Weekly Relative Value

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WEEK OF OCTOBER 2, 2023

Consumer Frugality and Fragility

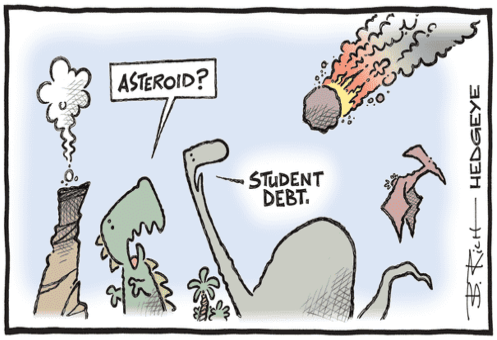
*“**Buying a home or car right now is completely unaffordable** for the typical American household because you’re mixing the higher borrowing costs with the high prices… the **typical American household would need to use 42 weeks of income to buy a new car, as of August, up from 33 weeks three years ago**. The National Association of Realtors (NAR) calculates that **the typical American family can’t afford to buy a median-priced home.”** — Mark Zandi, Chief Economist, Moody’s Analytics*

The U.S. consumer has been stronger than expected due to the following two factors:

- The lingering fiscal stimulus from direct-to-consumer payments and small-business loans handed out during the COVID-19 pandemic.
- A boom in consumer credit card usage has buoyed spending.

Now, the fiscal training wheels have been removed, and consumers have tapped out their credit cards. At the same time, there is a spreading United Auto Workers (UAW) strike. The longer this strike goes on the greater the economic damage.

That said, my primary concern remains centered on the resumption of student loan payments and the end of the pandemic-era “excess savings,” which will both have a potentially large impact on consumer spending.



While it’s true that the lower income demographic will be hit hard when payments resume this fall, they’re far from the only ones. In fact, the vast majority of student loans actually are held by much higher-income people (not necessarily “rich” people).

THIS WEEK

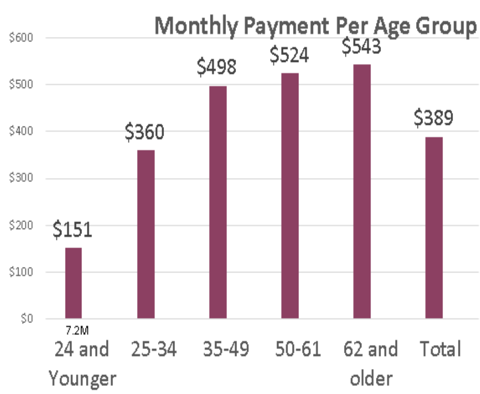
Consider the following:

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

Clearly, there's a strong relationship between the amount you earn because of the degree you obtained and the amount of student loan debt you hold.

And it's not just the recent graduates who will be impacted when student loan payments return. Anyone 25 years old or younger only holds 6.4% of student debt. Those aged 35–49 hold 39% of student debt. Even the 50+ year-olds hold 25% of it.

So, after 40 months of not paying student debt, millions of Americans will be impacted and will feel the sting of the resumption of student loan payments. In turn, this will force many Americans to divert their discretionary spending towards paying off student debt.



Source: New York Federal Reserve

Consider the following responses from a recent student loan survey by Empower:

"**50% say** they're already finding it **challenging to meet auto loan and mortgage payments.**"

"**33% expected their monthly loan payments to be $1,000 plus.**"

"**Pre-preparing for "significant" lifestyle and budget changes**, including anticipated cutbacks on dining."

Equally important, the Treasury curve is now at the highest level since just before the onset of the late-2007 Great Recession and the full impact across the economy of what the Fed has done has yet to be felt. Yes, the pain has been delayed, but it is likely not deferred indefinitely.

According to the *Wall Street Journal (WSJ)* article, *"*Americans Finally Start to Feel the Sting From the Fed's Rate Hikes*,"* the average annual cost of ownership (e.g., car prices, insurance and financing) is up more than 13% from last year to more than $12,000, or just over $1,000 a month.

