Weekly Relative Value

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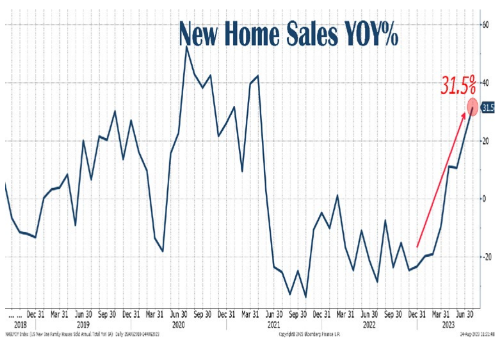
WEEK OF AUGUST 28, 2023

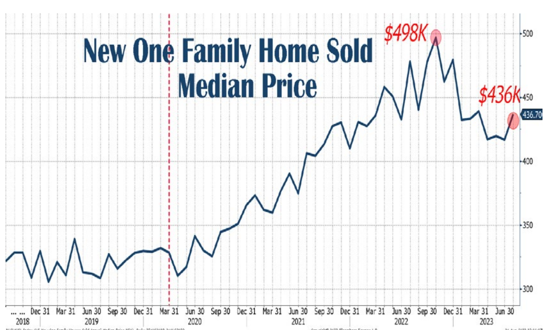
A Tale of Two Housing Markets

In July, new home sales, surprised to the high side, rose +4.4% to a +714,000 annual rate. In stark contrast to the resale market, new home sales are up a resounding +31.5% on a year-over-year basis and the level is back to where it was in February 2022.

The regional divide was huge. There were declines in the Northeast (-2.9% and down in three of the past four months) and in the South (-6.3% — the first decline since March), but sharp increases in the West (+21.5% — in one month!) and Midwest (+47.4% — the largest run-up in thirteen years).



Buyers hit a brick wall on price with a peak of $496,800 in October of 2022. Median price has fallen 16.4 % since then. The negative year-over-year price trend attests to the deflation that does exist in the residential real estate market.



The price point that is being hit the most is the mid-priced $400,000 - $500,000 range, with the share of sales in this category soaring from 20% in April, May and June to a record-high in July at 26%.

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Homebuilders have passed on lumber price discounts and offer interest rate buydowns. The percentage of home builders cutting prices to boost sales has risen to 25% and over half now (55%) are using incentives to lure in buyers as well.

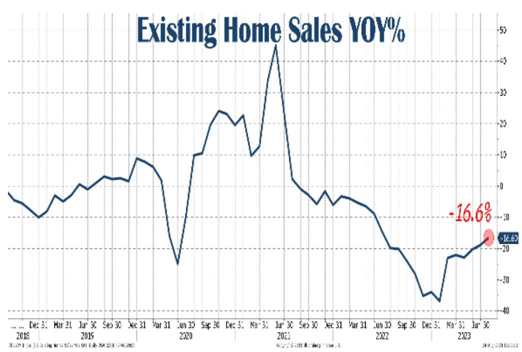
Also, builders are shrinking the average house size to compensate for higher mortgage costs as well as smaller families and lifestyle changes. Think smaller living rooms and fewer bedrooms.

- Construction on homes with fewer than three bedrooms increased 9.5% in 2022, which is over the year before.
- New construction of attached homes — with more stories but fewer bedrooms — was up 37% compared to 2019. Detached homes increased 11% over the same time period.

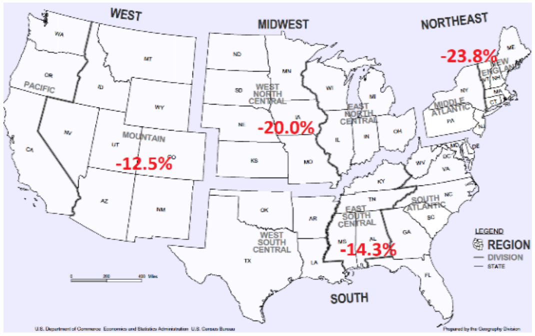
Bottom Line: Home builders are the "pros." They need to build and sell houses and will do what is necessary to move inventory. They can't just sit on inventory and wait for their "dream price." They can adjust to the new reality by building smaller homes to meet the needs and affordability of prospective buyers. As such, new home sales are helping to fill the void from the lack of inventory in the resale market. Despite the lack of overall housing activity, it's been a great time to be a builder!

