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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JANUARY 17, 2023

Neither Shaken nor Stirred

"The market thinks the Fed is playing without a playbook, since their forecasts have been wrong before and they've downplayed them in the past… Investors judge that the U.S. is headed for a recession, and that the Fed doesn't quite yet get it."
— Marc Chandler, Chief Market Strategist, Bannockburn Global

The so-called "dot-plot" released last month shows that the median Fed Funds rate is expected to reach 5.1% this year. The view is virtually universal with 17 of 19 Federal Open Market Committee (FOMC) members predicting a peak of 5% or more. While the committee's 12 voting members differ on where they think interest rates should go this year, they're "unanimously" against cutting rates until at least 2024. Unless the FOMC members change their mind (high probability in my mind), rates will move either sideways or up.

That message was again driven home last week as the hawkish rhetoric continued. Raphael Bostic (Atlanta) was the latest to talk tough, *"we are just going to have to hold our resolve."* When asked how long he thought rates should remain above 5%, Bostic responded with, *"three words: a long time."* He stated that he wants a five-handle on the Fed Funds rate, and he will not be supportive of any rate cuts until 2024, at the earliest. As if he knows what the future holds. Give me a giant break!

Meanwhile, Charles Evans (Chicago) stated, *"you can start doing 25s and you can still string them out. So just going to 25 doesn't mean a pause is imminent."*

Former "dove" Mary Daly (San Francisco) also echoed this higher-for-longer sentiment.

THIS WEEK

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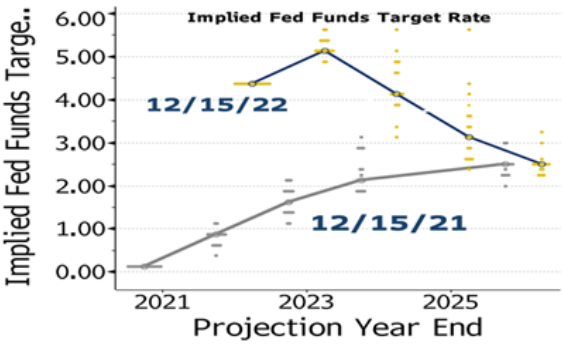
Esther George (Kansas) stated we should hold above 5% into 2024.

At best, the only person sounding less hawkish at the moment is James Bullard (St. Louis). He said we were getting closer to where he wants the Fed Funds rate to peak. Even still he seems to be angling for another 75-basis-point rate hike from here.

"If we want to get to the low 5% range, we should go ahead and move to that level, then we'd get the disinflationary impact of that now as opposed to some point in the future, So I think the front-loading policy has served us well and will continue to serve us well going forward. I don't really see any purpose in dragging things out through 2023."
—James Bullard, St. Louis Federal Reserve Bank President

Then again, these Fed forecast and "dots" are actually meaningless. For example: A year ago the median dot plot for the end of 2022 was 0.9%. Today we are above 4%. Now the Fed has become intoxicated by "groupthink" with virtually everyone on the FOMC keeping the Fed Funds rate north of 5% for this year. From my perch, they are afraid of making another mistake.



Source: Bloomberg

PAY ATTENTION TO THE BOND MARKET, NOT THE FED

"Fed officials have turned more hawkish because investors aren't listening to their warnings… Perhaps, Fed officials should listen to the bond market." – Ed Yardeni

In the recent past, the Treasury market would have freaked out over the hawkish comments from FOMC officials. But not today. As the Fed talks hawkishly, Mr. Bond is neither shaken nor stirred. Bond investors realize the Fed was late to tighten, and if history rhymes, it will also be late to ease. One mistake compounded by another mistake.

Despite the Fed forecasts, the futures market does not believe the hawkish rhetoric or the dots. Currently, the swaps market is fully priced for a 25-basis-point hike at the next meeting, one more after that (leaving the peak at 4.9%) and then at least one cut before 2023. The FOMC is telling us we are going north of that number.

In the Treasury market, the yield on the 2-year Treasury has plunged 60 basis points from the November peak. At 4.15%, the Treasury market is saying no way, no how, does the Fed get the Funds rate north of 5%. This is very important because the 2-year Treasury has a much better track record in predicting shifts in Fed policy than the Fed's own dot-

plots and Fed rhetoric, which can shift on a dime. Sorry, Charles, Ester, Mary and James, the front end of the Treasury curve leads.

