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INVESTMENT SERVICES

Weekly Relative Value

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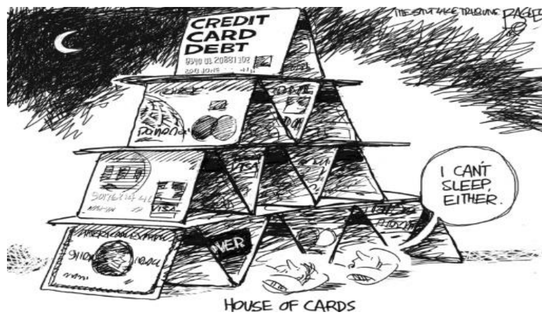
WEEK OF SEPTEMBER 18, 2023

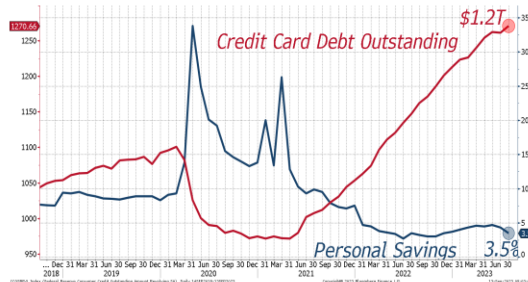
A House of Cards

"When you take an economy that has twice as much debt as it did going into the Great Financial Crisis and you raise rates on it in unprecedented fashion, you're going to cause major dislocations…" — Stephanie Pomboy, Owner, Macro Mavens

Amazingly, or perhaps not so amazingly, American households continue to tap their plastic as credit card usage replaces the end of the "excess savings." Outstanding credit card debt ballooned at a +9.2% annual rate in July to a record $1.2 trillion.



This explains why spending was at a solid even with the savings rate drawn down sharply to a record low of 3.5% from 4.3% (and around 9.3% pre-COVID-19).



While it's true that many people don't use their cards to "borrow," (i.e., many use them for points, miles, etc.) those that fail to pay off their credit cards monthly will pay handsomely.

For the first time ever, more than 50% of credit card balances are being rolled over. The median outstanding unpaid balance has doubled to $7,717 compared to $4,298 in 2022.

THIS WEEK

- SLOW MOTION CRASH
- THE HOUSING MARKET
- UNCLE SAM'S DEBT ADDICTION
- CORPORATE BANKRUPTCIES SURGE!
- ALL CREDIT BUBBLES BREAK
- BOUNCING AT THE BOTTOM
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
TELL ME MORE!

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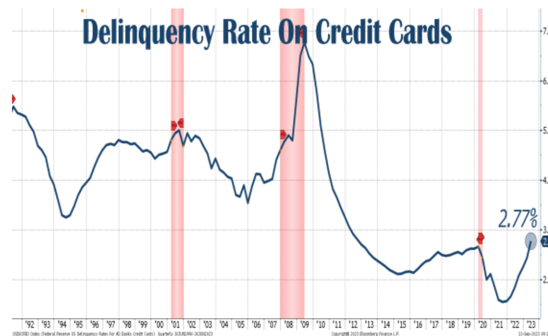
This means that people are paying huge amounts in interest, especially when the rate is a punitive record high of 22%! This is a classic end-of-cycle strain.

Sure enough, as the impact of interest rates truly kicks in, card delinquencies have practically doubled, albeit from historically low levels—moving from 1.5% in the third quarter of 2021, amidst the warmth of fiscal stimulus, to 2.77% today. However, going forward I expect this graph to make frequent appearances in the *Weekly Relative Value* with student loan repayments just days away.



For some context, during the 2008 recession, the unemployment rate moved from 5% in December 2007 to 9.5% by June 2009. Concurrently, credit card delinquency rates rose from 4.6% in the last quarter of 2007 to 6.8% in the second quarter of 2009. Simply put, as employment dwindled, revolving credit delinquencies grew. It's not exactly rocket science.

