alloya
INVESTMENT SERVICES

Weekly Relative Value

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SVP, Director of Institutional Fixed Income Sales

WEEK OF MARCH 6, 2023

The Consumer Squeeze

"The U.S. Consumer is resilient — they're in great shape!"
— Consumer News and Business Channel (CNBC)

Is that true or a false narrative? Let's discuss below.

First, while unemployment remains near historical lows, the U.S. consumer is saddled with sky-high inflation, which has dwarfed the nominal wage increase we have seen over the past year. Real disposable income (income adjusted for inflation) has been negative for 22-months. On a year-over-year basis, real income has declined a record seven months!

**Red shaded areas denote recessions*

As the higher inflation erodes purchasing power, consumers are relying on costly credit card debt to pay for the necessities of life including food and energy. Did I mention people are now "microfinancing" everything from $12 vodka cranberries to $10 chicken sandwiches?

THIS WEEK

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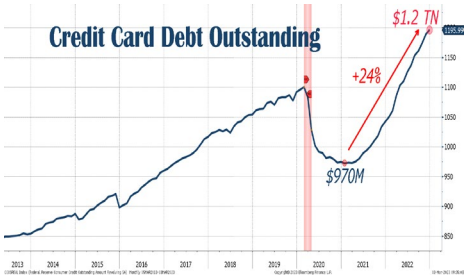
The latest consumer credit report from the Fed shows that consumer credit card balances rose at the highest annual pace ever (15.25%) in 2022 and now sits at a 20-year high of $1.2 trillion.



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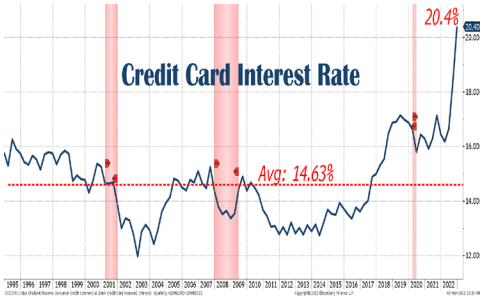
At the same time, while credit card debt explodes higher, the cost of servicing that debt is at multi-decade highs.



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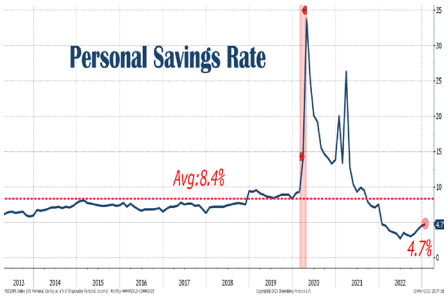
On the other side of the ledger, while credit card debt soars, the consumer savings rate is at multi-decade lows.



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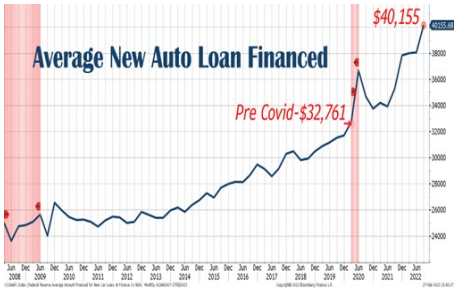
Given the above, it is no wonder that frugality is becoming more widespread. Here's an example: J.M. Smucker reported growth was in three areas: coffee (not good for Starbucks!), pet food (a remnant of the pandemic) and…you guesssed it… peanut butter. Just know that in recessions, first come the peanut butter and jelly sandwiches, followed by mac and cheese and, after that, Spam on saltines.

AUTO DEBT AND RATES SURGE

The same Fed report revealed an exponential spike in the amount of new car loans, which increased by more than $2,000 in one quarter from just over $38,000 (a record) to $40,155 (a new record). Since 2019, new auto loans have jumped by a record pace of 32%! In aggregate, total auto debt outstanding is $1.4 trillion — 20% higher today than it was prior to the COVID-19 pandemic.