THE WORST OF TIMES

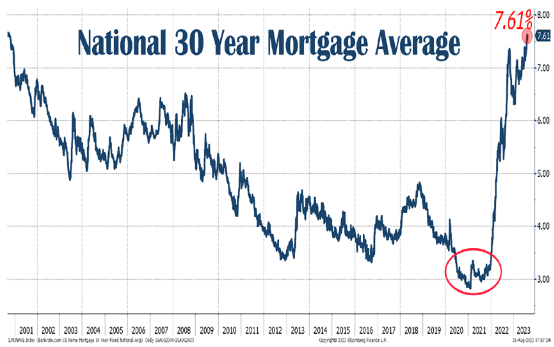
Existing home sales, which constitutes 85% of total sales (new sales are a small fraction), slipped -2.2% in July to a 4.07-million-unit annual rate. Sales are down -17% — below last year's moribund levels.



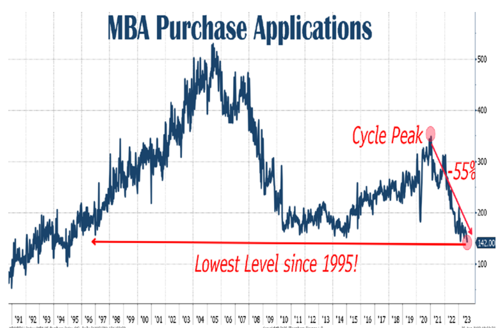
The softness of late has been regionally broad based, and even the recent hot slate of housing indicators in the Northeast have rolled over.



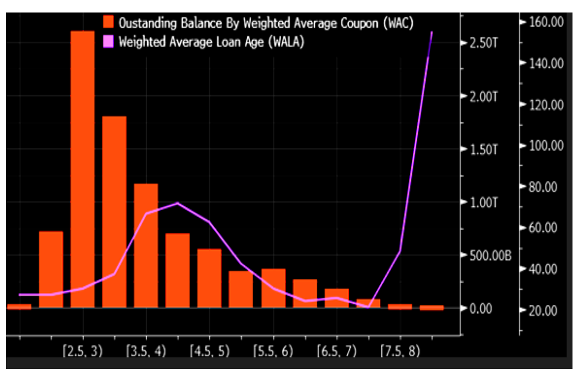
I should note that the sales data is based on contract closings, where contracts were signed in late spring or early summer. This means it doesn't reflect transaction activity since mortgage rates have surged higher. The average 30-year fixed-rate mortgage reached 7.61% — the highest since late 2000. One should expect even slower sales ahead.



In fact, mortgage applications as of August 18 fell -4.3% — the fifth consecutive decline and flirting with 27-year lows. The purchase index — down -5% week-over-week and -30% year-over-year — has completely broken down. This means that closed sales for August, when reported a month from now, will look even worse than those in July.

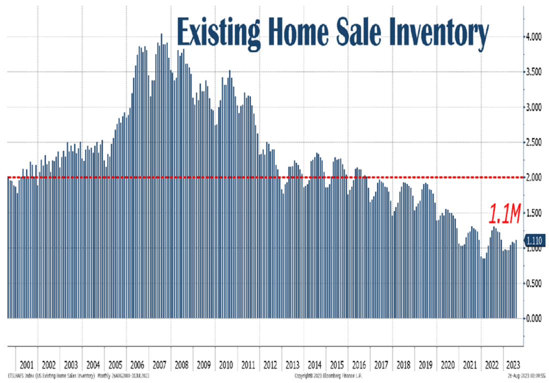


Because the Fed took rates to near zero in 2020 and 2021, homeowners had a lifetime opportunity to lock in their mortgages at rates between 2% and 3%. Approximately 85% of mortgagors did so. Now, these folks are becoming prisoners in their own homes. They can’t move without a serious financial penalty.

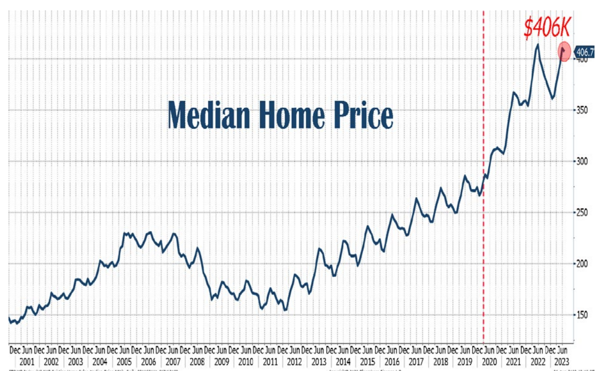


Source: Bloomberg

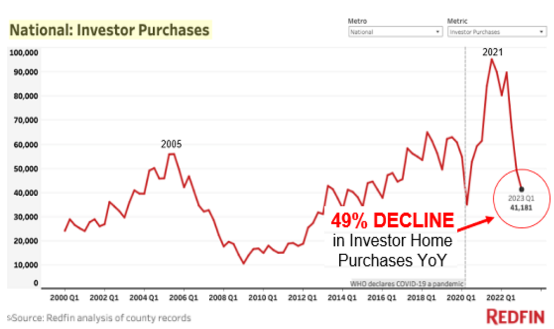
As a result, there has been no turnover and no inventory in the resale market. In July, inventory for sale rose to 1.11 million homes a little over three months' worth of supply available and remains 50% below the supply available in the same period in 2019, before the COVID-19 pandemic and well below the long-term average inventory level of two million homes.



