# Weekly Relative Value


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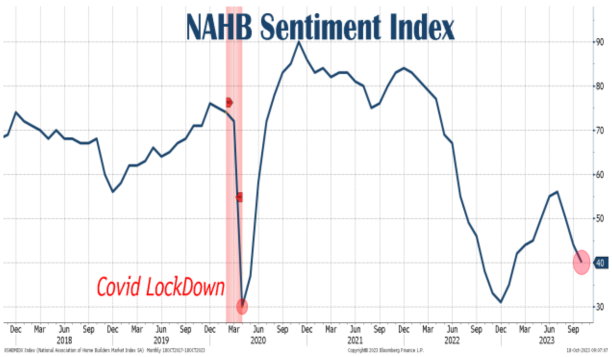
WEEK OF OCTOBER 23, 2023

## Housing Weeps While Retail Laughs

The National Association of Home Builders (NAHB) index, after taking a big tumble in September, declined -4.0 points to 40 in October. All regions slipped with the sharpest setbacks in the West and the South. The homebuilder market sentiment has now tumbled 16 points since July and reversed the upswing in sentiment witnessed between March and July. For some added context, the dismal 40 reading in October is just marginally above the May 2020 level when the economy was in full-bore COVID-19 lockdown mode.




Also of interest are the price discounts being offered by builders. Fully, 32% of builders reported cutting prices last month (the high for the year), with the average discount now at 6%. Additionally, 62% of the building community are now providing some form of sales incentive (up from 59% in September).

At the same time, fence-sitting potential buyers are no longer biting as just 16% of consumers surveyed by Fannie Mae in September said it was a good time to buy a home — this matched the record low going back to mid-2010!

### 47-YEAR LOW!

The last time there were 8% mortgage rates in the U.S. was back in 1999. In those days, the housing market continued to function, however, prices were a lot lower. As you can see below, mortgage rates hit 8% in 1999 but home prices were $142,000. Meanwhile, prices have spiked in recent years because the Fed repressed mortgage rates with quantitative easing and 0% short-term rates. Since the pandemic, home prices have skyrocketed 48% to $394,000. These sky-high prices are impossible to make work with 8% mortgage rates as the

### THIS WEEK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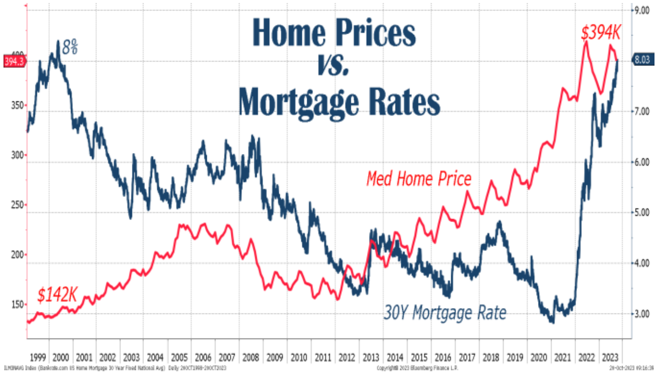
National Association of Realtors' (NAR) housing affordability index is now at a 47-year low! To mean-revert this ratio and take the residential market back into a truly healthy state, it would require either a 30% plunge in home prices, a 300-basis-point slide in mortgage rates or some combination of the two. Also, lowering prices by 10% and a 200-basis-point slide would also do the trick.

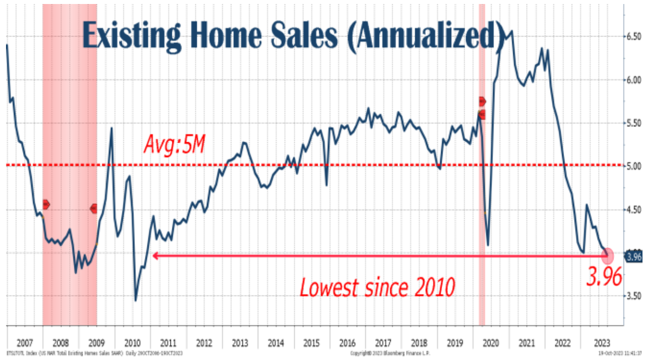



**Bottom line:** For the first time since the Fed started raising interest rates, every part of the housing market (i.e., home building, existing home and new home sales) are now poised to worsen.

