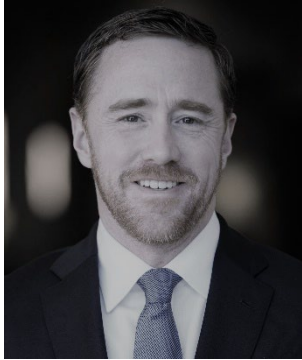


The Sizemore Income Letter

December 2022

Housing Hangover to Start the New Year?

By Charles Lewis Sizemore, CFA



Let me start with some good news.

The nasty bear market of 2022 has created opportunities for us in places I never would have imagined this time last year.

I have a fantastic new opportunity in a market that has been largely left for dead after years of political scandal and general chaos. It should also benefit from the US dollar retreating to a more “normal” level after rising to two-decade highs in 2022.

I’ll get to that in a minute. First, I have a lot to say about the housing market because, to start, the home is the single most important asset for millions of Americans. Secondly, this is an income letter, and real estate is a fantastic long-term income generator. Most of my personal assets are invested in dividend-paying stocks and in the low-correlation funds my firm manages. But I also own a profitable rental house and look forward to buying more at the right price.

And finally, housing is a major driver of the economy, as a home purchase tends to come with massive new expenses on furniture, gardening tools, Christmas decorations and a host of other things Americans love to burn money on. So as goes housing, so goes the economy. It’s hard for me to see a scenario in which we have a housing downturn without a recession or at least a significant economic cooling.

