alloya
INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF NOVEMBER 20, 2023

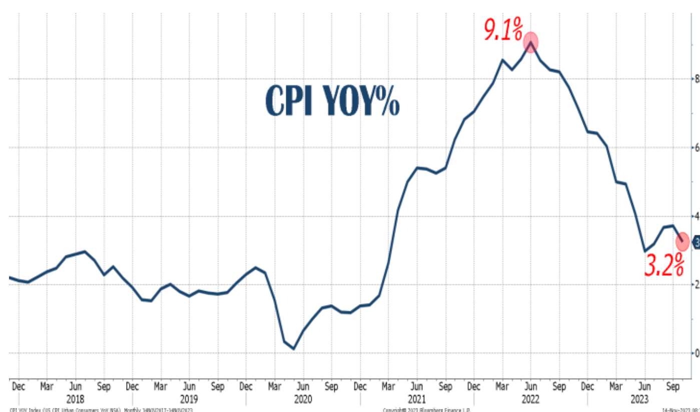
A Regime Change?

*"Ain't no reason to believe the last inflation mile will be the most difficult… **Slower consumer demand, reduced housing rents, lower profit margins, easing wage growth and restrictive monetary policy represent the ideal disinflationary combo heading into 2024**."* — Gregory Daco, Economist, EY-Parthenon

A week ago, *Bloomberg* released an article, *"Griffin Says Peace Dividend Over, High Inflation to Last Decades."* Now, take a second look at the graphs below and see if that is the case.

The October Consumer Price Index (CPI) print was expected to slow materially from the previous month. However, what we received was a whopper with CPI missing across the board. Both headline and core prints came in below expectations on a sequential and annual basis.

First off, the headline U.S. CPI came out for October and was light at +0.0% month-over-month. This was below the consensus of a 0.1% print, and sharply below last month's 0.4% print. Year-over-year, the inflation rate melted to +3.2% from +3.7% in September. The headline inflation rate has collapsed nearly 6% from the June 2022 peak (9.1% to 3.2% today).



It also must be said that CPI (excluding shelter) deflated -0.1% month-over-month and the year-over-year trend has sliced to +1.5% from +8.2% a year ago. As has been the case throughout the year, inflation in shelter costs has been the primary driver of service inflation.

THIS WEEK

- LOWEST LEVEL SINCE 2020!
- FOLLOW THE MONEY
- THE CONSUMER FUNK
- SLAMMING ON THE BRAKES
- BAD SANTA?
- MARKET OUTLOOK AND PORTFOLIO STRATEGY
- GIVING THANKS!

SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
TELL ME MORE!

SUBSCRIBE

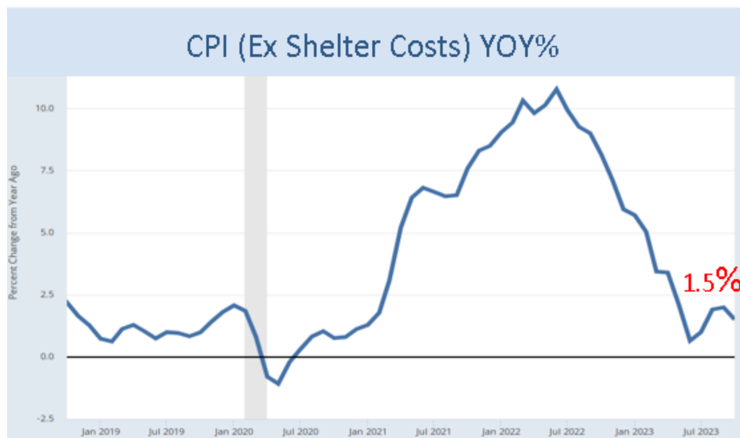
Most importantly, while the very stale shelter cost data is rising over 7%, real-time rent indicators are in freefall as the latest Apartment List data shows new apartment rents falling at a -1.2% year-over-year!

