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INVESTMENT SERVICES

Weekly Relative Value

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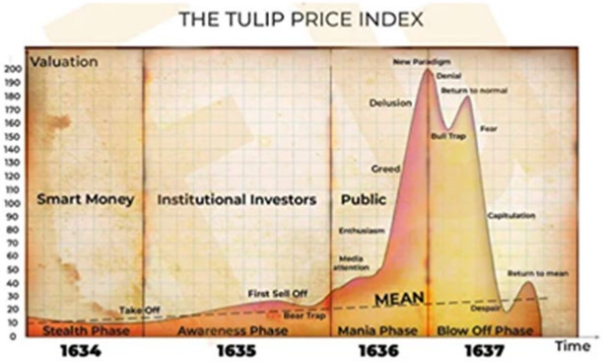
Extraordinary Popular Delusions

"Men, it has been well said, think in herds; it will be seen that they go mad in herds, while they only recover their senses slowly, and one by one…"
— Charles Mackay, "Extraordinary Popular Delusions and the Madness of Crowds"

Long before Alan Greenspan, "Maestro", spoke the words, "irrational exuberance" to describe the tech bubble, Charles Mackay had written his masterpiece "Extraordinary Popular Delusions and the Madness of Crowds." The book centers around "Tulipmania", which is one of the most well-known speculative bubbles in history.



Source: Finance Geek

It started in 1634, when the popularity of the tulip bulbs (a status symbol) and the price of tulips increased 12-fold. According to Mackay, during this bubble, speculators from all walks of life bought and sold tulip bulbs, and even futures contracts. Allegedly, some tulip bulbs briefly became the most expensive objects in the world trading for more than $750,000 in today's money.

Then the mania ended. In February 1637, prices began to fall and never looked back. The sharp decline was driven by the fact that people initially purchased bulbs on credit, hoping to repay when they sold their bulbs for a profit. However, as prices began to decline, holders were forced to sell their bulbs at any price and to declare bankruptcy in the process. By 1638, tulip bulb prices were back to normal. When all was said and done, Tulipmania was a case of the "greater fool" theory. Bulbs were worth only as much as someone was willing to pay.

THIS WEEK

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But it wasn't just Tulipmania. Mackay describes many other popular delusions *experienced* over many periods. Mackay's tour de force is a guide to human gullibility, irrational expectations and excessive greed, which continues to this day.

BACK TO THE FUTURE

"Clearly, sustained low inflation implies less uncertainty about the future, and lower risk premiums imply higher prices of stocks and other earning assets. We can see that in the inverse relationship exhibited by price/earnings ratios and the rate of inflation in the past. ***But how do we know when irrational exuberance has unduly escalated asset values, which then become subject to unexpected and prolonged contractions as they have in Japan over the past decade."*** *— Alan Greenspan,Former Federal Reserve Chairman*

In 2008, the Federal Reserve, in a desperate attempt to help the U.S. economy recover from the Great Financial Crisis, pushed interest rates near zero and kept them there for 13 years! In addition to near zero interest rates, the Fed initiated quantitative easing (QE) which created trillions of dollars out of thin air and pumped it into the financial system.

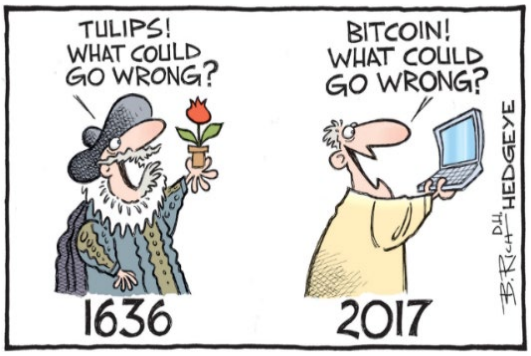
All of this new money had to go somewhere, but it did not end up in the real economy. Rather most of this free money ended up in asset prices creating the "everything bubble". There were a few voices that were warning that all of this excessive speculation and foolishness would end very badly. However, those voices were mostly drowned out by the Wall Street shills, promoters and asset gatherers, who created new narratives and schemes. Investors bought into the "new, new, thing" hook line and sinker. As long as free money was flowing, asset prices continued to keep rising to ever more ridiculous levels. The Fed had essentially created the ultimate "get rich quick scheme" and countless Americans were more than happy to take advantage of it. Indeed, it worked until it didn't!