*"As has been the case throughout this year, limited inventory and low housing affordability continue to hamper home sales****. The Federal Reserve simply cannot keep raising interest rates in light of softening inflation and weakening job gains."*** *— Lawrence Yun, Chief Economist, NAR*

## THIS IS A CRASH

With housing affordability at its lowest since at least the early 1980s, it's no surprise that existing home sales in September fell again by 2% month-over-month. This is the nineteenth monthly decline in the last 22 months. This decline left existing home sales down 18% year-over-year and existing home sales dropped back below 4 million for the first time since October 2010 (during the foreclosure crisis). The downward trend was regionally broad-based with only the Northeast posting a slight uptick in sales.

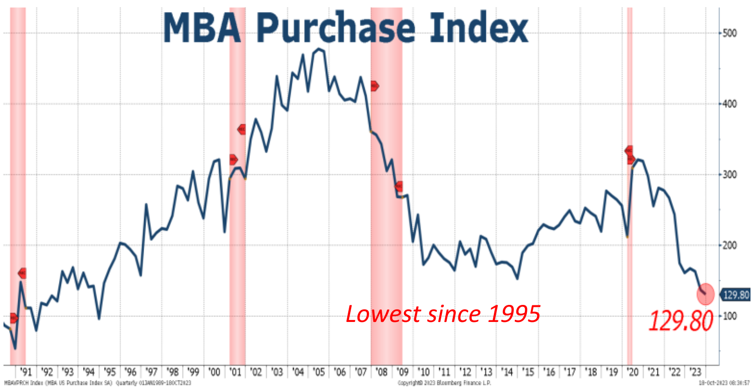



Median sales prices were reported at $394,000 and are now off by 4.7% from the peak 18 months ago. Also worth highlighting, price reductions jumped to 37.5% of active listings in September, blowing by the pre-pandemic highs, as sellers are getting more motivated to sell while the flattening in prices points to a big decline in demand too.

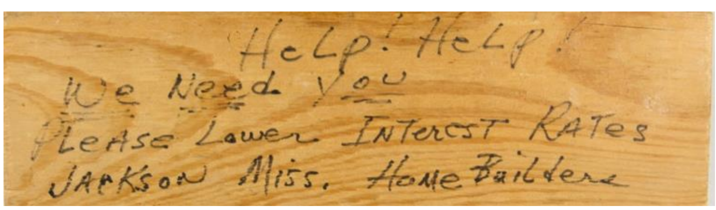
**Bottom line**: It is incredible how many people just look at the price and believe we have a roaring real estate market on our hands. Far from it. It is a sector with no supply and no demand. Totally inert. Because housing accounts for nearly 16% of the gross domestic product (GDP), the dramatic decline in housing activity will have a significant impact on the overall economy. When people do not buy homes, they do not buy new carpet, new appliances, lawn mowers, paint, wallpaper or start families. Family formation impacts clothes for toddlers, toys, playground equipment, etc.

## NEITHER A LENDER NOR A BORROWER BE

Home sales volume has already collapsed, and the recent weekly mortgage applications data indicates that it will continue on this trend. Home-purchase applications slid more than 5% to the lowest level since 1995 and are 48% below the same week in 2019.




Here's something that many readers may not be aware of. The last time the Fed tackled high inflation in the 1980s, homebuilders sent former Federal Reserve Chair Paul Volcker two-by-fours inscribed with the message: Lower interest rates.




And once again, history is repeating itself.

The NAHB, Mortgage Bankers Association (MBA) and NAR wrote a letter to Fed Chair Jerome Powell. In that open letter was their key concern:

*"To convey profound concern shared among our collective memberships that ongoing market uncertainty about the Fed's rate path contributes to recent interest rate hikes and volatility."*

To address these pressing concerns, the MBA, NAR and NAHB urged the Fed to make two clear statements to the market:

- *"The Fed does not contemplate further rate hikes."*
- *"The Fed will not sell off any of its mortgage-backed security (MBS) holdings until and unless the housing finance market has stabilized, and mortgage-to-Treasury spreads have normalized."*

As to the why:

*"We urge the Fed to take these simple steps to ensure that this sector* ***does not precipitate the hard landing the Fed has tried so hard to avoid."***

**Bottom line:** The industry has gotten hooked on the Fed's easy money between 2008 and 2022 that caused mortgage rates to plunge below 3%, and home prices to inflate to the moon. Now, they hate the normalization of interest rates, and they want their easy money back.

