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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF FEBRUARY 21, 2023

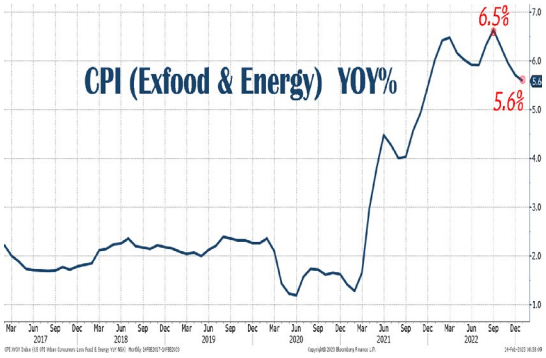
A Sigh of Relief

"From here, there is today's Fedspeak with which to contend, and we don't think there is anything contained within this read to call into question the Federal Open Market Committee's hawkish commitment." — BMO Economics

Did you know that half of the items in the Consumer Price Index (CPI), mostly services, are imputed by the Bureau of Labor Statsitics (BLS)? In other words, pure guesswork. They are NOT market prices. They are NOT based on transactions. This includes medical care, financial services and, of course, the rental measures. And yet, the media, the markets and even the Fed are obsessing with this metric that Alan Greenspan, Former Federal Reserve Chairman, once labelled a "flawed statistic."

Despite the flaws, this is what the Fed uses in measuring inflation in the U.S. economy. Despite whispers of a very high CPI reading, the January headline CPI came in as expected at +0.5%. The core (excluding food and energy) rose +0.4%. What a sigh of relief that inflation was not higher.

Shelter remains the prime source of price increases with a +0.7% uptick as the lags from real-time slippage in apartment rents have yet to kick in. Used vehicle prices fell 1.9% last month despite the hooking-up in the Manheim index. Air fares also sagged 2.1% and were down in each of the past four months. There were offsets in areas like education and communication (+0.5%), and in recreation (+0.5%).



More impotrtantly, regarding Fed policy, the Fed's eyes are on services. Inflation in services can be stickier than in goods. Nearly two-thirds of consumer spending goes into services like

THIS WEEK

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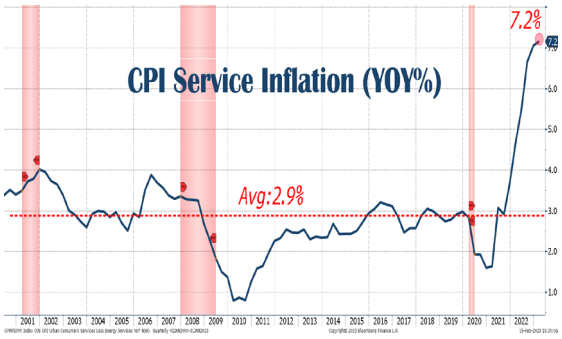
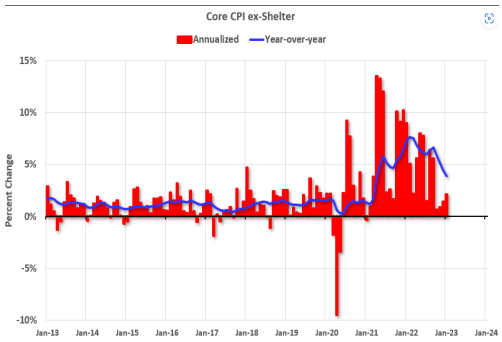
rent, other housing factors, insurance of all kinds, healthcare, education, repairs, travel and hotel bookings, subscriptions, streaming, telecommunication services, haircuts, pet services, etc.

On an annual basis, services inflation jumped by 7.2%, which is the worst year-over-year increase since 1982 and the fifth month in a row above 7%.



**Red shaded areas denote recessions*

But for me, the key was the core CPI services (excluding shelter, a 45% chunk of the index), which have cooled on a year-over-year basis. The graph below shows the year-over-year change in core CPI (excluding shelter) in blue, and the one month change annualized in red. The year-over-year trend has decelerated very nicely from +7.3% a year ago to sub 4%. This is great news because Fed Chairman, Jerome Powell, has identified housing as a sector of the economy with disinflation in the pipeline.



