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INVESTMENT SERVICES

Weekly Relative Value

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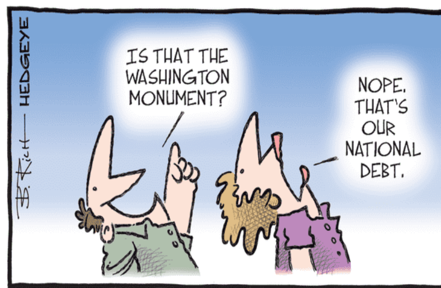
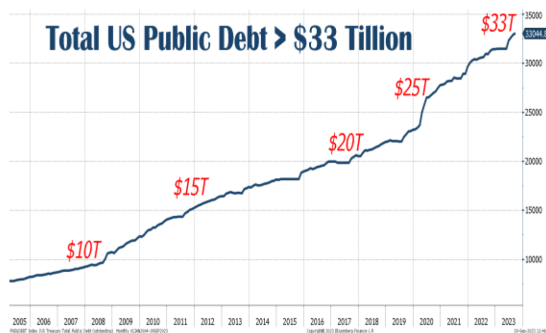
WEEK OF SEPTEMBER 25, 2023

The Fiscal Masquerade

Congratulations, America! Last week, the Treasury announced that for the first time total U.S. debt has surpassed $33 trillion, rising by $56 billion in one day and by a mind-blowing $1.58 trillion since the debt ceiling was lifted. Over the past year, debt has risen by $2.16 trillion.



Thus, a stunning amount of new debt has piled on in a stunningly short amount of time, even as the economy has been growing! What is even more disturbing is the historical fact that since the Great Financial Crisis (GFC) in 2008, total public debt has risen to $33 trillion from $10 trillion in 2008. When will this madness end? Or will it?



Here are two recent examples of how Washington works:

- The so-called "Inflation Reduction Act" of 2022 was supposed to cost $400 billion in the coming decade and is now slated to top $1 trillion.
- The Employee Retention Act, which was first earmarked for $55 billion of stimulus, ended up costing taxpayers $230 billion.

THIS WEEK

- IN THE BASEMENT
- HOUSING STARTS COLLAPSE
- TIGHTER THAN IT LOOKS!
- MARKET OUTLOOK AND PORTFOLIO STRATEGY
- IT'S NOT WHAT THEY SAY THAT MATTERS

SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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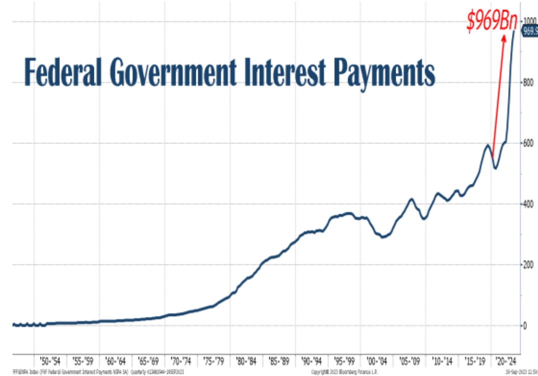
Think long and hard about this: the federal deficit is at -7.6%. This has never happened before. Only during sharp recessions (i.e., the GFC, the COVID-19 lockdown) have we seen deficits so large. Normally, when the economy is growing with full employment, deficits have averaged around 1%. What happens to our deficits when the economy succumbs to a recession and unemployment rises?

The historic breakout in debt took place just weeks before the interest on the total federal debt was set to hit $1 trillion! The average interest paid on all Treasury securities rose to 2.92% at the end of August. This is the highest rate since 2011.



However, things will likely get much worse. Approximately 75% of Treasuries will be rolling over within the next five years with coupons significantly lower than current market rates. In fact, looking at the current levels in the graph below, the reinvestment rate would double! Therefore, without any interest rate relief, the interest bill in the next decade could very well approach an incredible $2 trillion a year!

For those who expect a happy ending, I have one word for you, "**don't**."