THE RISE AND FALL OF CRYPTO

*"When we look at Bitcoin's potential, we segment it across several use cases — everything from it competing as a digital store of value, to a settlement network, to an insurance policy against arbitrary asset seizure…****When you stack every use case one on top of another, you come to about a 28 trillion-dollar opportunity, which translates to more than a million dollars per Bitcoin****. — Yassine Elmandjra, Crypto Analyst, Ark Investment Management*

Arguably, the most spectacular creation of the money-printing era was crypto. It started with Bitcoin in early 2009, just after the Fed's money-printing got started. Bitcoin was the new digital currency and would replace the U.S. dollar and all fiat currencies. Yet, despite years of effort, nobody has yet managed to find any serious use for cryptocurrency other than money laundering. Nonetheless, prices soared on the hype and hoopla, and are still being sustained by a hard-core

group of true believers. Now there are over 22,000 cryptos, and everyone and their dog is creating them, trading them and lending them. The market capitalization of cryptos reached $3 trillion, trillion with a T, about a year ago.



Then as inflation soared out of control, the Fed started raising its interest rates and reducing liquidity via quantitative tightening (QT) — the whole space imploded. Indeed, it has been annus horribilis as Bitcoin, the granddaddy of the crypto world, plunged 73% from the peak. If you're one of those people who bought Bitcoin or another cryptocurrency near its peak last fall, you've lost a lot of money. More than two trillion dollars of "crypto wealth" has already been wiped out. Less than a trillion is left. But the party was fun while it lasted, right? Short-term gain, long-term pain. Like Tulipmania, the Bitcoin euphoria was driven by consensual delusion and human gullibility; aided and abetted by free money. There were no fundamentals to support the meteoric rise; just another case of the "greater fool" theory.

**Red shaded areas denote recessions*

THE STOCK MARKET BUBBLE BURSTS

***"This has been a train crash waiting to come…Now, money has a cost**. You can't just throw money at unprofitable businesses, very risky businesses. **We need to have a much more sensible allocation of capital**."*
– Alexandra Morris, Chief Investment Officer at Norway's Skagen Funds

Then came the initial public offering (IPO) mania of many "profitless tech" and "concept companies", which were aggressively promoted as "disruptors". These companies were losing money hand over fist, and yet they shot higher on a wing and a prayer and nothing more.

But you have to hand it to the "geniuses" on Wall Street. In 2021, the spinmeisters on Wall Street created 400 IPOs — the most since 2000 — to raise $142 billion, the most ever, according to Renaissance Capital.

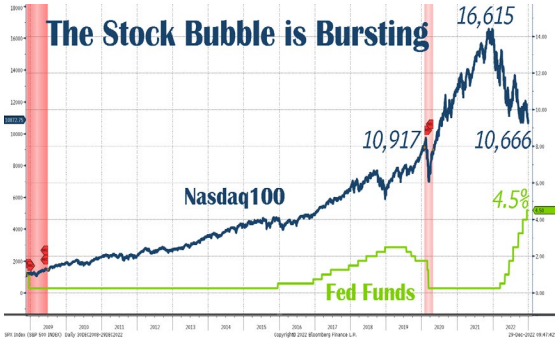
"What we learn from history is that people don't learn from history."
– Warren Buffet, Chairperson, Berkshire Hathaway

As shown graphically below, the Renaissance Capital IPO exchange-traded funds (ETF) peaked on February 16, 2021 at $76.18, and has since then plunged by 68%, wiping out over five years of gains. Lots of these once highflying startups have since collapsed by 70% to over 90% within the past couple of years. Some are now heading towards bankruptcy. Some already have turned out the lights.

**Red shaded areas denote recessions*

The past decade of free money has given rise to all kinds of mindboggling financial nonsense, supported by convoluted rationalizations and silly theories that didn't have a leg to stand on. This mania was further fueled by young naïve Wall Street analysts who did not experience the Dotcom Bubble. Remember Pets.com? Instead, "this time was different" because these pipe dreams were just so much more fun — and earned much bigger fees — than dealing with sordid reality.

But it wasn't just the speculative stocks. Real companies with real business models and real incomes were grossly over inflated and they too have hit the skids. To wit: The Nasdaq more than tripled in the 6.5 years between May 2015 and its peak in November 2021. This was an insane move, that is now beginning to be unwound.



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The Nasdaq composite index has plunged by 34% from its high last November (the worst year for U.S. stocks since 2008 in percentage terms). The tech laden Nasdaq 100 declined over 60% from its high in February 2021 erasing over $7 trillion in market capital.

