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INVESTMENT SERVICES

Weekly Relative Value

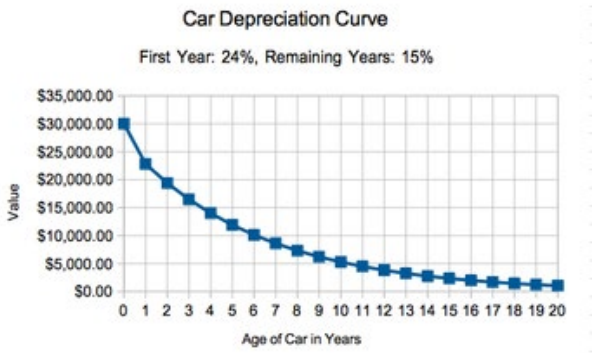
Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF JANUARY 9, 2023

The Auto Bubble

"Potentially, the biggest financial crisis ever." – Elon Musk, CEO, Tesla

Prior to the COVID-19 pandemic, auto prices would follow an inverse exponential curve with the vast majority of cars depreciating by nearly 40% in the two years!



Source: Ramsey Solutions

Then COVID-19 hit, the economy shut down, and automakers scaled way back on production in anticipation of demand plummeting. When it was recognized that COVID-19 was not the "black plague" and the vaccines arrived quicker than expected, people started to get out and about. Thus, the demand to buy cars was much faster than anticipated and overwhelmed the supply available as idled factories were unable to ratchet up production fast enough to meet the unanticipated jump in demand.

Exacerbating the supply and demand mismatch, the government flooded locked-down businesses and households with trillions of dollars in stimulus and support (stimulus checks, enhanced unemployment compensation, child tax credits, deferred loan payments, etc.).

The stimulus helped businesses keep workers on payrolls and bolstered consumer spending. It also led to an inflationary jump in auto prices as supply chains crippled by COVID-19 pandemic restrictions couldn't keep up.

Many people, including those with less-than-perfect credit, paid off debts and built savings during the COVID-19 pandemic. With this newfound cash, lower expenses and improved

THIS WEEK

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cash flow, some people were able to buy a car they could only afford if all that stimulus remained in place.

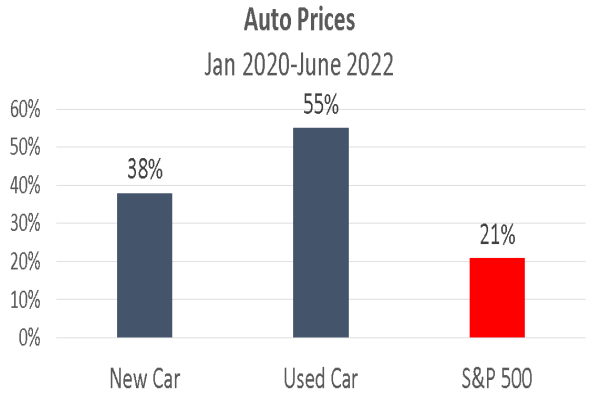
In addition, literally 0% interest rates caused many people to start buying any car that could "fit into their budget". Why responsibly buy a $30,000 car when you can finance a decked out $100,000 truck at 84 months with 0% rate? I mean, it's free money after all.

Dealerships capitalized on this by pushing higher and higher loan terms. Edmunds's data shows that 34% of financed new car purchases had an average loan term of 73+ months in October 2022, compared to 27% in October 2017. In some cases, auto loans were extended to a ridiculous eight to nine years. The sales pitch: "Heck its only $900 a month."

"There has never been a worst time in the last 30 years to buy a vehicle. Within the span of 2 years, cars went from being the largest depreciating asset one owned, to doing better than most of our stock portfolios" — Sully [@SullyOmarr], July 21, 2022

Making matters much worse, dealers, which have less oversight than financial institutions, were willing to lend money without proper background checks. The dealers and non-bank lenders saw the short-term margins, forgot about the long-term risk, didn't bother to qualify buyers and never conceived of a tightening, liquidity, and default problem. In fact, a study in late 2021 found that up to 50% of the loans were given out to customers who might not be able to afford them. The income and employment verification only happened 4% of the time. Anyone who could walk and chew gum at the same time was given a loan. This artificial and inflated demand further accelerated the meteoric rise in auto prices.

