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INVESTMENT SERVICES

Weekly Relative Value

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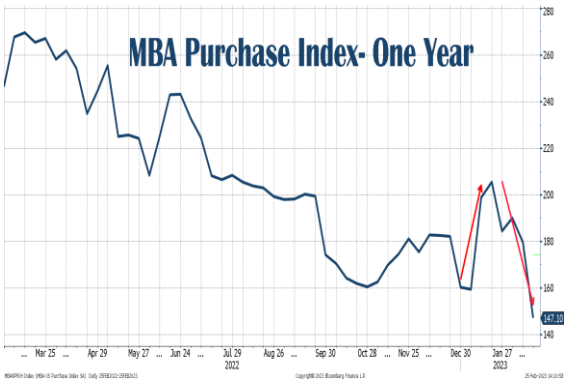
WEEK OF FEBRUARY 27, 2023

Free Falling

"The pandemic created a perfect storm for driving up housing prices and 2022 was the aftermath of that storm." — Ruben Gonzalez, Chief Economist, Keller Williams

After the holiday season, housing activity stalls. Soonafter, the spring selling season will kick off in January and February, in terms of foot traffic and other early measures of buyers' interest including mortgage applications to purchase a home.

In January, it appeared that housing had bottomed out with mortgage applications to purchase a home jumping by nearly 30% over the first few weeks. Improvements in January gave rise to hopes that the spring selling season might actually somehow materialize and mortgage rates would soon be below 6%, then below 5% and heading back to 3%.



THIS WEEK

- HOUSING LEADS THE ECONOMY
- TWELVE MONTHS IN A ROW
- THE NEXT SHOE TO DROP?
- STALL SPEED
- HOTTER THAN EXPECTED
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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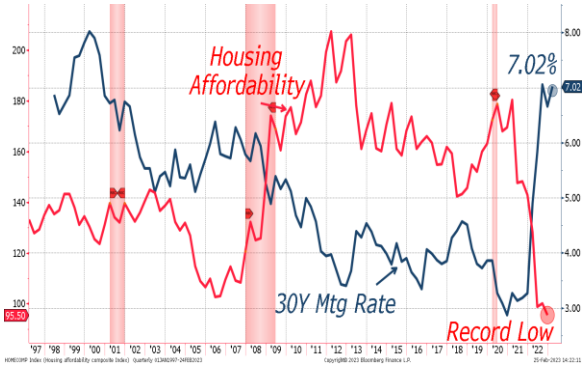
"We're sitting right now at the worst housing affordability we've seen in several decades."
— Ruben Gonzalez, Chief Economist, Keller Williams

Turns out, it was a false bottom. As incoming inflation and economic data surprised to the upside, the markets realized that the Fed might not pivot as early as the market had assumed. Perhaps the markets realized the Fed will raise rates further and keep them there for a lot longer.

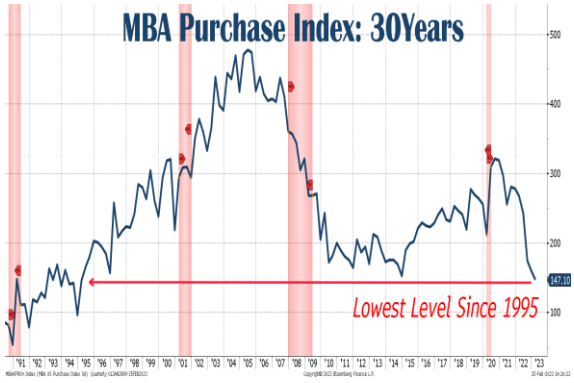
In fact, short term Treasury yields have surged with the six-month and the one-year yields now solidly above 5% for the first time in 15 years. The 10-year yield is once again near 4% as the era of interest-rate repression and money-printing ended.

Because mortgage rates are highly correlated to the 10-year Treasury benchmark, mortgage rates surged back to over 7% — back to levels last seen in 2000. For perspective, the existing home sales median price was over 50% lower than prices today.



**Red shaded areas denote recessions*

So with housing affordability out of reach for many Americans, it now appears that the beginning of the spring selling season will be challenging at best. In fact, for the week of February 17, new purchase applications were downright u-g-l-y, plunging 18.1% (after a 5.5% fall-off in the week of February 10). Year-over-year, mortgage applications to purchase a home are off 41% from year-ago levels — believe it or not, it now sits at the lowest level since the spring of 1995.



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Bottom line: Mortgage applications to purchase a home are a forward-looking indicator of where home sales volume will be. Unmistakably, the mortgage application data shows that housing demand is in free fall. The bond-led surge in

mortgage rates of late is clearly having an impact. However, the problem is not just rates but also the nasty combination of rates and prices.

