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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF DECEMBER 12, 2022

Love It or List It!

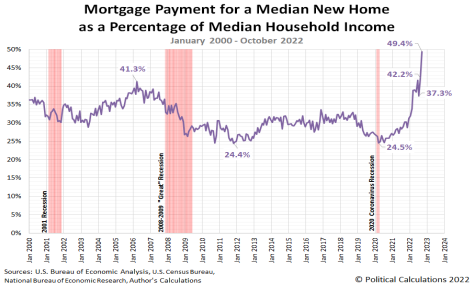
"Love it or List It" is a popular cable show about homeowners deciding to either renovate their house or sell and move to a different home to meet their needs. At the end of each episode, the homeowners decide if the home improvements are enough for them to stay in their current home, or if a new property better suits their needs.

Source: HGTV.com

With that show's theme as a backdrop, let's review the recent housing trends and the long-term implications.

As I have discussed in this space many times sharply, higher mortgage rates along with nose-bleed home prices have decimated the demand for buying a home. Last week, mortgage applications fell 1.9% in the week of December 2. The year-over-year trend is now running at an astonishingly weak -67%. Applications for purchase loans cratered 3%, the sharpest slide since mid-October.

This is hardly surprising as mortgage rates have doubled while median home prices remain elevated. As shown below, the mortgage payment for the median new home in October 2022 would now consume nearly half the monthly income of an American household earning the median income. Simply put, homes have never been this expensive!



THIS WEEK

- AUTO SALES LANGUISH; PRICES SOAR!
- WILL THIS MAKE POWELL HAPPY?
- FROM BOOM TO BUST!
- ARE WE THERE YET?
- INFLATION, IT WAS NICE KNOWING YA!
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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But not all is "doom and gloom" in the housing sector. In fact, there are areas of strength that could be a good investment opportunity.

As home purchase activity has come to a screeching halt, homeowners are spending more on fixing up their homes rather than buying a new one. This is likely more than just a fad due to the number of older homes on the market. Currently about 80% of existing homes are over the age of 20 years old, which of course means more repair and renovations.

This is what Lowes's CEO had to say about home improvement trends:

> ***"The average age of homes in the U.S. is over 40 years old*** *and roughly 3 million more homes built during the housing boom in the mid-2000s, will be entering prime remodeling years by 2025, which is a key inflection point for big-ticket repairs. This is one of the key reasons why* ***two-thirds of home improvement spend is nondiscretionary on repair or maintenance projects that cannot be delayed****." — Marvin Ellison, CEO, Lowe's*

The same theme was reiterated from the top brass at Home Depot:

> *"We're seeing another just interesting dynamic where with mortgage rates increasing,* ***our customer is becoming more and more likely to stay in place and begin a project****." — Richard McPhail, CFO, Home Depot*

So, despite the uncertain economic outlook, this "fixer up" trend has legs. Consider the following two surveys:

- The New York Fed's Survey of Consumer Expectations reported that **plans to move over the next year have dropped 14% — the lowest level on record.**

- A survey from Houzz revealed that more than 50% of homeowners plan to stay in their current house for the next 20 years. Obviously, a big "ouch" for mortgage bankers and brokers. **Nearly 25% respondents plan to start on a home improvement project over the next 12 months with an estimated median spend of $25,000.**

The fixer upper trend can also be seen in October's retail sales report. Spending on building materials was up a whopping 9.5% on a year-over-year basis. September's construction report also revealed that consumers are spending on home improvement at record paces. Spending in this sector has been up around 40% year-over-year for three months now.

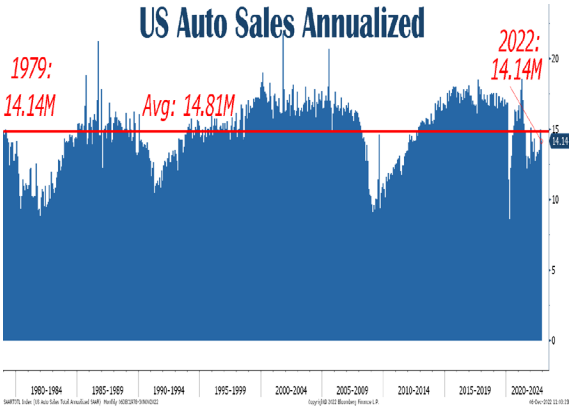
Bottom line: Unaffordable housing, along with a growing inventory of older homes, is pressuring more homeowners to "love it" (renovate their current spaces) rather than "list it" (move). So, tune into the next episode of your favorite home renovation show and look for some smart ways to enhance your home!

