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INVESTMENT SERVICES

Weekly Relative Value

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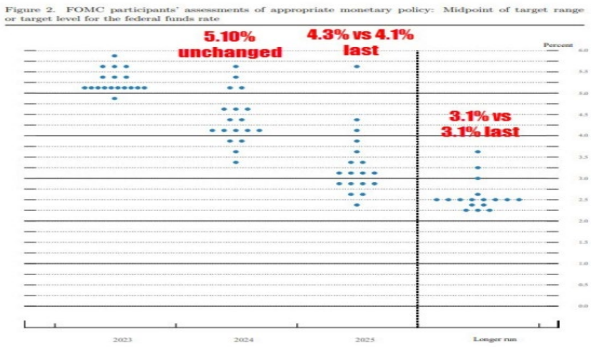
WEEK OF MARCH 27, 2023

Cognitive Dissonance

As expected, the Fed hiked 25 basis points raising the Fed Funds rate upper target to 4-3/4% to 5%. The terminal rate (via the Dot Plot below) was unchanged at 5.10%. As expected, the Federal Open Market Committee (FOMC) statement reaffirmed quantitative tightening and its commitment to reduce its holdings of Treasury securities, agency debt and agency mortgage-backed securities.

Despite the Fed announcement, the futures market continues to bet heavily against the Fed. The futures market sees the Fed starting to cut rates in July and finish the year at 4.00%-4.25% and then all the way down to 2.75%-3.00% by the end of 2024.



Source: The FOMC

The FOMC is forecasting +0.4% real gross domestic product (GDP) growth forecast for 2023. This is quite telling because if you believe the Atlanta Fed's GDP first quarter forecast (+3.2%), this means that the U.S. economy will see a steady diet of -0.5% prints for the second, third and fourth quarter. In other words, the Fed is implicitly calling for a three-quarter recession starting two weeks from now!

FOMC Projections : Change in Real GDP		
Projection Date	**2023**	**2024**
Mar-23	0.0 to 0.8%	1.0 to 1.5%
Dec-22	0.4 to 1.0%	1.3 to 2.0%

Source: The FOMC

THIS WEEK

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Jerome Powell, Federal Reserve Chairman, had the following to say about inflation:

"Despite elevated inflation, long-term inflation expectations appear to remain well anchored, as reflected in a broad range of surveys of households, businesses, and forecasters, as well as measures from financial markets."

On the inflation front, the FOMC now sees the personal consumption expenditures (PCE) inflation steadily declining to 3.5%-3.9% in 2023 to 2.0-2.5% by 2025. PCE core inflation was up 4.7% in January year-over-year. However, after accounting for the unusual dynamics related to the COVID-19 pandemic, inflation is likely lower than expected.

FOMC Projections: Core Inflation			
Projection Date	**2023**	**2024**	**2025**
Mar-23	3.5 to 3.9%	2.3 to 2.8%	2.0 to 2.2%
Dec-22	3.2 to 3.7%	2.3 to 2.7%	2.0 to 2.2%

Source: The FOMC

The FOMC slightly revised down their projected unemployment rate for the fourth quarter in 2023. Currently, the unemployment rate was at 3.6% in February, just above the 50-year low. The Fed is forecasting that unemployment will rise to over 4% over the next two years.

FOMC Projections : Unemployment Rate			
Projection Date	**2023**	**2024**	**2025**
Mar-23	4.0 to 4.7%	4.3 to 4.9%	4.3 to 4.8%
Dec-22	4.4 to 4.7%	4.3 to 4.8%	4.0 to 4.7%

Source: The FOMC

I believe the key takeaway from the FOMC statement was the change in the forward guidance. The language shifted from the *"committee anticipates that ongoing increases in the target range **will be** appropriate"* to the "*committee anticipates that some additional policy firming **may be** appropriate."*

It may not seem like much, but going from "will" to "may" is significant. This could mean that any further "policy firming" will just come from quantitative tightening.

