Weekly Relative Value

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WEEK OF NOVEMBER 6, 2023

The Summer Party Is Over

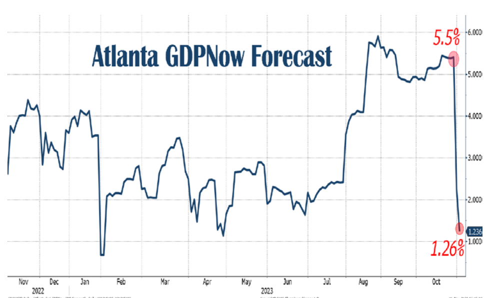
"Anything that cannot last forever…won't." — Herbert Stein, American Economist

As discussed in last week's *Weekly Relative Value*, the biggest reason for the "mini boom" in the third quarter was the collapse in the personal savings rate and the heavy reliance on ridiculously high-rate credit cards. In other words, the +4.9% real gross domestic product (GDP) print was a Potemkin-like number.

While there is no evident recession in spending, there surely is one on the income side of the ledger. From May to September, real personal disposable earnings fell at a recession-like -1.4% annual rate. Meanwhile, the savings rate went from 5.3% in May to 3.4% in September.

Here's some basic math. If the savings rate stayed at 5.3% in September, real consumer spending between May and September would have declined at a -2.4% annualized rate. Instead, real personal consumption expenditures (PCE) came in at 4.0% between May and September, owing to this epic drawdown in the savings rate.

And now, the same Atlanta Fed, which stunned Wall Street with its 5%+ third quarter GDP estimates last quarter, just came out with its second fourth quarter GDP forecast. This forecast was a doozy at 1.2%. It was almost 50% below the Atlanta Fed's first fourth quarter GDP estimate of 2.3%.



At the same time, Canada and Europe are in contraction, China's economy is imploding and the U.S., despite the rhetoric, will never decouple from the rest of the world.

THIS WEEK

- JOBS COME CRASHING DOWN
- DEFLATION IN THE AIR?
- AN OXYMORON
- NO COUNTRY FOR REALTORS
- NO OPTOM(ISM)
- MEAN REVISION
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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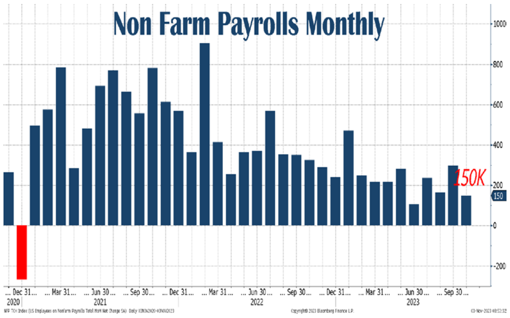
Bottom line: After being interrupted by the one-time, artificial and debt-driven burst in the third quarter GDP, the inflated economic "boost" is now gone and the economic growth is trending back to normal.

JOBS COME CRASHING DOWN

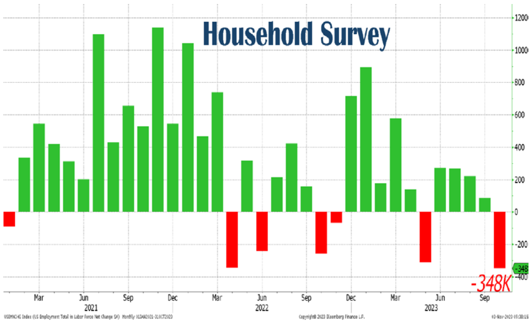
The October jobs report print indeed came crashing down to earth sliding to 150,000, a drop of more than 50% from the original September print, and the second lowest since 2022! This was the weakest headline in four months and the second softest since December 2020. According to Bloomberg, the 52% of private industries who added jobs last month was the lowest since April 2020, at the height of the COVID-19 pandemic.

This has been the case throughout the year — historical data was revised massively lower, with the jobs change for August revised down by 62,000 from +227,000 to +165,000. Also, the change for September was revised down by 39,000 from +336,000 to +297,000. With these revisions, employment in August and September combined is 101,000 lower than previously reported. **Get this: nine out of the past nine months have been revised sharply lower. For some perspective, the last time there were seven straight months of negative revisions was in 2008 during the Great Financial Crisis.**

But wait, there's more! According to the Bureau of Labor Statistics' (BLS) birth-death model, a whopping 412,000 non-existent but spreadsheet modeled jobs were added – the second highest on record! In other words, the U.S. economy is weakening and the BLS is modeling the second fastest pace of new business creation in history! Call me a bit more than skeptical!