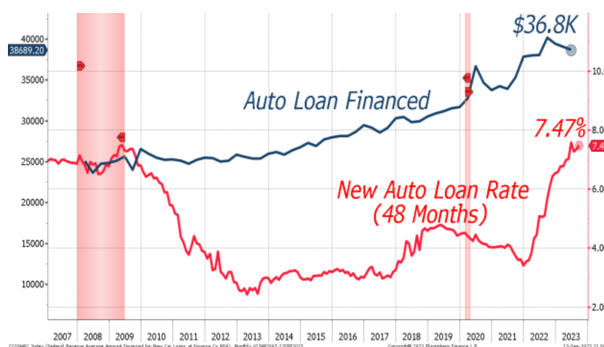
Fast forward to today. Imagine what happens to delinquency rates when today's labor markets weaken, and the unemployment rate normalizes.

Bottom line: I rarely utter, "It's different this time," because it often isn't.

SLOW MOTION CRASH

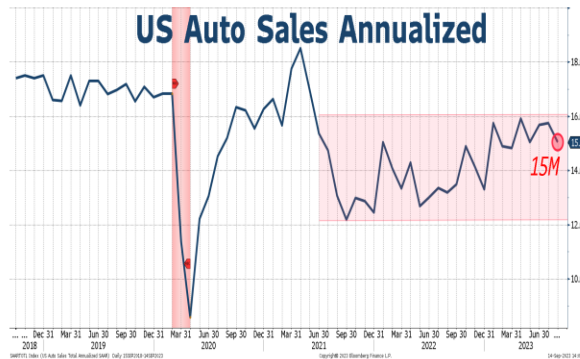
One of the areas of concern is auto lending. Banks have been tightening their belts by raising lending standards while setting aside an increasing amount of money for bad loans. Auto loan rejection rates are now at 14% — the highest they have ever been! And defaults are on the rise.

The average listing price in August is down a hair so far in 2023. But between the end of 2019 through 2022, just three years, the average listing price spiked by 30% after having surged in prior years. These massive price increases are toxic.



Additionally, the average new car loan rate is nearing 7.5% (up from 5.1% a year ago) and hovering around the highest level on record based on data back to 2005. Today, the average loan payment is $750 per month and a staggering 17% of Americans are paying over $1,000 per month!

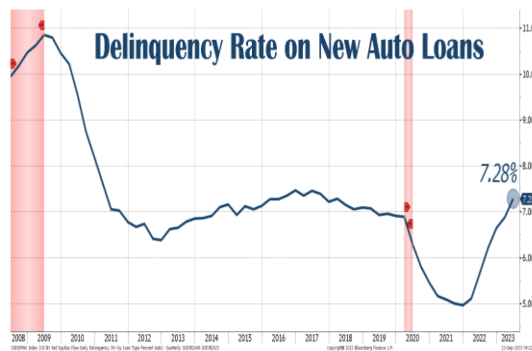
Given the affordability constraints (i.e., higher rates and prices), auto sales have flattened like a pancake over the past two years at 15 million units. Prior to the pandemic, sales were averaging 17 million units per year.



As a result, dealers are getting squeezed on both sides (financing access and less consumer demand). It's no wonder companies such as Capital One are pulling back on financing and lenders such as Wells Fargo are laying off loan underwriters.

Anecdotally, BMO just shuttered its indirect auto finance business as delinquencies piled up. And a large used car dealership in Florida, Off Lease Only, LLC, shuttered its doors recently. The company cited that the combination of high prices and increasing interest rates resulted in reduced consumer demand and affordability. Indeed!

What's even more disconcerting is that newly delinquent auto loans are up to 7.3% (as of the second quarter). This is the fastest run-up since 2017! This is happening in a fully employed economy.



