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INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF NOVEMBER 14, 2022

The Higher They Go, The Harder They Fall

"This approach eased financial conditions in the past and, so far, looks to be effective again. Stock prices rose and long-term interest rates fell when investors began to anticipate this additional action. Easier financial conditions will promote economic growth. For example, ***lower mortgage rates will make housing more affordable*** *and allow more homeowners to refinance. Lower corporate bond rates will encourage investment.* ***And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending.*** *Increased spending will lead to higher incomes and profits that, in a virtuous circle, will further support economic expansion."*
— Ben Bernanke, Former Fed Chairman, on November 5, 2010, when he unleashed quantitative easing (QE) two (nearly a year-and-a-half after the recession ended.)

On November 5, 2010, American politicians handed the economic baton to the Federal Reserve. This was a result of a decade of printing money and zero interest rates, which created an all-powerful "search for yield." This "search for yield" stoked virtually all asset prices to ridiculous levels leading to "artificial wealth" and the "everything bubble."

Now inflation is too high, rates are normalizing and the printing presses have been shut down. Simply put, it's the end of "free money." Jerome Powell, Fed Chairman, has now disavowed the Bernanke (Greenspan and Yellen) doctrine of creating positive "wealth" effects. Like "Tall" Paul Volcker, former Fed Chairman, his legacy will be restoring price stability. Wave "bye-bye" to any notion of the "Fed put," zero interest rates and round after round of QE. That era is over.

Let's face it, it's wonderful when bubbles inflate. We feel so "smart" and so "rich". When the bubbles burst, we feel "duped" and so "poor"!

THIS WEEK

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Now ask yourself this rhetorical question: If QE and zero interest-rate policy (ZIRP) were the primary catalyst for creating the "everything bubble" today, what do you suppose will happen when these policies are reversed?

Household net worth represents the total value of assets — financial and non-financial assets (i.e., real estate holdings) minus the total household liabilities. As such, it is the defining factor of a household's economic well-being.

At the beginning of 2022, households owned a combined $80 trillion in equities and real estate. In the first half of 2022, household net worth deflated by $6.2 trillion. The slide in equity values accounted for virtually all of the decline and were down an epic 17% on a year-over-year basis, echoing the decline in 2002 and 2009.

In quarter two, the household net worth to disposable income declined to 777% from 826% in quarter one. As denoted in the graph below, the long-term historical average is 544%, so this ratio remains extremely elevated with plenty of air beneath. If, God forbid, this series does mean revert, the wealth destruction will be epic and have a huge impact on the "artificial" wealth effect the Fed helped engineer. This in turn will have a significant and negative impact on spending as consumers realize that this downturn is not temporary.

This is what the San Francisco Fed had to say about this ratio:

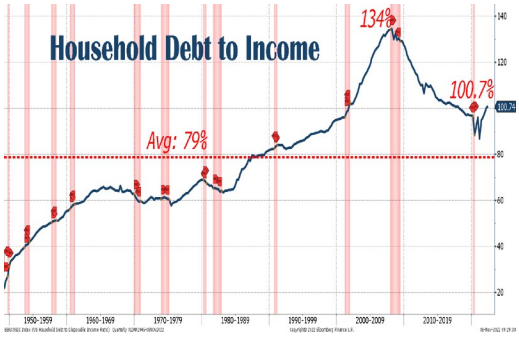
"Similar to the P/E ratio, this ratio generally tends to revert toward its historical average and does not remain at extreme values, either high or low, for prolonged periods." – San Francisco Fed

**Red areas denote recessions*

Keep in mind, the ratio of wealth to income does not include the recent 7% decline in real estate over the past three months. Now imagine what happens when the $45 trillion real estate bubble really deflates. As they say, the higher they go, the harder they fall.

**Red areas denote recessions*

Meanwhile, as U.S. household assets plunged to a record $6.2 trillion in the first half of the year, liabilities piled up by $560 billion to a new all-time high of $18.9 trillion. Everyone talks about how strong the consumer balance sheet is, and that's because they compare today's debt-to-income ratio of 101% to the massive bubble peak of 134% in 2007. Meanwhile, outside of that insane period, the household debt-to-income ratio is above any other peak in the past — which, by the way, averaged out to be 79%. This puts the current 101% ratio into proper context.