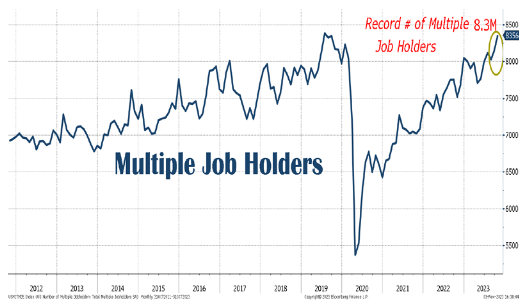
However, the scariest number did not come from the BLS establishment survey at all, but rather from the BLS household survey, where the number of employed workers plunged by -348,000 — the biggest drop since the pandemic lockdown in April 2020. Employment in the "breadwinning," key-prime working-age adult cohort (25 to 54 years old) cratered -238,000. One can't help but wonder if we are "already there"…as in recession.



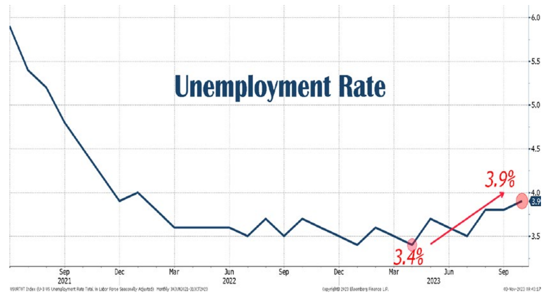
An astounding one-third of the jobs added were government hires bought and purchased by the ever-expanding debt ($33.7 trillion and counting, which our kids and grandkids will all pay for dearly).

Job losses were widespread across virtually all sectors of the economy. Even accounting for the 30,000 striking auto workers, factory payrolls fell -2,000 last month. Signs of a weakening of the labor market were widespread from retail to transportation/warehousing to banks and even the once hot leisure/hospitality industry. In fact, hotels and restaurants handed out nearly -1,000 pink slips last month. What's going on here?

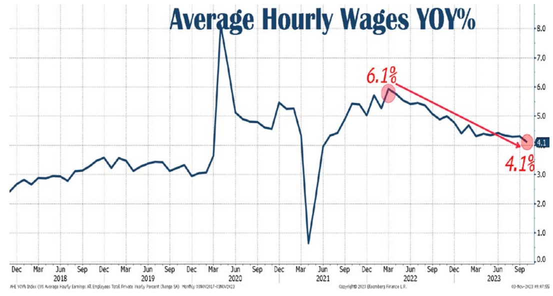
Also, part-time jobs for "economic reasons" shot up +218,000 last month. Multiple jobholders, an indicator for household financial stress, surged +205,000 (after the +123,000 jump in September). Today, 8.4 million Americans are now holding down more than one job — this is at an all-time high.



It wasn't just payrolls that disappointed. The unemployment rate rose from 3.8% to 3.9% and now sits at the highest rate since January 2022. While the actual unemployment number is still relatively low, it is the change, not the level, that determines the recession call. Since recent lows in April, this measure is up by 0.5% points, which historically has indicated a recession.



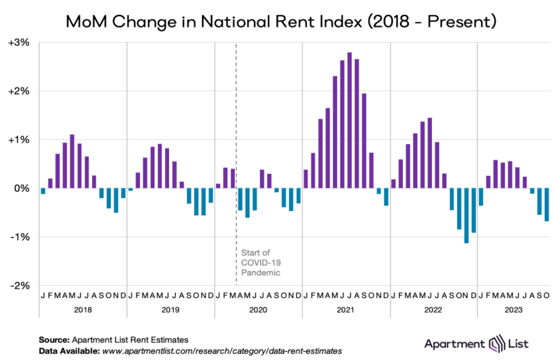
Turning to wages, there was more proof that the labor market bubble has peaked with wage growth in October at just 0.2%, down from the upward revised 0.3% in September. And on an annual basis, wage growth came in at 4.1%, which is below last month's 4.3% and now sits at the most moderate pace since June 2021.



