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INVESTMENT SERVICES

Weekly Relative Value

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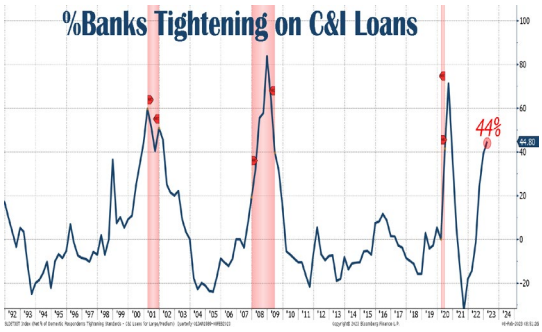
WEEK OF FEBRUARY 13, 2023

Turbo Tightening

"Tighter credit likely will drive slower spending, a reduction in risk and the potential for the Fed to pivot sooner rather than later to avoid or shorten a potential recession. That would be more good news for bond bulls." — Vincent Cignarella, Bloomberg

While the world was still hyperventilating over the jobs report from the prior week, the Fed's Senior Loan Officer Survey for the first quarter of 2023 highlighted that U.S. banks have been tightening lending standards for all forms of business credit — commercial, mortgage and credit card loans. Likewise, on the all important household side, consumer credit is turbo tightening across residential mortgages, credit cards and auto loans.

On the business side, the percentage of banks reporting stricter commerical and industrial (C&I) loan standards for large and medium sized firms tightened to a net 45%, which is up from 24% in the third quarter. This represents the sharpest rise in credit tightening since the height of the financial crisis back in 2008. As such, look for business capital expenditure (CapEx) to slow dramatically this year.



*Red shaded areas denote recessions

On the consumer side, obviously, lenders are tightening standards on the residential mortgage market. This should come as no surprise, given the recent deflationary pressure in the housing market.

At the same time, the demand for residential mortgage credit is faltering sharply with homeowner affordability the most stretched it has been since the mid-1980s. As shown below, the demand for mortgages this past quarter plummeted to its lowest level on

THIS WEEK

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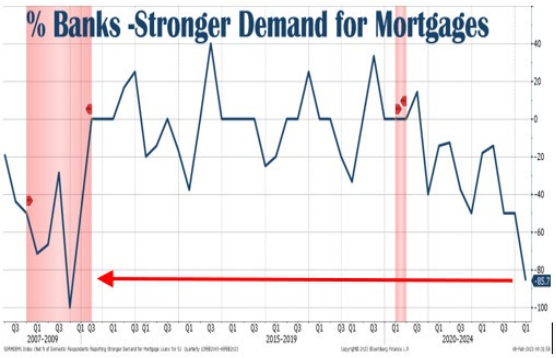
record. This says a lot considering what happened to the residential sector during the Global Financial Crisis more than a decade ago.



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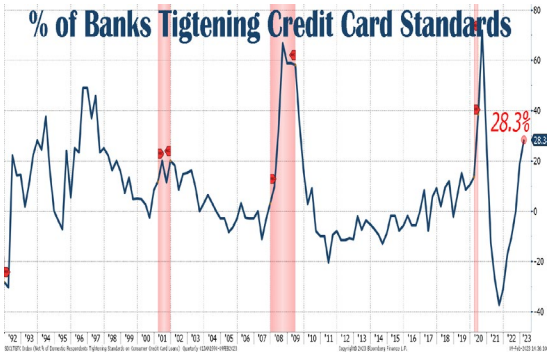
Other forms of household credit are also seeing much tighter loan standards. Both credit card and auto loans posted their most stringent credit conditions since the third quarter of 2020. Banks' willingness to make consumer installment loans decreased in the fourth quarter to -13% versus the previous -7%. The percentage of banks tightening credit standards for approving credit card rose to 28% from 10%.



