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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF AUGUST 21, 2023

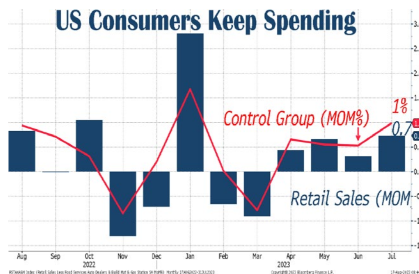
The Consumer Strikes Back!

"The resilience of the economy and the consumer has confounded a lot of people …At the beginning of this year, people were predicting that the Fed would actually be cutting rates by the end of the year, but the economy has withstood this higher-rate environment." – Melissa Cohn, William Raveis Mortgage.

Well, I do have to say that the recession I have been expecting is yet again likely to be delayed. The reason being is the all-important American consumer has yet to buckle even with sharply higher interest rates, more stringent credit conditions, the tailing-off the "excess savings" and the slowing in job creation. It is truly remarkable!

Nominal retail sales soared by 0.7% in July, easily beating the 0.4% jump expected. It was the strongest monthly figure since January, when sales soared by nearly 3%. (Taylor Swift must have been touring!) More importantly, on an inflation-adjusted basis "real" retail sales rose +0.6% (the second such reading in the past three months!).

Moreover, the key "core control" metric (strips out autos, gas and building materials) feeds directly into GDP calculations and came in solid at +1.0%— double the consensus estimate after a solid 0.6% gain in June.



Under the hood, consumers did pull back on bigger-ticket items, including furniture (-2%). Who needs new furniture when no one is buying a house? Likewise, cars and auto parts dropped (-0.3%). With auto loan rates approaching 8%, who can afford a car anyway? Thanks to Prime days, Amazon saved the day as online activity (+2%) more than offset the weakness.

THIS WEEK

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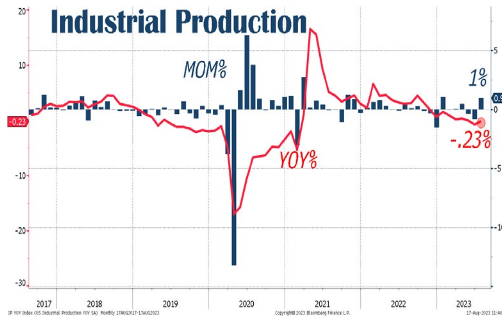
The bottom line: Even after more than a year of aggressive rate increases by the Fed, consumer spending continues to lift the economy. The big question is how much longer that will carry on.

It remains to be seen if such economic strength can continue against a host of headwinds, such as tighter credit standards, lower savings, resumption of student loan payments and the lag impact of elevated interest rates, begin to show full impact.

ANOTHER POSITIVE SURPRISE

In addition to robust retail sales, U.S. industrial production came in at an equally robust +1.0% month-over-month in July. This more than tripled the +0.3% consensus estimate. Even with the downward revision to June to -0.8% from -0.5%, this still was a solid beat.

Ditto for the key manufacturing segment. The market was looking for flat, but instead it bounced +0.5% (June was taken more negative to -0.5% from -0.3%). That said, year-over-year production is still negative.



Bottom line: The recession call is going to have to wait another quarter. Or maybe we have entered a new era where interest rates don't matter and the business cycle has been repealed.

REVVING UP?

"Strong start to consumer spending for the third quarter as the economy shifts into a faster gear rather than hit the brakes…Rapid wage increases continue to boost consumer spending power, helping to extend the expansion but also raising the specter of lingering inflation." – Ben Ayers, Senior Economist at Nationwide

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The stronger data has caused the Atlanta Fed to up its already aggressive GDP prediction for Q3 to a +5.8% annual rate (from +4.1% prior)!

This would suggest the economy is revving up – not slowing down.

Yes, but there are plenty of reasons to be skeptical. The GDPNow forecast is a running *estimate* based solely on *available* economic data. It swings around as more data points come in. Q3 is still underway, with many more economic releases to come that could influence the outlook.

Also, I should point out that the St. Louis Fed Nowcast model is at 0.46%. The Atlanta Fed model can miss so wildly that this conjures up the memory of when it was predicting a +6.2% GDP growth quarter at this same stage of the third quarter of 2021 and we ended up with +2.2%.