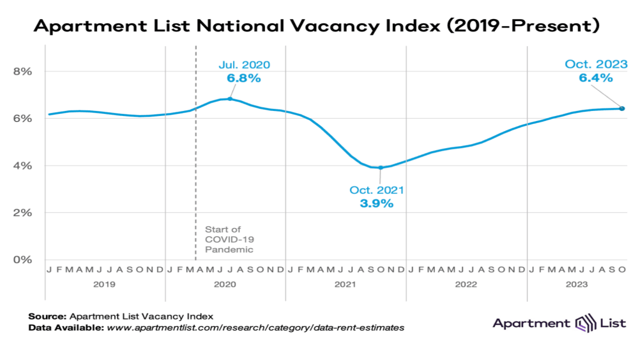
Bottom line: While one number does not make a trend, there were no redeeming features in this universally weak payroll report. Further, between this week's poor readings on the ISM Manufacturing Purchasing Managers' Index (PMI) and now employment, the string of hot economic data that generated the ripping +4.9% real GDP growth rate in the third quarter has come to a thundering halt. The peak in Treasury yields is in the rear-view mirror.

DEFLATION IN THE AIR?

The Apartment List National Rent Report for October showed a -0.7% month-over-month reading, the third venture in a row into deflation terrain on a sequential basis. The year-over-year rental trend remains mired in deflation, down -1.2% for the second month running. This is a sharp contrast to the prevailing conditions of 2021 and 2022 when rent prices were surging and year-over-year growth peaked at 18% nationally. The rent declines were widespread, declining month-over-month in 81 of the 100 large cities surveyed and down year-over-year in 65 of them.



I should note that the apartment vacancy rate has climbed back to three-year highs and, at 6.4%, is light years away from the 3.9% levels during the peak tightness in the market back in the fall of 2021.

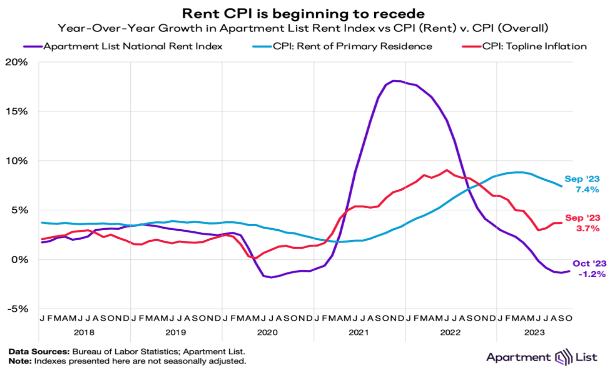


As the report concluded:

"Monthly rent declines are expected to persist through the remainder of the year… looking further ahead, a robust construction pipeline should drive strong supply growth in the year ahead."

Why it matters: The primary measure of inflation is the Consumer Price Index (CPI), which shows the rental component running at a 7.4% year-over-year clip. This is primarily due to the methodology and lag effect of the calculations in this index. More importantly, the Apartment List National Rent Index has proven to be a strong leading indicator of the CPI housing and rent components, since the index captures price changes in new leases, which are only later reflected in price changes across all leases (what the CPI measures).

As you can see in the graph below, the CPI's Rent of Primary Residence is now 7.4%. Whereas the Apartment List national Index is a negative -1.2%! Here's the thing: If you stick the Apartment List apartment rent number into the CPI calculation, instead of the lagged metrics in the CPI, headline inflation would be running at 1.0% year-over-year and the core at 0.8% year-over-year.



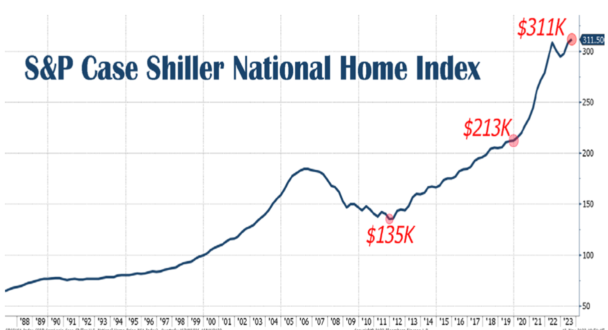
Bottom Line: Deflation in rents remains front and center in the residential real estate market. This sector comprises about one-third of the CPI and just over 40% of the core index. The problem is that the real-time data has yet to be incorporated into the lagging methodology of the government price benchmark. This will be a huge story in 2024.

AN OXYMORON

"It's like we fired all the bullets we have on housing affordability, and it's going to take a long, long time to build our way out of it…It's going to strain the social fabric of America that the younger generation isn't able to buy a home anytime soon." – Glenn Kelman, CEO, Redfin Corporation

Here's a quick definition for oxymoron: "Home prices hit a record high as sales fall."