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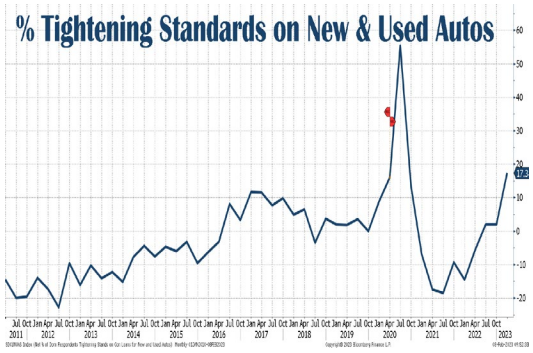
Likewise, as delinquencies and reposessions rise, credit standards have risen on auto loans dramatically since 2021.



Furthermore, the tightening standards are a result of most banks assigning the probability of between 40% and 80% to the likelihood of a recession in the next twelve months, with no bank reporting a probability less than 20%.

Even more ominously, on the household side, banks also reported weaker demand on balance for credit card, auto and residential real estate loans as well as for home equity lines of credit.

Bottom Line: Because the U.S. economy is primarily credit driven, arguably, there is no better leading indicator of economic activity (especially at turning points in the business cycle) than the survey of loan officers. The latest survey makes it more than abundantly clear that the credit cycle is feeling the impact from the the prior rate hikes, making the supply of credit increasingly harder to access. In fact, the above supply/demand levels for credit are comparable to previous recessions.

At the current pace, unless something changes, loan standards may soon hit the tightest on record. At that point, only the most credit-worthy households will maintain their access to credit — everyone else will be stopped out. Since the U.S. consumer is 70% of U.S. gross domestic product (GDP), a lot could go wrong.

Meanwhile, the banks and other lenders are shoring up their balance sheets by bolstering loan loss provisioning and shifting to liquid assets. Ironically, if banks remain skeptical and continue to tighten loan standards for consumers, this act in itself could prove to be self-fulfilling and could tip the economy into a recession.

All in, the Fed's Senior Loan Officer Survey presents a powerful contrast with benign market views of an increasingly likely soft-landing.

HITTING A BRICK WALL

During the COVID-19 pandemic, consumers saved an unprecedented amount of cash thanks to the government stimulus and lockdowns. By the end of 2021, a combination of government pandemic stimulus and reduced spending allowed Americans to amass nearly $3 trillion in extra savings.

Now there's just one problem. Savings have quickly disappeared. The *Wall Street Journal (WSJ*) cited the new Goldman Sachs estimates that show 35% of the extra savings accumulated during the pandemic was exhausted last month. By the end of the year, Goldman expects those savings to be drawn down by 65%. Also, recall that these savings are held primarily by the top 10% of income earners. The low-income folks saw their savings vanish months ago.

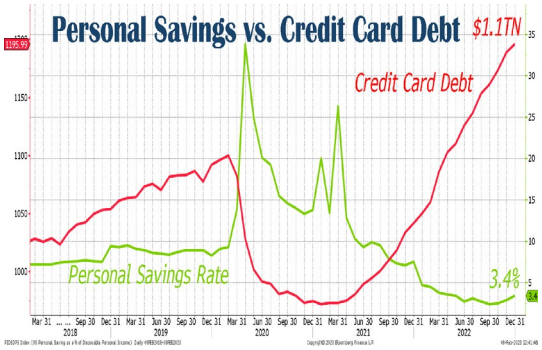
The WSJ spoke to folks that have already depleted their savings:

> *"Germán Vazquez, a 34-year-old freelance photographer in Philadelphia, said his savings swelled during the pandemic thanks to a combination of spending less while cooped up at home and government financial supports, including stimulus checks and unemployment assistance. His balance grew from $4,000 in early 2020 to $20,000 in early 2022."*
>
> *"Over the past year, it dwindled to $2,000. I've never had the opportunity to have that much money saved in my life, so it almost felt like I failed at something."*

In a time when U.S. savings have been shrinking fast and are offset with record credit card borrowings, the only thing that has allowed the party to go on have been relatively loose loan standards.