The graph below sums it up nicely. Autos outperformed the S&P 500 by 17-34% from January 2020 to June 2022. If only I had known, I would have loaded up on Foresters and RAV4s instead of stocks. Live and learn.

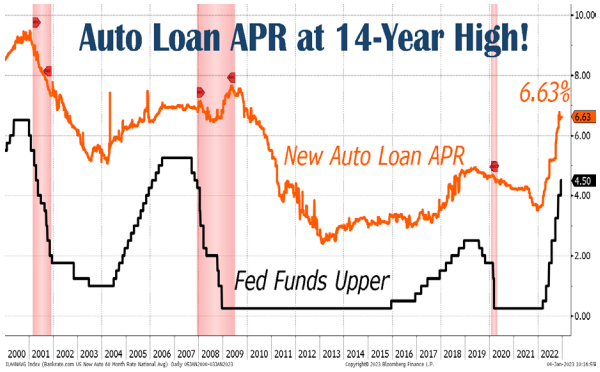


Source: Bloomberg

SHOCK AND AWE

Fast forward to the present. The economy is weakening, the free money from Uncle Sam is long gone and the Fed is raising rates. On December 14, the Fed raised its benchmark lending rate by 50 basis points, capping a year of seven hikes that have added 4.25% to the fed funds rate. The Fed also stated that further increases would be needed. The central bank indicated that it will likely take the fed funds rate past 5%, implying at least another 0.75% in cumulative hikes, before holding at that level for most of next year.

Because auto loans track the fed funds rate, auto loan rates have surged. As shown below, the average annual percentage rate (APR) on new-car loans was 6.63% in December, the highest since 2002. Meanwhile, APRs for used cars are at a staggering 10 %. Imagine paying 7-10% interest on a seven-year loan for a car. People are literally paying hundreds of dollars a month just in interest for their car.

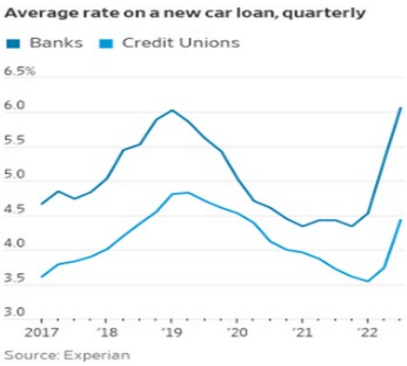


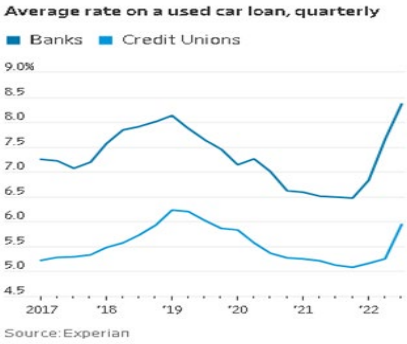
**Red shaded areas denote recessions*

NO ONE TOLD CREDIT UNIONS

"Credit unions were just a ridiculous deal." – Nick Honko, Doctor, Charleston, S.C

Auto lending is the bread-and-butter for credit unions. Despite the aggressive Fed tightening, many credit unions have been offering some of the best rates in town. As shown below, in quarter three, credit unions charged an average interest rate of 5.94% for used cars, well below the 8.36% offer from banks. For new cars, credit unions charged 4.43%, versus banks' 6.06%. While credit unions typically have lower lending rates than banks, the gap is at the widest in five years.