Yield Curve Inversion Most Extreme in 40 Years

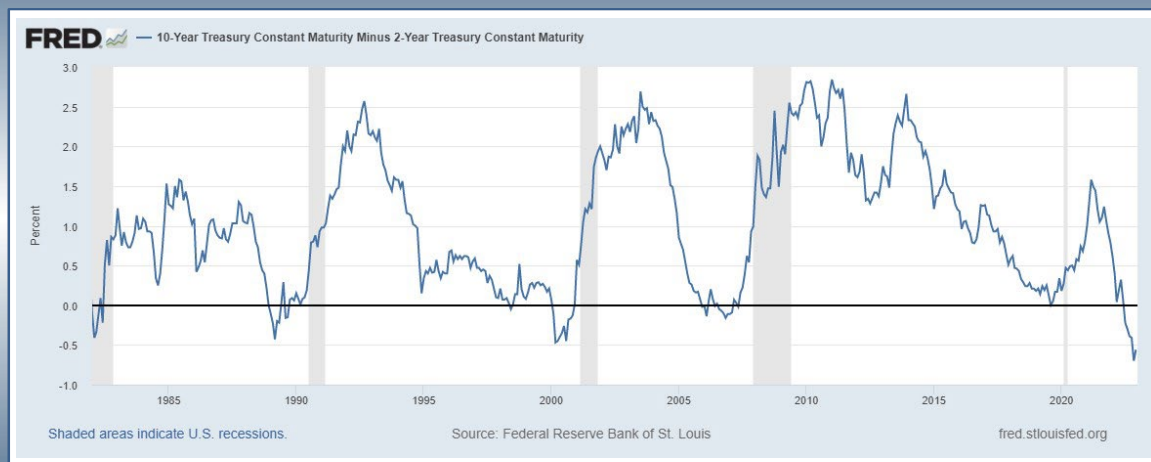


Figure 1

Housing Affordability Index

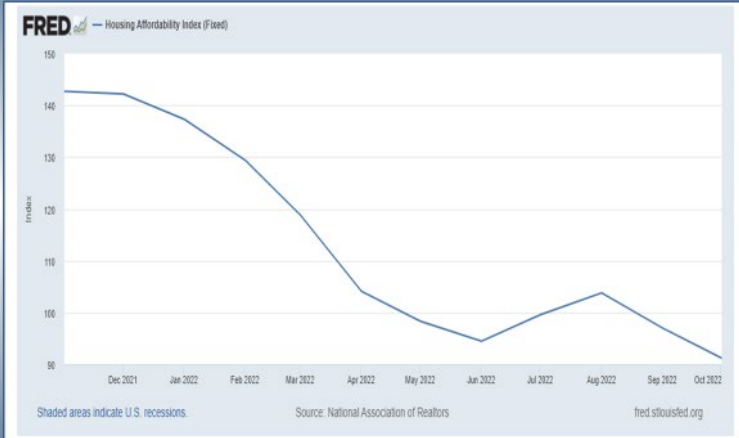


Figure 2

Average Mortgage Rate

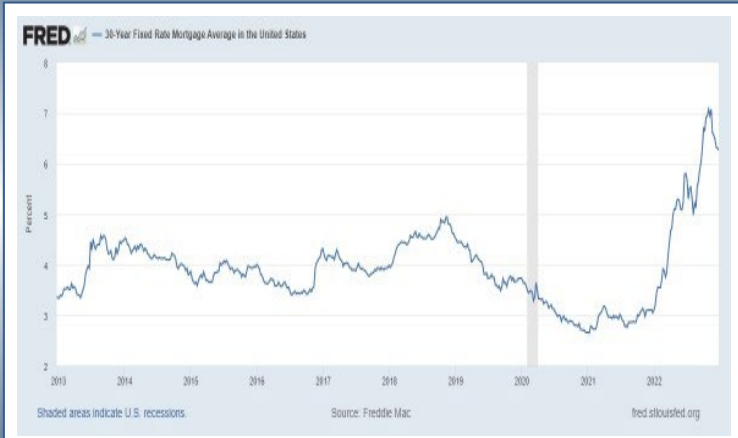


Figure 3

Months Supply of Homes for Sale

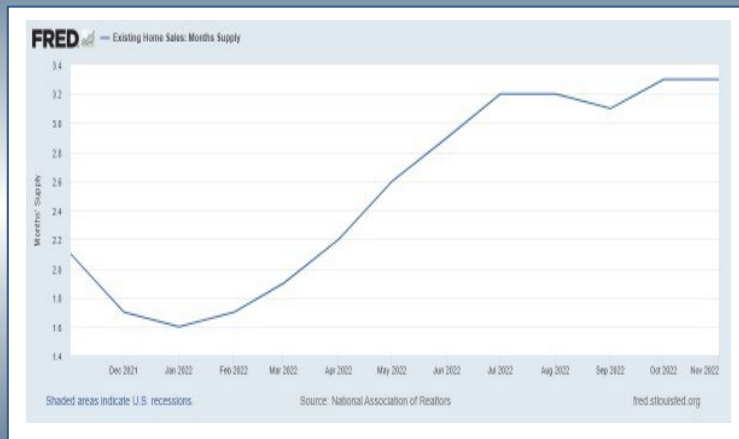


Figure 4

Existing Home Sales

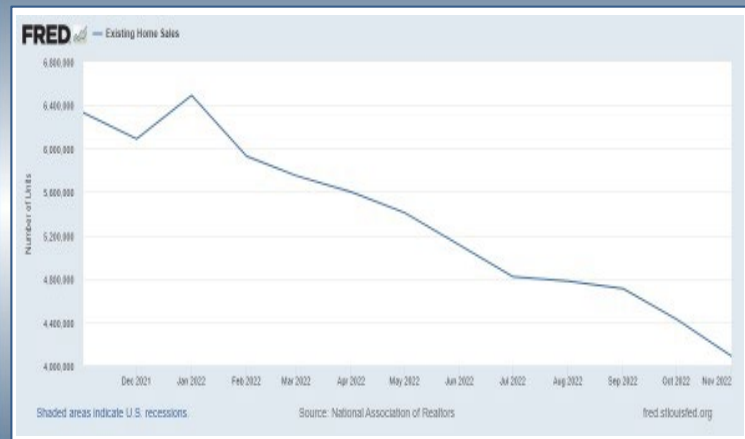


Figure 5

Signs were already pointing to a recession. The yield curve (Figure 1 on previous page) is ending the year at its most inverted in forty years. Historically, an inverted yield curve (i.e. when short-term interest rates are higher than long-term interest rates) has been a sign that a recession is imminent.