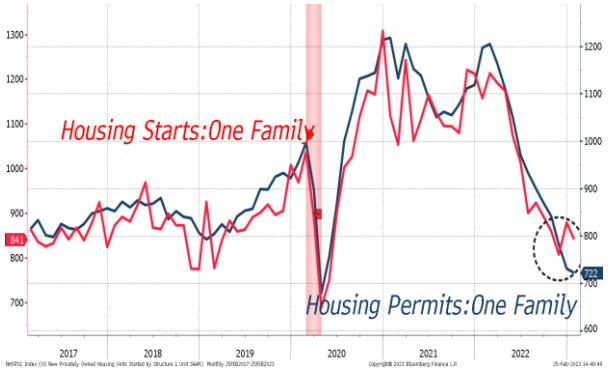
HOUSING LEADS THE ECONOMY

"From the Great Depression, to the stagflation of the seventies, to the current economic crisis caused by the housing bubble, every economic downturn suffered by this country over the past century can be traced to Federal Reserve policy. The Fed has followed a consistent policy of flooding the economy with easy money, leading to a misallocation of resources and an artificial 'boom' followed by a recession or depression when the Fed-created bubble bursts."
— Ron Paul, Former U.S. Representative

Housing starts and permits have declined for three straight months, but the data for January was expected to be more mixed with permits rebounding modestly while starts continued to decline. The forecasters were right in direction, but were way off in magnitude as housing starts tumbled 4.5% month-over-month (December was also revised notably weaker from -1.4% to -3.4%). Permits rose just 0.1% month-over-month in January after a 1.0% decline in December.

In the critical single-family sector, starts dropped a hard 4.3% month-over-month in January. Starts were down sharply in four of the past five months and are down a whopping -27% on a year-over-year basis. Single-family building permits also sagged 1.8% month-over-month and have been down for eleven months in a row. The last time this occurred was during the housing meltdown from May 2007 to April 2008.

In the following graph, please take note of the widening gap between starts (841,000) and permits (722,000). Today, the gap is at it's widest since the beginning of the housing debacle in 2007. In following year, starts collapsed an additional 43%.



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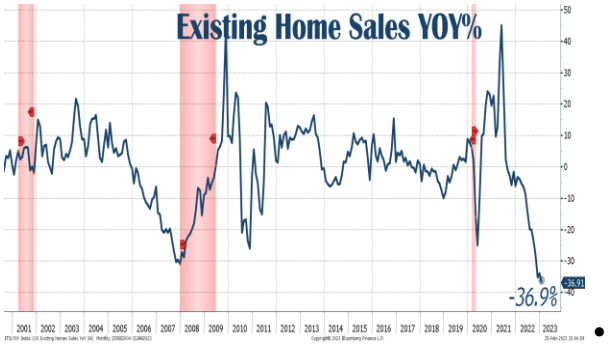
BOTTOM LINE: Starts lead the economy, and permits lead starts. Given the current trajectory of permits and starts, the widely hoped for spring housing rebound will have to wait.

TWELVE MONTHS IN A ROW

According to the National Association of Realtors (NAR), sales of existing homes fell by another 0.7% in January from December to an annualized rate of of 4.0 million homes. This was the twelfth month in a row of declines. Sales dropped by 37% year-over-year and are below the COVID-19 lockdown level low of May 2020. In fact, the decline in sales is now lower than what was seen at the depth of the housing crisis in 2007.



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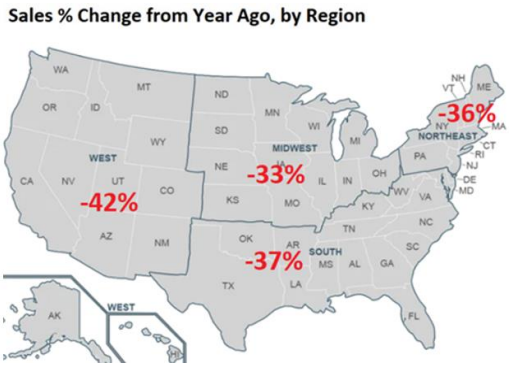
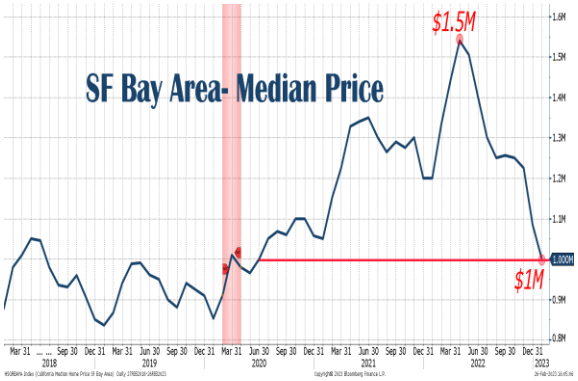
There was no region unscathed as sales plunged throughout the country.