## RETAILERS CHEER!

As the housing market weeps, retailers had some good news to cheer. Despite reports of plunges in card spending and a huge downward revision in U.S. consumption (per GDP), expectations were for a modest rise in nominal retail sales. However, to the surprise of the Wall Street consensus, retail sales soared across the board with the headline number up +0.8%.

More importantly, the core (excluding autos and gas) exploded higher (+0.6% month-over-month) and the Control group (used for GDP calculations) also jumped 0.6% month-over-month. So, gains were broad based. The previous two months were also revised higher to boot lifting retail sales up 3.8% year-over-year. This is certainly not the slowdown the Fed would have hoped to see.

There were a few blemishes in this otherwise bullish report. Housing-related categories continue to feel the heat from strains in the real estate market. Both furniture/appliances (-0.4% month-over-month) and building materials (-0.2%) went in reverse. In fact, the former has been negative in four of the past five quarters while the latter has been flat or down for four straight quarters.

Despite the weakness in the housing sector, there is no doubt that the September retail sales data capped off a strong summer of consumer spending. It accounted for roughly half of the +5.4% real GDP growth prediction (annualized) from the Atlanta Fed.

Interestingly**,** after the ripping September retail sales data, Bank of America's CEO had this to say:

*"Frankly, the Fed has won the battle of the American consumer — they are slowing down. And the question is what happens next." — Brian Moynihan, CEO, Bank of America*

**Note:** Retail sales cover only 30% of the total consumer spending pie. So, could it be the other 70% that is what is worrying Mr. Moynihan? Maybe it's the fact that Bank of America's credit card business has seen its growth cut in half over the past two months to a 4% pace.

**Bottom line:** This report was not what the Fed was hoping for and will continue to give ammunition to the Fed Hawks that are pressing the "higher for longer" theme.

## LAST HURRAH?

*"We think the largest effects of the hit from the resumption of student loan payments will come in October." — Goldman Sachs*

There is no denying that the third quarter GDP will come in hot. However, the more important question is what will happen from here as households are running out of options to keep this spending pace going?

Since peaking in early 2022, household savings held in checking accounts, term deposits and money market accounts have fallen by over half a trillion dollars. Savings rates have been drawn down to levels that are less than half the pre-pandemic norm.


At the same time, households have been tapping consumer credit cards like mad even with punishing interest rates of nearly 25%. However, households can only extend themselves so far. Banks are increasingly tightening credit standards as high interest rates bite, and concern over credit card exposures is building.

And of course, the resumption of student loan payments will create a headwind for the consumer as well.

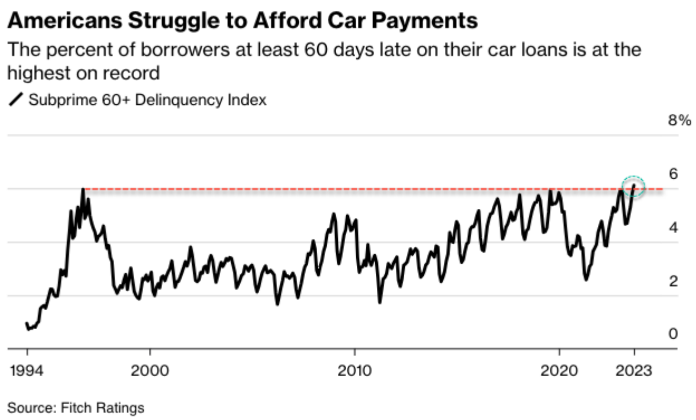
There is a limit to how long consumption spending can be sustained by dissaving and credit finance, even in good times. We're already beginning to see evidence of this in forward-looking indicators. The University of Michigan Consumer Sentiment Index and Conference Board Consumer Sentiment Index both show that households are pessimistic about the future.

Perhaps the *Financial Times* article, "Late Payments Rise on U.S. Loans Tied to Inflated Pandemic Credit Scores," will find its way to Jerome Powell's desk.

The opening salvo says it all:

*"U.S. borrowers who took on new debt in the middle of the pandemic are falling behind on repayments at unusually high rates after lenders extended more credit to households helped by government stimulus [...] **For credit card accounts opened in the first quarter of this year, the delinquency rate hit 4% in September, while in September 2022 the nine-month delinquency rate for new accounts was 4.5%. The levels were the highest for the same point of the year since 2008, according to Moody's Analytics data."***

And now Americans are falling behind on their auto loans at the highest rate in nearly three decades. According to Fitch Ratings, the share of subprime auto borrowers at least 60 days past due on their loans rose to 6.11% in September, the highest in three decades. The subprime borrower is often the first line where we start to see the negative effects of macroeconomic headwinds. It should be noted that approximately a third of Americans are subprime borrowers.