I've never seen a study that specifically links the size of the inversion with the depth of a recession. For example, the yield curve barely inverted at all leading up to the 2008 Great Recession, and that was the biggest economic upheaval

since the 1930s. But I would say, if nothing else, that it shows just how broken and out of sorts the financial system is right now. The Fed is attempting to unwind 20 years of easy monetary policy... and it's not going well.

Let's get back to housing.

Figures 2 and 3 tell the same story. The massive spike in mortgage rates over the past year, which has seen financing costs more than doubled, has translated directly into a major lack of affordability. The Housing Affordability Index

measures the degree to which a typical family can afford the monthly mortgage payments on a typical home. A value of 100 means that a family with the median income has exactly enough income to qualify for a mortgage on a median-priced home. An index above 100 signifies that family earning the median income has more than enough income to qualify for a mortgage loan on a median-priced home, and a reading below 100 means that average family cannot qualify for a mortgage for the median-priced home.

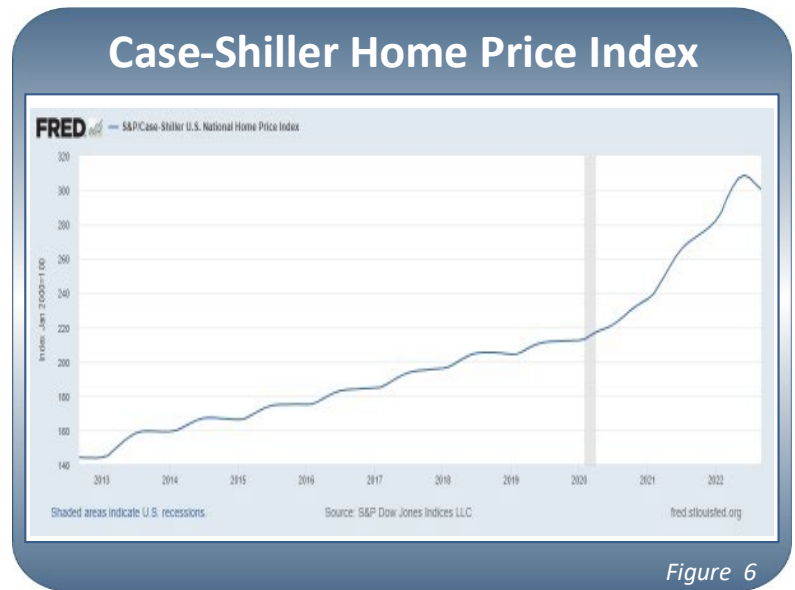
This time last year, the index read 142, and two years ago it read 170, meaning the typical family had **more** than enough income to cover the typical mortgage payment, at least based on national averages. (I'm sure anyone living in New York or San Francisco might beg to differ.)

Today the index reads 91.2.

I would focus less on the absolute number and more on the size of the reversal. A drop from 170 to 91 in two years is nasty. And we're seeing the results in home sales and inventory. Monthly existing home sales are down about 40% over the past year, and the months' supply for sale has doubled.

Now, the news here isn't all bad. Mortgage rates have started to creep down from their 2022 highs, and a months' supply of 3.2 months, while high by the standards of the past couple years, is by no means a sign of distress by itself. 3.2 months is actually a pretty average reading.

But the lack of affordability is starting to show in prices. Between June and September (the last month for which we



have index data), the Case-Shiller Home Price Index eased about 2%.

A 2% move might seem insignificant, but it's noteworthy because it shows the trend has changed.

I don't expect to see home prices utterly collapse like they did following the 2008 meltdown, as lending standards were significantly higher this time around. (Or more accurately, banks actually *had* lending standards this time around.)

And the supply of homes built over the past decade hasn't been enough to keep pace with population growth, which suggests we won't be left with a major supply glut like we were in 2008. But all the same, a drop in value of even 5% to 10% would be enough to completely wipe out the home equity of most homeowners who bought over the past year or two.

