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Weekly Relative Value

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WEEK OF SEPTEMBER 11, 2023

Have We Seen This Movie Before?

THIS WEEK

- EFFECTS OF MONETARY POLICY TIGHTENING
- HIGHER FOR LONGER?
- THE END OF THE BOND BULL MARKET
- SOFT LANDING?
- MARKET PORTFOLIO STRATEGY

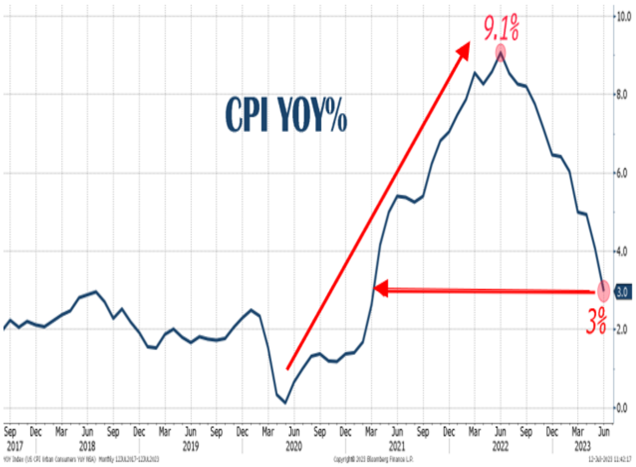
Everyone seems to believe that inflation is going to be “sticky,” interest rates will remain “higher for longer” and that the 43-year bull market in bonds is over.

I will take the contrarian side and believe that the consensus is dead wrong, and that “sticky” will end up having the same shelf life as “transitory.” Interest rates will revert lower and the bull market in bonds will continue on.

Let’s discuss “sticky” inflation:

There is no question that the supply and demand shock from the COVID-19 pandemic and the fiscal and monetary response (as well as the war in Ukraine) did indeed generate an 18-month spur of inflation, all the way to 9% from 0% in short order.

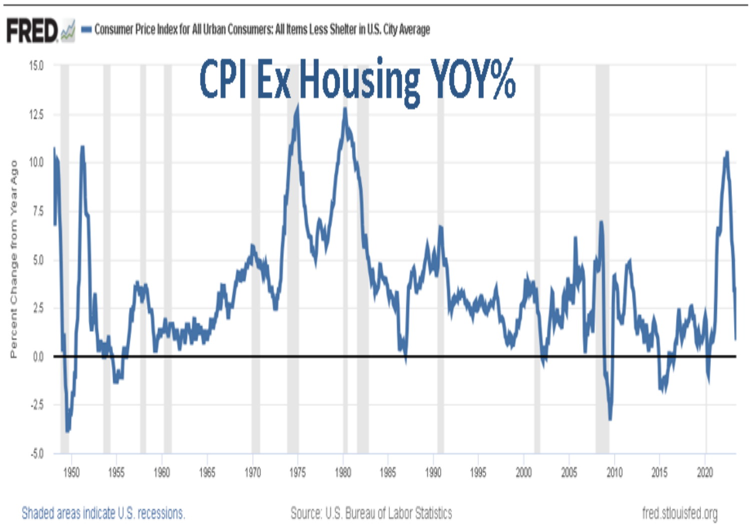
Many people have been quick to say it’s a return to the inflationary 1970s! Not so. We had one month of 9% inflation in the summer of 2022 and everyone’s brains turned to mush. In the 1970s, inflation was 9% or higher two-thirds of the time.



Now after inflation has experienced the third largest decline in the past 70 years, falling from 9% to 3%, the consensus believes we are in a new era of “sticky” inflation. They argue the “easy” part is over and getting inflation to fall from 3% to 2% will be a lot tougher than from 9% to 3%.

These bears are pointing to the elevated core rate of inflation. What they may not appreciate is that core inflation is only elevated because 40% of the index is centered in rental rates, which contains leases that were signed when the apartment sector was drum-tight two and three years ago.