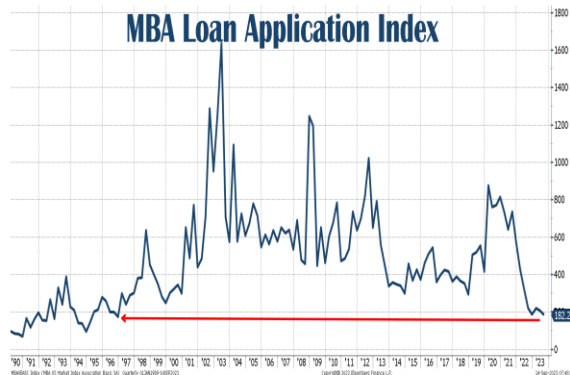
Bottom Line: It's clear that the auto lending sector is under pressure. This is another example of what happens when a credit-driven economy undergoes 525 basis points of tightening in 16 months by the central bank.

THE HOUSING MARKET

As interest rates have soared and mortgage rates have more than doubled to 7.5%, the soaring unaffordability of homes is genuinely hurting people and the overall economy.

Let's not forget the effects of a 7.7% 30-year fixed-mortgage rate (+160 basis points surge over the past year). The median monthly mortgage payment is now at a record $2,632 and is up 14% more than last year. Once you factor in taxes and insurance, this figure balloons to roughly $3,300 monthly. This means that homeowners are spending about 53% of the median household income before taxes and nearly 70% after taxes and insurances are incorporated.

Take a look at the graph below. The Mortgage Bankers Association (MBA) data on mortgage applications showed a -0.8% week-over-week drop in the week of September 8 after the -2.9% plunge the prior week. This index is down in seven of the past eight weeks and down an epic -29% on a year-over-year basis to the lowest level in 27 years.



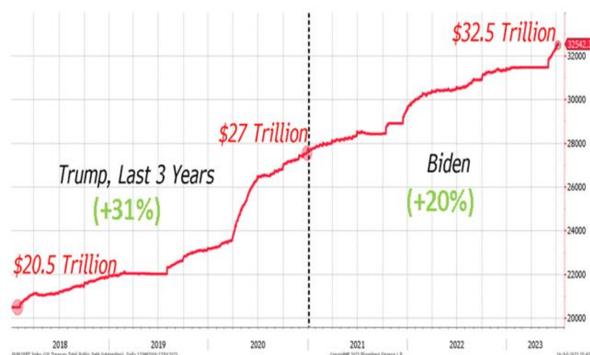
Bottom line: The housing market is broken. Many homeowners benefiting from low rates are hesitant to sell or refinance due to potential higher rates. Thus, inventory remains at rock bottom levels.

That being said, my belief is that in the face of a recession and rising unemployment, we are likely to see a spike in inventory as individuals sell homes to access equity. This influx of inventory will push prices downward prompting more homeowners to sell in hopes of retaining equity. This could effectively cause a cascade effect and a mean reversion in prices and affordability. This would be a healthy step towards normalizing a "broken" market.

UNCLE SAM'S DEBT ADDICTION

Since the Great Financial Crisis, U.S. government debt has risen 20% ($5.5 trillion) to $32.5 trillion (Debt/GDP: 100%). Even more shocking, the U.S. government debt has risen by over $12 trillion since 2017. Does anyone see a problem here?

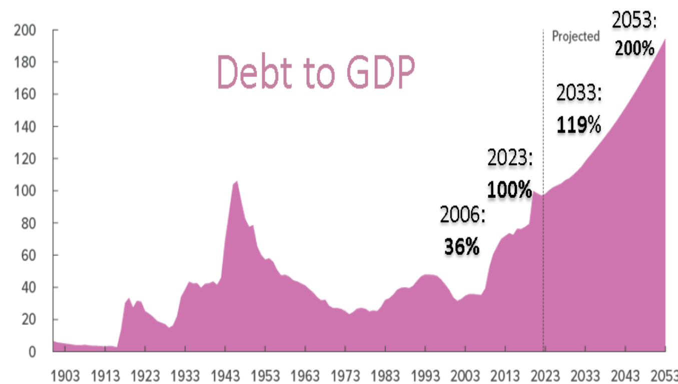
Yet, the policymakers will state this massive debt pileup has been nonexistent. Democrats and Republicans have both spent like drunken sailors. There's been no tradeoffs or compromises to cut spending. There's been zero effort to balance the budget.



