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INVESTMENT SERVICES

Weekly Relative Value

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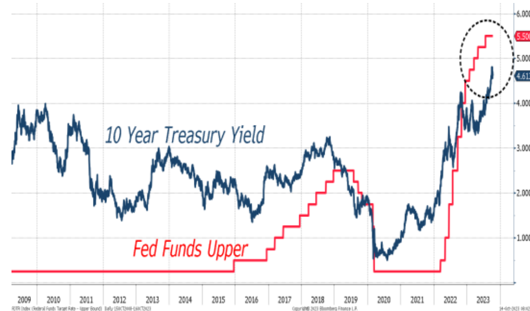
WEEK OF OCTOBER 16, 2023

Delayed, but Not Cancelled

"The question is when we enter a recession, not if. What I see with the yield curve and a lot of underlying things in the economy is that the kindling is there for a recession. What's the match?" — Matt Cole, CEO & Chief Investment Officer, Strive Asset Management

The U.S. economy has experienced an epic interest rate shock over the past 18 months. The fed funds rate has risen by 525 basis points (so far) to 5.5% and the quantitative tightening has tightened monetary policy further to approximately 7%. On the long end, the benchmark 10-year Treasury yield exploded higher by over 400 basis points to 4.61%!



With Treasury yields surging, high yield spreads widening, the dollar strengthening and stocks selling off, financial conditions have tightened significantly to the most restrictive levels since 2020.

THIS WEEK

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- DEBT DOESN'T MATTER…
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SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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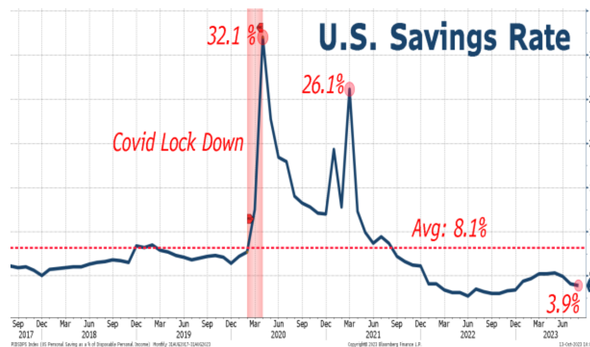
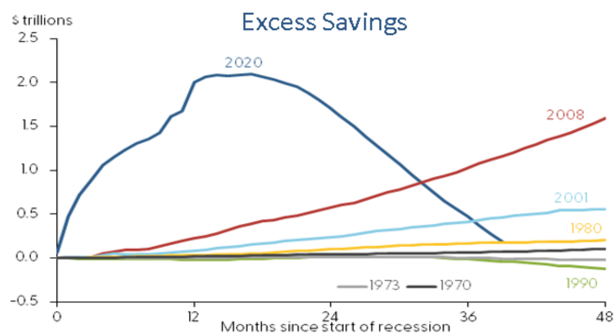
While it is widely accepted and acknowledged that monetary policy operates with lags, there is no consensus on how long the lags will be, or how powerful their ultimate effect is on the real economy. This has been especially true in the distorted post-COVID-19 pandemic cycle for the following reasons:

First, Uncle Sam spent $5 trillion in stimulus payments and a whopping $1.8 trillion in checks to households. And because of the pandemic lockdown, households were not able to consume so therefore their savings exploded. In fact, as shown below the savings rate hit a historical record of 32% in April 2020 and remained elevated in March 2021 at 26.1%. The combination of accumulated "helicopter money" and personal savings during the pandemic period provided a sustained tailwind to U.S. consumption, which has remained robust through the course of the hiking cycle.



So, households were able to escape the Fed's aggressive rate hikes due to this abnormal fiscal stimulus and pandemic savings. But the consumer has now run out of dry powder. Since 2020, the personal savings rate has been in a downtrend, standing at 3.9% in August 2023. The income accumulated through the pandemic has been absorbed by inflation, and the "excess savings" from stimulus payments are now gone, which is forecasted by the Federal Reserve Bank of San Francisco to be fully depleted by the fourth quarter of 2023. The graph below shows the trend in aggregate excess savings following the onset of recessions.