Better still, you might want to add a few shares of Home Depot and Lowe's to your investment portfolio.

AUTO SALES LANGUISH; PRICES SOAR!

One number that received scant attention last week was the 6.5% plunge in U.S. auto sales to 14.1 million annualized units in November from 15.1 million in October. In fact, as shown below, new vehicle sales have been a dismal affair for over two decades. Amazingly, auto sales today are no higher than they were 50 years ago!

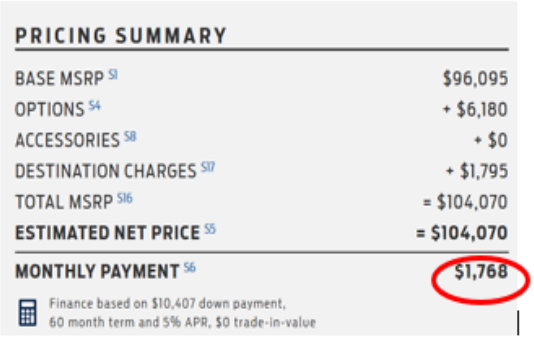
This year was hobbled by supply chain entanglements but there has been a huge thaw in the supply chain. To wit: On a year-over-year basis, shipments are up 16%, inventories are now up 14.7% and production is up 10.8%. This is about a big decline in demand for autos, and for big-ticket items in general, as prices have come unglued — especially those that are interest rate and credit sensitive.



Additionally, pickup trucks have been among the bestselling vehicles in the auto sector and because of the American love affair with pickups, automakers have turned what was a "working" vehicle into an "upscale luxury" vehicle. With upscale and luxury, comes higher sticker prices and much higher profit margins for auto companies. Ford lives and dies by its pickups.

Consider the following example:

A 2023 F-250 Lariat model on Ford's website is listed for $104,070. With a down payment of just over $10,000, and a term of five years, at 5% APR, the monthly payment would be $1,768. Yes, there are people that are buying a pickup truck and paying $1,800 per month!



PRICING SUMMARY	
BASE MSRP [S1]	$96,095
OPTIONS [S4]	+ $6,180
ACCESSORIES [S8]	+ $0
DESTINATION CHARGES [S17]	+ $1,795
TOTAL MSRP [S16]	= $104,070
ESTIMATED NET PRICE [S5]	**= $104,070**
MONTHLY PAYMENT [S6]	**$1,768**

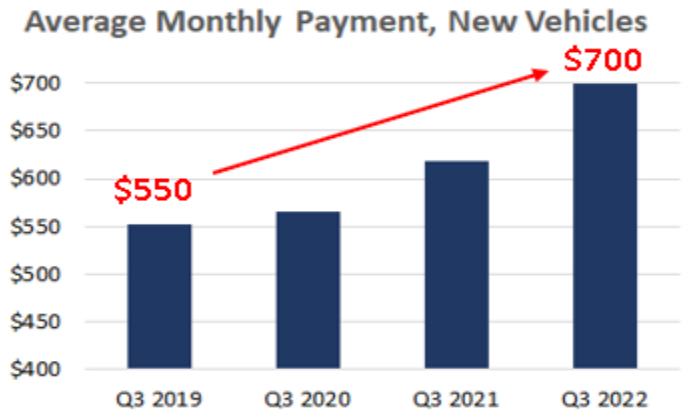
Finance based on $10,407 down payment, 60 month term and 5% APR, $0 trade-in-value

This is Nuts!

Source: Ford Motor

Although not everyone buys a loaded Lariat F-250 pickup, the average monthly payment for the basic F-150 pickup is now $893 a month.

And it's not just pickups. For all new vehicles, over the past 12 months, the average amount financed has risen by 10% to $41,665! Because the vast majority of new vehicles are financed, and as new vehicle loan rates have risen to 5.2%, the average new vehicle loan payment jumped by 13% year-over-year to $700 a month. Since quarter three of 2019, the average payment spiked by 27% (from $550 in 2019).