Likewise, intermediate and longer-term Treasury yields have been falling too. Despite the Fed raising the Fed Funds rate by 50 basis points since November, the 5-year Treasury yield has plunged by almost 100 basis points.

On the long end, the 10-year Treasury yield is now down 80 basis points from the peak.

The yield curve is the most inverted yield since the 1980s. In fact, the 2s/10s yield curve is going into its seventh month of inversion and is stuck around -70 basis points. With the yield curve so inverted for this long, a recession a year later has occurred 100% of the time in the past. Yes, maybe it's different this time, but why fight those odds?

**Red shaded areas denote recessions*

In addition, the spread between the 3-month Treasury bill rate and the yield on the 10-year Treasury is now inverted to -100 basis points. Amazingly, this curve has been inverted for 46 days in a row. Going back to 1969, there were eight times this spread has inverted for 20 days or more and a recession ensued each time within 300 days of the initial date of the inversion. Again, why fight those odds?

Even the "Powell yield curve" (3-month yield versus the expected 3-month yield 18 months out), which the Fed Chairman doesn't discuss any more, is inverted to the tune of -82 basis points.

"My 40-plus years of experience in finance strongly recommend that investors should look at what the market says over what the Fed says… There is no way the Fed is going to 5%. The Fed is not in control. The bond market is in control." — Jeffrey Gundlach, Chief Investment Officer, Double Line Capital LP

In summary, the bond market is calling the Fed's bluff and does not believe that they will raise rates as much as advertised. While the bond market is far from infallible, it has always been the single best indicator of economic growth and inflation. Further, it reflects the wisdom of thousands of traders and money managers placing their money on the view that the Fed is wrong yet again.

So, who's right — the Fed or the bond market?

Historically, the odds greatly favor the bond market over the Fed so I'm sticking with the bond market. I'm not the only one. Here is one who's putting her faith and money in the bond market's signals as well.

"The Fed is often wrong at turning points… One thing I keep in mind is that the dot-plot in September of 2021 didn't even show the Fed getting to 2% until 2024."
— Nancy Tengler, Chief Executive and Chief Investment Officer, Laffer Tengler Investments Inc.

Bottom line: Pay attention to the bond market, not the Fed, for how interest rates will evolve.

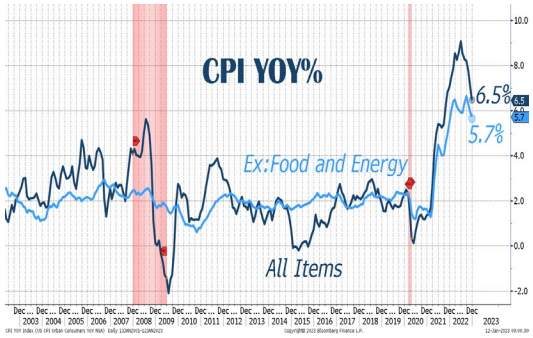
PEAK INFLATION

"The single largest component of core Consumer Price Index (CPI) is housing as measured by owners' equivalent rent and is based on outdated leases. As a result, it showed that housing continued to rise rapidly, going up 0.8% last month. Clearly, home prices and rents are declining. The result of this flawed methodology was an understatement of inflation a year ago and an overstatement today."
— Bryce Doty, Senior Portfolio Manager, Sit Investments

The headline CPI print for December came in as expected with a 0.1% decline month-over-month. The downward trend is encouraging with the headline inflation rate easing from +7.1% in November to +6.5% in December.

Core CPI (which excludes food and fuel costs) rose 0.3% month-over-month as expected, leaving the year-over-year rise at +5.7%, the lowest since December 2021.

More noteworthy, in the final three months of 2022, core inflation came in at an annualized 3.1%, which is higher than the Fed aims for but hardly crisis levels. In the second quarter of the year, that number was 7.9%.



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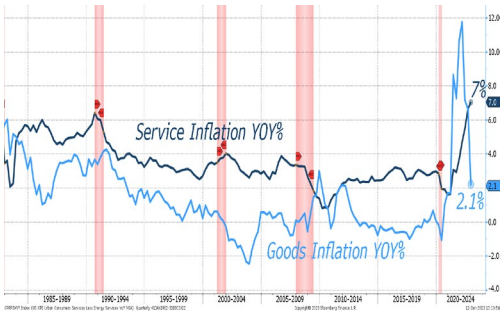
As shown below, while goods inflation continues to plunge, service inflation (housing, healthcare, insurance, etc.) spiked by 0.6% in December, and by 7.5% year-over-year. This is the highest year-over-year increase since 1982. And it was the fourth month in a row over 7%. The culprit was shelter costs, which rose an outsized 0.8% — the biggest rise since the 1990s. Recall shelter costs are 33% of the CPI.



