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Weekly Relative Value

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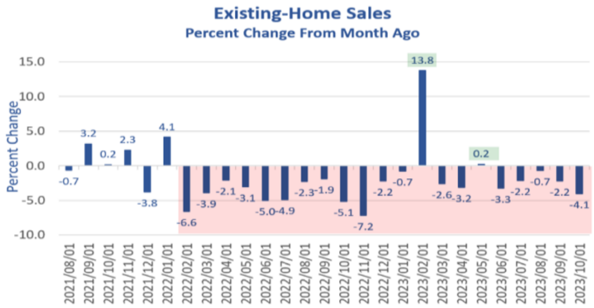
WEEK OF NOVEMBER 27, 2023

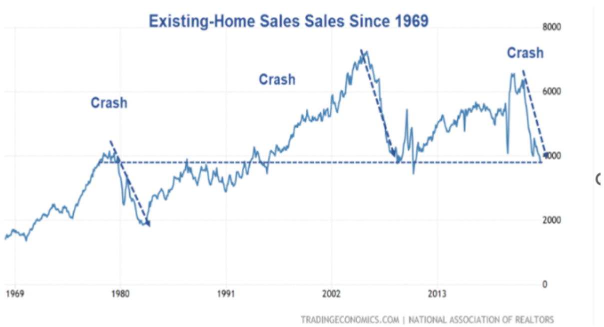
Bonds Will Have More Fun!

"Just that gap between renting and then owning, not even a big house, just kind of a starter house, it's like it's not even possible for us… Not now or probably not any time soon."
— Excerpted from ABC News, "Millennials Priced out of Homeownership are Feeling the Pressure."

Existing home sales were disappointing in October, dropping -4.1% month-over-month to a 13-year low of 3.79 million units — undercutting the consensus view of -1.5% to 3.90 million units. That's a decent-sized miss. Home sales have now been down 19 out of the past 21 months!



The year-over-year trend remains deeply entrenched in negative territory at -14.6% and is now back to a 13-year low. However, the percentage decline is very misleading. The graph below portrays the sorry state of the housing market. Existing home sales are now back to the same levels seen in the housing bust of 2006-2007 and are currently at the same levels seen in the late 1970s when mortgage rates were 14%!



THIS WEEK

- WHEN WILL THE CHICKENS RETURN TO ROOST?
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- CREDIT CONTRACTION
- A FIXED INCOME FIXATION
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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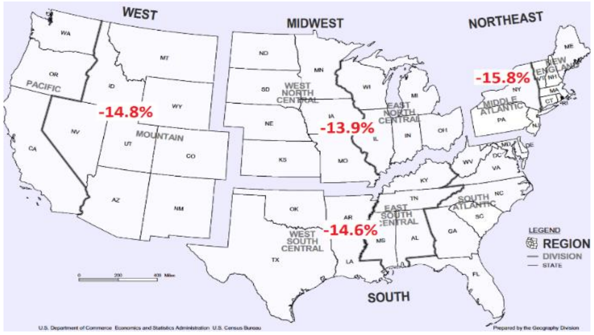
The regional backdrop was soft across the board month-over-month, and, as shown below, the year-over-year decline remains extremely depressing.



Home prices have begun their descent. The national median price of existing median home sale price dipped to $391,800, which is down by 5.1% from the peak in June 2022. The backlog of unsold homes edged up to 3.6 months' supply — the largest inventory since June 2020. This will surely play a role in further deflating residential real estate prices. Even still, homes are grossly inflated compared to the pre-COVID-19 pandemic levels, and mortgage rates have soared nearly 5% higher. In fact, homeowner affordability is the lowest in nearly 40 years! So much for the American Dream.

And I must ask, where does the narrative come from that pent-up demand from the 30-somethings will cause home sales to explode to the upside? At the current mortgage rates, along with inflated real estate values, the first-time homeowner needs a record $103,000 income to afford a starter home! This is 60% higher than the actual $64,000 median income. For some perspective, this is 20% higher than a year ago and nearly two times higher than just before the pandemic struck in early 2020.

