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Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF OCTOBER 10, 2023

A Unicorn

If we search the news from 2007, we can find plenty of headlines from the International Monetary Fund (IMF) and the Fed predicting a "soft landing."

October 2007: "The most likely outcome is that the economy will move forward toward a soft landing." — Janet Yellen, Former San Francisco Fed President

May 2007: "We believe the effect of the troubles in the subprime sector on the broader housing market will be limited and we do not expect significant spillovers from the subprime market to the rest of the economy or to the financial system." — Ben Bernanke, Former Federal Reserve Chairman

Today, there has been a lot of talk about whether we will get a "soft landing" or a "hard landing." Jim Bianco, President of Bianco Research, thinks we will get *no* landing. In other words, things will continue as normal, and rates will trend higher.

September 2023: "I've always thought that the soft landing was a plausible outcome... ultimately, this may be decided by factors that are outside our control at the end of the day, but I do think it's possible." — Jerome Powell, Federal Reserve Chairman

At present, things look fine. Inflation has trended lower, jobs remain plentiful and consumers keep spending. Because of the latest economic data, the Fed and the vast majority of Wall Street economists (promoters) now believe that the U.S economy will have a soft landing.

In this week's *Weekly Relative Value*, I will review the headwinds and tailwinds impacting the economy that may determine a soft landing (i.e., decrease in inflation without a significant rise in unemployment) or a hard landing (i.e., declining economic growth and sharply higher unemployment).

THIS WEEK

- LONG AND VARIABLE LAGS
- THE HEADWINDS
- THE TAILWINDS
- "STICKY" INFLATION?
- RENTS REMAIN THE KEY
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)

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LONG AND VARIABLE LAGS

“Monetary policy operates with long and variable lags.” — Milton Friedman, American Economist and Statistician

Here are some historical facts about monetary policy tightening cycles:

- Fed tightening cycles equal recessions 80% of the time.
- The average lag from the first hike to recession is 22 months; we are at month 17.
- 20% of the time when recession was avoided, the Fed did not invert the yield curve.

This means the full force of the Fed's hikes — 525 basis points since early 2022 — won't be felt until the end of this year or early 2024. Thus, it’s premature to say the economy has weathered the storm of higher rates. And the Fed may not even be done hiking yet. In their latest projections, central bankers penciled in one more rate increase.

THE HEADWINDS

“If financial conditions, which have tightened considerably in the past 90 days, remain tight, the need for us to take further action is diminished.” — San Francisco Federal Reserve

Financial Conditions: The Treasury market has become terrified by the Fed**.** Since September, the 10-year Treasury yield has shot up +60 basis points to a 16-year high of 4.7%. At the same time, inflation expectations have gone nowhere as the market resets to “higher for longer.”

As shown below, the Goldman Sachs Financal Index (FCI) has tightened by 75 basis points since the summer. Note that the 10-year Treasury yield makes up a 45% weighting of the index, whilst the fed funds rate only constitutes 4%. Thus, long end rates selling off is a far more effective way of tightening FCI.

As a reminder, 25 basis points of FCI tightening is roughly equivalent to a 25-basis-point rate hike and a 25-basis-point reduction in growth. As such, the 75-basis-point tightening that has already taken place from the summer is worth three 25-basis-point hikes and will reduce growth by 75 basis points if levels are maintained.

And it’s not just nominal interest rates that have surged. The “real” inflation adjusted five-year rate has swung higher by roughly 450 basis points over the past two years to a now punitive 2.58%. The last time real rates surged this fast was in 1981, which touched off a six-quarter recession. More recently, the 2.5% real rate was seen in advance of the Great Financial Crisis in late 2007. As depicted in the graph below, the 20-year average of the real yield of the 5-year Treasury is 0.4%.

Steepening the Yield Curve: The 3-month/10-year Treasury spread has aggressively inverted from -145 basis points to -70 basis points over the past six months. Using data going back more than six decades, the typical recession lead time in these circumstances is less than three months. That dynamic is shown in the graph below. Therefore, the empirical evidence is clear that these market moves are typically associated with future economic weakness, not strength.

Bottom Line: Over the past decade, financial markets and the economy have dealt with an average fed funds rate of 0.6%. Over the past two decades, the fed funds rate has averaged 1.8%. All in all, the sustained policy rates north of 5% are a huge shock for the economy.

