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INVESTMENT SERVICES

Weekly Relative Value

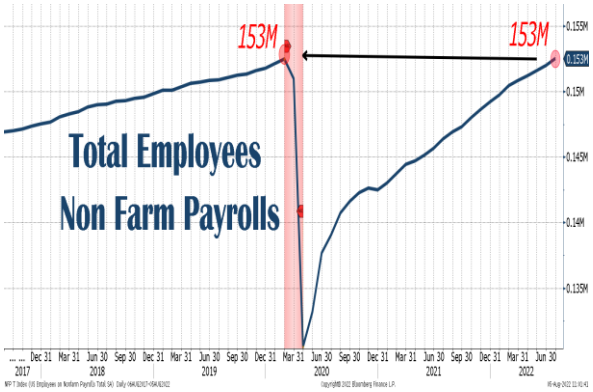
Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF AUGUST 8, 2022

A Sizzling Jobs Report

"This is not at all what the Fed wanted to see. The job market if anything is getting even hotter, not cooling…is going to price in a more aggressive Fed, only raising the odds of a hard landing somewhere down the road." — John Brady, RJ O'Brien

In a time when the U.S. is in a technical recession, when tech companies are mass laying off thousands of people, last Friday the Bureau of Labor Statistics (BLS) reported that in July the U.S. added a whopping 528,000 jobs, more than double the 250,000 expected. Not just that, but it far surpassed the highest forecast on the Bloomberg survey, which was +325,000. With a cherry on the top, both May and June payrolls were revised higher than previously reported by a combined 28,000 additional jobs. As shown below, the U.S. economy has now recovered all the jobs lost since the pandemic started.



**Red shaded areas represent recessions*

Meanwhile, the labor force — the people who are working or are actively looking for work – dipped by 63,000 in July, the second month in a row of declines, to 163.9 million, essentially where it had been in February.

There has been a lot of thinking about why the labor force has gotten stuck.

- The difficulty and expense in finding daycare.
- The need to care for elderly relatives.
- The excess mortality since 2020.
- "Long COVID" could be keeping as many as 4 million workers sidelined.

THIS WEEK

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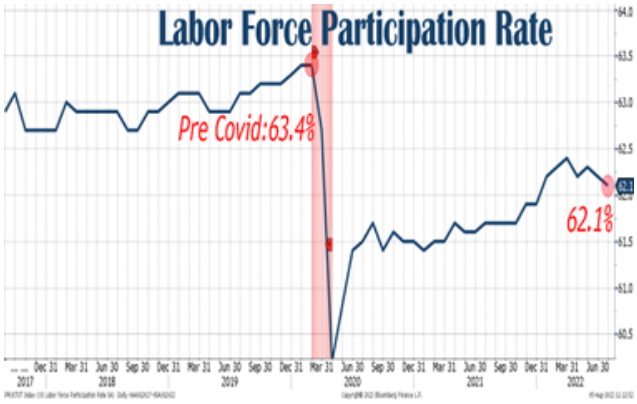
- A massive wave of "retirements" by people who have had enough already thanks to the massive inflation of asset prices.
- Ageism, where older people who want to work stop looking for work because they cannot get anyone in their industry to take them seriously (particularly in tech), and when they stop looking for work, they come out of the labor force. And the list of reasons goes on.

Whatever the reason, there obviously is a structural shift afoot and the decline in labor force participation is impairing labor supply. Many folks, including the Fed, are now suggesting that the "old normal" labor force may never return. There were permanent changes in the labor market that we're just now trying to figure out. Regardless, the decline in the labor force participation rate to a low for the year at 62.1% from 62.2% in June will make the Fed nervous.



