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INVESTMENT SERVICES

Weekly Relative Value

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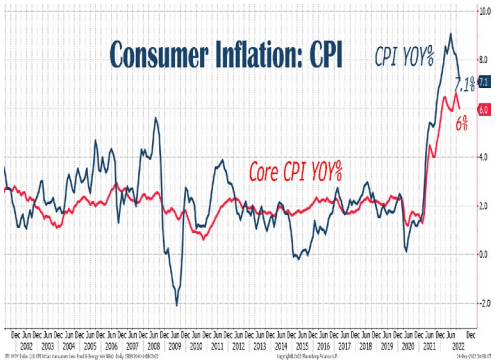
WEEK OF DECEMBER 19, 2022

Driving with the Rear View Mirror

"Meanwhile, the combination of easing supply-chain problems, cooling consumer demand, weakness overseas and many retailers' still swollen inventories should continue to put downward pressure on goods prices. And while there is some worry that rising labor costs could lead to protracted services inflation, services prices excluding rents have eased in each of the past two months." — "Inflation's Cold Case", Wall Street Journal (WSJ)

While still "hot", the year-over-year consumer inflation trend is now trending lower and at the coolest level in 2022. To wit: Instead of the expected +0.3% spikes in the headline and core indices, the metrics rose +0.1% and +0.2%, respectively. For the core personal consumption expenditures (excluding food & energy) composite, the +0.2% increase was the smallest since August 2021. The year-over-year headline inflation rate receded to 7.1% from 7.7% (consensus was 7.3%), and the core went from 6.3% to 6.0% (consensus was 6.1%).



Durable goods Consumer Price Index (CPI) is a real-time price indicator, it plunged 0.9% month-over-month, and this came on the heels of a 0.7% decline in October and the 0.1% dip in September. That's the lagged impact of the U.S. dollar kicking in.

Even restaurants and hotels (reopening trade) are losing price momentum with restaurants flat in November and hotels cutting their rates by 0.7%.

The "goods" component (things you can see, touch and feel) was -0.5% month-over-month after a -0.4% reading in October and flat in September. This represents the weakest three-

THIS WEEK

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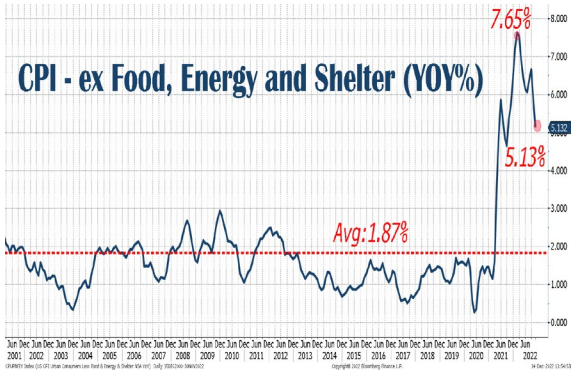
month period since March to May of 2020, when the economy was in full-on pandemic-lockdown recession mode.

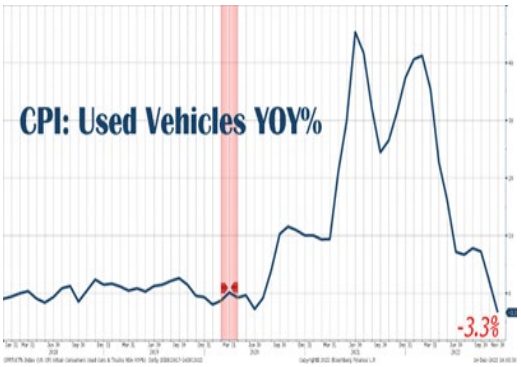
Even with high shelter costs (0.7%), the service sector managed just a +0.3% month-over-month price advance, which was slower than +0.4% in October and +0.8% in September. This is the second most sluggish reading of the year.

Arguably, the best nugget in the report was the CPI that strips out food, energy and shelter. This metric deflated -0.1% for the second month in a row. The last time there were back-to-back declines was in April to May of 2020. Remember what was going on then? Moreover, since 1969, this sub index has only declined for two consecutive months less than 1% of the time. Simply put, this was a 1-in-100 event!



It was also constructive to see lower oil prices filtering through the pricing system. Gasoline prices were -2.0% on the month, utilities were down 0.7% and air fares were down 3.0% (after dropping 1.1% in October).