And then check out what a recent *S&P Global Ratings* report had this to say about the U.S. consumer spending outlook:

"Excess household savings have been largely depleted, student-loan payments restart next month, and there's been a surge in subprime auto loan and credit card delinquencies*, especially among lower-income and younger Americans.* ***The costs of debt service and/or refinancing could be overly burdensome in this higher-for-longer environment, especially for lower-rated borrowers****."*

Bottom line: Consumer spending represents 70% of the economy and the headwinds are gathering strength as we move into the fourth quarter of 2023. I also need to stress that Fed policy tends to weigh on economies for years until something finally cracks. When you look historically, from the time of the first-rate hike by the Fed to the time the recession starts, it's typically two years. We are now in month 19. In other words, it's too soon to send an "all clear" sign that a recession has been avoided.

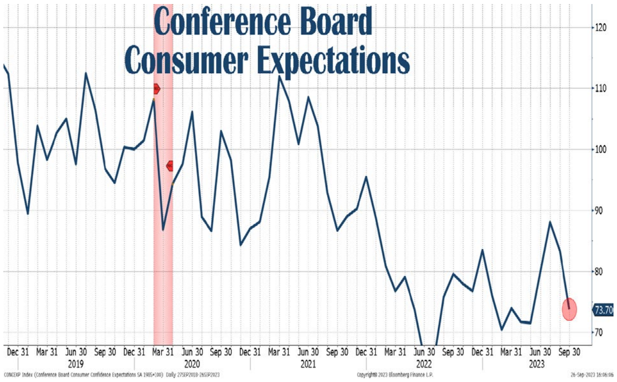
CONFIDENCE CLIPPED

"Write-in responses showed that consumers continued to be preoccupied with rising prices in general, and for groceries and gasoline in particular… Consumers also expressed concerns about the political situation and higher interest rates. ***The decline in consumer confidence was evident across all age groups, and notably among consumers with household incomes of $50,000 or more."***

— Dana Peterson, Chief Economist, The Conference Board

After reaching two-year highs in July, the Conference Board Consumer Confidence Survey has dropped for two straight months with the headline index tumbling to its lowest since May. The -11 point, two-month slide is the sharpest we have seen since September 2021.

The Expectations Index series tell us what people think is going to happen in the future. And based on the recent data, it would appear that people are not too optimistic as the Expectations Subindex for the next six months really took it hard, tumbling from 83.3 to 73.7. Readings below 80 for future expectations historically signal a recession within a year. This decline reflects waning confidence about future business conditions, job availability and incomes.



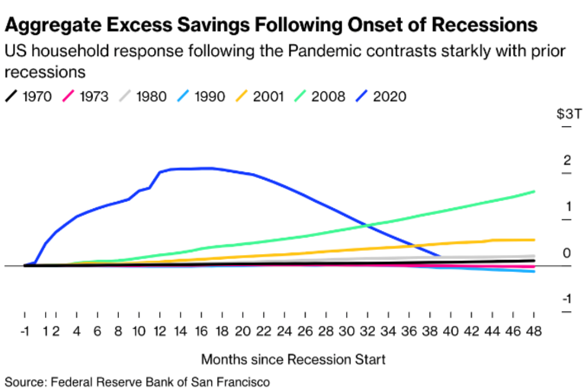
Remember, it is expectations that lead to household spending. As for spending plans, they were down across the board:

- Homes went from 6.1% to 4.9%, the lowest since July 2022.
- Appliances went from 48.0% to 46.2% in August. Washing machines, dryers, ranges, carpets, vacuum cleaners and refrigerators are all facing the knife. However, TV sets are not (which goes hand in hand with layoff expectations).
- Autos went from 12.3% in August to a three-month low of 11.0%.

Bottom line: A recession represents a pullback in spending. To conclude, the statement of "this isn't coming because it hasn't yet arrived" has become the consensus Wall Street narrative. This also is one of the most baffling things I have heard in 40+ years in this business. Here's a quick analogy: If it doesn't snow in Chicago or Boston this December, do you think meteorologists will be telling us that winter will not come this year?

PAYCHECK TO PAYCHECK

On the all-important consumer ledger, lower-income households have fully exhausted their excess savings while middle- and higher-income households are less willing to spend their excess savings on discretionary consumption. Meanwhile, soaring housing, food and childcare costs are putting pressure on households. According to a new Lending Club report, as of August, 60% of adults said they are living paycheck to paycheck.



Here's a small sampling of the reality the overwhelming majority of Americans is currently facing:

- Median family income is down -10%.
- Rising grocery prices are up +20%.
- Due to the expiration of free school lunch programs, the price index for food at employee sites and schools skyrocketed by 58%.

