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INVESTMENT SERVICES

Weekly Relative Value

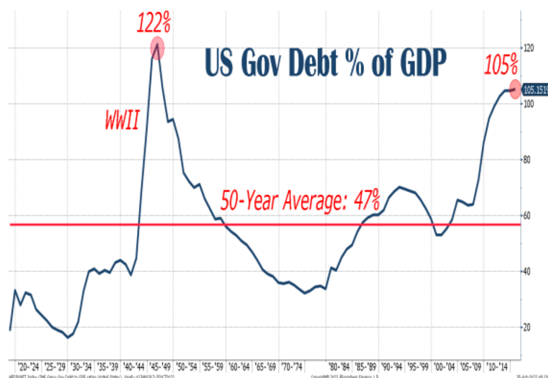
Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF OCTOBER 30, 2023

As Hot As It Gets

The U.S. added $600 billion in debt in one month, which is a staggering surge in debt that has only been matched by extreme crises. For the fiscal year, the September total debt rose by $2 trillion to $26 trillion at the end of 2023.

As a share of gross domestic product (GDP), debt rose to **105% of GDP** at the end of the 2023 fiscal year, which is more than twice the 50-year historical average of 47% of GDP. The only time debt as a percentage of GDP was higher was just after World War II.



More importantly, as spending is rising twice as fast as revenue, Uncle Sam is now running a $1.7 trillion deficit (roughly 8% of GDP). Making matters worse, the deficit does not appear to be an aberration. One-time revenue windfalls in 2022 – driven largely by capital gains and inflation – are behind us.

In the past, deficits of this magnitude only materialized during significant downturns like the bursting of the dot-com bubble, the 2008 Great Financial Crisis and the COVID-19 pandemic. It is unprecedented to have deficits of this magnitude with the economy and employment being relatively strong.

One can only imagine where the deficit goes when the Fed's aggressive interest rate increases tip the economy over. Past economic downturns typically have increased the deficit/GDP ratio by 8%-10%. So, should the economy move into recession in 2024, the U.S. could be looking at deficits as high as 10%-12% of GDP (around $5 trillion, if the economy slows dramatically).

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SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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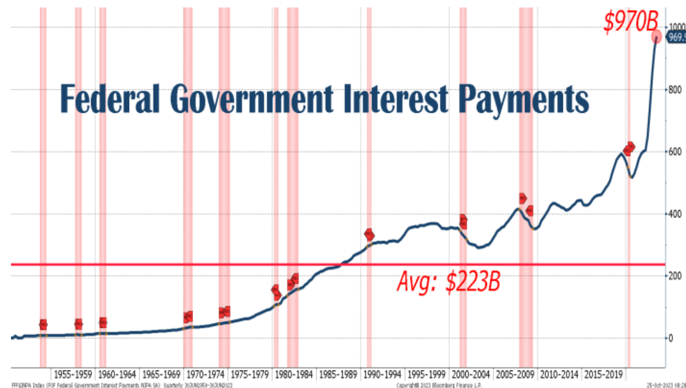
Meanwhile, the Fed's rapid increase of interest rates (i.e., taking the fed funds rate from 0.25% in 2021 to 5.25% today) and elimination of quantitative easing (i.e., the Fed buying Treasury bonds) has impacted the supply and demand for U.S. Treasuries.

The current debt balance of $33.5 trillion, combined with 16-year highs in interest rates, have caused interest payments to soar over the past two years. As shown below, interest expense has ballooned from roughly $600 billion (pre-pandemic) to nearly $1 trillion today. This is five times higher than the 50-year average of $223 billion.



Currently, the interest expense on the federal debt now exceeds the annual national defense spending of $816 billion as well as every other category except for Social Security and Medicare. The interest expense will likely worsen in the future as low-yielding older debt matures and is replaced by higher yielding securities.

"In less than four years, total U.S. debt will be north of $40 trillion. At 3% interest that is $1.2 trillion a year of interest payments, and at 4% that would be $1.6 trillion." — John Mauldin, Co-Founder, Mauldin Economics

Bottom line: On a year-over-year basis, government spending accelerated from 0.9% to 2.7% in the first quarter and then from 2.7% to 3.8% in the second quarter. The U.S. government will spend whatever it takes to delay an economic recession, at great costs in the months and years to come. So, there was no recession in 2023 because the U.S. government bought the numbers.

Thus, the U.S. government continues to issue more and more debt to kick their financial problems further down the road (with added interest tacked on). But this massive splurge in debt doesn't come free. The bill will come due and when it does, the signs of a slowdown that became apparent in late October will just be the beginning.