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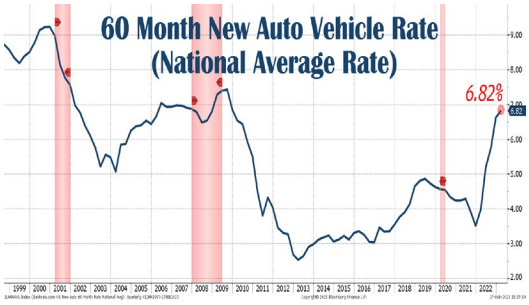
Meanwhile, the average loan rate for new car loans just hit a 13 year high of 6.82% and is likely to continue to rise as the Fed maintains its tigtening bias.



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RISK HAPPENS FAST

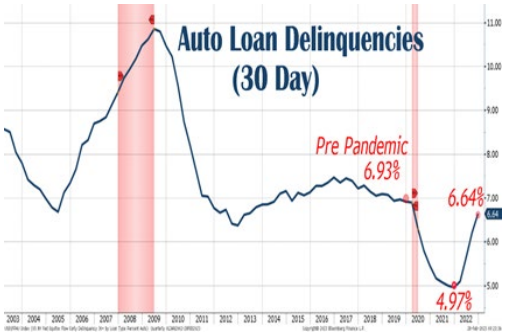
"I think there's idiosyncratic risk to banks that weren't paying attention, ones that didn't realize quantitative easing (QE) was temporary." — R. Christopher Whalen, Investment Banker

What has been striking is that even with so many Americans saddled with record amounts of auto loans — on average more than $40,000 —there have been very low amounts of delinquencies. But then again, risk happens slowly and then all at once.

After a lengthy period, in which nothing seemed to happen, suddenly the dominoes started to fall. As Bloomberg reported last week, used car retailer and subprime auto loan lender, American Car Center, suddenly annouced it was immediately closing its doors. This is just one day after the company had hoped to pull off a funding "Hail Mary" by selling a $222 million bond (it failed).

The collapse comes as more Americans are starting to fall behind on their car payments and the credit distress cycle is rapidly accelerating. To wit: Subprime auto borrowers are in the worst position since record keeping for this category began in 2005.

The 30-days past due in the auto loan market was 4.97% a year ago and has now risen to 6.64%, which is the highest since the COVID-19 pandemic struck in 2020.



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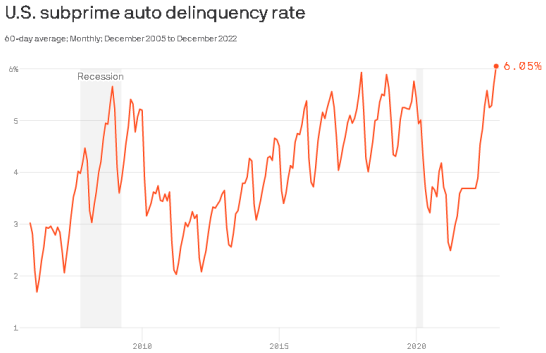
As shown below, the share of payments on "subprime" auto loans that were at least 60 days late rose from 3% to an all-time high of more than 6% in December, now above the prior peak of 5.7% set in 2009. When delinquencies reach 90 days late, the repo man comes a' knockin.

Notably, this credit deterioration is happening in a strong labor market.



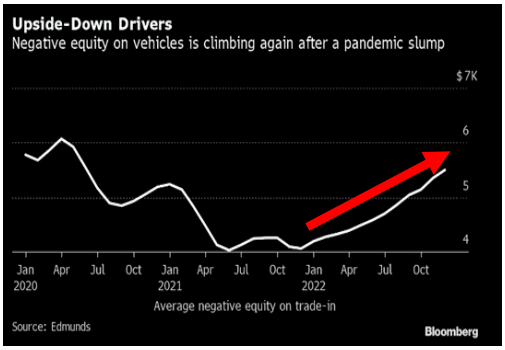
NEGATIVE EQUITY BUILDS

"Because these car loans are generally unaffordable at the outset, that means that every month, borrowers are getting closer to the financial edge." — Kathleen Engel, Law Professor, Suffolk University