Bottom line: Prices are still way too high**.** Interest rates are too high. Homes are unaffordable! Supply is increasing and demand is not. Either home prices will need to decline by 20-30%, mortgage rates will need to drop 200 basis points or a combination of the two will need to happen. My view is that home prices will eventually decline 10-15% (or more) and rates will fall by at least 100 basis points.

WHEN WILL THE CHICKENS RETURN TO ROOST?

"Federal debt has grown 8500% from $372 billion in 1970 to $33 trillion in 2023… By lunch, debt will soar more... by dinner time, more... and more. I'm not trying to scare you. It's just scary."
— Keith McCullough, CEO, Hedgeye Risk Management

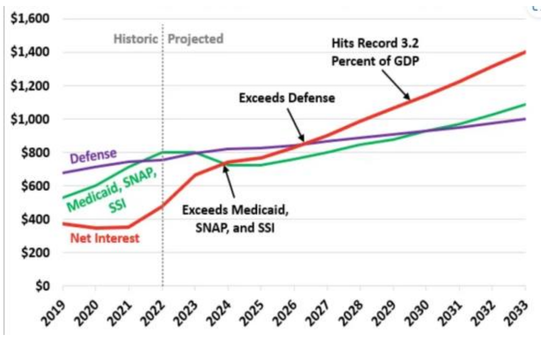
Due in part to policies necessary to combat the pandemic, the federal government added nearly $9 trillion to our national debt over just the last four years. The U.S. government debt stood above $33 trillion in fiscal year 2023. This is about $1.7 trillion more than the year before. As discussed here and elsewhere, the U.S. government is running a budget deficit of 6% of gross domestic product (GDP) in what on the surface appears to be a “good” economy. Jeff Gundlach, founder of DoubleLine Capital (aka the “new bond king”), projects that the deficit could rise to 9% of GDP in a recession.

Proponents of large government deficit spending have argued that servicing the debt isn’t much of a worry since the Fed can print the cash necessary to cover the interest or even buy up the debt. The Treasury would then pay the interest on the debt to the Fed, which would then use the money to cover the cost of its operations and send the surplus back to the Treasury. The government would, in effect, pay the interest to itself.

Interest on the debt has been growing steadily for decades, although at a relatively slow pace to about $570 billion in 2019 from about $350 billion in 1995 — or approximately 2%. However, things are changing fast as the explosion of government spending and the subsequent interest rate increases have resulted in the cost of servicing this massive pile of debt skyrocketing by more than 50% between 2019 and 2023. Over the past year, it has already surpassed the entire military budget.

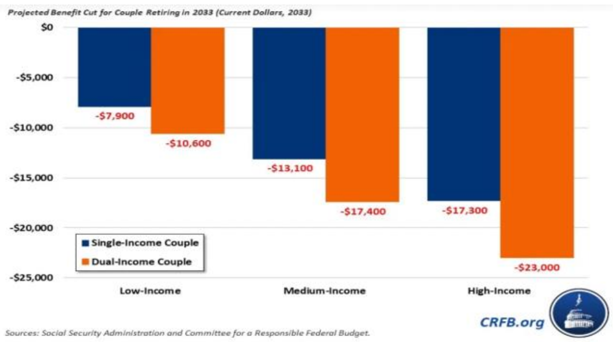
Unfortunately, the cost is expected to keep growing as old debt issued at low interest rates matures and is rolled over into higher rates. According to the Congressional Budget Office (CBO), interest costs are projected to rise to $1.1 trillion by 2030, reaching the previous record of 3.2% of GDP. It would then reach up to $1.4 trillion by 2033, or 3.6% of GDP.

To put these figures in context, by 2024, the bi-partisan Committee for a Responsible Budget (CRFB) interest will cost more than Medicaid, the Supplemental Nutrition Assistance Program (food stamps) and Social Security combined.



