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INVESTMENT SERVICES

Weekly Relative Value

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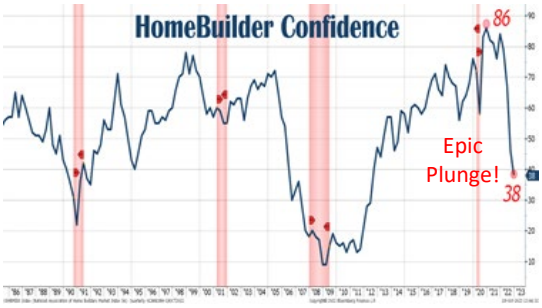
WEEK OF OCTOBER 24, 2022

The Unaffordable American Dream

"The Fed's talking about the labor market. Stop talking about the damn labor market. We've got class warfare and the Fed's got mortgage rates at 7%. Those two things are going to break the economy. Meanwhile, we're giving Nobel Prizes to these idiots."
— Hugh Hendry, Founder, Eclectica Macro

Housing leads the economy into and out of recessions. With that in mind, let's review the string of housing data released last week.

First, it appears delusion and hope can only last so long, even when one's salary depends on it. Against expectations of a small drop from 46 in September to 43 in October, the headline National Association of Homebuilder (NAHB) confidence index crashed to 38 – its lowest since the nadir of COVID-lockdown panic. This was the tenth straight monthly decline in homebuilder confidence, the longest losing streak since data began in 1985. It's amazing to think that the index was sitting at 86 at the end of last year.



**Red shaded areas indicate recessions*

Homebuilders are now finally seeing what homebuyers are clearly feeling as prices remain at insane levels. Mortgage rates have now soared over 400 basis points to over 7.20%, which is the highest level in 20 years! All told, housing affordability has been devastated for most Americans.

Under the roof, prospective buyer traffic and future sales expectations are at the weakest reading since the COVID-19 pandemic bottom (May 2020) and before that, the end of the Global Financial Crisis (GFC) in 2009.

THIS WEEK

- HOUSING STARTS STOP!
- IN REVERSE
- NO BOTTOM YET!
- RENTER NATION
- RECESSION ODDS HIT 100%
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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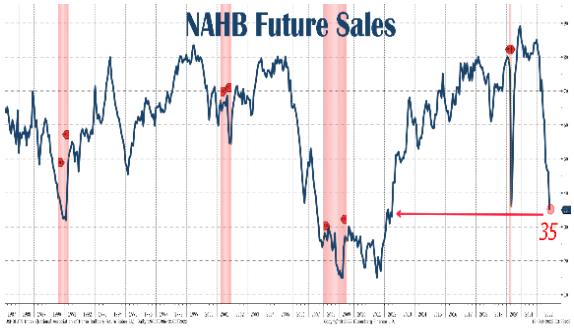
All in, this is absolutely horrible data that points to ongoing weakness in residential construction going forward.



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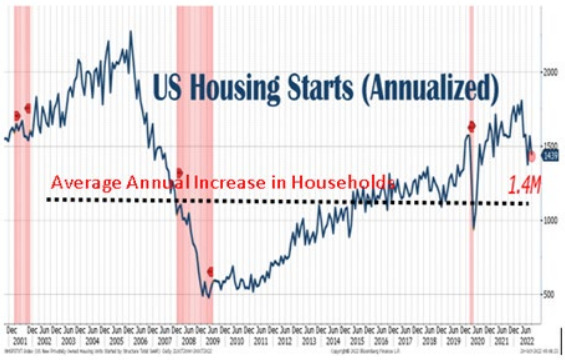
HOUSING STARTS STOP!

With homebuilder confidence collapsing, especially expectations of future sales, it was hardly shocking that housing starts declined 8.1% month-over-month in September to 1.439 million units (annualized). In the third quarter, housing starts are running at a non-annualized -11%. The last time we experienced this kind of weakness was during the depths of the COVID-19 recession and further back, the Great Financial Crisis.

The real estate industry uses the term "housing shortage" to justify the high home prices today. Below, I have included the average annual increase in households (black hyphenated line in the graph). This shows that housing starts fell behind household growth from 2008 to 2015. However, in thirteen years before then and in the seven years since then, housing starts have out-run the growth in the number of households. n 2020, the number of households actually fell, even as housing starts boomed.