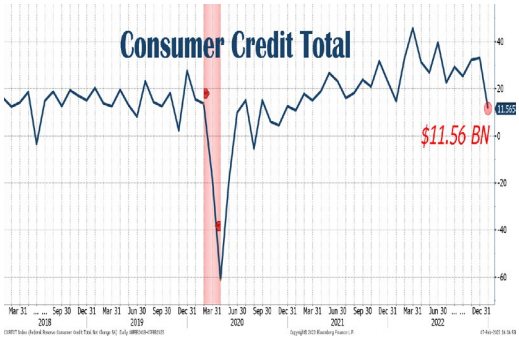
That party is nearing an end. The recent surge in rates has meant that even the indomitable U.S. addiction to credit may be coming to an end. The result is a sharp slowdown in credit-funded purchases, alongside an upward inflection in

savings as U.S. consumers are once again realizing the good old stimmulus days are long gone and more money has to be set side for a rainy day, and thus not spent.



To wit: In the latest consumer credit report, the total amount of U.S. consumer credit increased by just $11.5 billion. This was not only a huge 65% drop from November's $33 billion print, but also a huge 50%+ miss relative to consensus expectations of $25 billion!

What caused the sharp slowdown in consumer credit that has traditionally increased by anywhere between $20 billion and $30 billion, come rain or shine? Well, there was a sharp slowdown in revolving debt, or credit card debt, which increased just $7.2 billion in December. This was a drop of more than 50% versus the revised November print of $15.3 billion.



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For those asking if the surge in interest rates had anything to do with it, the answer is a resounding yes. As of December 2022, the average credit card rates, according to the Fed, was 20.40% — the highest on record.

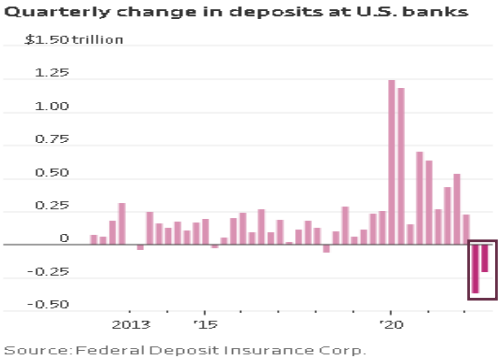
DRY AS A BONE

M2 (a measure of money supply in the economy that includes currency in circulation, balances in retail money-market funds and savings deposits) was bolstered during the COVID-19 pandemic by the Federal Reserve's quantitative easing and government stimulus efforts. Some of this stimulus seeped into the broader economy, including roughly $1 trillion in direct payments to individuals through the end of 2021.

Easy come, easy go. After surging during the COVID-19 pandemic, the money supply has been plunging. The growth rate for December marked the first-ever year-over-year decline (- 1.3%). Not even the great inflation slayer, Paul Volcker, sanctioned an outright contraction in the money supply.

If the current rapid decline of M2 Money growth persists, economic growth may be negatively impacted sooner than many have forecasted. If economic growth slows sooner than expected, then inflation could also moderate. That moderation may lead to a “true pivot” and a Fed Funds rate cut may be sooner than anticipated.

While bank lending is still increasing, it is showing signs of slowing and deposits are shrinking. Have a read of “Banks Borrow Unsecured Cash at Record Clip While Deposits Flee” from the *WSJ*. As the article points out, U.S. bank deposits have been falling at the fastest rate on record as customers pull cash from savings accounts to seek higher-yielding investments. And that’s causing liquidity to shrink.



As I’m sure most readers will agree, the same dynamic is unfolding in the credit union space. According to Callahan data, outstanding loan balances increased 19% annually to almost $1.5 trillion, the highest year-over-year growth rate on record. This has far outpaced the rate of share growth, leading to significant liquidity concerns within the credit union space. If lending activity continues, credit unions will need to turn to raising rates on deposits or borrowing funds from other lenders to generate liquidity.