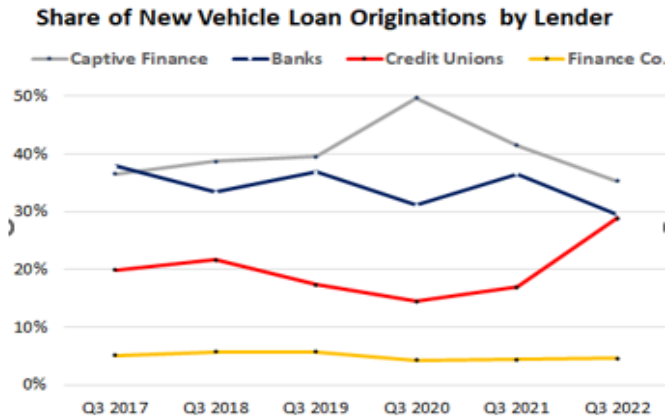
Source Experian

***Sidebar**: The median net worth in the U.S. is around $120,000 or $130,000 right now. If you buy the typical new car for $40,000+ and it depreciates 50% in three years, that's 15%+ of your net worth down the gutter. Do it over your entire working life and it's potentially more than the net worth you will end up with at retirement.*

This type of economic behavior (which is rampant in the U.S.) is Exhibit A why most Americans are much worse off than they could be and will be noticeably poorer later.

As prices rise and finance costs increase, the average loan terms rose to 69.7 months from a year ago. Not surprisingly, buyers with a credit rating of "prime" averaged the shortest loan term (71.2 months), while "subprime" averaged the longest terms (74.2 months). The share of loans with ultra-long loan terms (73-84 months) rose from 28.9% to 34.6% of originations.

Meanwhile, credit unions continue to be the auto lender of choice. As shown in the graph below, in quarter three, credit union originations (red line) rose sharply by 10% to 29% — the highest market share ever! This sharp gain in market share is attributable to credit unions offering below-market financing rates. Meanwhile, banks reduced auto loan originations to 29% (blue line). Automakers' finance divisions ("captive finance") remain the dominant source of financing, but market share has declined from 50% to 35% (gray line).



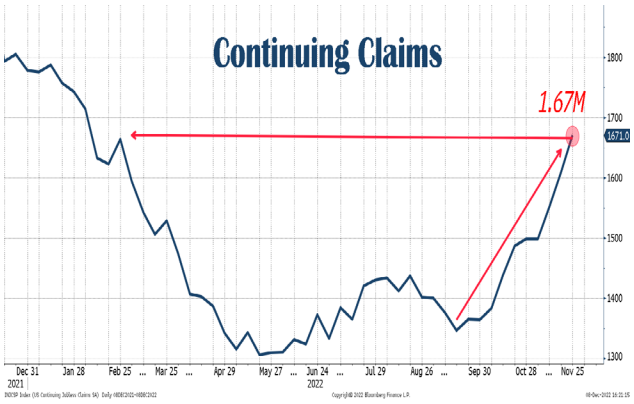
Source: Experian

Bottom line: New auto sales have languished for over 80 years at approximately 14 million units annualized. Moreover, today, auto prices are simply too high, especially at today's rate structure. If the auto industry wants to sell more vehicles, it needs to do some serious thinking about increasing the selection of lower priced autos and trucks.

WILL THIS MAKE POWELL HAPPY?

Some cracks are emerging in the U.S. labor market backdrop, which somehow have already been caught in the ADP numbers, as well as the household employment survey. The non-farm payrolls have proven to be the odd man out, but this often happens at turning points in the cycle.

Last week, initial jobless claims (leading indicator) ticked up to 230,000 in the week of December 3, which is up from 226,000 the prior week. This took the four-week moving average, up for the fourth week in a row, to 230,000 — and the highest level since early September. But it is the ongoing rise in continuing jobless claims that should be a worry for Americans. Continuing claims rose for the tenth straight week to 1.67 million — the largest rise in continuing claims since the peak of the COVID-19 lockdowns in June 2020. Notably, the tech space has been hit hard with close to 90,000 tech workers let go over the course of 2022.