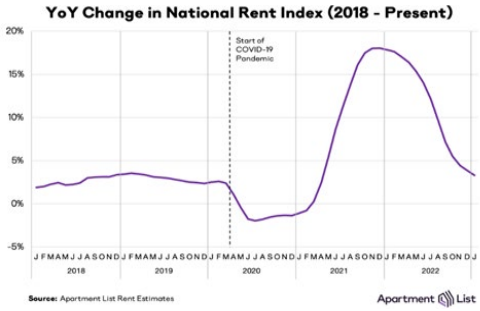
Source: Calculated Risk

During the COVID-19 pandemic, there was a surge in household formation which pushed rents up sharply due to simply too much demand and not enough supply. Rents have soared, climbing to 8.6% year-over-year in January — the highest since 1981. There are concerns about the persistence of high inflation, which means tighter Fed policy for longer.

Now household formation has slowed sharply just as more supply will be coming on the market. Indeed, apartment units under construction are up 24% from a year ago and a fresh five-decade high. Build them and they will come, correct? Maybe according to Kevin Costner. But this supply deluge is sure to have a major downward influence on those rental components of the CPI in the second half of the year.

Indeed, the good news can already be gleaned from the Apartment List National Rent Index.

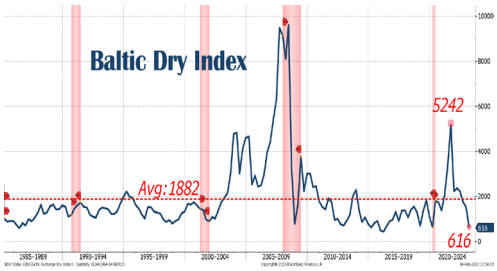
Year-over-year rents have plunged from 18% from mid 2021 to 3.9% today. While there are lags, the new leasing rates, which are in decline, will start to permeate through the headline price data. According the Cleveland Fed, we should start seeing the disinflationary impacts of rent on the CPI by the second half of 2023.



Bottom line: Inflation is like a race between watching paint dry and grass grow. The good news is that inflation has clearly peaked and the deceleration, if ever so gradually, is intact. As we move forward, the rent disnflation is key to the disinflation narrative. Look for service sector component (especially shelter) of the CPI to show much more disinflation in the second half of the year when rental supply comes on stream and dwarfs the demand.

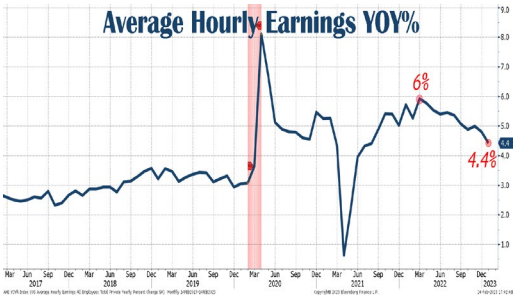
MORE ON DISINFLATION

Has anyone checked out the chart of the Baltic Dry Index recently? It measures changes in the cost of transporting various raw materials, such as coal and steel. It's collapsed 89% from the October 2021 peak and is lower than it was pre-COVID-19. There are no more supply chain issues.



**Red shaded areas denote recessions*

On the all important labor front, unit labor costs rose at a 1.1% rate in the fourth quarter, below its long-term average of 1.8%. Likewise, average hourly earnings over the past 12 months have continued to decelerate from 6% in March 2022 to 4.4% last month. Could wages and incomes really be slowing dramatically with the labor markets reportedly so strong?



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With energy, food and rent-induced CPI run-up, real average hourly earnings fell 0.2% month-over-month in January and are down 1.8% on a year-over-year basis. In fact, the year-over-year real wage trend has now been negative each and every month since April 2021.

After nearly over two years, not once did the working class manage to reap a wage gain more than inflation This is why the widespread commentary about the super-tight labor market doesn't hold any water. There simply is no wage price sprial like we witnessed in the 1970s! The cartoon below sums it up quite nicely.

REVENGE OF THE WORKER?