"I struggle to see how the recent yield moves don't increase the risk of an accident somewhere in the financial system given the relatively abrupt end over recent quarters of a near decade and a half where the authorities did everything, they could to control yields… So, risky times."
— Jim Reid, Head of European and U.S. Credit Strategy, Deutsche Bank AG

In fact, Goldman Sachs estimates that if it is sustained the sharp tightening in financial conditions, these past few months will drain 1% from real gross domestic product (GDP) growth in the coming year. This is occurring as the wave of fiscal support fades away (all forms of fiscal stimulus these past three years have accounted for half the growth in GDP and half the employment gains).

Even the Fed must realize that it is now just a matter of when. It is not waiting until something big breaks and the central banks are then forced to scramble in the other direction, rushing to cut rates as it seeks to undo the damage of overtightening because it kept rates too low for too long in the first place until we eventually go right back to square one.

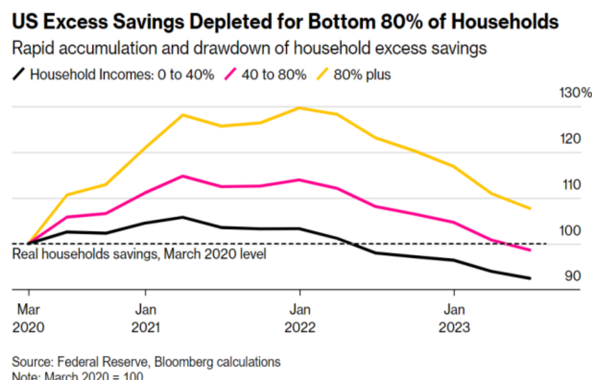
In addition to the monetary squeeze, the economy is facing the following major headwinds.

Depleted Savings: The excess savings that Americans amassed came from three rounds of fiscal stimulus during the COVID-19 pandemic, the student debt cancellation and eviction moratoriums.

From a peak in 2021, all income groups have seen their balances decline. According to the San Francisco Fed, the bottom 80% of Americans have run out of extra savings and now have less cash on hand than they did when the pandemic began.

As shown graphically below, the poorest 40% of Americans have seen an 8% drop in that period. And the next 40% — a group that roughly corresponds with the U.S. middle class — saw their cash savings drop below pre-pandemic levels in the last quarter.

Simply put: Outside the wealthiest 20% of the country, excess savings have been drained. So, what hasn't been spent is in the hands of people who prefer not to spend.



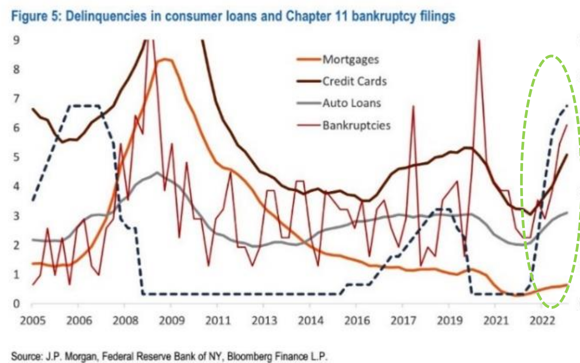
In August 2023, the personal savings rate was 3.9%, well below the pre-pandemic average of 6.9%. The long run average is closer to 8%. In other words, household spending will be constrained in the coming year due to the end of the fiscal goodies and lack of savings.

Credit Card Delinquencies: The speed at which consumers are going into credit card debt is stunning. In the second quarter of 2023, total credit card debt rose above $1 trillion for the first time ever. And now for the first time ever more than 50% of credit card carrying members are rolling their balances over (rather than paying them off) at a ridiculous 23% rate!

Auto Loan delinquencies : The total cost of buying, maintaining and financing a car/truck purchase has swelled +16% from year-ago levels. It's not so much a function of price. It is about the heavy hand of the Fed and interest rates. To wit: the average four-year new car loan rate has skyrocketed to a 14-year high of 7.5% from just over 5% a year ago!

And now look at the delinquency rates on both auto loan and credit card debt soar above pandemic-recession levels. The banks have a record $1.6 trillion of auto loans on their balance sheets on top of over $1 trillion of credit card outstandings.

