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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JANUARY 22, 2024

The Dark Side of Record High Home Prices

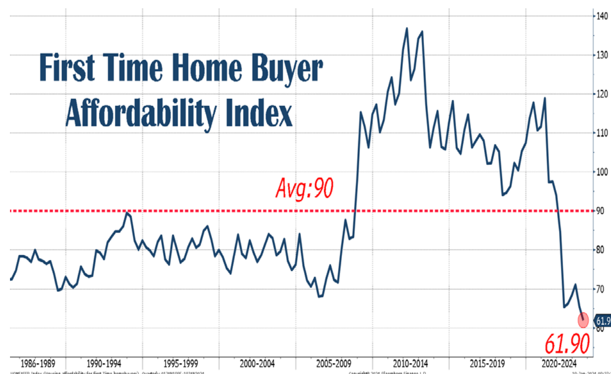
"Study after study, not only here but in other countries, show that ***the most affordable housing is where there has been the least government interference with the market —*** *contrary to rhetoric." — Thomas Sowell, American Economist*

Let me start by saying we have lived through the wackiest housing market of all time. Since January 2020, home sales have plunged by 68%, and mortgage rates have more than doubled. However, home prices have soared 37% to record high levels! Frankly, I wish I could have predicted all of this, but I didn't! No one did! It's simply unfathomable and unprecedented!

Indeed, like many of the readers that own homes, I have truly enjoyed the massive rally in home prices. It's been a gift! As they say, better to be lucky than smart.

But I do disagree with most Wall Street economists who claim the dramatic rise in home prices is beneficial for the economy. They posit that it's all about the "wealth effect." As asset prices rise, the consumer will feel more confident and spend more freely. To some extent, this is true, especially for the 20% of the population that owns assets. That said, there is clearly a darkside to this housing boom (or bubble if you prefer).

As mortgage rates press against 20-year highs, along with near-record starter home prices, first-time homeowner affordability has plunged to a record low. Currently, housing affordability is a massive 30% below the average affordability rate of the past 40 years!



THIS WEEK

- NO ONE IS SELLING OR BUYING
- THE SOCIETAL IMPACT
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- JOBLESS CLAIMS PLUNGE!
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- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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

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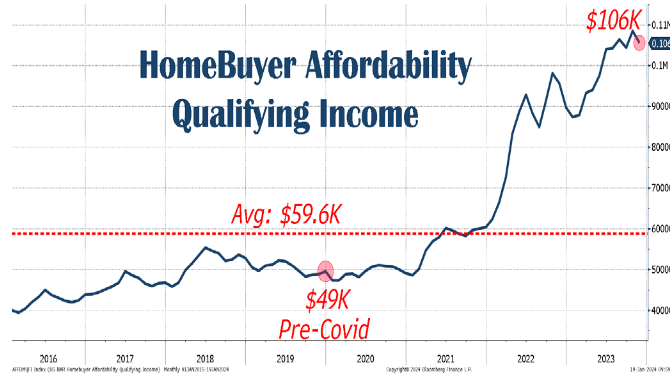
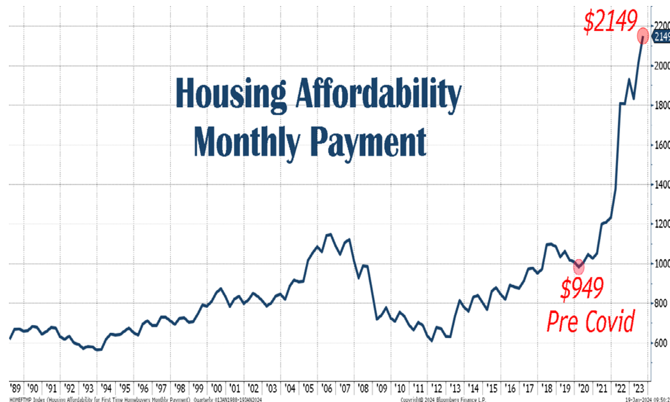
Amazingly, as shown below, the qualifying income for a starter home has topped $100,000 ($106,000). Prior to the COVID-19 pandemic, and the Fed cutting rates to near zero, the qualifying income was $49,000! Less than half the level today.