Sadly, this trajectory will only get worse as "mandatory" spending (i.e., Social Security, Medicare and Medicaid) are expected to grow by 49% from 2022 to 2033. But remember that mandatory spending (88% of your tax dollars goes here!) does not boost economic activity. There are no new jobs, new roads or new dollars of research and development created from mandatory spending. Thus, a dollar of debt financed to fund these federal expenditures will "at the end of the day" reduce gross domestic product (GDP).

While this debt addiction is hardly new, to think there is a Democratic or a Republican politician out there that will run on reforming these programs is nothing but wishful thinking. Thus, assuming the status quo, the bi-partisan Congressional Budget Office (CBO) now projects that debt will rise $5.2 billion every day for the next 10 years to $47 trillion by 2033 and debt-to-GDP will jump to 119%. If nothing changes by 2053, debt-to-GDP will skyrocket to 200%!

Our debt is out of control and no party has the will or conviction to change course. I'm afraid that we are getting closer and closer to a "reset," or if you're religious, a debt jubilee.



While the U.S. government has been able to get away with this fiscal recklessness when rates were hovering at record low rates, they will find it much more challenging and costly after rates have risen four-fold!

As shown above, interest costs of funding the burgeoning U.S. debt has already doubled since 2019 to nearly $ 1 trillion! As the debt pile grows and grows, interest costs will only rise significantly from here. To wit: Approximately 75% of outstanding low-yielding Treasuries will be rolling over within the next five years. Come 2033, total net interest costs will have accumulated to $10.5 trillion and 50 cents on every $1 borrowed will be used to pay interest on debt. Is that all we get for our money?

Bottom line: Without any interest rate relief, the interest bill on the U.S. government debt in the next decade could very well approach an incredible $2 trillion a year. Thus, with so much money being allocated to non-productive mandatory spending and interest payments, the U.S. government will be greatly constrained from making productive investments in R&D, infrastructure, education and transportation. Not good!

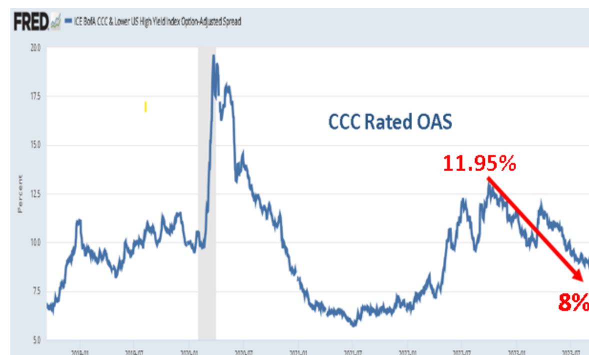
CORPORATE BANKRUPTCIES SURGE!

"It's really something, listening to johnny-come-latelys parroting my talking points on corporate bankruptcies (which none of them saw coming six months ago). But they still fail to connect the dots. If they did, they'd be calling for a fiscal and monetary response that makes 2008-2009 look like peanuts." – Stephanie Pomboy, Owner, Macro Mavens

Another victim of the aggressive Federal Reserve monetary policy has been Corporate America, with bankruptcies hitting a 12-year high according to data from S&P Global Market Intelligence. In August 2023 alone, another 57 companies filed for bankruptcy. Thus far in 2023, there have been 459 U.S. corporate bankruptcies**.** This compares with 373 for all of 2022 and 408 for all of 2021.

Despite the obvious stress with many companies, the market still fails to see the magnitude of the problem. Investor optimism surrounding a "soft landing" or "no landing" outcome is running rampant.

Take a look at the riskiest corners of the high-yield market — CCC-rated credit for evidence. Despite the most aggressive Fed hiking cycle since the 1980s, continued tightening of financial conditions, ongoing quantitative tightening (QT), elevated recession risks and an 18-month bear market in stocks, why is it that these companies — rated just above "default" — have behaved so well, in terms of narrow spreads?



Since peaking at nearly 1,150 basis points back in early October, CCC-spreads have come in 300 basis points — touching 825 basis points in recent weeks, the lowest they have been since May 2022.