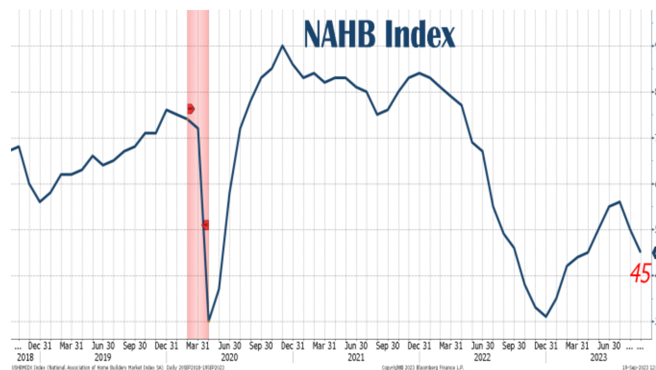
The latest debt forecast from the non-partisan Congressional Budget Office (CBO) shows that the U.S. debt is now set to hit $50 trillion by 2030 (probably much sooner though), and will proceed exponentially higher. The debt-to-gross domestic product (GDP) ratio will rise to 119% by 2033 and by 200% in 2053. Does anyone in Washington care?

IN THE BASEMENT

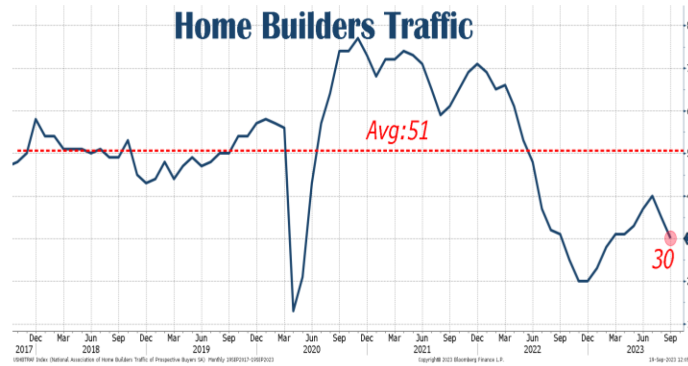
The National Association of Home Builders (NAHB)/Wells Fargo Housing Market Index is based on a monthly survey of NAHB members designed to take the pulse of the single-family housing market. The survey asks respondents to rate the market conditions for the sale of new homes at the present time and in the next six months as well as rate the traffic of prospective buyers of new homes.

Earlier this year, conditions rebounded from deep levels when mortgage rates briefly fell and homebuilders lowered prices by around 12% from their all-time high to $436,700. Also, homebuilders resorted to mortgage rate buydowns, passing on falling lumber prices and building smaller homes.

Further options to entice buyers have run out of steam as the homebuilder sentiment index took a big tumble in September, even in the face of incentives and discounting to lure in buyers. The consensus was at 49, but instead the index fell hard to a five-month low of 45 from 50 in August. That is the steepest decline since November of last year.



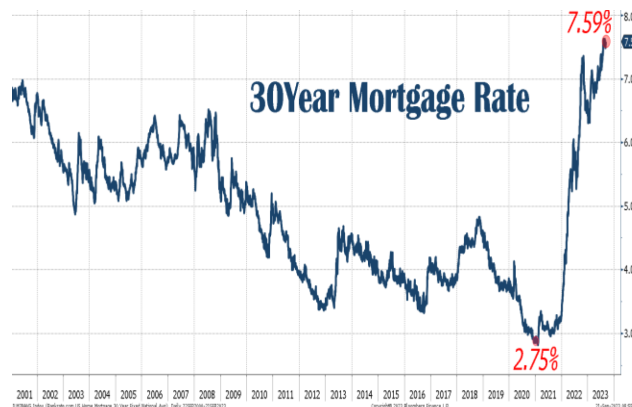
All the components were lower. Of note, prospective buyer traffic, a terrific leading indicator for home sales and starts, is in a deep recession. Last month, this index sagged from 40 in July to 35 in August. It now stands at a rancid 30 reading in September, a seven-month low.



Bottom line: The 30-year mortgage rate is now 7.59% and has risen by nearly 500 basis points since the pandemic low! Homebuilders have little room to lower prices and existing home sales are down 15% year-over-year. They are now closing on an all-time low seen during the GFC. And, if mortgage rates (and thus affordability) are anything to go by, things could get interesting.

