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INVESTMENT SERVICES

Weekly Relative Value

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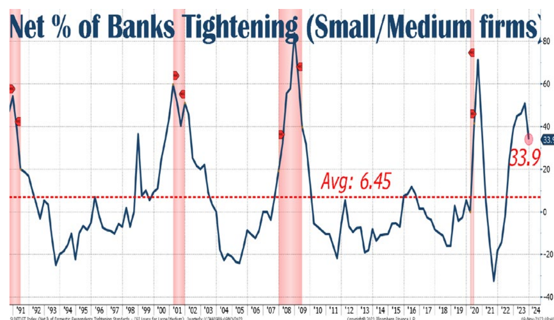
WEEK OF NOVEMBER 13, 2023

Credit Drives the Economy

"Banks most frequently cited a less favorable or more uncertain economic outlook, reduced tolerance for risk, deterioration in credit quality of loans and collateral values."
— Senior Loan Officer Opinion Survey (SLOOS)

The fourth quarter Senior Loan Officer Opinion Survey (SLOOS) indicated that a "net" balance of 34% of banks tightened credit standards for large and medium-sized firms. While this declined from the third quarter, it still implies increased difficulties for businesses seeking to borrow in the fourth quarter. The scenario was similar for small businesses, where a "net" balance of 30% of respondents tightened credit standards.



To no one's surprise, the credit crunch has been intense in commercial real estate. A "net" balance of 64.3% of banks have tightened lending standards. This was the sixth straight quarter in which a "net" balance of more than 40% of banks have tightened.

Meanwhile, credit demand in the commercial real estate (CRE) sector has collapsed, with a "net" balance of 52.6% of banks reporting that demand for commercial real estate loans is weaker.

With supply contracting severely and demand in freefall, I leave it to the reader to solve for the equilibrium in commercial construction spending.

On the consumer side, the same trend is widespread. Residential mortgage lending standards have now tightened for the sixth quarter in a row, with a rising share of banks becoming stricter each quarter (up to a balance of 16.0% in the fourth quarter), while demand fell for obvious reasons.

THIS WEEK

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SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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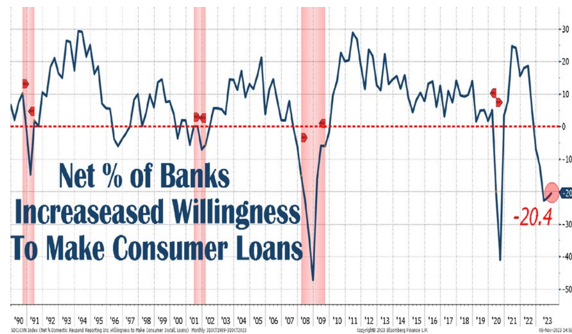
The survey reported a "net" tightening in standards for credit cards, auto lending and other consumer loans. In fact, banks' willingness to make consumer installment loans is hovering close to historical record lows.



It's important to note that the "net balance" of the headline numbers can be misleading. The balance figures do not reflect a mix of tightening and easing by banks. Rather, those banks that did not tighten credit standards this quarter left them unchanged. The key point is there was virtually no hint of any easing in any lending category whatsoever.

Bottom line: Credit is the oil that lubricates the engine of U.S. economic growth. With credit risk on the rise as high rates bite, banks are becoming increasingly selective in who they lend to, which is tightening credit conditions and the overall supply of credit.

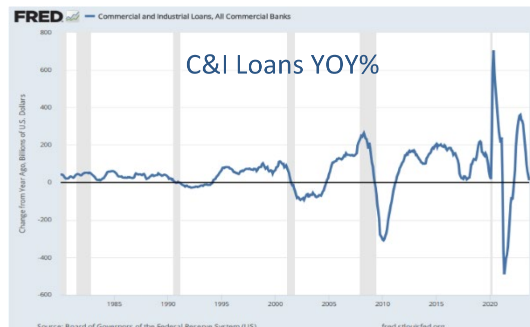
SMALL BANKS GET SMALLER

Small banks of $250 million or less in assets have historically been responsible for:

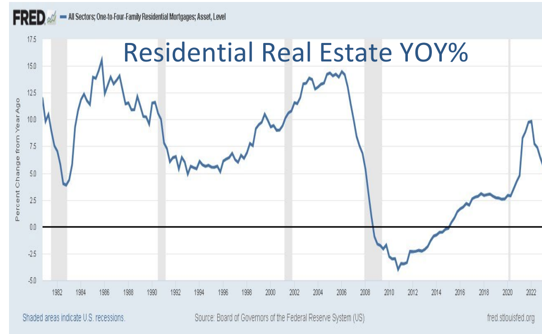
- 50% of all commercial and industrial lending.
- 70% of all commercial real estate lending.
- 60% of non-agency residential real estate lending.
- 45% of all consumer lending.

