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INVESTMENT SERVICES

Weekly Relative Value

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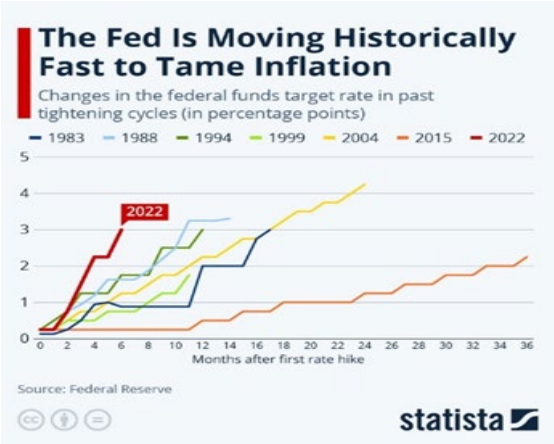
WEEK OF OCTOBER 17, 2022

Slamming on the Brakes!

"The economy is starting to go through the windshield, the financial system is starting to go through the windshield… The rapid pace of interest-rate hikes in response to inflation is not stepping on the brakes, this is slamming the brakes… This is the most front-loaded interest-rate cycle that we have seen in a very long time, and it didn't need to be this." — Mohamed El-Erian, Chief Economic Adviser, Allianz

The Federal Reserve has aggressively tightened policy into an inverted yield curve, fiscal tightening, a bear market in equities, a real estate funk, a sharp slump in industrial commodity prices, a soaring U.S. dollar and declining money supply.

Slammed by critics for being slow to respond to mounting price pressures, the Fed has unleashed the most aggressive tightening campaign since the 1980s. The graph below, from Statista, tells the historic tale as to how aggressive this Fed has been versus previous tightening episodes. Starting with rates nearly zero in March, it's hiked by 300 basis points in five months. The 2022 rate-hike cycle is the fastest, reaching a 3% increase nearly twice as fast as the rate hike cycle of 1988-1989.



Moreover, last week's Consumer Price Index (CPI) data (see more below) will only increase pressure on the Fed to tighten more aggressively. The futures markets is now fully pricing in the fifth consecutive 75-basis-point hike at the November Federal Open Market Committee (FOMC) meeting and a 70% chance of a similar move in December. And the tightening may continue beyond with the terminal rate rising to between 4.5% - 5%.

THIS WEEK

- IN A WORD,UGLY!
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Clearly, the tone of the Fed has changed drastically in recent months from one of "soft landings" and protecting stock markets to one of sacrifice in the name of bringing inflation down to 2%.

To wit: San Francisco President Mary Daly (a former super dove) said last week she's "very supportive" of continuing to increase rates to restrictive levels.

> *"We are not on some sort of course that can't correct if the economy needs more bridling or needs less bridling… But increasing rates to between 4.5% and 5% is the most likely outcome."*

Kansas City's Esther George echoed this sentiment when she also stated, "you may see a terminal funds rate higher and have to stay there for longer." So, the pause and pivot that are inevitable will only come later when something breaks.

From my perch, the Fed clearly isn't going to stop tightening until it gets what it wants, which is an unemployment rate up from where it is today. See the below excerpt from the FOMC minutes:

> *"Participants saw supply bottlenecks as likely continuing for a while longer, and a couple commented that constraints on production were increasingly taking the form of labor shortages rather than parts shortages…* ***Participants judged that a softening in the labor market would be needed to ease upward pressures on wages and prices."***

And don't forget the Fed is also reducing its balance sheet by $75 billion per month. On an annualized basis, this equates to an additional 200 basis points of monetary tightening. In total, the Fed is on pace to tighten monetary policy by a whopping 600-basis points. Unprecedented!

While rates have already risen dramatically, the economic damage has not yet been seen because rate hikes and quanatative tightening (QT) act with a long and variable lag between six months to a year to work its way through the economy. Thus, current tightening will slow the economy in ways that can't be observed. Let me finish that sentence: in ways that can't be observed until it's too late.

Not only has the Fed sharply increased the cost of capital, but the availability of credit is drying up considerably as lending guidelines are tightening across all sources of credit including consumer, residential and commercial sectors. This most assuredly is going to tip the U.S. economy into a downturn. Whether or not it has shown up in labor markets just yet is immaterial.