Meanwhile, the number of homes for sale edged lower to 1.1 million, the smallest August inventory in data since 1999**.** Amazingly, in this bizarre housing market with mortgage rates nearly tripling and activity plunging, the median selling price rose 3.9% from a year earlier to $407,100. This was one of the highest readings on record. Since August 2019, prices are up 46%!

The funny thing is that many believe we have a strong housing market because many homeowners are locked in at the lows. In reality, the housing market is broken! Very broken indeed!



Bottom line: There is a dearth of new buyers who can afford to buy and that is what sets the stage for a recession. Remember that GDP growth is all about new spending and spending in residential real estate is non-existent.

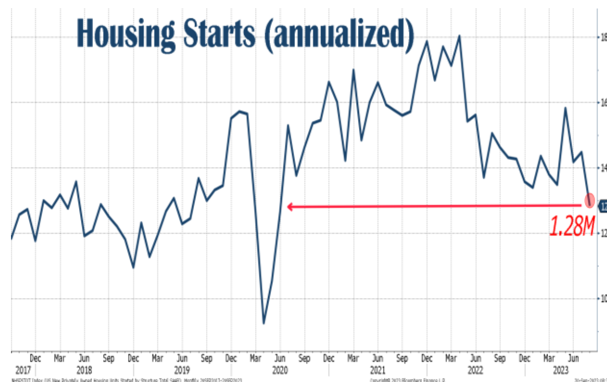
HOUSING STARTS COLLAPSE

"High mortgage rates above 7% combined with low resale inventory and higher home prices are slowing housing production, as many first-time home buyers and younger households are struggling to purchase an affordable home." — Alicia Huey, Chairman, NAHB

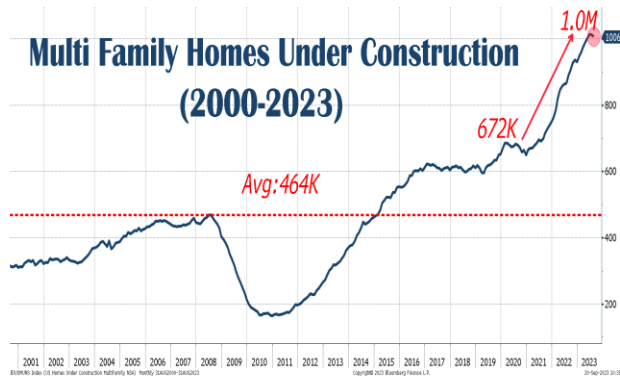
Starts, or as Bob the Builder would say, “footings,” show that builders are seeing their sales descend and order books squeezed in a dramatic fashion. Housing starts dropped by more than 11% to 1.28 million compared to last month. They are down nearly 15% from the same time in 2022. Remember, housing starts feed into GDP.

Single-family starts fell -4.3% and have now declined in two of the past three months. However, the biggest weakness was in full display with what has become an overbuilt multi-family market. Multi-family units have plunged by over 26% to a 342,000 annual rate. Multi-family starts are now at the lowest level since May 2020.

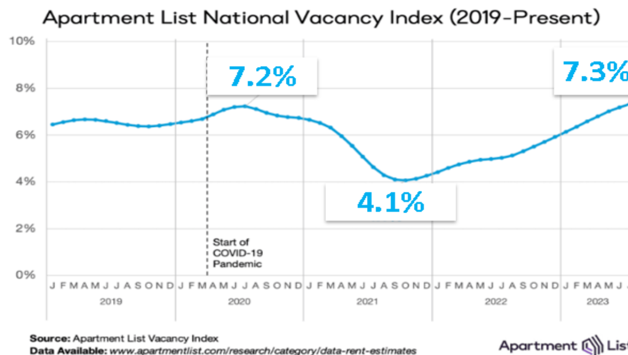
Outside of the Northeast, where housing activity was pretty flat, every other region got sliced. The Midwest was at -7.5%, the South was at -4.9% and the West was creamed at -28.9%. Compared to last year, single-family and multi-family starts were down nearly 23% in the Northeast, about 14% in the Midwest, nearly 9% in the South and about 16.5% in the West.