Today, the average monthly payment for those who do qualify to buy a home has spiraled higher as shown below. Since December 2019, the monthly payment has more than doubled from $949.00 per month to a whopping $2,149 per month. Over the past 12 months alone, the monthly payment has risen by nearly 20%!



Now, it would be one thing if earnings had kept pace, but we know that has obviously not been the case. Real median earnings for people in the 25-34 age category have declined by nearly -2% over the past year and have stagnated at approximately $63,000 over the past three years. Thus, the gap between earnings and the income required to qualify for a mortgage loan is unprecedented. Therefore, it is no surpise that the problem of income inequality is more acute today than ever before. This is clearly unhealthy and not cause to boast.

If you do the math, this means that 40% of wages are now being siphoned off to the local bank (preferably a credit union) in the form of mortgage payments. If you add in insurance, property taxes and maintenance, your monthly nut could near 50%!

Yes, there are emotional and economic benefits in the form of forced savings and potential appreciation. In fact, many younger Amercans have said that they don't feel like an "adult" until they become a homeowner. But also remember that debt is a big driver of financial stress. If you have a lot of debt, you will have a lot of stress.

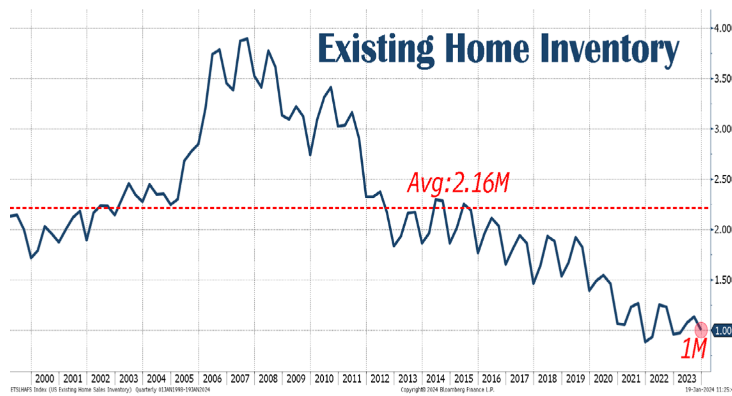
In other words, don't let buying a house become an emotional decision. Run the numbers. Make sure you can afford it. Your housing costs should be less than 25% of your income. Maybe 30% if you stretch.

Having said that, if you must buy a house today, the environment is a tad bit better than it was six months ago as mortgage rates have drifted lower and home prices have declined.

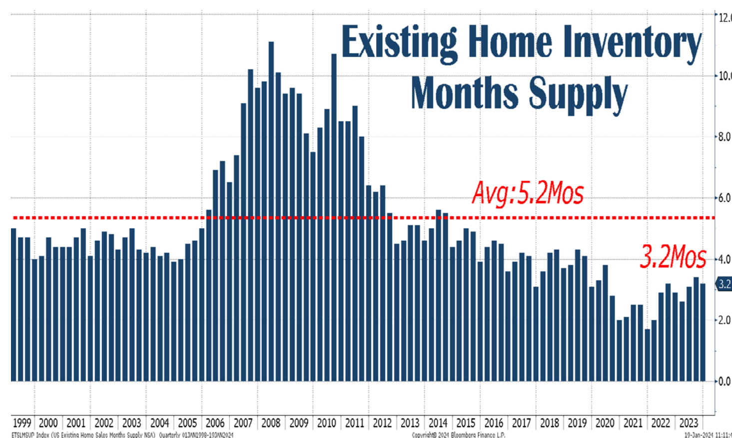
Bottom line: If you overpay for a house, you might not go bankrupt. However, if you are spending 50% of your income on housing costs, it will crowd out your ability to save for retirement. In essence, with home prices at nosebleed levels, buying a house today is probably one of the riskiest financial decisions you will ever make.

