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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF OCTOBER 31, 2022

The Housing Bubble Pops!

"The forceful deceleration in U.S. housing prices that we noted a month ago continued… Price gains decelerated in every one of our 20 cities…the growth rate of housing prices peaked in the spring of 2022 and has been declining ever since."
— Craig J. Lazzara, Managing Director, S&P Dow Jones Indices

Over the past two years, due to zero interest rates and money printing, home prices had risen by mindboggling and ridiculous gains ranging anywhere from of 30% to 60%. For those owning a home, it was a fun ride indeed.

Median Price	Pre-COVID (01/01/20)	Post-COVID (09/30/22)	% Change
Existing Homes	$267K	$384K	**+ 43%**
New Homes	$329K	$470K	**+ 42%**

Data Source: Bloomberg

But as mortgage rates have soared, the long-awaited home price deflation is now on its way. After tumbling for the first time since 2012 in July, Case-Shiller's 20-City Composite Home Price Index was expected to drop even faster in August (the latest data available). And sure enough, the 20-City Composite Index plunged 1.32%! This was the first back-to-back fall-off since February to March 2012 and the steepest one-month plunge since March 2009!

It's important to understand the Case-Shiller Home Price Index is a "lagging" indicator. Due to the delay between when a deal is made and when the "closed sale" is entered into public records, the time span for "August" roughly covers deals made in May through June. During

THIS WEEK

- MORE DISMAL HOUSING DATA
- NOT OUT OF THE WOODS
- WALKING AWAY FROM CAR LOANS?
- STILL TOO HOT!
- ANOTHER RECESSION INDICATOR
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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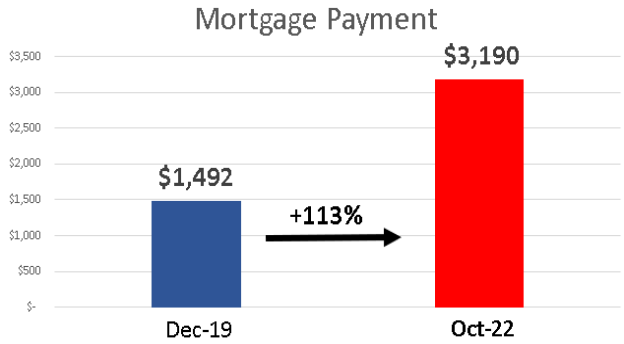
that time, the average 30-year fixed mortgage rate was in the 5% to 6% range. Today, we're at 7.2%! Simply put, it just means that the pain and hurt from the interest rate hikes are just slowly starting to show up.

In the west, home prices have taken the biggest hits. In Seattle, the month-to-month plunge was the steepest on record (-3.8%). In San Francisco, the month-to-month plunge (-4.3%) was the third steepest on record, outdone only by the two worst months during the Housing Bust in 2008. Prices in San Francisco have now dropped 8.9% from the peak and are going down faster than they'd spiked. No way! Impossible! Oops!

Elsewhere, in San Diego (-2.8%), Los Angeles (-2.3%), Phoenix (-2.1%) and other metros, the plunges were the worst since the Housing Bust. And the declines are spreading across the country to other metros, including Dallas, Boston, Washington D.C. and Las Vegas.

Despite the decline in home prices, over the past two months prices remain 30% to 40% above pre-pandemic levels. With mortgage rates now exceeding 7%, the monthly "nut" for financing a new median priced single-family home has increased by 67% in just 10 months! And when compared to pre-pandemic levels (December 2019), the mortgage payment on a median-priced new home has skyrocketed 113%. Nuts indeed!



Data Source: Bloomberg

The National Association of Realtors (NAR) Homebuyer Affordability Index tracks the affordability of housing based on a mix of median home prices, median income and mortgage rates. Note: The higher the number, the greater the affordability. As shown in the below graph, affordability ratios are more stretched now than at the mid-2000s bubble peak.