A CASE OF COGNITIVE DISSONANCE

"Cognitive dissonance is a mental conflict that occurs when your beliefs don't line up with your actions. It's an uncomfortable state of mind" — Psycom

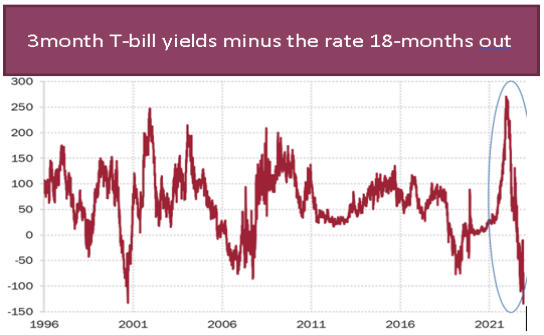
Last week, Powell said that rate cuts are not the Fed's "base case." Yet, a year ago, he said the following:

"If his preferred yield curve, the so-called "near-term forward spread" (three-month Treasury bill yields minus the rate 18 months out) were to go negative, that means the Fed's going to cut, which means the economy is weak."

He further stated:

"In this case, if you're in a situation where the markets are pricing in significant declines in inflation, that's going to affect the forward curve."

Don't look now, but Powell's preferred curve is now inverted by a record -134 basis points.



Source: Bloomberg

Bottom Line: On one hand, Powell's preferred curve says the economy is going to weaken, inflation is going to recede and the Fed will be cutting rates. On the other hand, last week, Powell seemed to indicate that the economy will emerge in fine shape, inflation remains troublesome and he has no intention of cutting rates this year!

Let's chalk this up to a bad case of cognitive dissonance. The man needs a shrink.

HE SAID, SHE SAID

*"The US banking system is **sound and resilient**. Recent developments are likely to result in tighter credit conditions for households and businesses and to weigh on economic activity, hiring, and inflation. The extent of these effects is uncertain. The Committee remains highly attentive to inflation risks." — The FOMC*

Powell later stated that the banking system is "sound and resilient." Of course, the Fed would never say anything else. So "sound and resilient" that the central bank spent most of the past week doing its utmost to ward off a crisis. And if the banks are so "sound and resilient," then why have U.S. banks borrowed $153 billion at a punitive 4.75% against collateral at the discount window, a larger amount than in 2008-2009? If banks are so "sound and resilient," why is there a compelling need for authorities to provide over $1 trillion in money or force bank mergers?

Also, the Fed raising rates into an inverted yield curve is certainly not going to do anything to alleviate the strains of ongoing deposit flight from the banking system. In fact, it makes money-market mutual funds offering interest rates close to 4.5% reinforce the bank deposit outflows because most banks have been incredibly stingy during this Fed rate hike cycle.

To wit: According to Bankrate, until March last year, the deposit rate was 0.06%. For all practical purposes this is 0%. It means that on savings of $100,000, the bank would pay its customers just $60 in interest when it should have paid them $3,000 or $4,000 in interest. For checking accounts and other transaction accounts, the banks paid 0% interest. For banks, this was the era of free money — and a lot of free money. Even today, after the Fed has raised rates by 450 basis points, the national average savings deposit rate stood at less than 0.3%! Yes, banks could and probably should raise their deposit rates, but they have resisted because it will obviously negatively impact income and margins.

There are over 4,000 commercial banks in the U.S. insured by the Federal Deposit Insurance Corporation (FDIC) with nearly $24 trillion in assets, most of them small or mid-sized. Powell stressed that all deposits in the banking system were "safe."

Strangely at the very same time, Janet Yellen, Treasury Secretary, said the following:

"I have not considered or discussed anything having to do with blanket insurance or guarantees of deposits."

She also added:

"It's important to be clear: ***Shareholders and debtholders of the failed banks are not being protected by the government."***

In two words, no bailout.

For reasons that escape me, the two people overseeing financial institutions don't appear to appreciate how serious this crisis of confidence has become in the small banking sector.

FADE THE FED

"Many are seeing ***recession. I don't see a way to avoid it****... Is this really a banking crisis? It's a Fed crisis, it's a rate hiking crisis,* ***it's a crisis built on a crisis we never solved... is it any wonder there's so much volatility in the market?****" — Rich Santelli, Editor, CNBC*

I've said before and I'll say it again, despite the legion (over 400) of PhD economists on staff, the Fed has never forecasted a recession (see table below) even when it was staring them in the face. Think about that.