And Americans had this to say:

- 55% describe their financial situation as “fair” or “poor.”
- 47% say it will take a miracle to achieve retirement security.
- 50% of respondents believe their financial situation is **deteriorating.**

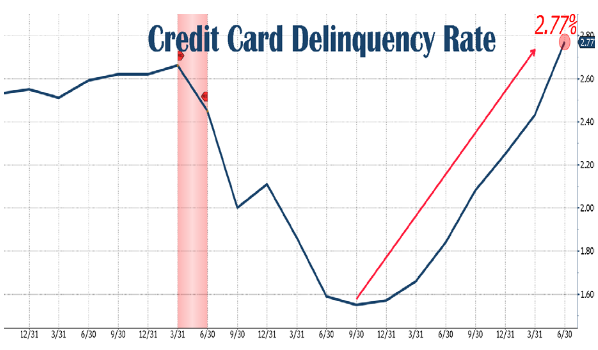
Given these challenges, how are people managing to get by? In a word, debt. Here’s what they had to say:

- Household debt has reached a record high of $17.1 trillion.
- Credit card balances exceed $1 trillion for the first time in history.
- More than 50% of credit card balances are being carried over. This is the first time roll-over balances have exceeded 50%!

At the same time, consumers are paying punitive interest rates on credit card debt and auto loan payments. The stress has become quite noticeable as delinquency rates on credit card loans have soared to 11-year highs.

And despite a “fully employed” economy, credit card losses have risen for the past 24 months to 3.63% (up 1.50% from the bottom). According to Goldman's analysis, the losses will rise at least another 1.30% from current levels (to 4.93%). This implies that we are roughly halfway through the credit loss increase cycle.

Also, while not discussed widely in the financial press, if at all , Americans filed more than 39,000 bankruptcy cases in August 2023. This is an 18% increase from the same time last year. Including businesses along with personal bankruptcy filings, there were more than 41,600 new bankruptcy cases recorded in August. This marks the thirteenth consecutive month that bankruptcy filings have shown a year-over-year increase.

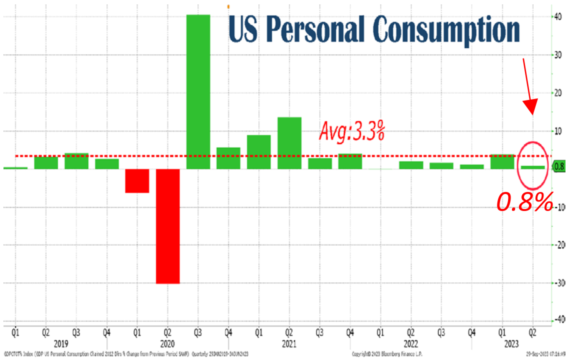


Bottom Line: The consumer is transforming from being the “strongest link” to becoming the “weakest link” in the U.S. economy.

THE LITMUS TEST

Traditionally, the second revision to the gross domestic product (GDP) data, which comes **three months** after the end of a given quarter, is a boring, subdued affair. But last week, the Bureau of Economic Analysis (BEA) released the revised GDP data, and boy was it a doozy. While the headline GDP number was as expected, the most important component to U.S. GDP, personal consumption expenditures (PCE), was **nowhere near as expected.**

In fact, the second quarter PCE printed at 0.8%, down 80% from 3.8% in the first quarter. Furthermore, the second quarter GDP consumption was not only the first sub-1% print since September 2020, but it was also the lowest consumption going back to the second quarter of 2020, the COVID-19 quarter. Suffice it to say, the consumer is running out of gas.



Additionally, we all know that when it comes to the U.S. economy, all that matters is consumer spending, which is 70% of the economy. The recent downward trend confirms that the U.S. economic growth is slowing, and that trend is likely to accelerate lower due to the following factors:

- Depleted savings
- Return of student loan payments
- UAW strike
- Oil at almost $100 and gasoline at one-year highs