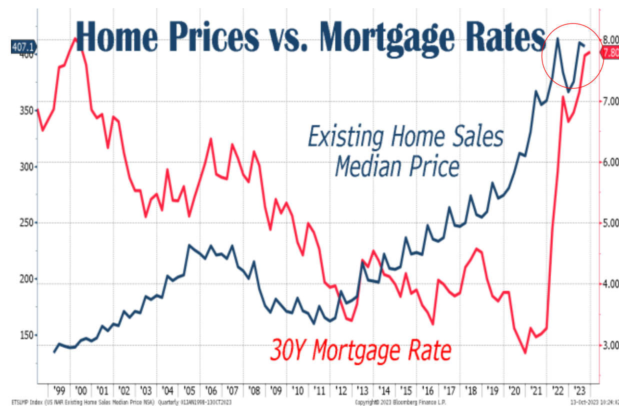


Second, the Fed slashed rates to the 0%-0.25% range in response to the pandemic and rates remained unchanged for almost two years. Historically low mortgage rates along with sharp changes in housing demand (i.e., remote work and commuting) fueled unprecedented demand for housing.

"Nobody with a 2%-3% mortgage is going to sell their house right now and get into a 7.5% mortgage. First-time buyers can't afford housing because there's so little on the market. I call it a housing black hole."
— Tracy Shuchart, Founder & CEO, Hilltower Resource Advisors

In fact, during the first three months of 2021, fixed-rate mortgage applications skyrocketed to the highest level in a decade. Also, as housing demand boomed, residential home construction rose by almost 30% from May 2020 to May 2022.

Unlike previous rate cycles, home prices have not declined despite mortgage rates doubling in 18 months. Mortgage rates went from 3.5% at the beginning of 2022 to 7.8% in October 2023. Inventory dried up as households that had locked in low mortgage rates became "prisoners in their own homes" once rates rose. Due to the lack of supply in the housing market, home prices remained resilient to rate hikes. Thus, because of these weird supply/demand dynamics, the wealth effect on personal balance sheets and its impact on consumption was not negatively impacted.



Third, like households, businesses took advantage of the historically low rates too. For example, the median corporate interest expense ratio (interest expense relative to total debt) for S&P 500 companies remained mostly unresponsive to the Fed rate hikes until 2023. That said, small companies with higher dependence on shorter-term bank loans have been more vulnerable to rate hikes compared to larger companies. Many of these small companies are experiencing increased difficulties and bankruptcies have surged.

Fourth, another boost to the all-important consumer was the moratorium on student debts. Nearly 43 million borrowers benefitted from this program, and most used the newfound headroom to increase their credit exposure according to the National Bureau of Economic Research (NBER) .

Interest accrual on student loans resumed on September 1 with the first payments coming due in October.

Student loan forgiveness created an unanticipated increase in spending, offsetting against the contractionary Fed policy. However, the three and a half year pause on student loan payments and interest accruals is in the rearview mirror. Now, many borrowers are faced with a sudden "payment shock" estimated to be around $400 per month on average.

This means some millions of Americans just had their discretionary spending budget cut by at least that amount. This comes to about $120 billion annually. If consumers incrementally spend $120 billion annually on student loan payments, it could wipe out 2.5% of the total $5 trillion in annual discretionary spending.

Furthermore, this comes at a time when U.S. consumers are increasingly feeling pressures from a variety of sources, including waning pandemic savings, rising gas prices and record-high credit card debt. Thus, with all those factors combined, it could weigh on a number of companies, especially retailers. Anecdotally, there is some indication that retailers are already feeling the effects. Macy's reported a 36% reduction in credit card sales year-on-year in the second quarter. Nordstrom also reported a similar trend.

The resumption of student loan payments will reverberate throughout the economy. Consumer spending primarily drives economic growth in the U.S. As spending shifts from buying goods and services to paying student loans, it will add to recessionary pressures. This is yet another reason to question the “soft landing” narrative. Despite all the rosy economic narratives out there, Americans are under a tremendous amount of financial stress.

Bottom line: Stimulus payments, forbearance of student loans, long-term fixed mortgages and high corporate bond issuance locking in low rates enabled consumers and businesses to sustain spending without accessing credit at higher rates. Together, this has significantly delayed the impact of monetary policy and lengthening lags.

IMMORTAL WORDS

The Fed is operating under the assumption that lags will be gentle enough to deliver a “soft landing,” even as they pursue the most aggressive tightening cycle since the 1980s. Indeed, many households and businesses have managed to “buy time” by locking in their debt. That rope is long, but not infinite.