The big question is given the unprecedented explosion in mortgage rates, where will home prices end? Is this a repeat of 2008? Or will the Fed freak out and pivot by lowering interest rates and thus re-inflating? (Not anytime soon!) A simple back-of-the envelope calculation says that home prices need to slide at least 20% to mean-revert on affordability, absent

either a plunge in interest rates or a boom in wages. With that being said, it is important to understand that real estate prices don't correct like cryptos do overnight. It takes years. Of note, the last housing bubble in 2006 took five years to deflate.

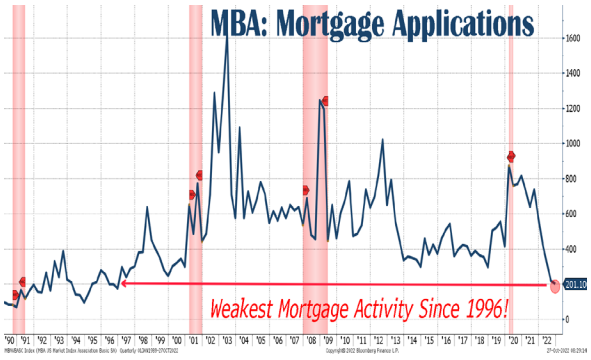
**Red shaded areas denote recessions*

Bottom Line: Much of the wealth in the American middle class ("middle 40%") — the population whose wealth falls in the 50th to 90th percentile — is tied up in their homes. According to Fed data in the past five years, the "middle 40%" has seen the value of its equity in homes rise by $5.7 trillion to almost $17 trillion, or roughly 60% of America's total housing wealth. Today, households own $43 trillion dollars of residential real estate assets, but the gravy train of free money is now ending, and house prices have a long way down before they can normalize. A bout of real estate deflation and the negative wealth effect is never a good thing for household wealth, confidence and spending. Unless the Fed comes to a quick rescue, (doubtful with inflation so high) the real estate market is set to weigh on overall growth, yet again, and lead to a long period of slow economic growth.

MORE DISMAL HOUSING DATA

"Housing IS the business cycle." — Edward E. Leamer, Professor of Economics and Statistics, UCLA

In the week of October 21, U.S. mortgage applications fell yet again and are down 1.7% after the 4.5% stumble the week before. A fresh near-quarter-century low. At -69% on a year-over-year basis, the trajectory is now the most negative it has been since October 1996. The recession is as much a sure thing as anything in life can ever be a sure thing.



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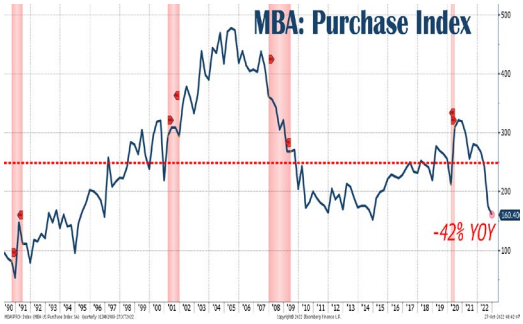
Demand is being destroyed in real-time. With applications for mortgages geared toward home purchases down 2.3% last week, declining in each of the past five weeks and faltering an epic 42% year-over-year, we are right where the trend was from November 2008 to February 2009. No recession, eh?



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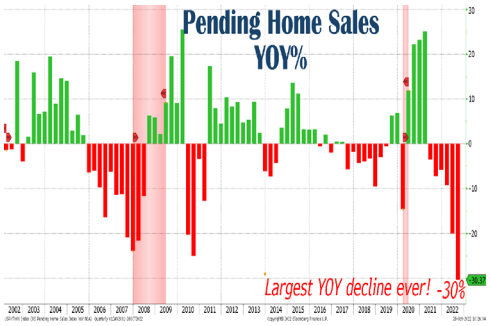
And in case you think the worst is behind us, think again! Pending home sales vomited -10.3% month-over-month in September (way worse than the -4.0% expected), pushing the year-over-year plunge to 30.4%, the weakest it has ever been. Note: Pending sales represent contracts signed but not closed and is an advanced indicator of existing home sales for October and partially November. So, expect a massive plunge in existing home sales in October.