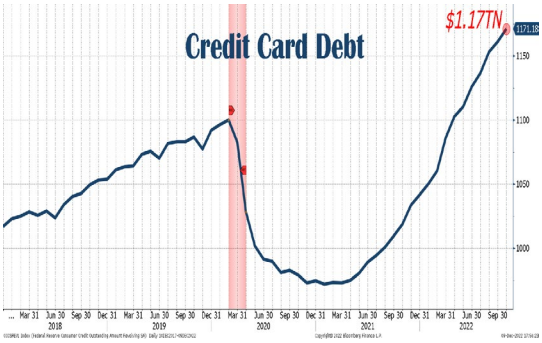


Bottom line: Claims are still historically low, about as low as during the lowest points just before the pandemic, and way lower than anything since the mid-1970s. But it does show that the trend has solidly reversed, some people are having a harder time finding a new job, and so they stay on unemployment insurance a little longer. This is a sign that the labor market is getting a little less tight.

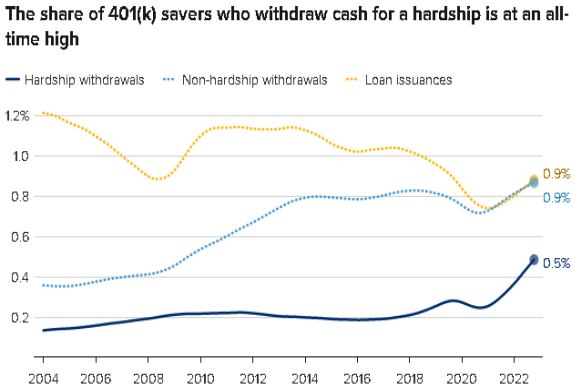
FROM BOOM TO BUST!

Following a decade of no growth in debt in inflation-adjusted terms, real household debt grew at a 4.3% annual rate in the third quarter — the fastest growth since 2007. While we hear constantly that households are still sitting on half of their "excess savings," that is only true among the upper echelons who don't need the money and are unlikely to spend it. Bank accounts and money-market funds are bloated with more than $18 trillion in relatively liquid deposits. But of course, the people who own the debt and the people who have millions in the bank are not the same.

In reality, the low- and middle-income tranches have seen this cushion dry up and are now resorting to "plastic" to buy food. Frankly, it is absolutely incredible that through the first 10 months of 2022, the household sector has tacked on nearly $130 billion of additional credit card debt — at 22% interest rates! This is a huge canary in the coal mine as we are already seeing signs of low default rates beginning to hook up. To say the consumer is living on "borrowed time" and "borrowed money" would be an understatement.



In addition, consumers are dipping into their savings to maintain their living standards. The personal savings rate has fallen to 3.7% of disposable income, after averaging more than 10% for the past 10 years. Some people are resorting to extreme measures to pay the bills. To wit: Roughly 0.5% of workers participating in a 401(k) plan took a "hardship distribution" in October, according to Vanguard. While a relatively small percentage, it's the largest share on record dating to 2004. This is yet another canary in the coal mine. Withdrawing retirement savings should be among the measures of last resort for cash-strapped households.



Source: Vanguard

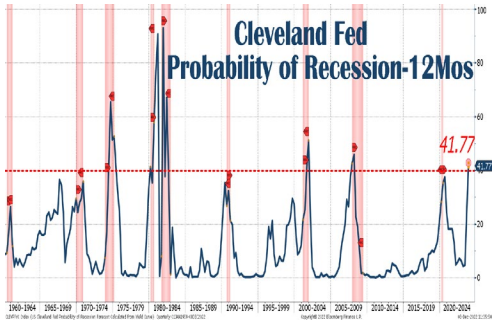
As balance sheets deteriorate and job losses mount, it's no surprise that credit is becoming harder to attain and at a higher cost. The Fed's Beige Book was chock full of signs of lenders pulling back on loans and increasing credit standards. This dynamic, which is likely to continue to build into next year, will add further strain on an already weakening economic backdrop, as business investment and consumer purchases of big-ticket, credit sensitive items (e.g., houses, automobiles, etc.) fall by the wayside.

Bottom line: Consumer debt has soared, and savings have been depleted as consumers try to make ends meet. Higher prices, the 375-basis-point run-up in the Fed funds rate and the soaring cost of credit are now biting hard. With recessionary pressures continuing to mount in the face of the Fed's aggressive hiking campaign, the dominant narrative in 2023 is set to shift towards one of reduced accessibility to credit.