So, on balance, I expect to see weakness here but not necessarily a collapse. But there will likely be a sweet spot to buy within the next 1-2 years when mortgage rates drop back down to something in

the ballpark of 4% but housing prices haven't snapped back yet.

All real estate markets are local, and you may get lucky and stumble across a motivated seller in your neighborhood that needs to unload their house in a hurry.

If you see a good deal, and the math works out – the rents you could collect at current market rates are high enough to easily cover a mortgage at current rates – then go for it.

Personally, I plan to start sniffing around for deals in the second half of 2023. Whether I actually find any deals remains to be seen, of course, and I am in no real hurry. No one is making me buy anything, and if I never buy another rental house, that's perfectly fine. I have my dividend stocks!

So, to summarize...

If you're thinking about adding rental real estate to your portfolio, I think it's still a little early. But we might get some really nice deals in the next 6-12 months.

Where Few Dare to Tread

You might know that I live part-time in Peru. So, I am no stranger to instability. I've lost count of how many road closures, general strikes, riots and other assorted mayhem I've witnessed here. I even had to flee the country on a humanitarian flight with my children and pregnant wife when the pandemic first shut the country down.

So again, I'm used to instability, and life has a way of going on.

But it does tend to scare away investors. And that's been the story of Latin America for over a decade now. After a

Brazilian Real to US Dollar

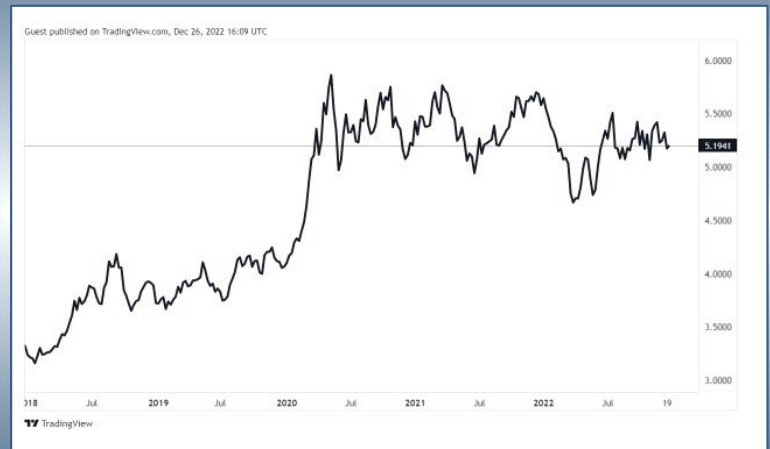


Figure 7

nice run in the 2000s that seemed to promise a golden age for the region, the past decade has been a never-ending stream of corruption scandals, and political radicalization, which has in turn paralyzed investment.

And naturally, the exceptionally strong US dollar of late didn't help.

Well, I have some good news on that front. Even while the region has become politically unstable, this hasn't translated into macroeconomic instability. Peru's president recently attempted a coup d'état... and was promptly captured and thrown in jail. His supporters have been rioting ever since. Yet remarkably, the exchange rate barely moved. Investors seem to have collectively shrugged.

Likewise, Brazil is in the middle of its own "January 6" crisis in which outgoing president Jair Bolsonaro is refusing to concede his loss to Luiz Inacio "Lula" da Silva, who is himself a convicted felon. The inauguration is scheduled for January 1, and violence is expected.

And yet... the Brazilian real has been remarkably stable relative to the dollar since July (Figure 7).

Investors seem to have stopped reacting to crisis in Latin America. Bad headlines no longer translate into bad market moves. And at the risk of oversimplifying, this suggests that there is “no one left to sell.” Emerging markets have been dead money for over a decade. They’re not even on the radar of most investors.

Do you know anyone actively investing in emerging markets?

I do this professionally, and I can tell you that I do not know a single manager with a significant allocation to emerging market stocks at the moment. I don’t know anyone who’s even *looking* at the sector.

It's not that the sector is hated. It's more like it's been forgotten about entirely.

So, with all of that as background...