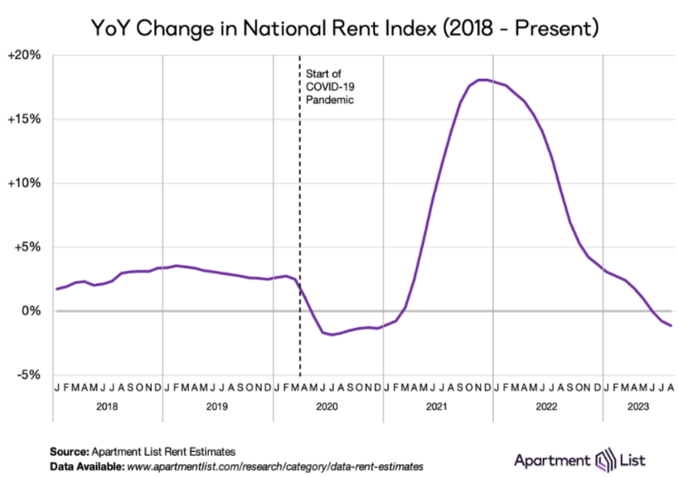
Please take a minute to review the graph below. Notice what happens to inflation once housing costs are excluded? The Consumer Price Index (CPI) has fallen to 1% on a year-over-year basis. In 2019, this metric was 2.1%!



We also know that in real-time, rents are deflating. To wit: The Apartment List National Rent Index has proven to be a strong leading indicator of the CPI housing and rent components as it captures price changes in new leases, which eventually trickle down into price changes across all leases (what the CPI measures).

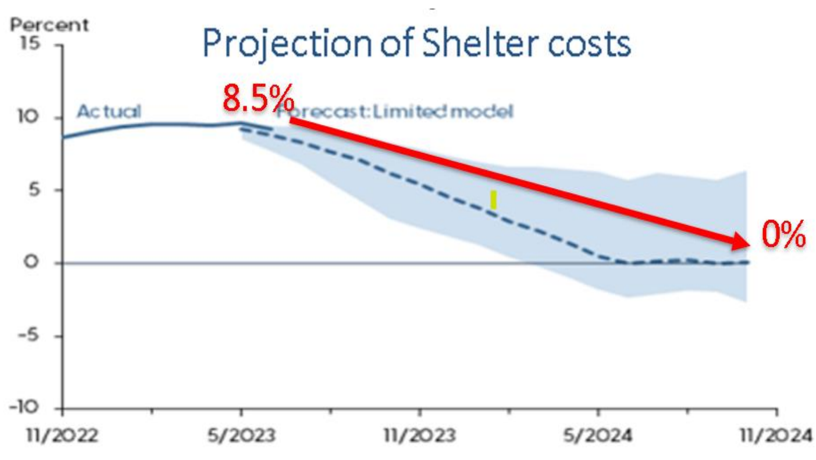
Last month, the annual rent growth turned negative (see the graph below). Today, rents are deflating -1.2% across the country compared to a year ago. This represents a huge deceleration from the pandemic highs when rent growth neared 18% nationally while soaring to over 40% in a few cities.

On a local level, for rent growth throughout the past 12 months, prices are down year-over-year in 72 of 100 cities.



Because of the lagged methodology of the Bureau of Labor Statistics (BLS) calculation, the rental components of the CPI are running at +8.7% year-over-year. But as the lagged effects of leases signed one and two years ago fall out of data, and rental components of the BLS calculation morph into reality, shelter inflation will be melting away.

However, don't take my word for it. According to the San Francisco Fed, the year-over-year shelter costs will decline to zero by November 2024.



Source: San Francisco Fed

Housing costs have the highest weighting in the headline and core CPI indices. They are key to determining where inflation goes from here. If the San Fransisco Fed is correct about housing inflation, core CPI could be well below 1% in a year's time.

Moving on, we often hear about the return of labor power. The headlines are full of big union settlements, but the fact of the matter is that a record-low 6% of the private sector workforce is unionized. This number was 25% back in the 1970s. How does one compare?