Outside of autos, there has been an endless stream of retailers, such as Walmart, Nordstrom, Macy's and Kohl's, all of whom have recently warned about a consumer slowdown. Banks have also raised concerns, such as Morgan Stanley's Mike Wilson, who believes the consumer is "falling off a cliff." And the latest high-frequency data from Barclays shows card spending has taken another leg down.

**Bottom line:** Establishment media gets paid to push the narrative that consumers are "going to be just fine."

My belief is that the consumer mid-year "mini boom" will likely be the "last hurrah" of post-pandemic consumption spending before the realities of the coming economic winter set in. The consumer is running out of options to keep spending going, and nothing is left to hold back the lagged impact of higher rates.

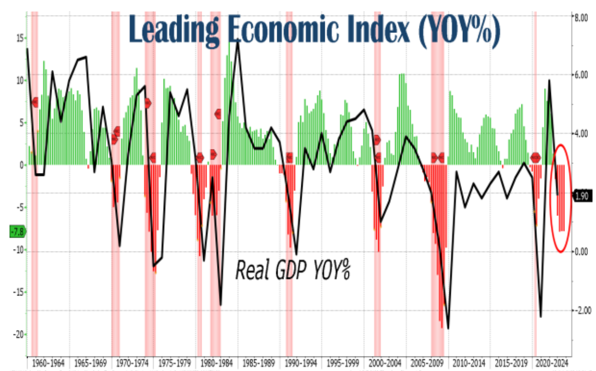
## THE BABE RUTH OF RECESSION INDICATORS

I'm referring to the 2s versus the 10s Treasury yield curve, which has a perfect record of forecasting recessions. Not so long ago the curve was inverted to -108 basis points. Today, the curve has steepened dramatically to -17 basis points. The steepening has historically meant that the wolves are at the door and the recession is here.


In the past, unemployment has intensified during this period of the curve dis-inverting, steepening and normalizing. Indeed, even though initial unemployment claims have been remarkably low, this will change. Layoffs start slowly and then escalate. Meanwhile, continued claims have been rising weekly, not dramatically, but indeed rising. The thinking here is that once people have lost a job, they cannot replace it.

## FOLLOW THE LEAD

Despite "soft landing" hype, the Leading Economic Index (LEI) is showing no signs at all of "recovering," tumbling back in line with the peak in March 2006. On a year-over-year basis, the LEI is down 7.8% — close to its biggest year-over-year drop (outside of the pandemic lockdown) since the Great Financial Crisis in 2008 enforced collapse. Given how far the index has fallen since early 2022, it's very difficult to look at this data and not conclude that a growth slowdown is coming. The graph below shows that the LEI leads economic growth by 12 months. Unless you believe "this time is different," the LEI continues to signal a recession over the next 12 months.

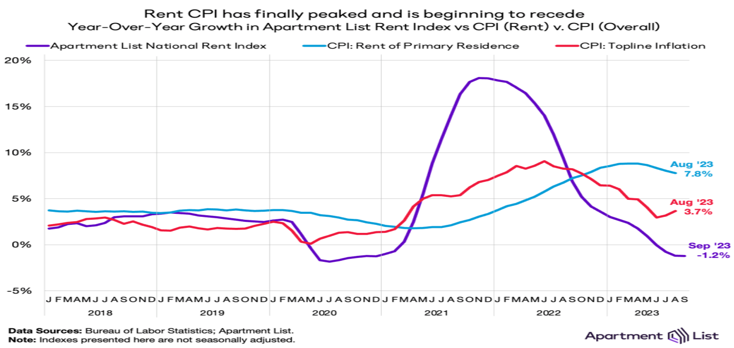



**Bottom line:** If this is the cleanest view of the Fed's tightening impact on the U.S. economy, it certainly doesn't look like a "soft landing."

## INFLATION IS OFF THE BOIL

Inflation has seen a dramatic decline since peaking but not by enough to satisfy a Fed seeking the 2% holy grail inflation target. The thing is, the shelter component has been responsible for 70% of the core inflation seen in the past year and once this skew is put aside, the inflation rate is at the 2% objective and below 2% for the core (excluding the shelter index).