Source: NAR

In terms of pricing, there are some markets that have already plunged from previously ridiculous levels. To wit: The San Francisco Bay Area has seen home prices already crater by 50%! Home prices went from $1.5 million to $1 million in a matter of eight months. Yes, I said 50%! Home prices in the Bay Area are now back to pre-COVID-19 pandemic levels.



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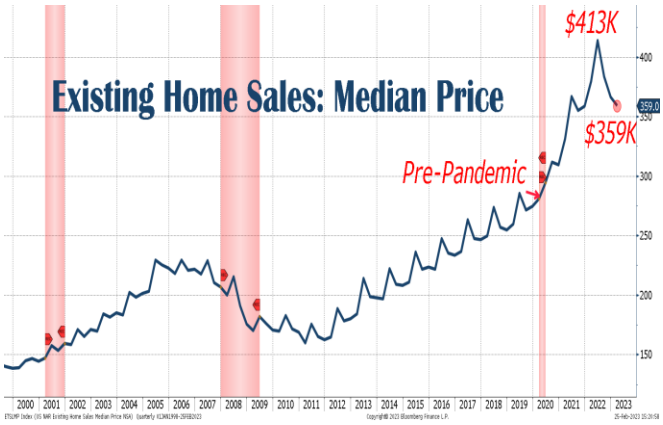
On a national basis, even though existing home sales back to levels below the Great Financial crisis, prices have just begun to adjust to the harsh new reality! Thus far, the national median price of homes has now fallen for the seventh consecutive month to $359,900, which is down 13.2% from the peak in June.

Redfin reported that U.S. home values have come down $2.8 trillion since last June — the sharpest six-month wipeout since the 2008 debacle. Next comes the negative "wealth effect" on spending considering that residential real estate occupies a record $46 trillion on household balance sheets (a 29% share, which is a 14-year high).

Even still, home prices remain well above pre-COVID-19 pandemic levels while mortgage rates have doubled over that same period. For the current mortgage rates, prices would need to decline by 20-30%, depending on the location, just to return to levels that would be considered very high versus the nonsensically high.

Also, the negative price action in the residential resale market is providing an additional signal that even with the inventory situation still rather tight, the demand is slicing below the supply. Recall that home prices do not drop like crypto. It takes time for house prices to find a sustainable low. During the housing crisis of 2007-2008, it took nearly five years to finally find a bottom. Point being, the current downtrend in prices may have a ways to go.



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As I have opined previously, those that "sell first, sell best." Sellers are finally catching on. Of all the active house listings, 30% had price reductions in January — by far the largest portion for any January month back to 2016. This shows that the seller's willingness to explore the market clearing price has increased, which is a good sign in terms of unfreezing the market.

While inventory levels appear quite low, it is not the total picture of supply. According to Census data, the actual vacancy rate for the entire housing stock was 10.4% in the fourth quarter, or 14.55 million housing units, of which nearly 11 million housing units were vacant year-round. Of them, 6.7 million vacant housing units were being held off the market for a variety of reasons. Think about this: If just 10% of the vacant properties being held off the market suddenly show up on the market, active listings (currently 626,000) would more than double. In other words, there is no housing shortage and the potential supply that could hit the market is quite high.

BOTTOM LINE: As long as the Fed sticks with a policy of higher-for-longer and prices remain at ridiculous levels, housing will be very weak. And if housing is weak, gross domestic product (GDP) will be weak due to the powerful knock-on "multiplier" impacts across the economy in both the goods and services sector. In addition, the deflating real estate values will have a depressing impact on the negative "wealth effect" and on spending. This process has only recently begun.

THE NEXT SHOE TO DROP?

"Commercial real estate activity slowed slightly, on average, with more notable weakening in the office market."
—Beige Book, Federal Reserve Board

There is no denying that the Fed's aggressive rate hiking campaign has sent the residential real estate market into a deep funk. The next big big shoe that may drop is the U.S. commercial real estate, especially the office market. The office vacancy rate across the nation is up to 12.3% compared to the 9.2% before the COVID-19 pandemic in early 2020. The volume of space for subleases is at the highest level on record (taking out the 2008 Global Financial Crisis peak) at 212 million square feet — nearly double the 2019 figure.