The good news on the inflation front comes from the multi-family complex where completions soared +46% month-over-month in August and are up a whopping 3% year-over-year. Better still since the pandemic, apartment units under construction have absolutely skyrocketed by 66% to a record high of one million units. Thus, look for rents to continue to disinflate as multi-family inventory (five units or more) swamps demand.

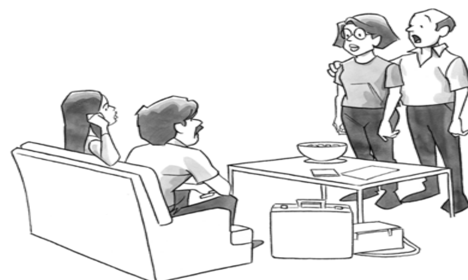


Due to the imbalance between supply and demand, the national vacancy rate has climbed from a historic low of 4.1% in the third quarter of 2021 to 7.3% in 2023. The rise in vacancy rates highlights the waning demand for multi-family units, hinting at an impending oversupply. To wit: In the first quarter of 2023, 109,000 new units entered the market but only 42,000 new rental units were absorbed. This is a significant drop from the pre-pandemic five-year average of 82,000. This is great news for inflation but not good news for the commercial real estate (CRE) market considering all the CRE paper that will need to be rolled over in the next 24 months will be at much higher rates than when it was originally issued.



Interestingly, as homeownership rates dip due to a lack of affordability and vacancy rates surge, it appears that first-time homebuyers (and others) may be opting for multi-generational living to economize. According to the National Association of Realtors (NAR), 28% of first-time buyers are seeking larger homes that only multiple incomes can afford.

Note: It's probably a good thing that the NAR does not publish any data on divorce rates after living with the in-laws.



"YOU CAN'T MOVE BACK IN AND LIVE WITH US. YOUR MOTHER AND I ARE MOVING IN WITH YOUR GRANDPARENTS."

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Bottom line: While the inflation-phobes scream about high oil prices and/or wages, the 800-pound gorilla driving inflation is housing rents. Rents are approximately one-third of the Consumer Price Index (CPI) and 40% of the core CPI. And the apartment market is going to be swamped with massive excess supply. Forget oil. Forget wages. If rental costs continue to descend, inflation will melt over the next 12 months.

TIGHTER THAN IT LOOKS!

"And even if investors do believe the economy can weather through next year, they might also think the Fed will need to lower rates to ensure the soft-landing scenario actually comes true. The first rate cuts could come faster than the central bank thinks." — Wall Street Journal Article, "Don't Buy the Fed's Rate Projections"

To no one's surprise, the Fed remained hawkish. The Federal Open Market Committee (FOMC) left rates unchanged (in target range of 5.25-5.5%, a 22-year high) but at the same time they signaled a "soft landing" with higher growth forecasts.

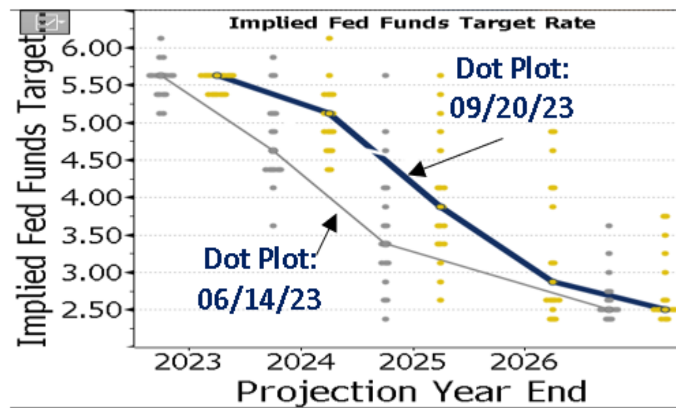
The Fed's dot plot continued the trend higher with each dot plot more hawkish than the prior ones. The median dot plot was left at 5.6% for 2023, which suggests one more rate hike this year. Maybe more importantly to bond and equity market sentiment, the Fed removed two cuts for next year to 50 basis points as opposed to 100 basis points prior. At the end of 2024, the fed funds rate would still be 5.25%.