As shown in the graph below, shelter should continue to decline, catching up with actual prices. With it, about 40% of the Consumer Price Index (CPI) will be dragged lower.




## WHAT'S WRONG WITH BONDS?

One blow after another, this bond bear market has been every bit as vicious as the equity bear markets of yesteryear. Who would have thought in March, in the middle of the banking sector maelstrom, that the 10-year Treasury yield would have soared +115 basis points by mid-October? Then again, who would have thought that in the third quarter, we would be talking about a five-handle on real GDP growth.


Thus, bonds continue to be impacted by the heretofore surprising strength of the consumer and Fed policy expectations. And even though most measures of inflation have come down impressively, especially once the flawed shelter measures are accounted for, the Fed has successfully scared investors away from taking on any duration risk.

Last week Powell appeared before the Economic Club of New York, and while not necessarily signaling another rate hike, left the door open for additional rate hikes if the economy refuses to slow below potential growth (below 2%).

He also intimated that policy may not be as tight as we thought because the so-called "neutral" rate may now be rising due to a host of factors, including structurally high debt and deficits.

Powell also seems to believe that given how many homeowners and businesses locked in their debt at or near the cycle-lows in rates, Fed policy is exerting less of a restraint on the economy than what used to be the case.

His real zinger was his comment:

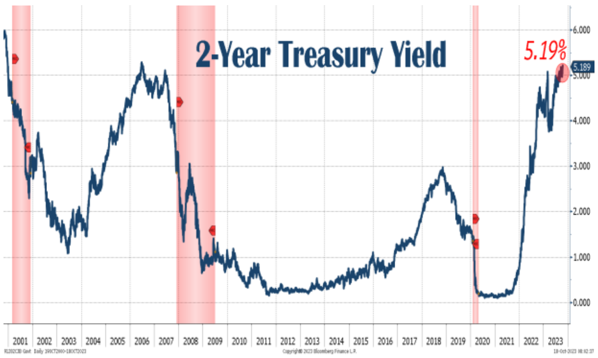
*"It may just be that the rates haven't been high enough for long enough […] the evidence is not that policy is too tight right now." — Jerome Powell, Fed Chairman*

Therefore, the bar is very high indeed when it comes to future rate cuts from the Eccles Building. Hence, the bond market has reset and continues to push out the day that there is a pivot.

There have been other impediments to a sustainable rally as well.

- Regulatory developments have constrained the banking sector's ability to be a buyer of Treasuries.
- The combination of quantitative tightening and bloated government funding needs has caused supply to explode higher. The total amount of Treasury securities outstanding has now reached $33.6 trillion. Going from quantitative easing, which in the end ran at $120 billion a month, to quantitative tightening of $60 billion a month, represents a swing of $180 billion a month.
- Hedge funds have also placed massive short positions in the futures and options pits. This too has dramatically reduced demand on the long end.

**Bottom Line:** Given the Atlanta Fed's projected red-hot third quarter GDP print (now 5.4%) along with the latest blowout payroll and retail sales data, bond bulls need to see a sharp slowing in the coming months. This in turn likely means that they will have to wait for the labor market to start to crack with flat or negative payroll readings and a visible move up in the unemployment rate to over 4%. Neither of these developments have yet to take hold.



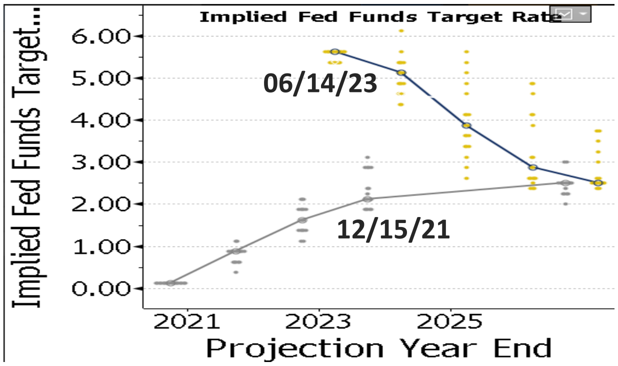

## MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"In any case, inflation is still too high, and a few months of good data are only the beginning of what it will take to build confidence that inflation is moving down sustainably toward our goal." — Jerome Powell, Fed Chairman*