Now, small-to-medium sized banks are shrinking their balance sheets.

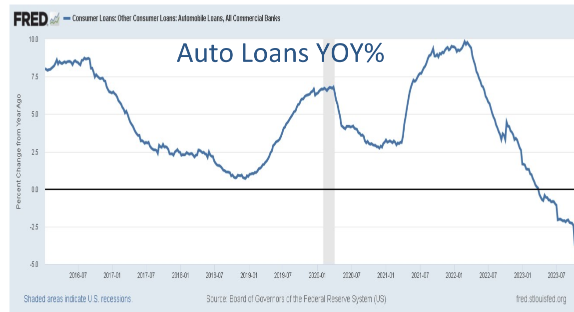
As one can glean from the graph below, commercial and industrial business lending has stagnated and is now fractionally negative year-over-year.



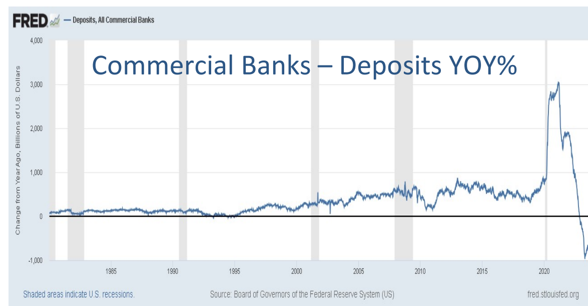
Growth in residential mortgages has been slowing markedly.



Auto loans have contracted nearly -4% on a year-over-year basis, which is unprecedented. This is likely in response to the sharp run-up in subprime delinquency rates.



At the same time on the liability side, deposits have stabilized at an unprecedented -4% year-over-year and remain at lower levels than at the peak of the bank runs last March! Yet, Federal Reserve Chair Jerome Powell is always telling the masses what great shape the banking sector is in. Maybe this is true for the big, well-capitalized banks but surely small banks are in shrinkage mode.



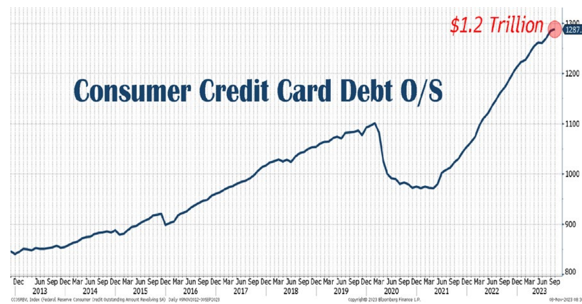
Bottom line: For the first time in over a decade, the growth in U.S. commercial bank credit has practically gone to zero. Every asset is slowing down sharply. Auto loans, commercial and industrial lending business loan growth and even residential mortgages are cooling off substantially.

The last time bank credit declined on a year-over-year basis was in 2009 (and the aftermath of the Great Financial Crisis). Before that, it was 1948-1949. Both periods were recessions. Just because it hasn't happened yet doesn't mean it's not going to happen; and the thing about recessions is that they sneak up on you when you least expect it.

WHAT'S IN YOUR WALLET?

"The continued rise in credit card delinquency rates is broad based across area income and region, but particularly pronounced among millennials and those with auto loans or student loans."
— Donghoon Lee, Economic Research Advisor, The New York Federal Reserve

As I have highlighted, a key driver of consumer spending and the red hot third quarter gross domestic product (GDP) report has been aggressive credit card spending. According to the New York Federal Reserve, credit card debt rose 16% year-over-year to an all-time high of $1.2 trillion. According to TransUnion, the average credit card balance is now more than $6,000, the highest in 10 years. There are now 4.5 credit cards per household, which is up from 4.2 a year ago.