> *"Mid-America Apartment Communities, which has ownership in more than 100,000 apartment homes in 16 states and Washington, D.C., last month said it has been lowering rents to attract new tenants. A pandemic-era building boom is leading more apartments to hit the market when their developers are being squeezed by higher debt-financing costs than they anticipated." — Excerpted from the Wall Street Journal, "Cooling Inflation Likely Ends Fed Rate Hikes."*

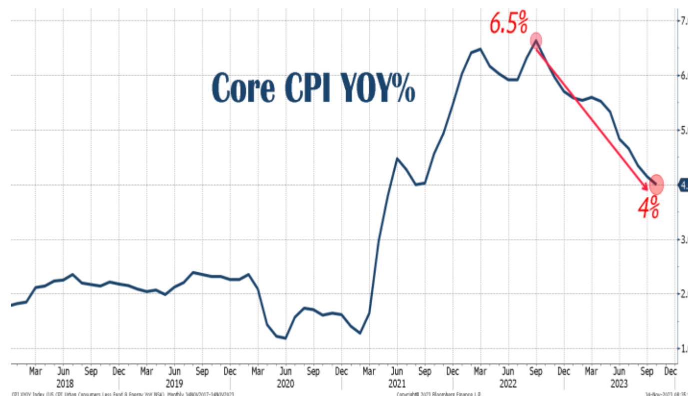
Once the lagged CPI rental measures converge on the real-time data, by this time next year both the headline and core inflation rates will have sliced below a +1.0% year-over-year rate.

But, don't take my word on it. Consider this ditty from the *WSJ* article, "As Rent Rises Cool, So Will Inflation."

> *"The Labor Department's measure of shelter inflation has come down a lot—it has a lot further to go […] But* ***it sure looks like the Labor Department's measure of rent inflation, and by extension shelter inflation, has nowhere to go but down."-***



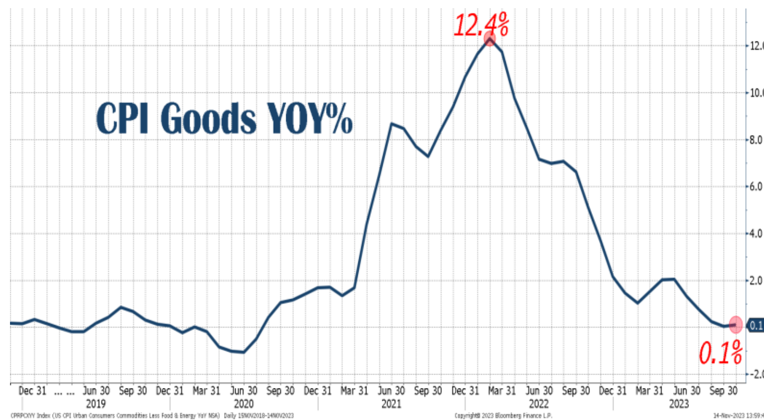
The core index (excluding food and energy) was also stellar at +0.2% (consensus was +0.3%). The trend is positive with the year-over-year core rate edging lower to +4.0% from +4.1% and now back to where it was in August 2021.



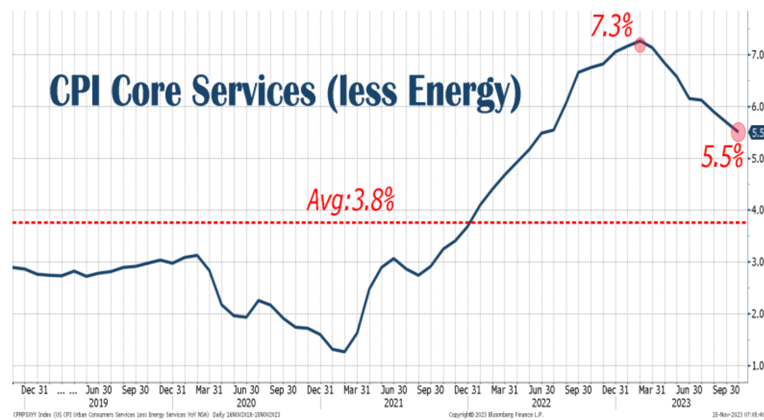
Looking at the contributions to CPI, it's clear that inflation has all but disappeared for the highly cyclical core goods (i.e., new and used vehicles, computers, smartphones, appliances, furniture, etc.). In fact, after blowing out during the period of COVID-19 pandemic shortages, goods prices have plunged from 12.4% to only 0.1%.