We live in a topsy-turvy strange world where economics has been turned on its head and declining demand leads to rising prices. Assuredly, the Chartered Financial Analyst (CFA) course doesn't teach this. I guess it's time for all of us to head back to Economics 101 when it comes to the bizarre U.S. housing market.



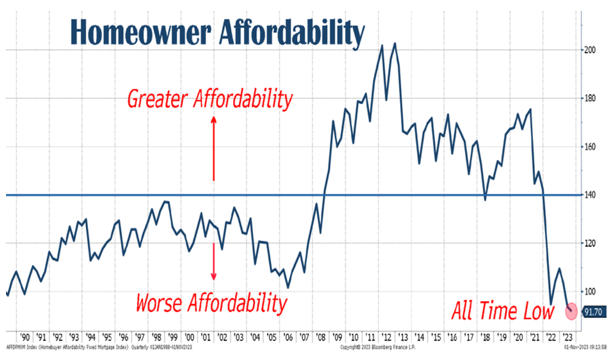
The S&P CoreLogic Case-Shiller Home Price Index is based on the "sales-pairs method," which compares the sales price of the same house over time and thereby eliminating the issues associated with median price indices. However, I don't like it because it lags months behind. To wit: The most recent data shown graphically below is a three-month moving average of home prices whose sales were entered into public records in June, July and August. Over this period, the

Case-Shiller data shows the home prices rising to a record high of $311,000. However, since the June-August period, mortgage rates have continued their ascent higher.

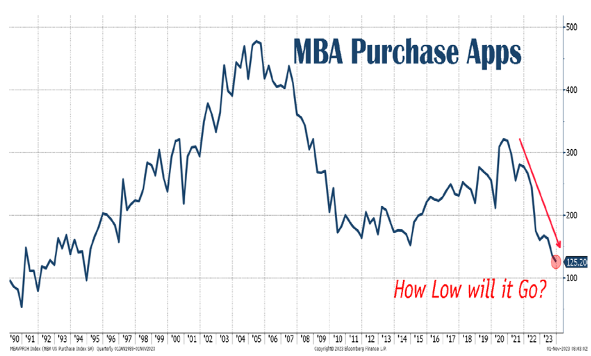
By contrast, the timelier National Association of Realtors (NAR) “median-price index” shows the deals closed in September. It fell for the third month in a row and is now down 4.7% from its peak last year in June 2022, making 2023 the first year since the 2007-2008 housing bust that the peak in June was below the peak in the prior year.

Regardless of which index you reference; existing homeowners are still seeing a nice “wealth effect” from their homes while potential buyers are increasingly crowded out. With home prices at all-time highs and mortgage rates soaring at two-decade highs, today’s homebuyer will need an income of $115,000 to afford a median-priced house (assuming a 20% down payment). This is up sharply from $99,000 a year ago!

Even as the pandemic pushed values up faster than ever, cheap mortgages kept buyers in the game. Now, the Fed’s aggressive tightening since last year has driven the 30-year mortgage rates close to 8%. Normally, home prices would drop as rates rose. However, not in this cycle because of the “locked in” effect. No one wants to trade a 3% mortgage for an 8% mortgage. The lock in reduces the rate at which homeowners move and also threatens to prevent younger owners from moving to larger homes while causing empty nesters to put off downsizing.



And the high frequency data bears this out. The most recent weekly Mortgage Bankers’ Association (MBA) data showed that mortgage applications to purchase fell -1.4% over the week of October 27. It has been down for three consecutive weeks (and five of the past six) and off -22.0% from what were already depressed levels of a year ago. Not since late December 1994 has the index been this low. The refinancing index also plunged -3.5% and is now down roughly -11.6% from levels from the year earlier. Likewise, existing home sales are down 37.5% in less than two years. For reference, home sales were 6.34 million in January of 2022 compared to 3.96 million today.



Bottom line: Today, the homeowner affordability ratio is some 35% more stretched than it has been in the past — even more so than during the 2006-2007 peak credit and housing bubble. In order to mean-revert this series, house prices will need to drop 25-30%, or mortgage rates need to decline 200-300 basis points or some combination of both.

NO COUNTRY FOR REALTORS

Making matters worse for the real estate industry, last week a federal jury found that the NAR and large residential brokerages were liable for about $1.8 billion in damages after ruling they kept commissions for home sales artificially high.