Source: CFRB

Making matters worse, according to the CBO, the Medicare trust fund will be exhausted by 2031, and the Social Security trust fund will be depleted by 2033. Upon insolvency, the law mandates that the Social Security trust fund can only spend in amounts equal to incoming trust fund revenue, **which means that all 70 million retirees, dependents and survivors — regardless of age, income or need — will see their benefits cut by 23%.**



As shown in the graph above, for a typical dual-income couple retiring in 2033, the bi-partisan CFRB estimates they would see a **$17,400 cut** in annual benefits. The actual cuts would vary dependent on the couple's income level. While the cut would be lower (-$10,600) for a low-income couple, the pain would be greater as it would represent a larger share of their income. Sadly, senior poverty would rise significantly upon insolvency.

Bottom line: The reason I constantly highlight the fiscal mess in this country is because fiscal policy and actions have powerful consequences on our collective national security and economic health. For our children, this is the worst thing we can do. Despite the gravity of this issue, little is done, and both parties continue to "kick the can" down the road.

With the national debt continuing to soar, interest costs accelerating and looming insolvency of critical trust fund programs, it is critical that whoever wins the 2024 presidential election takes steps to address these issues.

Neither the politicians nor voters can afford to "kick the can" down the road any longer.

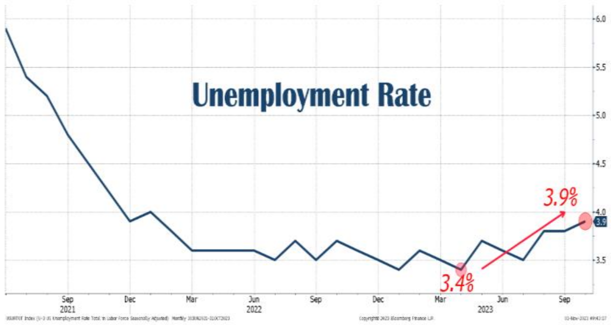
POINT, COUNTERPOINT!

Barron's published an article titled, "What Recession? Consumers Still Have Plenty to Spend.*"* I disagree with the article's premise that the consumer is strong and resilient. I identified some of the assertions below in the "cheerleading" piece. The article's assertions are italicized, and my counters are in bold.

"Although job growth slowed last year to a monthly average gain of 399,000, that was still more than three times the estimated level of 100,000 monthly gains needed to keep the economy on an even keel. Job growth has normalized further this year but remains elevated at a three-month moving average of 204,000 as of October."

Did you know that the non-farm payroll survey only has a 40% response rate, which explains why the jobs report is the least accurate and most heavily revised government data release? Get this, half of the "job growth" this year has come from guesswork and an excel spreadsheet from the Bureau of Laor Statistics (BLS) Birth Death model. Moreover, the BLS household survey shows that over the past six months, employment growth has flattened completely.

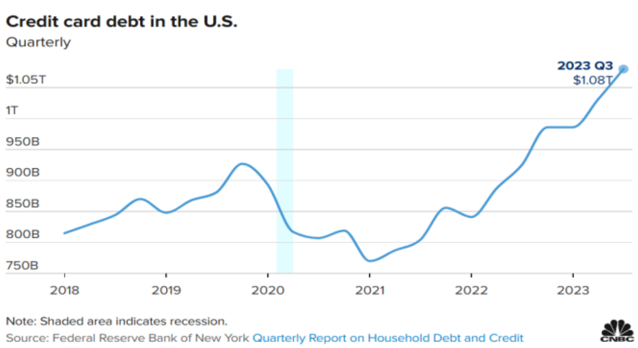
Finally, everyone focuses on the low 3.9% unemployment rate level and concludes that all is well with the labor market. Well, maybe they should look at a bit of history. For example, in January 2020, the unemployment rate stood at 3.5% and at 3.9% in December 2021. In November 1969, the unemployment rate sat at 3.5%. Recessions began very shortly thereafter in both periods.