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Here's the thing, when it comes to measuring inflation, the Fed is looking at out-of-date data. The result of shelter inflation and owners' equivalent rent, the most significant weight of the CPI basket, is being about 9-12 months behind the curve when it comes to what's really happening in the housing market.

Indeed, the time to panic about soaring rent was more than a year ago. We have already seen numerous monthly declines in residential rents, which will show through in the coming months. As for the housing bubble, Liz Ann Sonders, the Managing Director and Chief Investment Strategist at Charles Schwab, recently noted that the percentage of homes selling above their list price has fallen to 30% from a peak of over 50% at the turn of the year.

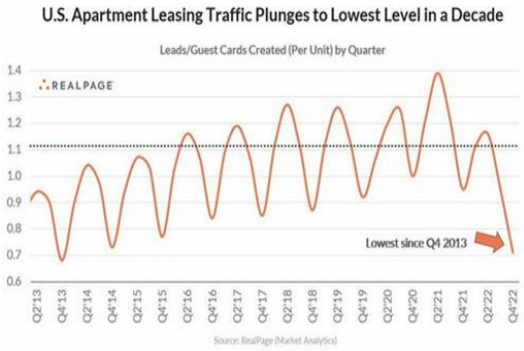
Bottom line: Thankfully, the respective peaks of 9.1% for the headline and 6.6% for the core are in the rearview mirror. I think inflation will continue to fall, and we will see more monthly CPI prints that will be much lower (possibly negative) in the months ahead. Many disagree, but I think that with quarter four coming in at 0.8% (3.2% simply annualized), inflation is yesterday's news.

LESS DEMAND, MORE SUPPLY

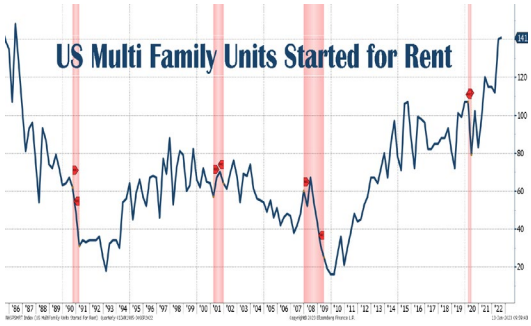
"We've never before seen a period like this – weak demand for all types of housing despite robust job growth and sizable wage gains." — Jay Parsons, Chief Economist, RealPage

A big reason we are likely seeing peak rental inflation is because of the massive supply of multi-family housing units coming online coupled with much lower demand. To wit: RealPage, a property management firm, published new data that shows demand for U.S. apartments began "evaporating" as early as last summer.

In fact, as shown below, the Apartment List National Rent Report has shown the sharpest three-month decline in the history of this index. In quarter three and quarter four, leasing traffic recorded the weakest numbers since 2013. In December 2022, the numbers were especially low. While December is always slow, this past December was the slowest month in at least 12 years.



On the supply side, multi-family housing starts have gone straight up and have easily surpassed its pre-Great Financial Crisis highs. Given the massive build up in multi-family homes for rent combined with lower demand, it won't be long before we are going to be seeing the dominant shelter component (30% of the CPI and a 40% share of the core index) acting as a big drag on the price data.



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Bottom line: The Fed chooses to ignore high-frequency data and uses laggard data in how it views the shelter inflation situation. Of course, the Fed will realize when it's too late that it overtightened. As home prices continue to deflate and rents adjust to real time data, look for the disinflationary trend to continue throughout the year.

HOW LOW WILL HOME PRICES GO?

The housing market, a pillar of the American economy, is doomed in terms of activity because the monthly mortgage payment is up more than 100% from its pre-COID-19 level. Home prices are simply too high.

Existing home sales have already plunged by 35% year-over-year, the sixteenth month in a row of year-over-year declines, making for a historic plunge.

But it will get worse.

Mortgage applications to purchase a home are a forward-looking indicator of where home sales volume will be. Even with the mortgage rate relief (the 30-year mortgage rate has declined to 6.3% from above 7%), applications aimed at homebuying (as opposed to refinancing) are down 44% from year-ago levels to the lowest level in eight years (when the Fed was still easing policy).