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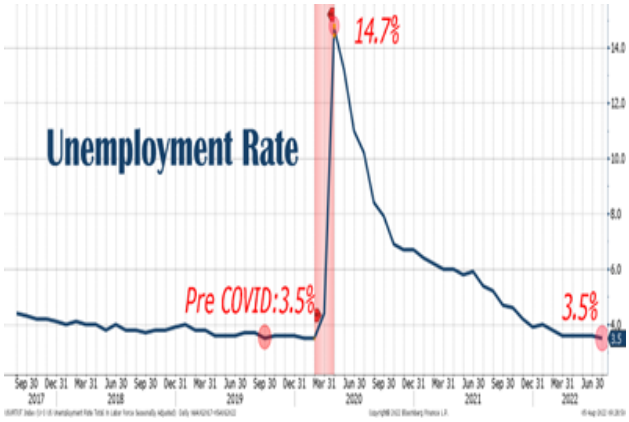
This lack of thrust in new entrants took the unemployment rate down to 3.5% from 3.6% in the prior four months — back to February 2020 levels prior to the coronavirus pandemic and matching a five-decade low as the number of unemployed persons edged down to 5.7 million. Recall that Fed Chair Jerome Powell mentioned at the last meeting that the estimate of the full-employment unemployment rate is likely well above 4%.



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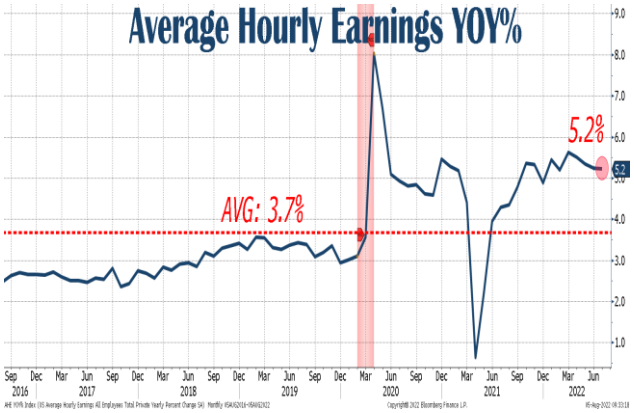
It wasn't just payrolls that smashed expectations, however, as wages also came in red hot. July average hourly earnings rose 5.2% year-over-year smashing expectations of 4.9% and increased 0.5% month-over-month; also beating estimates of 0.3%. The workweek held at 34.6 hours, which means that average weekly income came in at +0.5% too. So even with commodity prices tailing off, the consensus at the Fed will be that the risk of a wage-price spiral has taken a leap higher.

Additionally, the average workweek was 34.6 hours for the fifth month in a row. Interestingly, sectors where activity had been very soft posted surprising job gains last month. To wit, manufacturing added 30,000 jobs (defying the contraction evident in the Institute for Supply Management (ISM) Manufacturing Purchasing Managers' Index (PMI)), construction jobs increased by 32,000 (even in the face of unrelenting declines in housing activity), and retailing jobs gained +22,000 (shedding inventory while adding to the payroll... interesting dichotomy).



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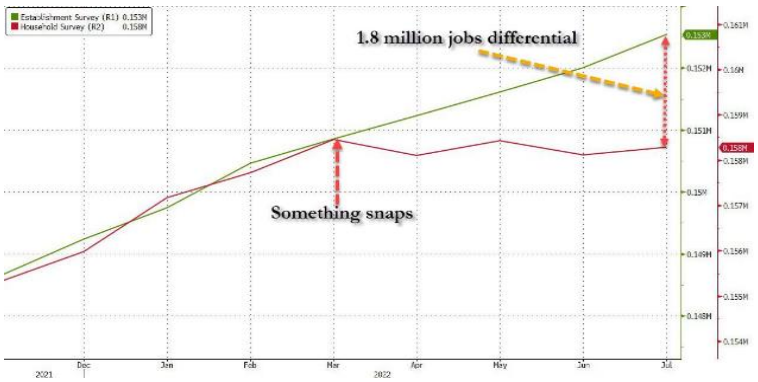
That said, once again there was a stark divergence between the Establishment (+528,000) and the Household Survey (+179,000). In fact, according to the Household Survey, there has been no jobs growth since March, while according to the Establishment Survey, the U.S. has added 700,000 jobs!

