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INVESTMENT SERVICES

Weekly Relative Value

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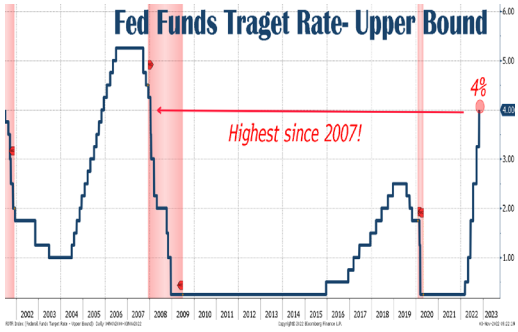
WEEK OF NOVEMBER 7, 2022

Inflation to Fade in 2023

"Everyone has a plan, until they get punched in the face."
— Mike Tyson, Former American Professional Boxer

As telegraphed, the Fed raised rates by another 75 basis points, to a 3.75% to 4% band. This was the fourth such move in a row and an epic 375 basis point cumulative hike for the year, which puts the fed funds rate well above the estimated neutral rate, of 2.5%. The last time Fed funds were at this level, we were on the cusp of the housing bubble in 2007. Also, as expected, the Fed talked hawkish and still anticipates more rate hikes to continue to flex its inflation-fighting muscles.



**Red areas denote recessions*

The Federal Open Market Committee (FOMC) released a statement at 2:00 pm, which was initially met with euphoria as traders saw hopes for a 'pause':

"[…] the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments."

But at the 2:30 pm press conference, Chairman Jerome Powell did yet another "pivot":

"It is very premature to be thinking about pausing […] we think we have a ways to go […] we may ultimately move to higher levels than we thought at the September meeting".

THIS WEEK

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In other words, rates will stay higher for longer. Powell reiterated previous comments that "at some point" it will become "appropriate to slow the pace of increases." Powell most notably pointed out that there is "significant uncertainty" around that endpoint by saying "we have some ways to go," adding that the ultimate level of the terminal rate may be higher than previously expected.

To drive home the point, Powell added the following:

> *"To be clear, let me say again,* ***the question of when to moderate the pace of increases is now much less important than the question of how high to raise rates and how long to keep monetary policy restrictive, which will be our principal focus****…. The historical record cautions strongly against prematurely loosening policy.* ***We will stay the course, until the job is done."*** — Jerome Powell, Federal Reserve Chairman

Powell couldn't have been clearer if he brought a bull on stage and shot it in the face.

As for those "policy lags", we don't have to wait. Right off the bat, here is what Powell had to say on the macro scene:

> *"The U.S. economy* ***has slowed significantly*** *from last year's rapid pace. Real GDP rose at a pace of 2.6 % last quarter but is unchanged so far this year. Recent indicators point to* ***modest growth of spending and production this quarter.*** *Growth in* ***consumer spending has slowed from last year's rapid pace****, in part reflecting lower real disposable income and tighter financial conditions.* ***Activity in the housing sector has weakened significantly****, largely reflecting higher mortgage rates.* ***Higher interest rates and slower output growth also appear to be weighing on business fixed investment****."* — Federal Bank Reserve Chairman

RULE #1: DON'T FIGHT THE FED

> *"Markets have become so dysfunctional (lazy), they now FOLLOW the fed and forgot Fed rule #1."*
> *— Wolf Richter, Wolf Street*

For years the mantra has been "don't fight the Fed". Indeed, that's been sage advice as markets have risen on good news and bad news as well as good earnings and bad earnings. Nothing has really mattered for the past decade other than the Fed and free money. Let's face it, who needs a chartered financial analyst (CFA) when the only thing that matters is the Fed. Just buy stocks and watch them go up. The free-money virus turned investors' brains to mush.

Take for example Dave Portnoy, the founder of Barstool Sports, who jumped on the liquidity bandwagon and turned stock picker.