And the prospects for further deflation in good looks promising as China is spreading its deflationary wings around the world. According to ABN AMRO Bank, prices of goods shipped from China have fallen around 20% this year. While some of that drop reflects easing supply chain bottlenecks, it is also a sign that Chinese sellers are discounting to preserve or expand market share during a period of weaker global demand. As China tries to export its way out of a recession, look for U.S. domestic goods pricing to be pressured lower from here.

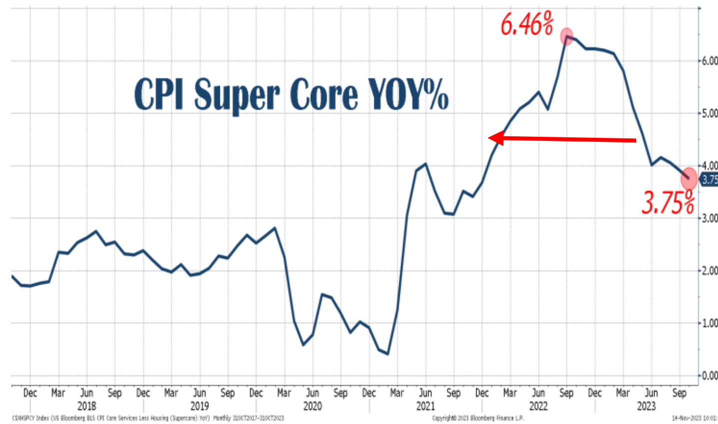
“Some Chinese factories, saddled with overcapacity in a struggling economy, are trying to export their way out of trouble and stoking new trade tensions in the process.”



Service inflation (primarily housing) remains on the high side at 5.5% but, as I’ve stressed repeatedly, we are starting to see a bit of a break in the stubborn and lagged rental measures. In fact, actual rents came in at +0.5% month-over-month after peaking at +0.8% earlier this year. Also, the Owners’ Equivalent Rent was at +0.4% and is tied for the mildest increase since August 2021.



Also, very encouraging, Fed Chairman Jerome Powell's favorite price index, the so- called "supercore" index (services excluding energy and rents), was a tame +0.2% month-over-month and has now come in light for five of the past seven months. The year-over-year trend has slowed to +3.7% in October, which was +6.4% this time last year! Even Jerome must like this data.



"The inflation fever has broken in the U.S." — Bill Adams, Chief Economist, Comerica Bank

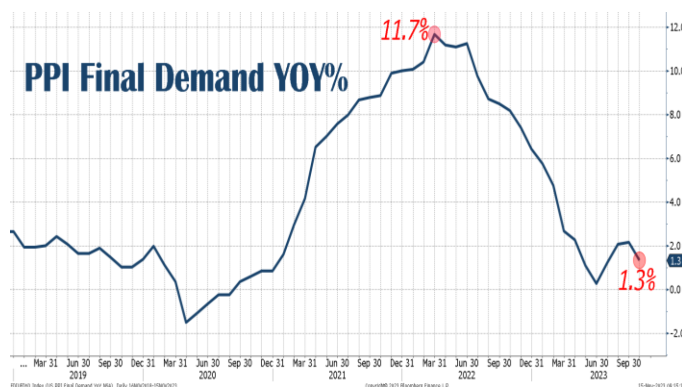
Bottom line: There's no way to deny that the latest consumer numbers were very encouraging for anyone who wanted to see inflation fall, and about as good as was reasonable to hope.

That said, the data is not sufficient for the Fed to cut rates in the near term. But assuming the present trend continues the soft October CPI report paves the way for rate cuts by the Fed, sooner than earlier expected. If so, U.S. Treasuries will be the biggest beneficiary.

LOWEST LEVEL SINCE 2020!