The result is less affordability. The median price for an existing home in July was $406,700, down by a measly 1.7% from the peak in June 2022. The Fed has created a massive housing bubble yet again!



Demand and supply have vanished in equal measure because homeowners who have a 3% mortgage are not buying a new home and are not putting their current home on the market. As shown below, investors continue to pull away with Institutional purchase plunging 49% year-over-year.



Simply put, no buyers and no sellers! In fact, many housing analysts estimate that the overall housing market for existing homes has shrunk by 20%.

Bottom line: Prices have not crashed but transactions have crashed to a level seen in the mid-1990s. People who want to move are effectively trapped in their houses because they do not want to trade a sub-3% mortgage for a 7.0% mortgage. The bidding wars we do see are from people who are price insensitive.

Historically, a weak housing market is simply not good for the economy. Let's face it, who doesn't spend a lot more money when they move into a new home? Home sales mean appliance sales, new furniture, cabinets, new carpet, landscaping, etc.

Finally, it's no time to be a realtor. Because realtors make money off the churn, they get commissions twice each time a 3%-mortgage-person sells a home to buy a home.

IT'S ALL ABOUT THE CONSUMER

In a panic mode, the government, in bipartisan fashion, not only doled out massive subsidies and stimulus checks, but also expanded and extended unemployment insurance benefits. Every penny got spent. COVID-19 unleashed a narcissistic psychology toward consumer spending. The term YOLO (You Only Live Once) became ubiquitous for the economy. In fact, some studies show that the wave of stimulus checks in 2021 were responsible for all of the growth in consumer spending over the past 28 months.

The effect of drawing down excess savings to stimulate consumption lasted more than two years and blunted the suppression from the most aggressive Fed tightening cycle since 1981.

But the problem is, as the San Francisco Fed just concluded, the lingering effects of the "excess savings" total subsides by the end of September**.**

Of course, we also have the end of the student debt relief program to consider as well.

A recent survey by Empower found that:

- A third of households with student debt expected their monthly loan payments to be at least $1,000 — and that many were preparing for "significant" lifestyle and budget changes when repayment begins, including anticipated cutbacks on dining out.

In essence, the growth witnessed over the past two years was artificial and non-permanent government stimulus that has kept the consumer above the zero-line, but we are now heading into a different chapter.

Let's talk about the binge in credit card usage, especially this past year as households who were seeing their "excess savings" dry up began to tap their plastic like never before. In the past year, credit card balances have soared $270 billion, which is more than double the average pace of $120 billion annually over the past three **decades.**

The New York Fed reported this month that outstanding balances soared above $1 trillion for the first time ever — not a milestone to be celebrated**.**

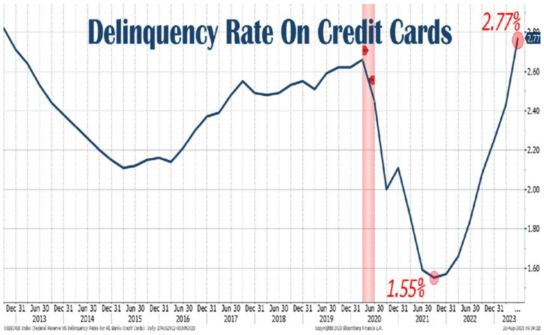
- According to JD Power, the number of Americans rolling credit card debt from month-to-month is now higher than the number of people paying their bills in full for the first time ever!

- Unpaid balances are up +16% from year-ago levels. The median balance is currently at $7,717, nearly double the $4,298 level in the summer of 2022 (and at a punitive average 22% interest rate!).

It's estimated that credit card reliance alone was responsible for nearly 20% of the consumer spending growth we have witnessed over the past twelve months**.**

But like the fading fiscal stimulus on consumer spending, the credit card story is reversing course as well.

The New York Fed Credit Access Survey shows that 21.5% of credit card applications are now being rejected. This all makes sense because the credit card delinquency rate has risen from 1.55 % in 2021 to 2.77% today, which is the highest it has been since the third quarter of 2012.