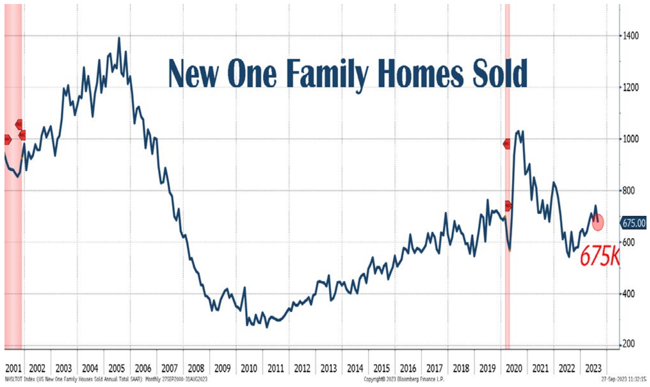
Bottom line: As the consumer goes, so goes the economy. I believe consumers will begin to slow their spending dramatically in the fourth quarter, especially with gas prices rising toward $100 per barrel. As such, the fourth quarter will be the litmus test on the vitality of the consumer and prospects for a recession in the coming months.

PRISONERS IN THEIR OWN CASTLES

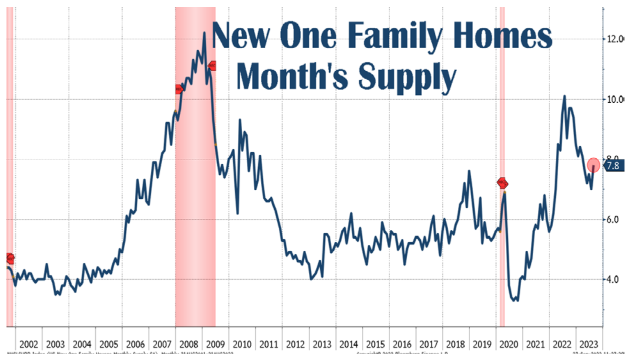
Cut the price, and they will come. Maybe not!

"Unlike the turn of the millennium, house prices today are rising alongside mortgage rates, primarily due to low inventory… These headwinds are causing both buyers and sellers to hold out for better circumstances."
— Sam Khater, Chief Economist, Freddie Mac

Despite lower prices, ample supply and large-scale mortgage-rate buydowns, the once-hot U.S. market for "new" home sales hit a wall in August. New home sales sagged -8.7% month-over-month in August to a 675,000-unit annual rate. This is the lowest level in five months and well below the activity in 2021. Thus, one of the last positive pegs for the economy has just been removed by this latest surge in mortgage rates.

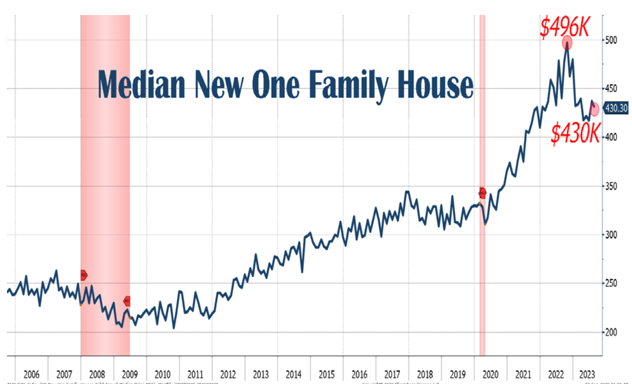


The supply backlog is starting to expand again, which is not good news at all for the homebuilder group as inventory for sale rose to 443,000 houses. At the current rate of sales, supply jumped to 7.8 months, which translates into more than ample supply. While this is not good for the builders, it's a good thing for prices, which are still way too high and would need to come down a whole lot more to make sense given mortgage rates, which are fast approaching 8%!

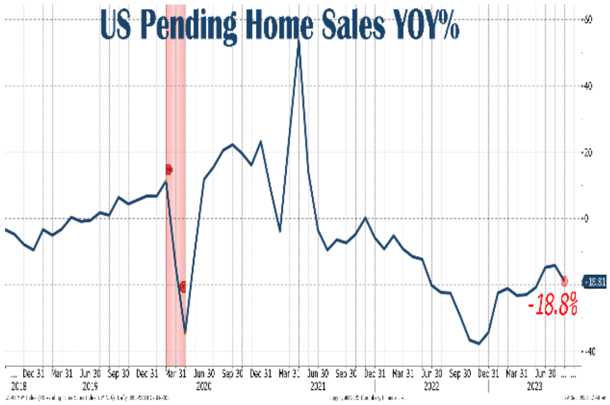


The median price of new single-family houses sold in August dipped by 1.4% from July, by 2.3% year-over-year and by 13.4% from the peak in October to $430,300, back where it had first been in November 2021. Also, to note, mortgage-rate buydowns and incentives are not included in the price.