One day after the CPI surprised to the downside and as inflation continues to ease, the Bureau of Labor Statistics (BLS) reported that prices paid to U.S. producers unexpectedly declined in October by the most since April 2020.

Specifically, in October, the Producer Price Index (PPI) for final demand decreased 0.5% from a month earlier, a sharp slowdown that was mostly reflective of a sharp decline in gasoline prices while the index rose 1.3% from a year ago.

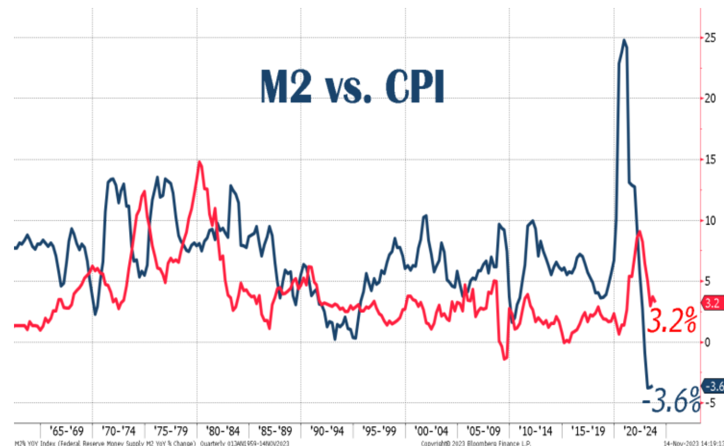


Bottom line: The PPI report adds to evidence of abating inflationary pressures across the economy.

FOLLOW THE MONEY

"Inflation is always and everywhere a monetary phenomenon, in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." — Milton Friedman

When I started in the bond business in 1980, virtually the only economic release that moved the market was the release of the money supply numbers (M1 and M2), which came out every Thursday afternoon. If money supply increased, bonds would trade off (higher yields). Conversely, if the money supply declined, bonds would rally (lower yields). In other words, the money supply was the key leading indicator of everything from inflation to the bond market to the stock market. So, we waited anxiously at the Telerate machine waiting for the number to be reported.



Yet, despite the strong historical correlation over the past 40 years, the money supply has been out of fashion within the economic and investing circle. It has been replaced by the central banks, who have focused on setting interest rates while allowing the money supply to fluctuate as needed to maintain the desired rates.

However, with the record growth in M2 during the pandemic and the rapid rise in inflation, there has been a re-ignited interest in the role of money supply measures in predicting prices. Moreover, now that M2 is contracting at the fastest rate ever, disinflation is now coinciding with a rapid reduction in the money supply.

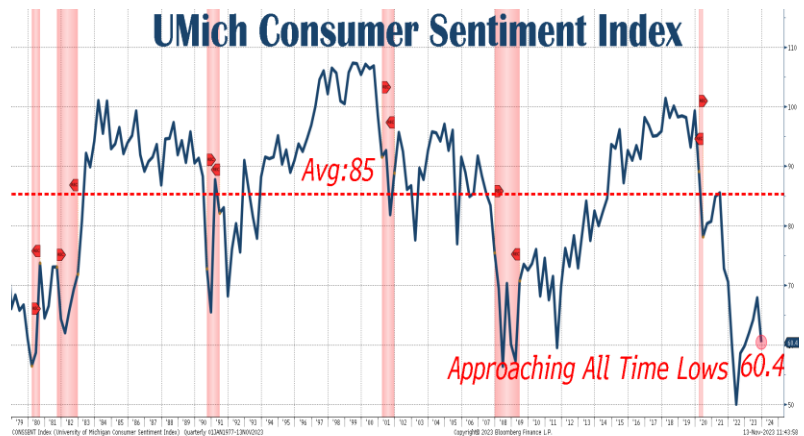
To quote Dr. Huw Pill:

"Monetarism has perhaps contributed more to the past, present and future of monetary policy than we conventionally admit." — Dr. Huw Pill, Chief Economist, Bank of England

Bottom line: It seems improbable that the 40-year correlation between M2 and Inflation is a mere coincidence. If Mr. Friedman and Dr. Pill are right, one should expect more good news on the inflation front going forward.