Meanwhile, as the supply chain issues are being resolved, the former poster children for supply bottlenecks that caused the inflation to begin with, car/truck rentals (-2.4%) and used vehicles (- 2.9%), have now slipped in each of the past five months are now paving the way for deflation.



A CANARY IN THE COAL MINE!

Last week's the *Wall Street Journal* had a very interesting article titled: "The Housing Slowdown Is Wreaking Havoc on the Short-Term Rental Market." If you have not had a chance to read this article, you should take the time and have a look. Frankly, it is amazing how many people levered up to invest in vacation rental properties like Airbnb. It was easy money. Just sit back and collect those rental checks. It is yet another example of the insane speculation in non-

productive assets during the period of free money in 2020 and 2021. Consider the quote below, which rings true to what we have experienced over the post-pandemic economy:

"Liquidate labor, liquidate stocks, liquidate farmers, liquidate real estate. It will purge the rottenness out of the system. High costs of living and high living will come down. People will work harder, live a more moral life. Values will be adjusted, and enterprising people will pick up the wrecks from less competent people."
— Andrew Mellon, Former U.S. Secretary of the Treasury

As an aside, is it possible to introduce this notion of thrift, discipline, morality and a hard work ethic into today's "early retirement/bucket list" narcissistic society? Doubtful. It could prompt a lawsuit!

Anyways, times have changed. The rental investment space is now imploding as inventory skyrockets while demand is waning. In the past year, the supply of available short-term rental listings has ballooned 23%!

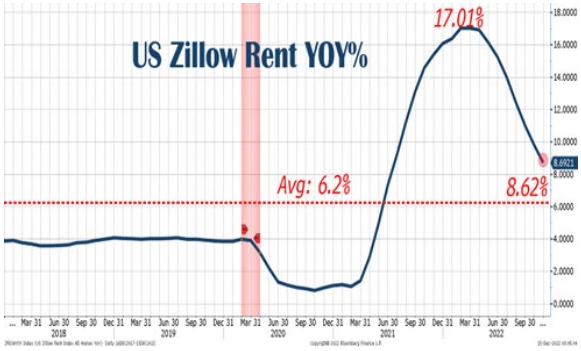
Take for example Sabrina Must who bought and then rented her two-bedroom, one-bathroom property in Encinitas, California on Airbnb. In the height of the pandemic, Ms. Must could rent her home for more than $1,000 per night, but now her rates have plunged to around $275.

"I've felt a massive drop…I am so beyond stressed by it." – Sabrina Must, Airbnb Host

At the peak, there was between 80,000 and 88,000 of these units being added to the market per month! Now, booking rates are contracting at an average of 6%. There are no more new buyers. This is another canary in the coal mine — the one bird we should always have tremendous respect for.

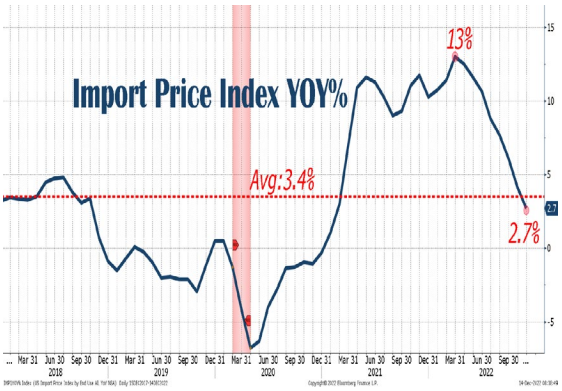
As I have highlighted in the past, the same thing is happening in the apartment space. Multi-family starts and completions have skyrocketed 18%. Units under construction, still to yet hit the market, have soared 26%. At the same time, the demand for rental units is running at just over 4%! Not surprisingly, the nationwide apartment vacancy rate in quarter three rose to 6.0% from 5.6%. This likely just the beginning of higher vacancy rates to come.

Meanwhile, Zillow reported that rental rates fell -0.4% in November — the largest month-over-month drop. The slowdown in rents isn't yet showing up in the monthly CPI inflation data because the Zillow data only covers new rental contracts while CPI captures rents more broadly. In other words, there is a lag before the CPI data reflects this deceleration. But it's on the way!



