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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF MARCH 20, 2022

What Will the Fed Do?

"There's an old saying: Whenever the Fed hits the brakes, someone goes through the windshield…You just never know who it's going to be."
— Michael Feroli, Chief Economist, JPMorgan

Silicon Valley Bank (SVB) was the sixteenth largest bank in the U.S. in assets and was big enough to be systemically important. If the Fed didn't stop the run, it could have spread to several other banks. In fact, it did. Signature Bank (the third largest bank failure) failed shortly after SVB. Authorities responded swiftly to stabilize these situations. Hence, the unlimited deposit insurance. Also, unlike 2008, shareholders were wiped out and and senior bank management was fired. When you mess up that way, you should be fired.

Being a "free market" advocate, I was still left with a bad taste in my mouth. These depositors were not the average bank or credit unions depositor. Most of its deposits came from a relatively small group of venture capital firms that "recommended" the startup companies they funded keep cash at SVB. In fact, most of SVB's deposits "averaged" $4 million.

These people should have been well aware that they Federal Deposit Insurance Corporation (FDIC) only insured $250,000. That limit is plastered all over bank walls, doors, desks and appears on virtually every account statement. However, in this case, almost all (94%!) SVB's deposits were above the $250,000 FDIC coverage limit, and therefore uninsured. Everyone was well aware that larger balances are at risk if the bank fails.

Nothing required people to keep all that money on deposit at SVB. But they did. Keeping millions in the same bank doesn't make sense. Yet, it was common at SVB. Apparently, these folks didn't care or didn't believe a bank failure was remotely possible. So they

THIS WEEK

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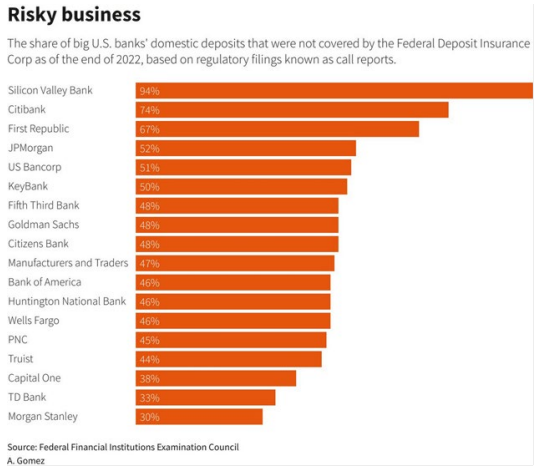
pushed the enevelope and took on imprudent and ridiculous risks. No one wants to see anyone hurt, but at some point, people have to bear the consequence of their decisions. Irresponsible people losing money is supposed to be a feature of capitalism. It cleanses the system of the bad actors. But sadly, we never let it happen. We just kick the can down the road time and time again. In short, the lesson is never learned!

I should add that while SVB customers were the biggest violator of this irresponsible behavior, they are not the only U.S. bank that had a large share of uninsured deposits. In fact, as of mid-2022, U.S. banks had $10.5 trillion in uninsured deposits (only $7.4 trillion insured).

When looking at this list, you will likley come to the conclusion that some banks are "too big to fail." Others are not. While this is clearly not fair, it has become essentially the law of the land.



Bottom line: The system is still at risk. Congress, the Fed and the Administration need to take a hard look at the deposit insurance system. I don't know the answer, but the present structure no longer fits.

THIS ISN'T 2008!

This isn't 2008. But it's also not nothing. Moving on. Crisis narratives continued to dominate bank-obsessed markets over the past week. From SVB to Signature Bank to Credit Suisse and to First Republic, it was one tape bomb after another.

The timing of Credit Suisse's problems in terms of it announcing some financial reporting irregularities was horrible in addition to the Saudi National Bank announcing it would not boost its stake due to regulatory. This came right after three bank failures in the U.S., and in particular, the demise of SVB.

With that being said, I belive these fears of contagion are overdone. Credit Suisse has been a problem child for years and is too big to fail. Morever, the big banks in the U.S. are in fine shape too. It seems unlikely that there will be spillovers outside the small banking sector.

Regardless, the events of the last week have put central banks between a rock and a hard place. While Inflation has peaked, it still remains well above the Fed's targey of 2%. Moreover, virtually everyone on the Federal Open Market Committee (FOMC) has telegraphed that they plan to continue to with sustained rate hikes. But now, financial stability is under threat in the U.S. and Europe.

So what path will the Fed take? They could pause, which would mean doing a mea culpa (again!) and once again lose what credibility they have left. Or they could stick with their plan and continue to hike, and risk a widening financial crisis. Which will it be?