THE CONSUMER FUNK

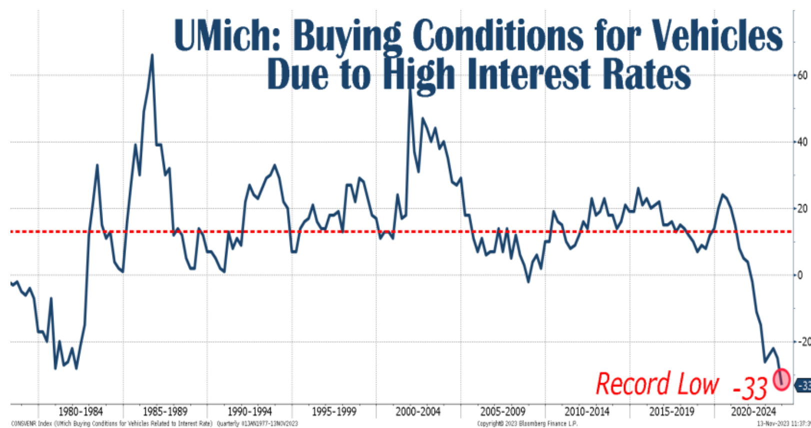
Despite the economy allegedly doing so great, Americans are in a rotten mood. The University of Michigan's Consumer Sentiment Index fell to its lowest level since May. At 60.4, the index is either at or below the levels seen in every recession over the past seven decades, and that includes the Great Financial Crisis of 2008-2009. The 60.4 reading compares to a long-turn norm average of 85. In other words, the current reading is roughly 26 points below the norm. Yet, all I hear about from Wall Street cheerleaders is the ongoing resilience in the consumer.



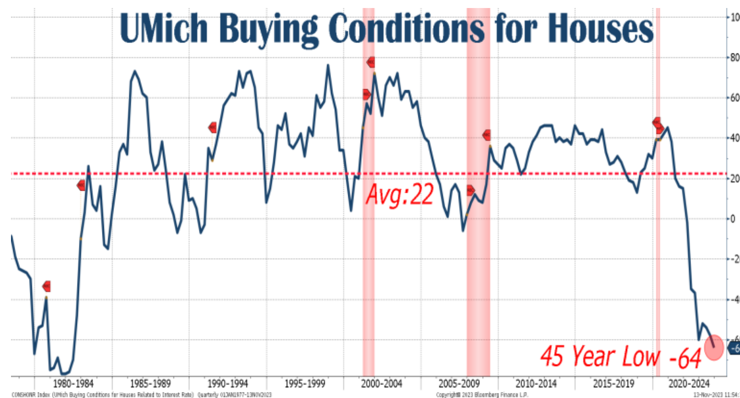
At the same time, Powell states for the entire world to hear that he has no clue just how restrictive Fed policy is at the moment. Apparently, a simultaneous contraction in the monetary aggregates and bank credit have yet to convince him. He also seems unmoved by the 16-month-long inversion of the yield curve. He focuses on the BLS payroll survey instead of the household survey. The two surveys are signaling entirely different things about the state of the jobs market. And he also focuses on gross domestic product (GDP) instead of gross domestic income (GDI), which is flat in real terms over the past year.

But all you need to do is look at the spending intentions components of the Consumer Sentiment Index to see just how tight monetary policy is (and the reasons why).

Spending intentions on autos have cratered. The share saying that they are out of the car market because of interest rates increased from 28% to 33%. This is an all-time high that takes out the prior record of 31% posted in September 1981 when the funds rate was sitting at 12.4%. Imagine that in the auto market? Today's 5.5% fed funds rate feels like the 12.4% fed funds rate of four decades ago.



What about housing? Well, homebuying plans in November went from a recessionary 44 in October to a depressionary 33 in November, and it is now tied for a record low. The share of respondents blaming interest rates for forcing them to the sidelines rose to 67% from 62%. This is the highest complaint rate about the Fed since August 1982 — when the funds rate was at 10%.