Many of the bellwether tech stocks have plunged by 50% or 60% from their money-printing highs, including Microsoft (-31%), Amazon (-50%), Meta, the former Facebook, (-64%), Google (-41%), Apple (-28%) and many others. The whole circus is coming apart as rates have surged and liquidity has tightened.

The poster child of the stock mania was no other than Elon Musk and Tesla. In many ways, Tesla was similar to what happened with Bitcoin even though the company does actually make useful things.

Take a look at the graph below. The share price of Tesla blasted from $26 to $412 in less than 2 years. The market cap soared from $75 billion to over $1 trillion and became one of the most valuable companies in America. It was fun while it lasted. It has since lost more than $700 billion (70%) of its value in just over a year.

Frankly, it's hard to explain the huge valuation the market put on Tesla before the drop, or even its current value. Electric cars may well be the future of personal transportation. In fact, they had better be, since electrification of everything, powered by renewable energy, is the only plausible way to avoid climate catastrophe. But it's hard to see what would give Tesla a long-term lock on the electric vehicle business. After all, to be that valuable, Tesla would have to generate huge profits, not just for a few years, but in a way that could be expected to continue for many years to come.

**Red shaded areas denote recessions*

Today, Tesla is no longer alone and has steep competition coming from the U.S. and global major car manufacturers moving into the electric vehicle business. This will quickly make electric cars so common that Tesla no longer seem special.

Which begs the question of why Tesla was ever worth so much. The answer, as best as I can tell, is that investors were mesmerized by the second coming of Thomas Edison despite the absence of a good argument about how this guy, even if he really was who he appeared to be, could build a long-lived money machine.

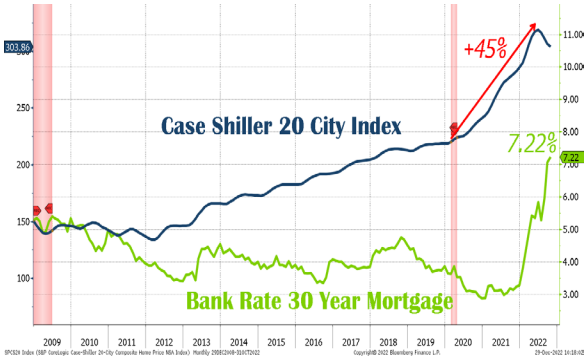
HOUSING BUBBLE #2

"Well, I guess I don't buy your premise. It's a pretty unlikely possibility. ***We've never had a decline in house prices on a nationwide basis. So, what I think is more likely is that house prices will slow, maybe stabilize****: might slow consumption spending a bit. I don't think it's going to drive the economy too far from its full employment path, though."* — Ben Bernanke, *Former Federal Reserve President*

Then there's residential real estate. We had a ridiculous bubble during the money-printing and near zero interest rate era. In some markets, home prices spiked by 50%, 60% or more in just two years! The whole world went bananas. Mass delusion was everywhere.

Ah, but this party is now over. Mortgage rates are near 7% which will not work with these over inflated house prices. In fact, over the past four months, from June to October 2022, U.S. median house prices dropped a remarkable 8.4%, with prices declining from their peak in all 60 of the largest metropolitan areas in the country. In October, sales of existing houses declined for the ninth month in a row and were down 28% from a year earlier. In spite of these rapid rates of decline, house prices in are still at crazy and unsustainably high levels.

Last week, the S&P CoreLogic Case-Shiller Home Price Index for "October" was released. This index covers 20 metropolitan area. On a month-to-month basis, house prices dropped again in all 20 metros. And some of the more ebullient markets have been smoked. For example, in the city of San Francisco, one of the formerly most expensive and hot housing markets in the US, the median house price has now plunged by 27% from the peak in April. That's a huge drop in a short time.



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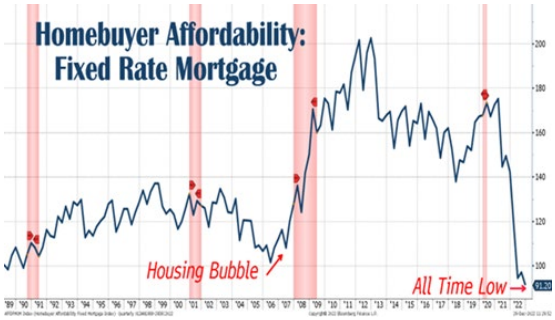
As I've noted before, it's also important to stress that the Case Shiller index is a three-month moving average of closed home sales in August, September and October. Most of these deals were made in July through September. So, this index lags three to four months behind what is happening in the real world. And we know, based on many surveys, that home prices nationwide have continued to decline.