ANOTHER DEFLATIONARY SIGN

We received more deflationary data last week in the form of a -0.6% month-over-month print in November import prices, the fifth straight decline. We haven't seen five months of decline in nearly eight years! The year-over-year headline slowed nicely to +2.7% from +4.1% as the downward trajectory gains momentum. Did you know that import price inflation has a near-80% correlation to headline inflation?



Bottom Line: As we all learned in Economics 101, more supply and less demand means lower prices. Yet, all I hear is that service sector pricing is going to be "sticky" to the downside. Really? Are these people oblivious to what is about to happen with residential rents? Rents and shelter costs are the key to the inflation narrative because shelter/rental costs represent 30% of the CPI and 40% of the core. There is strong evidence of falling shelter inflation even though it has not yet shown up in the CPI.

Likewise, import prices have plunged to only 2.7% and below the 5-year average of 3.4%. This is all quite positive for the "peak" inflation narrative. Meanwhile, the Fed continues to make monetary policy decisions using the rear-view mirror — justifying their actions on what has happened in the past versus where inflation is heading in the future.

HIGHER FOR LONGER?

"While it was good to see inflation come down these last two months, the Fed will need to see a few more signs over a longer time frame that inflation is under control before a full pivot. Fed hikes and volatility have been central themes of 2022, and investors should expect both–along with hits to corporate earnings — as we enter the new year."
— Jerome Powell, Federal Reserve Chairman

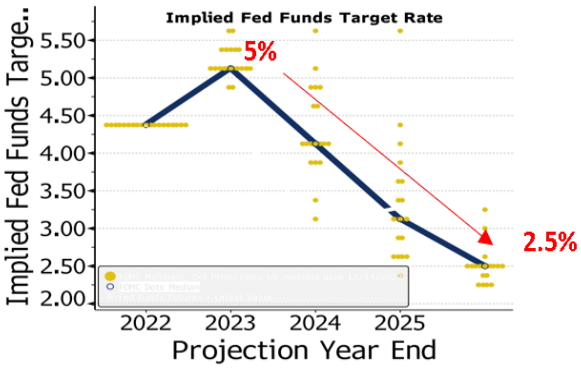
Despite key inflation drivers (housing, goods and services) all pointing in a downward direction, the Fed continued their uber-hawkish ways and hiked rates by 50 basis points to 4.25% to 4.5%, as expected. Since this rate hike cycle started in March, the Fed has raised its policy rates by 425 basis points — unimaginable earlier this year.

When asked by a journalist at the post Federal Open Market Committee (FOMC) rate announcement presser whether rate cuts were on the horizon, Powell answered simply: "No."

In addition, Powell said the following:

"We are taking forceful steps to moderate demand so that it comes into better alignment with supply…Reducing inflation is likely to require a sustained period of below trend growth…We will stay the course until the job is done."

Moreover, the "dot" plot showed that the median "terminal" (peak) funds rate projection for 2023 is now 5-1/8% from 4-5/8% back in September. 17 of the 19 FOMC participants are north of 5% compared with none three months ago. Five are at 5.4% and two are at 5.63%, with one staying there through 2025. The central bank is saying that we are into a period of "higher for longer" despite market pricing to the opposite.



Bottom line: The bond gods are saying: "Jerome, you're dead wrong!" The futures market still has two rate cuts priced in by the end of 2023 even as the dot plots said, "no pause." Here's something to think about: The yield on the 10-year note was 3.54% at the time of the FOMC press release, and it closed at 3.54 on Friday. Moreover, we have seen Treasury yields decline by approximately 100 basis points to the lowest level in three months. Point being, the bond market rarely gets the macro call wrong.

And why shouldn't the markets be playing chicken with the Fed? After all, this is the same Fed that in December 2021, just a year ago, was telling us per the median dot plot that the Fed Funds rate as of today would be 0.9%. Where is it instead? Try 4% plus. And keep in mind that the Powell Fed in December 2018 had the median dot plot at 2.9% twelve months out, instead of what we got, which was 1.625%.

So please, let's not treat these Fed projections as anything more than that. These so called "dot plots" are nothing but "guesses" and have a history of being horribly wrong.

KEY TAKEAWAYS!

Here a couple of key takeaways from the Fed statement. The Fed seems to be getting more anxious over a future of stagflation. The gross domestic product (GDP) revision to the upside for 2022 to 0.5% from 0.2% was basically a mark-to-market exercise. However, 2023 was cut significantly to 0.5% from 1.2%; and 2024 was trimmed to 1.6% from 1.7%. That is otherwise known as stall-speed and historically, in tightening cycles, you go from there to contraction.