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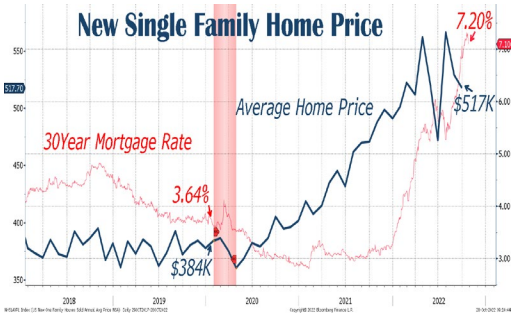
Meanwhile, in the same vein, new home sales slid 10.9% month-over-month in September to a mere 603,000 units annualized and are off 17.6% on a year-over-year basis. If not for a spike in buying on "spec," sales would have plunged 19.4% last month (as sales of completed units tumbled 30.5%). In aggregate, sales have sagged in three of the past four months and in seven of the past nine. Regionally, the most acute weakness is now in the once-hot South. The 20.2% slide was the steepest in nearly a decade.



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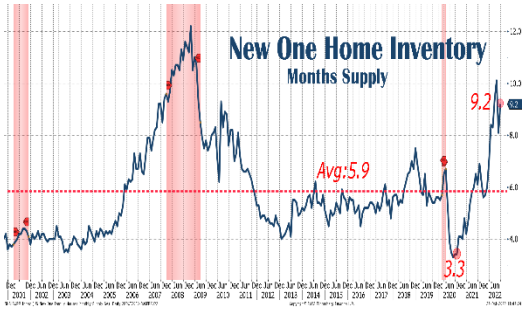
On the pricing front, average new home values deflated 2.1% month-over-month after falling 6.6% in August. The year-over-year trend has slowed from +22.6% in July to +10.0% in September. There is still a ton of downside to go, considering that average prices are currently at $517,000 compared to $384,000 just before the pandemic hit while mortgage rates have doubled from 3.64% to 7.2%. Think about this: The last time mortgage rates were at this level, home prices were 50% lower.

Finally, I keep hearing about how the housing market is undersupplied, and yet the inventory of unsold homes is 9.2 months in September. This is nearly twice the long-term average of 5.9 months. A year ago, this backlog of inventory was sitting at 6.1 months' supply, and two years back, try 3.3 months. Keep in mind this is where the housing supply was in the summer and fall of 2008, when we also heard from the shills not to fret about real estate deflation and its ripple effects.



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Bottom line: The Fed's housing bubble is now deflating and with mortgage rates above 7%, housing is going nowhere but down. For prospective sellers, those who panic and sell first, panic best.

NOT OUT OF THE WOODS

After declining for two consecutive quarters, the U.S. gross domestic product (GDP) grew 2.57% in the third quarter. Here's the kicker: Net trade contributed to 2.77% of this number, or 108% of the bottom line! In other words, the only reason the GDP print was strong is because Europe is collapsing into a recession and is now overly reliant on U.S. energy and weapons exports.

Outside of the trade boost, the economy actually contracted at a 0.2% annual rate. Government spending tacked on 0.4% to the headline data. The ongoing liquidation of inventories (second in a row) subtracted 0.7%. Consumer spending was a bit of an upside surprise at +1.4%, but the gains here were largely confined to transportation services. Anyone visiting an airport of late knows that travel and tourism are doing just fine.

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The key in this report that clearly suggests the economy is not out of the woods by a long shot, is real final domestic private sales — domestically goods produced and sold each quarter excluding inventories and net exports — which came in flat (less than +0.1% at an annual rate) in what was the weakest pace since 2020. This represents a deep slowing from what was an already anemic +0.5% annualized pace in quarter two, +2.1% in quarter one, and +2.6% in the fourth quarter of last year. The pattern of decay in the domestic guts of the economy is unmistakable.

Elsewhere, business capital spending jumped at a +10.8% annual rate but that was cut into by a huge 15.4% decline in non-residential construction expenditures — down six quarters in a row to the lowest level in 11 years. As discussed, the housing market remains in disarray as residential construction collapsed at a 26.4% annual rate and has contracted for six straight quarters, to the lowest level since the second quarter of 2020.