My Take: The Fed, while clearly concerned about financial stability, remains super-focused on inflation. Look for the following three words, "monitoring developments closely" in the forthcoming FOMC statement this week.

Banks tend to fail just before recessions begin. The SVB incident was yet another signal of an impending recession, the starting gun for the recession.

Interest rates work with a lag. The impact of tightening takes time to be felt. The first U.S. rate hike happened exactly a year ago today. Interestigly enough, we are also seeing the first bank failure.

So, under the proviso that the regional bank mess manages to stabilize (I belive it will), the Fed will probably hike one more time with 25 basis points and then pause.

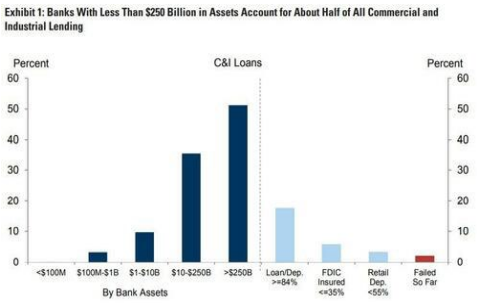
LESS CREDIT EQUALS LESS GROWTH

Last week Moody's cut the outlook for the U.S. banking system to negative from stable and issued the following statement:

"Regulators announced that all depositors of SVB and Signature Bank will be made whole, the rapid and substantial decline in bank depositor and investor confidence precipitating this action starkly highlight risks in U.S. banks' asset-liability management exacerbated by rapidly rising interest rates."

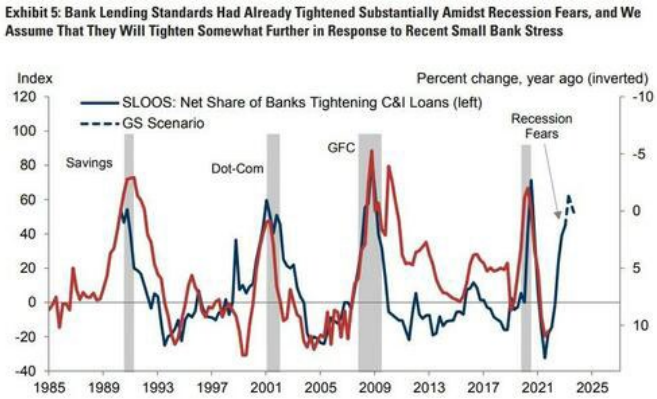
"The Fed has announced a new temporary liquidity facility to offer loans to banks against eligible government securities collateral to help meet their funding needs and reduce contagion risks. However, banks with substantial unrealized securities losses and with non-retail and uninsured U.S. depositors may still be more sensitive to depositor competition or ultimate flight, with adverse effects on funding, liquidity, earnings and capital."

It's important to highlight that small and medium-sized banks play a huge role in the U.S. economy. As shown in the graph below, banks with less than $250 billion in assets account for roughly 50% of U.S. commercial and industrial lending, 60% of residential real estate lending, 80% of commercial real estate lending and 45% of consumer lending.



Source: Goldman Sachs Research

Prior to the SVB debacle, bank lending standards had already tightened significantly over the last few quarters to levels previously unseen outside of recessions. See the graph below.



Soure: Senior Loan Office Survey

According to Goldman Sachs, this level of tightening in lending standards is equivalent to one or two additional 25 basis point hikes. Not surprising, Goldman Sachs has reduced its gross domestic product (GDP) forecast as smaller banks may become more conservative about lending in order to preserve liquidity in case they need to meet depositor withdrawals. A tightening in lending standards would further weigh on aggregate demand.

Bottom Line: Much like the Savings and Loans debacle in the late 1980s, there will likley be no contagion. With that being said, the Savings and Loan debacle led to a recession and a broad multi-year deflationary credit crunch.

Once the dust settles, look for more regulatory constraints, higher funding costs for the industry and an acceleration in the tighter bank lending guidelines that were already in place prior to this latest "crisis." Simply put, this means less credit growth to a credit driven economy.

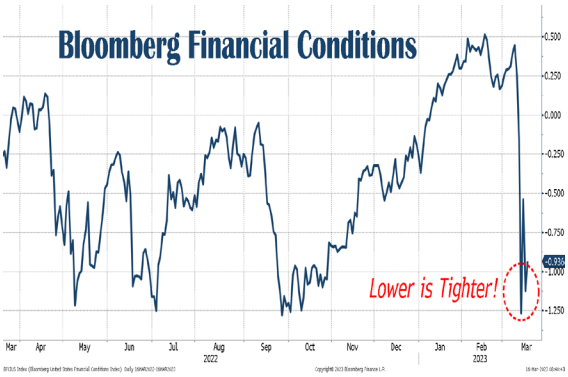
UNPRECEDENTED!