The jobless rate is now seen touching 4.6% next year instead of 4.4%. There has never been a time when the unemployment rate rose more than a full percentage point from the lows without the economy being in recession.

Finally, despite recent downside surprises to CPI over the past couple of months, the FOMC meaningfully raised its headline and core inflation projection for next year and 2024. Notably, a majority of FOMC participants now see core PCE decelerating to 3.5% at the end of 2023. This is significantly higher than the projection of 3.1% in the September forecast. The Fed's 2% target isn't seen as being achieved until 2025!

By the way, I have no idea how inflation manages to surpass prior expectations with growth lower and unemployment higher. But hey, I don't have a PhD.

Oh, and as for the Fed's forecasting prowess try this on for size: In June 2008, the Fed was predicting that inflation would be 2.35%. Instead, it was -1%.

Consider the following excerpt from the transcript in answer to whether he would consider raising the inflation target a la scared Europeans:

"Forget this nonsense about changing the 2% inflation target…Changing our inflation goal is something we're not thinking about. It's not something we're going to think about. We have a 2% inflation goal, and we'll use our tools to get inflation back to 2%."

"The committee – we're not considering that and are not going to consider that under any circumstances. We're going to keep our inflation target at 2% and use our tools to get inflation back to 2%."

— Jerome Powell, Federal Reserve Chairman

When asked at his post-decision press conference whether he believes it's no longer possible to engineer a so-called soft-landing, shorthand for inflation easing without a sharp rise in unemployment, this is what Powell had this to say:

"I just don't think anyone knows whether we're going to have recession or not — and if we do, whether it's going to be a deep one or not. It's just...It's not knowable." — Jerome Powell, Federal Reserve Chairman

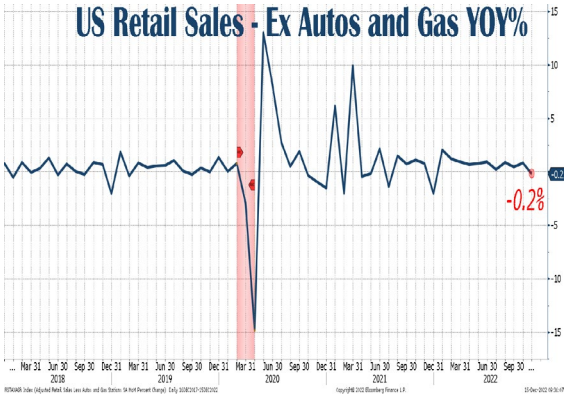
Bottom Line: The Fed is expecting growth to fall to 0.5% next year and unemployment increases to 4.6% which is hard if not impossible to reconcile with an environment of continued wage gains driving services inflation higher. Regardless, the Fed controls the monetary levers and is telling us that it intends to hike rates more than 250 basis points above neutral (still at 2.5%), taking out the 2006 to 2007 high and the highest gap since 1999 to 2000. As I see it, the Fed just put a bullseye on the forehead of the economy.

IS THE CONSUMER SPENT?

"I just think we are headed toward a recession, and it could be a pretty big one…Interest rates are skyrocketing and that's going to take us down." — David Rennie, a 61-year-old Retired Executive

In the wake of auto sales sliding 6% in November (-6.0%) and the Johnson Redbook chain store sales index weakening (-2.9%), the stage was set for an increased recognition that the consumer is spent. Indeed, retail sales notably disappointed in November. Against expectations of a 0.2% month-over-month drop, U.S. retail sales tumbled 0.6% month-over-month, the weakest since last December. Core retail sales dropped 0.2% month-over-month, notably worse than the +0.2% month-over-month expected.

Nine of thirteen retail categories fell last month, including electronics, furniture and building materials stores. Vehicle sales also declined, due in part to a drop in the prices of used cars and trucks. The value of sales at gasoline stations were down 0.1% as pump prices fell. Sales at restaurants and bars, the only service-sector category in the report, rose 0.9% in November, the fourth straight increase.



Bottom line: Various state stimulus programs coupled with significant price discounting over the past month has brought forward spending activity to such an extent that the consumer isn't showing up any longer. Now just wait until the credit card bills come due in early 2023 and the retailers are still stuck with a ton of excess inventory.

As the consumer goes, so goes the economy.