NO ONE IS SELLING OR BUYING

As widely discussed in the media, one of the big hurdles is the drum-tight housing market. The inventory for existing homes for sale has plunged to just 1 million units — nearly the lowest level in the past quarter-century.



This equates to a mere 3.2 months' supply of homes for sale! Realtors see anything below five months of supply as indicative of a tight resale market.

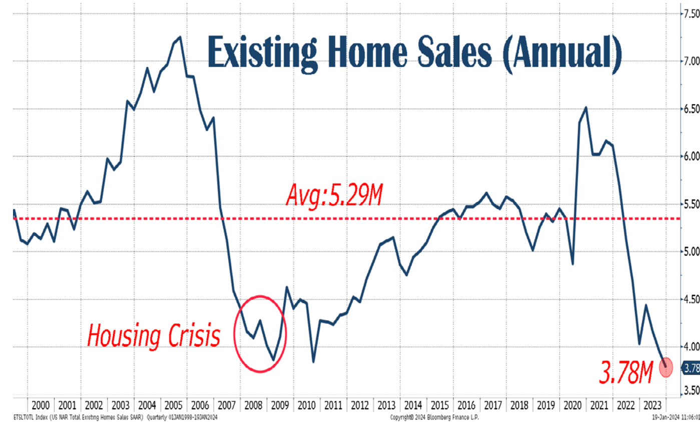


This is happening because the vast majority of homeowners have locked in mortgage rates at the lows in 2020 and 2021 — a byproduct of the pandemic and the draconian moves by the Fed.

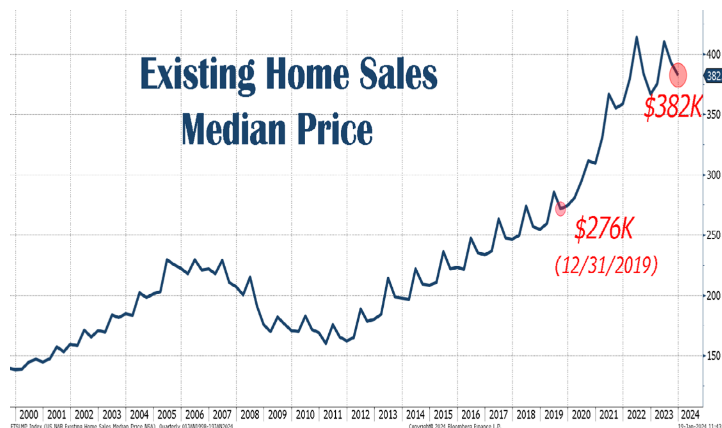
- 91% of mortgages: <5.0%
- 64.5% of mortgages: <4%
- 37% of homes are owned outright

And guess what? These folks ain't moving anywhere anytime soon. Indeed, the New York Fed consumer survey shows that mobility rates have plunged to all-time lows.

The downtrend in house activity was highlighted last Friday. Existing home sales for December declined 1%, leaving sales down to a measeley 3.78 million units, which is lower than the depths of the housing crisis in 2010.



Home prices dropped to $382,600 and are down by 7.5% from the peak in June 2022. Given the price surge in the spring of 2023, the median price was 4.4% higher than in December a year ago. Despite the sluggish activity, home prices remain near record highs!



Bottom line: The housing market is frozen. Prices are too high, buyers have gone on strike, demand has collapsed and sellers are trying to outwait this situation.

Despite their best intentions, the Federal Reserve is the primary reason as to why home prices are unaffordable today. Had they not intervened as aggressively as they did during the pandemic, home prices would **NOT** have spiked to ridiculous levels. This is yet another case of big brother making matters worse, not better.