Yes, there are plenty of reasons to think that monetary policy lags are longer than usual in this economic cycle. However, the reality is that the full effect of rate hikes has yet to be felt. Simply put, the business cycle may be delayed, but it has not been cancelled by the lags of unprecedented fiscal stimulus.

I say never forget these immortal words:

“Monetary policy works with long and variable lags.” — Milton Friedman

Interestingly, there was a fair amount of Fed officials who pivoted last week by acknowledging the tightening financial conditions and their impact on growth. They are now hinting that the tightening cycle is nearing its end. Most of the comments revolved around the effects of tightening financial conditions and the lagged impact on the economy.

Susan Collins (Boston) hinted that any further tightening hinges on the evolving data. No kidding!

On October 10, 2023, Raphael Bostic (Atlanta) chimed in with this:

“I think that our policy rate is at a sufficiently restrictive position to get inflation down to 2%. I actually don’t think we need to increase rates anymore.”

From Parker Harker (Philadelphia) we had the following:

“I believe that we are at the point where we can hold rates where they are. By doing nothing, we are still doing something. And, actually, we are doing quite a lot. I am sure policy rates are restrictive…”

And finally, Governor Christopher Waller added this:

"Financial markets are tightening up and they're going to do some of the work for us."

Indeed, Mr. Waller just take a look at what the 8% mortgage rates have done to the housing sector.

He also added**, "***we're finally getting very good inflation data."* Not just "good" but "very good!"

And for the coup-de-grace, this little ditty:

"If this continues, we're pretty much back to our target."

Then have a read of this *Financial Times* article, "Central banks still need to justify the case for 'higher for longer' rates."

"If policymakers want the market to embrace the 'long hold' narrative […] they will need to provide a credible explanation as to why rates will stay high for an extended period. Forward guidance without a rationale may not anchor rate expectations for long. That rationale may not be easy to come by ***. An extended hold at the peak of the rate cycle is arguably even more unlikely than an extended hold when rates are close to the neutral rate****."*

"It took an eye-watering surge in inflation to justify raising rates this far, this fast. On balance, it seems more likely that policymakers have over- rather than underdelivered. Many if not most policymakers appear to have been in risk management mode. ***Rates have been raised above what looks necessary given the most likely path of inflation. These "insurance hikes" provide some protection against the risk that inflation proves highly persistent — or, if you prefer, that the central banks' models are wrong."***

In other words, failing to catch the inflation up-swing, Fed officials have overcompensated on the other end.

Bottom line: Undoubtedly, the delayed impact of interest rate hikes on economic activity is longer than usual in the current tightening cycle. This is why I believe that a forceful drag on activity and prices is only just now emerging. This drag is likely strong enough to force the Fed into earlier easing than markets currently anticipate. This is a key reason of why I remain bullish on Treasuries.

DEBT DOESN'T MATTER…

Until it does…

"Deficits might matter again (they always have, frankly)…estimates interest costs of deficit could eat up >20% of tax revenue by 2032." — Liz Ann Sonders, Chief Investment Strategist, Charles Schwab

U.S. Treasury Secretary (and former Fed Head) Janet Yellen actually said she's *"very optimistic"* about the outlook for the economy. Shortly thereafter, Austan Goolsbee (Chicago) said that he does not see any clear signals that the U.S.

economy is veering off the "golden path" toward the Fed's 2% inflation goal and at the same time averting a recession, despite the recent rocket surge in long-term Treasury yields.

As I've pointed out numerous times, the most recent headline from the second quarter gross domestic product (GDP) number is highly misleading**.** Look beneath the surface. The consumption component continues to decelerate as real spending growth remains in deceleration while on a path to converge with zero growth. Meanwhile, the Government spending component has shot to the moon. In the last two quarters, on a year-over-year basis, Government spending has accelerated from 0.9% to 2.7% in the first quarter and then from 2.7% to 3.8% in the second quarter.

In dollars and cents, this means that in the past 19 days, the U.S. debt has risen by a tick over $500 billion. This means that $28 billion a day added over the 19 days (or $1.2 billion an hour) equates to $1 trillion in 45 days.