Also of importance, the move afoot by the consumer to "get small" is reflected by the fact that the share of new homes priced for less than $300,000 has more than doubled since late 2022 to 14% from 6%.



Interestingly, last week Fed President Neel Kashkari (Minneapolis) told *CNBC* that the "neutral rate" may be higher than believed because interest-sensitive spending (e.g., autos and housing) are doing really well. The very next day, pending home sales collapsed -7.1% month-over-moth in August (consensus was -1.0%) and the level dialed all the way back to the COVID-19 low in April of 2020. The year-over-year trend pushed further into a depression to -18.8%, from -14.1% in July.

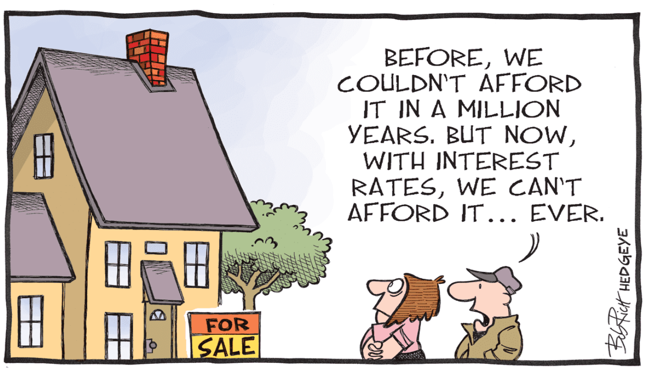


This marks the fifth disappointing print (e.g., housing starts/permits, existing home sales and the National Association of Home Builders sentiment) we have seen in recent weeks on the U.S. residential real estate sector.

Pending home sales is the gold standard leading indicator for the housing market.

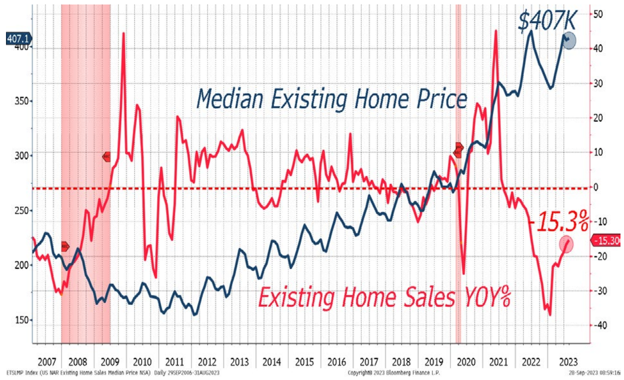
So, the fact that Neel Kashkari can utter the view that housing is doing really well is truly laughable and makes me wonder if the Fed actually knows what's going on.

Existing homes represent approximately 85% of the total residential real estate market. And as discussed last week, these sales have plunged -15.3% within the last year. Over the past two and a half years, existing-home sales are down 36% and back to a level seen in the mid-1970s.



Even though housing activity has been decimated and housing affordability is at an all-time low, it is amazing that home prices are actually inflated. Despite the most draconian tightening in Fed policy since 1981, existing home sale prices are now 4% higher than they were a year ago.

After all, price usually follows volume for the obvious reason that normally a fall-off in volume indicates weaker demand and fewer bids for available properties. But in the present case, demand is contracting, and yet, prices are firming. This attests to a sclerotic market where homes are not being listed because existing borrowers cannot move without losing their precious 3% mortgage.



Bottom line: Housing prices have not crashed, but activity definitely has. Thus, we are living through the strangest and most distorted residential real estate market of all time, where price acceleration is reflecting total lethargy as opposed to vibrancy. There isn't a "positive wealth effect" on spending from this type of home price appreciation because there is no way for homeowners to benefit from selling without getting zinged on their mortgage.

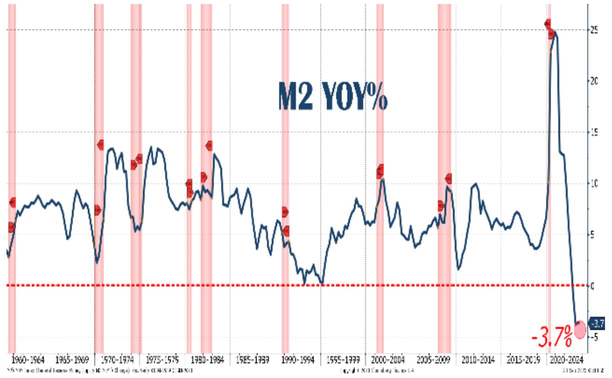
WILL THIS TIME BE DIFFERENT?