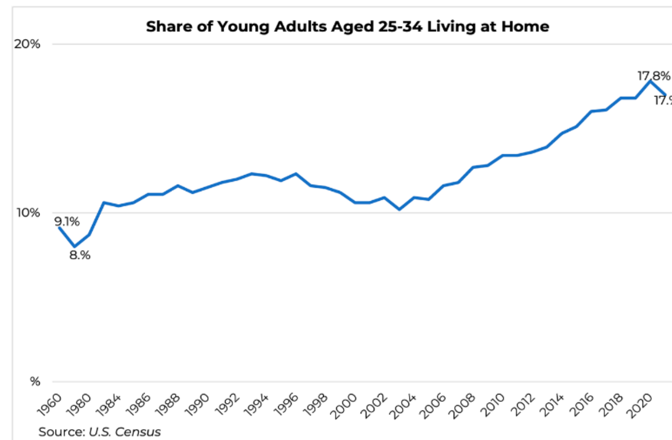
So whay happens next?

In a perverse way of thinking, maybe the current housing market dynamics provide a reason for the Fed to start cutting rates early. Lower rates will possibly encourage homeowners to start listing their houses, and the corresponding supply could lead to a mutually beneficial decline in residential real estate.

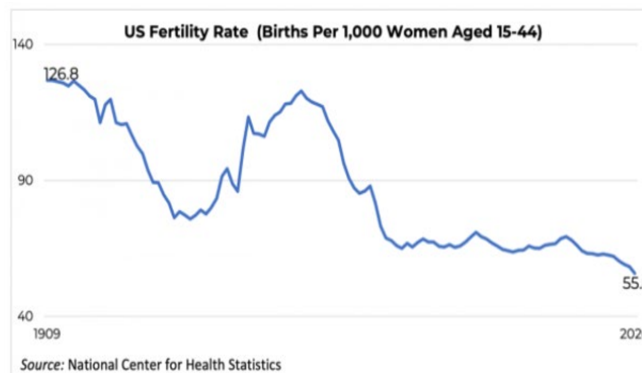
THE SOCIETAL IMPACT

Finally, consider the housing affordability crisis and the impact on societal and demographic trends in the U.S.:

- Today, 18% of the U.S. population in the 25-34 age group is living with Ma and Pa. This is the highest level ever!



- This same age cohort is delaying marriage and parenthood like never before. And if you are single and/or living in your parent's basement, it should be no surprise that the birth and fertility rates are flirting with record lows, triggering a secular decline in family size.



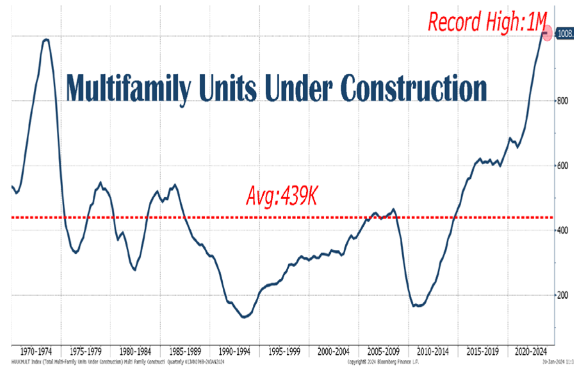
Bottom line: I guess you could say the Fed managed to kill sales, collapse inventories, send home prices higher, destroy affordability, and last but not least, add to the widening wealth and income inequality in this country.

Regardless, as things stand now, **we have on our hands a truly unstable and unproductive housing market backdrop.**

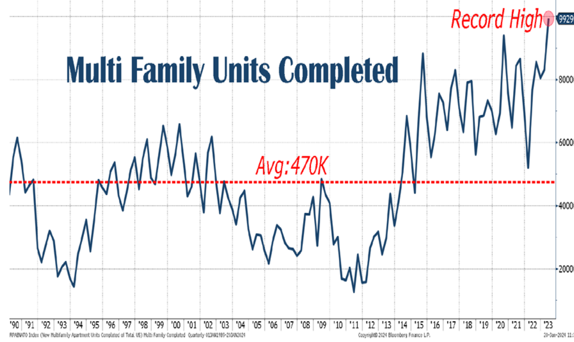
MORE DISINFLATIONARY NEWS

As the resident "disinflationista," and understanding the weightings and the lags of the rental components of the Consumer Price Index (CPI), it was really encouraging to see what is unfolding on the multi-family front because the excess supply is about to intensify.