"We have learned all through the course of the last year that actually we needed to go further than we had thought. You go back a year, and what we wrote down, it's actually gotten higher and higher. The upward drift of the dots continues." — Jerome Powell, Federal Reserve Chairman

***"Economic activities have been stronger than we expected, stronger than I think everyone expected**, so what you're seeing in this policy is what people believe as of now will be appropriate in order to achieve what we are looking to achieve, which is progress toward our inflation goal..."*

*"It's a good thing that the economy is strong. It's a good thing that the economy has been able to hold up under the tightening that we've done. It's a good thing that the labor market is strong. The only concern, and it just means this, **if the economy comes in stronger than expected, that just means we will have to do more in terms of monetary policy to get back to 2%, because we will get back to 2%."***
— Jerome Powell, Federal Reserve Chairman

There were 12 FOMC participants who are for one more rate increase this year while seven members are opposed. The question remains, which ones are voting members and which one is Powell's dot-plot. In the graph below, the range of predictions for the fed funds rate is enormous: 4.50% to 6.25% for 2024 and 2.75 to 5.75% for 2025. The divide is so wide that you can drive a Mack Truck through the gap.



Clearly, this Fed does not see a recession.

- Real GDP was revised higher in 2023 to +2.1% from +1.0%, and to +1.5% for 2024 compared to the +1.1% before.
- The unemployment rate is now seen unchanged at 3.8% instead of rising to 4.1% and remaining at 4.1% in 2024 as opposed to the previous projection of 4.5%.
- On the inflation front, the headline personal consumption expenditures (PCE) was revised up to 3.3% from 3.2%. For 2024, PCE remained at 2.5%. The core is seen being tamer at 3.7% in 2023 and the 2024 forecast was left at 2.6% before slowing further to 2.3% in 2025.

While rates were unchanged, the Fed policy is tighter than it looks. If you weigh in the effects of quantitative tightening (QT), the Fed has already de facto tightened the equivalent of +730 basis points since February 2022.

With all that said, this is the same Fed that told us in 2007 that house prices never go down nationwide and that the problems in subprime would be contained. In 2009, they highlighted economic "green shoots" everywhere. In 2018, they telegraphed much higher rates. In 2021, they told us that rates were going to stay at zero for years to come and that inflation was "transitory." Today, the mantra is "higher for longer." Historically, the Fed has missed its dot-plot rates nearly two-thirds of the time in the past. Which direction will it be this time?

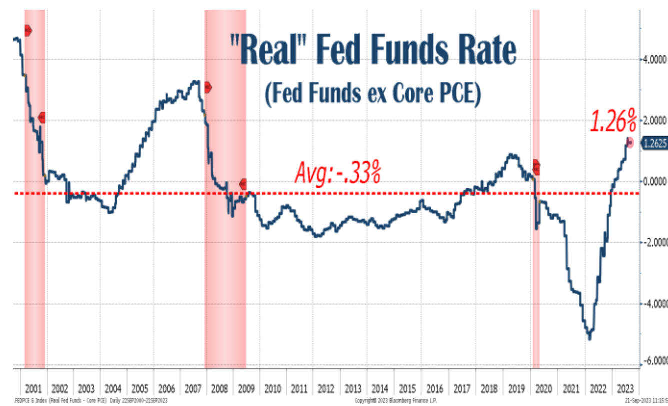
Bottom line: The Fed's track record is downright horrible and there have been many times when it has been quite profitable to bet against the Fed's predictions.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"There are things that have to be refinanced in this economy that cannot be refinanced in an orderly fashion at these rates" — Mohamed El-Erian, Chief Economic Advisor, Allianz