Bottom Line: Uncle Sam delivered the budget busting COVID-19 stimulus program that is now on its last legs. Further, there's no denying Jerome Powell's restrictive policy has delivered "some pain" to U.S. households and businesses. And it's abundantly clear that marginal consumers are under some distress from their rising high-cost credit cards and may be tapped out. All of this in a full employment economy?

So, while the economy has surprised to the upside in the wake of the Fed rate hikes, the question is how will the economy fare on its own going forward?

NON-FARM PAYROLLS GET "BENCHED"

The non-farm payroll (NFP) data is quite volatile and subject to change. In addition to monthly revisions, there are also benchmark revisions based on the QCEW (Quarterly Census of Employment and Wages) that covers more than 95% jobs in the U.S. The preliminary benchmark revisions occur with the QCEW's release of first-quarter numbers and then the month over-month NFP readings are revised from March of that year to April of the prior year.

The latest benchmark revision showed that the month-over-month change in non-farm payrolls was overestimated by +25,000 on average. Overall, the month-over-month change in non-farm payrolls between April 2022 and March 2023 were revised -306,000 lower — the largest downward revision since 2019. If government jobs are excluded, the total employment gain from April 2022 to March 2023 was -358,000 lower than the results before the benchmark.

Further, the initial NFP may be subject to even further downward revisions with final benchmark revisions reported in February 2024.

Bottom line: Non-farm payrolls showed a significant downward revision to its employment estimates. The downward benchmark revisions to payroll employment numbers show the labor market to be "less tight."

"A LONG WAY TO GO"

*"...inflation remains too high... we are prepared to raise rates further and intend to hold policy at a restrictive level... the process still **has a long way to go**, even with the more favorable recent readings."*
— Jerome Powell, Federal Reserve Board Chairman

The most important aspect of Powell's speech at the Jackson Hole Symposium was his total smackdown of the folks that had either been clamoring for the Fed to raise its 2% inflation target (core personal consumption expenditures (PCE)) or had been predicting that it would raise it.

Powell said:

*"**2% is and will remain our inflation target**. We are committed to achieving and sustaining a stance of monetary policy that is sufficiently restrictive to bring inflation down to that level over time."*

He did acknowledge the downward trend in inflation and uncertainty over the policy lags. He also mentioned that policy is restrictive. With that being said, he is more concerned that demand growth is too strong and that the labor market is too robust.

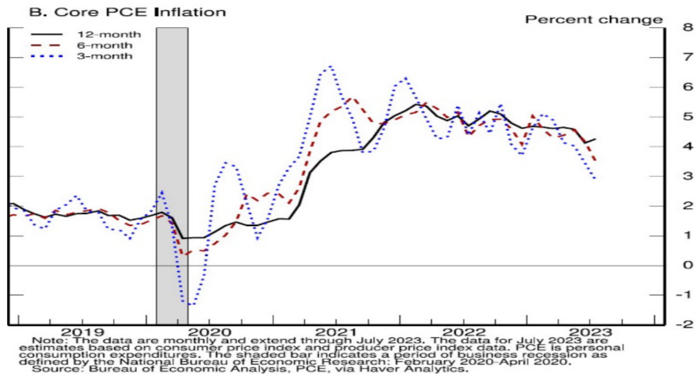
"So far this year, gross domestic product (GDP) growth has come in above expectations and above its longer-run trend (Q1 GDP: +2.0%, Q2 GDP +2.4% and Q3 has started out even stronger), and recent readings on consumer spending have been especially robust. In addition, after decelerating sharply over the past 18 months, the housing sector is showing signs of picking back up."

At the margin, he left the door open for an additional rate hike. I don't see it, but he clearly wants the markets and the

"Twelve-month core inflation is still elevated, and there is substantial further ground to cover to get back to price stability…We are prepared to raise rates further if appropriate, and intend to hold policy at a restrictive level until we are confident that inflation is moving sustainably down toward our objective."

general public to know that he is nowhere close to declaring victory on the inflation battle.

The bond market was expecting something more emphatic from the sharp drop in inflation. Powell clearly remains skeptical over the prospect of a further deceleration absent slack emerging in the labor market. Check out the chart below that Powell showed where the Fed staff is forecasting that core PCE for July, to be announced on August 31, will re-accelerate:



And Powell repeated what he's said many times before:

"Restoring price stability is essential to achieving both sides of our dual mandate. We will need price stability to achieve a sustained period of strong labor market conditions that benefit all."