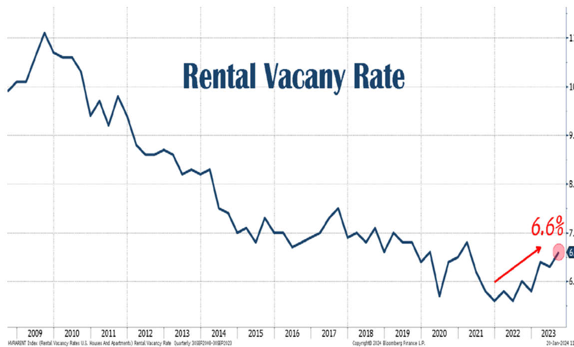
Rental units under construction inched ahead by +0.2% month-over-month in December (+7.4% year-over-year) and at 1 million units, it is tied for the highest level on record (back to 1970).



Multi-family units that were just completed jumped +11.1% month-over-month, and this followed a sharp +23% rebound in November to a seven-month high of 509,000 annualized units (+33.6% more than a year ago).



At the same time, apartment builders seem blind to the rising tide of rental vacancy rates, breaking ground on 433,000 units in December. This marks a +8.0% bounce month-over-month to close out the year, showing an increase in three of the past four months.



Bottom Line: The supply pipeline is building just as rental demand is subsiding, which is great for the rent induced disinflation momentum that lies ahead once the CPI data catches up with reality.

THE CHINA SYNDROME

While inflation concerns have been resurrected by the troubles in the Red Sea, this effect will likely prove temporary (though central banks are clearly concerned about how this could flow through into wages if the surge in global shipping rates does persist). However, the weakening demand picture is very likely to prevail so long as the Fed keeps interest rates far above their neutral levels.

We also have to ponder what it means to have China, the second largest economy, experiencing a -0.6% year-over-year decline in its gross domestic product (GDP) deflator in 2023 (with manufacturing goods down -3.2%) for the first time since the late 1990s.

Despite the friction, sturm and drag between the U.S. and China, global exports out of China are still rising as shown below. In other words, China is exporting deflation to the U.S. and the rest of the world.

Bottom line: I hear a lot of arguments from the other side of the debate about how inflation is going to ramp back up. The recent developments in China are clearly a deflationary threat for the entire global economy that is not fully appreciated, especially as Beijing works to push export growth as an antidote to the weakness in domestic demand.

INFLATION EXPECTATIONS DROP!

"'Improvements in inflation expectations have been supported by perceptions of easing price pressures in buying conditions for both durable goods and vehicles,' she said, adding that consumers increasingly expect the Federal Reserve to lower rates this year." — Joanne Hsu, Director of the Surveys of Consumers, University of Michigan

Meanwhile, consumer expectations for inflation have continued to recede. The consensus estimates for inflation expectatons from the University of Michigan's January data remained basically unchanged. However, the expectation for inflation over the next 12 months declined further to 2.9% and is now back to pre-pandemic levels.

JOBLESS CLAIMS PLUNGE!

The labor market continues to surprise! Initial jobless claims as of January 13 fell to 187,000, a decline of 16,000. This is the lowest since September 24, 2022, and the second lowest level of claims since May 1969. So, yet again, the claims data surprised the consensus looking for 205,000. The four-week moving average fell to 203,250, further smoothing out short-term volatility. Continuing claims also trended lower, hovering just above 1.8 million.

Bottom line: Firms still seem to be hoarding labor even as they have cut their hiring rates and the workweek. **The question is whether this means no recession is coming.** This is still open for debate. To wit: Claims were this low in September 1969. The recession began three months later.

But I've said it before and I'll say it again, as long as people have jobs, income and security, they will continue to spend and the economy will continue to grow, albeit at a slower pace! Thus, the latest claims data bolsters the "soft landing" advocates.