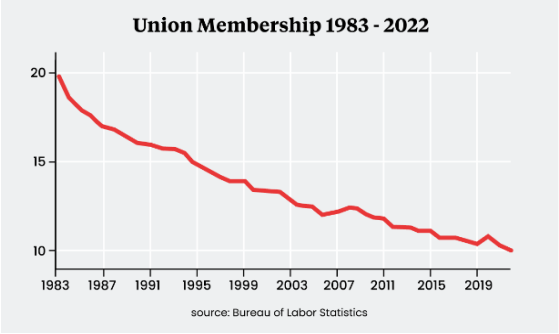
It's been widely reported that the Fed's biggest concern is cutting rates prematurely and following in the footsteps of Arthur Burns, Former Chair of the Federal Reserve, in the 1970s when inflation ran rampant. And it's true, I was around in those days and saw prices seemingly increase day by day.

It's also true that the Fed had to deal with a number of oil price shocks as oil price soared in the 1970s and the Organization of the Petroleum Exporting Countries (OPEC) made sure that oil prices rose every single year. Steadily rising oil prices lead to systemic inflation through rising input costs throughout the economy.

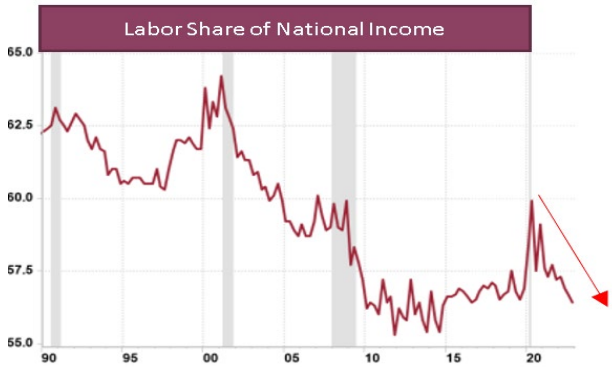
Moreover, demographics in the 1970s were profoundly different. Boomers, who were in their 20s, were on a spending spree buying everything from cars, homes, refrigerators to washers and driers. Today Boomers are in their 70s buying hip replacements and pickle balls. It's just not the same for what it means for demand-led inflation.

Also in the demographic file, the female labor participation rate soared by 20% in the 1970s as America shifted from the "Cleaver" household to dual income families. This further drove demand in the economy.

Another common theme I hear bandied about is "worker power" and the "revenge of the worker." Other than a few anecdotes, there is no evidence to support this. Yet, this theme is being peddled as if it's true. If the worker was clearly writing the script, would union membership fall to a record-low? But it did! According to the BLS only 10.1% of wage and salary workers belonged to unions in 2022, down from 10.3% — a record low.



Also, if the worker had the upper hand, the labor share of national income would be going up, not down. As you can see below, workers have seen their share of national income declining to 56.4%. This is lower than pre-COVID-19 pandemic levels in 2019. Does that look like worker power to you?



Source: Haver Analytics

Bottom line: Wage pressure is decelerating after the COVID-19 pandemic bounce. And there is no evidence to support the so-called "revenge of the worker." Yet, this theme is being peddled as if it's true. The narrative of employees having the upper hand is not supported by the data above. But then again, why let the facts spoil a good story.

LIGHTS OUT?

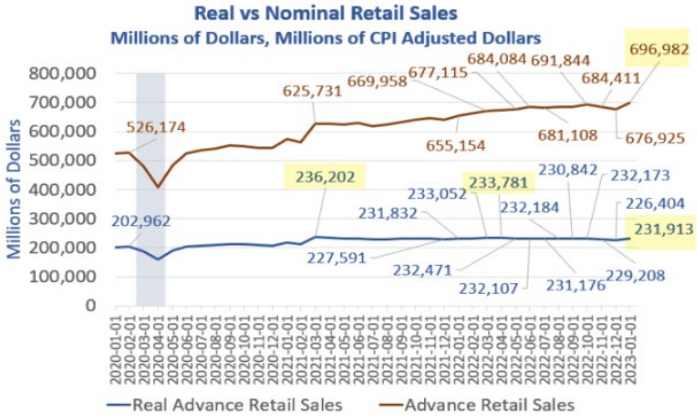
December retail sales hit the lights out with a +3.0% gain. The last time retail sales jumped this much was in March 2021, when the stimulus checks were being doled out.

The key "core control" group (retail sales excluding autos, building materials and gasoline), which feeds into gross domestic product (GDP), jumped +1.7%, versus the consensus view of +1.0%.

Consumers spent more in every single category the government tracks — except gasoline stations, where sales were flat.