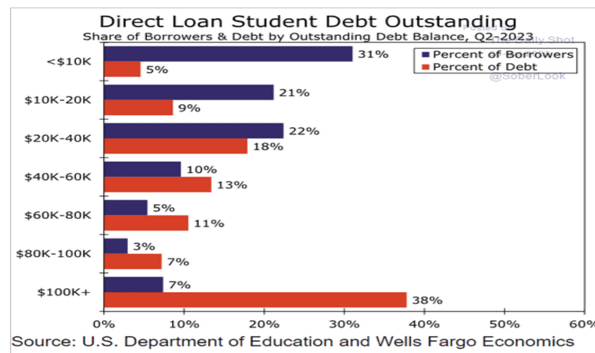
Figure 5: Delinquencies in consumer loans and Chapter 11 bankruptcy filings



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

Student Loans: Now that the three-and-a-half-year pandemic freeze has expired, millions of Americans will start paying on their student loans starting this month. The loan payments will impact virtually all age cohorts and income levels.

Today, 43.6 million borrowers have student debt with an average balance of $40,499. It's now estimated that $100 billion that was directed towards spending will now be reallocated to student-loan repayments (that alone will shave a full percentage point from consumer spending) and could shave off at least 0.3% to 0.5% from annualized growth in the fourth quarter alone.



Auto Strike: For the first time ever, the United Auto Workers (UAW) has called a walkout at America's big three auto firms. Obviously, if the strike is short, the overall impact on the economy will be low. That said, the longer the strike drags on, the more damage there will be to growth and employment. I should add that because of the auto industry's long supply chains, strikes can have an outsized domino impact on the labor market. To wit: In 1998, a 54-day strike at General Motors triggered a 150,000 drop in employment.

Small Business Bankruptcies Surge: According to the American Bankruptcy Institute, nearly 1,500 small businesses filed for Subchapter V bankruptcy this year, nearly as many as in all of 2022. The Fed can paper over bank losses on Treasuries and mortgages, but it cannot do anything about *realized losses* on bankruptcies and commercial real estate. This is where the big problems remain.

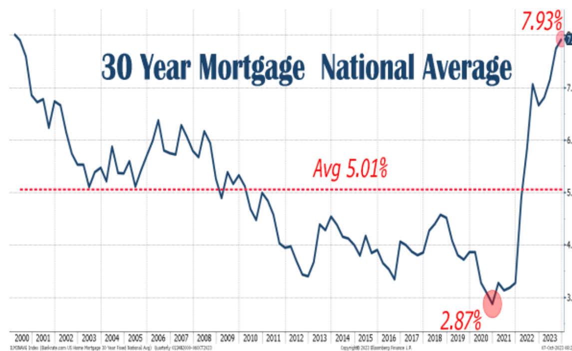
When you read the *Wall Street Journal (WSJ)* article, "Big-Company Bankruptcies Hang Over Economy," the corporate credit space is going to be in for a whole lot of pain going forward. Keep an eye on the proverbial canary in the coalmine, the CCC-rated space. The average yield has soared +130 basis points since mid-September to 14.7%, and spreads have ballooned around +100 basis points to 970 basis points.

Oil Spike: A surge in crude prices has hit every household in the pocketbook. Surging oil prices are also one of the handful of truly reliable indicators that a downturn is coming. Oil prices have climbed nearly $25 from their summer lows, pushing above $95 a barrel. Since 1946, 11 out of the 12 recessions have been preceded by oil price shocks.

Weak Housing: In the past three months, housing starts have collapsed at a -57% annual rate, resale activity has cratered at a -22% annual rate and new home sales are down at a -18% annual rate. Pending home sales are down nearly -20% from year-ago levels. Yet, there are Fed officials espousing the wonders of the housing market. I kid you not. Even despite the tumbling of sales, starts and mortgage applications.

No recession? Hopefully not but remember this: Housing is the quintessential leading indicator of the economy.

According to Bank Rate the national average on 30-Year U.S. mortgages has spiked to a mind-blowing 7.93%, which is insane when one considers that three years ago the same mortgage was less than 3%.