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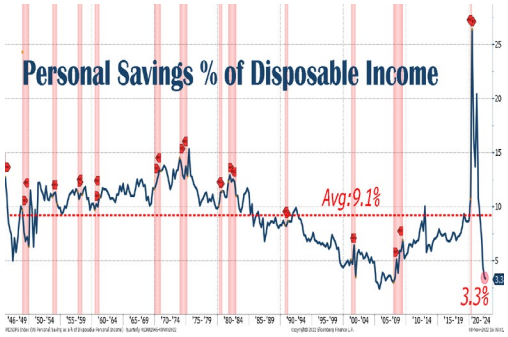
Not to mention the rapid drawdown in the savings. Household savings fell in quarter two to below $1 trillion at an annual rate ($945 billion) — the lowest since the second quarter of 2014. As shown below, savings as a percentage of disposable income is now 3.3% or three times lower than the long-term average of 9.1%



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THE MOTHER OF ALL BUBBLES

"This is the Mother of All Bubbles and the fraud embedded therein. Sam Bankrun-Fried? What's happening today in Crypto is not emblematic of a bottom." – Keith McCullough, CEO, Hedgeye Risk Management

Remember those Super Bowl ads? As it turns out, that was peak crypto. Recall the million-dollar Bitcoin predictions not so long ago? Those predictions now seem laughable.

Bitcoin was hailed as the new digital gold and a hedge against inflation. Really? The bullish narrative is that the unregulated Bitcoin would replace fiat currencies but that has failed miserably thus far. Crypto clearly hasn't achieved the core functions of currency as a store of value or a medium of exchange, and I'm guessing it never will. That said, it has been a speculative plaything over the past couple of years and has traded more like a meme stock than a currency.

To be sure, crypto is never boring. But even by the standards of crypto land, last week was extraordinary, thanks to the implosion of Sam Bankman-Fried's FTX empire. The short story goes as follows: Binance, the world's largest crypto exchange, had signed a letter of intent to acquire its rival FTX, once seen as among the best-run exchanges, which faced a "significant liquidity crunch."

It was reported that Binance would not go through with its proposed acquisition of FTX after less than a day of reviewing the company. The review showed the company held just $900 million in liquid assets against $9 billion of liabilities. The $8 billion shortfall (oops) was because it lent customer money to fund trading bets to its affiliated trading firm, Alameda Research. Another very big oops. By the way, that's illegal.

Glance at the graph below. X FreeType (XFT), the token of FTX, hit an all-time high of $79 in September 2021 but will likely be worthless. It has been widely reported that Sam Bankman-Fried's net worth plunged $16 billion in a couple of days. Yes, $16 billion! That's a bad, really bad, day at the office.

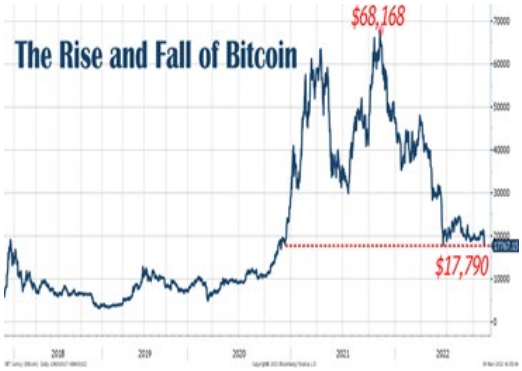
Fears over FTX's solvency led to ripple effects throughout the crypto markets. To wit: since peaking at $68,168 in November 2021, Bitcoin has plunged to below $17,000! In the last 12 months, the two largest digital currencies, Bitcoin and Ethereum, have lost 75% of their value. The industry, once valued at roughly $3 trillion, now sits at around $900 billion. In other words, over $2 trillion was wiped out! As they say, the higher they go, the harder they fall!

Here's the big thing. Up until a year ago, crypto's entire life was in zero to negative interest rates and massive central bank liquidity. "Everything" went up and up, with or without merit. The pre-collapse mania was further propped up by perpetual degenerate pumping from a long list of carnival barkers and a rotating cast of clueless clowns on CNBC. They convinced millions of unsuspecting investors that "crypto is their only hope."