Recession Start	Fed Forecast	What Happened
Dec -69	1.2%	0.2%
Nov-73	2.4%	-0.5
Jul-81	0.9	-1.8
Jul-90	2.0	-0.1
Mar-01	2.6	1.7
Dec-07	1.3	0.1
Mar-20	2.0	-3.4
Average	**1.8**	**-0.5**

Source: Bloomberg

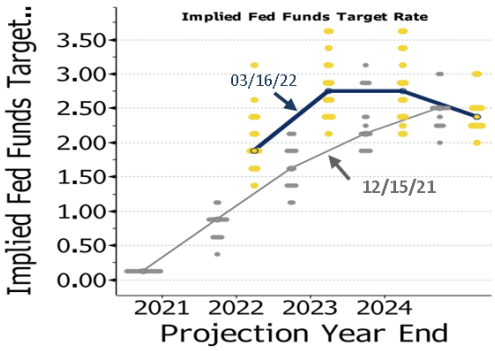
Frankly, it has always amazed me how many people treat what the Fed says as the gospel truth. In reality, the Fed has the worst forecasting record in the world. It's basically been wrong every year since 2009. One has better odds flipping a coin than listening to these PhDs.

Take a look at the table below. The Fed's accuracy in predicting inflation, unemployment and real GDP in a word is abysmal. But even worse is their forecast on the Fed Funds rate. This is one thing they absolutely control, but they get it wrong nearly two-thirds of the time. I repeat two-thirds of the time!

Forecast	Accuracy %
Fed Funds Rate	37%
Core Inflation	29%
Unemployment Rate	24%
Real GDP	17%

Source: Rosenberg Research

Here are a couple of recent examples. At the end of 2019, the dot-plots were at 1.625% on the Fed Funds rate for the end of 2020 and we ended up at 0% (with everlasting quantitative easing). At the end of 2021, the call was for a 0.9% median dot-plot, and we ended up north of 4%. What more do you need to know?



Source: Bloomberg

Not only that, but many of the problems today and in the past were a function of the Fed's policy mistakes. And they make a lot of them.

When you see suppress the true, market driven cost of capital for longer and longer periods of time, you incentivize the yield reach across the banking system. Then you juice rates 500 basis points in 13 months to "fight" inflation and light it all on fire.

"Oh we 'solved' it alright: by printing $20 trillion. Guess how much it will cost to 'solve' the current crisis..."
— Rich Santelli, Editor, CNBC

The cartoon below sums it up nicely.

THE NEXT CHAPTER, A CREDIT CRUNCH

"We will be unable to curtail the current turmoil without longer lasting and potentially severe repercussions within and beyond the banking sector, risking greater financial and economic damage than we anticipated."
— Moody's Investor Services

Small/regional banks have taken a much larger role on the lending side over the past 15 years. After the Great Financial Crisis in 2007-2008, big banks were put in the penalty box and small regional banks became the lending valve. During this stretch, small bank assets expanded from $500 billion to $7 trillion and gained a much larger slice of the credit pie. At the same time, they were far less regulated and supervised than their big bank brothers.

This is a very significant portion of the banking system. System-wide unrealized losses, as of year-end, on held-to-maturity securities were $341 billion and on available for sale securities were $280 billion. So combined, that's $620 billion of year-end unrealized losses.

Think about it. There have been two big failures, Silicon Valley Bank (SVB) and Signature Bank. SVB had +$200 billion in assets and was the sixteenth largest bank in the country. Signature Bank had $110 billion in assets. Now the fourteenth largest bank, First Republic Bank (FRC), is being impacted by similar dynamics. Not just that, but the super regionals such as Comerica and KeyCorp are starting to buckle.

What we know from history is that liquidity constraints can trigger a crisis of its own. In this case, contagion and deposit withdrawals that take hold. A flood of withdrawals can quickly turn into a credit crunch as banks pull back on lending.

That's what makes the ongoing credit crunch in the banking sector that much more disconcerting.

Many banks are highly exposed to commercial real estate. Small banks have near-record $2 trillion of Commercial Real Estate (CRE), after having made loans for office buildings and shopping centers, which are now struggling against post-COVID-19 changes. The work-from-home change appears to be sticking and that may mean a lot of unrented office space for a while. Bad news for both developers and their lenders.

Everyone talks about "under-water" Treasury securities and Agencies, but CRE represents 14% of small bank assets. The deflating CRE loans is an accident waiting to happen. Have a read of this story in the *New York Times*, "Bank Crisis Could Cast Pall Over Commercial Real Estate Market." The office vacancy rate is now 16.5% with a ton (123.5 million square feet under construction, which will only make the situation worse) of new supply coming online likely to reinforce the price deflation trend.

In the same vein, take a look at Gillian Tett's *Financial Times* article, "American Banks Face a Looming Credit Risk" (all about CRE). The summary tells the tale.