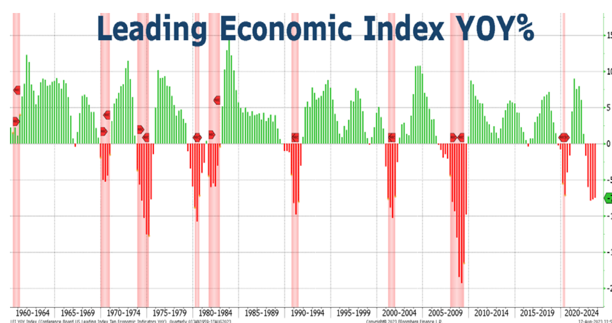
Bottom line: Think of the Atlanta GDPNow as a weather forecast. You're obviously going to have a better forecast for the weather tomorrow than three months from now. Right now, it's probably not that accurate.

SHOULD YOU FOLLOW THE LEAD?

"The U.S. LEI - which tracks where the economy is heading - fell for the sixteenth consecutive month in July, signaling the outlook remains highly uncertain."
– Justyna Zabinska-La Monica, Senior Manager, Business Cycle Indicators, at The Conference Board

The big economic news last week (that no one noticed) was the July reading of the Conference Board's leading economic indicator (LEI). The LEI continued its decline in July, dropping 0.4% month-over-month. This was the 16th straight monthly decline in the LEI (and 17th month of 18) and represents the longest streak of declines since Lehman. Only three other times in the past six decades has the leading indicator gone down at least 16 consecutive months. This happened from April 2007 to March 2008 (22 straight months of declines from June 2007 to April 2008).

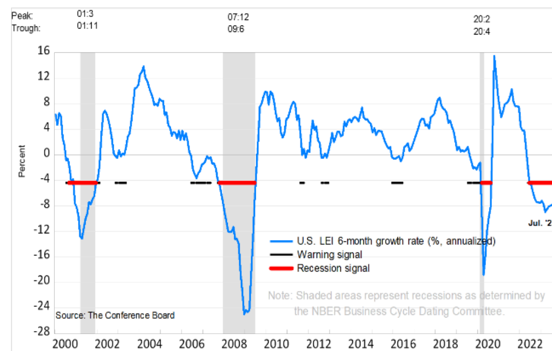
On a year-over-year basis, the LEI is down 7.5% – close to its biggest year-over-year drop since 2008 (Lehman) outside of the COVID lockdown-enforced collapse.



This is not a good sign for real GDP.

The Conference Board's leading economic indicator track record is impeccable. This index has telegraphed eight out of eight recessions since the 1970s. Folks, that is a perfect track record.

The LEI peaked in December 2021 and the average lead time back to the start of the recession is 13 months. We are now at 14 months. As shown below, the trajectory of the U.S. LEI continues to signal a recession over in the Q4 2023 to Q1 2024 timespan.



Bottom line: The reason why everyone is so jazzed up over the economy is because the coincident economic index firmed up +0.4% in July to an all-time high (Fed policy is heavily influenced by lagging and coincident indicators).

Yet at the same time, the leading indicators have retreated to their lowest level since June 2020! As noted above, the LEI has a 100% track record (eight out of eight recessions) in predicting recessions. The lags are long and variable, but the economic downturn has always followed.

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.

Will this time be different?

So, should we follow the coincident/lagging data? Should we follow every Tom, Dick and Harry economist who has thrown in the recession towel?

Or should we follow the LEI that has a perfect track record and is currently forecasting a recession?

A HAWKISH SET OF FOMC MINUTES

"The Committee remained highly attentive to inflation risks. Participants remarked on the uncertainty about the lags in the effects of monetary policy on the economy and discussed the extent to which the effects on the economy stemming from the tightening that the Committee had undertaken had already materialized."

In discussing the policy outlook, participants continued to judge that it was critical that the stance of monetary policy be sufficiently restrictive to return inflation to the Committee's 2 percent objective over time. With inflation still well above the Committee's longer-run goal and the labor market remaining tight, most participants continued to see significant upside risks to inflation, which could require further tightening of monetary policy."

