VINITY

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In a Nutshell

Inflation is prominent nearly everywhere you look today and does not appear like it will abate anytime soon. The Fed is behind the curve but is finally taking steps to implement tighter monetary policy, a significant departure from the past decade. As one may expect, the market is not handling it well. Broad declines and wild trading sessions are the status quo this year. High valuation growth stocks are getting crushed, and many of the “pandemic plays” obliterated. We believe this has been a long time coming and are not surprised by the extent of the declines. Inflation remains hot and not just isolated to particular items. Price increases are broad-based and approaching a point where consumers need to decide what to forgo to make ends meet. Inflation for shelter is just making its way into the data now and will cause the overall inflation prints to remain elevated longer than many anticipate. Wages are not keeping up with the higher prices for the goods and services we consume, creating a bad situation for consumer finances. Home affordability is at alarmingly-low levels, and rent increases will cut into the amount consumers have left for savings if any. We expect a challenging environment ahead as current dynamics do not bode particularly well for stocks, bonds, or the economy at large. We have made portfolio moves over the past year to mitigate risk and will continue to evaluate the changing landscape and take advantage of any opportunities should they present themselves.

The Relationship Status of Housing and Inflation: It’s Complicated

The housing component of inflation is a bit unique, and understanding how it is measured will help explain why we are just now seeing the effects of housing inflation, and it is about to get ugly. The Consumer Price Index (CPI) is the basket of goods and services people need for day-to-day living. Housing units are not a component of the CPI. Homes are a capital good, not a consumption item, so any price change is considered an investment gain or loss. Shelter; is the service provided by a home and is the consumption item included in CPI. Housing inflation is tracked through an owners’ equivalent rent figure, measuring how much a homeowner would have to pay in rent to be comparable to their cost of ownership. The monthly amount includes expenses like a mortgage, taxes, and insurance.

In 2020, the U.S. existing single-family home median sales price increased by 13.3%, but at the same time, the average 30-year mortgage rate fell to 2.7% by the end of the year from 3.7% one year earlier. Existing homeowners could refinance at a lower rate, reducing their owners’ equivalent rent, even though home prices advanced 3.5 times faster than the historical average pace. For new homeowners, the lower mortgage rate offset the price increase. The median sales price ended 2020 at $313,700, up from $277,000 at the beginning of the year. Even with the $37,000 price increase, the principal and interest payment with mortgage rates at 2.7% was $2 less than purchasing the median-priced house at the beginning of 2020 for $277,000 when mortgage rates were 3.7%. People were willing to pay rapidly-rising, higher prices to buy a home since the monthly cost of ownership was little changed. Prospective home buyers typically shop for a monthly payment, not the price of a home. Throw in a record-low

supply of homes and increased demand, and it is easy to see how things could get out of hand quickly. Precisely, that is what happened.

Ultra-low mortgage rates made homeownership more affordable while making an already tight housing market more competitive. From an increased demand for second homes; to investors taking advantage of favorable borrowing costs, everyone wanted in on the action. Mortgage rates hit an all-time low of 2.65% in early January 2021, coinciding with an at-the-time record low inventory of homes for sale (January 2022 set a new record-low inventory). The median sales price shot up, advancing 18% in six months. As mortgage rates slowly drifted higher throughout the year, the race was on to lock in a historically-low rate, and prices remained propped up while affordability dwindled. Then, in the final months of 2021, the Fed finally said the fun was over, ending an era of unconventional monetary policy that included a 0% Fed Funds Rate policy for 9 of the past 13 years. The Fed projects the policy rate will reach 2% by the end of this year, while the market is pricing in a 2.5% policy rate. On top of the rate moves, the Fed will begin shrinking its holdings of mortgage-backed securities, ending a program that helped keep mortgage rates low and encourage lending. Like a rocket ship, the average mortgage rate went from 3.1% at the start of 2022 to more than 5% today. Affordability has plummeted across the country. In almost 30% of metropolitan areas, less than half of the homes sold were affordable to a family earning the local median income in the first quarter of 2022. Across the U.S., 57% of homes sold were affordable to families earning the median income, versus 63% in December 2019. Among the worst markets for affordability is right in our backyard, the Phoenix metropolitan area. Before the pandemic housing boom, 66% of homes were affordable to families earning the local median income, which has dropped to just 44% through March of this year. Presumably, the share of affordable homes will continue to drop as mortgage rates and home prices persistently move higher. We are on the brink of an affordability crisis. Based on a 10% down payment and 5% mortgage rate, the monthly principal and interest payment for the median-priced home in the U.S. is now $1,850 versus $1,150 at the end of 2019, a 61% increase. This pace is not sustainable, and many people will be priced out of specific markets or simply not able to buy a home altogether. Rents are not forgiving either. Over the past six months, the year-over-year rent increase has been in the double-digits, and the rate of change has increased each month, with the average nationwide rent up 16.7% as of March 2022, compared to the same month last year.