ARE WE THERE YET?

"Expect a recession by the middle of next year…The Fed's monetary tightening will not be as aggressive as expected, but high rates will dampen housing, consumer spending and other sectors, and will force the economy to contract."
— Jeffrey Gundlach, CEO, DoubleLine Capital

The Cleveland Fed's yield curve model shows recession odds having risen to 42% — the highest level since February 2020. Before that, try January 2008. In fact, it is very clear from the chart below that once this metric crosses above 40%, the recession is a done deal and is staring us in the face. Historically, once this moves above 40%, the recession probability moves to a certainty. There is no turning back. To wit: This indicator has presaged a recession eight out of eight times!



**Red shaded areas denote recessions*

We have the most inverted yield curve since 1981 (which was sandwiched between two recessions at the time), and the Conference Board's leading indicator has been down eight months in a row. This makes the recession call as ironclad as any call can possibly be.

"You have to assume that we have some bumpy times ahead…"
— David Solomon, CEO, Goldman Sachs

Meanwhile, Wall Street has cried UNCLE! The CEO of Goldman Sachs, David Solomon, cautioned that the economy faces "bumpy times ahead." JPMorgan Chase CEO, Jamie Dimon, expressed a grimmer view that this would be a "mild to hard recession." Meanwhile, Morgan Stanley Wealth Management's Lisa Shalett said that corporations are facing a "rude awakening" on earnings.

And in the C-suite, the attitude has turned downright gloomy according to the CEO Business Roundtable Economic Outlook Survey for quarter four. The headline outlook index slumped from 84 in quarter three to 73 in quarter four — the lowest reading since the third quarter of 2020. In the year ahead, the real GDP growth expectation was pared to just +1.2% from +2.3% in quarter three, +3.2% in quarter two and +3.9% in quarter one of this year.

Now pundits will say, "Hey, +1.2% isn't a recession, right?" Maybe, but before you celebrate, from 1948 to now, real

GDP growth has been this soft only 18% of the time, and guess what? Each time, these periods of low growth fell into the definition of a National Bureau of Economic Research (NBER) official recession!

Finally, the latest *Wall Street Journal* (WSJ) survey of the economics community shows a 63% probability of recession. The Philadelphia Fed poll shows that real GDP will contract in three of next year's four quarters, which is the direst projection since this series began in 1968. Then I look around and I see that no asset class is fully priced for either of these probabilities.

Bottom line: The recession clouds are clearly darkening with every passing day.

INFLATION, IT WAS NICE KNOWING YA!

*"Well, I believe by the end of next year you **will see much lower inflation if there's not an unanticipated shock**."*
— Janet Yellen, U.S. Treasury Secretary

First, inflation is an "annualized rate of change," not a level. Here's a quick example:

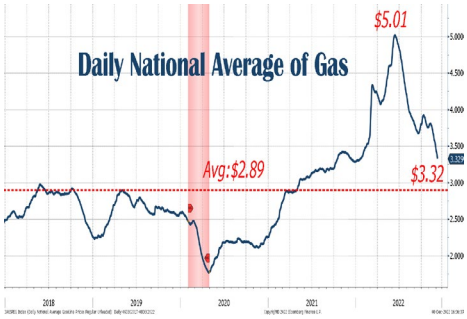
A year ago, a baseball cost $5.00. Twelve months later, it costs $5.50. Thus, baseball inflation was 10%. The following year, the baseball price increases by an additional 10% to $6.05. So, baseball inflation is still only 10% for the past year, although over two years it was 21%.

Now, assume baseball manufacturers increase production, and the price stays the same ($6.05) for the next year. The inflation rate is now 0% even though the price is still up 21% from three years ago.

So, how can anyone still be talking about inflation when commodity prices have peeled off 30% from the 2022 highs? Energy prices have plunged 39%. As shown below, gasoline prices have cratered 30% from the $5+ per gallon highs in June to $3.32 per gallon and cheaper than it was a year ago, even with the war in Ukraine and the Organization of the Petroleum Exporting Countries (OPEC) production cutbacks.

Food prices are still high but have declined 19% from their highs. Base metals are down 26%. Soft commodities, like cotton, have plunged 47%. Textile prices are off 17%.