To give you a sense of how bad that is consider that residential investment pulled more from total growth (1.37%) than consumption spending added (0.97 %). Yet residential investment is only about 4% of the total economy while personal consumption is 68%.

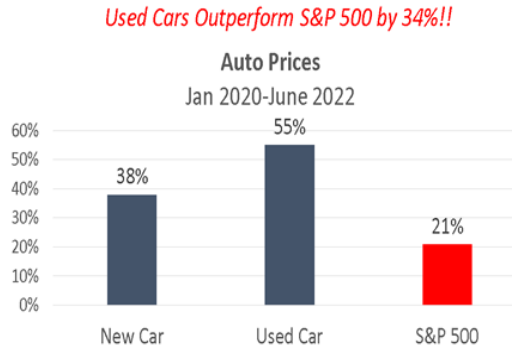
Bottom line: The talking heads will be saying, "what recession?" The thing is they wouldn't recognize a brief blip in an otherwise downward economic trajectory if it was staring them in the face. Remember, an hour after Titanic hit the iceberg, it was a celebration. People gathered ice fragments and played hockey with them. In a word…noise.

From my perch, the GDP print is either just a blip in a recession that started with the food and fuel inflation shock at the turn of the year, or we are set for a double dip as the lagged impact of the Fed's aggressive policy tightening percolates through with the classic lags.

WALKING AWAY FROM CAR LOANS?

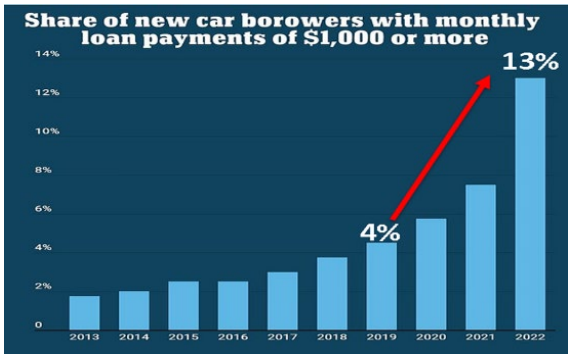
"People are walking away because payments are too high, and the loans have nothing to do with the value of the car… It's just incredible. And we are seeing delinquencies rise before the layoff cycle begins."
— Consumer Finance Protection Bureau (CFPB)

Since the pandemic, auto prices have been the poster child of supply chain problems. The breakdown of the supply channel led to declining auto inventories, which drove both new and used car prices to ridiculous levels. As shown below, cars, a "depreciating" asset, have dramatically outperformed the S&P 500 by 34% from January 2020 to June 2022. Had I known better, I would have dumped equities and bought a diversified portfolio of cars — Foresters, Corollas, Explorer, Wranglers, etc. What the hell was I thinking?



Data Source: Bloomberg

As auto prices soared during the pandemic, borrowers had to take out longer maturity and bigger loans for their wheels. The average maturity of auto loans has extended to 84 months and the monthly auto payment soared to over $700 per month. As noted below, a whopping 13% of car buyers are paying $1,000-plus per month, a huge increase from 4% prior to the pandemic.



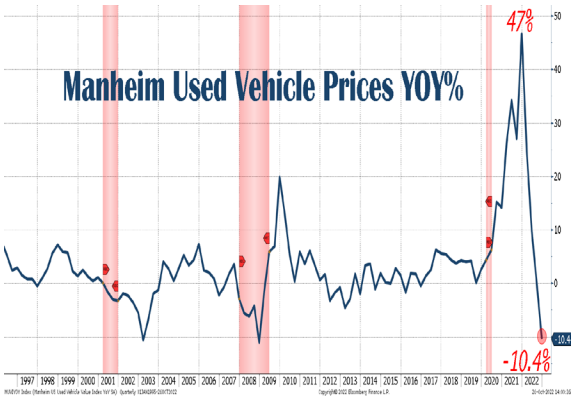
Data Source: Consumer News and Business Channel (CNBC)

Meanwhile, as prices soared, car dealerships lent money without proper background checks. In 2021, it has been estimated that up to 50% of the loans were given to customers who might not be able to afford them. In fact, income and employment verification only happened 4% of the time!