One reason being is the Establishment survey includes the birth-death model (that adds an estimate of new businesses created in any given month. The Household survey contains no such artificial sweetener. This birth death model added a whopping +153k to the headline number- even though the Census data show that new business applications are down 8.6% over the past year!

Further, it's important to put the jobs numbers into proper perspective. In the Household Survey, if you work as little as one hour a week, even selling trinkets on eBay, you are considered employed. In the Household Survey, if you work three part-time jobs, 12 hours each, the BLS considers you a full-time employee.

In the payroll survey, three part-time jobs count as three jobs. The BLS attempts to factor this in, but they do not weed out duplicate Social Security numbers. The potential for double-counting jobs in the payroll survey is large.

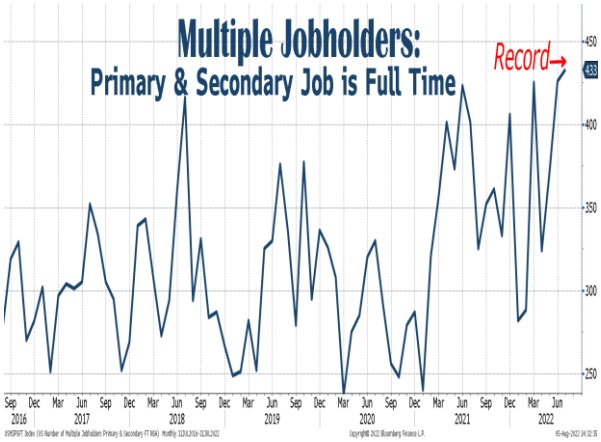


Historically, this data set is noisy, but a five-month divergence really stands out. As shown below, something appears to have snapped last March, when the Establishment Survey kept on rising unperturbed, while the Household Survey hit

some unexplained brick wall, and hasn't moved at all. In fact, since March, the Establishment Survey shows a gain of 1.680 million jobs while the Household Survey shows an employment loss of 168,000- and fully 84% of that job loss has been in full-time positions.

Half the job gain last month was de facto double counting from people garnering a second or third part-time job. And even more remarkable, the number of multiple jobholders, whose primary and secondary jobs are both full-time, just hit a record high! Hardly the sign of a strong job market, one where people can afford to quit jobs at will.

So, what's going on here? The simple answer, fewer people are working, but more people are working more than one job, a rotation which picked up in in March and has only been captured by the Household Survey.



And it's hardly as if the payroll report resembles anything we are seeing happen in the real world. Initial jobless claims came in for the week of July 30 at 260,000, up from 254,000 the prior week and the second highest level since November 13, 2021. Claims have now risen by 94,000 from the low of 166,000 on March 19.

The four-week moving average rose to 254,750 — the highest reading since November 27, 2021, and is up 84,2500 from the trough and, yet again, anything that is up 60,000 or more from the lows validates the recession call. It’s not about the level — it’s about the change.

Here's are a couple of examples:

- The last time claims were up this much was in March 2008, when the economy was already in a recession.
- Claims also rose this much by August 1990 when the recession was one month old.
- Going back a bit further in time, claims had spiked by 84,000 by October 1981. The National Bureau of Economic Research (NBER) later decided that the recessions started in July! This pattern of rising claims presaged the recession in 1979 and 1974 and back in 1970.

So, rising claims of 60,000 or more has led to seven out of seven recessions. Again, seven for seven. A 100% tried, tested, and true recession indicator. Just because the Fed (and the consensus economics community) chooses to ignore it doesn't mean you should.

As an aside, the backlog of continuing claims gapped up to a three-month high of 1.416 million from 1.368 million in the week of July 16. No matter what the lagging pay data suggest today, goosed and juiced by the "birth-death" model, the labor market is showing some cracks.

Remember that non-farm payrolls are a "coincident" economic indicator. But jobless claims are in the "leading" indicator, for those investors who prefer to look at the forest past the trees. And claims have already provided the recession signal. Full stop. You may want to buy those bonds back.