**Red shaded areas denote recessions*

This ongoing decline in purchase applications suggests that rates are not the problem. The problem is that current home prices — though they have come down in many markets and have come down hard in some markets — are still simply way too high.

With nosebleed home prices, much higher mortgage rates and a possible recession that possibly threatens job security, housing transactions have slowed down, leading to more sellers than buyers and higher inventory. In fact, the supply of new homes is now at the highest levels since the housing meltdown in 2005-2006.

Also in the coming year, inventory will continue to increase as “shadow inventory” hits the market. This shadow inventory consists of potential sellers with multiple homes, money-losing vacation rentals, vacant rentals, etc. As home price depreciation gains traction, more homeowners will be dragged into selling to retain what value they had. But it takes time. Recall that in the first housing bubble, it took three years for home prices to bottom.

I need to stress that this is not a repeat of the housing crisis in 2006-2008. There isn’t a vast wasteland of bad mortgages sitting on the books, as seen in 2008. But it will impact the “wealth effect.” For many Americans, most of their net worth is tied up in the homesteads. This is a huge housing bubble that has plenty of air underneath it. For perspective, at that previous peak in 2007, the equity in homes was around $15 trillion, while mortgage debt stood at $9 trillion. When the bubble popped, home prices collapsed, flipping homeowner’s equity from positive to negative. Today, home equity is roughly $30 trillion, while mortgage debts have increased to roughly $12 trillion. That is an incredible spread, unlike anything seen previously.

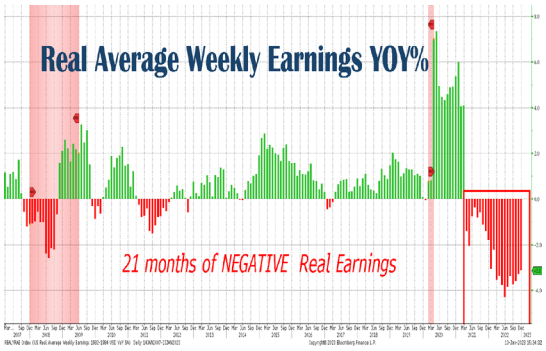
Bottom line: The reversion in home prices has begun and higher interest rates will drag home prices lower. Not only are further home price declines possible, but it is also quite likely they could be deeper than many currently expect. As that occurs, the “home equity” that many new buyers had in their homes will dissipate. This will negatively impact the wealth effect, consumption and overall economic growth. The good news is that declining home prices will put a nail in the coffin of high inflation.

LOWER TAX REFUNDS IN 2022

"Refunds could shrink by a few hundred to a few thousand dollars, all else being equal."
— Beth Logan, Enrolled Agent, Kozlog Tax Advisers

The consumer spending outlook is clouded by receding wage growth, a punishing credit card bill coming due after the late 2022 debt binge and the pullback early this year in tax refunds from Uncle Sam.

First, from a big picture perspective, real (inflation-adjusted) average weekly earnings have continued to decline for 21 months in a row.



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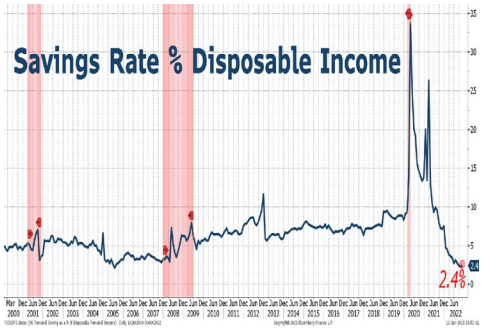
And savings have been tapped out. The savings rate as a percentage of disposable income is a measly 2.4% or three times lower that the 22-year average of 6.6%. Of note, the last time savings were this low was in September 2005, right in advance of the Great Financial Crisis.



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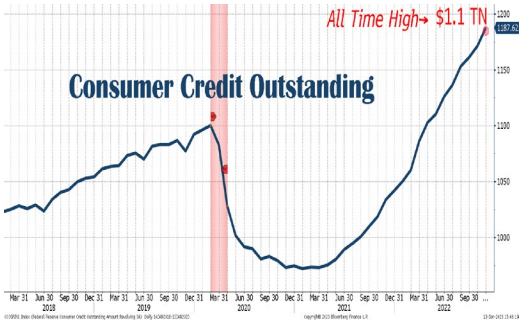
Meanwhile, the consumer is living and breathing off the fumes of credit and at substantially higher interest rates than was the case a year ago.