Historically, autos have "always depreciated" with auto prices declining steadily the minute you drive off the lot. However, due to the widely discussed COVID-19 pandemic related supply chain issues and microchip shortgages, used vehicle prices appreciated (Subarus and Rav4s outpermed the S&P by 30%) and skyrocketed to ridiculous levels during the COVID-19 pandemic. While prices have declined of late, used vehicle prices are still up a whopping 37% since the start of the COVID-19 pandemic. In turn, the risng cost of used vehicles has driven up borrowing activity sharply, especially among people with low credit scores who predominantly buy used cars.

Regardless, consumers are buying at still-sky-high prices and financing at the highest auto lending rates in 13 years. Amazingly today, about 15% people are making monthly car payments of $1,000 or more! In response to to higher vehicle costs and higher rates, lenders have been extending the length of auto loans with more loans being extended to 84 months (for a depreciating asset!). Making matters worse, some people are trading up or moving into newer vehicles and rolling debt from one car to another. Due to the recent decline in auto prices, prospective auto buyers are arriving at dealer lots significantly underwater. According to Edmunds, the average amount of negative equity for those people

that trade in their autos is approaching pre-COIVD-19 pandemic levels at $5,500. Some are experiencing negative equity of up to $10,000.



The big risk is that as used car prices continue to decline and adjust downward from the COVID-19 pandemic auto bubble, each month more and more consumers will find themselves falling from positive to negative equity.

"They're just continuing to amass debt in a way that's not very financially responsible… For folks in that space, if they can afford to, they'd be far better off staying in that vehicle."
— Todd Nelson, SVP of Strategic Partnerships, LightStream a division of Truist Bank.

Bottom Line: Even if the U.S. economy avoids a recession and the labor market remains healthy this year, consumers will likely struggle to make payments on their auto loans. Worsening of economic conditions and higher unemployment combined with the prospects of a continued decline in car prices is the more liekly scenario. In this scenario, delinquencies and defaults would continue to ascend.

BANKERS PREPARE

"As the U.S. economy heads into the worst period of credit loss since 2008, the primary victims will be lower income Americans." — R. Christopher Whalen, Investment Banker

The same rising default-trend is happening across the full credit spectrum, a function of the interest rate shock that the Fed has administered to the U.S. economy over the past year.

Commercial loans are seeing rising delinquencies and defaults. Here are two examples:

- Brookfield fund delivered a small shock to the U.S. CMBS market after it defaulted on two office towers in Los Angeles.
- Private equity giant, Blackstone (Wall Street's largest commercial real estate landlord), announced it has defaulted on a $562 million bond backed by a portfolio of offices and stores.

More commercial loan defaults are expected.

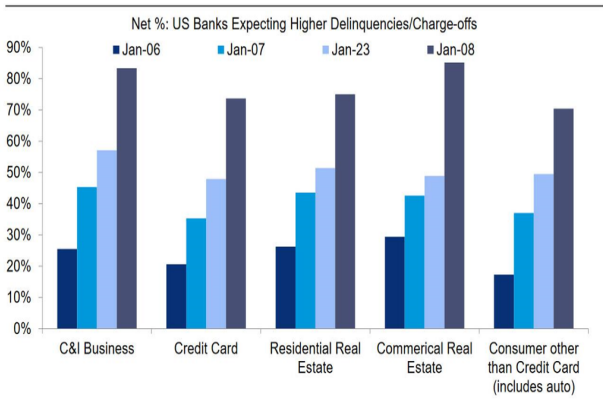
Delinquency on the $1.2 trillion in bank credit cards is rising, especially among younger consumers. The credit card delinquency rate has gone from 4.27% to 5.87%, the highest since the second quarter of 2020. Now that we are beyond

the "free money" environment, the loss given default on bank credit cards has been rising since the end of 2021 and is trending upwards.