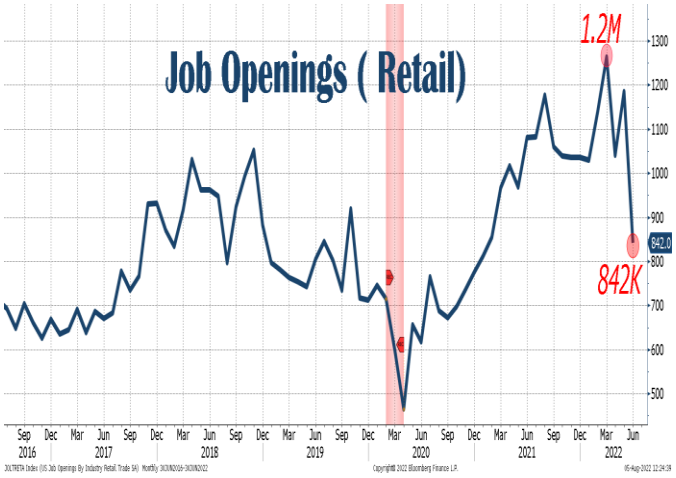
Further, the Challenger Survey — another "leading" indicator — showed job-cut announcements ratcheting up +36% year-over-year in July. The two-month tally of 58,327 is the highest since March 2021. Cost-cutting was the primary reason. As for sectors, the run-up in pink-slip announcements over the past year was notable across a wide swath of industries: autos, electronics, consumer products, real estate, media, transportation services, technology and financials.

Bottom Line: Needless to say, the non-farm (Establishment) payroll report came in well above all expectations. But there was no confirmation from the household survey. In addition, other leading indications suggest that the labor market is peaking. Even still, the markets and the Fed put a lot more credence on non-farm payrolls (even though it almost always provides a head-fake at the business cycle peak). A 75-basis-point increase is obviously back on the table, and any thought of a "pivot" is off the table (in fact, market-based odds of another 75-beeper surged to 70% from 30% before the data were released). The only thing that could reverse the narrative is if next week's Consumer Price Index (CPI) print comes in far below expectations.

WHAT A JOLT!

Despite July's red hot non-farm payroll number there are more cracks in the surface of U.S. labor market. Job openings, the holy grail statistic for this Federal Reserve, plunged by a near-record 605,000 in June to 10.698 million. This was the third biggest drop on record. Openings are now down 1.16 million in just the past three months, which is unprecedented with only the COVID crash seeing bigger drops.

The declines in June were widespread. The largest decreases in job openings were in retail trade (-343,000), wholesale trade (-82,000), and in state and local government education (-62,000). Leisure/hospitality also fell 91,000, down in three of the past four months. The job openings in manufacturing slumped 26,000 after a 201,000 slide in May to a four-month low of 790,000. Construction is really hurting — openings were down 71,000 to 334,000, a year-long low.



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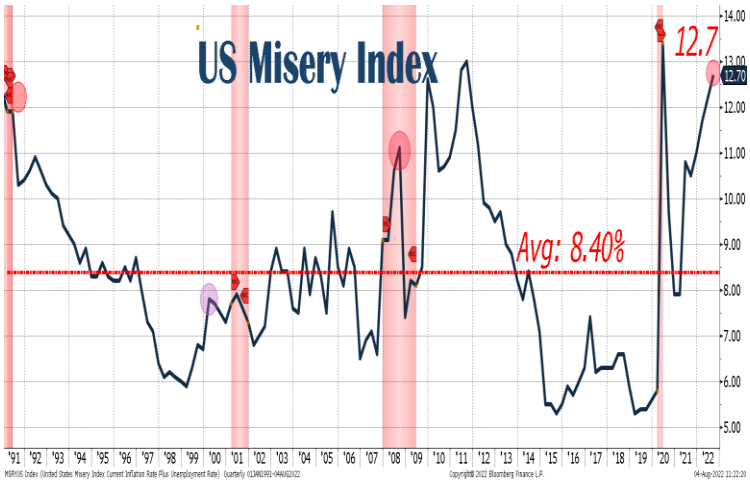
It wasn't just the deterioration in job openings, the number of hires in June also slumped by 133,000 to 6.374 million, the lowest since May 2021, and the fourth consecutive decline to a 10-month low as the labor market is clearly slowing down. Since February, the level of hiring activity has plunged 458,000! Construction dropped 13,000 and has been down in three of the past four months. Professional/business services dipped 104,000 (after a -25,000 decline in May) and accounted for most of the overall decline.