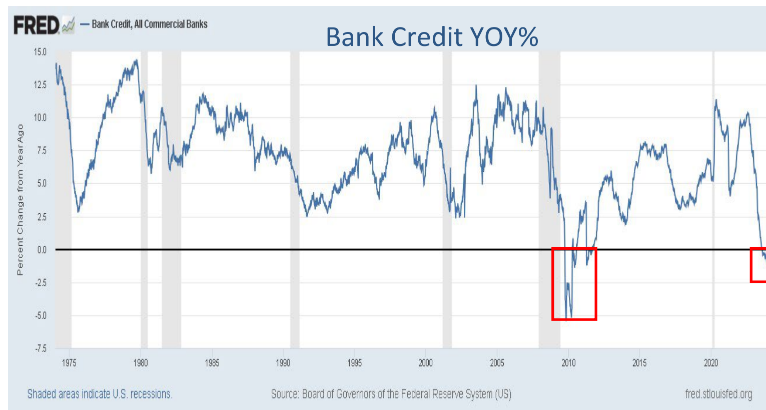
One final caveat: The data's reliability is a bit suspect when noting that in 2023, government hiring outpaced the manufacturing, transport, warehousing, mining and construction sectors combined.

A RED FLAG

"I still think the chance of it not being a soft landing are higher than other people…It's not terrible. It might be a mild recession or a heavy recession…It's possible that the downturn bites in 2024."
— Jamie Dimon, CEO, JPMorgan Chase

Bank credit has now fallen for three consequtive quarters and is contracting year-over-year, marking only the second such decline in more than half a century. The last one was during the Great Recession, brought about by the Global Financial Crisis of 2008-2009.

The credit contraction means that companies are borrowing less. Companies are also less likely to press ahead with spending projects, which can put a further drag on economic growth.



Bottom line: While many have moved to the "soft landing" view, there are some who have a less rosy outlook. In addition to the lagged impact of the Fed's aggressive rate increases, the contracting bank credit is another sign the pessimists could be proven right.

ANOTHER KICK OF THE CAN!

"We need to stop the practice of passing temporary tax and spending policies with arbitrary sunsets that exist only to hide the true costs. Policymakers already face nearly $4 trillion of policy expirations at the end of 2025, and this package would lead this cost to grow massively."
— Maya MacGuineas, President, Committee for a Responsible Federal Budget

Congress cleared the stopgap spending bill yet again, in a classic kick-the-can-down-the-road fiscal policy, and in doing so averted a partial government shutdown that otherwise would have happened last week.

In addition, a bi-partisan group of Republicans and Democrats in Congress reached an agreement on a $78 billion package that would provide tax breaks for businesses and an increase in child tax credit for low income households. This combination offers both parties an opportunity to claim wins ahead of the election in November.

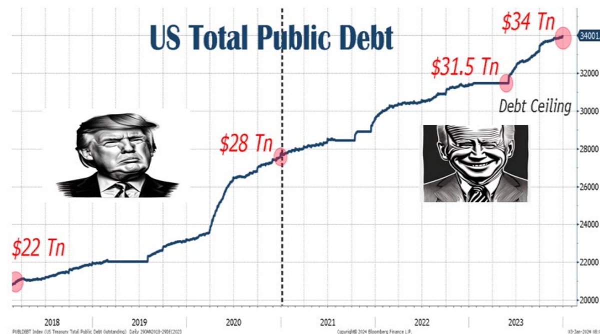
The fact that the federal debt just topped $34 trillion, or 123% of GDP, does not seem to have resonated at all with these lawmakers. Apparently, they take the view that, at this point, what difference does it make to boost the budget deficit by $100 billion here or there?

As to the long term effect on the economy, according to an analysis by Goldman Sachs, the deal reduces revenues by $78 billion (0.25% of 2024 GDP) over ten years and contributes to a larger increase in debt and the near-term deficit.

In other words, the politicians continue to buy votes with money we do not have.

Anyone out there remember the Tea Party?

Anyone care?