That environment has obviously changed. Like meme stocks and "profitless" concept companies, the crypto speculative high is long gone and the tide is going out. There are many folks who are "long" in this space and are now suffering around the world, searching for answers. They are now paying the price for buying into the hype and unwillingness to ever admit that these "things" are next to impossible to value.

This is what Warren Buffet had to say about Bitcoin:

"If you said... for a 1% interest in all the farmland in the United States, pay our group $25 billion, I'll write you a check this afternoon. For $25 billion, I now own 1% of the farmland. If you tell me you own 1% of all the apartment houses in the United States and you want another $25 billion, I'll write you a check; it's very simple. ***Now, if you told me you own all of the Bitcoin (BTC-USD) in the world and you offered it to me for $25, I wouldn't take it because what would I do with it?*** *I'd have to sell it back to you one way or another. It isn't going to do anything. The apartments are going to produce rentals and the farms are going to produce food. That explains the difference between productive assets* ***and something that depends on the next guy paying you more than the last guy got."***



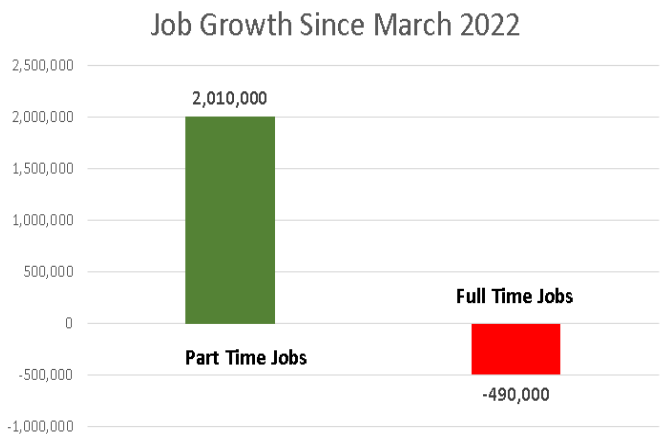
Bottom line: Maybe crypto does eventually become widely used as a currency. Then again, maybe not. But more importantly, no one, and I mean no one, knows how to value these things. Is bitcoin worth $100, $500, $20,000, $50,000 or is it worthless? It's purely emotional and psychological. It really comes down to what the next guy is willing to pay. From my perch, it's just another case of the "greater fool theory."

For those trading or investing in this sector, all I can say is good luck!

CONSUMER STRESS BUILDS!

As for the all-important labor market, cracks are showing up despite the headline numbers. As I have said previously, the October non-farm payroll report provided a false glow over what is really happening in the labor market. Take a look at the graph below. Let's just be honest and say that since the month of March every job that was created has been the replacement of full-time positions with part-time work. Since March, full time employment is down 490,000! Not every job is created equally, despite what the headlines tell you.

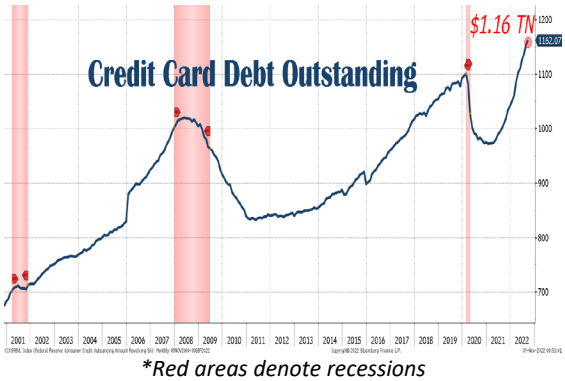
More importantly, layoffs are increasing across a wide swath of industries — tech, finance and, of course, real estate. To wit: online real estate broker, Redfin, just announced a 13% headcount reduction is a real-time sign of what is happening in the U.S. housing market. This is one sector that is definitely not witnessing a soft landing or mild recession. Going forward, Bank of America is projecting that job losses will soon hit 175,000 a month starting early next year, with job losses continuing through much of 2023.



