longer hiring, up 6% from July. And 12% are laying

people off. Similar to those in real estate, 60% of small construction firms have instituted a hiring freeze, up a staggering 18% from July. Elsewhere, the healthcare sector reported that hiring freezes rose from 20% to 67%. Among retailers, 64% of those surveyed have initiated a hiring freeze and 14% are starting to let their workers go. Likewise in the restaurant and health and beauty sectors, 55% and 56% of proprietors, respectively, are no longer hiring.

The only two sectors that showed an increase in the percentage of small businesses seeking new hires were gyms, trucking companies, limo services and Lyft/Uber drivers.

Sector	Sept.	July	Up or Down
Real Estate	69%	63%	Up 6%
Automotive	67%	55%	Up 12%
Healthcare/Doctors	67%	47%	Up 20%
Retail	64%	57%	Up 7%
National Average	63%	45%	Up 18%
Finance	61%	54%	Up 7%
Construction	60%	42%	Up 18%
Gyms	58%	66%	Down 8%
Beauty Salons	56%	34%	Up 22%
Restaurants	55%	38%	Up 17%
Transportation	50%	58%	Down 8%

Source: Alignable

THE EVERYTHING BUBBLE IS POPPING!

"Today I am more convinced than I have been that this is the biggest bubble in capital market history. Bar none. And by a lot. Because it includes the options market, the credit market, the crypto market, the mega-cap bubble cap market." — Keith McCullough, CEO, Hedgeye Risk Management

Asset bubbles have been prevalent throughout history. Whether it was the "tulip bubble" in the 1600s, the "South Sea bubble" of the 1700s, the "dot.com bubble" of 2000 or the housing bubble of 2006, they were all a result of excessive investor speculation.

Today, we have the "everything bubble," which is now popping. Year-to-date, the S&P, Russell and Nasdaq are down -18%, -25% and -28%, respectively. So far this year, $7.6 trillion of equity market valuation has vanished. That is equivalent to one-third of gross domestic product (GDP). All in, global equities have now lost $23 trillion so far this year, equivalent to the size of the entire U.S. economy in what is beginning to look like the biggest destruction of shareholder value since the global financial crisis.

That being said, the bear market may just be beginning. Valuations remain stretched and interest rates have risen sharply. If the Fed raises rates another 200 basis points, look for more wealth destruction ahead. Ray Dalio, CEO and founder of Bridgewater Associates, stated last week that a mere increase in rates to about 4.5% would lead to an additional 20% plunge in equity prices.

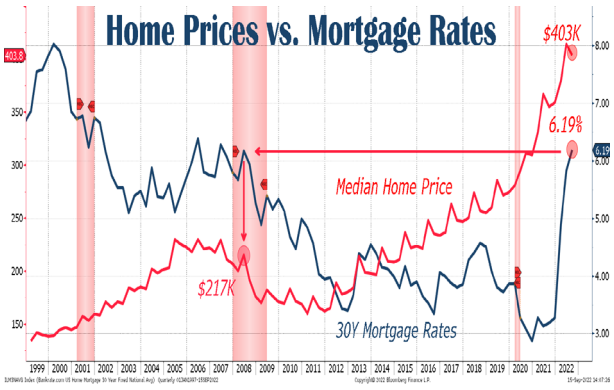
Furthermore, corporate earnings — the mother's milk of equity markets — have gone from +87% to +7%. Now they're going more broadly negative. It's not about inflation anymore. It's about revenues slowing, profits slowing and recession.

Moreover, the Fed is reducing its balance sheet by $95 billion per month. This is the real elephant in the room. Quantitative tightening (QT) is the opposite of quantitative easing (QE). Simply put, QE creates money out of thin air and QT destroys that same money.

With QT, the Fed is draining liquidity from the system. It's the same liquidity that has propelled asset prices over the past decade. Additionally, people need to understand that the Fed's balance sheet has a 91% correlation to the S&P 500. Take a good look at the following graph. The S&P 500 and QE have gone hand in hand. So, if QE drove the markets higher, isn't it logical to believe that QT will negatively impact the markets?

The Fed raising rates even more into an inverted yield curve is only adding insult to injury. Be that as it may, the realization is sinking in that there is no Powell pivot, there is no Fed put any longer and there is no "soft landing."

As shown below, over the past 12 months, the 30-year mortgage rate has now risen 300 basis points to 6.19%. The last time rates were this high was in the heart of the financial crisis in November 2008 and home prices were 51% lower! As such, first-time homebuyer affordability will become further crushed at a time that the new unsold housing inventory has soared to 10.9 months' supply (where it was in March 2009), almost doubling in the past year.