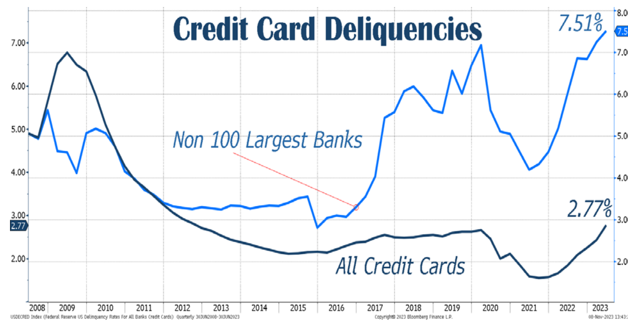
While credit card debt is at a record high, it appears that usage is slowing. Credit card debt rose by just $3.1 billion in September. This was the lowest monthly increase since the COVID-19 crisis, with the exception of June's freak negative revolving credit print. Frankly, the slowdown in credit card debt growth is not a surprise since the average rate on credit cards just hit a record high of 22.77%!

"Basically, for every person who's using credit cards for convenience and to earn cash back and travel rewards without paying interest, there's someone else who's carrying a very expensive balance."
— Ted Rossman, Senior Analyst, Bankrate

For those that use credit cards for transactions, pay off their balances and collect their points, the record high rate is a moot point. However, for those that have outstanding balances, all I can say is good luck financing this debt at 22.7%!

Meanwhile, the New York Fed's quarterly household debt report showed that aggregate delinquency rates for credit card debt increased in the third quarter of 2023, with 2.77% of outstanding debt in some stage of delinquency at the

end of September. Also, note that delinquencies, “not” among the 100 largest banks, have soared from just over 4% to 7.51%.



In aggregate, the current level is not crazy yet, but the rate of change is breathtaking. The rate of growth in delinquency is about as steep as it was during the Great Financial Crisis. The rate has more than doubled in less than a couple of years and it’s been accelerating during that time. It’s not the end of the world yet, but it will be interesting to see where it goes in 2024. Will it eventually spread from sub-prime card holders to the middle class?

Moreover, delinquencies are rising when the U.S. economy is at full employment. What prey tell will happen when unemployment begins to rise?

Bottom line: The household debt report, coupled with the SLOOS report, paints a picture of a consumer rapidly running out of room as high rates and stricter lending standards start to throttle the flow of credit. With the personal savings rate down from over 5% to 3.4% in just a few months, it is now only a matter of time before economic reality hits and that pillar supporting 70% of the U.S. economy (the consumer) will buckle.

“OUR CONCERN GOING FORWARD”

Consumers appear to be feeling the pinch of higher rates and depleted savings. Indeed, most recent retail earnings reports have confirmed that consumer behavior is occurring, especially on the low-priced end of the spectrum.

On that note, this week, the market will turn its attention to retailers with retail bellwethers such as Target, Walmart and Home Depot reporting their latest results and more importantly, their future outlooks. But in a possible taste of what may come our way, Under Amour, Nike, eBay and Adidas called out consumer softness in North America.

Roger Lipton is a highly rated consumer stock analyst, and this is what he had to say in his latest missive, “*Earning Season is in High Gear.*”

"You should not need us to remind you that consumers are carrying a record trillion dollars of credit card debt, paying over 20% interest on that debt, and have reduced their saving rate to under 4% (from a peak of over 30% in March 2020) to service that debt. This has been reflected in lower traffic counts at most chains, especially for on-premises dining, changed the way diners use the menu, and shifted traffic from mid-week to the weekends, when families are increasingly interested in a dining 'experience.'"

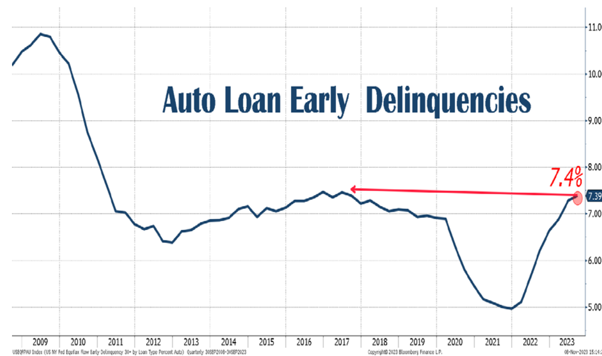
Bottom line: As we enter the all-important Holiday season, all eyes will be squarely on whether the consumer will continue to run up credit card balances one last time or will they finally hunker down and live within their means? If history is any guide, look for the drunken sailors to continue to spend despite the warning signs.