Under the current system, sellers pay their own agent a commission, which is typically 5% to 6% of a home's selling price and is shared with the buyer's agent. The homeowner plaintiffs' attorneys argued this model has suppressed competition by making it difficult for buyers and sellers to negotiate for lower rates.

According to the *Wall Street Journal (WSJ)* article, "Jury Finds Realtors Conspired to Keep Commissions High," the verdict "could lead to industrywide upheaval by changing decades-old rules that have helped lock in commission rates even as home prices have skyrocketed — which has allowed real-estate agents to collect ever-larger sums."

Of course, the NAR will challenge the suit and the appeal process could take years for a final ruling.

Bottom line: This verdict is by far the NAR's biggest setback yet. The real estate market has already experienced a transactional crash for the past two years (i.e., low inventory, no buyers and no sellers) and now the split commission may soon be eliminated. Should this decision be upheld, all I can say is good luck to realtors and mortgage brokers. Many are going to be in deep trouble.

NO OPTIM(ISM)

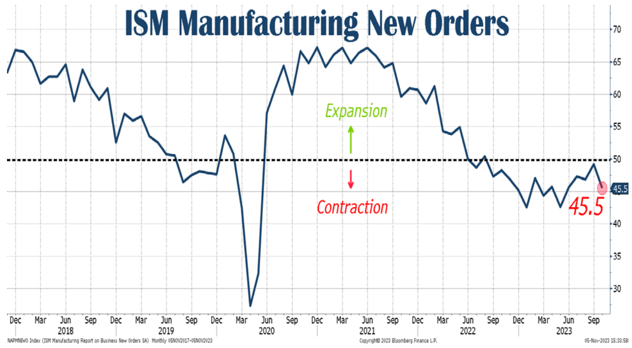
The ISM Manufacturing PMI report is a monthly gauge on the level of economic activity in the U.S. manufacturing sector compared to the previous month. It is a leading economic indicator for the level of activity in the manufacturing sector. When the reading is above 50, the manufacturing sector expands. Conversely, when the index is below 50, manufacturing contracts.

So, with that backdrop, the PMI report for October was downright ugly at 46.7, which is down from 49.0 in September. This was the twelfth straight print below the 50-cutoff mark for contraction-expansion.

The share of industries reporting growth plunged to just 11.1% last month. For some perspective, the last time this happened was during the 2008-2009 Great Recession and during the pandemic recession. A grand total of two (out of

18) industries are expanding right now. I should add that new orders, the mother's milk for future demand, fell hard to a five-month low of 45.5. In other words, many industrial companies (e.g., Caterpillar) are just draining their order backlog to generate earnings, and that backlog continues to tick back down.

In addition, the ISM employment index softened to 46.8 from 51.2, standing at a three-month low. In October, 17.4% of purchasing manager executives were busy cutting staff while only 11.7% were adding to their payroll.



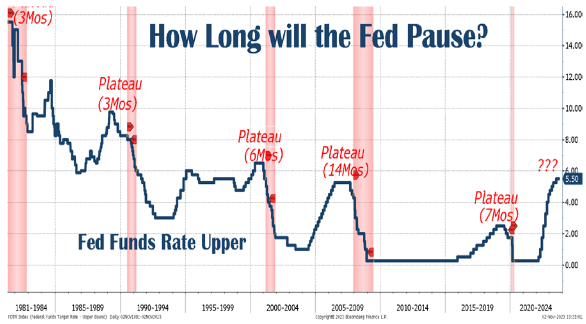
MEAN REVERSION

"Markets tend to return to the mean over time." — Bob Farrell, Market Rules to Remember

Simple rule, but elegant.

The past year has been, needless to say, challenging for the bond market. The headlines have pointed at the government deficit as the prime culprit for the sharp run-up in bond yields since mid-2023. However, as shown below, fiscal policy only commands a 20% correlation with the direction of Treasury yields. Fed policy has a far stronger impact with a 90% correlation. Thus, the resetting of the market's expectations on Fed policy has been the real culprit to this bear market in bonds. This too shall pass.

The widespread consensus is that the Fed will remain "higher for longer." Be careful with that assumption. Historically, the Fed always overdoes it and has to backtrack. As one can glean from the graph below, the Fed typically doesn't cut, then hike, then cut and then hike. It gets on either a rate-cutting or rate-hiking cycle that lasts for months or years. And when rates change, they change fast.