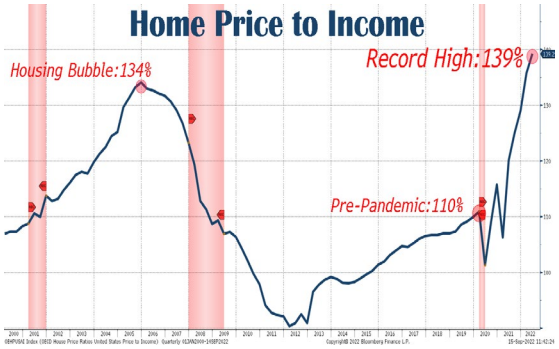
**Red shaded areas are recessions*

Here's the difference between today at 6.19% and a year ago at 3.00% for mortgage rates: any borrower with a 20% down payment on a $500,000 home (do these even exist anymore?) was paying $207,109 in interest payments over the life of the mortgage. That payment is now $481,021 or a 132% increase ($272,912). The bulls better hope and pray for significant wage gains to pay that bill — either that or home prices must deflate.

Bottom line: It's no surprise that new and existing home sales are down 30% and 26%, respectively, from a year ago. With the backlog of unsold inventories building sharply in both the new and existing market, prices are going to follow volumes, which already are in a deep recession.

The stakes are high, because nearly 66% of households own homes and residential real estate is the single largest asset on the household balance sheet. Whether you measure home prices against incomes or rents, this real estate bubble is bigger than the one we had on our hands in the mid-2000s. Except, back then, it was a $25 trillion asset class on consumer balance sheets versus $45 trillion today.

If residential real estate does mean-revert by 30%, home values in aggregate would plunge by $13 trillion. The reality is there is no wage increase that can compensate for the negative wealth effect.



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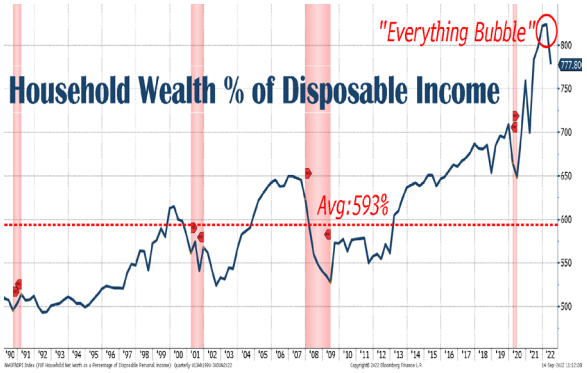
"The household net worth as a percentage of disposable income index should be viewed like the P/E ratio of the stock market. This ratio reverts to its average and does not remain at elevated values for prolonged periods."
— Federal Reserve Bank of San Francisco

As equities have declined, household wealth as a percentage of disposable income has declined from 825% to 777%, but remains well above its historical median of 593%. If housing prices fall along with declining equity prices, this ratio could mean-revert as well. If so, total household wealth would decline by an additional 25% from today's levels.



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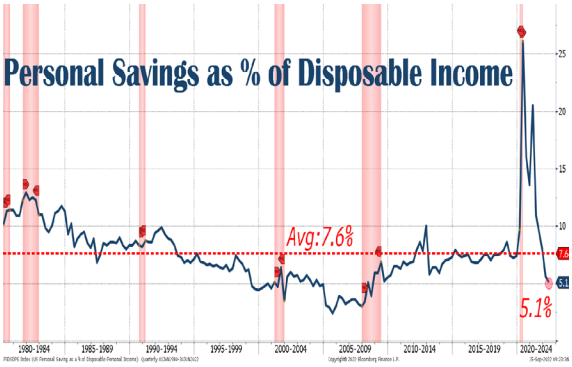
AS THE CONSUMER GOES…

So goes the economy.

Question: How can the household sector be in such terrific financial shape with "excess savings" when we are seeing the lowest savings rate in almost 15 years?



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At the same time, there has been an acceleration in revolving consumer credit when average interest rates on "plastic" are now well above 15%!

**Red shaded areas are recessions*

Bottom line: This data indicates classic end-of-cycle consumer stress, which happens as recession pressures take hold.

The consumer stress is now showing up in the data. The headline retail sales print for August rose 0.3% month-over-month, but July was revised down from unchanged to a 0.4% drop. Core (excluding autos) tumbled 0.3% month-over-month and excluding autos + gas also disappointed (+0.3% month-over-month vs +0.5% month-over-month expected).

**Red shaded areas are recessions*

On a year-over-year basis, both headline and core retail sales growth slowed. Once again, all these numbers need to be adjusted for inflation, which surprised to the upside in August, and that suggests demand pressures on a volume basis.