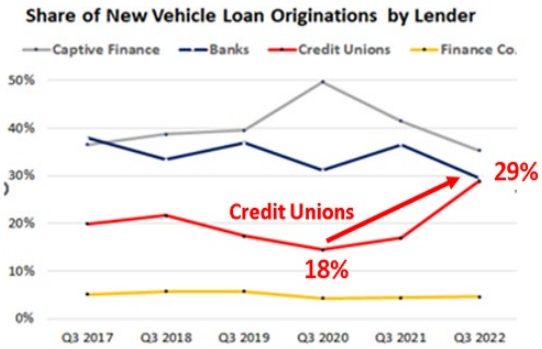




With credit unions offering such low rates, it is no wonder that credit unions now have a bigger share of the auto-finance market than any other type of lender. In the third quarter, they held 29% of all auto financing, up from 18% pre-COVID-19 pandemic. As credit unions have gained significant market share banks, finance companies and dealers have lost market share.

I should stress that unlike the dealer community and non-bank financiers, credit unions have maintained higher lending due diligence standards. I should also add that historically credit union loan portfolios have performed well during recessions.

That said, undisciplined, free-wheeling credit unions, targeting marginal debtors could struggle in a recession and have a bad credit cycle.

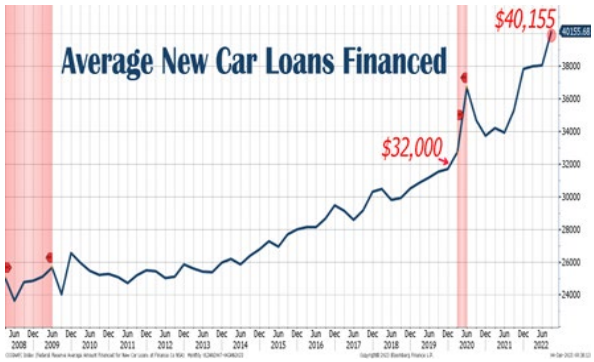


Source: Wolf Richter

AUTO DEBT SOARS!

"Sticker shock doesn't begin to describe it…When you factor in the financing, it's very jarring...and we are only seeing the tip of the negative equity iceberg." — Ivan Drury, Director of Insights Now, Edmunds

While financing costs have soared, prices for new vehicles are still unbelievably high. According to J.D. Power and LMC Automotive, the average price paid for a new car in December set a record of $46,382. According to the Fed, the amount of new car loans increased by more than $2,000 in one quarter, from just over $38,000 (a record), to $40,155 (a new record). Prior to the COVID-19 pandemic, the average auto loan financed was $32,000.

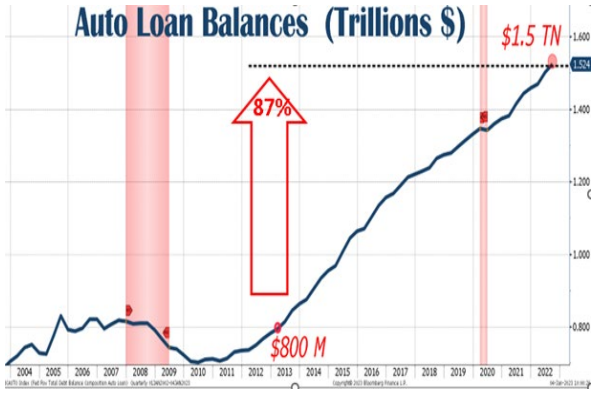


**Red shaded areas denote recessions*

As a result of spiking interest rates and ridiculous auto prices, a record number of 16% of customers who financed a new car in the fourth quarter of 2022 are now paying at least $1,000 a month for their vehicles — and it's not even a Mercedes! This is up from 10.5% in late 2021 and 6.7% in 2020.

"For the first time, just over 15% of consumers who financed a new car in the fourth quarter of 2022 committed to a monthly payment of $1,000 or more — the highest level on record — compared with 10.5% one year ago."
— Edmunds

As shown below, in just the last ten years, outstanding auto debt has risen by an unprecedented and whopping 87%, to a record high of $1.5 trillion. Not surprisingly, lenders are increasingly worried that consumers are taking on too much debt amid a slowing economy and are warning of a potential wave of missed loan payments, followed by repossessions.