So, where's the so-called "housing shortage"? In reality, there is not a shortage of homes. What we have is a glut of homes that people cannot afford. In other words, there is no shortage of housing, prices have just been inflated beyond recognition.



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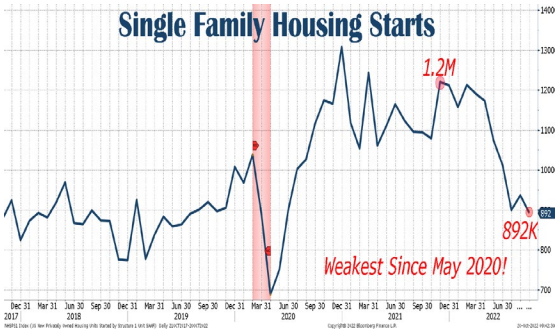
The weakness was broad-based, with single-family housing starts declining 4.7%, the sixth decline in the past seven months, to 892,000 units – the weakest since May 2020. On an annualized basis, single-family housing starts are down a whopping a 34% annualized rate, which is something the economy – with the exception of the COVID-19 pandemic – hasn't experienced since 2009.



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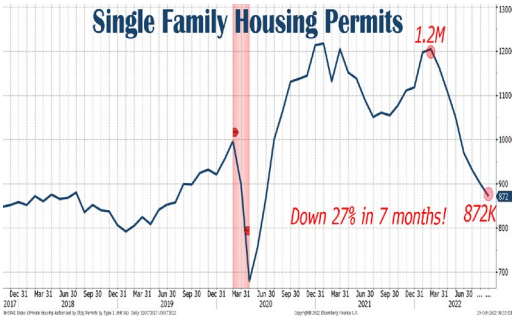
There isn't relief on the horizon either, as permits for single-family homes dropped 3.1% month-over-month in the seventh straight month of contraction. Since the beginning of the years, single-family housing permits have plummeted by 27% in just 7 months! Year-over-year, this housing metric has plunged -17.3% – the steepest fall-off since 2011.



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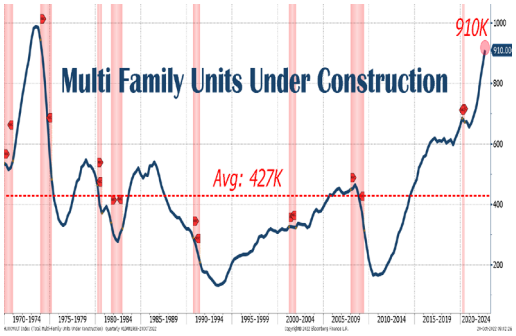
The good news is that multi-family starts are up 17.6%, versus last year at this time, and remain near multi-decade highs. While single-family permits fell in September, multi-family unit permits rose 7.8% as renter-nation escalates. This is perhaps the lone bright spot in terms of forward-looking indicators when it comes to the overall housing market.



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The total number of apartments currently under construction jumped 2% month-over-month, to 910,000, bringing the year-over-year pace to +27%. For perspective, this is the most multi-family buildings in the pipeline since September 1973! This means that a wave of units will be coming to market in the back half of this year and into 2023. This is welcome news for renters and the rental component of the consumer price index (CPI).

Bottom Line: Despite the support from multi-family sector, the outsized influence that single-family homes have on the sector ensures that activity will continue to slow as the impacts of rising mortgage rates and a slowing economy hit with

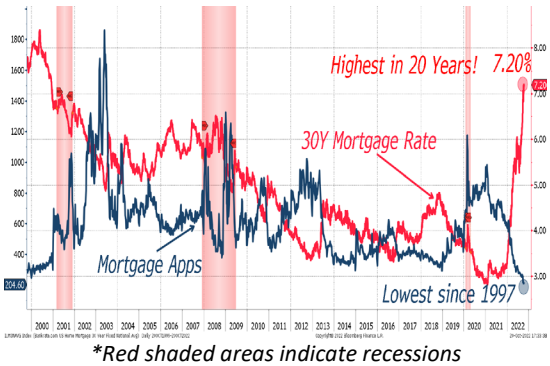
their typical lags. Meanwhile, the epic rise in multi-family units will serve to temper rents which will filter through to a lower CPI going forward.