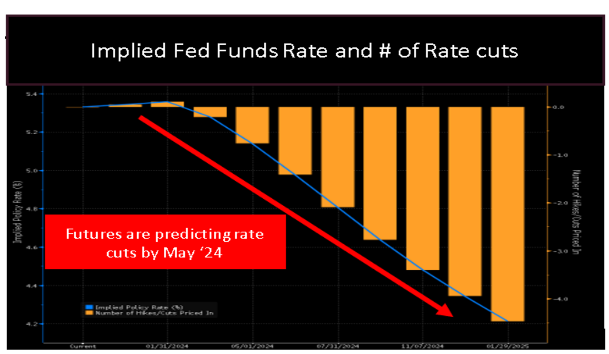
Here's another takeaway from the above graph: The fed funds rate eventually peaks and then, with an average 10-month lag, the easing cycle begins. Every tightening cycle in history was followed by an easing cycle (and vice versa). And note that recessions follow the end of the tightening phase each and every time.

If the Fed bypasses the December 12-13 meeting, then it will have been around five months in which the central bank paused. Because the average lag between the last hike and the first cut is 10 months, it puts the initial easing in May 2024. And then it is a matter of how deep the rate cuts will be in the next cycle.

Here's are a couple of additional factoids:

- **The average lag from the first rate hike to the recession is about two years,** which means that we may begin to see more definitive recession signs in the first half of 2024.
- **In recessions, the Fed reduces the fed funds rate by an average of -500 basis points.**
- **Even if the economy does not fall into recession, the Fed would need to lower rates by 300 basis points to get back to the so-called "neutral" rate.**

Bottom line: The conventional wisdom is that the Fed probably won't cut, and even if it does, it will do a few token cuts in line with the dot plots. No. If the Fed starts cutting interest rates, it is because there is protracted weakness in the economy, and it will cut **much more** than people think is possible with the caveat being that it's unlikely to go back to zero. In fact, the jobs data were so powerful that the odds of a rate hike for December have been pared to a 9% chance. However, very interestingly, futures now are pricing in for the inevitable easing cycle to commence earlier in May 2024 (pre-jobs report, it was June) and already pricing about 100 basis points over the next year.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

October 24, 2023: "The economy is slowing faster than recent data suggests. There is too much risk in the world to remain short bonds at current long-term rates. We covered our bond short"
— Bill Ackman, CEO, Pershing Square Capital Management

The one thing we know is that all bear markets end. And now that the pied piper — the venerable hedge fund manager, Bill Ackman — has covered his shorts, we could end up seeing the mother of all short-covering rallies in the months and quarters ahead.

And just last week, Stan Druckenmiller, former hedge fund manager, joined Bill Ackman and Bill Gross, founder of PIMCO Managing, in sounding the alarm about the economy.

When asked why he took a massive leverage position in 2-year Treasuries, Druckenmiller said this:

"I started to get really nervous, and I took a 'massive' leveraged position in the 2-year Treasury note."

If he's right about the economy, Druckenmiller said **2-year yields could fall to 3%.**

And finally have a read of the *WSJ* article, "How This Year's Hottest Investment Could End Up Costing You."

To wit:

***"With markets rocky and cash earning 5% or more, investors have boosted their holdings of money-market funds to a near-record $5.6 trillion**, according to the Investment Company Institute. **Both individuals and institutional investors are piling in — asset managers now have about one fifth of their portfolios in money-market funds**, State Street data show."*

Bottom line: Short-term money market funds and cash alternatives have been a safe harbor over the past 18 months, however, as the standard disclosure says, "past returns do not predict future returns." More importantly, it's over a "full market cycle" that cash will likely underperform longer-term securities. Now, imagine what would happen if the massive amounts of cash were reallocated into longer-term securities.

Last week, the 10-year Treasury yield plunged 36 basis points in three days and is among the largest plunges in the last 12 years (outside of the pandemic)**.** The sharp yield declines across the yield curve are yet another example of why timing is futile.

Finally, if one waits for the Fed to signal an "all-clear" message, it will be too late! Markets will move much faster than the Fed and will lead rates lower across the curve. As such, I **continue to advocate that credit unions maintain the ongoing discipline of maintaining a risk-appropriate ladder strategy in managing their excess cash reserves.**

While markets do not move in a straight line and there will undoubtedly be interest rate zigs and zags going forward (future selloffs provide an attractive entry point), from my perch, all roads lead to curve steepening in a bull market in

Treasuries. For any credit unions with “excess” cash, it’s an excellent time to buy the front end of the yield curve and lock in the highest yields in 15 years.

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.