Bottom line: Let me be clear: I think it is a good thing that the Fed is hiking rates. They must fight inflation and frankly there is no doubt that the Fed should have been tightening and should have started earlier. Inflation exceeded the 2% target for 12 months before the Fed began to raise rates. This is also the same central bank that was adding mortgages to its balance sheet all of 2021 as the housing bubble just got bigger and bigger. Now, panic has clearly set in and the Fed is trying to overcompenaste for their mistake. That said, these are the fastest rate hikes in history, and it would be smart to take a break and evaluate how the rate hikes were feeding through the system and to see their effect on inflation.

Some may be counting on a Fed pivot but the cavalry ain't coming to the rescue until something really breaks, a major credit dislocation or currency crisis. Otherwise, the Fed seems determined to carry this through. The Fed "put" and

quantative easing (QE) are not coming anytime soon. No more talk about the Roaring Twenties. No more talk of "FOMO" (Fear of Missing Out) or "TINA" (There is No Alternative).

The Fed now wants the stock market to go down (which it has), it wants home prices to go down (just beginning), it wants the economy to contract (already happening), and it wants unemployment to head up (it will). What the Fed is now doing reminds me of Lucy pulling the football away from Charlie Brown at the last minute. Jerome Powell, Federal Reserve Chairman, is Lucy and everyone else is Charlie Brown. Simply incredible that 12 men reading from the same textbook and without any real life business experience are able to control the most important market price in the economy. It's even more incredible when one looks at their track record. As Charlie would say… good grief!

IN A WORD, UGLY!

Disappointingly, for the hopeful bulls, the CPI printed hotter than expected. The headline CPI number came in at +0.4%, double market expectations and now running at 8.2% year-over-year. This is the largest CPI increase since 1981. Energy was the only bright spot in the CPI, as gasoline declined another 4.9% in September. Inflation in the other five components is accelerating. Notably, the food index increased 0.8% in September, the same increase as August. Over the last 12 months, the food at home index (i.e., grocery bills) was up 13% in September over the previous year. Food is a huge problem (a tax on the low-end consumer), with huge gains since January offsetting the relief in energy (-2.1% and down three months running). Interestingly, the grocery bill at +0.7% has more than doubled the fairly tame +0.3% price increase posted in the restaurant sector.

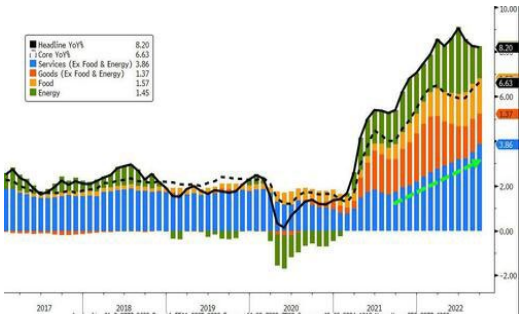
The kicker was the core index (food and energy), which spiked +0.6% for the second month in a row and took the year-over-year trend up to +6.6% in September to stand at the highest level since August 1982.

**Red shaded areas represent recessions*

The service sector (see blue bars below) was the culprit. Rents rose (+0.8% month-over-month) and the operating expense ratio (OER) increased the most in 32 years! Overall, the shelter index rose 6.6% year-over-year, which is the highest ever and accounted for over 40% of the total increase in the core reading. Tack on a +0.8% rebound in air fares, ending a three-month retreat. Education services spiked +0.4%, which is huge, and medical care services were up a hefty 1.0%.

Education, medical care and housing command nearly 50% of the CPI and and they dominated the CPI surge. There isn't a whole lot the Fed can do about components. While the rental rates are lagging indicators, and we know that 50-year highs in multi-family unit construction will show up in rising vacancy rates and reduced rent pressures, but likely not until the spring.

So, as they say, "it is what it is." And the inflation readings of late have been a huge disappointment, and this is the Fed consumed with how lagging indicators are performing. In other words, more rate hikes to come.