"The Fed has the chance to achieve something quite rare in the history of central banks — to defeat inflation without tanking the economy. ***If we succeed, the golden path will be studied for years. If we fail, it will also be studied for years. But let's aim to succeed."*** *— Austan Goolsbee, President, Federal Reserve Bank of Chicago*

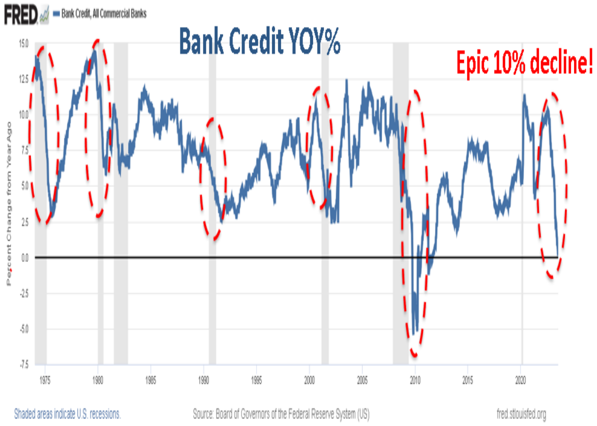
Despite the less-than-sanguine narrative above, virtually every Tom, Dick and Harry economist thinks the Fed has turned more bullish on the economy. I don't see anything but weakness in the latest rounds of "hard" data in August and "soft" survey data in September. So, I can bury my head in the sand and believe what the Wall Street cheerleaders and promoters have to say or I can rely on my own set of eyes and base my views on data metrics that have a high accuracy rate in predicting the direction of the economy.

The following charts have a 100% track record of predicting recessions.

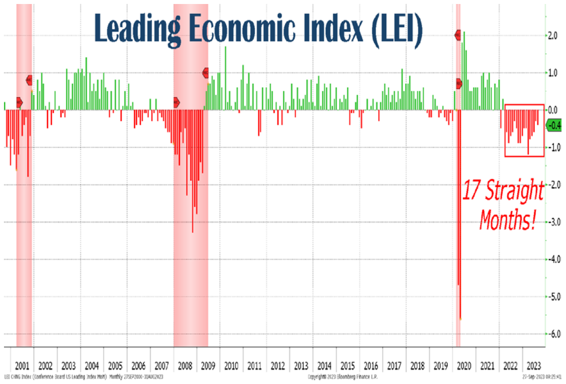
First, M2 is contracting 3.7% year-over-year. This has **never** happened before. Whenever money supply growth has plummeted, the U.S. economy has fallen prey to a recession. I should add that inflation also fell significantly.



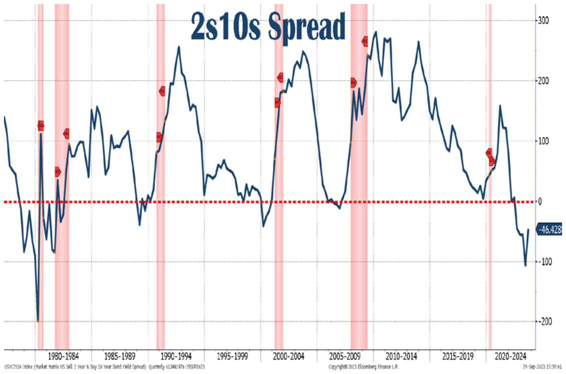
Second, as money growth is slowing, bank credit is now contracting. Since the peak in February commercial bank credit has plunged. Once robust at nearly 13%, in November 2022, year-over-year growth has dwindled by an epic 10% to 0.2% by September. As can be gleaned from the graph below, such downturns in loans typically foreshadow recessions.



Third, the venerable Conference Board's Leading Economic Index has fallen for 17 consecutive months as economic uncertainty continues to grow. This is the longest monthly decline since the Great Financial Crisis in 2007-2008. Historically, whenever this index has declined in 14 consecutive months, a recession has ensued. I repeat we are in month 17.