SWIFTIES AND BARBENHEIMER

"Compared to the second quarter, the acceleration in GDP in the third quarter primarily reflected accelerations in consumer spending, inventory investment, and federal government spending and upturns in exports and housing investment. These movements were partly offset by a downturn in business investment and a deceleration in state and local government spending. Imports turned up." — U.S. Bureau of Economic Analysis (BEA)

U.S. GDP rose to an outlandishly high 4.9% in the third quarter, which is up more than double from 2.1% in the second quarter and the highest since the second quarter of 2021. The surge was driven by a sharp rebound in personal

consumption, which surged from 0.8% in the second quarter to 4.0% annualized in the third quarter — this was also at the same time when government spending was up 4.6%.

Services were the bigger component of consumer spending, contributing 1.62% to the 4.9% growth pace. This is the strongest since the third quarter of 2021 when "revenge" spending after the reopening was the theme.

"This time around, the Taylor Swift concert effect as well as the Barbie and Oppenheimer movies played a role."
— Bloomberg Economics

Bottom line: In addition to the $2 trillion deficit spending spree in 2023, the third quarter red-hot GDP spasm was primarily due to a frenzy of consumer spending on entertainment this summer. Think "Swifties and Barbenheimer." These were one-off events that suggest this level of growth is a blip and not sustainable.

SPENDING MORE SAVING LESS

*"People have less in the bank than they did pre-pandemic, at a point where the bank is finally paying you to have money in the bank…**But instead, people are spending it. Why? Because we're Americans, and we spend."***
— Keith McCullough, CEO, Hedgeye Risk Management, LLC

As noted, consumer spending was the main driver of a summer growth surge, but Americans can't keep borrowing and drawing down their savings forever. To wit: The personal savings rate has now dropped to 3.4%, down from 4%. With the exception of a couple of months last year, this is the lowest savings rate since 2008. Prior to the pandemic, the personal savings rate was running at 7%-8%. In other words, the consumer has little left in the tank to draw from.

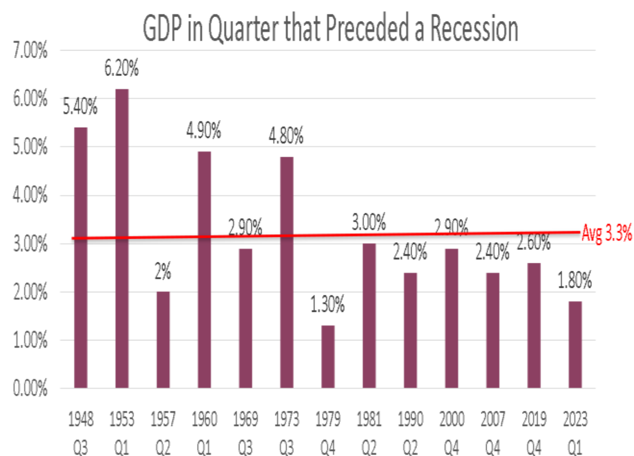
Bottom line: The hot print for the third quarter has been widely predicted for a couple of months and was not a major surprise. But savings are finite and being exhausted at a rapid rate, which provides further evidence that consumers are currently living beyond their means.

Moreover, relying on credit cards to maintain spending is not sustainable. Indeed, financial stresses are on the rise as average interest rates and delinquencies are already ticking higher, particularly for subprime borrowers and those on the lower end of the income spectrum.

The third quarter GDP report is as hot as it gets and represents the peak of the consumer-fueled "mini-boom." As such, I expect a sharp pullback in growth in the fourth quarter and beyond as consumers are forced to cut back.

A BOOM BEFORE STORM?

While the third quarter GDP report was strong, I should add that it's not unusual for the economy to have one blow out GDP number right before the downturn occurs. The graph below tells the story. Each of the bars in the graph below shows the economy's growth rate immediately before the onset of a recession. On average, the GDP in the quarter that preceded a recession was 3.3%. In seven of the last 10 recessions, real GDP growth was running at 2% or above. Call it the boom before the storm.



Bottom line: One cannot look at current or lagging data to tell you where the economy is headed. In fact, the most dangerous thing anyone can do is extrapolate this sudden and unsustainable growth spasm in the third quarter. This is why it is premature to call off a recession as we move into year-end and next year.