Consider the following:

*"Walmart is paying some new store workers less than it would have three months ago, a sign that employers are seeking to cut labor costs as the once-hot market for hourly staff cools. Under the new structure, most new hires will earn the lowest possible hourly wage for that store. In the past, some new hires, such as those who collect items for online orders, would have made slightly more than other new staff members, such as cashiers. Starting pay for salaried workers is falling after wages, especially for people who changed jobs, climbed in recent years**. Businesses have become more cautious in their hiring and companies are paying new recruits less than they did earlier this year."***

— "Walmart Cuts Starting Pay for Some New Hires," *The Wall Street Journal*

Moreover, the latest data on unit labor costs, the Employment Cost Index and average hourly earnings all showed a slowing in wage compensation. The unemployment rate and the labor force participation rate are both on the rise, and that should squash any notion that we are heading anywhere close to a wage-price spiral.

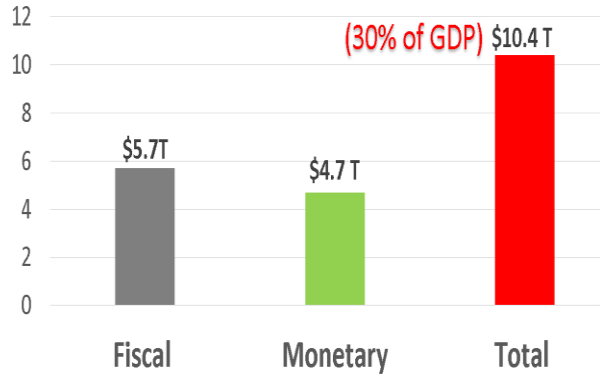
I'm also told that the aging demographics are going to lead to labor shortages and generate sustained wage inflation. If true, would the two countries with the oldest populations (Japan and China) happen to have the lowest inflation rates? Could it be that aging societies tend to spend less, which reduces aggregate demand?

We also hear about the end of globalization. Not true! It is not contracting. It's simply changing shape. To be sure, less manufacturing will be coming from China, but capacity has ended up being shifted to lower cost locales in other parts of Asia (e.g., Vietnam, Bangladesh) and Mexico.

Maybe bond investors read the article in the *New York Times*, "China Is Flooding the World with Cars." So far this year, car exports have jumped +104%, which is led by electric vehicles. Because China is exporting its deflation across the globe, export prices have deflated -5.6% year-over-year through July. And China's export prices reflect somebody else's import prices. This is a big deal!

I should also add that the long deleveraging cycle underway in China will pose a serious constraint on inflation across the planet as far as the eye can see.

Finally, there is no mistaking that the U.S. government and its partner in crime, the Fed, have been behind the surge in inflation. As shown below, the total stimulus from 2021-2022 was $10.4 trillion — that is 30% of gross domestic product (GDP). As usual, the government and the Fed once again blew it and went overboard. How could there not be inflation? The good news is that it is now in the rearview mirror.



Source: CBO

Bottom line: As the statistical impact from the rental rates fades away, inflation in the coming year is going to melt away. All of these horror stories about deglobalization and union wage demands will also fade away just as the Great Retirement did. (Now, whatever happened to that narrative?)

I remain squarely in the disinflation/deflation camp. I do not believe in new era thinking. Nor do I believe excesses are permanent. I do not believe that the business cycle has been repealed and that interest rates and credit availability are trivial for a market-driven economy. I believe in what history teaches us about what happens when central banks overtighten to correct their prior policy errors — and it does not lead to a world of inflation. Quite the contrary.