Source: Bureau of Labor Statistics (BLS)

While the 261,000 payroll print last week had pundits claim that the U.S. consumer is strong enough to ride out the Fed's policy tightening, the reality is entirely different. As it turns out, U.S. consumers piled on another $25 billion of consumer debt in September, taking the total balance outstanding to $4.7 trillion. Year-to-date, consumer credit is up $270 billion, marking the greatest nine-month surge in recorded history. Why are consumers borrowing hand-over-fist if their so-called "excess savings," which are at a 14-year low, are supposedly high enough to carry them through this period?

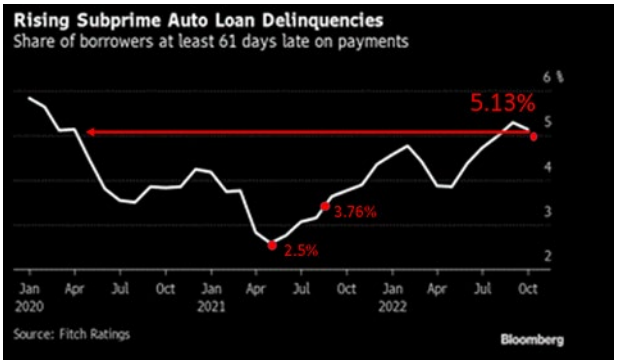
Meanwhile, revolving credit, which includes credit card borrowing, increased by $8.3 billion. This is a new record high of $1.16 trillion as consumers try to keep up with a high cost of living. Year-to-date, outstanding credit card debt has risen by a whopping 19%. This surge in revolving credit is unusual at a time of usury-like interest rates of nearly 17%, and it looks like a train wreck is coming our way.



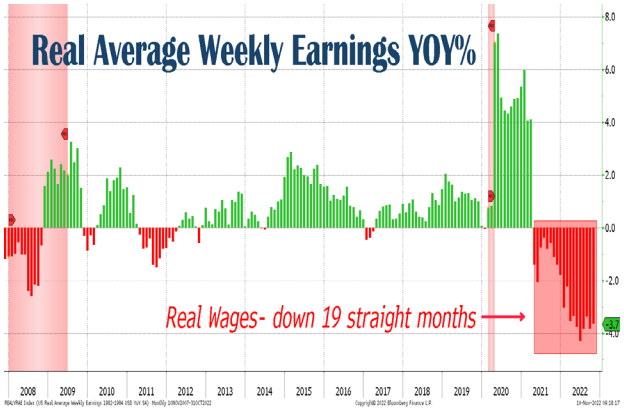
**Red areas denote recessions*

Don't look now, but the one-month credit card delinquency rate has quietly started to climb, it is up four months in a row to 0.9%. And while this rate remains below the pandemic peak of 1.64%, this is a trend to watch, especially since Paul Siegfried, the Senior Vice President and Credit-Card Business Leader at TransUnion, noted that subprime consumers are increasingly turning to credit at this time.

In the same vein, last week Fitch Ratings reported that, with used car prices deflating 15% so far this year, the share of subprime auto borrowers in default by at least two months rose to 5.13% this past month from 3.76% a year ago. This is around the same level as April 2020. Is this the proverbial canary in the coal mine?



You can also see the consumer stress in holiday spending plans as well. According to Morning Consult, a net 17% of those surveyed believe they will spend less this year. Many are stressed over gifts and even the Christmas or Thanksgiving dinner. In fact, 47% say they're celebrating "Friendsgiving" because of its more budget-friendly menu. Specifically, just 24% of Friendsgiving celebrations will even have a turkey on the table, with 33% opting for a pizza instead. This is hardly surprising given that the savings rate is a measly 3.3%, while incomes, adjusted for inflation, have declined for 19 straight months.



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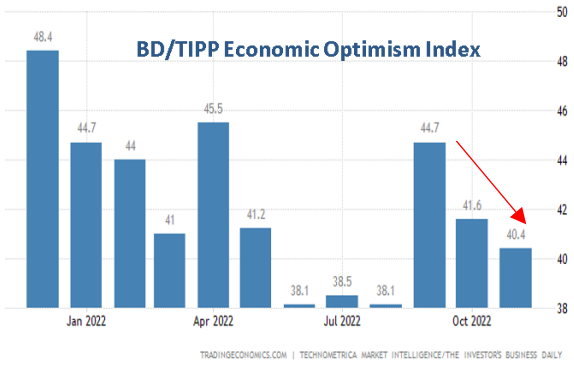
SENTIMENT TURNS TO SEDIMENT

The Investor's Business Daily and the TechnoMetrica Institute of Policy and Politics (IBD/TIPP) Economic Optimism Index fell 1.2 points in November to a bleak 40.4, and is now just 2.3 points shy of setting a fresh 11-year low, as it did in August. Since May, the share of Americans who are convinced the U.S. economy is in a recession has jumped from 48% to 58%. The six-month outlook also dropped 1.1 points to a gloomy 34.3. This is not far off the all-time low of 30.6, established in the dark days of July 2008. This prevalent view of a "soft landing" — where does that come from exactly?