As I have highlighted numerous times before, it's not about the level, it's about the change at the margin. The jobless rate is up a half-percentage point from the cycle low, which is right in line with the patterns of the past when the recession nobody ever sees takes hold.

"For example, the share of credit-card holders who carried a balance declined from 50% to 45% from April 2020 to December 2021, according to the U.S. Government Accountability Office. And about a third of outstanding home mortgages were refinanced in this period".

The one thing we know is that total outstanding credit card balances have surpassed $1.1 trillion, auto debt is now $1.6 trillion and household debt has expanded to $17.3 trillion. While consumer debt explodes higher, rates on auto loans are reaching unprecedented levels. Credit card rates are as high as 25%, used car rates are at 14% and new car rates are at 10%. For consumers from median households servicing debts for just a car, home and student loans could now eat up 70% of their pre-tax income.



"Although household indebtedness has risen since then, only 3% of Americans' outstanding debt was in some stage of delinquency at the end of September, according to the latest data from the Federal Reserve Bank of New York. By comparison, delinquency rates hit a record of nearly 12% in 2009 and stood at 4.7% at the end of 2019."

For auto loans, the 30-day late-payment rate is at a 13-year high of 7.4%. For credit cards, delinquency rates have nearly doubled since the third quarter of 2021, but remain relatively low at 2.98% compared to the 2008 Great Financial Crisis peak of 6.77%. Even mortgages, at 2.8%, are back to where they were in the pandemic recession of 2020. But one must also consider that the data is skewed by the sub-1% default rate on student loans because of the debt moratorium, which is now over. What happens when, not if, a recession ensues.

"Given that wealthier Americans are the primary drivers of consumer spending, however, the question is what might get them to cut back."

It's true that the wealthy do not change their spending habits in recessions that much, and people on the low end of the income spectrum have always spent 100% of their incomes, which is mostly on essentials. Recessions are about changes at the margin and not at all about levels. In other words, it is how the middle-class, the dominant 60% of the population, is impacted and how it shifts in consumer spending through the business cycle.

Finally, if the data doesn't convince you that large swaths of the population are floundering, please consider the *Wall Street Journal*/NORC Poll October 2023.

Only 36% of voters that were surveyed said the American dream still holds true, substantially fewer than the 53% in 2012 and 48% in 2016. Last year, when a *Wall Street Journal* poll asked whether people who work hard were likely to get ahead in this country, only 68% said yes — nearly twice the share as in the new poll.

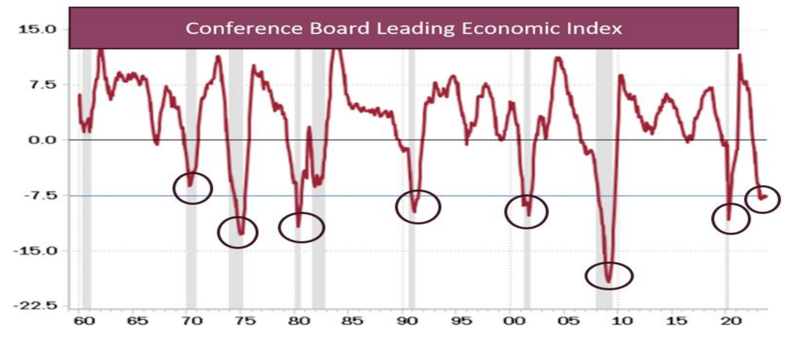
In essence, The American dream — the proposition that anyone who works hard can get ahead, regardless of their background — has slipped out of reach in the minds of many Americans. The majority of those surveyed thought it was better 50 years ago!

Bottom line: The 2008 crisis was a Wall Street crash with secondary effects on Main Street. Today's predicament is rooted in widespread affordability issues, which show real potential for serious consequences. The metaphorical bowling ball above our heads is becoming heavier to hold up.