EFFECTS OF MONETARY POLICY TIGHTENING

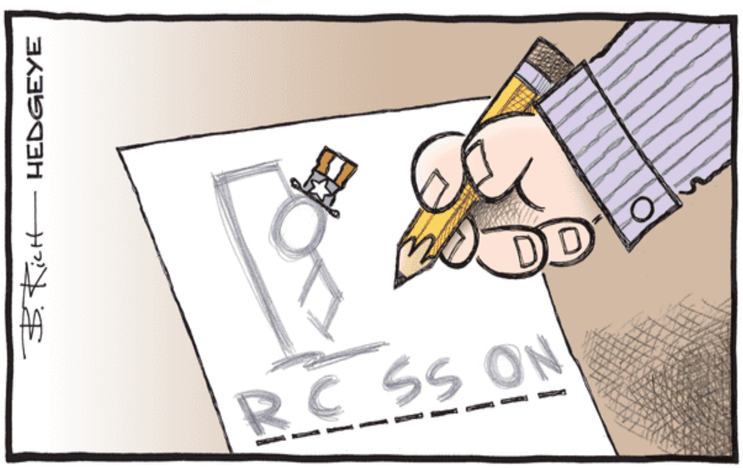
I wonder how many people have seen the just-released Chicago Fed Letter titled, "Past and Future Effects of the Recent Monetary Policy." If they haven't, they should!

The conclusion says it all.

> *"…the policy tightening that has already been implemented will exert further restraint in the quarters ahead, amounting to downward pressure of about 3 percentage points on the level of real GDP and 2.5 percentage points on the CPI level…"*

All I can say is that a 3% hit to real GDP growth, when the current run-rate is 2.5%, tells me that contraction is the next phase of this economic cycle.

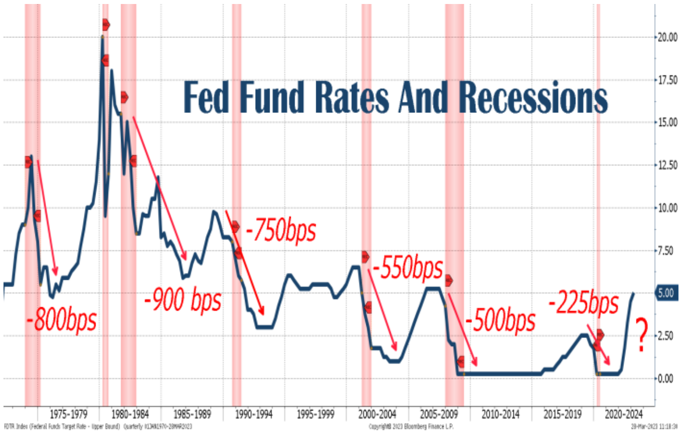
And a 2.5% drag on the CPI, at a time when inflation is running just north of 3%, signals to me a move well below 1%. This dovetails with the San Franciscos Fed's work on shelter inflation in the coming year as well.



HIGHER FOR LONGER?

The graph below shows the history of the federal funds rate. The key takeaway is when the Fed is in a hiking cycle, the fed funds rate rises fairly quickly but does not remain high for long. On average, the fed funds rate peaks and plateaus for about nine months and then the trend reverses. If there is no recession, the rate cuts are limited to 75 basis points. In a recession, the Fed cuts rates 500 basis points or more on average.

As a reminder, the economy has never escaped a recession with a Fed-induced inversion of the yield curve. Further, it is simply hard for me to fathom how the most leveraged economy of all time will be able to escape a recession this time around.



Bottom line: The Fed always over-eases and over-tightens. Wash, rinse and repeat. Every Fed rate hike cycle is followed by an easing cycle.

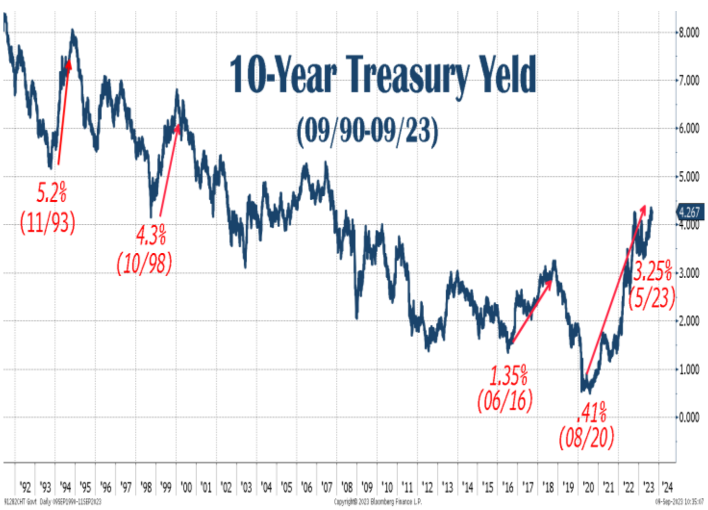
This time will not be different!