Bottom line: All-in, the continued slumping consumer confidence suggests limited spending growth ahead, which in turn should lead to more disinflation to come.

SLAMMING ON THE BRAKES

And it's not just consumers who are feeling the bite from the rate hikes. Last week, the *WSJ* ran with this article, "With Interest Rates Above 9%, Small Businesses Slam the Brakes."

Here are a couple of key snippets:

"More than half of small-business owners reported higher rates were affecting their business, while 19% anticipate they will be affected."

"The dollar value of new small-business loans declined 16.8% in the second quarter compared with a year earlier, reflecting rising rates, weaker loan demand and tighter lending standards. Of more than 1,200 small businesses responding to an October survey by Goldman Sachs, ***53% said they can't afford to take out a loan at current rates. The 9.8% average rate that small businesses paid in September was the highest since December 2006."***

BAD SANTA?

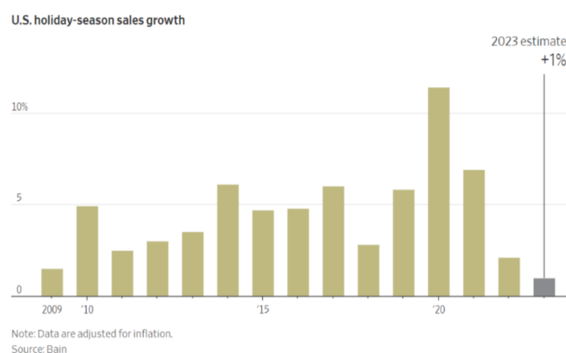
The usually optimistic *WSJ* lays waste to the entrenched belief that the U.S. consumer will never succumb to the daggers of the sharpest runup in interest rates since 1981.

Have a look at another *WSJ* article, *"Five Economic Signs You're Smart to Procrastinate on Holiday Shopping This Year."*

To wit:

*"The National Retail Federation expects overall sales increases could be in line with the slower pace we saw in the decade leading up to the pandemic, from 2010 to 2019, when the average annual increase over that period was 3.6**%. It expects November-December spending, not including inflation, to rise 3% to 4%. By contrast, sales rose 5.4% in 2022, 12.7% in 2021 and 9.1% in 2020."***

Others are even gloomier. The consulting firm Bain expects inflation-adjusted retail sales in November and December for stores and e-commerce to rise 1%, the slowest pace since the financial-crisis holidays of 2008.



In the same retail file, have a read of this *WSJ* article, "Holiday Hiring Demand Drops Off, a Warning for the Job Market." Indeed, according to Challenger, Gray & Christmas, the number of seasonal positions publicly advertised for this season has fallen to the lowest level in a decade!

Meanwhile, the National Retail Federation estimates that between 345,000 and 445,000 seasonal workers will be hired this year, which is down as much as 40% from the recent highs posted in 2021. They expect spending this holiday season (November 1- through December 31) to expand between 3% to 4%— down from 5.4% year-over-year growth in holiday sales last year.

And then we have this from Walmart, the bellwether for the American consumer:

"It makes us more cautious on the consumer as we look into the fourth quarter." — John David Rainey, CFO, Walmart

This was reinforced by Target's CEO:

"Overall, consumers are still spending, but pressures like higher interest rates, the resumption of student loan repayments, increased credit card debt and reduced savings rates have left them with less discretionary income, forcing them to make trade-offs." — Brian C. Cornell, CEO, Target

Between Walmart and other retailers, it's becoming obvious that the "resilience" the consumer may have had in the third quarter is quickly coming to an end.

Bottom line: Savings are at a near record low and credit-card delinquencies are already exceeding 2019 levels for the first time since the pandemic**.** If these surveys prove to be accurate, this holiday season is looking… Ho! Ho! Horrible!

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The Federal Reserve has overdone it, we're going to see a lot more deflation going forward… If we're right, and they've gone way too far, they'll have to cut fairly significantly… the CPI inflation rate could turn negative at some point next year." — Catherine Wood, CEO, ARK

There have been some loud and annoying bond bears in the last few months. The "higher for longer" view had turned into a minor cult comprised of a group of people who thought that rates would stay high forever and go higher. I heard calls for 6%, 7% and 8% yields on 10-year notes and beyond.