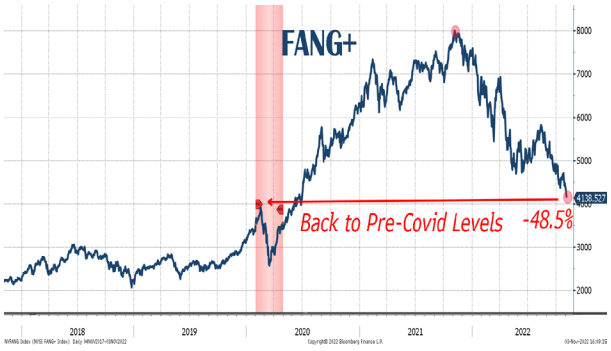
> *"Say it with me … Stocks only go up. Only losers take profits." — Dave Portnoy, Founder, Barstool Sports*

Sorry, Dave.

RULE #2: DON'T FORGET RULE #1

"Don't fight the Fed" applies in both directions. Investors were reminded of this last week as Jerome et al continued to actively lean against any potential easing in financial conditions. Meanwhile, the Fed is reducing its balance sheet by $75 billion per month and the Fed fund's futures have been priced in a 5.17% peak in the funds rate. The 2-year Treasury yield at 4.70% is back to where it was in 2007. But the thing is, we went into this rate rising cycle with valuations in both equities and residential real estate more bubbly than was the case back in 2007.

However, the healing has started. The once infallible and "can't miss" Facebook, Amazon, Netflix and Google (FANG) stocks have really taken it on the chin, erasing virtually all of their post pandemic gains. With hopes dashed of a Federal Reserve reprieve, investors are being forced to do something they've been trying to avoid for years, assess stocks on their merits. All those Robinhood accounts are now seeing in real time that you can't stay home and think you can get rich indefinitely by trading the market.



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	Year-to-Date %	From 52-Week High
Alphabet (Google)	**-41%**	**-44%**
Meta (aka FB)	**-73%**	**-74%**
Amazon	**-46%**	**-52%**
Netflix	**-54%**	**-76 %**
Apple	**-18%**	**-29%**
FANG+ Index	**-43%**	**-48%**

Source: Bloomberg data

Meanwhile, the Fed is hell bent on killing housing as mortgage rates have now doubled from 3.35% to 7.35% in the past ten months.

This what Powell had to say about the overheated housing market:

> *"The housing market was very overheated for a couple of years after the pandemic as demand increased and rates were low. We all know the stories of how overheated the housing market was. Pricing going up, many bidders, no conditions. The housing market needs to get back into a balance between supply and demand. We're well aware of what's going on there."*

Home prices have clearly peaked, (See last week's WRV - *The Housing Bubble Pops!*). Now we have sky-high home prices, and I mean ridiculous home prices, and mortgage rates that were normal when home prices were just a fraction of today's prices. After mind-boggling, ridiculous spikes, home prices in most markets are dropping. In some markets, home prices are plunging at the fastest pace on record. According to the National Association of Realtors (NARs), the median price of all home types is now down 7% from the peak in June. The 7% decline was the largest drop for this three-month period since the "Housing Bust One".

Here's an example close to home. In Tampa, prices home prices spiked by 60% in two years. Which is just nuts! Now as the mortgage rates over 7%, the housing market has frozen; home prices are declining up to -1% per month.

Cash buyers and investors are pulling back even faster. Their share of total home sales has dropped further, now down to a share of 15%, from a share in the range of 20% earlier this year. They're pulling back because they can clearly see what's going on in the housing market.

It's nearly always true that the "right home, priced right, will sell,". The keyword here is "priced right", and "priced right" means priced where the buyers are, and not priced at some aspirational level in the seller's imagination.

Buyers have vanished at these sky-high prices, and sales that do take place are taking place at lower prices. Potential home sellers now have a problem and have been slow to lower their prices even though demand has cliff dived. Sellers a few months ago got higher prices than sellers today. And those who sell now are getting higher prices than those who'll sell in a few months. Sellers are muttering to themselves, "and this too shall pass." They're hoping for a pivot by the Fed on interest rates, and they're hoping for the Fed to restart the money-printing press.