With the Fed pushing on the "higher for longer" messaging, and the buy-in from markets that there was no downturn on the horizon, investors were less worried about credit risk. Again, it all comes back to widespread confidence that the economy will experience a "soft landing" despite the rapid tightening in financial conditions and monetary policy to date.

There is also a belief that corporate balance sheets are less exposed to rising rates, and that there is no looming refinancing wave that will lead to increased debt defaults. It's true that with the Fed keeping rates at artificially low levels for many years, many large-cap companies were able to "term out" their debt and lock in very low rates. This "new normal" certainly seems astonishingly abnormal to me. However, if you look just below the very large-caps stocks, the old "normal" still applies.

It's estimated that nearly $6 trillion of commercial and corporate debt is resetting to the toughest monetary policy backdrop since 1981 and 1982. In fact, one-third of the CCC index will have to re-finance by the end of 2026 (and half by 2027). Over time, the reality of higher interest rates hits.

"Most companies are still living in the 'real' world where higher rates hurt…To the extent post the Great Financial Crisis (GFC) quantitative easing (QE) and direct pandemic relief kept so many zombie companies on life support (an oxymoron?), the recent sharp rise in rates really could cause a shocking rise in bankruptcies beyond all fears."
— Albert Edwards, Economist

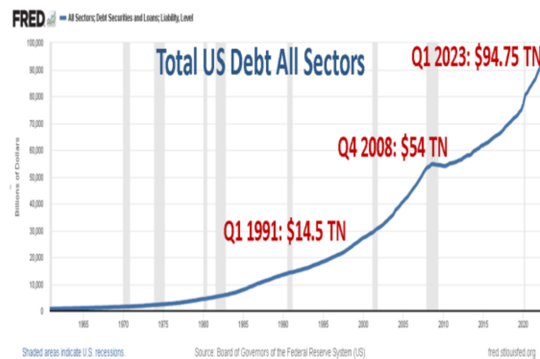
With the Fed steadfast in its "as long as it takes" and "higher for longer" policy stance, the risks of re-financing these debts at much higher rates and then requiring a rising share of cashflows to service the obligations, is the darker side of the tradeoff that perhaps some investors are forgetting.

Bottom line: Monitoring employment and corporate bankruptcies will be decisive in the coming days, weeks and months. Look for more corporate bankruptcies (maybe a lot more) to be announced as we move forward.

ALL CREDIT BUBBLES BREAK

"When asked how to unwind the world's huge borrowings, he said when debt becomes a big share of the economy, the situation tends to compound and accelerate as interest payments also grow. We're at that turning point of acceleration." — Ray Dalio, American Investor

The U.S. is the most leveraged asset-dependent economy ever! As shown below, total debt (which includes the government, corporations and individuals) has doubled since the GFC to an all-time high of $94 trillion (a 400% increase since 2000). Much of this debt has been issued within an extremely low-rate environment. However, in a "higher for longer" rate environment, look for stresses to build as the government, corporations and individuals find it much more difficult to service its debts.



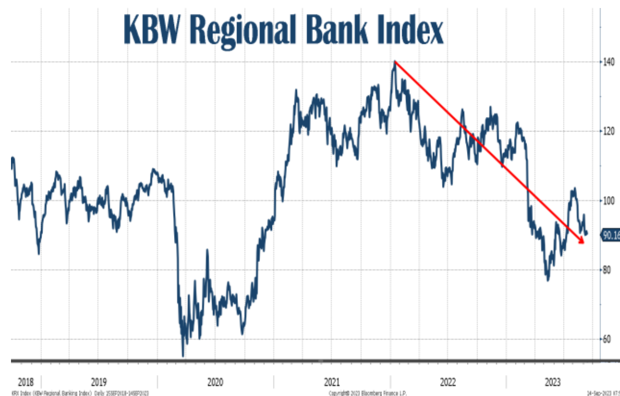
Bottom line: Given the leverage the economy depends upon, "higher for longer" is not possible without breaking something. The lag effect is a ticking time bomb with each day another borrower feeling the impact of higher interest rates. The financial impact is slow but steadily increasing. Also, remember that the various types of pandemic-related stimulus are quickly exiting the economy. If the economic activity is normalized, the slow but steadily growing lag effect will likely result in a recession.