IN REVERSE

"While some analysts have suggested that the housing market is now more 'balanced,' the truth is that the homeownership rate will decline in the quarters ahead as higher interest rates and ongoing elevated construction costs continue to price out a large number of prospective buyers."
— Robert Dietz, Chief Economist, National Association of Home Builders (NAHB)

The lagged effects of tightening financial conditions, alongside a slowing economy and wildly unaffordable housing prices, are continuing to show up in the weekly mortgage data. Indeed, as of the week of October 14, overall application volumes fell 4.5%, marking the fourth consecutive decline and the ninth out of the past ten. This index now sits at the lowest level since 1997. On a year-over-year basis, applications are down a whopping 68%, which is also worst since 1997. Given the overall dismal state of the housing market, it is no surprise to see the underlying weakness driven by both purchases (-3.7% week-over-week; -38% year-over-year) and refinancing volumes (-6.7% week-over-week; -85% year-over-year), especially with 30-year fixed mortgage rates now over 7%.

Bottom line: What is happening to the real estate market does not fully reflect the impacts of tighter monetary policy, given the inherent delays in filtering through the economy. With economic activity set to keep slowing in the coming quarters, and the Fed to keep at its plans to hike interest rates, the negative housing data is likely to continue.



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NO BOTTOM YET!

"We are not yet at the bottom." – Lawrence Yun, Chief Economist, National Association of Realtors (NAR)

To end the dismal string of housing data last week (housing starts, mortgage applications and homebuyer confidence and homebuilder sentiment), existing home sales (houses, condos and co-ops) have dropped 1.5% month-over-month in September and are now down every month since January. Year-over-year, housing starts have plunged 23.79%, the worst drop since November 2010 (example: COVID-19 lockdowns). This was the fourteenth month in a row of year-over-year declines. Compared to the peak in October 2020, sales are now down 30%. Sales fell in three of four regions, including a 1.9% drop in the South.

Note: Existing home sales account for about 90% of U.S. housing sales and are calculated when a contract closes. Bear in mind, these contracts were likely signed before mortgage rates really started to accelerate and hit 7.00%! Even Yun, the NAR's #1 cheerleader, expects the figures to keep deteriorating given the current data is not reflective of where mortgage rates are now.

We have not seen downturns like this outside of recessions. Ordinarily, a deepening recession in the U.S. housing market in the past has been a signal that Treasury yields will peak out, but in this period of market illiquidity and an ongoing aggressive Fed posture, no such luck (at least not yet). In the process, the residential real estate market is slip sliding away with no end in sight, and no sympathy from Powell & Company.

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Indeed, prices fell sequentially for the third straight month as the deflation in housing follows this year's deflation in equities. The median price of all home sales dropped for the third month in a row and are now down 7% from the peak in June, the largest for this period since the end of Housing Bust One. Year-over-year, home prices are still up 8.4%, but well below the 20% to 25% increases at the peak frenzy last year.

While prices have dropped, they remain at extremely lofty levels. Home prices are still up 35% from January 2020 pre-pandemic prices. Meanwhile, mortgage rates are up from pandemic lows of 2.5% in 2021 to 7%.

With 75% of homes bought with a mortgage, people either qualify or they don't. Right now, most people don't quality with high home prices and high interest rates. Unless the laws of economics have been turned upside down, lower demand means lower prices. The solution to the affordability crisis is lower home prices, more listings and lower mortgage rates.

Bottom line: U.S. household own $43 trillion of residential real estate assets on their balance sheets. House prices have a long way down before they normalize, and a bout of real estate deflation is never a good thing for household wealth, confidence and spending. Unless the Fed comes to a quick rescue, the real estate market is set to weigh on overall growth, yet again, and lead to a long period of slow economic growth.

RENTER NATION

Many housing bulls have used demographics to justify their positive outlook on residential real estate. There is no question that millennial home ownership has been rising for the past six years.