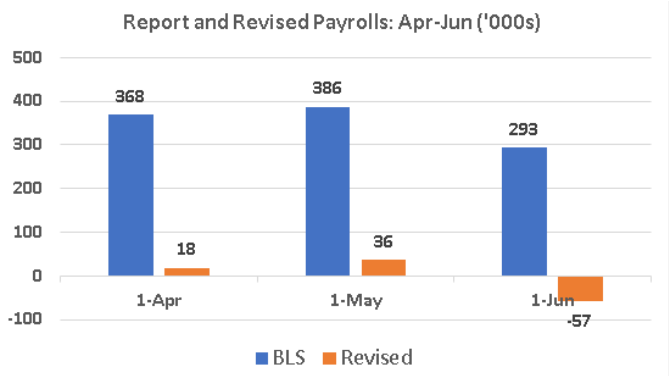
NOT AS STRONG AS EXPECTED

The Bureau of Labor Statistics (BLS) monthly jobs report is timely but inaccurate, and grossly inaccurate at turns. Nonetheless, economic cheerleaders tout the monthly data put as the gospel truth!

Last week, the Federal Reserve Bank of Philadelphia released benchmark estimates of monthly state payroll employment on a quarterly basis to predict the subsequent annual benchmark revisions by the Bureau of Labor Statistics.

Their revisions indicate that the employment changes from March through June 2022 were significantly lower than the BLS report showed. In aggregate, 10,500 net new jobs were added versus the BLS estimate growth of 1,047,000 jobs for the period. In other words, the Philadelphia Fed revised jobs lower by 1.04 million for quarter two.

Still think the Fed would be hiking 75 basis points this summer if instead of an average monthly job gain of 350,000, Powell was seeing zero monthly payroll increases?



Source: Federal Reserve Bank of Philadelphia

And then consider the following from the Philadelphia Fed:

> *"If payroll job growth did shift to a markedly slower pace during the second quarter of the year as interest rates were raised to counter high inflation, our Early Benchmark process should note larger downward revisions in December 2022. Not until February 2024—with the incorporation of the March 2023 benchmarks—will the BLS estimates offer a full accounting of U.S. employment for the bulk of 2022.* ***Unfortunately, our Early Benchmarks lag the moments when critical policy deliberations are made, but they do offer earlier confirmation of apparent shifts in recent payroll job trends. And pervasive, persistent, and deep downward revisions may presage the National Bureau of Economic Research's (NBER) declaration of a recession****."*

Finally, the Fed made it clear that it is no longer focused purely on inflation numbers (which are sliding fast anyway) but will also be looking at clearly wrong jobs data. How long until the Fed makes it a point that the U.S. labor market is in far worse shape, it is in fact contracting, than it was when it decided to hike 75 basis points several times in a row?

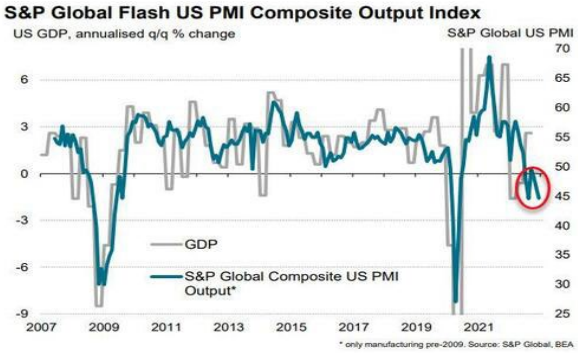
Bottom Line: For months on end, we heard an endless stream of "jobs are too strong for there to be a recession," despite the known fact that jobs are a lagging indicator and the Household Report showed labor weakness.

SURVEY SAYS…

> *"Business conditions are worsening as 2022 draws to a close, with a steep fall in the Purchasing Manager's Index (PMI) indicative of GDP contracting in the fourth quarter at an annualized rate of around 1.5%. Jobs growth has meanwhile slowed to a crawl as firms across both manufacturing and services take a much more cautious approach to hiring amid the slump in customer demand."*
> *— Chris Williamson, Chief Business Economist, S&P Global Market Intelligence*

After tumbling to their lowest since the COVID-19 lockdown collapse, S&P Global's PMI surveys saw further, notable deterioration. U.S. Manufacturing PMI dropped from 47.7 to 46.2 (contraction). U.S. Services PMI dropped from 46.2 to 44.4 (contraction), below the expected 46.5. The U.S. Composite Index fell to 44.6 (contraction), which is its lowest since May 2020. The last time PMIs fell to this level, things got ugly fast.