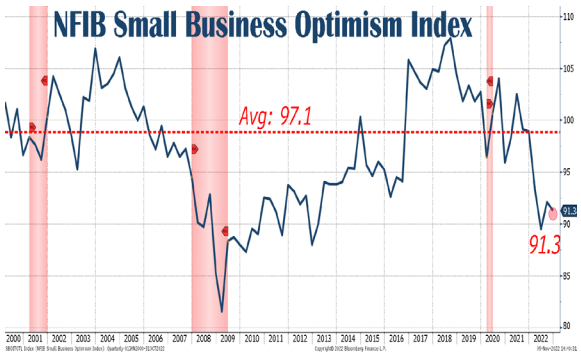
The recession view received a big shot in the arm on Friday with the November University of Michigan consumer sentiment report. Here's the key commentary:

"It is pretty unambiguous that consumers expect a downturn going ahead and do by and large expect a recession."

"We have the highest share of consumers expecting unemployment to rise in the year ahead, since the very beginning of the pandemic, and it's comparable to what we were seeing in the middle of the great recession. Consumers are absolutely expecting labor markets to worsen."

"And what that tells us is that the improvements we have seen in the last few months were really tentative. We're going to have a bumpy ride ahead."

Likewise, the National Federation of Independent Business (NFIB) Small Business Optimism Index came in below expectations for October, slipping to 91.3 from 92.1 in September. The long-run average back in 1974 is 98, so consider this to be well below what is normal. In fact, it is basically at the same level that was posted in April 2020, not to mention September 2008, when the Global Financial Crisis really went into high gear.



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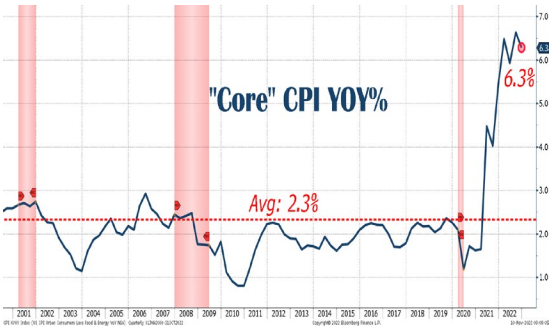
PEAK INFLATION

The headline consumer price index (CPI) printed cooler than expected at +7.7% year-over-year (vs the 7.9% that was expected) and down from the +8.2% in September. While still very high, it is the lowest since January. If not for big increases in shelter (+0.8%), energy (+1.8%) and food (+0.6%), the CPI would have "declined" by 0.1%. This would have

been the first dip back to deflation on this measure since May 2020. That attests to just how weak the U.S. economy has become.

Core CPI rose for the twenty-ninth straight month but inched back off 40-year highs on a year-over-year basis (+6.3% vs. the expected +6.5%). Once again, the "lagging" shelter index was the dominant factor in the monthly increase in the core. Rent inflation is at 6.92%, which is the highest on record, up from 6.59%. Rent is 7.352% of the CPI. Shelter inflation is at 7.52%, which is also the highest on record, up from 7.21%. The operating expense ratio (OER) is the single largest component 23.97% of the CPI.



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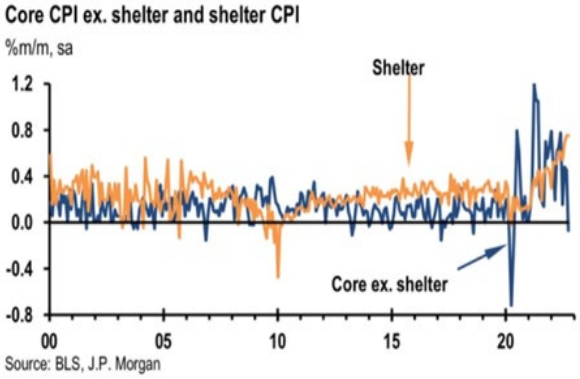
On the services side, prices declined in medical care, financial services, airlines and car and truck rentals. This was also the second slide in delivery services in the past three months. This is the pulse on consumer demand.