After adding $275 billion to the balance sheet (just last weekend), the U.S. federal debt now stands at a staggering $33.521 trillion and counting!

And this massive debt will come with a significant cost.

"The other thing alongside all of this is the ***interest expense*** *that the government is spending… Based on the second quarter numbers, it comes to about $10,000 per person per year in the U.S. That's just government interest expense. This whole thing is unsustainable." — Daryl Jones, Director of Research, Hedgeye*

Forever and a day, people have said that debt didn't matter. But at this point, you can't say that.

And it's not just the U.S. Government debt. When including corporate, individual, state and federal government debt, the U.S. economy is the most leveraged it has ever been. In fact, as of 2023, the total leverage in the economy is $97 trillion whereas the entire economy is currently at $22.2 trillion. Think about this: It takes $4.36 in debt for each $1 of economic growth. Importantly, the total debt has nearly doubled since 2008, when it stood at $54 trillion and the economy was at roughly $16 trillion. So, in only 13 years, the economic leverage rose from $3.38 per $1 of growth to $4.36. That massive surge in leverage was made possible by the near-zero interest rates during that period.

The table below displays the dramatic shift in benchmark interest rates compared to the average over the past ten and twenty years, which strongly implies a negative economic and/or credit cycle ahead.

Benchmark	10-year Average	20-year Average	Today
Fed Funds Rate	1.15%	1.45%	5.33%
10-Year Treasury Yield	2.27%	2.89%	4.63%
30-Year Fixed Mortgage	4.31%	4.75%	7.8%
Investment Grade Yield	3.40%	4.15%	6.30%
High Yield	6.40%	7.61%	9.19%

Given the financial system's leverage along with the restrictive financial conditions, it is highly likely that growth will slow for the following reasons:

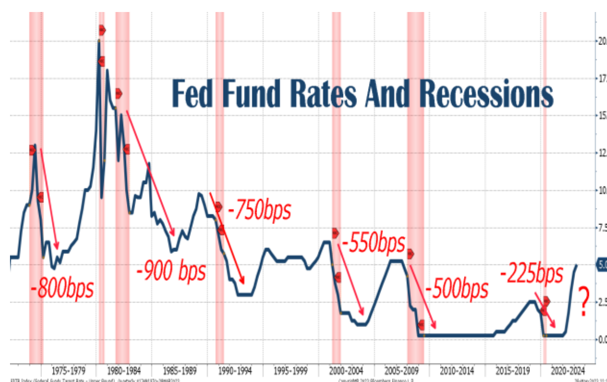
- Housing activity has collapsed. People buy payments, not houses.
- Interest payments on credit cards, auto loans and home equity loans will increase.
- Rising defaults will negatively impact banks.
- Corporate capital expenditures are dependent on low borrowing costs.
- Higher rates will reduce future productive investment.
- Higher borrowing costs will lead to lower profit margins.
- Many corporate share buyback plans and dividend payments were accomplished using cheap debt.
- The deficit/GDP ratio will soar as borrowing costs rise sharply.

Historically increases in financial conditions have always preceded recessions and crisis events. So, yes in the short term, the economy and markets can DEFY the laws of financial gravity as interest rates rise. However, as I have said before and I'll say it again, the U.S. economy is so leveraged and asset dependent that it will not be able to function on high rates for an extended period of time.

Bottom line: Simply put, just because the collision of higher borrowing costs, reduced money supply and slowing economic growth hasn't caused a crisis or recession yet, doesn't mean it won't.

In other words, the "higher for longer" narrative is a false narrative. Also, consider that it is always "higher for longer" after the Fed completes a tightening cycle. The central bank seems to want to convince us all that this is a brilliant new strategy. But here's the rub: Going back the last three decades, the average lag from the last hike to the first cut is ten months. Is that "higher for longer" enough for everyone?

And there's also nothing new in that the fact that rates are cyclical as is the economy. And in recessions, the fed funds rate inevitably gets sliced 500 basis points before the cycle low is turned in. Full stop.



RATES ARE NOT BEHAVING!