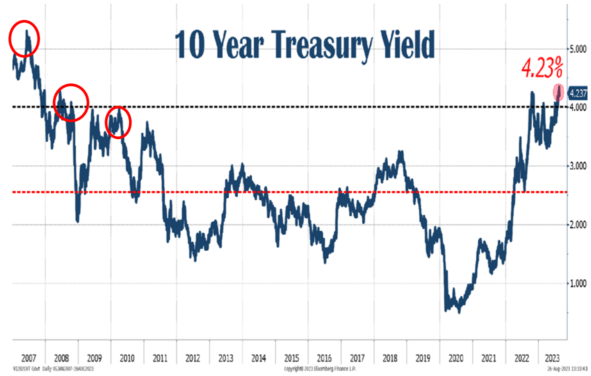
Which was followed by his closing sentence:

"We will keep at it until the job is done."

Bottom line: I believe the primary risk is that this Fed ends up overstaying this era of policy restraint in perfect symmetry to how it overstayed its welcome on the excessive accommodative front in 2021 and into 2022.

SHAKEN AND STIRRED

This is the ninth attempt by the ten-year Treasury to break above 4% over the past fifteen years. Every time, the bond bears claim an even bigger breakout higher. But what has happened is that buyers are driven back in at these yield levels and the shorts cover en masse.



The ten-year Treasury yield breached 4% in December 2007 as the consensus believed in a "soft landing" — completely oblivious that the recession had just started.

In March 2008, the ten-year yield crossed above the 4% mark. At the time, everyone was talking about the new era of Chinese double-digit growth, global decoupling and the commodity super-cycle.

In early 2010, we had the economic "green shoots" and by early April, once again, the ten-year Treasury yield crossed above 4% temporarily.

The so-called gurus back then were scaremongering about ever higher bond yields much like Bill Dudley is doing today.

Remember that in early 2020, the yield broke sharply below at the low end of the range of 1.5%. Was that the signpost of further yield declines? No. So why will the break of 4% be any more sustainable on the other side? I doubt that it will.

Bottom line: The economy is so debt-laden that the borrowing cost levels will not be maintained. Something is going to break and the regional bank failures earlier this year were very much the proverbial "canary in the coalmine" like when New Century Financial closed its doors in early 2007.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Where we part ways (materially) is just how much pain will be administered in the months and quarters ahead, as the weight of higher interest rates falls squarely on the shoulders of a tapped-out economy"
— Daryl Jones, Hedgeye, Director of Research.

Even though Powell said he's encouraged that inflation tumbled from 9% to 3% in recent months, it's not enough. The central bank is prepared to do whatever it takes to bring the rate down to the magical 2% target.

While the official Fed narrative is we are headed for a "soft landing," these forecasts of the probability of recession should be trusted as much as their "transitory" inflation forecast. People should not have confidence in the Fed's forecast. The Fed is doing what they always do, looking at the recent past. The "no-landing" or "soft-landing" thesis is using the rear-view mirror.

The American consumer will be heading into the fourth quarter free of all stimulus.

In the meantime, the Fed is likely underestimating the lagging impact of their tightening program in the future and has set the table for a major event in the credit markets.

The "real" fed funds rate of -7.375% has swung dramatically to +2% currently**.** This is precisely where it was in September 2007, January 2001 and August 1990. For the record, these were periods when we were heading into recession or already there.

Further, the last time real interest rates were so far above the Fed's own estimate of neutral (0.5%), we were already knee-deep in the 2008-2009 recession.

At the same time, real M2 is down -7% on a year-over-year basis, and this has never before happened without there being a recession. The real interest cost of buying a new home today is bordering on 10%. But everyone is so convinced that there will not be a recession and that complacency is unsettling — and dangerous. Fiscal policy and Taylor Swift, as powerful pro-growth forces as they may be, are no match for the two most important words in economics and finance: interest rates.

Finally, China is in a structural slowdown with implications for all of Asia. Germany is heading back into recession with implications for all of Europe.

Nothing out of Jackson Hole, not even reiteration of "higher for longer," has managed to upset the apple cart. The futures market is now leaning modestly towards another rate hike in November — close to 60% odds now versus 40% a week ago. The two-year Treasury yield at 5.07% looks very juicy when you consider where rates are likely to be heading in the next 12-24 months (lower).

Also, have a read of the column on the debate over the Fed in today's *Wall Street Journal*: **"**Despite What Powell Says, the Fed Is Likely Done."

In terms of portfolio strategy, for those credit unions that have excess liquidity, the most prudent approach is to continue building a risk appropriate ladder strategy of high-quality securities.

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.