On the goods side, used autos deflated for the fourth month in a row, new car prices slowed sharply, and there were sizeable price declines in apparel, furniture and appliances.

Here is Core CPI excluding shelter which came in at -0.1% month-over-month.



Meanwhile, the signs of global disinflation are growing by the day. Take a look at the plunge in worldwide shipping freight rates. The cost of shipping a 40-foot container across the world has soared, then collapsed. During the pandemic, spot rates jumped as the faster-than-expected recovery from lockdowns created bottlenecks. The average spot price to ship a container from Asia to L.A. was lesser to around $2,000 in May 2020. In January 2021, the rate was more than six times that amount at almost $12,262. Now it is back to $2,262 and below the long-term average of $2,767.

Bottom line: I cannot believe how many pundits still focus on a 12-month trailing trend in consumer prices, which is in the rear-view mirror. What is more important is where that trend is going to be in the months and quarters ahead. And this CPI report had deflationary thumbprints all over it. The breadth of the price weakness was remarkable and the lags from sharply higher interest rates are only now percolating through the system. In fact, if we continue to see prints like this and residential rents mean to revert, we will be talking about "deflation" in 12 months from now.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

I don't want a recession. But I'm going with the odds and also not going to argue with the yield curve, which is very confident a recession is coming. The New York Fed's recession probability model, based on the yield curve that Powell seems to dismiss, has cleared the 30% threshold that has presaged all recessions in the past. "Will it be different this time?" As Clint Eastwood in Dirty Harry once said, "Feel lucky, punk"?

**Red areas denote recessions*

Also keep in mind that there is no Fed pause. Powell has put everyone on notice that he needs to see a multi-month string of numbers just like this before shifting policy. So, they will likely go 25 basis points — maybe 50 basis points — at the December meeting.

The reality is that the Fed still intends to hike again, no matter what, into an inverted yield curve. Talk about playing with fire. In his news conference following the September Federal Open Market Committee (FOMC) meeting, Powell gave a surprisingly clear picture of where he thinks interest rates should go:

So, Powell wants to see every interest rate from overnight out to 30 years higher than the inflation rate as measured by the core (example: food and energy) personal consumption expenditures (PCE) index. The last report put year-over-year core PCE at 5.1%.

Philadelphia Fed President, Patrick Harker, had this to say:

"You want to be at a place where real rates are positive across the entire yield curve."

Now that's a major "yikes"! What does "slow" mean when the Fed has been giving a steady diet of 75-basis-point hikes? A 50 beeper? Even 25?

And notice the plural — "hikes" and not "hike."

Harker doesn't seem to believe that policy has become restrictive enough! Geez, try telling that to anyone involved in the housing industry.

I would suggest that, with the recession staring us in the face and inflation clearly peaking and moving lower, there are significant opportunities to be made in long-term bonds, especially over a one-year horizon. And keep in mind that the Fed, no matter what, is nearing the end of this aggressive tightening cycle. And the COVID-19-inspired inflation burst is in the rear-view mirror. All that lies ahead is the recession, and how deep and long it will prove to be.

In normal circumstances, the entire Treasury curve would be rallying in recent months (as in, yields declining) because the Fed would have already responded to the macro-circumstances cited above. But this Fed has made it painfully obvious that the CPI, along with the unemployment rate (both part of the Conference Board's index of lagging indicators), are the variables it is chasing in this epic tightening cycle.

I should note that the 2-year Treasury yield has a 97% correlation with the funds rate. The 10-year Treasury yield is 98% correlated to the 2-year Treasury; they move in tandem. In other words, it all comes down to Fed policy. The Treasury market will begin to respond to disinflationary and recessionary forces once the Fed stops making it so attractive for investors to flock into the T-bill market (4.4% for the six-month maturity).

We just have to be patient.

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 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.

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.