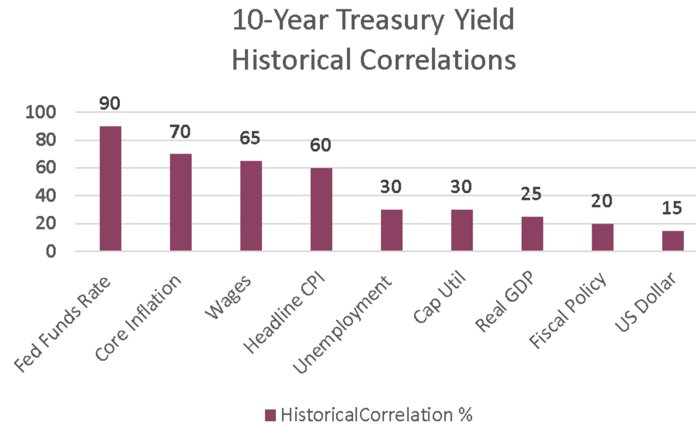
Undoubtedly, the past 12-18 months have been very challenging and frustrating for those who remain long term bond bulls (me included). The cartoon below sums it up nicely.

Long-term rates have risen sharply from the all-time lows in 2020. The rise has been steady with virtually no reprieve. As shown below, the 10-year Treasury has jumped by 130 basis points since April 2023.

Likewise, intermediate yields have followed suit with the 5-year Treasury jumping 130 basis points!

Many pundits have made the point that the upward move is about fiscal policy and quantitative tightening. Yes, the booming issuance along with quantitative tightening has not helped the bond market, but there have been fiscal expansions before without such a huge bond yield backup.

So, what has changed in recent months and in the past year-and a-half? The backup is primarily due to the long arm of the Fed. As shown below, the fed funds rate is the one variable that has the largest correlation to the direction of Treasury yields. Nothing else comes close!

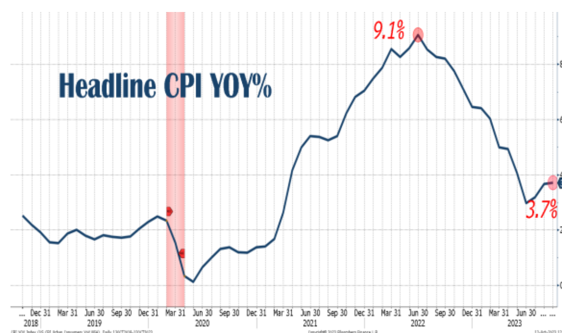


Bottom line: There has been a steady diet of Powell shifts in terms of where the policy rate is going. Remember, there was a time, at the end of 2021, when the Fed was telling us that the funds rate was going to be 1.0% by the end of 2024 — and now the dot-plot is at 5.1%. And then at the beginning of this 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.

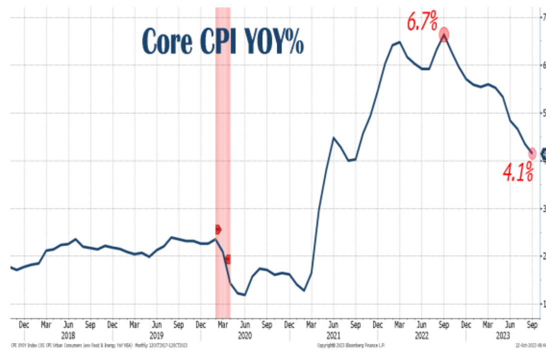
MUDDYING THE WATERS

"The report was almost exactly in line with expectations. The economy is on track for a year-over-year headline Consumer Price Index (CPI) being 2% or less in the fourth quarter of next year. This is one year ahead of the Fed's target." — Charles Schwab

The headline September CPI came in above expectations at +0.4% month-over-month, against consensus of +0.3%. However, it is still slowing from August's +0.6% print. Year-over-year, headline CPI accelerated to 3.70%, which is the third year-over-year acceleration in a row after it had accelerated to 3.67% in August, to 3.18% in July and from 2.97% in June. Even still, it is dramatically lower than peak inflation at 9.1%



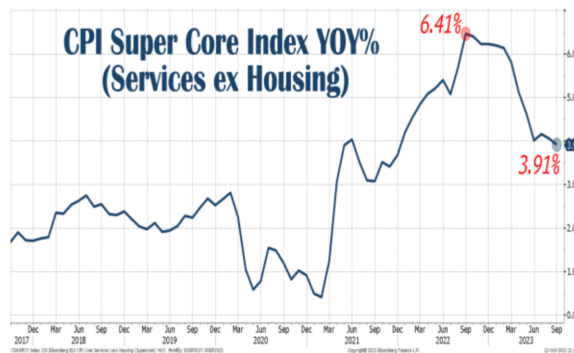
The core CPI (excluding food and energy) rose by just 0.1% month-over-month and is now running at +4.1% year-over-year (from 4.3% in August), a fresh low since October 2021.