A DAY LATE AND A DOLLAR SHORT

"In the latest quarterly survey by the Wall Street Journal, business and academic economists lowered the probability of a recession within the next year, from 54% on average in July to a more optimistic 48%. ***That is the first time they have put the probability below 50% since the middle of last year."***

— Survey of Wall Street Economists, the Wall Street Journal (WSJ)

The Federal Reserve also suggests the same. Following the September Federal Open Market Committee (FOMC) meeting, the Federal Reserve reiterated its "higher for longer" mantra and upgraded its economic forecast to include a "no recession" scenario.

The Fed's projections are always initially overly optimistic and guided lower to reality. The *WSJ* economists are seemingly confident in their expectation of "no recession."

This is the problem. The Fed, as well as Wall Street economists, have a horrible track record. Actually, the word is "abysmal." Regarding the Fed, the so-called Fed dot plot has yet to be accurate in over 12 years. Also, the Fed has historically had a huge bias towards being overly optimistic.

Consider the following quotes from the former Federal Reserve Chairs**:**

July 25, 1990: *"We clearly have a sluggish economy, but the chances of a recession were low." —Alan Greenspan*

The recession started that month!

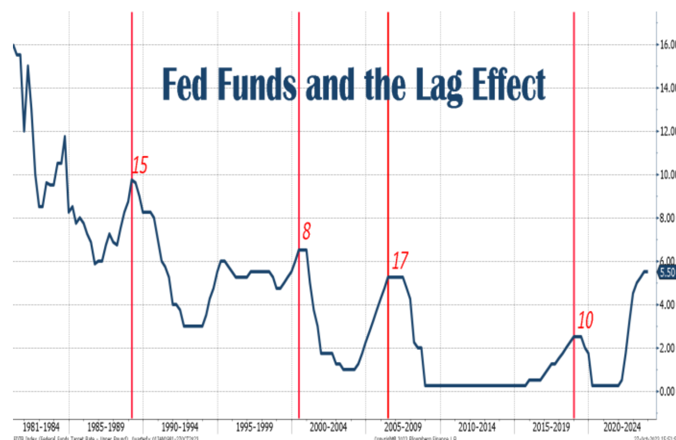
February 13, 2001: *"At the moment, we are not (in a recession)." — Alan Greenspan*

The recession started the very next month!

November 8, 2007: *"Our assessment is for slower growth, but positive growth, going into next year." — Ben Bernanke*

The recession started the very next month!

Furthermore, as has been discussed many times in this space, tighter monetary policy's "lag effect" is still working through the system. To wit: The average lag from the first hike to a recession is 22 months (we are at month 18). And the average delay between the final rate increase and a recession is 11 months (the last hike was in July 2023). We are not out of the woods yet.

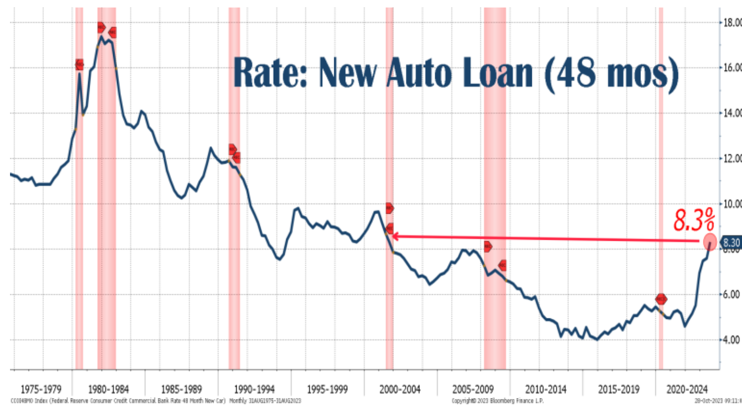


Bottom line: Today, the Fed and the majority of Wall Street economists now believe that a recession will be avoided. The problem with that optimism is that it is entirely based on lagging economic data, which is subject to relatively large negative revisions in the future. Meanwhile, they are seemingly ignoring early recessionary warnings including the Leading Economic Index (LEI), inverted yield curve, monetary supply and velocity.