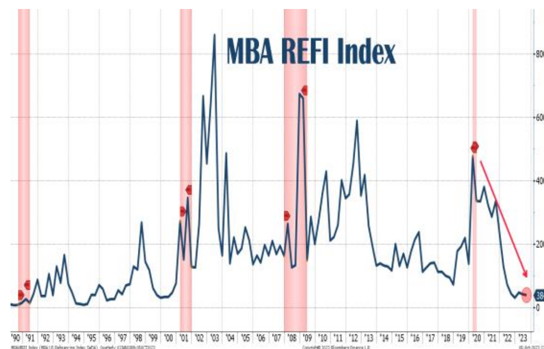
One thing is certain: Nobody, ***and I mean nobody,*** who can't afford 100% cash down, can afford to purchase a home today. The median income an American household needs to cover payments on a median-priced home has risen to an unheard of 43%.

Indeed, the latest data from the Mortgage Bankers Association (MBA) confirms this as applications for a mortgage to purchase a home fell 6% for the week and have plummeted 22% year-over-year to the lowest level in 30 years!

"Mortgage rates continued to move higher last week as markets digested the recent upswing in Treasury yields. As a result, mortgage applications ground to a halt, dropping to the lowest level since 1996."
— Joel Kan, Vice President and Deputy Chief Economist, MBA

Meanwhile, as purchases continued to sink, applications to refinance a home loan have absolutely imploded and are dropping another 7% for the week. They are now 11% lower than the same week one year ago. This is obviously due to the fact that *there is nobody, **and I mean nobody,** that hasn't managed to refinance at a lower rate in the past 23 years*.

The good news is that most mortgage borrowers dodged a bullet by locking in low rates. However, the bad news is that when the Fed does decide to cut rates, it will be "pushing on a string." There will be no significant impact from a "refi" perspective through the first 300 basis points of rate relief.



Tightening Credit: A 3% mortgage is a huge asset for the borrower. Homeowners don't and won't trade a 3% mortgage for a 7%-plus mortgage. That's why inventory remains tight, and prices are holding up.

But what is not discussed, and maybe not appreciated, is that these same 3% mortgages are a huge liability for the lender. It's not about default. In fact, defaults would actually help lenders. The problem is the mortgage itself. The banks

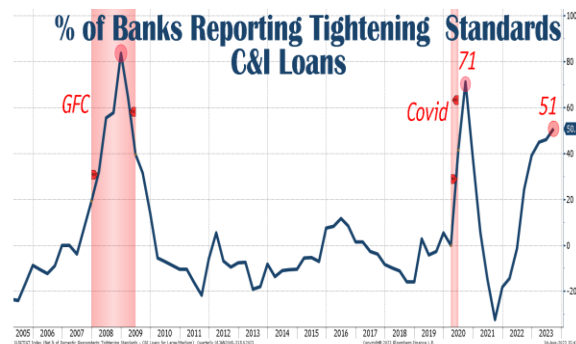
are losing money on every mortgage that's outstanding. So, even though people are still paying their mortgages, the bank is still losing as their cost of funds has risen sharply.

At the same time, banks are losing depositors. Investors want yields. They are pulling their money out of the banks and putting it in money markets with a 5.5% yield.

And due to the most recent bond yield shock banks are in the sick bay. Note: Banks are still down -22% from the nearby 2023 peaks and the regionals have collapsed -48%! The crisis was papered over by the Fed back in March, but the reality of the situation is that paper losses on U.S. bank holdings of bonds are closing in on a record-high $400 billion and higher than the level that touched off the Silicon Valley Bank (SVB) collapse just over six months ago. Keep an eye on the eye of the storm — Western Alliance Bancorp, whose share price has plunged -20% since late August.

As a result of the above , along with multiple rating downgrades, banks are downsizing and reducing both their assets and liabilities. As banks contract, lending growth will be greatly restricted as well.

One indicator that does have a good track record of anticipating downturns is the Fed's survey of senior loan officers at banks (SLOOS). The latest reading shows that about half of large and mid-sized banks are imposing tougher criteria for commercial and industrial loans. Aside from the pandemic period, that's the highest share since the 2008 financial crisis. The impact is set to be felt in the fourth quarter of this year – and when businesses can't borrow as easily, it usually leads to weaker investment and hiring.



Government Shutdown: A last-minute bipartisan deal spared Americans the drama of another government shutdown and kicked the risk from October into November. However, a shutdown may yet come back after the stop-gap spending deal lapses. If so, this could easily shave 1% off GDP growth in the fourth quarter.