BACK TO THE JOBS DATA

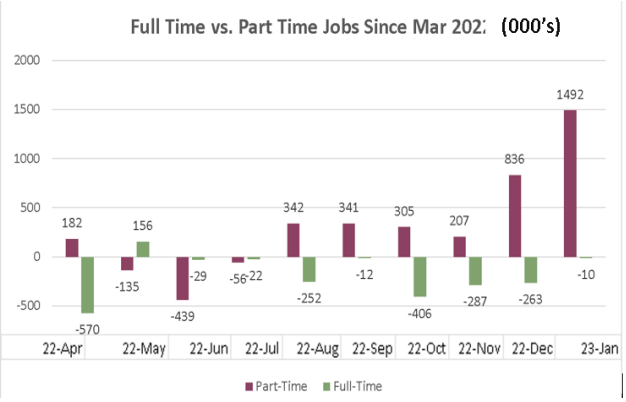
"The reality is if we continue to get strong labor market reports or higher inflation reports, it might be the case that we have to raise rates more than is now expected." — Jerome Powell, Federal Reserve Chairman

It was an allegedly strong jobs report that triggered belief in the Fed's stance of higher for longer. In a speech at the Economic Club of Washington last week, Fed Chairman Jerome Powell stated the Fed may need to hike rates more than what is priced in the markets if employment reports come in unexpectedly strong and inflation climbs.

Undoubtedly, it is true that some industries (air travel, restaurants and leisure/hospitality) have openings and are staffing up. However, job losses are spreading out elsewhere and not just in tech, but also in the financial sector. These are the highest-paying jobs in the economy while the employment gains are in lower-skilled service sector segments. Employees in both the tech and financial sector make, on average, three times what those earn in leisure/hospitality. All jobs are not created equal.

I still am a bit skeptical about the last payroll report. How is it that the ADP payroll report has been lower than the non-farm payroll report in twelve of the past thirteen months? If you recall, ADP come out with its report showing just a +106,000 expansion in private sector employment. This was the weakest gain in nearly 24 months. Two days later, the non-farm payroll report (NFP) showed a 517,000 surge in employment, the best showing in six months. In fact, the ADP has been below NFP in twelve of the past thirteen months. The difference is a whopping 1.55 million jobs. Both labor metrics are nearly 100% correlated. This wide divergence makes no sense. Which one has the story right? Time will tell. Here's something else to think about, the ADP report has a sample size of 400,000 establishments (covering 25 million workers) compared with 122,000 for the non-farm payroll survey.

Also, as we were lost in the commotion over the shocking non-farm payroll headline, perhaps we should be asking why was it that the level of full-time employment in the U.S. is lower today than it was last March 2022. Part time jobs have risen to make ends meet. But full-time employment is stagnant no matter how one slices and dices the data. In fact, not one full-time job has been created on net over this time span.

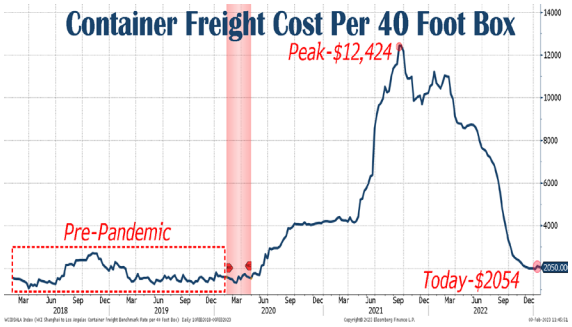


Source: Bureau of Labor Statistics

REMEMBER THE SUPPLY CHAIN ISSUES?

"It's a different picture now. We've seen demand falling from both the U.S. and Europe, and it's a pretty sharp correction." — Vincent Clerc, CEO, Maersk

A report from Danish shipping giant, Maersk, shows that global trade flows have moved into a disinflationary state. The company stated that earnings could plunge nearly 80% this year amid weakening demand to ship containers. In the fourth quarter, average freight rates deflated 3.5% and shipping volumes cratered 14%. This should begin filtering through to lower prices in the not too distant future.



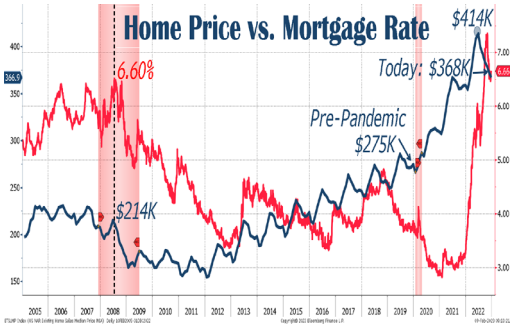
** Red shaded areas denote recessions*

MEAN REVERSION IN HOUSING MARKET

"Reversion to the mean is the iron rule of the financial markets." – John Bogle, Founder, Vanguard

There have been two major housing bubbles in the past twenty years. The first housing bubble peaked in March 2007 and its deflation phase then lasted until December 2011.