From a top-level perspective, the housing industry looks OK. But even here, the late-payment rate in residential mortgage market has risen to 2.25% — the highest it has been since 2020.

Moreover, in the bottom income strata, delinquencies are rising much faster. For example, the average delinquency of Federal Housing Administration (FHA) loans jumped 2% from 8.51% in the third quarter of 2022 and to 10.61% in the fourth quarter of 2022. Extra credit question: If FHA delinquency rates are over 10% today, where will they be in June of 2023 or even December 2023?

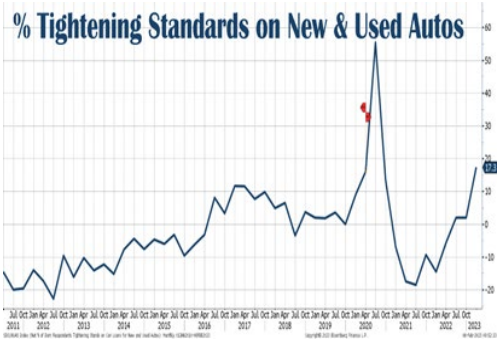
Indeed, banks are becoming more concerned. As shown below, the share of banks forecasting rising delinquencies across all lending segments has now exceeded levels in 2007.



Source : Deutsche Bank, Federal Reserve Board

The Feds latest Senior Loan Officer Opinion Survey (SLOOS) highlighted that as the credit contraction moves into its early phase, banks are now building cash reserves and preparing for increased charge-offs. This is typical of an economy transitioning from an expansion in the business cycle towards a contraction.

In addition, the SLOOS shows that lending guidelines have tightened across all lending segments, which may be the canary in the coal mine of what is lurking around the bend.

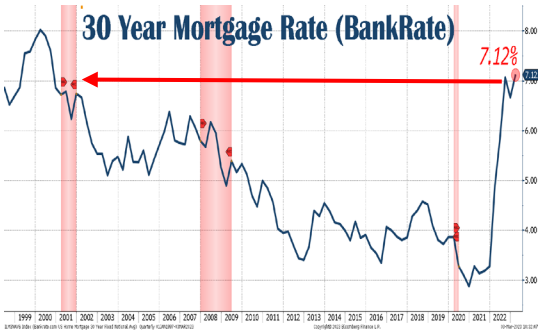


Bottom line: Even though the albor markets remain healthy**,** the consumer (especially the lower income consumer) seems to be running on borrowed money and time. Oh, but Wall Street tells me *"the U.S. Consumer is in great shape."*

Give me a break. Look around you. Things are not good.

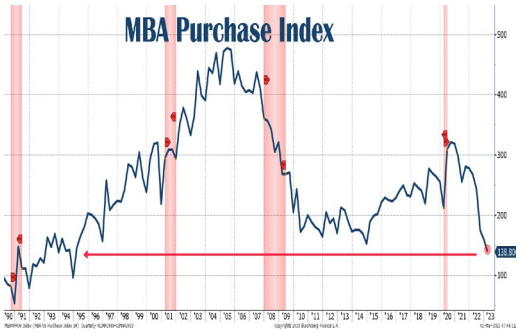
MORTGAGE RATES BITE

The hype about the housing market picking up in January was based on what amounted to a two or three week period in January when mortgage rates declined toward 6%. But it's already over, just weeks after it started. The spring selling season already fizzled as the average 30-year fixed mortgage rate is now above the magic 7% again.



**Red shaded areas denote recessions*

The bond-induced run-up in mortgage rates is biting hard. Mortgage applications dropped again in the week of February 24 by 5.7% and is on the heels of the 13.3% drubbing the week before (and down 7.7% the week before that). The year-over-year trend is running at a very contractionary 59%. Amazingly, the level of applications is lower than the housing crisis in 2008-2009. As shown below, applications for home purchases sagged 5.6% last week and are down sharply in three of the past four weeks. Appliacations are down 43% over the past year and are back to the levels seen in the the spring of 1995.