There's more to the demographic story to consider. The birth rates and immigration rates are slowing and as America ages, death rates continue to rise. This in turn will result in a deceleration in population growth for the next decade. Simply put, household growth will decline predominantly due on deaths, which will offset any benefit over the next decade for the growth in younger cohorts. As boomers retire, downsize and die, homeownership rates will continue to decline further. Especially with the Fed attempting to burst the housing price bubble it created via quantitively easing (QE) interest rate suppression.

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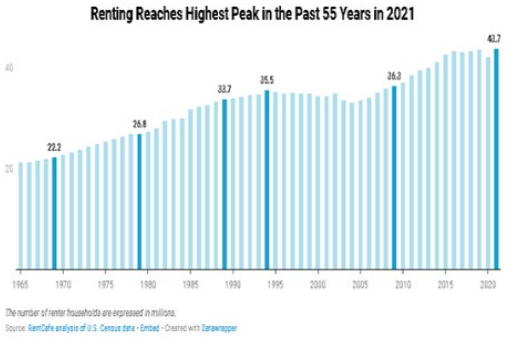
Meanwhile, according to RentCafe, 43.7 million households are now renting – the highest level we have ever seen! Between 2010 and 2020, 23 large and mid-sized cities transitioned from the owner-majority to the renter-majority. Renters now surpass homeowners in 41% of zip codes in the 50 largest U.S. cities.



RECESSION ODDS HIT 100%

"Our economy is strong as hell." – President Joe Biden

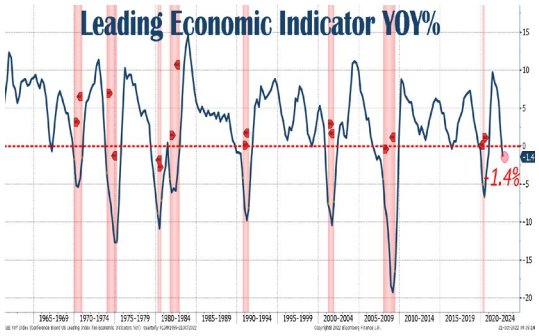
Last week, President Biden declared our economy is strong as hell. White House press secretary, Karine Jean-Pierre, doubled-down on that narrative, suggesting: ***"Economic "indicators" are not pointing to a recession..."***

There's just one thing. The "indicators" are pointing to a recession.

The Conference Board's index of leading economic indicators has either slipped or flattened in each of the past seven months. Every single time that has happened in the past, a recession occurred.

Likewise, the year-over-year run-rate, which is a very reliable recession indicator, is now -1.4%. Take note that, as the graph below vividly illustrates, this sort of decline has only happened in recessions.

From this perch, this should leave little doubt that we are in/heading for an economic downturn, even though lagging economic variables have yet to indicate the sort of weakness that will soon transpire.



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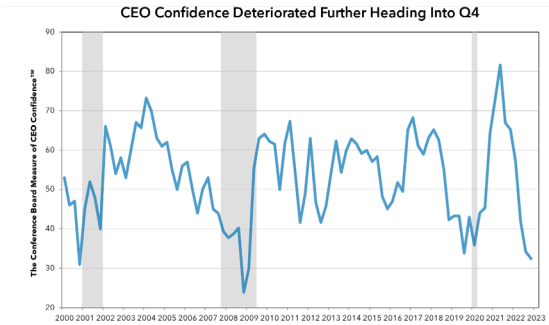
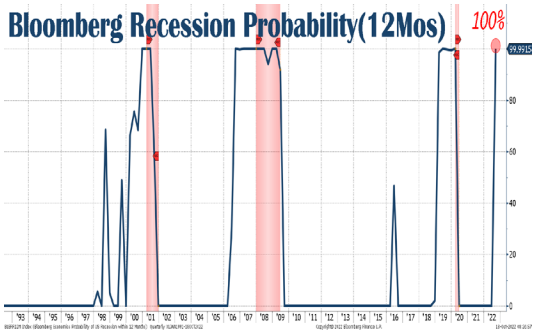
Moreover, the Conference Board's CEO confidence index fell to its lowest level in quarter four since the first quarter of 2009. Look at the graph below. This index is now down five quarters in a row, and the 35-point plunge is the second steepest over this timeframe on record. How can this be bullish?