Treasury yield volatility has absolutely soared over the past week and is now higher than it was during the COVID-19 pandemic. One has to go back to the Great Recession to find worse conditions.

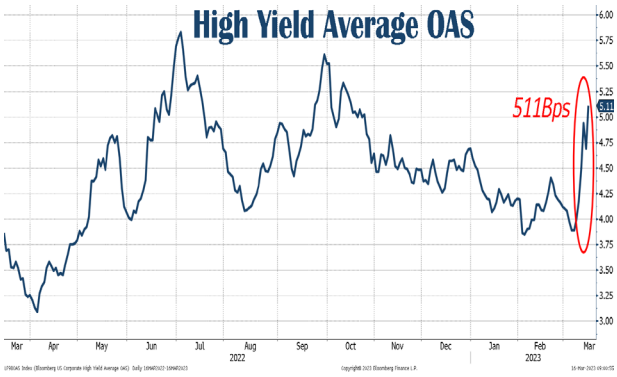
Last week, Treasury yields fell sharply across the curve. Of note, the three-day move on the two-year yield was down 115 basis points — the biggest since 1987 (ouch!).

Accordong to Janet Yellen, something so improbable was never supposed to happen.

While it's true that short-term rates have come down big time (indicating imminent rate cuts), it's also true that financial conditions have tightened dramatically (lower is tighter).



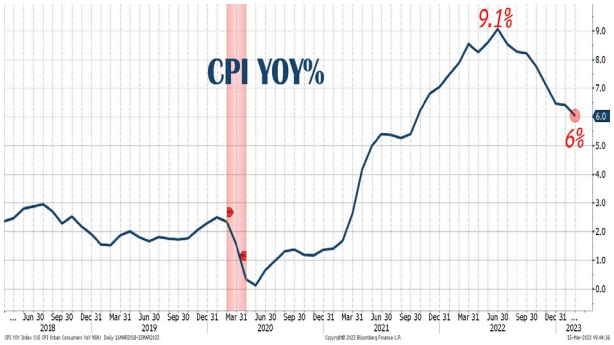
In addition to stock market pain, we've also seen a surge in high-yield spreads and other stress measures in the wake of the bank collapse. Credit spreads continued to widen and have blown out 100 basis points in just the past three sessions to 500 basis points for the first time since October 14, 2022.



Bottom Line: It stands to reason that generally the collapse of a major bank will constrain both credit and general confidence while have a cooling effect on activity, or at least as long as the uncertainty about the fallout remains. So while the market has priced in a lower path for policy rates in the months ahead, the net effect of everything indicates significant tightening.

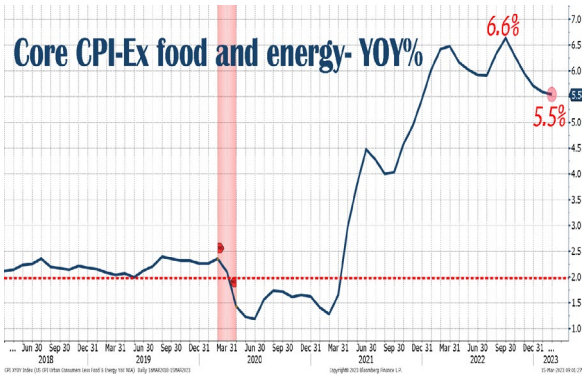
PEAK INFLATION

Peak inflation is in. The "headline" Consumer Price Index (CPI) has now declined for the past eight consecutive months from a peak of 9.1% in January 2022 to 6% today!



**Shaded areas denote recessions*

Month-over-month, the "core" CPI, which excludes food and energy, rose 0.5%. This is the third month in a row of acceleration, despite the drop in goods inflation. Year-over-year, the core CPI is now 5.5% — just a tad less than the 5.6% increase in January. This is still well above the Fed's target of 2%.