Source:

Meanwhile, Americans have lost an immense amount of purchasing power. In terms of real earnings, this has been devastating for many wage earners. According to the Bureau of Labor Statistics (BLS), average hourly earnings in September came in at $32.40. This is an increase of 4.92% year-over-year. This might be good news were it not for the fact that price inflation was up 8.2% during the same period. The gap between wage growth and price inflation in September was -3.8%. Sadly, as prices outpace wage gains, "real" inflation-adjusted wages were once again lower for Americans for the eighteenth straight month.

**Red Shaded areas represent Recessions*

But its actually much worse than that.

"Over the past 43 years, real wages for Americans are up 6.9%. Not 6.9% per year. 6.9% total for 43 years."
— Ben Hunt, Epsilon Theory

OK, that's roughly 0.16% a year. Hard to get ahead on that.

THE GREAT UNRETIREMENT

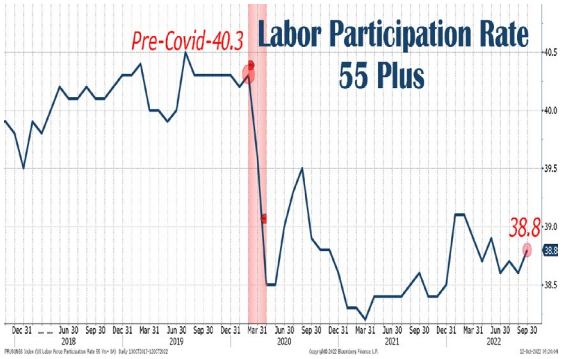
The Fed has justified its "strong economy" narrative based on a strong labor market. Indeed, the unemployment rate is close to 50-year lows and the job openings have been raised. However, according to the Fed, there is still more work to do on this front even though there is no correlation with anything, not with wage inflation and not with actual inflation. Yet the Fed is focused on the Job Opening and Labor Turnover Survey (JOLTS). Amazing!

Sidebar: I think it is very easy to artificially inflate job openings numbers. A company could post a job opening in every state for one open position. So 50 openings for one job. This is more relevant in the current remote work environment. Likewise, I could place a job opening for 10 sales people with a pay of minimum wage. Those are officially job postings. But, of course, they're not real jobs. So, I think that number is completely bogus, and yet that's what's being leaned on.

Also, it is important to note that the low unemployment rate has been, in part, due to the so called "Great Resignation" as many workers in the 55+ category decided to sail into the sunset and rely on their investment portfolio to make ends meet. In fact, during the pandemic, household wealth increased by a record $25 trillion in less than two years. And, as shown graphically below, household wealth as a percentage of disposable income soared from 125% to 825%. Tongue in cheek, pandemics are not all that bad. Right?

**Red shaded areas represent recessions*

In the wake of the COVID-19 pandemic, the participation rate of those 55+ remains 1.5% below pre-pandemic levels. Approximately two million workers aged 55+ exited the labor market, and more than half a million of them never returned. However, now, the Fed has put the kybosh to asset values and the declining wealth effect is nudging many to return to work. To wit: In September, jobs in the 55+ age category rose by 355,000 and fell 151,000 for everyone else!



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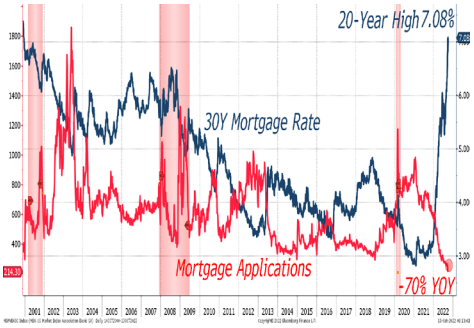
Maybe these folks realize that they have to come back to work because the bear market has undermined their early-retirement calculations. According to a recent poll by the American Staffing Association, over 30% of retirees have indicated that an ongoing cost-of-living crunch would motivate them to rejoin the workforce.

If the participation rate in this age cohort returns to pre-pandemic levels, up to two million workers could come back to the workforce. This is good news for the inflation file. As these folks start applying, interviewing and competing for job openings, the labor market will expand, the unemployment rate will likley rise and wages will ease.

Bottom line: The "reverse" wealth effect may lead to a "return to work" theme, laying the groundwork for a notable rise in the unemployment rate in coming months and quarters and blazing the trail for a marked wage growth slowdown. The "Great Resignation" theme may soon morph into the "Great Unretirement" theme.