Interestingly, the number of “voluntary quits” dropped 37,000 and has declined for three months in a row — down 212,000 over this span. This is great news for the bond market and for providing a cap on wage growth since the rollover in “job hopping” means that workers are now finally satisfied with the pay packets from their current employer.

Bottom line: Job openings — while still historically high - plummeted at the third fastest pace on record (with only the COVID crash months worse) and since the U.S. is now in a technical recession, it’s quite possible that July and subsequent months will be far worse. Job openings have fallen 9.8% from the March peak.

THE MISERY INDEX

The U.S. economy has contracted for the past two quarters, according to the federal government's own numbers. And while the White House may be trying to convince the voters that all is well, the U.S. misery index (a composite of unemployment and CPI inflation) has risen to 12.7. That's the highest since September 2011 when the U.S. economy was experiencing a time of very weak job growth and economic growth following the Great Recession. June's misery index is also above level from the 2007 — 2009 recession when the index peaked at 11.4%. The index is also about equal to where it was in the run-up the 1990 — 1991 recession.



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It should not be surprising to hear that the misery index tracks rather closely with consumer sentiment. The final University of Michigan Survey number came out for July. The key "expectations" component has gone from 62.5 in April to 47.3 in July. That is the lowest reading since the post-recession print in May 1980. It is weaker now than it was at the depths of despair of all the recessions since that time: 65.9 in May 2020; 49.2 in June 2008; 73.5 in September 2001; 50.9 in October 1990; and 53.1 in March 1982. What does it say about a "data dependent" Fed when consumer expectations are lower now than they were at the peak shocks around 9/11 and the Great Financial Crisis?

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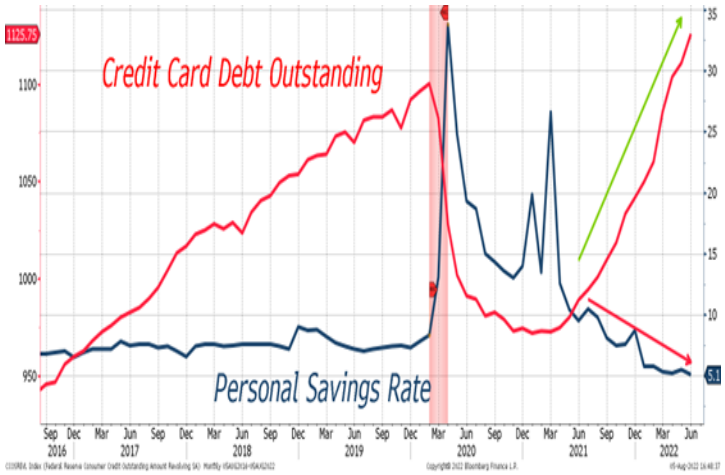
Of course, the Fed, Wall Street economists and the White House could claim that consumer sentiment is "wrong," and that people don't understand how good things are. Indeed, it's worth noting that politicians, central bankers and economists have done exactly that during months preceding previous recessions. Ben Bernanke, former chair of the Fed,

for example, repeatedly noted in 2008 that the Federal Reserve was not predicting recession at all — this was after the recession had already begun (according to the NBER.) Of course, as Bernanke was insisting "all is well," both consumer sentiment and the misery index were trending in recessionary directions. Now we may be in a similar situation with Fed Chair Jerome Powell talking up the economy's alleged strengths while consumer sentiment goes into a nosedive, and the misery index repeatedly rises.