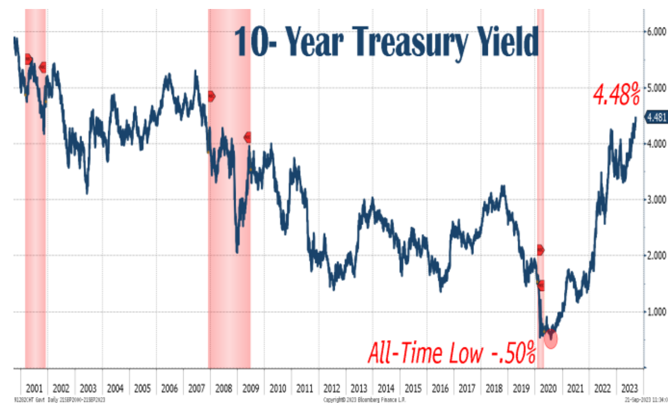
The inflation-adjusted real fed funds rate has risen by nearly 6% to 1.26%. So, the real funds rate excluding PCE and core PCE is 2.2% and 1.26%, respectively.

Using the Fed dot plot, this means that the real funds rate will go up to 2.6%. What this means is that next year the gap between the funds rate and the estimate for neutral (2.5%) will still be 2.6%. In turn, this means that policy will be super restrictive even after this rate-hike cycle is behind us.

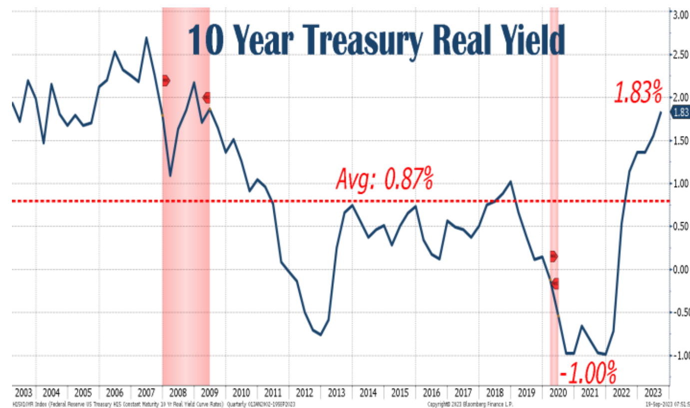


The 2-year Treasury yield hit its highest level since mid-2006 (5.13%).

The 10-year yield has soared to 4.48% and is now testing October 2007 levels. October 2007…wasn't that two months shy of the recession nobody saw coming and ahead of a monster bond rally nobody saw coming?



Over the past two years, real 10-year rates have ballooned nearly +300 basis points. There is no evidence of the U.S. economy avoiding a full-blown recession in the aftermath of such a surge in inflation-adjusted borrowing costs.



IT'S NOT WHAT THEY SAY THAT MATTERS

Suffice it to say that short-term and long-term rates have become quite restrictive. At the same time, the savings rate is at a record low of 3.5%. "Healthy" American consumers have blown through their savings and have turned to using credit cards with 20+% interest rates to make ends meet.

At the same time, student loan debt repayments are now beginning. All this with an imminent government shutdown along with the United Auto Workers (UAW) strike will not help matters one iota. So, I am still expecting a recession to start by the end of the year. December 2023 is my bogey.

Consider that interest rates are higher than they were in June 2006, the peak of that hiking cycle that burst the housing bubble. The difference then and now is that we have even more debt in the economy. Why will turn out differently this time?

Meanwhile, there were more corporate defaults through the first six months of 2023 than we had in all of 2022.

Despite the Fed's insistence that "the U.S. banking system is sound and resilient," we've already witnessed three major bank failures but it's only a matter of time before something else breaks. Commercial real estate is a good candidate.

Bottom line: The fiscal debt and deficit are at an all-time high when unemployment is sub 4%. So, when you factor in the reckless and unprecedented fiscal boost along with the savings rate decline and the desperate surge in consumer credit usage, there has been practically no organic growth in the U.S. economy this year.

The growth we have seen has been a mirage, a Potemkin village! You can only put lipstick on the economic pig for so long. Now, the power of what the Fed has already done with interest rates (+730 basis points when QT is counted) is going to start to come into full display now that the fiscal masquerade is over.

Cuts are coming, no matter how tough Powell talks today, or what the rest of his crew put on a dot plot. It doesn't matter what they say. It's all about what they do.

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.

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