- Excerpt from the Federal Open Market Committee Minutes, July 25-26, 2023

The Fed staff did exit its recession call and sees downside risks to growth, but upside risks to inflation. There were at least TEN references to upside inflation concerns.

Obviously the Fed does not believe they have won the inflation battle and seem to believe that the rate lags have worked through the system and that housing actually poses increased as opposed to decreased inflation risks. Not my view but it is their view, and they control the fed funds rate.

As I noted last week, the CPI index has had an epic decline from 9% to 3%. Clearly inflation has peaked from the cycle high and the long-term outlook looks quite favorable for those in the disinflation camp. That said, nothing moves in a straight line. While the latest CPI report was rather benign, the August data may not be so kind. The near 10% surge in gasoline costs along with a 1.3% rise in food prices (the second increase in the past four months) along with a less favorable base effect may drive the headline higher.

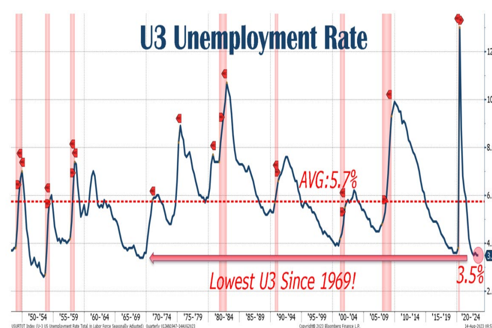
The one saving grace may well come from the dominant rental component of the CPI, with listing and property data companies showing a sharp slowing in average new apartment leases, which are actually down to just a 2% annual rate, and lease renewal rates have been sliced in half over the past year.

Bottom line: This Fed is not done until they believe inflation has been slayed.

They also are focused on the Phillip Curve and want to see more slack in the labor markets. So, Jerome and Company need to see unemployment begin to hook up on a sustainable basis. Even though the unemployment rate is a classic lagging indicator, this is what this central bank needs to see. And even with the cooling-off in job creation, increased slack has not yet emerged.

Because of the reckless government response to the pandemic, companies became separated from their workforces. In the past year, even as economic growth cooled off, this lingering fear among business owners that if they ever do lay off staff for cyclical reasons that they may never end up finding them again. Thus the scars from the pandemic means we may never get the labor market to play along with the Fed's stated intent to boost the unemployment rate from 3.5% to 4.5%.

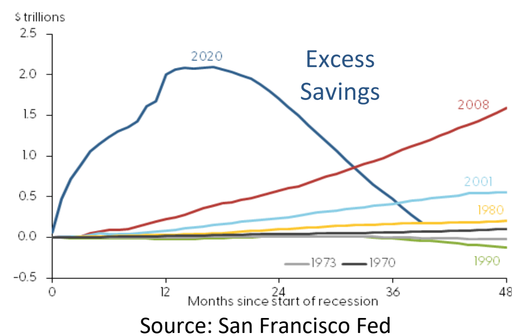
That is a problem and may be the most important reason of all for the Fed's relentless hawkish tone and its feeling that it needs to do even more on the policy tightening front – and underscored in the most recent set of FOMC minutes, a loosening up in the labor market.



ALL GONE!

"There is considerable uncertainty in the outlook, but we estimate that these excess savings are likely to be depleted during the third quarter of 2023." – San Francisco Fed

As discussed numerous times, the COVID "giveaway" has thankfully ended. According to the San Francisco Fed, the so-called "excess savings" will be depleted by the end of Q3 – so in one month.



Source: San Francisco Fed

The exhaustion of the free money will clash with the end of the student debt relief program. Student loan payments are set to resume in two weeks. This translates to an average monthly decrease of $400 in spending for 43.5 million Americans, or 13% of the population.

According to a Credit Karma survey, 68% of borrowers earning under $50,000 report they'll have to prioritize student loan payments over essential expenses like food. Additionally, half of these borrowers admit they're already finding it challenging to meet auto loan and mortgage payments. There's growing apprehension that this could significantly impact spending in the restaurant and entertainment sectors. This potentially catalyzes the 5% unemployment rate Jerome Powell is looking for.