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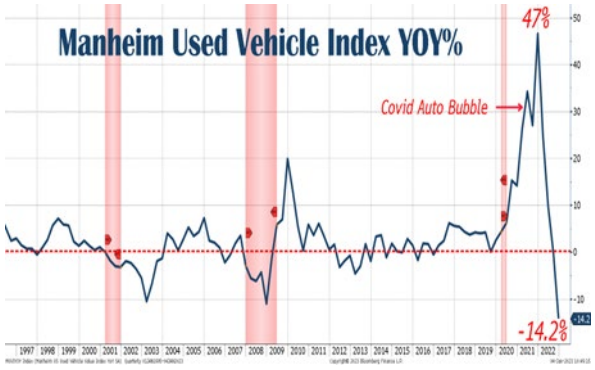
USED CAR PRICES TUMBLE

"At the onset of the pandemic, consumers benefited from low interest rates and elevated trade-in values, helping shield even the more questionable financing decisions from resulting in negative equity…But as we shifted toward an environment with diminished used car values and rising interest rates over the past few months, consumers have become less insulated from those riskier loan decisions, and we are only seeing the tip of the negative equity iceberg."
— Ivan Drury, Director of Insights Now, Edmunds

Now used car valuations are now plummeting. Take a look at the graph below. The Manheim Used Vehicle Index measures the prices that dealerships pay for used cars at auctions. After spiking to insane levels during the COVID-19 pandemic, the trend has totally reversed with some cars declining in value as much as 30% over the past 12 months. Those who bought a used vehicle at a 30-40% premium are now significantly underwater on a car they financed for seven years.



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A PERFECT STORM

In the good ole days, it used to be that once consumers stuck with a vehicle that they paid too much for, could not trade it in without putting some money up front to cover the difference of what is owed on it versus what it is worth. At that point, in most cases, the auto cycle ended because the dealer can't sell the consumer a car, the consumer can't buy a car, and, you guessed it, the lender can't finance a car!

But not so fast. According to an anonymous but widely followed CEO of a car dealer group, (Twitter account: @CarDealershipGuy) something nefarious is happening today.

Because the lender knows that when most consumers are stuck, the dealer waives the "open auto stipulation". This means they allow the consumer to buy the new car with a second loan, knowing they already have a first one. But the lender does it because they know that the buyer will default on the old, other car.

This is what the @CarDealershipGuy tweeted in late December:

"I conduct a team meeting to recap our week…This morning, one of our general managers opened up DealerTrack — a portal that dealers use to communicate with auto lenders — and highlighted something very concerning."

"9 of our lending partners have started WAIVING 'open auto stipulations' for consumers…. that's the 'only way' lenders can finance cars and dealers can put cars on the road. However, this means tons of repossessions ahead."

Simply put, this guy claims you can owe significantly more on your car than it's worth, be behind on payments and somehow still get financed for a new vehicle. He says lenders and dealers are doing this because they're losing out on deals. If these people who are behind on their current car payments can finance something new or newer, it's a whole new game. If true, this is incredibly reckless and shortsighted. If lenders are willing to backstab each other in order to put more loans on the road, we're in trouble.

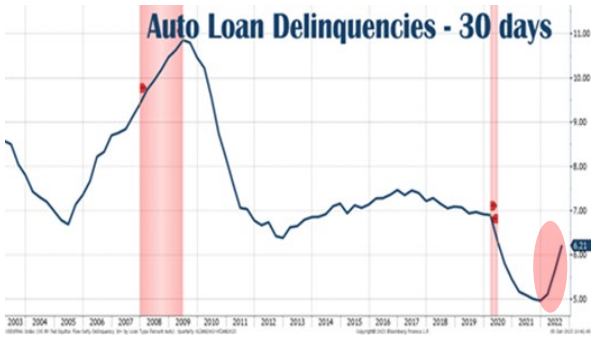
Celebrity investor Cathie Wood responded to @CarDealershipGuy's thread, warning of this potentially explosive situation.