My recommendation for this month is the **iShares MSCI Brazil ETF (EWZ)**. This is an index fund that gives broad exposure to the Brazilian stock market.

As you might expect, EWZ is heavy in commodities. The largest holding, at 18% of the portfolio, is diversified industrial miner Vale. But the ETF also has ample exposure to Brazil’s banking and energy sectors, as well as exposure to consumer staples like global beer giant Ambev.

Brazilian stocks have gone exactly nowhere in almost 16 years, as EWZ is sitting at levels first seen in 2007. The shares are trading at half their pre-2008 levels.

Brazilian Stocks Trading at 2007 Prices



Figure 8

EWZ Holdings

Ticker	Name	Sector	Asset Class	Market Value	Weight (%)
VALE3	CIA VALE DO RIO DOCE SH	Materials	Equity	\$902,968,602.86	18.47
ITUB4	ITAU UNIBANCO HOLDING PREF SA	Financials	Equity	\$325,948,653.38	6.67
PETR4	PETROLEO BRASILEIRO PREF SA	Energy	Equity	\$321,179,142.05	6.57
PETR3	PETROLEO BRASILEIRO SA PETROBRAS	Energy	Equity	\$284,576,254.02	5.82
B3SA3	B3 BRASIL BOLSA BALCAO SA	Financials	Equity	\$215,512,642.25	4.41
BBDC4	BANCO BRADESCO PREF SA	Financials	Equity	\$192,144,872.74	3.93
WEGE3	WEG SA	Industrials	Equity	\$186,432,136.94	3.81
ABEV3	AMBEV SA	Consumer Staples	Equity	\$181,241,540.20	3.71
ELET3	CENTRAIS ELETR BRAS-ELETRORBRAS	Utilities	Equity	\$123,012,052.84	2.52
RENT3	LOCALIZA RENT A CAR SA	Industrials	Equity	\$120,772,008.31	2.47

Figure 9

Yet quietly, Brazilian stocks have been quietly trending higher. 2016 started what could have potentially been a durable bull market, but the pandemic knocked the shares back down to earth. But since 2020, the shares have been pushing higher... and this despite dollar strength that punishes the prices of all non-US assets.

The bullish case for Brazil is straightforward:

- Brazilian stocks have effectively been left for dead. Investors have largely ignored the entire emerging market universe for the past decade, and Brazil is no exception.
- The US dollar recently hit two-decade highs against many world currencies, including the euro. This was due in part to the Fed's aggressive rate hiking. But now the rest of the world is catching up... and the dollar's strength may be coming to an end. This is positive for non-US stocks.
- It's also positive for commodities... which are priced in dollars. Brazil is the world's commodity powerhouse.
- Brazilian stocks are ridiculously cheap. The stocks making up EWZ trade at a price earnings ratio of just 5.
- Brazilian stocks have been mostly bucking the overall bearish direction of the world's stock markets this year and has been trending higher.

And naturally, this being the *Sizemore Income Letter*, dividends are part of the story.

As and cheap as EWZ is today, it delivers. Based on the ETF's last two semiannual dividend payments, the yield today is an impressive 12%.

So, what kind of returns should we expect here?

I'm not too keen on making official price targets in a market like today's. But I can tell you that the last time we saw a proper bull market in Brazilian stocks,

between the 2002 bottom and the 2008 top, the index backing up EWZ rose by a factor of close to 20. **Investor who caught the entire move made returns of about 2,000%.**

Are returns like that possible this time around?

Maybe, maybe not. Only time will tell. But I do believe that returns of several hundred percent is very doable.

So, with no further ado...

Action to take: Buy shares of the iShares MSCI Brazil ETF (EWZ) at market. Set an initial stop loss at \$20.15 based on closing prices.

I should note that EWZ is not what I would consider a traditional income play. In a stock I'm buying primarily for income potential, I prefer a quarterly or even monthly payout rather than semiannual. But it's also worth noting that most bonds pay semiannually too, so EWZ is certainly not alone on that front.