The shelter index increased .7% over the last year, accounting for over 70% of the total increase in all items (excluding food and energy). I have to chalk this up to the CPI methodology, which has been slow to capture underlying adjustments. However, its heavy weight of rents in the index (35% of headline, 44% of core) is impeding overall normalization.

Meanwhile, real-time rent indicators are in freefall. To wit: Apartment List's September rent drop was the biggest on record. September's 0.5% decline puts us squarely in the rental market's slow season and keeps year-over-year rent growth at a low -1.2%.

As apartment demand wanes throughout the remainder of the year, and apartment supply improves through a strong construction pipeline, I continue to believe that rental costs will remain in a downward trajectory and will keep annual rent growth in negative territory for several months to come.



The "super" core CPI index (services excluding housing) rose 0.7% for the month — the largest monthly gain in a year. The Fed pays close attention to this index to mark its progress in squeezing out the final leg of disinflation toward the target.

The underlying driver of the increase appears to be a pop in medical care service prices, which has swung from -0.4% month-over-month in July to +0.3% month-over-month in September. There may be some seasonality at play, but this bears close watching over the next few months.

Bottom line: Overall, there is nothing here that will convince Fed officials to hike rates at the next Federal Open Market Committee (FOMC) meeting. The overall trend in annual prices is encouraging, and certain core measures look benign. That said, the CPI print was a bit of a disappointment to a steady disinflationary path. Moreover, the so called "sticky core services" will be highlighted by the hawks, which will keep additional rate hikes in play.

LOOK AT THIS CHART

Break-even inflation is the difference between the nominal yield on the 2-year Treasury and the real yield. If the breakeven rate is negative, it suggests traders are betting the economy may face deflation in the near future.

The two-year market-based inflation expectations have compressed sharply from the cycle peak of 4.9% in March 2022 (as the Fed started its tightening campaign), the nearby high of 3.4% in March 2023 and currently to 1.96%. Jerome, please rent yourself a Bloomberg terminal.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"The law of supply and demand has been eradicated. We have these narratives, and they all end with the consumers being strong**. Which is hooey! The consumer is not strong**. The consumer has one by one-by-one lost pillars of support from Uncle Sam." — Danielle DiMartino Booth, CEO & Chief Strategist, QI Research*

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 kick in, and kick in hard.

*"Obviously, nobody in our audience or elsewhere has ever heard of a central bank or government telling citizens, 'Dear friends, there's going to be a phenomenal crisis.' Of course, they're not going to say that. **The reason they talk about a soft landing is because it's much more palatable than to say, 'Dear friends, we overdid it with money supply in 2020-2021. We went through massive excesses. In order to bring down inflation, you the private sector – consumers, families and businesses – will have to see a significant contraction."***
— Daniel Lacalle, Chief Economist, Tressis

Despite the headwinds or should I say gale forces facing the consumer, Treasury yields have soared, which has led 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.

To end this weekly missive, let me present the following from Barron's. (I swear I could have written this!)

"In short, although ***much ink has been devoted to concerns that U.S. yields will rise inexorably, the more likely path is one of falling yields driven lower by weaker U.S. growth and lower inflation****. And there is neither precedent nor much logic to support the notion that the U.S. fiscal position will undermine the Treasury market. The* ***factors likely to produce falling bond yields — above all weaker economic activity — are likely to disappoint rosy expectations for a 'soft landing' and stronger corporate profits now discounted into equity valuations.***

So, if — as we expect — bond yields crest soon and thereafter decline, then Treasury holders will benefit*. The same may not be true for equity investors. After all, stock markets do not necessarily rise when bond yields fall if the reason for lower interest rates is weaker growth and flagging corporate profits.*

In sum, stock and bond markets have had a rough couple of months. But equity investors still have more to fear. Weaker growth and falling inflation may not help them out. ***Bondholders, on the other hand, should hold their nerve. Today's elevated yields represent more opportunity than risk."***

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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