THE END OF THE BOND BULL MARKET

The bond bears have been emboldened as the 10-year Treasury yield has pierced 4%. Just like clockwork, the bears are yet again proclaiming the end of the bull market in bonds.

However, this is not new. Over the past 43 years of this great bull market cycle in bonds, there have been many pundits claiming the end of the bull market:

- **September 1993**: The gurus said the 10-year bull market in bonds was over after the 10-year Treasury yield touched a cycle low of 5.2%.
- **October 1998**: The bond bears proclaimed the 15-year bull market is over.
- **June 2016:** The consensus went wild with the view that the 30-year bull run in bonds was over.
- **April 2020:** The 10-year Treasury yield touched 0.41% and as expected we hear the same song from the same group. This time, the 40-year secular decline in rates is over! Indeed, now that the yield has risen by more than 350 basis points, the group is bolstered that they are finally right.



Here's the thing, no market moves in a straight line. Obviously, the bond market is no exception. It is cyclical and subject to spasms like every other asset class. And with the Fed implementing the tightest monetary policy since Paul Volker in the 1980s, hiccups can be violent.

And yet, now that the 10-year Treasury yield is 4.26%, the consensus crowd believes the great bull market is over! As you can glean from the graph above, the yield pierced 4% in 2010. But if you recall at that point, the business cycle was just beginning. The fed funds rate was ultra-accommodative (essentially zero percent) and the unemployment rate was at nearly 10% and on its way down.

Today, the business cycle is nearing its end. The unemployment rate, a classic lagging indicator, is at 3.8% and is likely heading higher. The fed funds rate is at the highest level in four decades. Apparently, the bond bears are concerned that we are heading back to the inflationary 1970s! And that is dead wrong!

Bottom line: The true "real rate" embedded in the 10-year Treasury note is well over 3%. Imagine what happens if inflation melts away over the next 12 months. And this is the crux of why I remain a long-term bull in the Treasury market!

SOFT LANDING?

"Every recession starts out looking like a soft landing."
— Greg Ip, Chief Economics Commentator, The Wall Street Journal

Truer words have rarely been spoken.

The media tends to look at headline numbers. They are too lazy or maybe ignorant of the fact that sometimes the "real" story is in the details.

Consider what's going on in the auto sector. I'm talking about the fact that the automakers knew that they were going to run into an aggressive United Auto Workers (UAW) during the contract negotiations and that a strike was a strong possibility.

So, they cranked out output like there was no tomorrow. Auto production surged at a +16% annualized rate in the second quarter.

Strip out that sector, and real GDP was a ho-hum +1.7% annualized growth rate, which is down from +1.9% in the first quarter, +2.4% in the fourth quarter of last year and +3.3% in third quarter.

Now, the inventory level is 33% higher than a year ago. The days' supply on dealer lots in July were up +26% year-over-year and was up +53% for trucks.

Looking at the industrial production data, which has the macro-bulls salivating; it has all been this brief spurt in motor vehicle assemblies. Excluding autos, production was flat in July and actually down at nearly a -3% annual rate. That's a soft landing?

Over the summer period, the auto sector employment managed to rise to the highest level since June 2006! And this week, there is a good chance that we will see 150,000 auto workers begin to strike. This is why most of the employment indicators, outside of the workweek, are considered either lagging or coincident at best.