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The mortgage application data tell us the housing market has frozen. There is a stand-off with many potential sellers who are still thinking that this too shall pass, namely these mortgage rates, and that somehow the sub-3% mortgages will return to make their aspirational prices possible. And so they cling to their aspirational prices or hold their vacant properties off the market while waiting for the Fed to cut rates to zero and the return of the 3% mortgage rate. Good luck with that.

Results are as one should expect, pending home sales fell in all 50 of the most populous U.S. metros. They fell most in:

- Las Vegas, NV: -55.2%
- Austin, TX: -49.5%
- Portland, OR: -46.9%
- Riverside, CA: -45.4%
- Nashville, TN: -45.3%

Bottom line: Sellers want the prices they could have gotten 18 months ago. Moreover, existing home owners do not want to trade a 3% mortgage rate for a 7% mortgage rate. Meanwhile, buyers simply want lower prices. If sellers cut the price enough, eventually the home will sell. The clearing price is reality.

A healthy housing market needs to have sellers who are in touch with reality, and the reality is set by potential buyers. For sale volume to rise to normal levels, prices need to come down, and by a lot, to make sense with 7% mortgages.

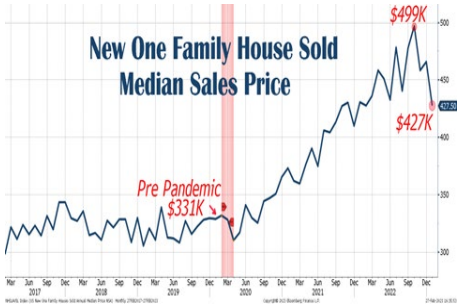
THE HOUSING BUBBLE DEFLATES

"We're far from affordability for the masses." — Nicole Bachaud, Senior Economist, Zillow

Home prices exploded into the stratosphere because of the Federal Reserve's monetary policies. The Fed cut rates to zero and printed nearly $5 trillion between March 2020 and March 2022. This repressed long-term interest rates, including mortgage rates, and created the biggest "everything" asset price bubble ever.

Now, the housing bubble is deflating relentlessly. Across the U.S., home sales have plunged month after month ever since mortgage rates started to rise a year ago. In January, across the U.S., total home sales plunged by 37% over the past 12 months. Sales plunged in all regions, but they plunged the most in the West, by 42% year-over-year. The least worst, if I may, is the Midwest. The Midwest plunged by 33%. This is happening because mortgage rates have reverted to the normal levels of 6% to 7% , which existed before the money-printing era started in 2008.

The median price of all types of existing homes across the U.S. in January fell for the seventh month in a row, down over 13% from the peak in June. This drop whittled down the year-over-year gain to just 1.3%. At this pace, we will see a year-over-year price decline in February or March, which would be the first year-over-year price decline across the U.S. since the Financial Crisis. Moreover, as shown below, the median price of new home prices has fallen even faster, declining by 15% from their recent peak, but remains signficantly higher than that of pre-COVID-19 pandemic levels.



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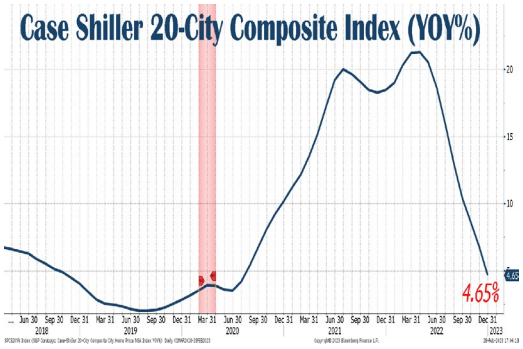
Median-price indices reflect the price in the middle of all homes that sold that month. They represent the most current clearing price for homes. Timeliness is good. However, when transaction volumes are falling off median, prices can be skewed by a change in the mix of homes sold. This can be an issue when a market undergoes sudden and dramatic changes such as in 2022.