Bidenomics: As everyone was focused on a potential shutdown, over the past weekend alone, the government added another $275 billion of debt! So far this year Treasury supply has swelled to an incredible $1.8 trillion, the second-highest tally on record behind the early stages of the pandemic in 2020. The Treasury market is now roughly $25 trillion in size today, which is a five-fold surge since 2008! That is a lot of supply to digest, especially at a time when the Fed's policies are encouraging investors to pile into 5.6% yielding cash.

As I have ranted on previously many times, America's balance sheet is deteriorating fast, and its income statement is an absolute disaster. Year-to-date, the federal government is running a deficit of $1.52 trillion. That's up over 50% from the comparable period last year. Never mind the fact U.S. national debt is north of $33 trillion and climbing every second!

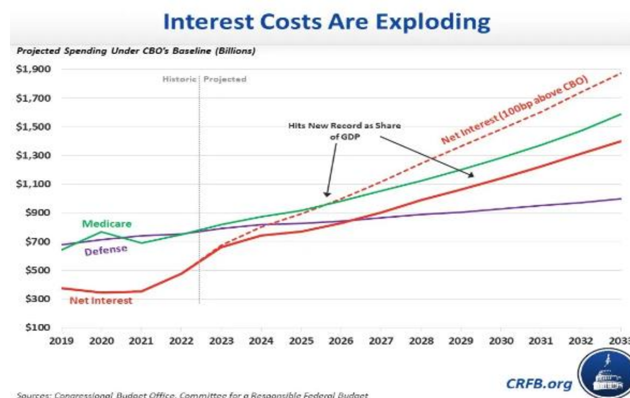
There is no doubt that reckless, rising debt has kept GDP afloat and Biden's embrace of industrial policy – which is doling out subsidies to the electric vehicle and semiconductor industries to spark higher business investment – could keep the economy growing.

During the past seven years, both the Republican and Democratic administrations issued a lot more debt (at low rates) during the pandemic. But the cost of this out-of-control spending will come back to haunt the U.S. economy in the future. As both short-term and long-term rates have surged to nearly 20-year highs, the Treasury has to refinance that at a much more damaging level, which will pressure debt and deficits significantly higher. Political dysfunction and credit rating downgrades have added to the headwinds.

As both short term and long-term rates have surged to nearly 20-year highs the Treasury has to refinance that at a much more damaging level which will pressure debt and deficits significantly higher. Thus, the cost of servicing this massive heap of government debt would exceed defense spending by 2025 and exceed the net cost of Medicare by 2026.

If rates remain at such high levels interest would reach a record share of the economy within three years, at which point it would become the second largest federal program.

Moreover, the outsized government spending ultimately "crowds out" other borrowers and in turn decreases private sector spending. This is due to the higher cost of loans and reduced income that results from the government issuance of more debt for its own spending. Thus, rising government debt and deficits means higher taxes or higher debt in the future**.**



Global Slump: The rest of the world could drag the U.S. down. China is in a structural slowdown while Germany, the largest economy in Europe, could drag the continent into recession. Along with the global slowdown, the strong dollar negatively impacts exports.

THE TAILWINDS

As the consumer goes, so goes the economy. Of course, the optimists look to the labor markets and consumer spending to support the soft-landing scenario.

Employment: A key part of the case for a hard landing rest on the view that the labor market is overheated and cooling it will require a rise in unemployment. Historically, that has been the case but thus far, the labor markets have remained surprisingly resilient as demonstrated by the most recent Job Openings and Labor Turnover Survey (JOLTS) data regarding jobless claims and September non-farm payroll reports.

To wit, last Friday, non-farm payrolls soared +336,000 in September, almost twice the consensus forecast of +170,000 — exhibiting a trend opposite of the weak ADP report. This was the strongest print since January and the gains were broadly based across industries. Unfortunately, the household survey failed to validate the super-sized payroll headline, coming in soft at +86,000.

Not just that, but full-time jobs declined -22,000 and are down three months in a row by a total of -692,000. For perspective, the last time there was such a negative string was in June 2020 when the economy was in lockdown mode. In fact, virtually every time full-time employment has fallen to this extent over the past five decades, the economy was either heading into, already in or moving out of a recession.

But these numbers are being completely ignored and likely for good reason — the Fed only looks at the headline payroll data. Full stop.