THE DEEP HOUSING FUNK

Due to the fastest repricing of mortgage rates in 30+ years (up a record 400 basis points this past year to 7.08%), mortgage applications continued to tumble. In the latest week (October 7), total applications (refis and purchase) slumped 2%, and are down nearly 70% on a year-over-year basis — the weakest pace since October 1999. And this is a leading indicator. The key purchase index slid 2.1% and was down each of the past three weeks to the lowest level in seven years. Homeowners continue to get less cash flow from refinancing activity— the refinancing index sagged 1.8% and contracted in eight of the past nine months.



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And the mortgage market underpins the huge $43 trillion U.S. residential housing market. Homebuilding stocks are in a deep bear market and starts and sales volumes are in a complete funk. Marginal buyers are cut off.

The chart above, from Redfin, shows how higher mortgage rates and a pullback in buyer demand have forced sellers to cut prices to entice bids. Nearly 8% of homes for sale on the market each week had their prices slashed — and that's a record high. That's compared to just 4% of homes having their prices reduced each week over the same period a year

ago. Taylor Marr, Deputy Chief Economist at Redfin, added that looking over a bigger time period (i.e. a month), the data shows that 25% of homes are dropping prices.

The question that has to be addressed now is how bad it will be on the home price deflation front. Housing affordability is currently at the worst ever because the price of the median home over the past two years is up by 40%. And, of course, the mortgage rates were in the high twos, and now they're in the low sevens, which is a monumental repricing of the affordability.

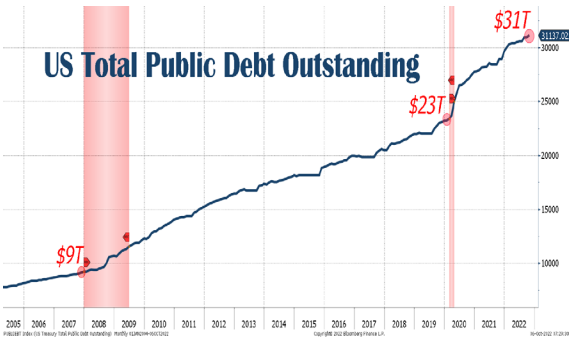
So when you take a look at the monthly payment on the median-priced home in America, in 2020, it was at $1,000 per month. But thanks to the double whammy of the prices going up and the interest rates more than doubling, that monthly mortgage nut is now over 100% higher. It's now over $2,000 as affordability of the housing market has deteriorated at a pace that is perhaps unprecedented.

And, sure, wages have gone up a little bit, but they sure as heck haven't doubled. And so housing affordability is now looking a lot like it was during the global financial crisis. That was based upon completely imprudent lending. Today it is based on interest rate increases and home price increases. But that's a big piece of people's psyche, it's a big piece of the economy and there's almost no hope that it is going to do anything but contract.

$31 TRILLION AND COUNTING!

"Too many people were complacent about our debt path in part because rates were so low."
— Michael Peterson, CEO, Peter G. Peterson Foundation

Most people just shrug off the ever-growing national debt. Many have become complacent into believing that because the massive debt hasn't mattered, it never will. But you can only kick the debt can down the road so far before you run out of road.



**Red shaded areas denote recessions*

Take a good look at the graph above, tracing the ever-ballooning national debt in the U.S. Before the Great Financial Crisis, debt stood at 9 trillion. Between massive fiscal, spending and QE, which made a mockery of moral hazard, government debt climbed to $23 trillion. Since the COVID-19 pandemic, debt has risen an unprecedented 35% ($8 trillion) to $31 trillion. Of course, the only reason we've been able to pull this off without (until recently) massive, consumer-scorching inflation is because interest rates have been historically and artificially low. And more importantly, the dollar is still the global reserve currency. Spending has slowed somewhat with the end of pandemic-era programs, but even still the government has spent nearly half-a-trillion dollars every single month. With one month left in the fiscal year, the government has spent just over $5.35 trillion.

On top of increased spending, rising interest rates will balloon the debt even more. So far in fiscal 2022, the U.S. Treasury has forked out $471 billion just to fund interest payments. That represents a 30% year-over-year increase in fiscal 2021. Those costs will continue growing rapidly.