Higher mortgage rates will certainly cool the housing market, helping to correct the worst supply and demand mismatch since the data became available in 1982. But that is only part of the problem. Existing home inventory has steadily declined since the housing bubble burst in 2008. The housing market eventually stabilized in 2012, and home inventory has declined about -2.5% per year on average through 2019 before falling off a cliff once the pandemic began. Housing inventory now stands almost 40% below its pre-pandemic level. Historically, a six-month supply of homes was associated with a healthy housing market experiencing moderate price gains. Today, we have just two months' supply of homes. To reach the six months' supply level, we either need the number of homes for sale to increase by 1.5 million, a 191% increase over the current level, or the pace of home sales needs to decline by about 250,000 per month, a 66% drop from the current pace. Neither are likely to happen overnight and is the reason we do not foresee home prices dropping any time soon.

The issues plaguing the housing market are multifaceted, and the Fed raising interest rates will not solve the problem alone. More than a decade of underbuilding following the housing bust has limited

the supply, intersecting with Millennials, eclipsing Baby Boomers as the largest generation in 2019, reaching their peak home-buying years. Higher mortgage rates will curb demand, although sorting out the underlying structural problems is a much larger task.

Flashbacks to the 2008 housing bust are natural, but we do not have the same loose lending standards today that made homeownership available to anyone regardless of creditworthiness leading up to 2008. At the peak of the recklessness leading up to the bust, the family dog could qualify for a mortgage. Lenders lowered their minimum credit scores, did not verify income, and shuffled borrowers into adjustable-rate mortgages (ARM). ARMs offer teaser rates affording low monthly payments in the early years in exchange for variable monthly payments based on prevailing interest rates once the promotional period ends. The questionable practices increased demand for homes, driving up prices. Everything was great until the adjustable rates kicked in, and no one could afford the monthly payment, creating a wave of foreclosures leading to the collapse of home prices. Today, lending standards are tight. 72% of borrowers have a FICO score above 760, versus only 23% at the end of 2006. And only 2% of borrowers have a FICO score below 620, versus 14% at the end of 2006. The housing market is backed by high-quality loans but faced with a record-low number of homes for sale, with many qualified buyers competing against each other, leading to bidding wars and sustained sky-high home prices. The supply challenges should keep the floor from falling out under home prices, while higher interest rates serve as a ceiling for home price growth. Save for the hottest housing markets where affordability is in jeopardy; the floor may not be as stable since there will be a point where simply no buyers are left that can afford to buy a home.

The share of consumer spending allocated to shelter-related expenses through mortgage payments and rent is rapidly expanding. As the amount increases, consumers have less to spend on other goods and services. And the average price level for all goods and services is increasing at a blistering pace. The inflation rate hit 8.5% in March, the fastest year-over-year increase in prices since January 1982. And that figure does not even include the full impact of the massive home price growth over the past two years. An analysis from two economists at the Federal Reserve Bank of Dallas points out that home price growth has historically led rent inflation and owners' equivalent rent inflation by about 18-months. So the bulk of the home price growth in 2020 and 2021 is only beginning to show up in the data. Rent and owners' equivalent rent are material components of the CPI measure, accounting for a combined weight of 31.6%. According to the forecast model presented by the authors of the analysis, inflation for rent and owners' equivalent rent could reach nearly 7% by year-end 2023, the highest year-over-year increase in more than 30 years. When the authors published their research in August 2021, their model predicted year-over-year rent inflation and owners' equivalent rent inflation for March 2022 of 1.8% and 2.6%, respectively. The actual rent inflation and owners' equivalent rent inflation for March were 4.4% and 4.5%, respectively. The Fed has underestimated the impact of inflation, and we are not confident that price pressures will ease anytime soon. Inflation is broader-based than expected, and factors like shelter have yet to show up in the data, leading us to believe inflation will remain elevated for longer. While many talking heads keep saying that we are nearing peak inflation or have reached peak inflation by pointing to specific components which declined from the prior month, we say "not so fast". Saying used car prices increased 35.3% in March from the previous year, instead of the 41.2% year-over-year increase in February, does not provide much comfort to the average person searching for a vehicle. Prices are still up 48% since the beginning of 2020. Used vehicle prices are not just an isolated

issue, as the broad inflation indicator has risen almost 12% since January 2020. Problematic, the growth in average hourly earnings after inflation is flat over the same period.

Personal spending growth may still be strong, although it is outpacing personal income growth at the expense of personal savings. The personal savings rate has made a roundtrip sharply off the pandemic highs and now stands at the lowest level since 2013. As consumers spend their savings down, they will have to spend less on all goods and services; this is not a good situation. Corporate profits will take a hit, and economic growth will slow. Calls for a recession in the following year are not just talk, but instead a real possibility. We believe a recession in 2023 is more likely than not where we stand today.