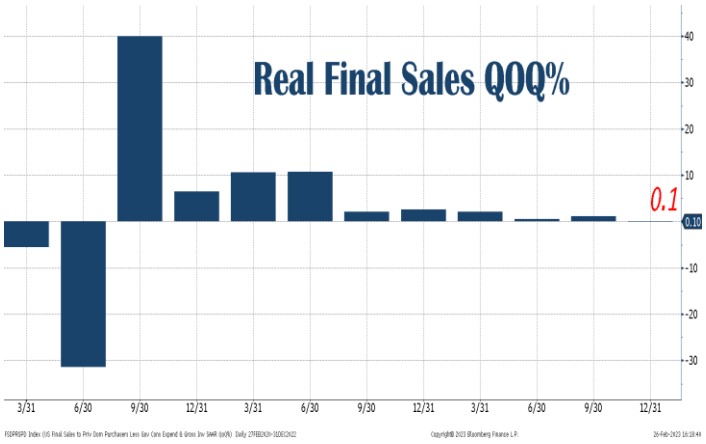
Bottom line: As the "work from home" theme becomes more entrenched along with widespread layoffs across tech and financial firms gathering steam, the outlook for the office sector is dismal as the COVID-19 pandemic "work-from-home" standards continue to weigh on demand at a time when employers are increasingly engaging in cost-cutting practices.

STALL SPEED

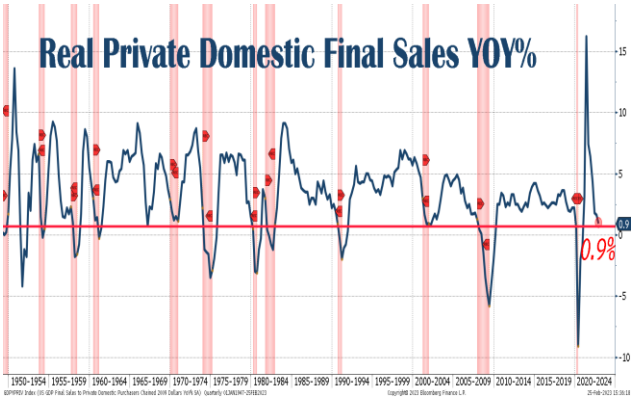
There was a modest downward revision to real GDP growth for the fourth quarter to +2.7%. The most interesting part was the cause. Consumer spending knocked down to just +1.4% at an annual rate from +2.1% (tied for the weakest performance since the second quarter of 2020). And the full brunt force from the Fed's bite has only just begun.

While the media focuses on headline GDP, the trend in real private final sales (RFS) is key to understanding the underlying strength of household and business demand. The difference between Real GDP and RFS is in inventory adjustment that nets to zero over time.

RFS to private domestic purchasers in the fourth quarter continued to decline to a mere 0.1% (the weakest print since the second quarter of 2020) from +1.1% in the third quarter. Over the past six months, the average is 0.6%. Otherwise known as "stall speed."



As shown graphically below, when looking at the history of RFS back to 1950, whenever this metric is this weak, the U.S. economy has been in or is coming out of a recession. There is nary a head-fake along the way.



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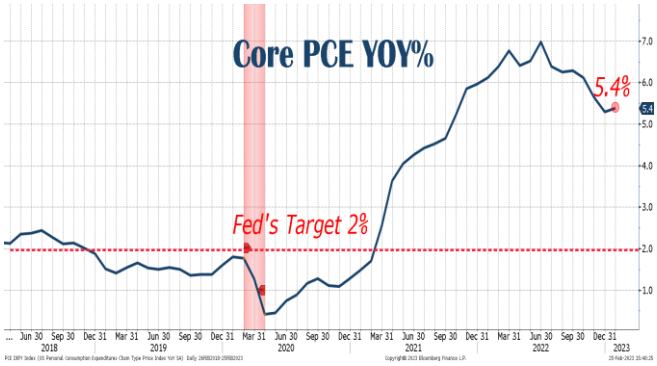
Bottom line: The same consensus that told us about the "new economy " in 2000 and "global decoupling" in 2008 is now telling us that the U.S. economy can have a soft landing. However, the data above suggests just the opposite.

HOTTER THAN EXPECTED

The Fed pays particular attention to the Personal Consumption Expenditures (PCE) price index. The "core PCE" price index (which excludes the volatile food and energy components) is its measuring stick for the 2% inflation target.