TURNING TO AUTOS

Tight credit conditions and affordability issues are weighing on demand as the average borrowing rates for used cars have surged from around 3.85% in February 2022 to 7.3% this month. With used car prices still above pre-COVID-19 highs, a rate shock like this has sparked an affordability crisis among consumers. To wit: Auto sales fell -1.2% month-over-month in October and have been down in three of the past four months from 15.7 million units at an annualized rate in September to just under 15.5 million in October.

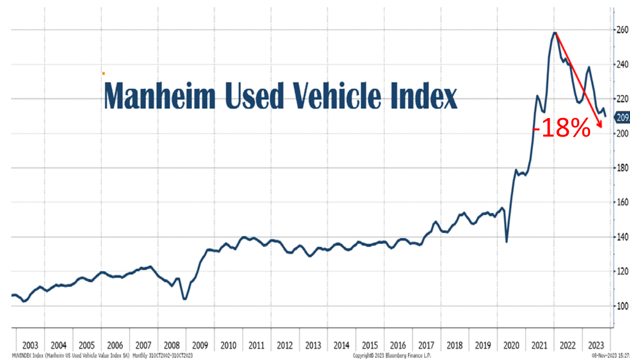
However, even more concerning is the fact that new delinquencies continue to tick higher rising to 7.4% from 7.2% in the second quarter and 6.2% a year ago, which now stands at the highest level since the second quarter of 2017. New seriously delinquent loans (90+ days in arrears) rose to 2.5% and is the most since the third quarter of 2010. This is particularly the case for sub-prime borrowers.

Note: As with credit card delinquencies, it is not the level that is troublesome, it is the rapid rise and upward trajectory from 2021 that should be closely watched.



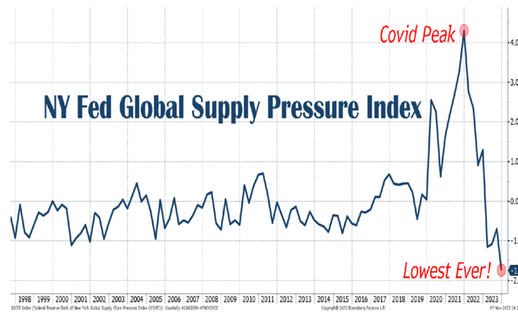
The silver lining is that as auto sales slump, used car prices are peeling back. The Manheim Used Vehicle Value was down 2.3% in October. This index measures wholesale prices which eventually filter into the retail side of the market with a slight lag.

More importantly, the index has been contracting for 14-straight months and has extended its drawdown to -18%, which is largest decline in this index's history. So, after being the original "poster child" for the pandemic inflation spurt, this development should continue to filter through to the Consumer Price Index (CPI). While a positive for the disinflation narrative, those who panic-bought cars during the peak of COVID-19 will find themselves underwater in auto loans.



REMEMBER THOSE BOTTLENECKS?

Well, they are long gone. Global supply chains continue to ease, with the latest reading of the New York Fed's index of bottleneck pressures slumping in October to the lowest reading on record (data back to 1997). Meanwhile, Bloomberg is reporting that FedEx is encouraging its pilots to fly for American Airlines as the shipping company deals with a significant slowdown in package volumes.



The Baltic Dry Index, the poster child for global freight rates, is rolling over again. It is now down a whopping -74% from the October 2021 inflation peak and back to the levels in 2019 when the Fed was on the precipice of cutting rates from a 2.5% peak!

What does this data tell you? It tells you that the price of goods is deflating. Moreover, 40% of the CPI is goods!

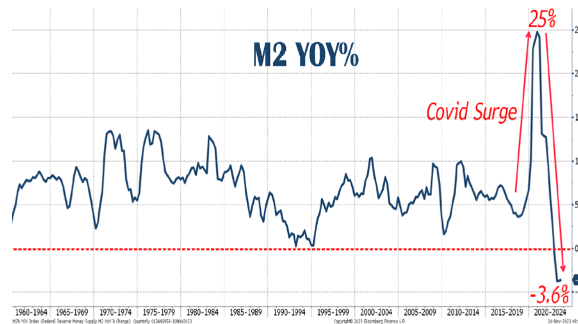
Yes, the service sector prices have remained more "sticky," but keep in mind that in real-time, the dominant rental measures in the CPI indices are deflating. This has not yet shown up in the CPI statistics, but I believe that with a lag, they will.