MARKET OUTLOOK AND PORTFOLIO STRATEGY

"We're not out of woods yet. We still think that recession risk is still elevated…When you look at all the supports that consumers have had, a lot of those are fading." — Wells Fargo Economists

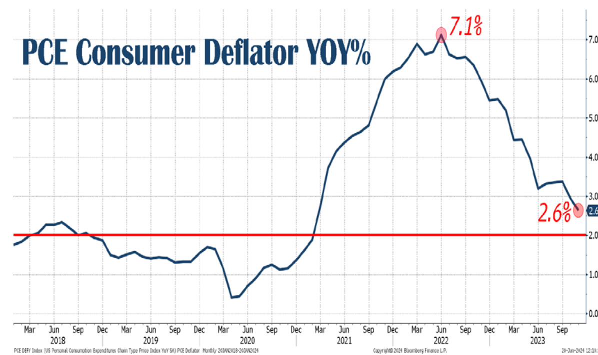
"It goes without saying that I echo these sentiments emphatically." — Dana M. Peterson, Chief Economist and Leader of the Economy, Strategy & Finance Center, The Conference Board

So, with jobless claims at a 50-year low, how in the world can the Fed even think about cutting rates, esoecially when everyone and their mother has thrown in the towel on the recession call?

Here's the thing to remember: While Fed's track record is horrendous, the Fed never intends to cause a recession. Frankly, the Fed almost always tries to cut rates in time to avoid a recession. And in certain cycles, the Fed cuts either in time because it feels it has done enough (the mid-1980s, the mid-1990s and 2019 are classic examples), or in response to a sizeable market pullback (1987 and 1998 come to mind). It is also important to note that in each period, the Fed stopped tightening once the yield curve flattened. Unfortunately, this was not the case in the recent tightening campaign.

Also, as highlghted numerous times, policy lags tend to be long. In fact, the average lag from the onset of the Fed tightening cycle to the recession is 26 months (recall that this one began in March 2022). And waiting for the lags to kick in can be like waiting for Godot. But in the end, history shows that a recession has a way of appearing just when no one sees it coming.

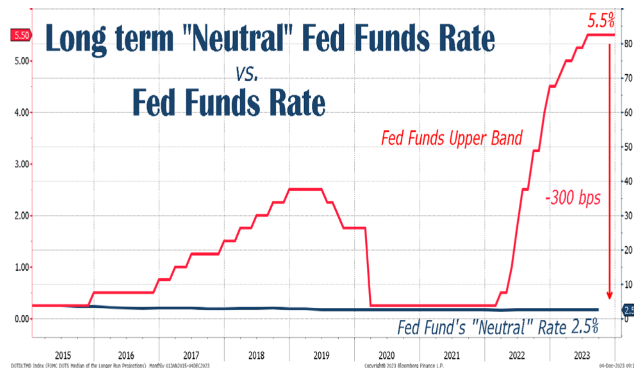
And, by the way, what's wrong with the Fed moving to neutral (2.5%) when the economy is at full employment and inflation, as measured by the core personal consumption expenditures deflator (PCE), has been running at 2.6% over the past 12 months?



Bottom Line: If there is no recession, getting to the neutral rate (2.5%) will equate to roughly 300 basis points of cuts. If by chance we do end up in a recession, the historical average of rate cuts would be more like 500 basis points.

As to the timing, what seemed like a certainty for a March rate cut in the swaps curve a few weeks ago has been pared to just below 50% odds. Now, the first cut is priced in for May, which would be a classic 10-month lag from the last rate hike in July. The end game has not changed all that much, just the timing. There are still 5.5 cuts being discounted for all of 2024 as investors continue to challenge the Fed's median dot-plot of just three policy moves.

More importantly, unless you are trying to time the markets (only active traders really care if it's March or May) you should remain focused on the potential magnitude of the forthcoming rate cuts.



Bottom line: Continue to buy the dips in the bond markets (as we saw last week) while maintaining a risk-appropriate and diversified ladder.

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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