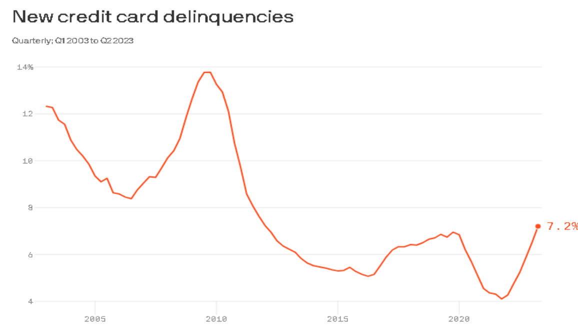
What gets glossed over is the vast majority of student loans actually are held by much higher-income people, but not necessarily people who are rich. So don't be surprised to see a significant slowdown in spending among those cohorts as a result of those resumption in payments.

Of course, graduates with advanced degrees make more money, but their student loan balances are often equal to (or even surpass) their annual median salaries.

- Doctors and dentists have between $175K-$200K in student loans and their median income is between $150K-$175K.
- Lawyers and pharmacists have between $110K-$130K in student loans and they have income in similar ranges.
- Lowly bachelor's degree holders have around $25,000 in student loans with a median income around $60,000.

So very clearly, there's a strong relationship between the amount you earn as a result of the degree you obtain and the amount of student loan debt you hold.

Even before the end of all this stimulus, households were becoming increasingly late with their credit card and auto loans. According to the New York Fed's recently released second quarter Quarterly Report on Household Debt and Credit, those becoming 30-days-plus late is now occurring at a pace that is faster than in 2019!



Source: New York Fed's Q2 Quarterly Report on Household Debt and Credit

Bottom line: You've got large cohorts of earners who fully exhausted their excess savings built up from the pandemic period and continue to struggle from a cost-of-living standpoint.

The lack of excess savings coupled with the resumption of student loan payments is likely to negatively impact consumption for the latter part of the year. The secondary impact will be rising delinquencies, higher defaults and a contractionary credit environment.

WHAT A RIDE

The Treasury market has been on a wild ride. After dropping to 0.5% in August 2020, the 10-year yield closed the week at 4.28% – the highest level since November 2007 (of note that was the last year before the arrival of QE).

To be sure, a 35-basis point back-up in the 10- year Treasury yield doesn't happen all the time. But the reasons being given are ridiculous.

There is a lot of misinformation being spread around why the bond market has sold off so much.

1) It's not an isolated event, every bond market on planet Earth has sold off.
2) It's not the federal government deficit-spending its way to happiness. There is a tsunami of longer-term Treasury securities to fund the ballooning government deficits and to increase the balance in the Treasury Department's checking account (TGA). So it would be nice to blame all of this yield spasm on the aggressive supply calendar. But what gets in the way of this weak argument is that the correlation between net Treasury issuance and the direction of the 10-year Treasury (going back to 1980) is precisely 0%.
3) It's not the Fed unloading Treasuries via its quantitative tightening (QT). So far, the Fed has reduced its holdings of Treasury securities by $723 billion from the peak in June 2022. Again, there is no correlation between QT or QE on interest rates.

4) Inflation? That's not the story. Since those tame CPI numbers came out for July, the 10-year yield has leapt 25 basis points.
5) It's not the lack of foreign buyers. The TICS data show that year-to-date, net international buying of Treasury notes and bonds has topped $400 billion, which is 13% more than a year ago and only three other times in the past has the interest been this strong. This is NOT the reason for higher bond yields this month or this year.

The reason is simple: A hawkish Fed and the market repricing the "higher for longer" narrative.

As for where the selling is coming from, the "fast money" group in the Chicago trenches. When it comes to bonds, they are loaded for bear! Hedge funds have doubled down on their short bets. CFTC data shows that the net speculative short position (on the CBOT) in the 10-year Treasury note (futures and options) totals an incredible $800 billion, which is up 20% this month alone. Rarely in the past has there been such a lopsided bet.

Bottom line: While everyone is now convinced that rates are heading to 5% and never come down again, I should remind readers that we heard the same narrative in 1981, 1989, 2006 and 2018.

I also want to remind everyone that the typical lag from the first rate hike and a recession is 22 months. Not 22 weeks, not 22 days – 22 months! The Fed began tightening in March 2022 (17 months ago, not 22). Let's see what happens in Q4.