"However, the bad news is that this trifecta of problems means that anyone who hopes for a quick resolution to the bank woes will be disappointed. If the FDIC extends insurance, that would reduce the panic. A halt to rate rises would reduce the business squeeze. But today's mess is the result of a decade of policy mistakes and will not be fixed in ten days or ten months; particularly if the next chapter of the drama now moves from interest rate risks to credit woes."
— Gillian Tett, Chair of Editorial Board and Editor-at-Large, Financial Times

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Here are some statistics. Small and mid-sized banks are defined as any bank up to $250 billion in assets, which is anything outside of a top-10 bank in the U.S.

These banks collectively account for:

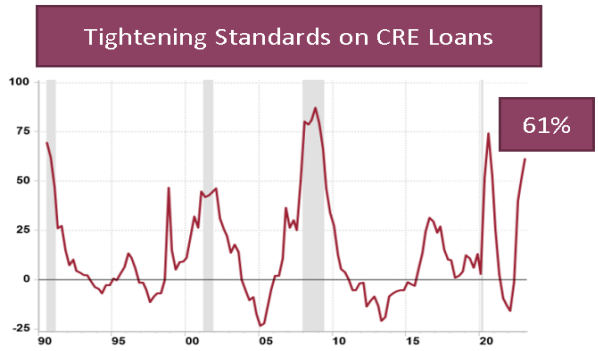
- About 50% of all Commercial and Industrial (C&I) lending
- About 80% of all Commercial Real Estate lending
- About 60% of Non-Agency Residential Real Estate lending
- 45% of all consumer lending

In other words, as significant stress on the banking system continues to worsen, banks are likely tightening lending standards. When lending standards are tightening, they create an economic slowdown, rises in unemployment and rises in business failure. And on and on the dominoes fall. This precipitates worsening credit quality, rising delinquencies and rising charge offs, which are triggers for further contractionary underwriting dynamics.

I need to stress that the largest U.S. banks (and I should add the credit union network) are well positioned to weather the current market tumult. In fact, it would appear that the large banks and credit unions will come out of this episode smelling like a rose. Indeed, in the days immediately following the SVB failure, it was reported that Bank of America saw $15 billion in new deposit inflows suggesting the biggest lenders may ultimately emerge from this episode on a stronger footing.

I believe the end result is a credit crunch. In fact, prior to this current round of turbulence, the Fed Senior Loan Officer Survey (SLOOS) showed that a net 61% of banks have been tightening their credit guidelines in CRE loans (for quarter one). Likewise, the small banks have tightened the reins on C&I loans. The effect isn't small. I've seen estimates it will be equivalent to the Fed hiking an additional 150 basis points.

The last times credit guidelines for commercial real estate and business loans were this tight was in 2020, 2008-2009 and 1990. All credit crunches. All recessions. I hate to tell you there were no soft landings in these periods.



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Source: SLOOS

Here's something else to think about. A survey of 1,400 small and midsize businesses by the executive coaching and advisory firm, Vistage Worldwide Inc. — conducted in partnership with the Wall Street Journal immediately before and during SVB's collapse — found that 53% believed the economy would worsen in the next year. Only 9% said conditions would improve. That's enough to lift an eyebrow or two, don't you think?

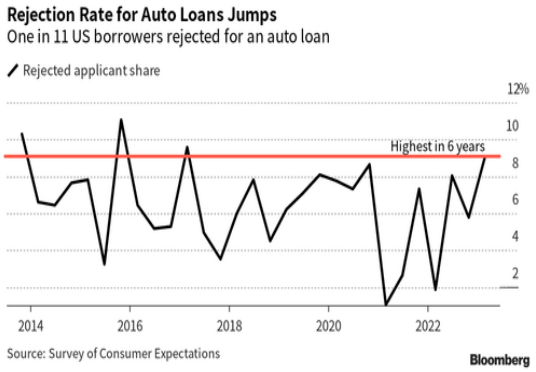
Bottom line: Lightning never strikes twice, but following every Fed tightening cycle something breaks. And as such, we are merely living through history. Even though the big banks and credit unions will end up being just fine does not mean the economy escapes a recession. A huge credit crunch is coming our way as the banks are going to be coming to terms with the need to shore up their balance sheets. The casualty will be the rising tide of loans being called in and no new credit being extended.