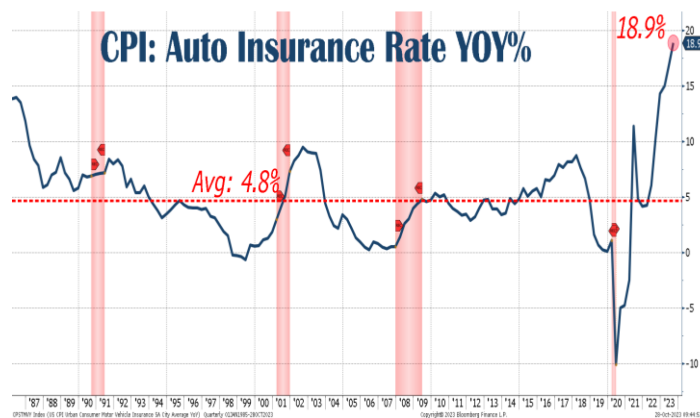
This is why the Fed and economists are always a day late and a dollar short.

AUTO UPDATE

Tighter lending standards and rising interest rates offer no relief to the auto industry. The average interest rate on a new car auto loan currently stands at 8.3%, with used car financing typically 2%-3% higher. As shown below, the last time auto loans were this high was in 2000. But back in 2000, the average new auto price was approximately $22,000. Today, the average new auto price is approaching a whopping $50,000.



Making matters worse, it's not just high finance rates and skyrocketing auto prices, it's also rising auto insurance costs. On a year-over-year basis, the cost of insuring your favorite wheels has risen 19%! Since the start of the pandemic, auto insurance premiums have risen 27%. In certain instances, consumers find themselves paying more for car insurance than for their actual car payments.



So given this environment, many prospective auto buyers are being rejected when applying for a loan. In fact, auto loan rejection rates have surpassed 14%, marking an all-time high. And it should be no surprise that 6.1% of subprime auto borrowers are now 60+ days overdue, setting a new record. For some perspective, the highest delinquency rate for this demographic was 6% in 1994 and 5% in 2008. Notably, during the Great Financial Crisis, many chose to forfeit their homes but held onto their Toyota Camrys. Regrettably, the scenario appears reversed in 2023.

Bottom line: Concurrently, the auto industry is grappling with record-high insurance rates, the highest finance rate in 20 years and climbing insurance rates. Needless to say, this "perfect storm" will have a significant impact on auto sales and the overall auto industry.

JOBS UPDATE

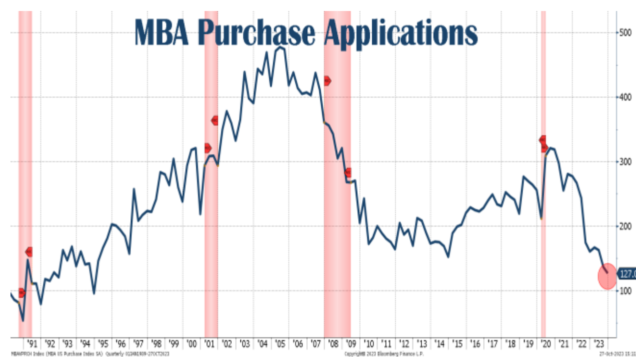
The number of Americans filing for jobless benefits for the first time rose from 200,000 last week to 210,000 (slightly above expectations), but still remains at or near record lows. However, continuing claims rose for the fourth straight week to its highest since May at 1.79 million (above 1.7 million for three straight weeks).

Bottom line: The jobs market remains tight but there are warning signs that the labor market is weakening.

FROM BAD TO WORSE

The U.S. housing market is going from bad to worse as 8% mortgage rates bump against the median $400,000 price of an existing single-family home. For some perspective, home prices were less than $300,000 in June 2020 when mortgage rates were barely higher than 3%.

Demand is clearly waning as the Mortgage Bankers' Association (MBA) Purchase Index sagged -2.2% on the week and off -22% from already depressed levels of a year ago. And few seem to have noticed that the bellwether for consumer spending, Home Depot, has seen its shares drop for seven consecutive sessions — the longest losing streak since 2016.



Bottom line: With mortgage rates at +8%, housing activity will remain depressed as affordability is increasingly challenged.

THE EVERYTHING BUBBLE IS BURSTING

I've argued that as long as the Fed was at "zero" rates and printing money 24/7, asset prices would rise. And they did — from stocks, to junk bonds, to real estate, to crypto and to Treasuries. It really didn't matter how the economy was doing (good, bad or awful), asset prices were driven by "free money."

The funny thing is that when "free money" and quantitative easing were in full swing, everyone investing in stocks was a genius. People were coming up with all kinds of theories as to why stocks were going higher and higher, when in fact, the only reason they were going higher was due to the Fed's quantitative easing and the interest rate repression.

But what "zero" fed funds and quantitative easing giveth, higher rates and quantitative tightening taketh away.