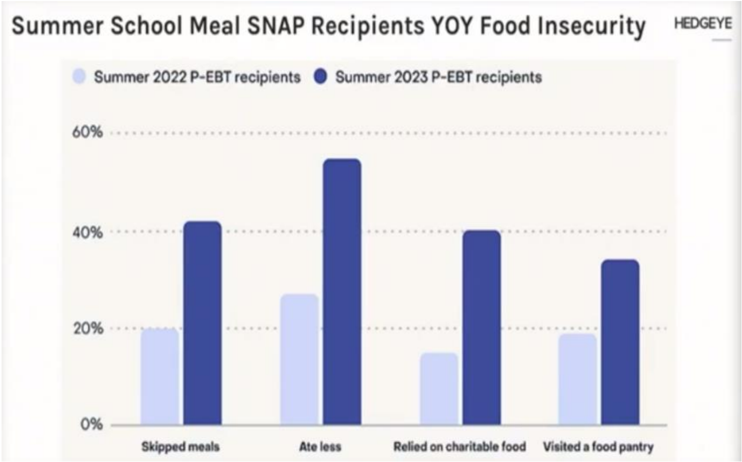
Bottom line: Imagine what happens when the support that the auto sector has given the economy over the summer shifts into reverse.

MARKET PORTFOLIO STRATEGY

"I think we've gotten monetary policy in a very good place in terms of we have a restrictive stance of policy."
— John Williams, New York Fed President

Words matter. John Williams (New York) is, after all, the second most powerful figure at the Fed! Subtle shifts in language matter. And when it comes from the #2 person at the Fed, it may as well come from the Chairman himself.

For an indication of just how bad things have gotten for many Americans, look at where people are turning for food. The elimination of SNAP benefits forced more families to visit food pantries, rely on charity or even skip meals altogether this summer. This may be the most depressing graph ever!

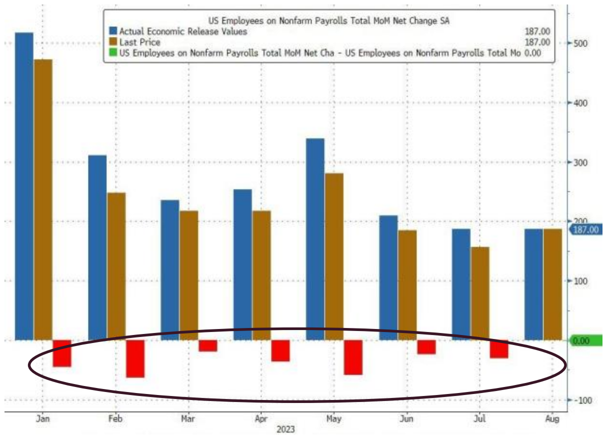


Even at McDonald's, the average price of items on the so-called "Dollar Menu" is now $2.50. Thus, Mickey D, once a bastion of cheapness, is becoming unaffordable.

Affordability will become an increasingly larger problem as more people struggle to find work. August's jobs report showed non-farm payrolls increased by 187,000 jobs last month. This is a severe drop from the average monthly gain of 271,000 over the past year.

Meanwhile, those who are paying attention will notice something even more troubling: each of the past seven monthly reports were eventually revised downward after the fact. From April 2022 to March 2023, the total non-farm employment was negatively revised by 306,000. Total private employment was -358,000.

Here's why that is troubling. The last time non-farm payroll numbers were revised lower seven months in a row was during the Great Financial Crisis.



Further, the student debt relief plan is expiring. At the end of this month, the San Francisco Fed has concluded that the “excess savings” from the massive 2021 stimulus checks will have completely run out. The risk of a government shutdown is certainly not trivial and will negatively impact GDP every week it goes on.

Additionally, the backup we have seen lately in bond yields came courtesy of the flood of supply coming from the corporate sector. This reflects that CFOs can see beyond just a window of investor appetite. It reflects that financing conditions could be at risk as the U.S. economy is about to face a barrage of “event risk” to the downside.

In the meantime, the Fed is likely underestimating the lagging impact of their tightening program in the future and has set the table for a major event in the credit markets.

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.