Bulls Make Money, Bears Make Money, Pigs Get Slaughtered

As much fun as it was to blindly throw money at stocks and treat investing like gambling, once the market finally put on corrective lenses, the writing on the wall for the past year has ultimately come into focus. The market sell-off this year should come as no surprise. Similarly, the market run-up over the past two years should have been a surprise. The market had no business trading at absurd levels, especially given the highly uncertain economic outlook. We cautioned in our second quarter letter last year, when the S&P 500 was trading near 4,000, that if the market ignores reality and continues higher, it would only result in more future pain. Unfortunately, the market proceeded to run 20% from April 1 through the end of 2021 before giving up most of the gain this year. We believe that further downside is likely, given inflation remains out of control, wages are not keeping up with inflation, and patience is the only remedy for supply problems. Contrasting to the end of 2019, when inflation was under control, consumers were in a healthy financial position, and the global supply chain functioned adequately.

Admittedly, the future looks a bit dreary. Economic conditions are uncertain, and both stocks and bonds are expensive. We first wrote about the challenges for bonds in a rising interest rate environment in our fourth quarter 2020 letter and explained the consequences for a traditional 60% stock and 40% bond portfolio. Since a bond's price moves inversely to a change in interest rates, as rates move higher, the price of a bond falls. During the sustained rising interest rate period from 1940 through 1979, bonds experienced an annualized real total return, taking out the impact of inflation of -0.9%. While in the sustained falling interest rate period from 1980 through 2019, bonds delivered an annualized real total return of 4.1%. The impact of bonds on a 60/40 portfolio during the rising interest rate period was profound. The 60/40 portfolio eked out an annualized real total return of 3.3% during the rising interest rate period; compared to the 7.2% annualized real total return during the falling interest rate period investors have become accustomed to over the past 40 years[1]. The meaningful difference today is stock valuations are more than double the level at the start of the rising interest rate period in 1940.

We have been shifting portfolios to a more defensive posture for more than a year, anticipating a challenging environment for stocks and bonds. In our flagship Balanced multi-asset portfolio strategy, we boosted our allocation to hedged equity at the beginning of 2021 to 10% from 5%, then added to the position in June 2021, bringing the weight to 15%. We have also reduced the overvalued growth allocation and increased the reasonably-priced value exposure, which tends to hold up better in a rising interest rate environment. Most recently, at the end of December 2021, we increased the exposure to

[1] All mentions of stocks and bonds refer to the IA SBBI US Large Stock Index and IA SBBI US IT Govt Index, respectively.

funds that invest in value stocks within the U.S. to 70% of the U.S. equity portion of the portfolio, up from 56%. At the same time, we diversified the fixed-income bucket of our portfolios by adding a second core-plus fund. Although both funds can invest in similar fixed-income sectors, their process and areas of expertise differ. Notably, the new fund takes a neutral approach to interest rate risk and currencies while emphasizing security selection and sector allocation, making them great compliments. In addition, we added an interest rate hedged strategy to lower the interest rate sensitivity of our portfolios in anticipation of rising interest rates. The fund's inclusion at 20% of the fixed-income portion of our portfolio reduces our interest rate sensitivity by the same amount.

We could conclude by telling you that we have a crystal ball, and you can be rest assured to ignore the numerous concerns facing the economy. But we take great pride in the trust you place in us and recognize this comes with great responsibility. So, it is our duty to be upfront in our communication while setting reasonable expectations. The circumstances have changed, and the dynamics that provided for the fruitful past ten years, including cheap money, minimal inflation, and a disregard for valuations, are no longer present. A recalibration of expectations suitable for this moment will go a long way. The new environment will be tricky but not impossible, and we will continue to dynamically manage our portfolios, seeking to add value as we navigate the challenging investing landscape ahead.

The views expressed are through the period ending March 2022 and are subject to change at any time based on market or other conditions. This material does not constitute a recommendation of any particular investment strategy or product. Although the information included is compiled from sources believed to be reliable, its accuracy cannot be guaranteed, and Vinity nor its affiliates assume liability for loss due to reliance on this material and/or such views expressed herein.

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Diversification does not guarantee a profit or protect against loss.

S&P 500: Measures the performance of U.S. large-cap equities and is comprised of 500 companies across sectors and covers approximately 80% of available market capitalization. **IA SBBI US Large Stock Index:** Measures the performance of U.S. large capitalization stocks. **IA SBBI US IT Govt Index:** Measures the performance of Treasury and Agency securities issued by the U.S. Government with 3 to 10 years in maturity.

Sources: Bureau of Labor Statistics, National Association of Home Builders, Redfin, The Wall Street Journal, YCharts.

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