Consider the following quote:

> *"What I'm seeing is them listing at wish prices, listing at wish rent prices, relisting at still wish prices, relisting to rent at wish rental prices.....properties sitting." — Darth Powell*

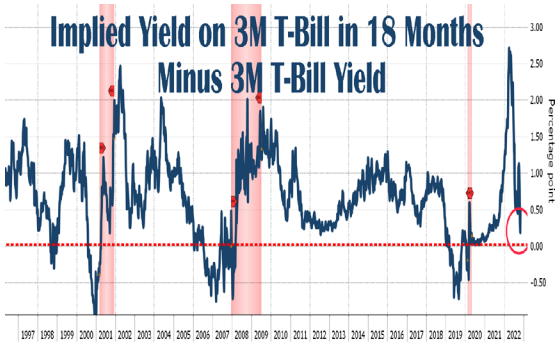
This is called walking the market down, always wanting the price at what they could have gotten last month. They are hoping for a return to where prices were at the beginning of 2022. That isn't going to happen. Homes are still egregiously overpriced and need to decline to restore the supply and demand of homes. Accepting reality can be hard,

but as I noted last week those who sell "first", sell "best"! The longer potential sellers hold out, the lower the price will be. And then they'll end up chasing those prices on the way down.

Bottom line: The Fed continues to tighten into an inverted yield curve, and we haven't yet seen all the bad stuff hit the wall just yet. Powell knows the economy is weak. He knows inflation is a lagging indicator. He knows about the yield curve. So, what is the real agenda? From my perch, the Fed wants to hammer the economy, risk assets and real estate to reverse the "wealth effect" to slow consumption. Obviously, Powell CANNOT come out and say that while he's employed by the Fed, but he knows it. Simply put: the inflation Powell really wants to destroy is in assets — equities and real estate. Powell will go down in history as the Fed Chairman who burst the bubbles in equities, housing and who destroyed the concept of the "Fed put."

FOLLOW THE CURVE

It was incredible how Powell dismissed his favorite yield curve — the spread between three-month rates and the 18-month forward expectation of the three-month rate — from a reporter, who reminded the Fed Chairman that when it was steep six months ago, the view was "no problem" until it inverts. Back then, Powell intimated that an inversion would signal the need for the Fed to begin thinking of easing policy. The spread between three-month rates and the 18-month forward expectation of the three-month rate, touched +2 basis points in recent days, and is well off the nearby highs of +270 basis points. Yet another recessionary message to the uninitiated. And the best the Chairman could say was "it's not inverted."



**Red shaded areas denote recessions*

All the while, the 2s/10s curve (the one that Powell chooses to ignore despite its near-perfect track record) touched a four-decade low in recent sessions of -59 basis points.

**Red areas denote recessions*

FOLLOW THE MONEY

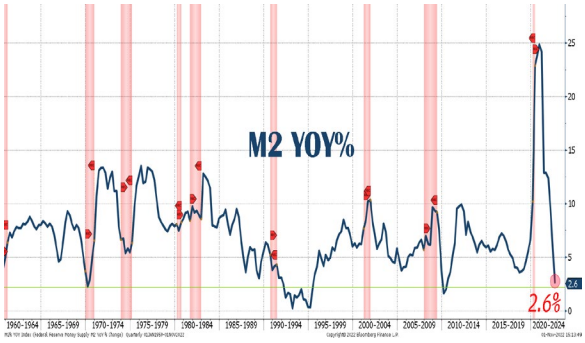
"Inflation is always and everywhere a monetary phenomenon!" — Milton Friedman, American Economist

The money supply is one of the Conference Board's leading economic indicators, and it is pointing to a literal meltdown in inflation in the coming year. The broad M2 money measure leads inflation by 16 months, and as shown below, has been flat or down in five of the past six months.

The year-over-year trend has been pared to 2.6% from 12.4% at the end of 2021, and 12.9% a year ago. The pace has not been this weak since July 2010.

Further, I find it a bit more than incongruous for the "inflationists", who ranted over the booming money supply numbers in 2020 and 2021, for causing today's inflation. They are now absolutely silent over the sharp slowing and now contraction in the monetary supply.

Bottom Line: If Milton is right, then one should expect inflation to decline next year.



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RENTS HAVE PEAKED!