And lastly, yield curve inversions are the most reliable predictors of recessions. After a protracted period of inversion, the steepening phase is when a recession hits the real economy, which appears to be in the early stages.



Finally, did you know?

- Since 1954, 10 out of the 10 recessions have been preceded by rising short-term rates.

- Since 1946, 11 out of the 12 recessions have been preceded by oil price shocks.

Bottom line: While I realize most readers prefer to hear that "all is well and a recession will be avoided," the historically prescient data shown above suggests that economic growth will slow materially. Yes, I suppose "this time could be different" but the odds suggest a recession remains the clear and present danger.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I would be cautious*… I think we* ***are feeling pretty good because of all the monetary and fiscal stimulus, but it may be a little more of a sugar high****…* ***deficits can't continue forever,*** *and as policymakers continued to face this alongside an array of other serious issues — including the war in Ukraine and volatility in oil and gas markets —* ***interest rates may need to go up even more than anticipated."*** *— Jamie Dimon, CEO, Chase*

Last week, bond yields continued to chug higher. The crazy thing about this is we know the economy is getting weaker. It is in our words and actions. This is a paradox. The economy is bad and getting worse, and the bond market acts as if it is good and getting better.

That said, I have to admit surprise and disappointment that the 10-year Treasury note yield approached 4.6% last week (up an incredible +35 basis points this month alone!) on hawkish comments from Fed governors. In addition, Jamie Dimon hinted that the Fed may end up going as high as 7%.

As you can vividly see in the graph below, the last time the benchmark 10-year Treasury yield was this high was in October 2007 — two months ahead of the Great Recession. Like today, in 2006 and early 2007, people were also talking about "higher for longer." How well did that consensus narrative prove to be?

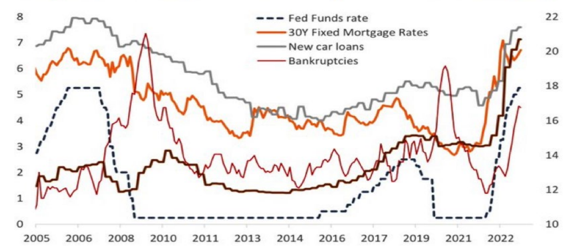
Here's the thing. The Fed gets what the Fed wants, and the Fed calling for a recession starting in the fourth quarter of this year has been wiped off the table. That is all the Federal Open Market Committee (FOMC) has to hear and see. Until their view changes, the Fed will continue to sound hawkish. This is what has undermined the Treasury market.

Despite the rising yields on the long end of the Treasury yield curve, the fed fund futures market has 16% odds priced in for a November 1 Fed rate hike and 38% odds for December 13. So, the markets still don't see another rate hike as being better than a toss-up and are calling the bluff of the more hawkish Fed officials (Jamie Dimon too), pricing in just a 4% chance that we see the fed funds rate getting as high as 5.75%-6%.

Bottom line: There are many views on whether we will get a “soft” landing or a “hard” landing. That said, the one thing I learned from my 40+ years is that there is no such thing as a “soft landing” ever. It is a unicorn. And I rarely say “this time is different” because it rarely is.

I expect tight liquidity and an end of fiscal stimulus to be reflected in the economic data sooner rather than later. I also believe that the lags from the Fed’s aggressive tightening will have consequences that will lead to a significant slowdown (whether you want to call it a recession or not is immaterial) or some sort of credit event, a shift towards disinflation/deflation and much lower bond yields even from higher levels today and over the near-term.

Figure 4: Interest rates across products have surged, and corporate bankruptcies are ticking up



Source: J.P. Morgan, Bloomberg Finance L.P., Federal Reserve.

In turn, the Fed’s hand will be forced to discard its “higher for longer” narrative and cut rates more than it currently anticipates. Use your imagination. While timing the move is next to impossible, I think 200-300 basis points would be conservative over the next 12-18 months.

Thus, over the next few quarters, bond yields could retreat from their overshoot. If so, this downward yield shock, which may come at any time, could put hedge funds (which have record shorts in 10-year futures) in a fix as underlying futures prices would rise. This would translate into increased margin requirements and potentially freezing in the market. This would be a surprise to virtually everyone thinking in terms of “higher for longer.”

Given the uncertain economic and market environment and the reasons discussed above, I continue to believe the most prudent approach to managing “excess cash reserves” over a full market cycle is to build and maintain a risk-appropriate ladder strategy.

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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