THE CONSUMER CREDIT CRUNCH

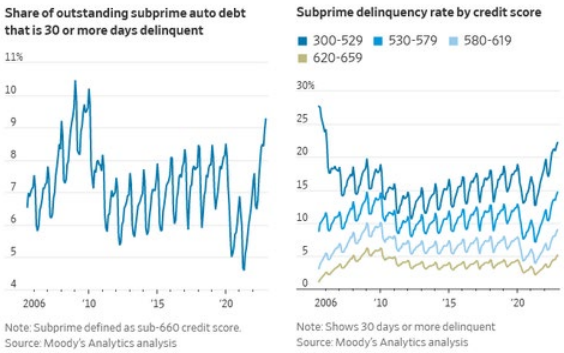
"The findings show how higher interest rates are squeezing consumer credit in some key areas, in line with the Fed's goal of cooling inflation. But in recent days, the collapse of three U.S. banks has spurred fears of a sharper credit crunch that risks tipping the economy into a recession."
— Bloomberg

The number of folks with $1,000 monthly car payments has soared in recent years with the average loan amount financed hitting a record high of $40,000 — a disaster in the making.

And banks are now cracking down on auto loans. A new Federal Reserve Bank of New York survey shows the auto loan denial rate rose to 9.1%, a six-year high in February and is up from 5.8% in October. The good news for the auto market is that tighter financial conditions have reduced the number of people buying new cars. This will hopefully cap auto prices.



Even before the banking meltdown, financial conditions were tight and were pressuring subprime consumers the most. One has to believe that denial rates will continue increasing as banks lose faith in subprime consumers.



THE CANARY IN THE COAL MINE

"Found it quite ironic that as we are debating the strength of the labor market, Indeed.com (major online U.S. recruitment website) is slashing jobs citing a challenging macroeconomic backdrop."
— Goldman Sachs Analysts

Indeed will be letting approximately 2,200 people go, which is roughly 15% of their staff. The cuts come from nearly every team, function, level and region at Indeed.

The CEO acknowledges the error of excessive hiring in recent years.

"We have held out longer than many other companies, but the revenue trends are undeniable. So, I have decided to act now." — Chris Hyams, CEO, Indeed

What's likely happening is that companies are pulling job listings posts from Indeed as recession threats surge and economic uncertainty ripples across sectors.

Let's face it, when headhunters start chopping the heads, it can't be good for the rest of us. Now imagine what happens when all this news starts to seep into outright declines in non-farm payrolls? Nobody will be caring too much about the Consumer Price Index (CPI) at that point, including Powell.

Bottom line: Even though jobless claims remain very low**,** layoffs at one of the largest job websites in the U.S. might serve as the proverbial canary in the coal mine and a signpost of potential turbulence in the job market.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I predict the Federal Reserve will be cutting rates substantially soon."
— Jeffrey Gundlach, Chief Executive and Chief Investment Officer, DoubleLine Capital

Markets are signaling the Federal Reserve is dead wrong when it talks about the prospect for further interest-rate hikes**.**

To wit: The two-year Treasury yield is at 3.65% while the Fed's "dot plots" through year-end are north of 5%. Never before have we seen the market and the central bank so far apart.

There's no indication that the Fed is going to be easing. Quantitative tightening is still in effect. In other words, with very low unemployment and very high inflation, higher for longer is the Fed's playbook.

But remember who won the debate in early 2022 when the Fed was sub -1% for the end of that year and the market was busy repricing for 2% and then higher. It was the same bond market who told the Fed back then that it was way behind the inflation curve. The bond market is now telling the Fed that it is miles behind the recession/disinflation curve.

The May rate hike that was 50-50 priced in just two days ago is now down to just one-in-three odds… and then the eventual rate cuts coming two months hence. In fact, the strips curve is now predicting 50 basis points of cuts by July and 100 basis points of easing by year-end!

Meanwhile, keep an eye on the yield curve "de-inverting." We're now getting close. The yield curve steepened last week (5s/10s un-inverted) with the 2s/10s only inverted by 40 basis points. The spread was 107 basis points just a few weeks ago. These are red alert recession signals. Remember, when the curve "dis-inverts" it will lead to a recession on average about four months later.

One thing we can say with certainty is that we're nearing the end of the tightening cycle. The economic cycle and the credit cycle all point in the direction of recession and disinflation.

The markets will respond long before the Fed does. The sharp decline in yields over the past ten days highlight, once again, why timing is a fool's errand. The most prudent risk management approach in managing "excess cash reserves" is to maintain a diversified risk appropriate ladder strategy.

Maintain the discipline.

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.