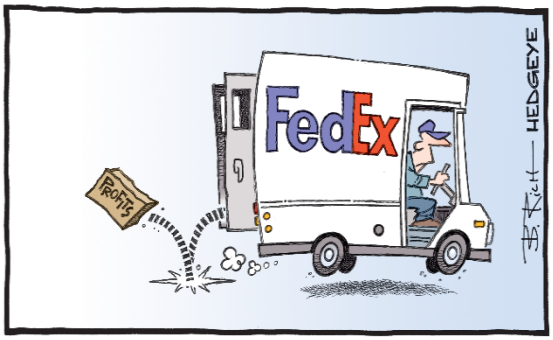
Finally, the control group — which feeds through to GDP — was very disappointing. Against expectations of a 0.5% month-over-month rise, it was unchanged in September.

Bottom line: Whether they want to or not, the consumer is becoming more frugal. Don't expect retail spending to pick up anytime soon. For the all-important holiday season, Deloitte is forecasting a 4% to 6% increase in 2022 holiday sales, which is down 7-8% from the same period in 2021.

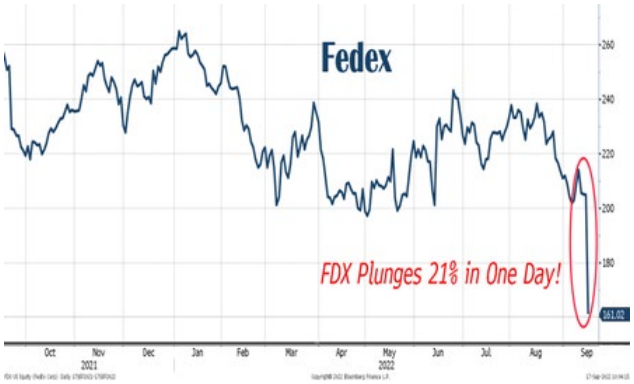
THE HEARTBEAT OF THE ECONOMY

FedEx — a barometer for "everybody else's business" — sounded the alarm on consumer spending and weakening growth. The company reported earnings per share (EPS) at $3.44 versus the consensus view of $5.10 (it missed big on the top-line too). Raj Subramaniam, CEO of FedEx, said he expects the economy to enter a worldwide recession and would have to implement cost-cutting initiatives (i.e., closing 90 offices and five corporate locations, freezing hiring, reducing flights, etc.).

Subramaniam told Mad Money's Jim Cramer (after he fell off his chair) that, "we see things before others do" (including Powell, no doubt) and added that he does see a global recession. He went on to say that it is not just Asia and supply chain issues but also that "the U.S. consumer is spending less… and we are a reflection of every other business."



The shipping giant — heartbeat of the economy — expects conditions to worsen in the coming quarter. Uh-oh! This guy did not mince words, and it's not often that Jim on Mad Money is left speechless. FedEx shares tumbled over 20% in response — the largest decline in 40 years!



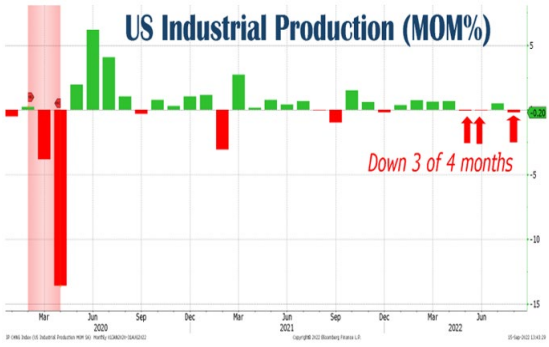
The same people who have been saying to ignore the inverted yield curve and the back-to-back real GDP contractions were out in full force on Friday, claiming that all the things that went awry with FedEx were idiosyncratic. Sure thing. So explain to me why the UPS stock sagged 4.5% in sympathy. The transports have broken down, and the recession message is undeniable.

Bottom line: This is all about the consumer. As consumers pay more and buy less, there's fewer packages for FedEx to ship. I should add, it's no coincidence that Amazon recently announced it had slashed its work force by 100,000.

THREE IN A ROW?

Industrial production fell in August, dropping 0.2% month-over-month and July was revised lower. August was the biggest month-over-month drop since September 2021. This is the third monthly drop in four months. Not exactly the picture of a healthy recovering economy.

Downward revisions to July retail sales data as well as disappointing industrial production numbers are dragging down growth estimates. In fact, after GDP has already declined for two consecutive quarters, the Atlanta Fed growth measurement for the third quarter is now at just a measly 0.5% and is down 2.6% from September 1. If the third quarter does decline, this would be the third consecutive drop in GDP. But please, don't call it a recession.