The Fed has now raised its funds rate 525 basis points to 5.5% in 16 months, and the Fed's balance sheet has been reduced so far by $1.06 trillion via quantitative tightening. This draconian monetary tightening and withdrawal of liquidity has effectively pulled the rug out from under asset prices.

Let's take a look at the heretofore beloved stock market:

- **S&P 500**: On Friday, the S&P 500 index closed 14% below its January 2022 peak and is now back to levels last seen in April 2021. In other words, it's back to where it was two and a half years ago. Even still, the S&P 500 return has remained artificially inflated by a select group of seven stocks dubbed the "Magnificent 7," which represents around 20% of the index, and thus far have maintained high valuations. Excluding the so-called Magnificent 7, the equally weighted S&P index is much lower. In other words, all things point to a "hidden bear market" while the mega-caps continue to distort reality.
- **NASDAQ:** The tech-laden NASDAQ is now down 22% from the November 2021 peak and back to December 2020. Thus, despite wild gyrations over the past three years, this index has gone nowhere in three years.
- **Russell 2000**: This small cap benchmark index is now down 33% from the November 2021 peak and has retraced all gains back to October 2020! Note: Small cap stocks best represent the overall economy and lead the large cap stocks.

The same phenomenon has occurred in the corporate credit and crypto markets as these asset prices take it on the chin along with Treasuries.

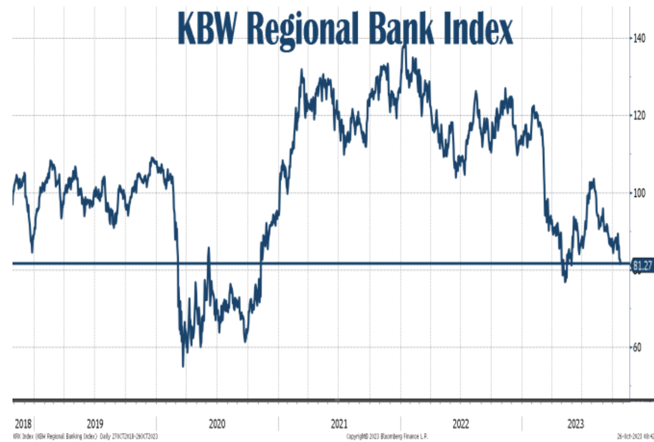
Bottom line: The sole reason behind the asset price inflation for years has been free money and reckless, irresponsible money printing by the Fed. Nothing else. Now in the "higher for longer" environment, along with quantitative tightening, the "everything bubble" is in the process of bursting.

Asset prices feed consumer confidence and spending via its wealth effect. When the stock market rolls over, the Fed will realize that they have gone too far. If history is any guide, forthcoming market dislocations may force the Fed to loosen monetary conditions.

WHAT WILL BREAK NEXT?

Looking at the graph below, it tells me that the issues surrounding regional banks have not been fixed as the sector is trading where it was during the March banking sector meltdown and lower than April 2020!

Something nasty is brewing in this space. Could it be the continued outflow of deposits that crashed by a massive $83.7 billion last week, which is the biggest outflow since Silicon Valley Bank (SVB), to the lowest since June. One thing we can certainly say is that the “mini boom” in real GDP for the third quarter is clearly not helping the banking sector one iota.



Bottom line: In March of this year, things did break in the form of SVB’s bankruptcy, but the Fed was able to patch that up with a new liquidity program that they claim is not quantitative easing but in reality it is quantitative easing. So, the next question is, what will break next and when? Sadly, these events come out of nowhere.

“In any case, inflation is still too high, and a few months of good data are only the beginning of what it will take to build confidence that inflation is moving down sustainably toward our goal.”
— Jerome Powell, Federal Reserve Chairman

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Here’s an example of the Fed’s forecasting prowess: In December 2021, just ahead of the aggressive tightening cycle, the median fed funds rate dot plot for the end of this year stood at 1.6% and for the end of 2024, try 2.1%. Contemplate that for a minute and think of the businesspeople and bankers who bought in and planned for this horrible projection. Who’s to say the current 5%-as-far-as-the-eye-can-see forecast isn’t as equally off base but in the other direction?

The U.S. economy was built on borrowing and spending. Easy money is its lifeblood. It simply can’t run for an extended period of time without artificially low interest rates. These higher rates will ultimately break things in the borrow-and-spend economy.

My expectations haven’t changed. It’s all just taking longer to play out. I will stay the course, as painful as it has been, and remain for the precious few bond bulls left on the planet.

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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