Today, we are experiencing the deflation of the second housing bubble, which started in 2020. As shown below, during the COVID-19 pandemic, the national median home price soared from $275,000 to a peak of $414,000 in July 2022. Prices have since declined 11% to $368,000. Even still, home prices remain 33% above pre-COVID-19 pandemic levels.



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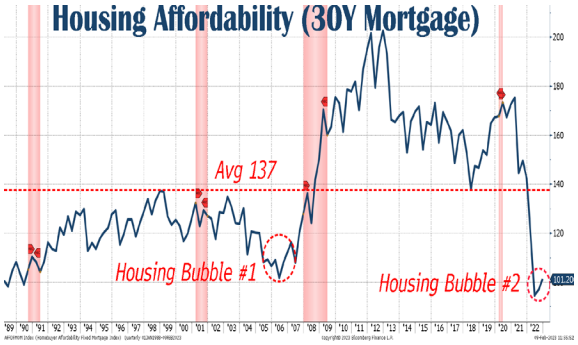
Given the inflated home prices and doubling in mortgage rates from 3% to 6.66%, housing affordability is at the most strained level since the mid-1980s. It is interesting to note that the last time mortgage rates were at 6.66%, the median price of a home was $214,000 in 2008.

The monthly mortgage payment on a typical existing single-family home priced at $378,700 with a 20% down payment is $1,969, representing a major surge of 58% or $720 from one year ago.



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So, if "mean reversion" is the "iron rule" what will it take for house prices to mean-revert to average homeowner affordability levels? Either house prices decline by 25-30%, mortgage rates decline by 200 basis points (why I am a long term bull on the Treasury market) or personal income rises by 33% — or some combination thereof.

Bottom Line: It's hardly any wonder why housing demand is in the dumps. And there is no recovery in the housing sector until we have lower prices along with mortgage rate relief.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

As to the economy's growth rate, the Conference Board's Leading Economic Index has been flat or down ten months in a row and by 7% (annualized) over this period. As shown below, whenever we have had this consistent weakness in the past, we have had a recession. This is not an opinion. It's data. Yes, because this is a truly strange goofy time, this time could be different but is it wise to bet against an index that has correctly predicted the last of the eight recessions?

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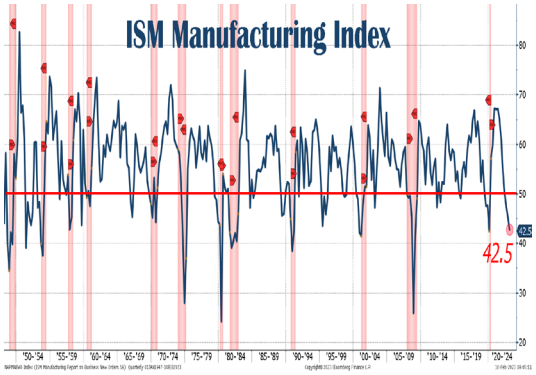
And then we have the Institute for Supply Management (ISM) manufacturing the Purchasing Manager's Index (PMI) for January, which had the recession-disinflation label written all over the report. Get this. Only two industries saw any

growth at all, and no industry saw expansion in its order books in January. Not one! The only other time this happened was in 2009, the worst point of the Global Financial Crisis.