At the same time, temporary pockets of income during the pandemic like stimulus checks, extra unemployment aid and child tax credit payments, eviction moratoriums and student loan deferrals allowed many to pay up for pricier cars that they normally could not have afforded.

"We're beginning to see used-car prices mitigate with faster depreciation."
— Mike Manley, CEO, AutoNation

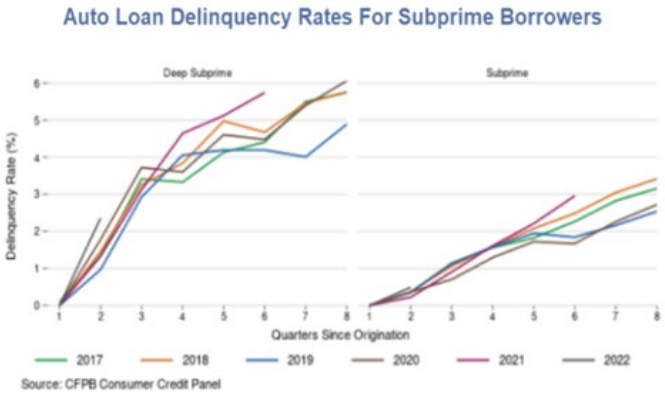
Fast forward, the auto bubble has burst and used-car prices are plunging. Used-car prices slumped 7% in the third quarter, the worst decline since the depths of the Global Financial Crisis. Year-over-year prices have plunged 10.4%.



**Red shaded areas denote recessions*

And individuals are tapped out. To wit: the savings rate fell in September to just 3.1% from 3.4% in August and 3.5% in July — it was 7.9% a year ago. The normalized level over the past two decades is 6.8%. In other words, the rainy-day funds from the prior fiscal stimulus are in the rearview mirror. Now that Uncle Sam's "free" money is gone and close to

two-thirds of Americans are living paycheck to paycheck, the credit stress is beginning to build. According to the New York Fed, auto loan delinquencies are now rising, and loans originated in 2021 and 2022 are starting to show higher delinquency rates relative to loans originated in previous years. For example, auto loans originated in 2021 have a delinquency rate of 0.67 % in the sixth quarter after origination, which is 13% higher than the delinquency rate of auto loans originated in 2018.

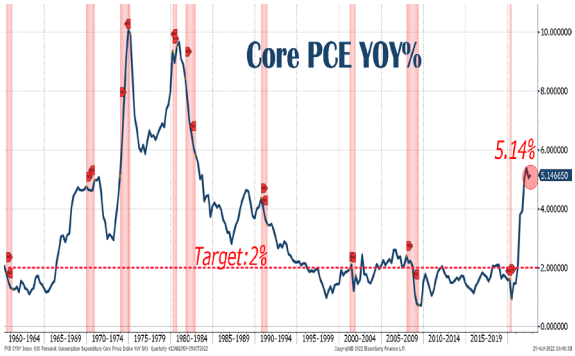


This trend is even more pronounced for consumers with subprime and deep subprime credit scores. For example, 2022 vintage auto loans for consumers with deep subprime credit scores were 2.4 % delinquent two quarters after origination, which is a 33% increase from the previous five-year high set in 2020.

Bottom line: Many Americans are living paycheck to paycheck and now relying on credit cards to make ends meet. The big risk is that as unemployment rises, consumers are forced to or voluntarily choose to default on their underwater car loans. This is especially true for those consumers who purchased used cars during the COVID-19 auto bubble at egregious 30-40% premiums and now owe a lot more than their cars are worth. All of this is happening with unemployment at a near 50-year low. What happens when the layoffs starts to increase?

STILL TOO HOT!

The Fed's preferred inflation gauge is the core personal consumption expenditures (PCE) price index, which jumped 5.1% in September, compared to a year ago — the fourth-highest reading in this cycle, behind January, February and March. All of them are the highest since 1983. In terms of the Fed's 2% inflation target as measured by core PCE, inflation is worsening and now measures over 2.5 times the Fed's target.