Given the nosebleed house prices along with the highest mortgage rates in 20 years, it's no wonder applications for a mortgage to buy a house are down 42% from last year. As shown below homes have never been less affordable!



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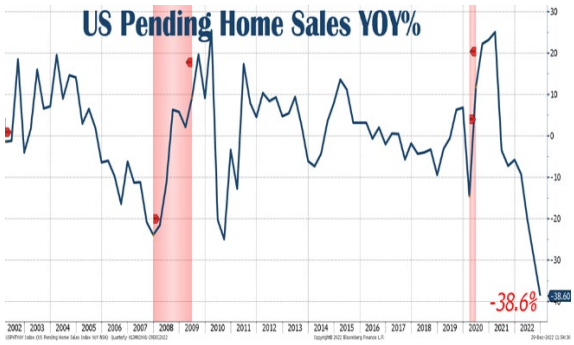
And last week there was more bad news. Pending home sales —one of the best leading indicators for where the housing market is going next — slumped 4.0% in November. This was the sixth straight month-over-month decline in this

predictive sales indicator and was down in twelve of the past thirteen months. On a year-over-year basis, contract signings are now down an incredible 38.6%!

Given the Fed's posture and threat to raise rates further, record lows in the near future are likely.



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Something has to give. With interest rates so high, very few people want to or can afford to buy homes right now.

"Price declines are just starting, and recent weakness probably has far to go." – Gary Shilling

Unless the Fed reverts back to free money and QE (doubtful), home prices have to drop. A lot!

It is only ten years since 2012, the year house prices stopped falling in the U.S., and formed the trough of the painful housing bust of 2006-2007. Back then, the so-called experts said that housing prices could not deflate on a national basis because of the size and diversity of the U.S. economy. Now that was a big OOPS! During the 2006-2007 housing bubble, the national average of house prices fell 27%, thus reminding us that house prices can go both up and down, perhaps by a lot.

Despite this painful lesson, we find ourselves caught up in the second housing bubble. Why? Because when large numbers of people believe house prices cannot fall, especially when they are emboldened by central bank behavior, it makes it more probable that the prices will ultimately fall.

Regardless, there is now a sea-change in the real estate market. And it's not pretty. The second great housing bubble of this still young century is over, and a new phase has begun. But the bubble is so huge, fueled by money-printing and interest rate repression, that the deflation of this bubble will likely be messy and uncomfortable.

How much further can house prices fall from here? No one knows for sure. Unlike stocks and bonds there is no way to quantify what a house is worth. A house price is a function of human expectations, hopes and fears. However, based on many metrics (i.e., home prices to income or home prices to rent) prices could easily fall 10% to 15% or more during 2023. That would wipe out a lot of housing wealth that the bubble made people think they had, a reduction of perhaps $4 or $5 trillion of perceived wealth, on top of the $3 trillion lost so far this year. It would put many houses bought near the top of the market, into no or negative owner's equity.

Bottom line: All of these assets, from crypto to housing to stocks, that money-printing and near zero interest rates gave rise to must have continued money-printing and interest-rate repression to exist, but the opposite is happening. We have soaring interest rates and the opposite of money-printing, QT.

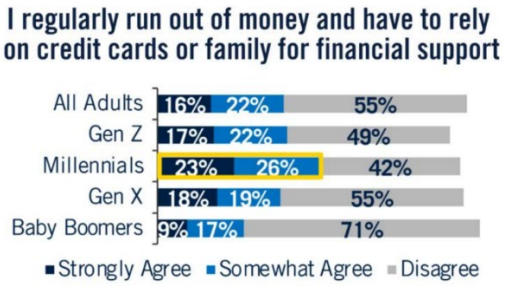
MARKET OUTLOOK AND PORTFOLIO STRATEGY

As we jump into the new year, there are few growth catalysts.

First and foremost, consumption represents 70% of economic growth so as the consumer goes so goes the economy. And as we start the new year, the health of the consumer is a big question mark. The low-income households will continue to be pressured the most. Consider that food, energy and shelter make up 62% of the lowest income Americans' expenditures (that's 12 % higher than the wealthiest Americans). So, while prices at the grocery store and rent remains high and sticky, on a relative basis, the least able to afford it get hit the most.