EWZ is also more volatile than most of the stocks I recommend. So, please take that under consideration when you build out your allocation. I might suggest making EWZ a smaller allocation than your typical income play.

Before I sign off, I would be remiss if I didn't nag you at least a little bit regarding your 401(k).

Starting in 2023, you can dump fully \$22,500 of your salary into your 401(k) at work. And if you are 50 or older, that number jumps to \$30,000.

Before you invest a single nickel into any of my recommendations in the *Sizemore Income Letter*, you should do absolutely everything in your power to max out

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your 401(k). Between the potential matching and the tax break, you simply can't beat it. The humble 401(k) plan is still the best legal tax shelter out there. Make it your priority in 2023.

That's going to wrap it up for now.

2022 was a tough year, but we made it through. Let's make 2023 our best year yet!

Have a good week, and until next time, keep cashing those dividend checks!

A handwritten signature in blue ink that reads "Charles Sizemore". The signature is fluid and cursive, with a long horizontal stroke at the end.

P.S.: Apart from writing this newsletter, I run a full-service wealth management

firm along with my colleagues. At **Sizemore Capital Management**, we build income portfolios like those I write about in the *Sizemore Income Letter*.

But we also do a lot more than that. We manage a suite of low-volatility strategies offering low correlation to the S&P 500. If you think your portfolio is a little too exposed to the stock market right now, let's talk. I may have some alternatives that can offer competitive returns without the heartburn. If you'd like for me to take a look at your portfolio and offer some recommendations, contact me at info@sizemorecapital.com.

The Sizemore Income Letter Portfolio

Stock	Ticker	Entry Date	Buy Price	Recent Price	Stop Loss	Yield	Cumulative Dividends	Total Return	IRA Friendly?	Action
iShares MSCI Brazil ETF	EWZ	12/26/2022	\$28.79	\$28.79	\$20.15	12.19%	\$ -	0.00%	Yes	Buy
Atlantica Sustainable Infrastructure	AY	11/22/2022	\$27.75	\$26.45	\$20.41	6.65%	\$ -	-4.68%	Yes	Buy
AGNC Investment Corporation	AGNC	11/3/2022	\$8.16	\$10.71	\$6.37	13.45%	\$ -	31.25%	Yes	Buy
Cheniere Energy Partners	CQP	8/4/2022	\$46.49	\$58.79	\$33.01	5.94%	\$ 1.07	28.76%	No	Buy
Citigroup Inc	C	6/23/2022	\$47.34	\$44.26	\$32.57	4.61%	\$ 1.02	-4.35%	Yes	Buy
ONEOK, Inc.	OKE	4/28/222	\$65.50	\$65.56	\$47.91	5.70%	\$ 2.81	4.37%	Yes	Buy
Energy Transfer Partners	ET	12/27/2021	\$8.16	\$11.96	\$7.79	7.69%	\$ 0.87	57.23%	No	Buy
EPR Properties	EPR	11/29/2021	\$47.78	\$38.31	\$33.92	8.61%	\$ 3.20	-13.12%	Yes	Buy
Chevron Corporation	CVX	9/30/2021	\$103.33	\$177.40	\$130.77	3.20%	\$ 7.02	78.48%	Yes	Buy
ClearBridge Energy Midstream Opportunity	EMO	5/26/2021	\$21.94	\$29.30	\$20.49	6.96%	\$ 2.68	45.76%	Yes	Buy
Magellan Midstream Partners	MMP	1/29/2021	\$44.41	\$50.17	\$41.78	8.27%	\$ 8.28	31.62%	No	Buy
Iron Mountain	IRM	8/25/2020	\$30.22	\$50.63	\$42.57	4.88%	\$ 5.57	85.97%	Yes	Hold
Starwood Property Trust	STWD	8/25/2020	\$15.70	\$19.24	\$18.15	9.98%	\$ 4.32	50.06%	Yes	Buy
Ecofin Sustainable and Social Impact Term Fund	TEAF	6/24/2020	\$10.73	\$13.09	\$12.53	8.25%	\$ 2.24	42.82%	Yes	Buy

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