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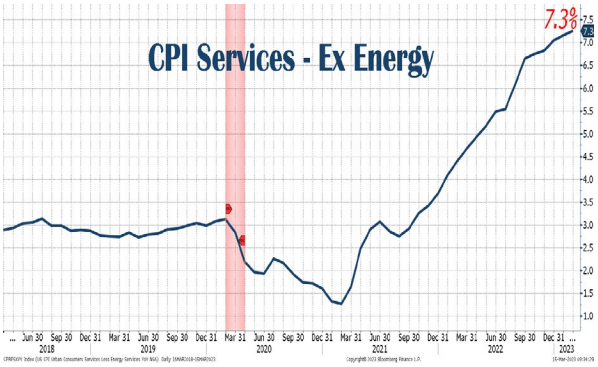
Even though the aggregate inflation data appears to have peaked, inflation continues to rage in services. To wit: The CPI for services inflation (excluding energy) jumped by 7.3% in February — the third month in a row above 7%. Year-over-year, service inflation is the highest it's been in four decades. It's important to note that nearly two-thirds of consumer spending goes into services.

As discussed in this space numerous times, shelter costs are the key (34% of CPI) to the disinflationary trend in services. The rental components will take time to help out on the disinflation process especially with how the sector is calculated with the lags involved. This should begin to slow markedly in the second half of the year.



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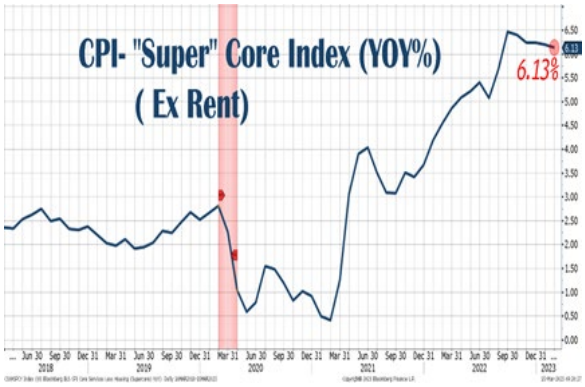
Meanwhile, the Fed's new "super-core" measure (core services excluding rent) came in at +0.5% month-over-month. This narrow measure is the only reason why the Fed will probably tightens 25 basis points this week, under the condition that the regional bank mess manages to stabilize.



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However, I do take comfort from the fact that the core CPI critical cyclically sensitive goods segment has been flat or lower each month since last September. The year-over-year trend has melted from 7.1% last August to only +1.0% today. No mas. Yet, Powell and crew, for some reason, do not think this is sustainable and believe that the deflation in goods prices won't be sustained.

We have to see what the fallout in oil foretells. Last week, oil prices collapsed with West Texas Intermediate (WTI) now below $70, which is its lowest since 2021 and is now almost down 34% from the peak. Surprisingly, this is happening in the context of China's re-opening. So, given how tight supplies are, we must be seeing a huge demand contraction to be seeing the price in freefall.

Also, in the commodity space, Dr. Copper (PhD in economics) crashed to nearly red on the year, after "meh" China data and global stress**.** The overall commodity index (CRB) index is down 16%. Even still, the commodity price action is not yet getting much attention. Central banks that choose to gaze through the rear-view mirror as opposed to driving the policy bus by looking straight through the front window are destined to make a serious policy error. I say stop looking at the twelve month trailing trend in the CPI and look at where it will be a year from now.

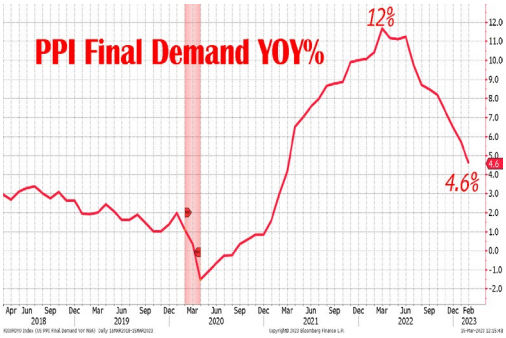
Bottom Line: From my lens we have moved from rampant inflation to moderate disinflation. Moreover, I believe that as time moves on, deflation will emerge as the primary theme in 2024.

ROOM TO PAUSE?

"February's surprising decline in the Producer Price Index (PPI) — larger than most forecasts in a Bloomberg survey of economists — adds another data point to the 'totality' of evidence that slightly reduces the urgency for the Fed to hike rates at the March 21-22 meeting." — Anna Wong, Chief U.S. Economist, Bloomberg Economics

Powell has flagged the PPI as a key indicator ahead of this week's gathering of policymakers. On that note, the PPI has slowed significantly on a year-over-year basis amid improving supply chains and declines in many commodities.

Producer Prices (final demand) unexpectedly has dropped from 12% to 4.6% — its lowest level since March 2021.