Both the headline and core PCE deflators printed hotter than expected. The headline PCE jumped +0.6% month-over-month, which is the biggest uptick since last June. The core rose 0.4% and snapped what had been an encouraging three-month deceleration in the core inflation rate. Year-over-year, the headline and core PCE are rising 5.4% and 4.7% respectively.

On a year-over-year basis, the PCE price index for "services" spiked by 5.6% — the worst since 1984. December, November and October were all revised up sharply. This is where inflation is running hot, and services is nearly two-thirds of consumer spending. This is where the inflation action now is, where it's entrenched and self-propagating.



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Bottom line: I won't hide my disappointment, but Friday's PCE deflator ran hot, there is no doubt about it, and the price increases were widespread. I wouldn't have guessed at this stage that companies would still be managing to put through such sizeable price hikes after the gouging in 2021 and 2022. Apparently, businesses still have pricing power even though corporate profits are deflating at a -3% year-over-year rate.

Inflation may have peaked, but so much for that smooth ride of lower inflation that everyone hoped for. As such, the Federal Open Market Committee (FOMC) hawks are in full control (there are no more doves). Several former Fed officials and academics are now saying their models support a peak in the Fed Funds rate as high as 6.5%. I can't argue with that because I never saw this cycle even getting as high as 5%, yet here we are. In early 2022, the Fed was telling us in the dot-plots that we would finish last year south of 1%. The January data was not good news.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Despite the sentiments of many current Fed officials that they can manage a "soft landing" while tackling high prices, a white paper says that is unlikely to be the case.

"We find no instance in which a central-[bank]induced disinflation occurred without a recession…"Simulations of our baseline model suggest that the Fed will need to tighten policy significantly further to achieve its inflation objective by the end of 2025." — The Paper, Coauthored by Economists Stephen Cecchetti, Michael Feroli, Peter Hooper and Kermit Schoenholtz.

Meanwhile, back in the real world, all anyone needs to know about how the economy is doing can be gleaned from how CEOs are talking repeatedly about four things:

1. Order books contracting
2. Inventories rising unintentionally relative to sales
3. Consumer savings being depleted
4. Head counts being too high in comparison to production.

And even the Fed is not shying away from what it is seeing unfold as far as the economy is concerned. The most recent FOMC minutes contained four mentions of "recession" — the most since June 2020 and, in fact, more than any of the meetings during the 2008 Global Financial Crisis. This is a big admission, the Fed recognizes that a recession is a high-odds development.

Obviously, the Fed can't come out and say it, but it is abundantly clear that they want tighter financial conditions which means lower asset prices across the board. Jerome Powell, Fed Chariman, wants to extinguish animal spirits and remove the punchbowl. The fact of the matter is that it is financial conditions that drive the Fed's inflation model, which is why asset deflation is and may well be the order of the day.

Moreover, the Fed wants unemployment to rise, a recession to crush consumption and to end this inflation cycle for good. That may end up being fantastic for the future (short-term pain for long-term gain). In the early 1980s, Paul Volker slayed the inflation dragon and ushered in a decade of uninterrupted economic growth and a huge bull market. Then again, Ronald Reagan was President, and Congress was filled with Democrats who were economic conservatives as opposed to today's band of left-leaning interventionists.

Meanwhile, the money markets are pricing in a tighter Fed policy and have three +25 basis point moves at each of the next three FOMC meetings. The terminal rate is now 5.41% with no rate cuts being priced in over the remainder of 2023. So, the Fed is raising rates into the most inverted yield curve since the spring of 1981. The often cited 2s/10s yield curve is more inverted now in both magnitude and duration, which is the most since 1981. Anyone remember what happened in 1982? Even the Powell yield curve (3-months/3-months forwards out 18 months) is now inverted to the tune of -45 basis points. Is it any wonder why Powell never discusses his favored yield curve anymore?

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Investors are back to pricing in an environment where the economy will enter a "no landing" and that inflation will prove "sticky." From my lens, I have a hard time seeing how this will occur in the face of the money supply contracting, a sharply inverted yield curve and a looming credit crunch (both the supply and demand for credit is in decline). If it does occur, it will definitely be a first.

Bottom line: When looking at the above while having a great respect for history, a recession appears to be a high probability forecast unless you are willing to dismiss the following three assumptions:

1. The yield curve doesn't matter anymore as a macro signal
2. The business cycle has been repealed
3. "This time is different"

For those who respect history and try to game the odds, a recession appears to be in the cards.

One last note: I realize that Treasuries have seen a marked sell-off in the wake of higher than expected employment data and disapointing inflation data. However, I also do know about discipline and resolve. Unless this time is truly different, I would stay the course by maintaining a risk appropriate ladder strategy of high quality investments.

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.