Bidenomics: The U.S. is making a huge bet on domestic manufacturing via the Creating Helpful Incentive to Produce Semiconductors (CHIPS) Act and the Inflation Reduction Act. As a result of this massive government infusion, U.S. manufacturing is gaining steam. Companies are planting roots in new and old communities, which will hopefully increase productivity and strengthen the manufacturing economy while creating high-paying jobs.

It's too early to determine but the key will be whether these transformational investments in the domestic manufacturing industry pan out as supporters hope. If all this spending and domestic industrial policy doesn't work, it could be a recipe for waste, inflation, stagnation, overcapacity, inefficient infrastructure and falling behind the technological cutting edge in areas like batteries. It could also bring costly, unreliable electricity.

Productivity: In the late 1990s, rapid productivity gains — the IT revolution — allowed the economy to outperform without the Fed having to hit the brakes too hard. Fast forward to 2023, the creative destruction sparked by the pandemic, plus the potential in artificial intelligence, might mean a fresh surge in productivity while keeping growth on track and inflation in check.

Bottom line: The past few years have provided a lesson in humility. The pandemic and Ukraine war were seismic shocks that distorted historic relationships and econometric models. Accordingly, many people have missed the mark. Thus, all of this provides good reasons for caution.

On the other hand, history and data suggest the consensus has gotten a little too complacent — just as it did before every U.S. downturn of the past four decades.

Yes, I suppose a soft landing remains possible. But is it the most likely outcome?

With the U.S. confronting the combined impact of Fed hikes, auto strikes, student loan repayments, higher oil prices and a global slowdown, I think not.

The one thing I learned from 40+ years in this business is that there has never been a soft landing when the Fed is hiking into an inverted yield curve. Never! There have been only hard landings.

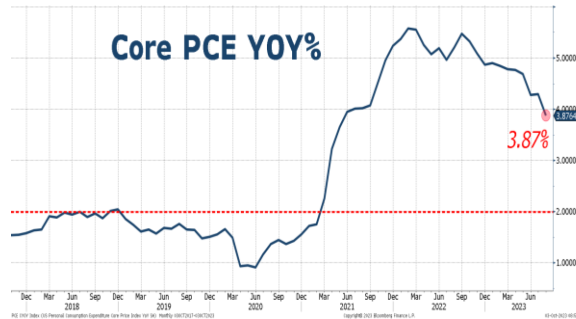
It is a unicorn.

"STICKY" INFLATION?

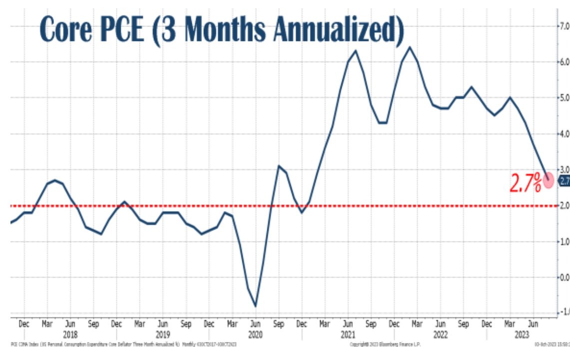
The headline personal consumption expenditures (PCE) deflator rose +0.4% month-over-month and on a 12-month basis the index ticked a bit higher to 3.5%. While energy and food costs are proving intractable, the reality is that unless the Fed finds a way to discover oil or grow food, these are not areas of the Consumer Price Index (CPI) or PCE deflator that the central bank has any control over and that is why the focus is on the "core" indices.

This week, all eyes will be on the forthcoming CPI this Thursday. The consensus forecast sees both the headline and core inflation indices dropping to 3.6% and 4.1%, respectively.

The key market-friendly report that came out about a week ago was the core PCE deflator — inching up +0.1% month-over-month in August, which was the tamest reading since November 2020 and the third straight monthly print at +0.2% or lower. Year-over- year, this price index has fallen from nearly 6% to 3.7%. While still above the Fed's target of 2%, the trend has definitely been bond-friendly.



Equally supportive of the disinflation narrative is that the three-month annualized trend has slowed for six straight months (was nearly 5% at an annual rate at the turn of the year) and now running at just a +2.2% annual rate. This is something we have not seen happen since December 2020.