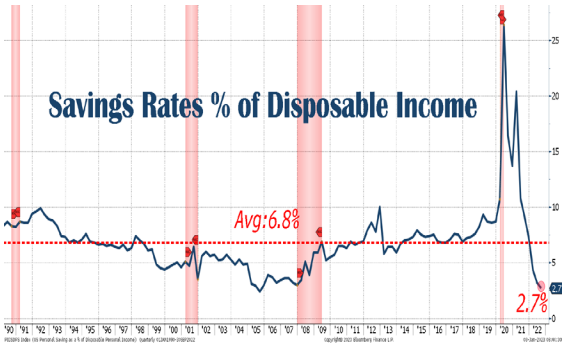
But 2023 may play out as the "high income" hit year. The wealth effect is taking a toll, but more importantly this part of the work force seems to be facing the brunt of recent layoffs. Bear in mind, the huge layoff announcements we have seen of late in both the technology and financial sectors have yet to show through in the payroll data. As such this year won't be about the number of jobs lost, but it will be a function of the number of jobs lost multiplied by the average income (which could be surprisingly high). That is coming our way soon. Overall jobs appear plentiful in certain segments of the economy (though that could tail off too), but it will be a combination of job fears coupled with the wealth effect that will make the consumer seem much weaker in 2023 than in 2022.

As an aside, consider the following graphic from Prudential Pulse Survey, which finds large percentages of millennials, Gen Z and Gen X struggling with finances.



Source: Prudential Pulse Survey

Moreover, with personal savings now at very low levels, don't be surprised if the past holiday season was the last binge as the consumer embarks on a "dry January".



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Moving on, housing historically leads the economy into and out of recessions, and the current sharp housing downdraft shows no sign of abating.

Taking a global perspective, the new year has started off on a bad economic note as both the Chinese manufacturing and service sector purchasing managers' indices for December eroded badly. The message from the China Beige Book that the country entered a GDP contraction in the fourth quarter. In addition to that, the International Monetary Fund (IMF) calls for at least one-third of world GDP will soon be expected to be heading into an official recession. Not the best news for the markets to hear as we tiptoe into 2023.

Finally, last year was the year of the policy tightening, and this year is the year where the lags kick in and kick in hard. Adding fuel to the fire, 83% of global central banks are raising rates into this in order to quell inflation but also exacerbating the growth slowdown. Once the yield curve-based odds hit 80%, there never has been a case when this wasn't a sure-fire signpost for an imminent recession. Interestingly, Bloomberg Economics shows its recession model at 100%, but not beginning until August.

Thus, the stage is set for slower growth with a high probability of a recession within the U.S.

On the inflation front, commodity prices have peaked for the cycle. So have rents. Ditto for home prices. Pundits who focus on wages don't seem to understand that prices lead wages, wages do not lead prices. Besides, as the Fed seeks a 4.6% unemployment rate for this coming year, enough slack will emerge to look after nominal labor compensation growth as well.

Meanwhile, the bogeyman that got the ball rolling on the inflation cycle, and I am talking about transportation costs, are now tumbling. The Baltic Dry Index is off more than 70% from the cycle high. Is that well acknowledged by those who think inflation is going to be "sticky"? The World Container Index, compiled by London-based Drewry Shipping Consultants, plunged 77% in 2022. How "sticky" was that? The Danish shipping giant A.P. Moller-Maersk is fully aware, with its stock price sliding 33% this past year — the giant handles about 20% of the world's container shipping capacity.

Further, there is also a ton of inventory that still needs to be unloaded. Retail inventories are up a huge +19.8% on a year-over-year basis and this is because there simply has not been enough price discounting. This time last year, the inventory levels were low, and the retail community enjoyed considerable pricing power. Those days are gone. Wholesale inventories are in even worse shape, currently +21.3% above year-earlier levels (and the inventory-to-sales ratio is up to the highest level since September 2020).

As for the labor market, a thaw is clearly emerging. Small-business owners say it is getting easier to hire workers and keep them around, in what they hope is a sign that the worst of their labor problems are behind them. Indeed, since July, more small business owners said in a December survey for The Wall Street Journal that they found it easier — rather than harder —to find workers.

Bottom line: The stage is set to usher in lower growth and more deflation ahead.

In terms of portfolio strategy, look for Treasuries to benefit next year from sinking inflation and a likely change of policy stance by the Federal Reserve by mid-2023. Credit unions that have "excess" cash should continue to overweight Treasury securities while maintaining a risk appropriate ladder portfolio.

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.