I also caution everyone from jumping to the conclusion that Biden's industrial policy has managed to defeat the business cycle. If you recall, FDR's New Deal did not stop the Great Depression. It was World War II.

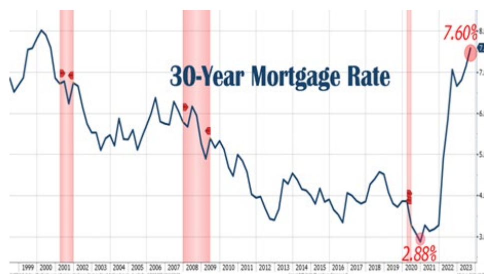
Finally, if we have moved to a "higher for longer" rate environment, higher rates mean lower asset prices. Just like lower rates meant higher asset prices all around for the past 15 years of interest rate repression.

In this scenario, Cash is King!

REAL ESTATE REELING

"The 30-year is at a critical stage…If the 30-year-fixed mortgage rate can hold at a high mark of 7.2% — and the 10-year yield holds at 4.2% — then this would be the high for mortgage rates before retreating. If it breaks this line and easily goes above 7.2%, then the mortgage rate reaches 8%."
– Lawrence Yun, chief economist at the National Association of Realtors

The U.S. housing market went through a rebound several months back as mortgage rates came down alongside a less jittery Treasury market. But with Treasury yields rising, mortgage rates have soared to a 22-year high and are fast approaching 8%.



Not surprisingly, housing has taken another leg lower. Let's hope Warren Buffett's foray into the group has a long-time horizon attached to it.

But for the here and now, mortgage applications dropped -0.8% in the week of August 11 and that came on the heels of a -3.1% slide the prior week (down now in each of the past four weeks). The year-over-year trend is super-depressed at -29.4% and the level is back to where it was 26 years ago!

The purchase subindex is also down to where it was in the mid-1990s and down nearly 27% from a year ago. It's a good thing that the private equity groups are still coming into the market and scooping up units for rental purposes. But there can be little doubt that traditional first-time buyers remain crowded out by both sky-high prices and nosebleed mortgage rate levels.

At the same time, median home prices at $410,000 are near their all-time high. Yes, there is a dearth of supply, but it can also be said that virtually no one can afford a house (except cash buyers) as home affordability remains at a four-decade low.

Consider Millennials and Zoomers now looking to buy their first home. They have seen mortgage payments double or even triple for the very same house vs. 2020.

See the table below: For the exact same house, pre-pandemic vs now, with 20% down and assuming a mortgage rate at 3.0%, the mortgage payment has risen from $1,349 per month to $3,161 today.

Case-Shiller Mortgage Rate Example

Case-Shiller $400,000 Home Pre-Pandemic now costs $572,385
Numbers assume 20% down payment

Simple Mortgage Calculator	Pre-Pandemic	Now
Mortgage Amount	$ 320,000	$ 457,908
Interest Rate	3.00 %	7.37 %
Mortgage Term (years)	30	30
Total Interest	$165,688	$680,087
Total Cost	$485,688	$1,137,995
Monthly Pymt.	$1,349	$3,161

Bottom line: It's no wonder existing home sales are in the gutter. If prices don't correct, then mortgage rates have to decline – and that will require a Treasury market rally.

In a nutshell, the current interest-rate structure is simply not sustainable. The Fed is overstaying its welcome in this tightening cycle as it did in the easing cycle in 2020 and 2021.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The Fed has achieved its inflation goal in many ways, except for the lagging data like owners' equivalent rents. Most indicators show that inflation is now under control, and we can go about our deflationary day.

However, the Fed's continued fixation on the Phillips curve raises concerns that the Fed may turn a manageable recession into something worse. To wit: if you were to base the analysis on the Phillips curve, the Fed would have to hike rates to push unemployment from the present 3.6% to roughly 5%. This translates to a potential job loss of about 2.26 million which could significantly reshape the financial flow landscape.

All eyes this week will be on Powell at Jackson Hole on Friday. Historically this event has often marked an inflection point.

In terms of portfolio strategy, for those credit unions that have excess liquidity, the most prudent approach is to continue building a risk appropriate ladder strategy of high-quality securities.

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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