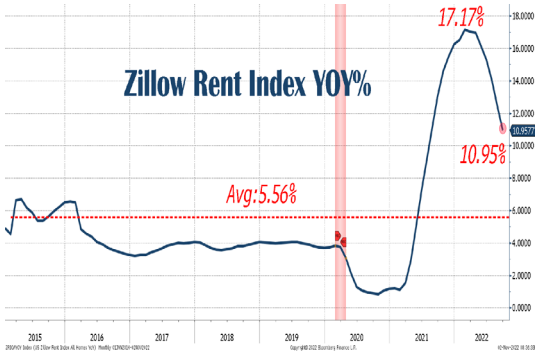
"The national median rent increased by a record-setting 17.6 percent over the course of 2021. This rapid growth in rent prices is a key contributor to overall inflation, which is currently rising at its fastest pace in 40 years."
— Apartment List

There was a remarkable moment during Powell's post-FOMC press conference. Powell was asked about the ongoing devastation in the housing market in general, and rent inflation in particular, Powell's response was the following:

- *POWELL: POINT AT WHICH RENT INFLATION SLOWS IS STILL FAR AWAY
- *POWELL: AT SOME POINT YOU'LL SEE RENTS COMING DOWN

Powell was once again using his "rear-view" mirror and referring to the latest shelter/owner equivalent rent (OER) inflation data as reported by the consumer price index (CPI), which is indeed soaring. However, rent is a lagging indicator (six to nine months). In fact, while the lagging CPI data is showing runaway inflation, real life rents are finally fading. The Zillow apartment rental rate series has slowed year-over-year for seven months running. From the +17.1% peak in

February to +10.7% as of September, still hot, but the least hot peak since July of last year. The month-over-month change of just +0.48% was the smallest since February 2021. Home prices have also deflated for two months in a row.



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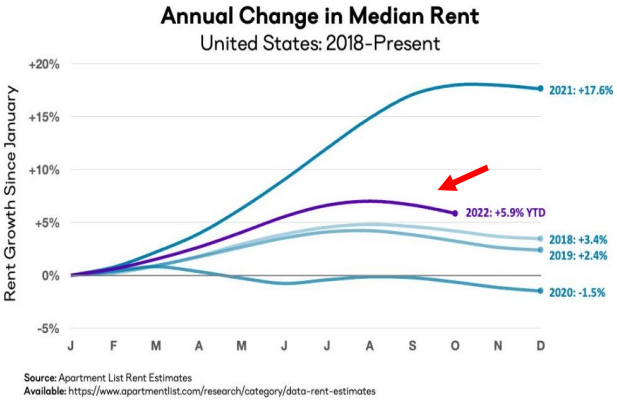
In addition to the Zillow data, the Apartment List index fell by 0.7% this past month, marking the second consecutive decline, and the largest single monthly slide in the history of the index. The breadth of rent slowdown is considerable with rents decreasing this month in 89 of the nation's 100 largest cities in October.

"Several of the country's most popular "Zoomtowns" for digital nomads are beginning to cool off. *Nearly every city in Florida is down month-over-month and every city in Arizona is either down or flat over last month (both states saw sharp price increases as new residents streamed in throughout the pandemic)…* ***Going forward it is likely that rents will continue falling in the coming months as we enter the winter slow season for the rental market."***
— Zumper National Rent Report

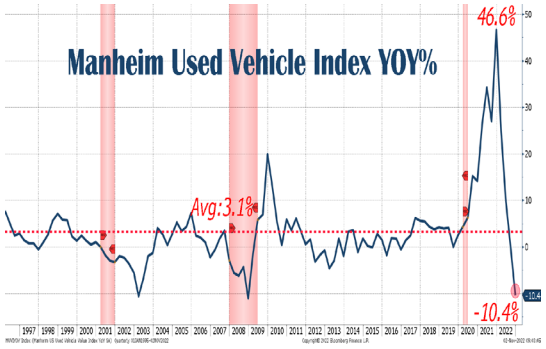
Take a look at the graph below. The year-over-year trend in new rental prices is +5.9%. Still high versus the pre-pandemic levels, but well off the +18% pace a year back.



The Apartment List rent index is particularly relevant, since movements in market rents lead movements in average rents paid. As a result, the index is signaling what is likely ahead for the housing component of the CPI inflation estimates.