I should stress that this data has been quite volatile of late. I would caution against extrapolating one monthly number into the future. It's the trend that matters. January did follow declines in November and December, so the three-month trend is running at a fairly tepid +3.0% annual rate. For perspective, a year ago the comparable pace was running at a +9.5% at an annual rate. The three-month "core control" (which strips out autos, gasoline and building materials) is running at a +1.8% annual rate over the October-January period, and again that compares poorly to +8.7% exactly a year ago. So just how strong is the consumer?

Also, a very important point is that retail sales are adjusted for seasonal variations, but not for price changes. Take a look at the graph below. The nominal charts below show weakness for just a couple of months. However in real (inflation adjusted) terms, following the blue line in graph below, the sales reports look much worse. In January sales were –1.8% and have been heading south for the last 22 months! Simply put people are spending more but buying less.



Source: Mish

TRIPLE TROUBLE

"It's triple trouble for credit card borrowers. Balances are up, rates are up and more people are carrying credit card debt" — Ted Rossman, Senior Analyst, Bankrate

A couple of years ago, when stimulus checks were given out, American consumer's credit card balances had dropped 17% from the pre-COVID-19 pandemic high. Times have surely changed, as savings have been depleted and credit card balances have ballooned. The New York Fed's Household Debt and Credit Report showed that American households, even in the face of punishingly high interest rates where the average credit card rate is 21%, took on a record $61 billion of extra credit card debt in the past quarter to an unprecedented $986 billion. From December 2021 to December 2022 credit card debt soared $130 billion — the largest annual growth on record. Making matters worse, consumers are paying dearly with credit card rates at a 40-year high!

Credit card borrowers aren't just swiping plastic more than ever — they're missing payments too, with delinquency rates surpassing pre-COVID-19 pandemic norms. A little over 4% of credit card debt has transitioned to serious delinquency, which means failing to pay for 90 days or more. 46% of Americans with plastic have yet to pay off their outstanding balance, which is up from 39% a year ago.

But the big bubble is not just in credit cards. It's also in subprime autos where loans 60 days past due have risen sharply to 5.67% compared to 2.58% in April 2021 as well as taking out the 5.04% level at the depths of the Global Financial Crisis in January 2009.

Now consumers are under the gun as stimulus checks are long gone, savings have disappeared and the debt piles up. Nearly 40% of Americans are having trouble paying bills, and almost 57% of Americans can't afford a $1,000 emergency.

"68% of people are worried they wouldn't be able to cover their living expenses for just one month if they lost their primary source of income. And when push comes to shove, the majority (57%) of U.S. adults are currently unable to afford a $1,000 emergency expense. — Bankrate

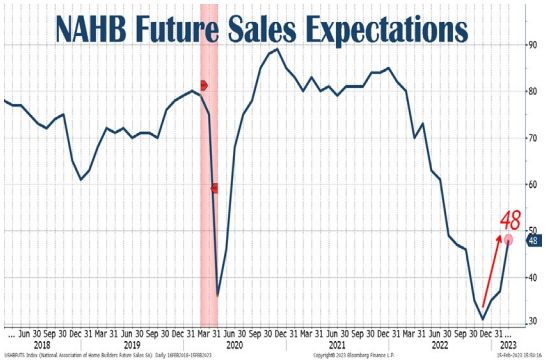
Bottom line: Despite the fluctuations in the retail sales data, nothing has really changed in that the consumer is living on borrowed time and money. The combination of depleted savings, record high credit card debt and record high credit card interest is very worriesome for the strapped consumer, who has no choice but to keep buying on credit while hoping next month's bill will somehow not come.

As the consumer goes so goes the economy. I don't believe this will have a happy ending.

BLOWING THE ROOF OFF

"Even as the Federal Reserve continues to tighten monetary policy conditions, forecasts indicate that the housing market has passed peak mortgage rates for this cycle …While we expect ongoing volatility for mortgage rates and housing costs, the building market should be able to achieve stability in the coming months, followed by a rebound back to trend home construction levels later in 2023 and the beginning of 2024."
— Robert Dietz, Chief Economist, National Association of Home Builders (NAHB)