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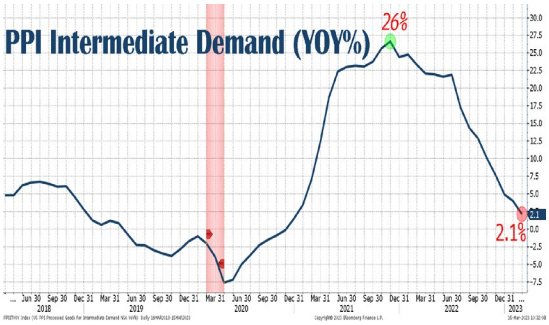
The pipeline (intermediate demand) for PPI is also now dragging the headline even lower.



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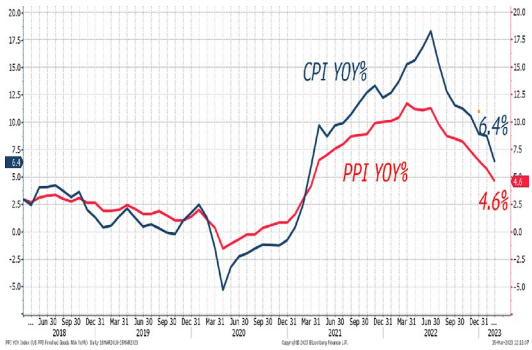
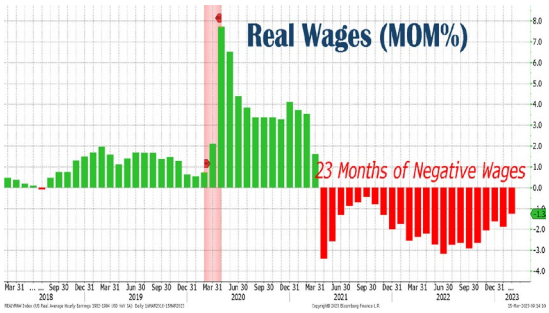
There is now less pipeline inflation than in final demand. Over the next two or three months, PPI will likely continue to accelerate to downside. As shown below, PPI is now leading CPI lower.



NO WIND IN THE SALES!

"The latest BAC card spending data suggest that the acceleration in consumer spending might have been more short-lived than we were expecting. Card spending per household slowed to 1.3% year-over-year in the week ending February 25" — Bank of America

The consumer is being squeezed…and hard. Real wages remain under downward pressure at a time when the "excess savings" from the prior fiscal largesse evaporate and credit becomes more difficult to access.



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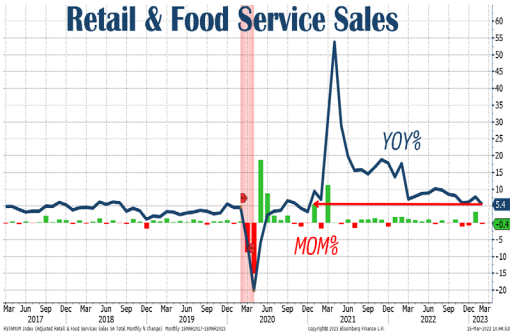
Also released last week was the latest update on February retail sales. With price rises slowing, retail sales (measured nominally) were expected to shrink in February. They did shrink down to 0.4% month-over-month. Year-over-year, this is the lowest rise in retail sales since December 2020.

The weakness was widespread with nine out of thirteen retail categories falling last month, led by furniture and restaurants.

Bottom Line: January's spending spree was a one-time outlier. The consumer is clearly becoming more stressed and is being forced into reducing discretionary spending.



**Red shaded areas denote recessions*

MARKET OUTLOOK AND PORTFOLIO STRATEGY

I keep hearing about how the Fed can't begin to ease until inflation gets down to the 2% target. This would be a real break from the past. To wit: The inflation rate was 3.5% in October 2007 when the Fed began easing. Inflation didn't get to or below 2% until November 2008, and by that time the funds rate was cut by 425 basis points.

Things happen fast. It was just over a week ago that Powell was hinting at a 50 basis points at the upcoming FOMC meeting? Time to wipe the egg off his face.

The deeply inverted U.S. yield curve means that the bond market is forecasting aggressive rate cuts —around 200 basis points through the next two years. As the Fed only cuts aggressively in a recession, the bond market is anticipating a recession. With that being said, the forecasted pace of cutting 25 basis points per quarter is too low — given that in previous recessions, the pace of cutting has been between 80-150 basis points.

Meanwhile, keep an eye on the yield curve "de-inverting." We're now getting close. The day that happens after an inversion, the countdown to a recession starts in earnest at an average of four months and median of two months.

The markets will respond long before the Fed does. This is why the ladder stratgey is an effective means of managing excess cash over a full rate cycle. 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.