I have never bought into this narrative. Instead, my long-held view was the highly leveraged and debt addicted U.S. economy cannot sustain "higher for longer" rates for long.

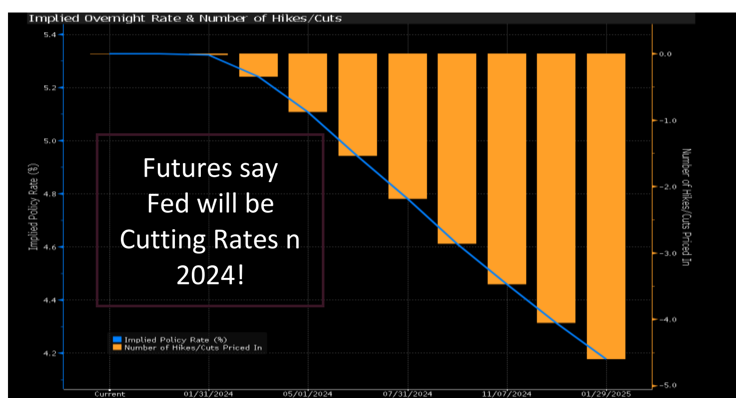
As discussed above, even though monthly inflation data can be very choppy, the October CPI report was undeniably good news. Moreover, on the labor front, both jobless claims and the continuing claim count are rising in tandem. The latter speaks to the rise in the unemployment rate that we have been seeing in the BLS household survey and is a signal to the inflation-wary Fed that slack continues to build in the once-tight labor market. The former is flashing something brand spanking new, which is that the era of labor hoarding by businesses has come to an end — after all, you can only cut hours for so long.

With core inflation still at 4%, it is too early for the Federal Open Market Committee (FOMC) folks to let their guard down. That said, the hiking cycle has ended. The Fed cannot ignore the recent economic deterioration (and will probably continue to see). Sooner than expected, this may likely push the central bank to start the easing campaign by June, if not earlier (March cannot be ruled out). The markets clearly agree with the futures market pricing in nothing but rate cuts in 2024. Simply put, a new regime may have started.

The yield on the benchmark 10-year Treasury note is now down nearly 60 basis points from the nearby peak.

How low will yields go? 4%, 3%, 2%...?

I don't know, but here is my answer: probably further than you think.



In terms of portfolio strategy, for those credit unions that excess cash balances, the most prudent strategy is to continue to build a risk appropriate ladder. Market retracements provide excellent entry points.

GIVING THANKS!

"Reflect upon your present blessings, of which every man has plenty; not on your past misfortunes, of which all men have some." – Charles Dickens

Last, but not least, I wanted to wish everyone a happy Thanksgiving. Despite the many troubles around the world, we all have so many more blessings we can count.

Let's be grateful and thankful and celebrate this truly American holiday season.

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.

The views and opinions expressed herein are those of the author and do not necessarily reflect the views of Alloya Corporate Federal Credit Union, Alloya Investment Services (a division of Alloya Solutions, LLC), its affiliates, or its employees. The information set forth herein has been obtained or derived from sources believed by the author to be reliable. However, the author does not make any representation or warranty, express or implied, as to the information's accuracy or completeness, nor does the author recommend that the attached information serve as the basis of any

investment decision and it has been provided to you solely for informational purposes only and does not constitute an offer or solicitation of an offer, or any advice or recommendation, to purchase any securities or other financial instruments, and may not be construed as such.

Information is prepared by ISI Registered Representatives for general circulation and is distributed for general information only. This information does not consider the specific investment objectives, financial situations or needs of any specific individual or organization that may receive this report. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities. All opinions, prices, and yields contained herein are subject to change without notice. Investors should understand that statements regarding prospects might not be realized. Please contact ***Alloya Investment Services**** *to discuss your specific situation and objectives.*

**Alloya Investment Services is a division of Alloya Solutions, LLC.*