A gauge of new orders at manufacturers slipped further into contraction, falling to its lowest level since May 2020. New business at service providers also shrank by the most since the early months of the COVID-19 pandemic.



ANXIETY RISES

"The anxiety index often goes up just before recessions begin." – Philadelphia Federal Reserve

The Philadelphia Fed's Survey of Professional Forecasters provides a metric called the "Anxious Index" (chance of real GDP decline next quarter). Forecasters now believe that there is a 47.2% probability that real GDP will fall in quarter one of 2023. Looking two quarters ahead, the index sits at an alarming 49.4%. The last time this metric was this high was during the Global Financial Crisis. In fact, when this metric breaks the 40% barrier, the economy is in a recession (12 for 12 back to 1968).

The outlook for the second half of 2023 didn't fare any better. The chance of contraction in quarter three of 2023 is 46.1%, and 43.5% for quarter four of 2023. Both are record highs! So, if you are stressing about the holidays, or are feeling anxious about the year to come, know that many at the Survey of Professional Forecasters are in the same boat. Misery loves company!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

We never know where we're going, but we ought to know where we are.

We know for a fact that the first and second quarters of 2022 in real GDP contacted -1.1% at an annual rate. This only happens in NBER-defined recessions, as an aside.

We also know the yield curve is single most accurate metric for forecasting growth and inflation. Today, it is the most inverted it has been since the 1980s. Since 1986, every yield curve inversion has been followed by a recession. Moreover, the Fed continues to tighten aggressively, and we haven't even seen the full extent of the policy lags of what the Fed has already done because that is going to show up in full force in 2023.

Moving on. Housing, which historically leads the economy into and out of recessions, is in the basement.

In the C-suite, companies are in a pessimistic mood which does not bode well for investment and employment going forward.

Most importantly, consumers have blown their wad and are now relying on credit cards to maintain their lifestyle. When you hear that 65% of Americans are living paycheck to paycheck, what more needs to be said.

Sidenote: Many people argue that because the unemployment rate is so low — and it is — we can avoid a recession. Remember unemployment is a lagging indicator and typically reached extremely low levels just when the economic cycle changes. Here's a bit of history. In February 2020, the unemployment rate was only 3.5%. In May 2007, the U-3 rate was only 4.4% and in April 2020 the unemployment rate was 3.8%. Indeed, unemployment rates were crazy low levels — until they weren't. In fact, each time these lows marked the end of the cycle. And each cycle ended because of the heavy hand of the Federal Reserve. So, unfortunately it isn't different this time. Recession comes. Disinflation or even deflation follow suit.

Bottom line: There is no "get out of jail free" card with the Fed tightening policy this aggressively, hiking substantially into the most inverted yield curve since the Volcker era of the early 1980s. While there are no guarantees in this business, a recession in 2023 is a high probability scenario. If so, inflation will be yesterday's story and interest rates will decline.

Then the sun will rise, and an economic recovery will commence.

HAPPY HOLIDAYS TO ALL!

I am so grateful to have had the privilege of writing about the economy, markets and then sharing my thoughts with all of you every Monday morning. Believe it or not, the first edition of the "Weekly Relative Value" was published in 2008. Amazingly this marks my fourteenth year of writing this weekly missive. To me this is a labor of love. I truly hope to be writing until at least the end of this decade. Since the beginning I have tried to base my views on the "facts" and tell the story in an unbiased manner. Unquestionably, there are many opinions on the economy and markets, but I truly hope that I have added some unique insights along the way that have helped readers steer their way through the confounding economic and market puzzle we find ourselves in.

In looking back over the past year, 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 the Fed would be hiking interest rates at the fastest pace in history and Treasury yields would post the worst return since 1788! But it all happened.

As we look forward, the one thing I have learned over 40-plus years analyzing the economy and trading markets is not to extrapolate today's environment into the future. Things can change fast and amazingly fast, and when it is least expected. So, with that said, if next year is anything like the past two years, 2023 is going to be another year of twists and turns. I look forward to being there with you every week.

And with that, I will hit the final send button for 2022.

On behalf of the Alloya team, I wish you the best for the holiday season and all good things for 2023.

Warm regards,

Tom Slefinger

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.

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