SAVINGS TAPPED & CREDIT CARDS MAXED

The Fed reported that consumer credit rebounded dramatically with an additional $40.154 billion spike (well above the expectation of a $27 billion rise). That is the second largest monthly spike in consumer credit in history. Non-revolving debt —which funds less discretionary items such as cars and college education —surged by a record $25.35 billion in June. Revolving consumer debt (i.e., credit card usage) rebounded in June with an increase of $14.799 billion.



Bottom line: The information begs two questions: If households are stuffed with so much “excess savings,” why are they borrowing like there’s no tomorrow? Especially with the cost of credit surging. And what does this really say about the state of consumer balance sheets? Can’t be as solid as the economics consensus claims them to be.

The renewed reliance on revolving debt to maintain lifestyles in June suggests the consumer is anything but “happy” (as sentiment surveys make very obvious). What's worse is that (despite the anomalous surge in payrolls) surging initial jobless claims from a new wave of corporate layoffs combined with soaring inflation —all at a time when most marginal credit cards are maxed out —will increase the pain across U.S consumers, as it will come just as most households are tapped out and no longer have dry powder on their credit card for discretionary purchases. Simply put, savings are tapped out and credit cards are maxed out!

In short, the recession which may have unofficially started in the first quarter and worsened in the second, could take a turn for the worse in quarter three when the key support pillar of the U.S. economy, consumer spending, which accounts for 70% of GDP, goes into reverse now that maxed out credit cards have to finally be repaid.

MONEY SHRINKS

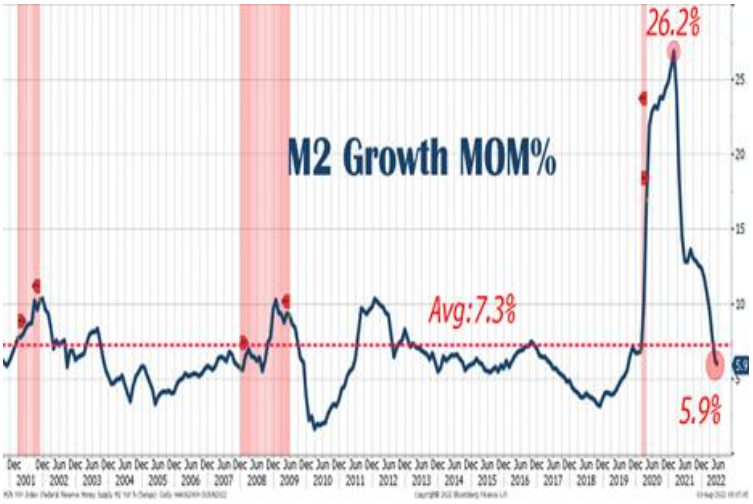
"Inflation is always and everywhere a monetary phenomenon."
— Milton Friedman, American Economist

The inflationistsas, who screamed that the printing presses running 24/7 would ignite today's headline inflation, have gone silent. And I assume that's the case because the aggressive Fed tightening has generated a substantial contraction in the money supply.

M1 money supply declined 0.4% month-over-month in June and has been flat or negative in each of the past three months. The year-over-year trend has totally collapsed to 6.3%, and back to where it was in February 2020. Year-over-year, the trajectory has decelerated for 10 consecutive months.

The broader M2 money measure is down in two of the past three months (at a -1.3% annual rate), which is a negative trend we haven't seen for two decades! The year-over-year trend, at +5.9%, is less than half the +12.9% trend of a year ago and is now back to levels last seen in September 2019. This is what the bond bulls see that the bond bears do not.

Meanwhile, the Fed, the Treasury, the White House and the economics consensus, who are still clinging to the "soft landing" view, all seem to be in denial mode.