According to the Congressional Budget Office, if interest rates remain elevated, interest payments will triple from nearly $500 billion in fiscal 2022 to $1.2 trillion in 2032. And it's worse than that. The collateralized bond obligation (CBO) made this estimate in May when rates were sharply lower. The 30-day Treasury interest rate this week was more than 2.5% higher than in May, the one-year rate was more than 2% higher, and the 10-year rate was almost 1% higher. And the Fed says that higher rates are coming later this year.

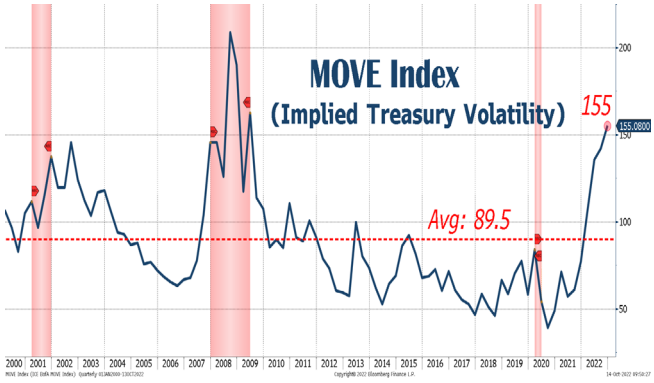
"The drop in bank demand has been stunning… As deposit growth has slowed sharply, this has reduced bank demand for Treasuries, particularly as the duration of their assets have extended sharply this year."
— Jay Barry, Strategist, JPMorgan

Now that the Fed is hiking interest rates at the fastest pace in decades, it's also shrinking its balance sheet after putting an end to bond purchases earlier this year. Meanwhile, U.S. commercial banks, foreign investors and foreign central banks are all exiting stage left. With the largest players out of the picture, Treasuries are now in search of other investors to buy that debt.

"Thin U.S. Treasury liquidity and limited demand may make the U.S. market vulnerable to a market functioning breakdown, similar to U.K." – Mark Cabana, Managing Director, Bank of America Securities

In the meantime, volatility is soaring and liquidity is quickly evaporating in U.S. Treasuries — the world's most important market. As shown below, according to Bloomberg, liquidity in the Treasury market is worse now than during the early days of the pandemic and the lockdowns, when no one knew what to expect. In the same vein, implied volatility as measured by the ICE/Bank of America MOVE Index is near its highest since 2009.

**Red shaded areas denote recessions*



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Last week, Treasury Secretary, Janet Yellen, said the Treasury Department is, "worried about a loss of adequate liquidity." Indeed, make no mistake, if the Treasury market seizes up, the global economy and financial system will have much bigger problems than elevated inflation. But there's little doubt that the securities will eventually end up in someone's hands. The bigger question is at what yield? Lower demand means the government is paying more to borrow and we, the taxpayers, are stuck with the bill.

"It's dangerous to just assume that the U.S. Treasury will ultimately find buyers to take the place of the Fed, foreigners and the banks." — Peter Boockvar, Chief Investment Officer, Bleakley Financial Group

Bottom line: Debt is future consumption denied. Excessive debt is economic stagnation ensured. Today, the debt-to-gross dmoestic product (GDP) ratio is 125%. Studies have shown that a debt-to-GDP ratio of over 90% retards economic growth by about 30%. More government debt means less economic growth. This throws cold water on the conventional "spend now, worry about the debt later" mantra, along with the frequent claim that "we can grow ourselves out of the debt" is now popular on both sides of the aisle in D.C.

And now the cost of servicing this massive debt has soared as the Fed hikes rates. Moreover, less demand and higher volatility will increase the clearing rate for Treasuries. Simply put, debt isn't without consequences. You can only kick the can so far down the road before you have to pay the piper. Our political leaders, both Republicanss and Democrats, have said time and time again how important deficit reduction is to their agendas. Their actions say the opposite. Sadly, we are going to hand this debt morass to our children and grandchildren.

EXCESS SAVINGS?