"@ARKInvest has been concerned the impact of declining residual values on the $1+ trillion auto loan market…Most of these loans back gas-powered vehicles. @GuyDealership explains that the crisis is underway. The consumer preference shift toward EVs will exacerbate this crisis." — Cathie Wood, CEO, Ark Invest

You might ask yourself why anyone would lend more money to reckless and irresponsible borrowers who have now fallen behind on payments? Here's why: There are certain lenders who thrive on repossessing cars. Not only do they collect the amount people are behind, they also add additional fees.

Plus, the people most likely to fall behind on car payments are paying exorbitant interest rates, say 15-20%. Thus, the lender is making incredible money off the loan as long as the debtor pays. Should the debtor not pay off the loan, the lender can repossess it a few times until finally the borrower just doesn't want the hunk of junk back. The lender sells it at auction, a dealer puts it on the lot and it's the same process over again.

As shown below, early auto delinquencies, while still relatively low, have risen quite sharply in 2022. This is notable because it's occurring in a full employment environment. Further, when the car market fully adjusts, cars will once again begin to depreciate like they always have. And guess what happens? Some, if not many, are going to let their vehicle go. Combine that with people walking away from new factory-order cars and this situation gets complicated fast. Top it off with a potential recession, you can paint an ugly picture in the car market. Given the fact that more than 85% of cars are financed, we are looking at a potentially massive problem.



**Red shaded areas denote recessions*

LOOK UNDER THE HOOD

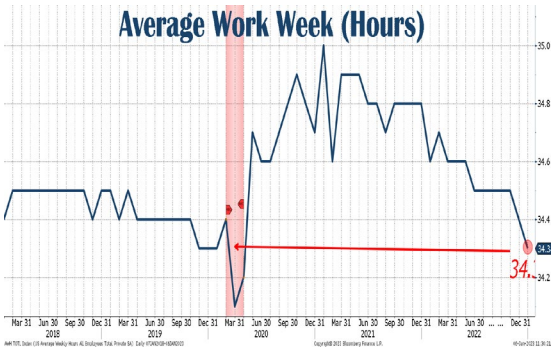
"The jobs creation for the month of December 223,000…3.5% on the unemployment rate…That equals the best levels we've seen post-COVID-19. ***Historically, unbelievably good****!" — Rick Santelli, Anchor, CNBC*

Non-farm payrolls came in, yet again, above expectations, at +223,000 in December. The unemployment rate is back to a cycle-low of 3.5% from 3.6% in November.

Businesses continue to add staff, but at the same time companies are reducing the hours that people are working. The workweek was cut 0.3% in December and back to the lowest level since April 2020 (at 34.3 hours) when the economy

was caught in the crossfire of a massive pandemic and lockdown. The whole enchilada is workers and the number of hours they are busy producing something.

When you count in the bodies and the hours together, it is as if non-farm payrolls actually declined 150,000 last month — and this followed a similar 300,000 decline in November. As I have said time and time again, you cannot just look at one headline number. This is a "report" not a "number". Yet most pundits and media types are too lazy to do a little analysis and focus on a singular number.



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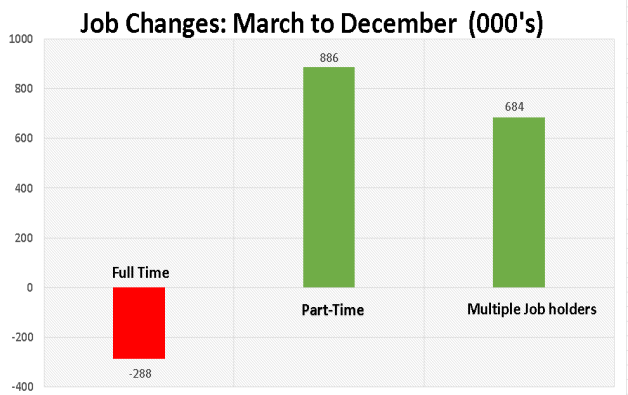
Moving on. The only reason why the unemployment rate fell to 3.5% from 3.7% was because the business sector added an incredible +679,000 part-time jobs last month. Get this: No net full-time jobs were created.