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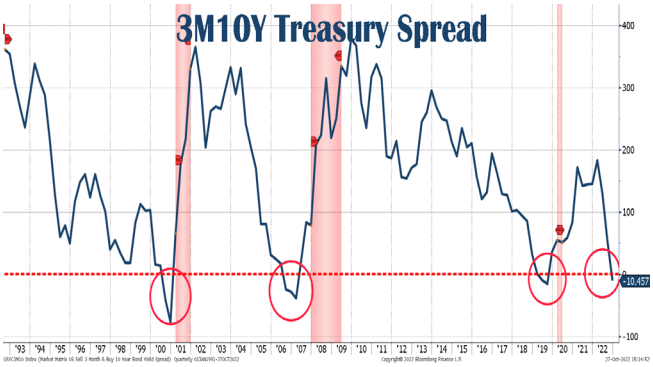
Whether or not core PCE measures actual inflation as you or I experience it is totally irrelevant. What matters is that the Fed uses core PCE as a yardstick for its inflation target. It matters for future rate hikes. It matters for the bond and stock market. And it gives some clues as to where the Fed might be going with its policy rates.

Bottom line: The PCE price index released Friday was the last inflation index before the Fed's meeting this week. Based on Friday's core PCE measure, and on other measures too, including services CPI, the Fed has gotten all the ammo it needs to lift its policy rates by 75 basis points this week, which will take the upper limit of its federal funds target range to 4.0%.

ANOTHER RECESSION INDICATOR

"Our preferred combination of Treasury rates proves very successful in predicting the recessions of recent decades. The monthly average spread between the 10-year constant maturity rate and the three-month secondary market rate on a bond-equivalent basis has turned negative before each recession in the period from January 1968 to July 2006."
— New York Federal Reserve

After watching every other segment of the curve invert, the much-watched (Fed-blessed) indicator of recessions has finally gone negative, which is as strong of a recession signal as there is. I should add that the 3-month/10-year Treasury yield spread is the Federal Reserve Bank of New York's preferred recession signal. It has also been successful at predicting recessions since 1968.



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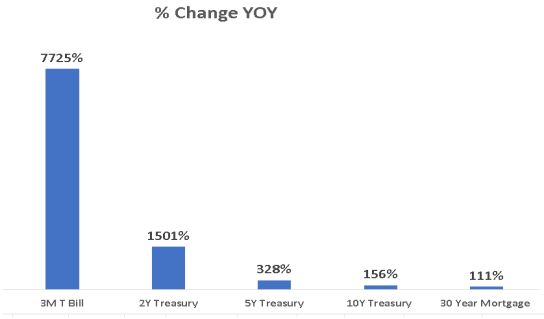
Bottom line: The inversion of the 3-month/10-year Treasury yield spread is yet another indicator pointing to a recession. This may, just possibly, feed the "pause" or even "pivot" the narrative because of its recessionary predictive ability.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

If I had told you at the start of the year that the U.S. economy was heading into a recession, housing was tanking, the dollar was surging, the stock market would be in a bear phase, commodity prices were sagging sharply and the fiscal deficit having plunged 50%, would anyone have believed that this would be the sharpest run-up in Treasury yields in a generation?

That is exactly what has happened. Rates have been higher, but never in history have they risen at such a torrid pace. Take a look at the table below, which shows rate changes on a percentage basis. The shorter the duration, the faster the move.



Data Source: Bloomberg

Indeed, it's been a very painful year for the bond market. But it's also important to understand that interest rates are cyclical and as inflation subsides and the economy weakens, interest rates will reverse course and head lower. I wish I could tell you when all of this will happen, but sadly, I don't have a crystal ball.

The one thing I have learned over 40-plus years in the bond market is not to extrapolate today's environment into the future. Things can change fast, very fast, and when it is least expected. So rather than waiting for the "bell to ring" when it's time to buy (which it won't), credit unions should stick with an agnostic, all-weather, risk-appropriate 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 rebalanced with much higher yielding securities and 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.