Also, there has been some more constructive inflation news in the form of declining food prices. As shown below, the Food and Agriculture Organization's Food Price Index (FFPI) fell for the third straight month. The year-over-year pace has been contracting for 12 months in a row now and is down -25% from the peak. Again, with a lag, this should filter through to the official data.

The monetarist theory, popularized by Milton Friedman, asserts that money supply is the primary factor in determining inflation/deflation in an economy. If so, inflation is yesterday's news.

The graph below shows the massive surge in the money supply and the recent decline. The increase was unprecedented during the pandemic as is the current decline. After surging by 25% year-over-year, the broader M2 metric is now running at an epic -3.6% year-over-year pace and has fallen for ten consecutive months, a feat not accomplished since the Great Depression. I'm not sure how one squeezes inflation out of these numbers. For the economy to grow over extended periods, money supply growth must keep up with economic growth.

Further, for inflation to rise with contractionary money supply, money velocity (how often money circulates in an economy) would need to surge to prevent the economy from shifting into an outright deflation. As discussed above, velocity is more than likely to head back down just by judging from the contraction in the banking sector credit.



Bottom line: Barring renewed growth in M2, which entails lower rates, a steeper yield curve and the cessation of quantitative tightening, a slowdown appears likely. This is a disinflationary/deflationary development and should be a positive for the bond market.

FINAL WORD ON EMPLOYMENT REPORT

"The jobs report was a Goldilocks report…We may be getting a soft landing."
— Anthony Saglimbene, Chief Market Strategist, Ameriprise Financial

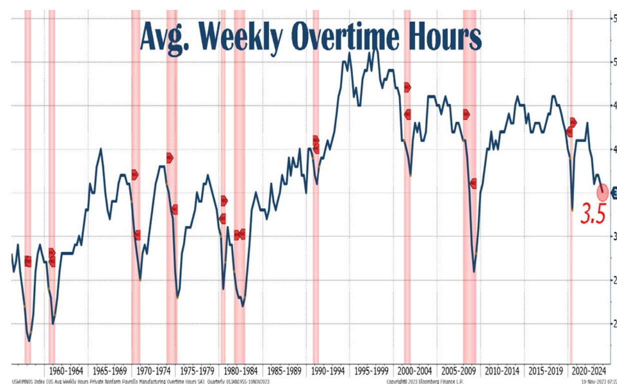
The October non-farm employment report showed the first cracks on the labor market front. At +150,000, it was the second softest print since December 2020. Be grateful for the beloved government sector, as well as health and education services, because they were responsible for 93% of the jobs that were created in October.

If you factor in the downward revisions, the shorter workweek, along with the distortion from the questionable birth-death model, jobs would have been down an estimated -530,000 last month.

In fact, the Bureau of Labor Statistics' (BLS) household survey was not far off as the market had collapsed -348,000 in October. This includes the additional +218,000 that were working part-time for economic reasons and the +205,000 surge in the number of people taking more than one job to make ends meet.

The one thing I wouldn't do is tell any of the 348,000 people in the household survey who lost their job in October that we are in a "Goldilocks" economic phase. It might not be taken too well!

Here's another wrinkle in a very weak jobs report. Overtime hours have dropped to recessionary levels.

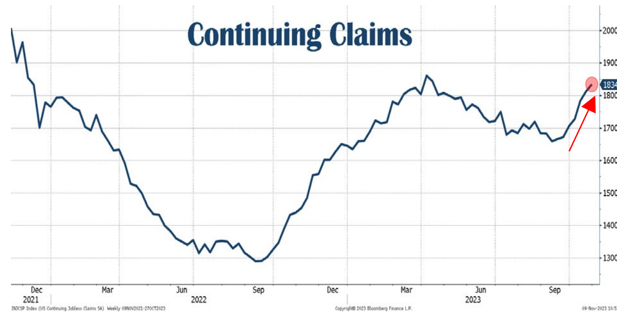


The headline unemployment rate ticked up to 3.9%, the highest since January 2022. It is now up a half-point from the early 2023 low of 3.4%. This is a recessionary signal (it is the change, not the level, that determines the recession call).