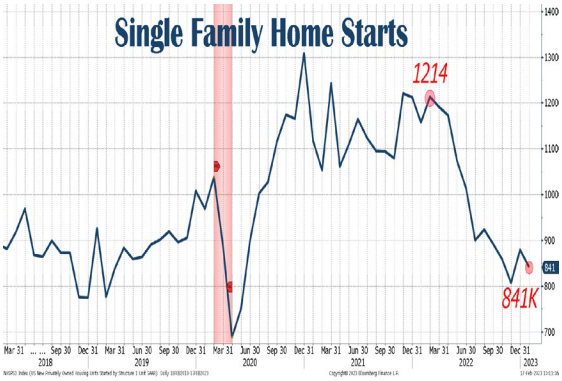
The NAHB homebuilder sentiment index blew the roof off jumping to 42 in February from 35 in January. This was the sharpest monthly increase since July 2020. The two-month, 11-point rebound is also the most since September 2020, but back then the Fed was easing policy and the recession was in the rearview mirror!



**Red shaded areas denote recessions*

BUT THEY AREN'T BUILDING!

Whle builders seem to be getting more optimistic, housing starts sagged 4.5% month-over-month in January to 1.309 million annualized units — the lowest starts level since June 2020. Year-over-year, housing starts are down a whopping -21.4%. Meanwhile, building permits, while little changed for the month, are down 27.3% year-over-year.



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The single-family sector is in a state of gloom. Starts plunged 4.3% — the fourth thrashing in the past five months. Year-over-year single-family housing starts are down a huge 30%. At 841,000 units, hosusing starts are back to the second lowest since May 2020 amidst the peak of the COVID-19 pandemic crisis.

If single-family building permits are any indication of things to come, there isn't any rebound on the horizon. Permits fell 1.8% and are riding an epic eleven-month losing streak to 718,000 units — the lowest since April 2020.

So why are builders "bulled" up? Perhaps Upton Sinclair has the answer:

> *"It is difficult to get a man to understand something, when his salary depends on his not understanding it."*
> *— Upton Sinclair*

Bottom line: Have you ever met a realtor or a homebuilder who didn't think it was a great time to buy a home? Watch what the builders do, not what they say. Builders are getting bulled up, but they're not building.

HERE'S THE DEAL!

Using President Biden's vernacular, "here's the deal," one can debate the type of whatever landing we are headed for, but the data below shows everything from production, sales, shipments, orders and to exports contracting in the last quarter of 2022. Rarely do you see such a wide swath of spending categories weakening at the same time without the economy nearing a recession or coming out of one.

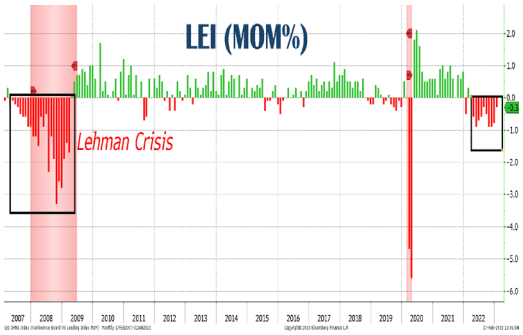
- Building permits: -47%
- Housing starts: -21%
- Exports: -11%
- Construction expenditures: -7%
- Retail sales volumes: -6%
- Industrial production: -5%

Take a good look at the trend in the high frequency indicators below and tell me if any of these have a "no landing" label written on them? Do you see a "soft landing?"

- Port of Long Beach cargo activity: -28%
- Cass Freight shipment volumes: -4%
- Lumber orders: -5%
- Mortgage applications: -58%
- Steel production: -7%
- Major home appliance shipments: -10%
- Lumber shipments: -10%

A FEW OTHER THINGS TO THINK ABOUT

While the market is defiant that the Federal Reserve will engineer a *"soft landing,"* the Federal Reserve has never entered into a rate hiking campaign with a *"positive outcome."* Instead, every previous adventure to control economic outcomes by the Federal Reserve has resulted in a recession, bear market or some *"event"* that required a reversal of monetary policy. Or, rather, a *"hard landing."*