Last week, the widely followed CoreLogic Case-Shiller Home Price Index confirmed the price decline. Prices dropped more than expected (-0.51% month-over-month) for December. Prices in many areas are dropping much faster. On a month-to-month basis, the Case-Shiller Index for single-family house prices dropped in all 20 metros that it covers.

This house price metric has now declined for six months in a row at a -8.6% annual rate. The last time prices dropped this much, this fast was tail end of the Global Financial Crisis in June 2009.

Unlike the median home prices reported, the Case-Shiller Index uses the "sales pairs" method, which compares sales in the current month to when the same houses sold previously. The price changes are weighted based on how long ago the prior sale occurred and adjustments are made for home improvements and other factors. This "sales pairs" method makes the Case-Shiller index a more reliable indicator than median price indices.

Recall that this data reflects sales primarily made in August, September and October. This means that the declines shown are undoubtedly understated by a lot, depending on the market. Due to the three month lag, this index is likely to show continued declines.



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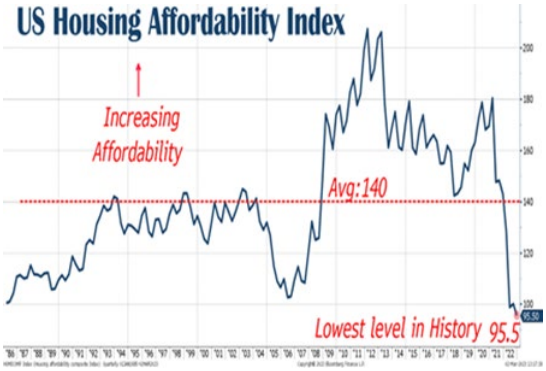
What we're seeing is the unwinding of the biggest asset bubble ever! Home prices do not trade like crypto. It will take time for home prices adjust to the new reality. But the trend is lower as mean reversion to the uber-stretched homeowner affordability continues.



Of note, first time homebuyers are screwed. To wit: This is first time, since records began, that first time homebuyers made up the smallest share of sales last year at 26%. Meanwhile, the median age of first time buyers has jumped from 29 in 1981 to 36 in 2022, the oldest in the National Association of Realtors' records. This is due to the fact that home prices have far outpaced wages. Thanks to higher interest rates, a buyer purchasing a $400,000 home with 20% down on a 30-year fixed loan, the monthly payment, including principal and interest, is now roughly $230 a month more than it would have been a month ago. Compared with a year ago, when rates were in the 4% range, today's monthly payment is about 50% higher.

Not surprising given the cost of shelter (housing and rent). Additionally, Pew Research Center reported that half of Americans ages 18 to 29 were living with their parents in July.

Now, as the spring homebuying season approaches, tight inventory and uncomfortably high interest rates means that the "American Dream" can only be achieved by those with high-paying jobs, lots of money or rich parents.

To get back to reasonable affordability for most Americans, home prices could easily see an additional -20% of downside or a dramatic decline in mortgage rates (unlikley to happen given the Fed's hawkish policy).

Bottom line: While everyone gazes at consumer price data, residential real estate is in full-on deflation mode. For the two-thirds of the households who own a slice of this super-sized $46 trillion asset class, the negative wealth effect on spending could prove to be epic.

While the current housing decline may turn out to be a sobering trip from the free-money decade, back to normal, the silver lining is that this will end up being the trigger for renewed consumer price disinflation.

LABOR HOARDING?

While virtually every measure of hiring plans are falling like stones, the weekly jobless claims continues to refuse to show anything but an extremely strong labor market. For the latest week, initial claims were reported at 190,000. Remarkably, claims have remained below 200,000 for the past seven weeks.

The Fed has stated that it wants unemployment to rise to 4.6%. So, at 3.4%, we are still quite a bit away from that desired level that seems to be absolutely necessary for the Fed to cease and desist in this most aggressive policy tightening cycle since 1981.