The last words go to Stephanie Pomboy:

"The impact on the economy, and then the corporate and household credit situation, will be so severe that they'll take rates down dramatically." — Stephanie Pomboy, Owner, Macro Mavens

BOUNCING AT THE BOTTOM

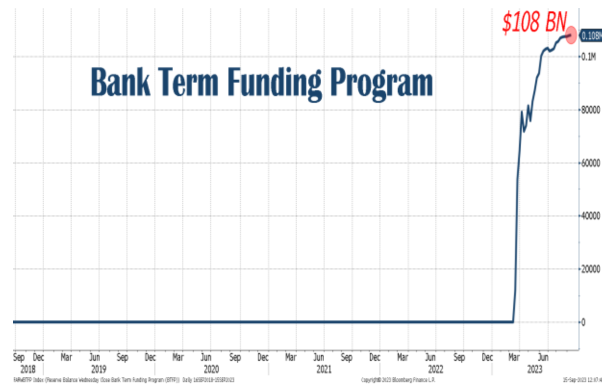
The S&P 500 banking index is off -18% from the nearby highs. The view that the problems among the regional banks are behind us is a pure fallacy as the index remains -45% below the pre-crisis highs and is bouncing along the bottom.



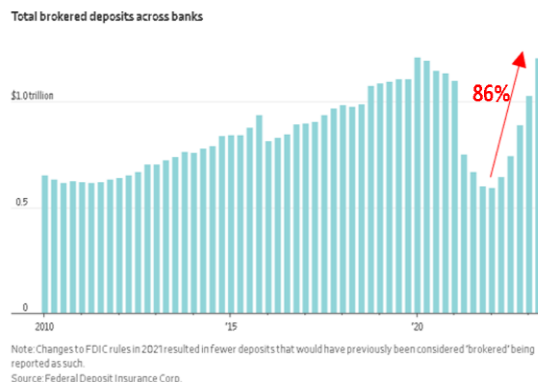
All anyone needs to do is read this *Wall Street Journal (WSJ)* article, "'Almost All Loans Are Bad'—Why Banks Aren't Lending," and look at what the usually cheerful Jamie Dimon, CEO of Chase, had to say.

At the peak of the GFC in 2008, bank deposits fell by $70 billion. Interestingly, bank deposits have decreased by $862 billion since this Powell rate cycle began (or by 12 times since the GFC).

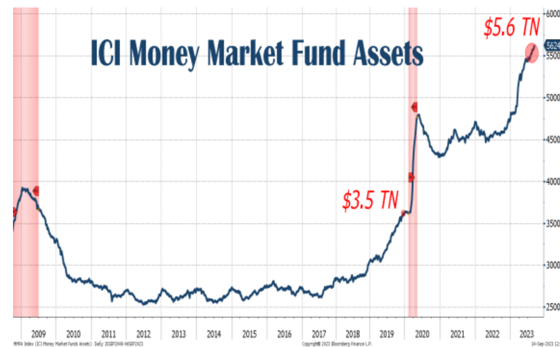
Federal Home Loan Banks (FHLB) advances as of the end of the second quarter hovered around $900 billion. The Bank Term Funding Program (BFTB), an emergency facility, keeps growing, now surpassing $108 billion — albeit at a decelerating pace. It's worth noting that these facilities don't come cheap as BTFB loans currently stand at 5.5%. Remember, it's an emergency initiative and banks have six months to figure out how to clean up the $108 billion hole in their balance sheet that they're currently paying the Fed's exorbitant rates to fill.



And now, in a desperate move, they're beginning to lure in risky brokered deposits to shore up its capital base. Have a look at this *WSJ* article, "Banks Load Up on $1.2 Trillion In Risky 'Hot" Deposits."