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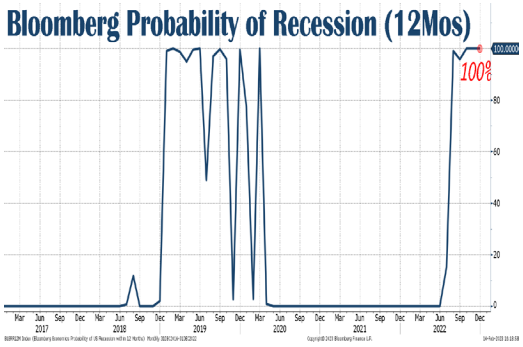
Meanwhile, the Conference Board's Leading Economic Indicators (LEI) continued its decline in January, dropping 0.3%. This was the tenth straight monthly decline in the LEI, and the eleventh month out of the past thirteen months. This is the longest streak of declines since Lehman. On a year-over-year basis, the LEI is down 6.03%, which is close to its biggest year-over-year drop since 2008 outside of the COVID-19 lockdown-enforced collapse. The trajectory of the

U.S. LEI continues to signal a recession over the next twelve months. Meanwhile, the Bloomberg model (13 indicators) is at 100% (can't get higher than that) for a recession to start in the second half of this year.



The 2s/10s yield curve has been inverted for the past eight months and is now inverted to over -80 basis points. Last time it was here was in 1981, and the double-dip recession was three months away. The average lag from when the yield curve (2s/10s) first inverts and a recession is just over a year, but some have been as short as six or nine months. Different this time? I somehow doubt it.

Bottom line: If you believe it's "different this time" then we will have a "soft landing." But this is the most inverted yield curve since 1981, ten months of contraction in the Conference Board's leading economic indicator and a 100% recession probability this year, per the Bloomberg index, tell me that this is a case of hope triumphing over experience.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The Fed will tighten until something breaks"
— Michael Harnett, Chief Investment Strategist, Bank of America

Last week, Loretta Mester (Cleveland) remarked on how she saw a compelling case for a bigger increase earlier this month when policymakers met. Not much later in the day, her colleague James Bullard (St. Louis) commented that he would not rule out supporting a 50-basis point hike at the March meeting.

The rate-trajectory expectations have surged back hawkishly, with the terminal rate now nearing 5.25% and less than one rate-cut priced-in for second half of 2022. Specifically, the odds of 25 basis point hikes in May and June have jumped to 82% and 59%, respectively.

This Fed is trying to come up with any macro-reason it can to keep hiking even though the lags of everything it did last year haven't even percolated through the economy yet, and the focus is constantly on lagging or coincident indicators.

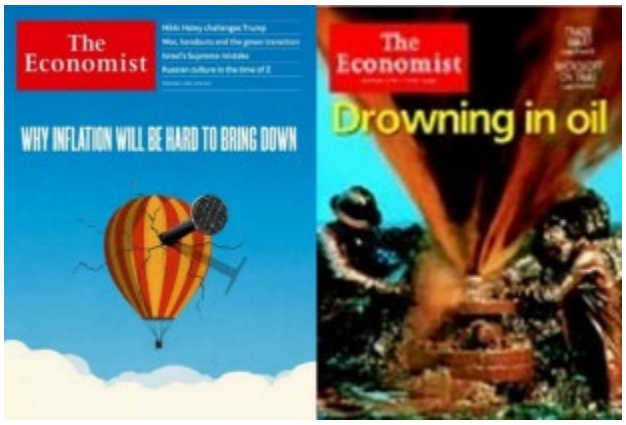
Interestingly enough, while the front end of the curve has adjusted for the higher rate paradigm, the long Treasury bond yield is trading at a yield nearly 150 basis points below the mid-point of the projected 5.25%-5.5% band. Mr. Bond is screaming recession as the Fed tightens even more aggressively into the most inverted yield curve since 1981.

Given the steepness of the current rate hike campaign and deep inversion, it is unlikely that the equity market and economy will remain unscathed.

"When all the experts and forecast agree — something else is going to happen."
— Bob Farrell's Market Rule #9

Finally, for those with any contrarian genes, remember the "front cover" effect. Today, everyone and their grandmother believe that inflation is here to stay and that interest rates will remain higher for longer. This sentiment is reflected in the Economist's cover story "Why Inflation Will Remain Hard to Bring Down." Now, consider the cover of the Economist "Drowning in Oil" in March of 1999. Everyone, and I mean everyone, believed that the world had too much oil and prices would stay low for longer. Yet, they more than doubled from $13 per barrel to $30 a year later.

As Mr. Farrell succinctly says, when all the experts agree something else is going to happen. Indeed!



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.