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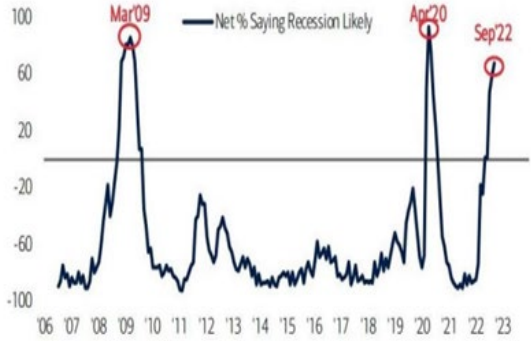
MARKET OUTLOOK AND PORTFOLIO STRATEGY

The big event this week is the Fed's decision on interest rates. The consensus widely expects the Federal Open Market Committee (FOMC) to fire off a 75-point rate hike at the two-day meeting, followed by a 50-basis-point rate increase at the November FOMC meeting and a 25-basis-point increase in December. However, future trading is still implying a 16% probability that the Fed frontloads the rate cuts with a full-point hike.

Frankly, it really doesn't matter whether or not the Fed hikes 75 or 100 basis points and/or if the fed funds rate ends up at 3.5%, 3.75%, 4.0% or 4.25%. Factoring in QT, the Fed will have tightened by over 500 basis points in a year! All I can say is that no Fed team was this aggressive in such a short period of time since the spring of 1981. The rest, as they say, is history. We had a 30% bear market, but inflation did plunge, and the economy ended in a recession.

Not surprisingly, as the Fed tightens aggressively, the so-called "pros" are seeing darkening clouds ahead. According to a recent Bank of America Global Fund Manager Survey, 68% of professional money managers now see a recession coming, the highest share since May 2020.



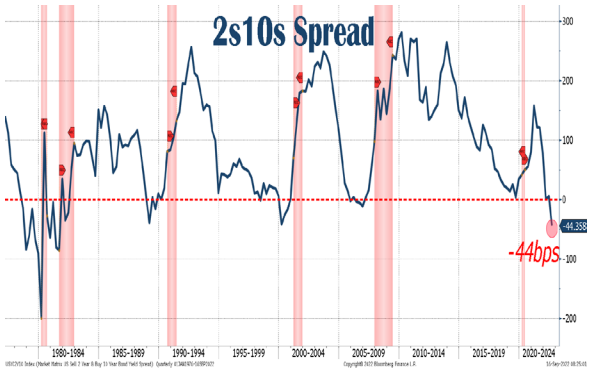
Source: Bank of America Global Fund Manager Survey

Moreover, the background of the country is so different today than when Paul Volker was the Fed Chair. The country is much more highly leveraged than in 1981 and asset prices (stocks and housing) have been hugely distorted and remain at artificially high valuation levels.

In other words, the economy and financial assets are highly dependent on low interest rates staying low. If the Fed hikes as much as discussed, the economy and markets (i.e., housing and stocks) will be in a world of hurt.

Meanwhile, the Treasury yield curve continues to invert, with yields on the front end rising sharply on the Fed's expected monetary tightening. The two-year Treasury yield has risen to 3.88% — the highest level since 2007. The benchmark 10-year Treasury yield is 3.45%.

The closely watched 2s/10s spread is now at -44 basis points — the most inverted the curve has been in over 40 years! As the graph below illustrates, when the yield curve has inverted this much in the past, a recession was inevitable within the next 10 months.



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Bottom line: This zealous Fed is chasing yesterday's story. Any more tightening, given accelerated QT, the fiscal drag, and the inverted yield curve — not to mention an economy flat on its back before all the monetary policy lags have kicked in — is overkill. I believe we will look back at this period of tightening as a huge policy overshoot and yet again another big Fed mistake. A recession is inevitable; whether it has already arrived is immaterial. Meanwhile, the "everything bubble" is popping and the wealth effect is now unwinding. This is what Powell meant by "pain."

What should credit unions do?

My view has not changed one iota. Rates can rise over the short run, but it's only a matter of time before higher rates drive the debt-saturated U.S. economy into the ground. Think about what has already happened in the housing sector

and then ask yourself how much more pain can this sector take?

Timing is a "fool's errand" but with short-to-intermediate risk-free Treasury yields close to 15-year highs, credit unions would be well served to lock in some of these generous yields. If one can take a longer term view and look at the forest through the trees, I sense a big reversal in rates by this time next year.

In terms of strategy, stay the course! The most prudent, all-weather approach to managing excess liquidity is to maintain a risk-appropriate ladder strategy. In other words, continue to systematically "dollar average" into the market. Tactically, periodic selloffs provide attractive entry points.

In terms of sectors, short to intermediate (2-7 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.