In fact, the total number of full-time jobs has declined by 288,000 in the past ten months. Over the same period, there has been a surge of 886,000 part-time jobs. In fact, in December, the entire employment increase was thanks to part-time workers.

This means that contrary to conventional wisdom, some 684,000 jobs added in the past ten months were not the equivalent of 684,000 workers finding a job. It means that the bulk of job growth since March has been in the multiple jobholder category. Instead of 684,000 jobs having been given, what really happened is that 684,000 workers found more than one job make ends meet.



Source: Bureau of Labor Statistics (BLS)

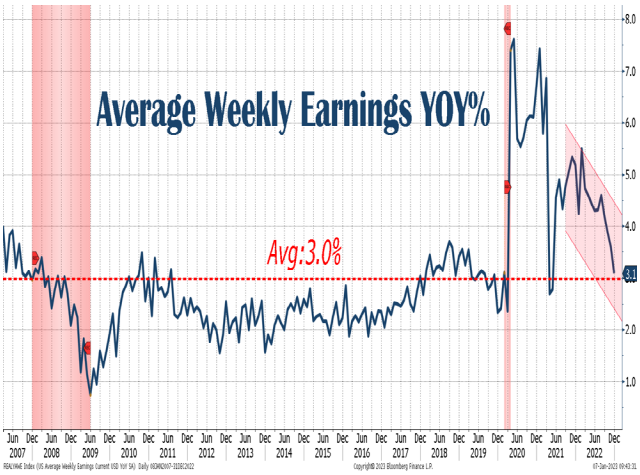
Digging deeper. Those who got part-time work because of weak "economic conditions" expanded +190,000! Then tack on the fact that the ranks of the self-employed soared +141,000. So, we have become a nation of part-time consultants.

Add on to that that the number of people who were compelled to take on an extra job because the economy is heading into a hard landing, not a soft landing, jumped +370,000 in December (taking the share of the employed working at more than one job to 5.1% from 4.8% in November and 4.7% in October — now at the highest since February 2020!).

Let's face it, not all jobs are created equally. Being self-employed is not the same as having a steady salary and part-time is not full-time. Part-time jobs pay far less, have zero benefits and generally are far worse quality than full-time. The rising trend in multiple-job holders is every bit a sign of duress as the surge we have seen of late in the share of households tapping their credit cards to cover the bare necessities.

Moving on. Average hourly earnings came in at a tame +0.3% month-over-month, which is the weakest increase since February of last year. The year-over-year trend was trimmed from +4.8% to +4.6%, the slowest trajectory since August 2021. Over the past three months, wages are at +4.1% annualized pace, in a sign that labor compensation is slowing down. If the labor market was as tight as is commonly perceived, then wage growth would be accelerating, not decelerating.

With the workweek down and the big moderation in wages, average weekly earnings flattened in December. The year-over-year pace has been shaved from +4.2% in September to +3.1% in December. Over the past ten consecutive months, average weekly work-based income has slowed on a year-over-year basis. Put that in your pipe and smoke it!



**Red shaded areas denote recessions*

Possibly, it's the constant headlines over an imminent recession or possibly it's about the layoffs at tech and social media companies that are starting to have a psychological effect on both employers and workers. For whatever reason, it would appear that the working class is satisfied with their pay packet that they are staying put.

One final note: One of the most reliable leading indicators for employment is a temporary agency employment. In December, employment in this sector slumped by 35,000 and has declined now in each of the past five months by a combined -111,000. One truly has to ponder what sort of landing the labor market is going to experience when the head-hunters are chopping off their own heads.