"Delinquency risk is rising, especially for low-end consumers who have exhausted their excess savings." — Nancy Lazar, Chief Global Economist, Piper Sandler

One of the foundational economic assumptions about the U.S. consumer – -and thus, the economy – was that consumers were sitting on a $2.4 trillion pile of cash that will continue to support consumption, and as a result, the U.S. economy could avoid a recession, even as the Fed agressively raises interest rates.

The thing is, discussions of the American consumer are often oversimplified. One has to be careful talking about aggregated savings data or on-average savings data, because I'll bet you any amount of money that the people in the lower two quintiles of the economic spectrum don't have any savings anymore. And these are the ones that are now desperately forced to borrow money to buy food, which, of course, is just a tractor-pull. Every month, it gets that much harder, until the tractor stops.

On a year-to-date basis, the household sector has run up its outstanding credit card balances at a +15.8% annual rate, the fastest in over a quarter century. Consumer credit soared +$32 billion in August and is up a record $273 billion year-to-date. And all of this is happening in a punishingly high-interest-rate environment, especially for credit card debt with the average APR soaring at over an 18% annual rate in August.

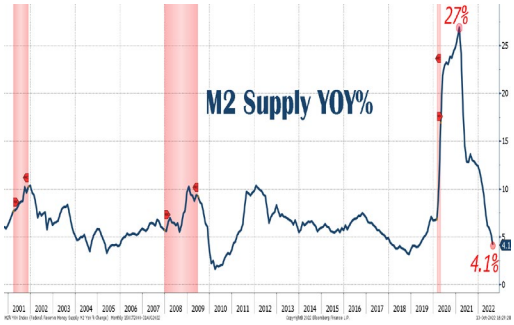
On CNBC, they idiotically say that's a sign of strength because consumers are borrowing because they feel good. Anyone who sees this as a positive needs to have their head examined.These people are using their credit cards because they need to borrow money to buy food and gasoline. They're buying food with a credit card. It's actually a source of consumer stress. So the economy's completely shifted from a wants-based consumer to a needs-based consumer. Everything that is discretionary spending is assuredly under pressure.

Bottom Line: Low-income households are under increasing stress, with savings depleted and defaults set to rise.

MONEY SUPPLY CONTRACTS

"Inflation is always and everywhere a monetary phenomenon!" – Milton Freidman, American Economist

In my early trading days in the early 1980s, one of the most important variables that people looked at was the money supply. In fact, everybody just stopped what they were doing, headed to the telerate machine and waited for the Thursday announcement to be made on the money supply. Based on the money supply you would see massive market moves in one direction or another. Today, nobody even talks about it. Instead, we look at JOLTS data. Unbelievable!



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The August money supply data have come out and showed the M2 money supply measure down or roughly flat in five of the past six months. The year-over-year trend is +4.1%, down from +13.6% 12 months ago and now back to where it was in April 2019. The six-month trend is close to 0%! The same thing happened ahead of the 2001 and 2007 recessions!

How exactly do you squeeze sustainable inflation out of monetary contraction?

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Remain underweight in equities, and start getting your toes wet in long dated, highly rated debt securities."
— Komal Sri-Kumar, President, Sri-Kumar Global Strategies

Central banks are front-loading monetary policy tightening in order to avert tighter labor market conditions from becoming self-reinforcing, which could lead to a dangerous wage-price spiral. The belief is that front-loaded monetary policy tightening can lower the risk that inflation will run rampant throughout the economy.

However, the trouble with this policy is that, firstly, there is no wage-price spiral, and secondly, the Fed's tightening cycles are almost always followed by some sort of crisis and a recession. For reference, there have been 14 Fed hiking cycles and 11 landed in recession.

The Latin American Crisis resulted from rising rates impacting dollar-denominated debt. That crisis could have rendered many U.S. banks insolvent. Rising rates triggered the 1987 market crash as "portfolio insurance" failed. Following that was a series of adverse events from the 1994 bond market crash, the Mexican peso crisis, Orange Countty bankruptcy, Asian contagion, Russian debt default, long-term capital management, the dot.com crash and the Great Financial Crisis.

While "high inflation rates" are certainly problematic for the economy, high inflation is not persistent. As Alfonso Peccatiello, author of *The Macro Compass*, recently pointed out (see table below), high inflation periods reverted to low levels over 16 months. This is because high inflationary periods also correspond with higher interest rates. In highly indebted economies, as in the U.S. today, such creates faster demand destruction as prices and debt servicing costs rise, thereby consuming more of available disposable income.