By and large, things aren't too bad right now. Just wait. Things are really going to suck in 2023. To wit: In a recent survey by Klynveld Peat Marwick Goerdeler (KPMG), 91% of CEOs said they anticipate a U.S. recession in the next 12 months – and only one-third believe it will be "mild and short."

"Everybody likes to forecast recessions, and there will be one" ... "It's just a question of when, and frankly, how hard. Is it possible at the end of '23 we have a hard landing? Absolutely." — Ken Griffin, CEO, Citadel

Economists surveyed by The Wall Street Journal (WSJ) rated, on average, that the probability of a recession within the next 12 months is 63% – up from an average probability of 49% in July. One statistical model, using 13 macroeconomic and financial indicators, says there's a 100% chance that the U.S. economy will tip into a recession within a year. This is up from 65% for the comparable period in the previous update.



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MARKET OUTLOOK AND PORTFOLIO STRATEGY

"If we don't see progress in underlying inflation, or core inflation, I don't see why I would advocate stopping at 4.5%, or 4.75%, or something like that." – Neel Kashkari, President, Federal Reserve Bank of Minneapolis

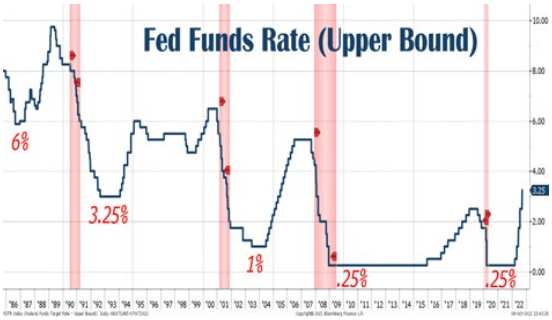
Last week. St. Louis Fed President, James Bullard, said he expects the central bank to end its ''front-loading" of aggressive interest-rate hikes by early next year and shift to keeping policy restrictive with small adjustments as inflation cools. So, the Fed is telling us today that it will stay restrictive for a prolonged period of time, but circumstances are bound to change and so will monetary policy. Remember, this is the same Fed that told us little more than a year ago that rate hikes, let alone quantitative tightening (QT), weren't coming until we were well into 2023. Things can change… and fast.

With that in mind, the quote of the day goes to Troy Ludtka, Senior U.S. Economist at Natixis Americas, FT:

"We're right now basically teetering on the precipice of what could be a very major economic contraction at the Fed's hands. They are trying to make up for a mistake they made back in 2020 and 2021 with an even bigger mistake."

So, despite how tough it's been for bond bulls this past year and change, mostly due to the aggressive reset in Fed expectations, the future actually looks pretty bright. I say this because "risk free" yields are now at the highest level in nearly 20 years. Moreover, at no point in the past did the Fed funds rate and Treasury yields fail to decline in recessions.

As I noted last week, the Fed always unwinds the complete tightening cycle in the next easing cycle. In recessions, the Fed slashes rates by on average 450 basis points, which means we may be destined in the next two years to revisit the zero bound.



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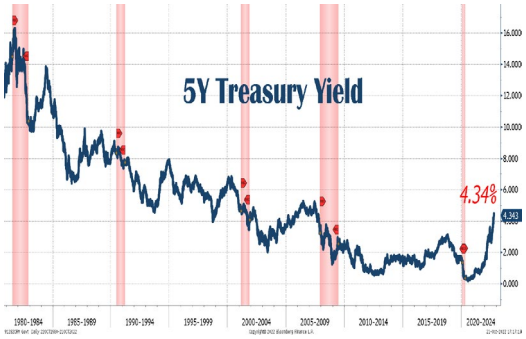
Take a good look at the following graph which plots the 5-year Treasury yield since 1980. Every time, without exception, Treasury yields have declined during a recession. Every time!



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Bottom line: From a portfolio managers 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 is wrong on the recession call. Unless this time is different, interest rates always decline during recessions. Always!

Credit unions should stick with an agnostic, all-weather ladder discipline and continue to "dollar average" into the market. By reinvesting proceeds from maturing low yielding securities and locking in the higher yields today, the investment 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.