Also reported last week was the the upward revision to unit labor costs to +3.2% annualized from +1.1%. For bond bulls, this was a huge disappointment and will keep the hawks at the Fed squawking about the need for higher-for-longer interest rates.

In the same report, productivity was almost halved to a +1.7% annual rate from the initial estimate of +3.0%. Productivity growth is the mother's milk of profit margins, so the sharp downward revision is hardly good news for the equity market.

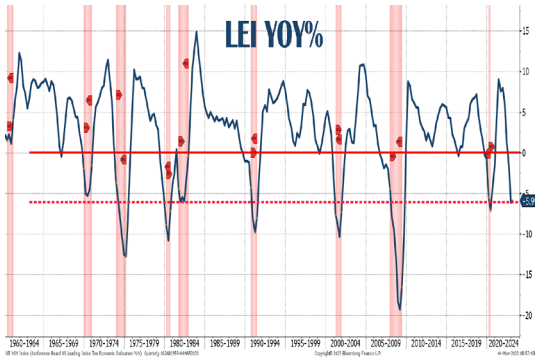
Bottom line: If you believe in the "labor hoarding" story will prevent a recession by keeping the job market humming along, you better sell every stock you own because profit margins are going to end up being squeezed like it's nobody's business.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Fed policy is being heavily influenced by lagging and coincident indicators. Yet, the leading indicators are pointing to a slowdown ahead. The index of leading economic indicators (LEI) has now declined for the tenth month in a row. The LEI peaked in December 2021, and the average lead time back to 1959 to the start of the recession is 13 months. The most recent year-over-year perent change (-5.9%) in the LEI has only occurred around recessions in the past. Also, money supply has contracted for the first time ever, the supply and demand of credit is declining and the yield curve is deeply inverted. The LEI, money supply, credit growth and the yield curve have historically been a good record of telegraphing recessions.

Recall before the pandemic, incoming economic data had been declining which prompted the Fed to pivot and cut rates in the second half of 2019. Then the "black swan" arrived (COVID-19), the economy shut down and economic activity did a faceplant. This was met with an unprecedented policy response that would have made former presidents FDR and LBJ blush.

The era of zero rates is long gone. Now, the Fed is fighting for its loss of credibility by not tightening earlier. In 2022, the Fed had raised rates by 450 basis points since March — the most rate hikes in history! And it's all but certain that the Fed will continue its hiking campaign. The futures market is pricing the terminal Fed Funds rate at 5.20%. Some are projecting that the Fed Funds rate will end up near 6%.



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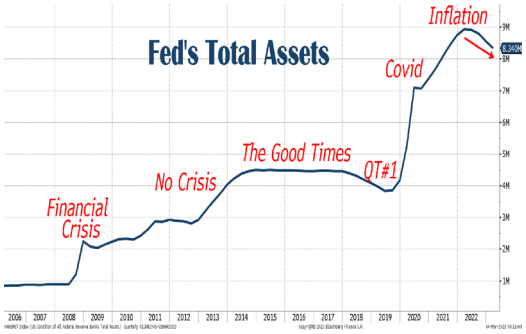
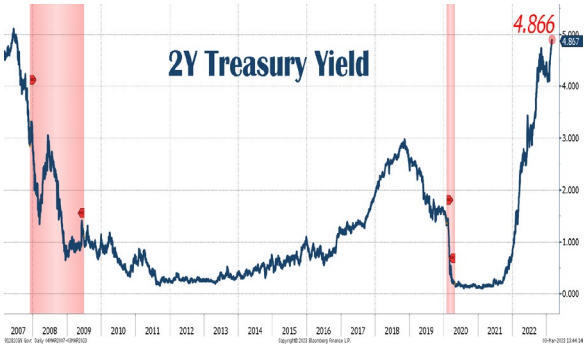
At the same time, the Fed has raised rates aggressively and is draining liquidity by reducing its balance sheet by $626 billion since the peak in April 2022. Total assets now down to $8.34 trillion, the lowest since August 2021. Even with the global supply chain bottleneck pressures are easing dramatically, freight rates are collapsing, there are wide swaths of commodities in a bear market and real time rents have peaked and are heading lower, the Fed hasn't stopped yet. But, I'm sure the Fed knows all this.