Inflation Always Leads To Deflation

Year	# Months For CPI To Slow To 2% Or Less	Peak CPI Ahead Of Recession	Low In CPI After Recession	Change In CPI (Peak To Trough)
1923	6	3.6	-0.6	-4.2
1926	7	4.7	-3.4	-8.1
1929	*			
1937	9	5.1	-4.1	-9.2
1945	*			
1948	11	10.2	-2.9	-13.1
1953	*			
1957	16	3.7	0.3	-3.4
1960	*			
1969	30	6.2	2.7	-3.5
1974	24	12.3	4.9	-7.4
1981	41	14.8	2.5	-12.3
1990	16	6.3	2.6	-3.7
2001	13	3.7	1.1	-2.6
2008	5	5.6	-2.1	-7.7
2020	*			
2022-2023	?	?	?	?
Average For All Periods	16.2	6.9	0.1	-5.8

* Gray Bars Period Ignored As CPI Was <3% Entering The Recession

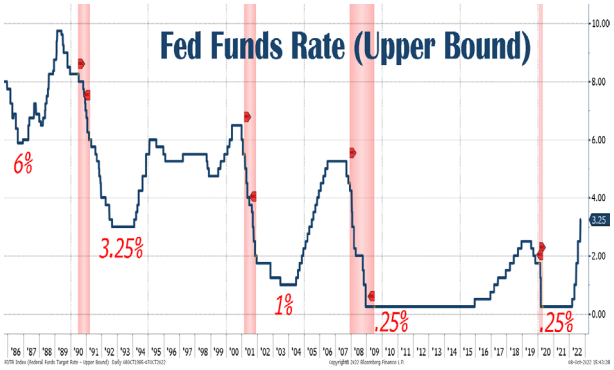
Source: Macro Compass

As the Fed continues to hike rates to slow the economy and "kill" inflation, the real risk is "something breaks" due to overtightening monetary policy. When the lag effect of monetary policy collides with accelerating economic weakness, the Fed's inflationary problem will transform into a deflationary recession. This is "deflationary" because it coincides with wealth destruction, further undermining consumer confidence. Each rate hike puts the Fed closer to the unwanted "event."

What will that event be and when? Who knows? Scientists use computer-simulated sandpiles to study complex systems. The piles can grow quite large and then suddenly collapse with a single added grain of sand. The point at which this happens is unpredictable. That it will happen is highly predictable.

Bottom line: From a portfolio manager's perspective, the last thing you ever want to do is extrapolate today's environment into the future. Inflation is going to come down. Admittedly, the debate is by how much, but it is going to come down. And I don't think Jamie Dimon, CEO of JPMorgan Chase, is wrong on the recession call. And unless this time is different, interest rates always decline during recessions. Always!

As I wrote last week, the Fed will pause at some point. That day will happen. When? Who knows? There is traditionally a six-month lag from the pause to the actual pivot (i.e., rate cuts). Here's all you have to know: The Fed always unwinds the complete tightening cycle in the next easing cycle. In recessions, the Fed slashes rates by 450 basis points, which means we are destined in the next two years to revisit the zero bound. Take a good look at the following chart.



**Red shaded areas denote recessions*

I have been in the bond business for 40 years and I can honestly say that this is one of the most volatile and challenging market environments I have experienced. As such, it is understandable why credit unions would want to stay in overnight funds and wait for the storm to pass. I get it. However, when one takes a longer-term perspective, inflation will decline, volatility will subside and interest rates will revert lower. "When" is the question. Good luck trying to time this.

The one thing I know is that "risk-free" Treasury yields are at their highest levels in over 15 years! Yes, they could go higher, but they could be close to peaking as well. Given the extreme uncertainty today, I'm sticking with an agnostic, all-weather ladder discipline and continuing to "dollar average" into the market. By reinvesting proceeds from maturing, low-yielding securities and locking in the higher yields today, the invesment portfolio will be well positioned over the full market cycle for the eventual change in monetary policy when the Fed pauses and then reduces interest rates.

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.