The Fed better get that next rate hike done in a hurry because the economic window for additional tightening is going to be closed very soon.

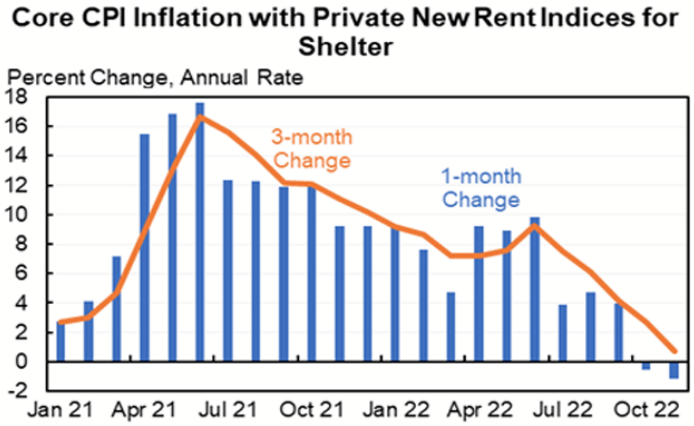
INFLATION ROLLS OVER

Real estate deflation is definitely gaining momentum. Only lags separate what's happened thus far from what will happen with the real estate market. The Fed's tightening from 2003 to 2006 was only felt in the real estate market starting in 2007. Demand is clearly fading away, and more price deflation lies ahead. The stakes are high because this real estate bubble is bigger than the one in the mid-2000s. Except, back then, it was a $25 trillion asset class on consumer balance sheets, not $46 trillion, as is the case today.

Also, according to Moody's Analytics, there has been a rapid run-up of apartment vacancies and rents are now starting to decline outright, and in some of the hottest markets. In the past six months, rents have fallen 3% in Las Vegas, 2% in Phoenix and 1% in Tampa. More than 400,000 rental units that were completed last year will be coming on stream and flooding the market with supply in 2023, which promises to be the largest supply bulge since 1986.

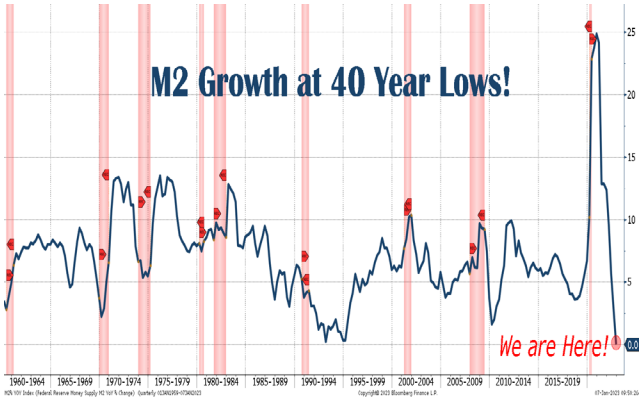
Shelter costs (housing and rents) represents over 30% of the core Consumer Price Index (CPI). Uncle Sam measures rent when leases come up for renewal. This gets worked into the indexes gradually, so the rates on new leases can be quite different. Based on real time data from Zillow and Apartment List, rents have been falling recently.

To drive home this point, Jason Furman, Economist and Professor at Harvard Kennedy School, created a modified core CPI that substitutes "spot" rental rates for official calculations. This gives you a better perspective of where rents are today. As you can glean from the graph below, housing costs are going to be a significant disinflationary force in 2023.



Note: Private new rent indices are Zillow Observed Rent Index and Apartment List National Rent Index. Apartment List seasonally adjusted using Macrobond.
Source: Bureau of Labor Statistics; Zillow; Apartment List; Macrobond; author's calculations.

In addition, goods price inflation has peaked. Commodity prices have rolled over and the supply bottlenecks, major contributors to inflation in 2021 and the first half of 2022, are now mostly behind us and almost certainly won't return. Another energy shock can't be ruled out but looks unlikely. The anti-inflationary effects of the Fed's monetary policy are yet to come as money supply growth has now turned negative. The U.S. annual money supply (M2) year-over-year growth just went negative for the first (and only) time using data going back to 1960! Not even during the Volcker tightening in 1980 did this occur.