And for those who still have inflation on the brain, something that is not proving to be "sticky" on the service sector front is transportation services. Have a look at this *WSJ* article, "Ship Freight Rates Tumble as U.S. Consumers Buy Fewer Good." Global freight rates are down -90% from where they were in early 2022 and reports show that ocean freight haulers are seeing an anemic peak season, dragging container shipping rates sharply lower (even with the recent bump-up in fuel costs).

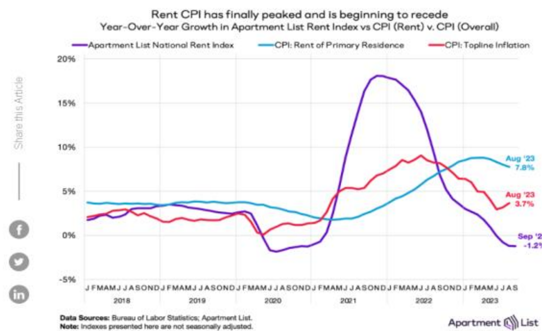
RENTS REMAIN THE KEY

As highlighted previously, shelter costs have a disproportionately high 42% weighting in the core CPI and a 20% weighting in core PCE rents, which are the key to the inflation puzzle.

Last week, the Apartment List data for September showed a -0.5% sequential decline in apartment rents. The fall-off was breathtakingly broad-based with rents deflating in 85 of the 100 cities in the survey (up from year-ago levels of 71). The year-over-year trend is now running at -1.2% — a far cry from the cycle peak of 18%!

When the lagging CPI rent components adjust to this new reality, the Bureau of Labor Statistics (BLS) data (showing rents up 8%) will converge on this deflation rate next year. If so, about 3% will be wiped off the headline inflation, and even more on the core.

This means that, ceteris paribus, inflation could be trending towards *zero* a year from now. The Fed will be forced to ease and this run-up in Treasury yields will reverse course.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

These are crazy times, my friends. The narrative is all about “sticky” inflation and the “resilient” consumer. At the same time, the core PCE deflator has slowed to a +2.7% annual rate over the past three months. Meanwhile, savings are gone, and real disposable incomes are down three months in a row at a -1.7% annual rate. So, the income recession has already begun. And it is spending that follows the trend in incomes, not the other way around. The only reason consumers have remained resilient, and spending has yet to follow suit, is because of prior fiscal stimulus and the boom in credit card usage.

The U.S. economy has received an award for its “resilience,” but this is because the massive fiscal thrust has accounted for half the +1.7% average annual GDP growth these past three years.

Despite the headwinds, or should I say gale forces, facing the consumer, Treasury yields have soared, leading to the worst bear market in bonds ever. But understand that the outsized move seen in Treasury yields this year is not based on economic fundamentals; it’s a function of the Fed.

At the beginning of the year, the “dot plots” were pointing to a funds rate of 4.1% by the end of 2024, and that has surged +100 basis points since to 5.1%. That is a big shift, and the bond market has reset to this radical change in the Fed’s rate projections. End of story. The 10-year Treasury yield has gone vertical by more than +50 basis points since the hawkish guidance provided by the central bank just two weeks ago.

Unquestionably, this has been one of the strangest economies that I have experienced. And while there are still many cross currents impacting market sentiment, I remain of the belief that there are no new eras and Mother Nature is alive and well. The business cycle has not been eliminated, interest rates do matter, and this is the year the lags from this rate hike campaign will kick in and kick in hard.

It could very well be that the recession has been delayed for a host of reasons, one of them being the lingering “excess savings” from that Biden Budget Buster in 2021 — the Energizer Bunny gift that just kept on giving. This massive and unprecedented fiscal stimulus acted as an antidote to the Fed rate hikes. But this Energizer Bunny is starting to run out of gas. No bueno. The long fiscal bridge from expansion to contraction was indeed a long one, but it’s over. Ultimately,

you will get a significant hit on consumer spending, which is going to be very, very damaging to the U.S. consumer-driven economy.

Whether one calls it a "recession" or not is immaterial. I believe we are heading into a serious economic slowdown in the fourth quarter of 2023 and into the first quarter of 2024. It will be an environment where inflation pressures continue their downward trend.

My view remains as such: Rates (bond yields) have peaked or are close to peaking; they will be much lower in 2024. Fed funds are also peaking. I see the Fed starting to cut rates as early as March and when they do, they will cut hard. As in, panic.

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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