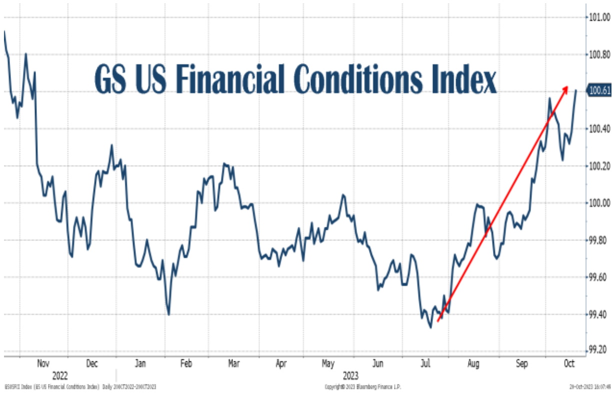
At the Federal Open Market Committee (FOMC) meeting, the Federal Reserve reiterated its "higher for longer" mantra and upgraded its economic forecast to include a "no recession" scenario.

However, there is a problem with the Fed projections. They are historically the worst economic forecasters ever**.** In fact, since 2011, the median point of the Fed projections has yet to be accurate. While the Fed is hopeful they can navigate a soft landing in the economy, historically, this has never been the case.

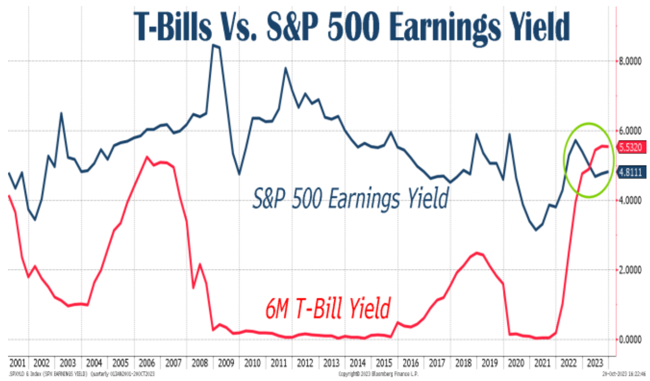
Here's an example of the Fed's forecasting prowess: In December 2021, just ahead of the aggressive tightening cycle, the median fed funds rate dot plot for the end of this year stood at 1.6%, and for the end of 2024 try 2.1%. Contemplate that for a minute and think of the businesspeople and bankers who bought in and planned for this horrible projection. Who's to say the current 5%-as-far-as-the-eye-can-see forecast isn't as equally off base but in the other direction?




Meanwhile, as one can glean from the graph below, financial conditions have tightened significantly. If rates remain "higher for longer," along with restrictive lending standards, the economy will slow significantly.




Valuations are always the key to winning the long-term investing game. As shown below, bond valuations are now at the cheapest levels that they have been in my 40 years in this business.




If the goal of investing is to buy something when it is cheap, those opportunities don't exist in bull markets. Buying something truly undervalued can ONLY occur when no one wants to own a particular asset.

Here's the hard part. You must be willing to hold the "out of favor" asset long enough for the market to recognize it. For most, investing and being willing to "be wrong" for an extended period is difficult. Eventually, psychological pressures outweigh investor convictions. Whether it's performance chasing, herding or loss aversion, investors will eventually abandon their positions before the value is recognized.

*"In good times, skepticism means recognizing the things that are too good to be true; that's something everyone knows. But in bad times, it requires sensing when things are too bad to be true. People have a hard time doing that."*

*"The things that terrify other people will probably terrify you too, but to be successful, an investor has to be a stalwart.* ***After all, most of the time the world doesn't end, and if you invest when everyone else thinks it will, you're apt to get some bargains****." — Howard Marks, Co-Founder, Oaktree Capital Management*

**Bottom line:** I realize that the world has seemingly turned bearish on bonds, and that there's safety in numbers by sticking with the herd. Yet, despite everything above, and as painful as the bond market has been this year, I believe it's prudent to continue to systematically dollar-average into the weakness. Yes, yields may continue to back up, but to turn outright bond-bearish here and now would be akin to an equity portfolio manager turning bearish in the summer of 1982, fall of 2002 or early winter in 2009. No matter the asset class, all bear markets end.

The U.S. economy was built on borrowing and spending. Easy money is its lifeblood. It simply can't run for an extended period of time without artificially low interest rates. These higher rates will ultimately break things in the borrow-and-spend economy.

My expectations haven't changed. It's all just taking longer to play out. I will stay the course, as painful as it has been, and remain for the precious few bond bulls left on the planet.

## 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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