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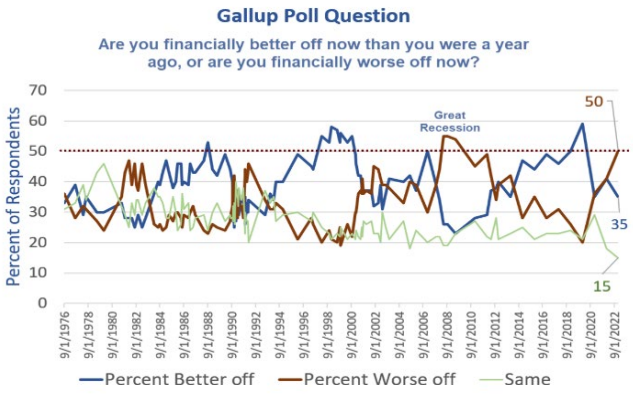
As for the consumer, the latest Gallup survey shows that 50% of Americans across all income groups say they are worse off when it comes to financial conditions. This is the most negative read since 2009. Of note: A massive 61% of lower-income workers say they are worse off. How is this bullish for consumer spending going forward?

- Lower: 61%
- Middle: 49%
- Upper: 43%

Also, a low savings rate of 3.4% in December combined with the negative wealth effects from home depreciation and lagged impacts of last year's interest rate increases, will undoubtedly weigh on consumption.



However, on the positive side, weaker demand coupled with easing global supply chain bottlenecks, will hopefully lower inflation giving the Fed room to reverse its current hawkish stance probably late in the year.

Now consider the following from former Fed Vice Chairman, Alan Blinder, from the *WSJ* article, "The Fed Now Has a Good Chance at a Soft Economic Landing":

"The Consumer Price Index (CPI) rose at an 11.1% annual rate in the first half of 2022 ***and a 1.9% annual rate in the second half. No, that is not a typo — a tad under 2%...*** *Meanwhile (PCE) inflation (The Fed's* ***preferred inflation metric) also crumbled — from 8% in the first half of 2022 to 2.1% in the second****. That's 'only' a 6-point drop, less than the 9-point drop in CPI inflation, but still remarkable."*

"Six months of quiescent inflation data doesn't prove that the inflationary dragon has been slain*. True again.* ***But six months is also too long a period to be dismissed as a mere blip in the data****.* ***The dragon is, at minimum, seriously wounded."***

— Alan Blinder, Former Federal Reserve Vice-Chairman

While its too early to say that disinflation is well entreched, inflation has clearly peaked. Over the past six months, core inflation has been running near the Fed's target of 2%. That's remarkable progress.

Meanwhile, this is the most hawkish Fed I have seen in 40 years in the business. Powell made it very clear that we are in for ongoing rate "increases", which is plural, not singular. Meanwhile, Former Atlanta Fed President, Dennis Lockhart, stated that the central bank is prepping to hike its dot-plots on the Fed Funds rate yet again at the March Federal Open Market Committee (FOMC) meeting. He emphasized that once the overnight rate is firmly above 5%, the Fed is to keep it at that level for "quite some time". He then left open the prospect that the Fed stands ready to resume hiking rates even after it pauses.

Regardless of what actually happens, the Fed has been successful in nudging the futures contracts out of pricing in any rate cuts later this year. The bond market has acquiesced and now is discounting the terminal policy rate at 5.2%. This was clearly not good news for the front end of the curve. In fact, the 2-year Treasury yield suffered a coronary these past few days (up +50 basis points in just over a week!).

Meanwhile, as the Fed has been succesful in talking rates higher, the yield curve has inverted even further (-80 basis points) to levels not seen since the Volcker era 42 years ago. Recall that the eleven recessions since 1950 followed an aggressive Fed tightening program that inverted the yield curve. That is the historical track record.

It's also important to recognize that recessions typically begin either at the end of the Fed tightening program or after it is over. Timing is up for debate, but betting against the interest rate cycle and the business cycle that is hitched with a lag to the rates cycle is too risky. I say don't mess with Mother Nature. And it's not just rate hikes, the Fed has reduced its balance sheet, to little fanfare, by $102 billion through the first five weeks of this year.

**Red shaded areas denote recessions*

Bottom line: Near term the Fed will likely raise rates again, but it is unknown what will happen to intermediate to longer term yields and the yield curve. Because of this uncerainty, a risk appropriate laddered portfolio of Treasuries remains a prudent approach to managing excess cash reserves over a full rate cycle. Tactically speaking, credit unions should try to capitalize on periodic yield increases in the early parts of 2023.

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.