On the goods side (40% of CPI), the slump in commodity prices has already caused import prices to deflate for three months in a row. Looking at used car prices, prices were down 2.0% in October and have been dropping now for five

months in a row. The year-over-year trend, at -10.4%, is the weakest since the depths of the Global Financial Crisis in December 2008.



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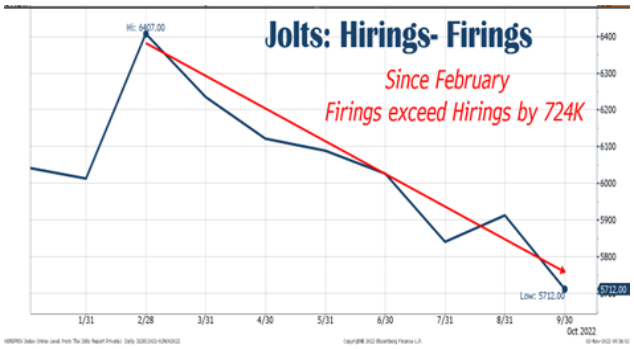
Bottom line: When the effect of receding apartment rents bump against the ongoing decline in goods prices stemming from the commodity markets and the strong U.S. dollar, the disinflation, or deflation, impulse will show through more visibly. At the same time the Fed, using its rear-view mirror, will be hiking with gusto, and signaling that the market the terminal rate is 5% or more just as the economy goes into freefall. A few months later the Fed will finally be scrambling to undo its latest mistake.

JOLTED!

Jerome Powell's favorite labor market indicator is the ratio of job openings to the level of unemployment. Job openings are back 10.717 million and the level of unemployed people is 5.753 million. This means that there were almost two job openings for every unemployed worker. The investment community at large has bought into this metric hook, line and sinker. But openings can always be pulled. It is jobs and not job openings that provide the working class with the paychecks they need to feed their families and pay their rent.

I have my own labor market metric, which has less importance, obviously, since I don't pull the monetary levers. My metric is hirings minus firings, and this indicator is heading straight down. The gap between hirings and firings was -90,000 in September and has been negative each month since February and by a cumulative -724,000. While job openings soared, hiring tumbled to the lowest since February 2021. Makes perfect sense, right? And you wonder why I'm bit skeptical of job openings.



In the same vein, the Challenger job layoff data for October was none too pretty. Layoffs soared +48.3% year-over-year and jumped +12.85% month-over-month. This came on the heels of a +46.4% surge in September, the sharpest successive increases since April to May 2020. At 33,843, the head-count loss announcement was the most since

February 2021. ALL of the layoff announcement increases and then some (4,353) came from these two sources: cost-cutting measures and corporate restructuring. In terms of sectors, the culprits in October cut a wide swath across the economy: construction, real estate, retail, consumer products, technology, telecom, financial and even leisure and entertainment.

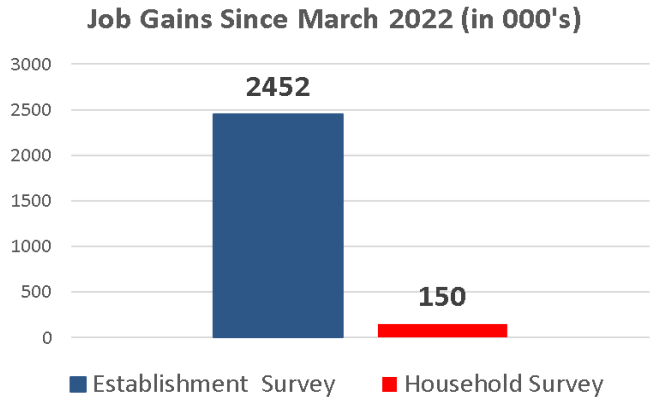
Bottom line: Forget about job openings as they have no semblance of what is happening in gross domestic product (GDP) or the economy, but it makes for a nice cocktail conversation.

NO TIME TO CELEBRATE!

At a time when the best paying tech companies are mass laying off double digits of their workforce (just ask Twitter employees), the Bureau of Labor Statistics (BLS) reported in October that payrolls jumped by 261,000, far higher than the 195,000 expected.