Moreover, the plethora of supportive COVID-19 pandemic era policies have come to an end. Last week, the generous expansion of the food stamp program, which will negatively impact 32 million Americans at a time when food prices are still going up, ended. Going forward, monthly support, which has averaged $251 per recipient this past year is about to shrink by one-third or $82. At the same time, the Biden Administration's plan to forgive student loans (held by 40 million people) is facing a very a skeptical Supreme Court. The era of fiscal largess has come to an end.

Fed Chairman Powell will present the Semiannual Monetary Policy Report to the Congress on Tuesday and Wednesday. There is no chance he sounds dovish. It's all a matter of degree of how hawkish he will be. If Powell starts to chatter about the need for the terminal funds rate to go significantly above the latest 5.1% median dot plot and focuses on the "higher for longer" theme, then both Treasuries and equities will end up having a tough go at it.

As for the bond market, the 10-year Treasury yield pushed up towards the 4.00% level and the 2-year Treasury yield broke back above its November highs to 4.866% — its highest yield since July 2007.



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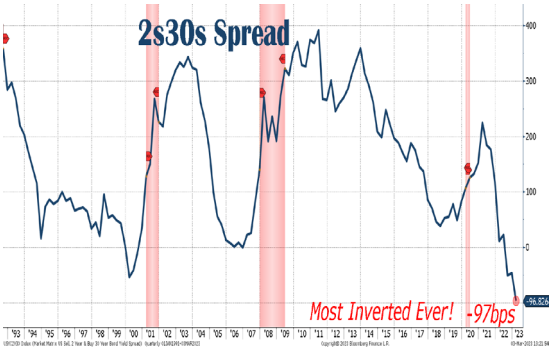
The yield curve as measured by the 2s/10s spread is 89 basis points — the most negative spread since 1981. The 2s/30s, as shown below, is the most inverted ever! The curve is saying that while inflation remains sticky, the Fed's tightening will eventually slow the economy down.



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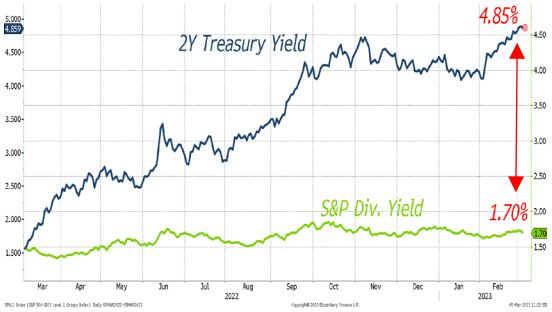
Treasury yields have now risen significantly over the past 12 months. Yes, there's plenty of scope for bonds to disappoint if inflation turns out to be endemic. But at least yields are at a reasonable valuation, based on current yields. At a near-4% yields on the 10-year Treasury, there is a high probability that you will make money on a 12-month forward basis. At a minimum, picking up the coupon.

I should add that bonds are at their cheapest to stocks since the very peak in 2007. Currently, the highly liquid, fully Government guaranteed 2-year Treasury is out yielding the dividend yield on the S&P by a near record 300 basis points. In this period of economic uncertainty, it is important to keep some cash reserves to be able to deal with any scenario.



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 believe "this time is different."

In terms of strategy, the Fed is likely to continue to raise rates further and the bond market may adjust lower (higher yields). However, I really believe that the next "BIG" long term cyclical move in inflation and bond yields is lower. Timing this is next to impossible.

I believe it is not possible to catch the exact bottom (or the peak), so it is best to invest regularly and consistently in a diciplined manner. As such, I believe the most prudent and time tested approach in managing excess cash is to maintain 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.