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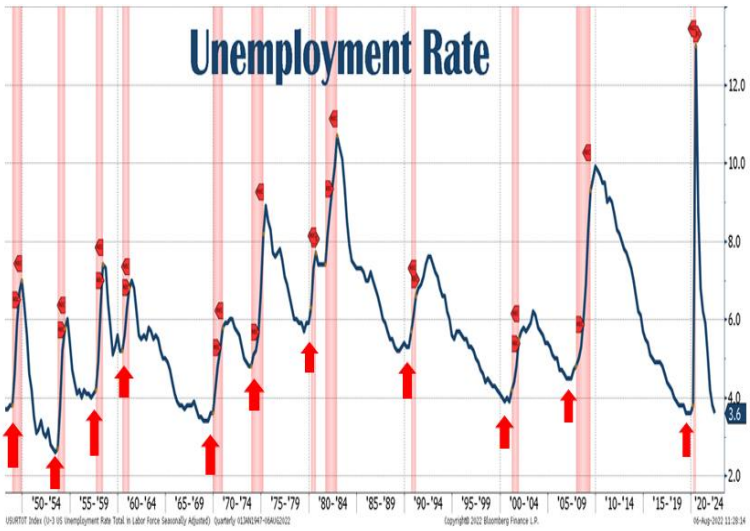
MARKET OUTLOOK AND PORTFOLIO STRATEGY

"None of the post-war expansions died of natural causes, they were all murdered by the Fed. The motive for this murder is usually to save the economy from incipient inflation by killing the economy."
—Rudi Dornbusch, Economist, Massachusetts Institute of Technology

Everyone has an opinion. Some say we are in a recession while others say no. Fair enough. But here's what we all know: Inflation is high, growth is weakening, and the Fed is tightening. All these seem likely to persist, though to varying degrees and with occasional breaks. That means recession is coming, if not already here.

The strangest factor going into this recession is the still-strong employment data. It's just very tough to have an official recession with this type of labor market, with employment growing and wages growing sharply, and with unemployment falling. But this may be because the recession is still young.

Consider the following graph. It shows the unemployment rate with arrows pointing out a bottom just ahead of each recession (the shaded areas). In fact, low unemployment numbers are precursors to recession — they are evidence of an overheated economy, and inflation is one additional, although not necessary, symptom.



Moreover, today the yield curve is inverted from six months to 30 years. The closely followed 2-year/10-year curve has now remained inverted for 24 consecutive days and is inverted a significantly deep 40 basis points. Inverted yield curves are tricky, but the deeper they are and the longer they persist, the higher recession odds rise.

This is what the St. Louis Fed has to say:

> *"On average, since 1969, the unemployment rate trough occurred nine months before the NBER-determined recession trough, while the yield curve inversion occurred 10 months before… based on this evidence, it appears that both indicators tend to be reliable predictors of a business recession."*

Meanwhile, the Fed will continue to tighten as it focuses on unemployment — a "lagging" economic indicator as well as headline non-farm payrolls, which is a "coincident" economic indicator. These are the trees. The forest past the trees are initial jobless claims. They are a "leading" indicator. But Powell recently labeled them as being "wonky," ostensibly because this set of data doesn't comport with his rosy view of the labor market. But initial jobless claims are forward looking, while non-farm payrolls have, in the past, managed to rise into and even pass the initial start to the official recession.

So, as discussed above, we have an indicator that has historically predicted seven for seven recessions. A 100% tried, tested and true recession indicator. Just because the Fed (and the consensus economics community) chooses to ignore it doesn't mean you should.

What should credit unions do? In the current environment it is tempting for credit unions to stay in cash all but knowing for certain that the Fed will raise rates again. But as the Fed raises rates the economy will continue to weaken, demand destruction will cause inflation to decline, and if history is any guide, "something" will break. The Treasury market is forward looking and has already begun to discount these scenarios as the yield curve continues to plunge into deep negative territory.

Today, yields are close to 15-year highs. Yes, they may go higher still. But eventually higher rates will drive the highly leveraged U.S. economy into the ground. While "timing" is next to impossible, I believe the most prudent approach to managing excess liquidity is to maintain a risk-appropriate ladder strategy. Periodic sell-offs provide attractive entry points.

In terms of sectors, short to intermediate (2-7 years) U.S. Treasury securities, and high-quality bank notes offer attractive risk return profiles. For credit unions looking to increase loan exposure, select loan participations (i.e., autos) are now attractively priced and offer generous yields and spreads versus comparable duration Treasury counterparts.

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 30 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.