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From my perch, inflation has peaked and is now rolling over. In fact, over the past five months (June to November 2022), inflation has slowed to a crawl. Whether measured by the consumer-price index, CPI (which most people watch) or the price index for personal consumption expenditures (PCE), which the Federal Reserve prefers, the annualized inflation rate has been around 2.5% over these five months. Yes, you read that right. This is near the Fed's 2% target. This has gone unnoticed because the market focusses on yearly data, which are still 7.1% for CPI inflation and 5.5% for PCE inflation.

The only issue going forward is where we end up and what the longer-term outlook is going to be. The Cleveland Fed's five-year inflation expectations is at 2.3%. In years past, the Fed would have been uncorking the champagne bottles over numbers like these. Some inflation backdrop, eh? Talk about fighting yesterday's war. But this Fed is suffering from a bad case of "once burnt, twice shy" and will not let its guard down until it is convinced that inflation has been crushed for good. I like those odds, and that is why I like the entire Treasury market.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I would be stunned if we didn't have a recession in 2023." — Stanley Druckenmiller, American Investor

The incoming data continues to point toward a weakening economy. Manufacturing is declining at the fastest pace seen since the early days of the COVID-19 pandemic. Auto sales were the lowest seen for a full year in more than a decade. Financial assets have imploded. Existing home sales have fallen for ten months in a row and are now down by more than a third since January 2022. Layoffs have risen with the tech industry handing out 150,000 pink slips already.

Meanwhile, all you hear is that the consumer is "resilient". Well, I beg to differ. The all-important consumer has less cash to spend as stimulus checks evaporate, inflation remains high and equity/housing/crypto drawdowns have a negative impact on the wealth effect. Simply put, the consumer is on thin ice.

Here's a little tidbit to digest: The Census Bureau Household Pulse Survey found that last month, 35% of U.S. households were either tapping their credit cards or accessing loans just to cover their essentials — and that followed a similar disturbing 32% share in November. Not even the Wall Street charlatans can put lipstick on that pig.

And then, of course, we had Macy's come out and tell us just how uneven the holiday shopping season was, which caused its shares to fall more than 3% in after-hours trading. Then again, what can one expect when an epic 35% of the American public was forced to tap their credit cards just to pay their food, rent and utility bills last month??

At the same time the Fed has already tightened by an epic 400 basis points in the past nine months and continues to promise more rate hikes into weakening growth. As I have said previously, if the Fed tightens by 1 basis point into a slowdown, let alone a recession, something or many things break. And by definition the Fed has said they are OK with this.

I also need to stress that there is a significant lag between when the Fed raises rates and when the effect is fully felt (between nine months and, at times, over a year.) In March 2022, the Fed started to raise rates from zero percent. If the lag is a year, the first interest rate hike will not be fully absorbed into the economy until March 2023. In other words, this is the year the lag kicks in and hard.

Given this backdrop it's only a matter of time before yields across the curve break down along with slowing demand and peak inflation.

As to what the Fed does, the range of fed funds expectations for 2023 is between 4.875% and 5.625%. Most Federal Open Market Committee (FOMC) members expect fed funds to end the year somewhere between 5.125% to 5.375%.

My word of advice is to expect the unexpected in 2023! Just like no one predicted what the Fed did in 2022 we all may be equally surprised by what happens this year. Here's something to consider. During the last three recessions, excluding the brief downturn in 2020, the fed funds market misjudged how far fed funds would fall by roughly 2.5%. In other words, the implied fed funds of 4.6% today may be 2% by December if the market similarly underestimates the Fed and the economic and financial environment.

Historical odds favor a recession with lower inflation, a much lower fed funds rate. We should invest accordingly. Look for Treasuries to be the primary beneficiary 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.