The primary beneficiary of these deposit outflows has been money market funds as inflows into money-market funds (of $17.7 billion) has been pushing total assets to a new record high of $5.642 trillion. This is the eighth weekly inflow of the last nine weeks. Between the end of the third quarter of 2022 and the first quarter of 2023, these funds accumulated nearly $700 billion. These shifts have especially strained regional banks.



Bottom line: Although there hasn't been any massive bank failures recently, the underlying pressures persist. As the Fed maintains a tight monetary policy, and the yield curve remains inverted, the risk of additional bank failures is a distinct possibility.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The great American consumer is running on fumes (and credit cards). Bloomberg's latest Market Live Pulse Survey shows that 56% of those surveyed expect U.S. consumption change to turn negative in early 2024 and about 21% expect consumption to crack even sooner by the end of this year.

The reasons are aplenty:

1. Consumers have run out of excess savings from stimulus checks.
2. Student loan debt repayment is about to begin in October, which will further crimp spending.
3. Liquidity for consumers continues to become tighter as the interest rate charged on credit card accounts sits at 22% — the highest since 1972.
4. Wage growth has started to cool down. Indeed's wage tracker shows 4.2% growth now compared to 7.5% year-over-year growth a year back.
5. Most importantly, the impact of the recent wave of rate hikes (525+ basis points) will be felt with a lag, especially on the consumption of big-ticket items like cars.

We will find out over the next three to four months if the U.S. consumer is an invincible force as the emperor gets disrobed.

Meanwhile**,** the U.S. economy is likely be on the receiving end of some major negative shocks including the end of all the fiscal stimulus, the United Auto Workers (UAW) strike, and the likely government shutdown at month-end. Look for real GDP to take a potentially significant hit (depending on how long the last two effects last).

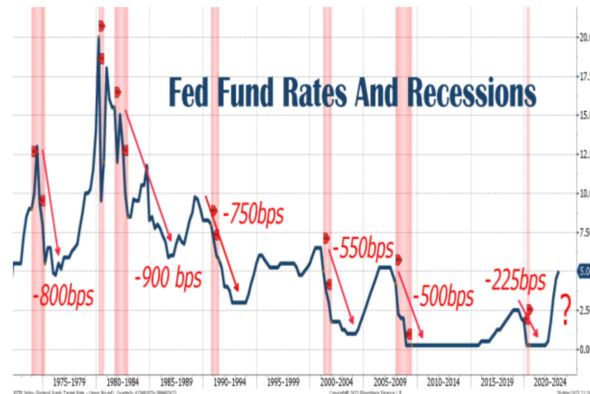
It will be interesting to see how the U.S. economy withstands the extent of the monetary tightening in the pipeline at a time when fiscal policy is about to shift from stimulus to restraint.

Yet, more than 40% of the economists polled believe the Fed will hike rates at least two more times from the current 22-year high level of the funds rate at 5.25%-5.50%. This is at odds with the market pricing of the Fed basically being done, with one last hike not being discounted as more than a 50-50 chance.

Going forward, my belief is the Fed may hike one more time. With real rates positive, inflation down significantly from the highs and the bank system under stress, the Fed will recognize that it has done enough (for now) and will pause. Yes, they will state that they will remain vigilant on inflation and are prepared to hike rates more, if necessary, but for all intents and purposes it should be done.

Here comes the interesting part: In all the rate hike cycles going back to the great inflation of the 1970s, the Fed has never *maintained* rates at the peak for more than nine months. The Fed typically does not underreact to things on the upside or the downside. It does too much, and that is true today, too.

Here's a bold prediction: Don't be surprised if the Fed begins to cut rates in 2024! Yes, cut rates!



Bottom Line: Despite the weakening economic and credit backdrop, the same group who brought us "transitory" has now offered up "higher for longer." The former should clearly have faded three years ago, and I would posit that in a similar vein, the latter should be met with a high dose of skepticism as well. As I continue to emphasize, the lagged impact of such a sharp increase in rates will be powerful, and the business cycle is alive and well. Contraction still follows expansion.

In terms of portfolio strategy, for 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.

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