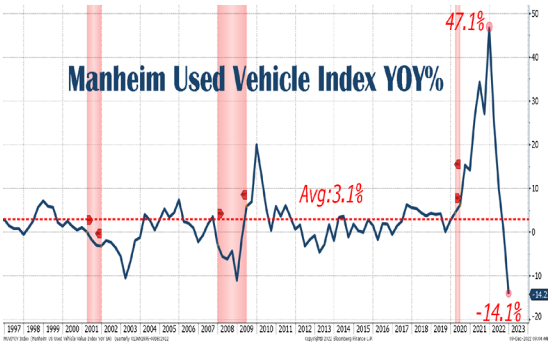
Shipping costs have plunged. Delivery lags, which were very long, have shortened.



**Red shaded areas denote recessions*

Then on top of that, tack on what is happening in the housing market with rents and home prices sagging these past several months as well as pending home sales that are in a tailspin. Realtor.com reported that buyers are balking and forcing the sellers to either cut their prices or de-list. Indeed, I find it tough to square the ongoing inflation narrative with lumber prices that can't stop falling.

This, along with the cooling-off in the used car market, will sow the seeds for a much larger decline in inflation in 2023 than is commonly appreciated.



**Red shaded areas denote recessions*

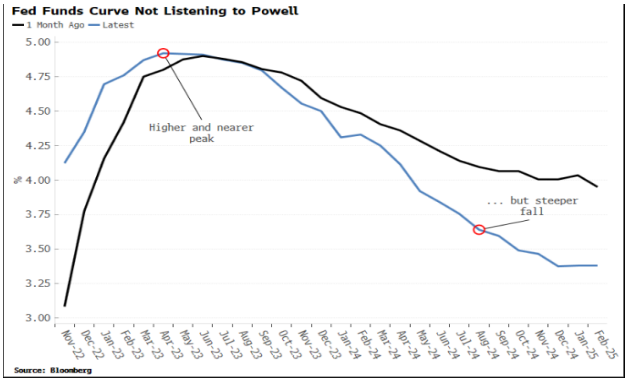
Bottom line: Inflation has peaked. The only question is how far and how fast prices fall.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Fed has been consistent in its messaging over the past few weeks. They intend to slow down the speed of interest rate increases but are expected to keep them higher for longer. The central bank looks set on Wednesday to increase its benchmark rate by 50 basis points in a downshift after four straight 75-basis-point moves to curb inflation. Such a move, widely flagged by officials, would lift rates to a 4.25% to 4.5% target range — the highest level since 2007.

While the message is clear, the bond market isn't buying it. The bond market believes the ongoing rate increases will slow the economy down significantly and at the same time inflationary pressures will dissipate faster than what the Fed believes. In fact, the futures market is pricing in rate cuts starting in the fall of 2023 with over 200 basis points of upcoming Fed rate reductions now priced in over the next 24 months.

Simply put, it's a battle of the inflation versus deflation. The view in markets shows the Fed quickly putting inflation on a path to its 2% goal, possibly with the help of a recession or the long-term secular disinflationary forces that kept prices low for two decades.



So, will inflation continue to soar, will the economy implode or will deflation to take hold and we return to the low inflation experienced during the prior decade?

Since July, the 10-year Treasury yield has been below the 2-year equivalents, creating the widest yield curve inversion since the early 1980s. The 1-year note is inverted with the 10-year note by (3.57-4.72%) 115 basis points. Even the Fed funds rate is inverted with the 30-year long bond. Moreover, the inversions will likely deepen this week. This implies that a recession is coming, assuming it's not already here and the current rate-hiking campaign will be followed by years of cheaper money.

Again, that's not what the Fed is saying:

"I do think we're going to need to keep restrictive policy in place for some time,"
— John Williams, New York Federal Reserve President

"I would expect that to continue through at least next year…History cautions strongly against prematurely loosening policy," — Jerome Powell, Federal Reserve Chairman

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So, who's right? Mr. Bond (long bond, that is) or Jerome? If history is prologue, look for the Fed to pause and then pivot late next year as employment weakens, the economy stalls and inflation declines.

What comes next?

At this week's last policy meeting of 2022, the Fed will release its projections ("dot plots") of how much they expect to raise rates in the coming years, and they could show that many officials expect rates above 5% by late 2023.

But that doesn't mean the markets will believe them.

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.