"Bankrate data shows it would take 16 years for someone to pay off the current average credit card balance of $5,474 by making the minimum payments at 19.2%. At that point, they would have shelled out $7,365 in interest alone."
— NBC News

Over the past year, consumer credit has surged $350 billion, which is unprecedented. Almost half of that was in credit cards, where balances have exploded nearly +15% on a year-over-year basis to stand at a record high of $1.1 trillion. Making matters worse, much worse, the average credit card interest rates (APR) currently stand at an all-time high of 19.59%. Of course, this is not a sustainable trajectory. A credit card has this inconvenient thing called a "limit."



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As expected, the Wall Street types spin rising indebtedness as mainly a sign of strength in the economy. I beg to differ. Running up credit card balances month after month is not a sign of a healthy economy. In fact, Americans continue to borrow at an excessive rate because they don't have any other way to make ends meet. People don't run up their Visa balance month after month to buy groceries when they are in "very strong" financial shape.

Then take a look at the *Wall Street Journal's* article, "You Might Get a Smaller Tax Refund This Year":

"Don't count on a hefty tax refund this year. Since Congress chose not to extend the tax breaks put in place at the height of the COVID-19 pandemic as part of its year-end budget bill, many taxpayers will get smaller refunds when they file their tax returns for tax year 2022. And some who received refunds in recent years may now have a balance due.

The amount will depend on taxpayers' situation, including whether they adjusted the amount they asked their employer to withhold in taxes and whether they paid estimated taxes. The average individual tax refund last year was $3,176, up 14% from $2,791 in the 2021 tax season, according to Internal Revenue Service statistics." — Kozlog Tax Advisers

Bottom line: The all-important consumer is on thin ice. The stimulus checks are long gone, savings have been depleted, and people are relying on high-cost plastic to make ends meet. Should unemployment rise as expected, look for more consumer stress and "frugality" to become a dominant theme in 2023. Less consumption and more savings, suggest that the economy will slow down significantly in the coming year.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"In theory, it works; in practice, it doesn't." — Lawrence "Yogi" Berra, Professional American Baseball Player

The Fed has already tightened by an epic 425 basis points in the past nine months. In addition to the reduction in the balance sheet (quantitative tightening), the de facto funds rate is closer to 6%. At the same time, the FOMC continues to promise more rate hikes into weakening growth, an inverted yield curve and declining money supply. What could go wrong?

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 okay with this. The Fed actually wants higher unemployment and lower aggregate demand.

While the Fed is likely to raise rates again in 2023, the big question isn't so much whether we get more rate hikes, but when previous hikes will show their full impact. In March 2022, the Fed started to raise rates from zero bound. 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 hard as higher financing costs change consumer and business decisions. As time passes, more people see their debt servicing costs rise as rates reset to higher levels. That leaves less money for other spending, which is again what the Fed wants.

Thus far the economic data is pointing to a soft landing of sorts. While cracks are clearly emerging, employment remains seemingly stable thus far and growth has not plunged. But we don't live in a static world. Decisions made months ago (on the policy side, on the household side, on the corporate side, etc.) take time to play out. The economy is not like a jet ski; it is a huge tanker, and once underway, it is difficult to turn or even change speed.

Maybe I'm wrong here, but simple Newtonian physics tells us that an object, once set in motion, will stay in motion and that is what the Fed has done. We are going to blow right through the "soft" landing station and enter into some unsafe territory.

Bottom line: In theory, the Fed could get inflation down to its 2% target without sparking recession. The historical odds are very low, and I have no confidence they can do it. Yogi said it best: *"In theory, it works; in practice, it doesn't."* As I have stated previously, the Fed continues to drive the bus through the rearview mirror, making policy decisions based on what has happened in the past. If they stick to their guns, the likely ending will be a recession, rising unemployment, asset deflation and more credit problems.

Let me close by saying that interest rates are cyclical and move with the economy. Should the U.S. economy stumble into a recession, the Fed usually cuts rates by an average of 500 basis points. Even in "soft landings," the Fed has historically cut rates by at least 75 basis points.

Most credit unions are reluctant to invest further out the curve because short term rates are currently higher than long term rates. Understood. That said, when looking at what is potentially coming down the road, credit unions should look at the forest through the trees and begin to factor in (hedge against) a sharp downward reversal in short term rates.

In terms of sectors and securities, 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.