On average, going back to 1960, whenever the jobless rate has gone up half a point from the cycle trough, the recession is just beginning. The broader U-6 measure of joblessness rose to 7.2% from 7.0%, which is up +0.7 percentage points from the cycle low posted in December 2022. It reflects a notable loosening up of the labor market.

Also, continuing jobless claims increased for the sixth straight week rising to 1.83 million — the most since early April 2023. This metric clearly indicated that it is becoming more difficult for Americans to find a job should they receive the dreaded "pink slip."

According to Goldman Sachs, it's going to get worse as ongoing seasonal distortions have increasingly weighed on the level of continuing claims over the last six months. They now expect that the reversal of those distortions could exert a cumulative boost of 375,000 to the level of continuing claims between now and March.



All of the above helps explain why last month's wages were so benign at +0.2% month-over-month. The three-month trend is running at an annual rate of +3.2%.

Finally, take a look at the fascinating article in the *Wall Street Journal* entitled *"*The New Headache for Bosses: Employees Aren't Quitting." Hot off the heels of the "great resignation," firms are now finding that employees (facing an uncertain labor market) are refusing to quit and turnover is too low.

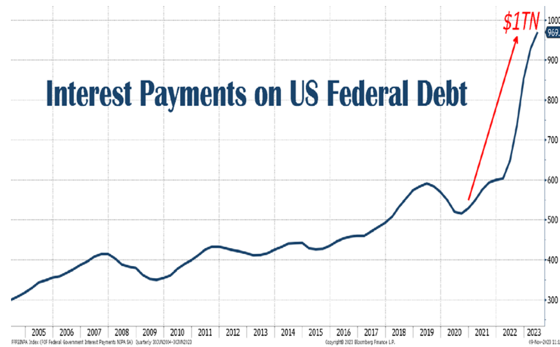
Instead of running out of workers, it's quite possible that companies hoarded labor during the pandemic and are now looking to downsize their staff.

Bottom Line: As long as people have jobs, they will probably continue to spend, with many consumers spending above their means. However, should labor strains continue to increase, this spendthrift attitude could shift quickly.

GRAPH OF THE WEEK

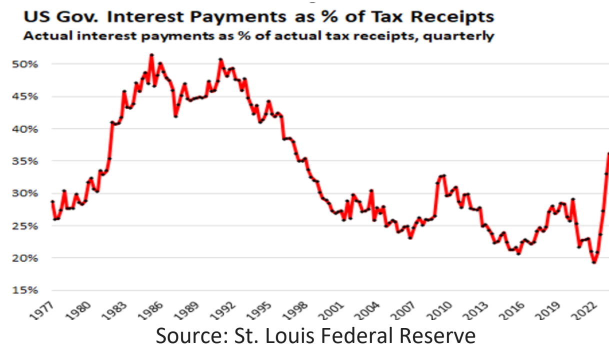
"The Congressional Budget Office (CBO) projects that U.S. government debt will rise by $20 trillion next 10 years, or $5.2 billion every day or $218 million every hour!" — Michael Hartnett, Chief Investment Strategist, Bank of America

The cost of the debt pile will continue to grow and grow. Government debt has risen by $604 billion in one month. This equates to $20 billion every day and $833 million every hour. If this pace continues, U.S. debt will be $41 trillion in one year!



Why it matters: If the debt was creating growth that increased tax revenue, one could argue that the debt is "productive and good." Sadly, that is not the case.

As the graph below points out, interest payments as a percentage of tax revenue is going parabolic and greatly outpacing the gain in tax revenue. The graph below shows that interest payments as a percentage of tax revenue has already spiked from 19% to 35% in one year!



Source: St. Louis Federal Reserve

Earlier in the year, Fitch downgraded U.S. Government debt to AA. On Friday afternoon, Moody's Analytics cut the U.S. Government outlook to "negative."

"In the context of higher interest rates, without effective fiscal policy measures to reduce government spending or increase revenues…Moody's expects that the U.S. fiscal deficits will remain very large, significantly weakening debt affordability." — Moody's Analytics

Bottom line: Government spending is not on a sustainable path. It's flying up at a record pace and there could be a point where Congress will be forced to address it by decreasing deficit spending. Maybe someday we'll hear words like "sequestration" and "austerity" again. If Congress ever comes to their senses, which might be too much to ask, and reduces deficit spending, economic growth would slow materially.