Here's the problem; the BLS "birth-death" model, added 455,000 to the headline figure, which was 100,000 more than the same month last year. Indeed, strip out the "birth-death" model skew, and non-farm payrolls were just +78,000. Like magic, the BLS shows a headline of +261,000, and even if there is an inkling of truth to that, it was still the most modest increase since December 2020! I should stress that the BLS employment numbers always miss the turning points, and the reason why it can often be found in the "birth-death" jobs assumptions. (Note: this is the birth and death of businesses, not people).

What is even more perplexing, is that despite the continued rise in non-farm payrolls, the Household survey continues to telegraph growing weakness. As of October 31, the gap that opened in March has since grown to a whopping 2.3 million "workers", which may or may not exist anywhere besides the spreadsheet model of some BLS analyst.



Source: Bureau of Labor Statistics

When looking at the Household Survey, we see LOSSES of 328,000 — the steepest fall-off since April. Also, when looking at the composition of the collapse in actual employed workers, we find the following stunner: full-time workers cratered -433,000 while part-time workers rose +164,000. Also, one more shocker, those aged 45 to 54 (prime earning years), had LOSSES of 406,000. This shows a reluctance to hire and a willingness to cut more costly employees.

So, what's going on here? The simple answer is due to deterioration in the economy, more people are losing their higher-paying, full-time jobs and switching into much lower-paying, benefits-free part-time jobs. This also forces many

to work more than one job, a rotation which picked up in earnest in March, which has only been captured by the Household survey.

Bottom line: We are clearly at an inflection point. All in, above-consensus payroll gains fueled by an inflated and stale "birth-death" model, and a shift from full-time to part-time employment, are absolutely no reasons for celebration. Further, due to tech and finance layoffs, I expect significant employment declines starting next month. For the real data and backward revisions, look to December's numbers.

THE WEEK AHEAD

The U.S. mid-term elections on Tuesday will be the primary focus for the markets. The consensus expectation is that a divided government between the White House and Congress will lead to more political gridlock, which markets tend to favor. A scenario that could rattle the market would be the lack of clarity with regard to Senate control, if results are contested.

Meanwhile, the economics calendar will be dominated by the October CPI report. Unfortunately, we will likely not see any reprieve from inflationary pressures this month. The consensus is for a 0.7% increase in CPI, and a 0.5% increase in core CPI, driven by very strong shelter inflation and idiosyncratic factors. Year-over-year, CPI is forecasted to be up 8.0% year-over-year and core CPI to be up 6.6% year-over-year.

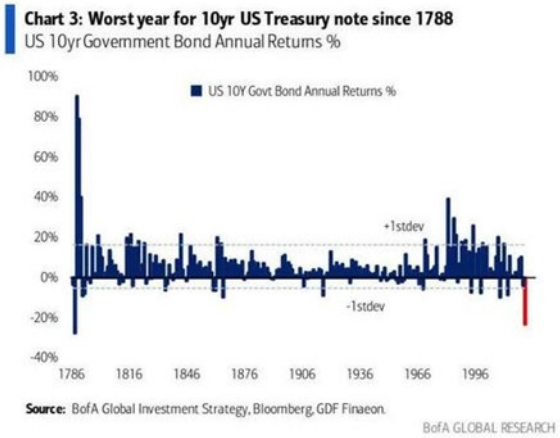
MARKET OUTLOOK AND PORTFOLIO STRATEGY

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? And that the 10-year Treasury would post the worst return since 1788! Yes, 1788!

As for the inflation boogeyman, it was interesting to see Mark Zandi of Moody's Analytics show in his analysis that 60% of the current 8.2% inflation rate is due to supply-side factors. This has more than double the 28% share coming from demand influences. And now the supply side is thawing on its own, and the Fed is looking after the demand side. Rental rate lags aside, I see nothing to suggest that going forward, inflation will be sticky. Quite the contrary.

As I noted last week, interest rates are cyclical and as inflation subsides (it will), and the economy weakens (it has already), interest rates will reverse course and head lower. The two things I have learned over 40-plus years in the bond market is not to "time the markets" or extrapolate today's environment into the future. So rather than waiting for "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.



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.