The last words go to retiring West Virginia Democratic Senator Joe Manchin:

"The Democratic and Republican machines have no interest in solutions. Instead, they stoke outrage because doing so brings them fame and funding. Today, the business of politics is about monetizing anger and getting paid for it."

JUST GETTING STARTED

"The cloud is breaking because the economy is heading into a hard landing...But it's a process that will take time. The U.S. economy has very serious difficulties that will be with us for a long time in the future." — Dr. Lacy Hunt, Chief Economist, Hoisington Investment Management

Long-term Treasury yields have slid sharply since late October due to speculation that the Fed has completed its most aggressive tightening cycle in decades and the wave of new debt supply is abating.

Dr. Hunt believes (as I do) that inflation is yesterday's story.

As I discussed at this year's Credit Union Leadership Symposium in Las Vegas, once the pandemic noise fades, the economy, inflation and interest rates will revert back to lower pre-pandemic levels as the long-term secular forces of excessive debt and aging demographics reassert themselves.

"The problem for the U.S. and the rest of the world is that there's going to be very poor growth, very erratic growth."
— Dr. Lacy Hunt, Chief Economist, Hoisington Investment Management

Dr. Hunt sees a fiscal and monetary backdrop that bodes well for bonds and the recent rally will gain steam once the U.S. economy careens into a hard landing.

"What we are going to see – we are beginning to see it now – is the yield curve will normalize…Short yields will drop more rapidly than the long yields, but the greatest capital gains opportunities will be in the longer end of the curve."
— Dr. Lacy Hunt, Chief Economist, Hoisington Investment Management

Bottom line: I believe the Fed is done with this tightening cycle. The only question is when the next easing cycle begins and how far the Fed is going to have to go to fight the downturn.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The long rate is very damaging…It increases the cost of capital, so it makes it difficult for businesses to invest. It craters the housing market with mortgages all of a sudden at 8%. This causes implications in indeed in our financial system. Our banks are taking a hit right now…All of this points to weakness in 2024."
— Campbell Harvey, Founder of the Yield Curve Recession Indicator

It is now three and half years after the pandemic shock. In July of 2020, it was hard to imagine that consumers would spend at the rates they ultimately did. Today, consumers seem to continue to spend despite whatever the Fed does to slow the economy. And it's also easy to get caught up in recent trends and believe they can continue for long periods. Consequently, it's hard to imagine how they end.

"But the inflationary problem in my view for all practical purposes has already been solved."
— Dr. Lacy Hunt, Chief Economist, Hoisington Investment Management

Consider the following data below, which all have become disinflationary or deflationary.

- The money supply is down 3.6% year-to-date (disinflationary/deflationary).
- The Fed balance sheet is down 10% year-to-date (disinflationary/deflationary).
- The fed funds rate is at 5.33% (disinflationary/deflationary).
- The government deficit is $1.69 trillion (less inflationary).
- Supply lines have fully healed (disinflationary/deflationary).
- Personal savings fell by 9% year-to-date (disinflationary/deflationary).

- Crude oil is hovering around $75 per barrel, which is $10 above the five-year average (disinflationary/deflationary).

I know it's safer to stick with the herd**,** but I just don't see the "sticky inflation" that the broad consensus talks and writes about. Clearly, it's not in the data. To wit: The San Francisco Fed publishes a monthly median personal consumption expenditures (PCE) deflator, and it has slowed year-over-year for six months, running from +6.6% a year ago to +3.2% presently. The share of items in the inflation goods and services basket that is deflating on a year-over-year basis has ballooned to 25% from 6% a year ago (where it was pre-COVID-19). Everything has normalized except for interest rates, and that's because the Fed is doing what it does best, which is fighting the last battle. Some people in the Treasury market seem to be paying attention.

Bottom Line: People want to talk about the $18 Big Mac, but that is not the future — that is the past. I am more convinced that we're entering a disinflation/deflationary phase. In other words, the Fed's tightening of monetary policy worked — with a long lag — and you will see prices continue to fall over the foreseeable future. While it may take time, I soon see a day when a disinflationary or deflationary reality hits the bond market and bond yields plummet.

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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