19 MONTHS IN A ROW

The Conference Board's index of leading economic indicators continues to hammer the point that the recession that was delayed in 2023 will likely not be derailed as we move into 2024. The index fell yet again in October by -0.8% month-over-month. This was the nineteenth consecutive decline. The last time this happened was in September 2007 to March 2009. Before that? Try September 1973 to March 1975.

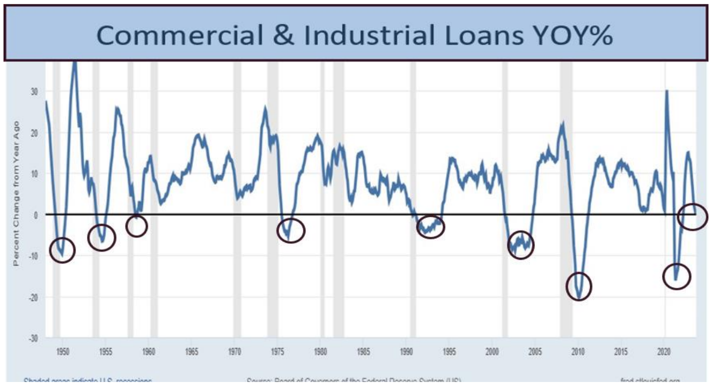
The year-over-year trend at -7.6% has a perfect track record presaging recessions (the circles in graph below). More often than not, the recession has already begun by this point. The same holds true from the decline off the peak — down -11.8%, another foolproof indicator.



Source: Haver Analytics

CREDIT CONTRACTION

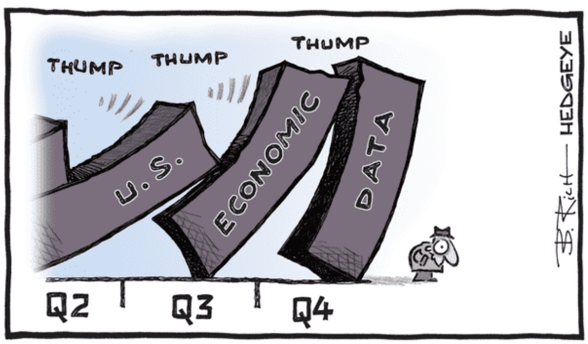
The following graph speaks for itself and requires few words. Total bank credit is running -0.8% on a year-over-year basis as of the week of November 8. One of the most reliable leading indicators for the economy, and a risk-on/risk-off signal, was the trend in commercial and industrial loans. Make sure to take a look and draw your own conclusions.



A FIXED INCOME FIXATION

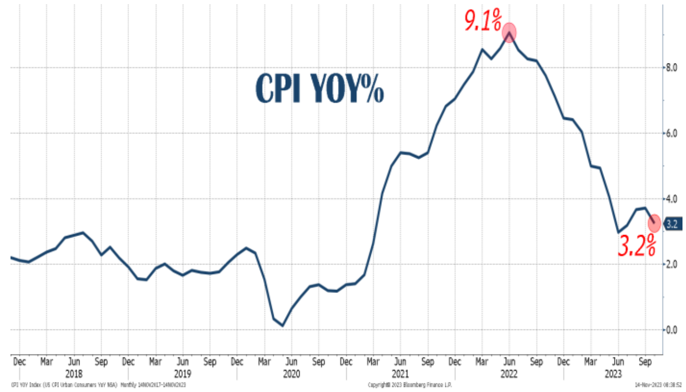
The 10-year Treasury yield has fallen to 4.47% from the nearby high of just over 5%. The rally in Treasuries is a sign that bond investors are preparing for a recession in 2024 and the onset of a significant Fed easing cycle.

At some point next year, pundits are likely to look back and say, *"Why didn't I pay heed to that 19-month string of declines in the leading economic indicator?"*



I remain bullish on bonds because, first and foremost, on the inflation front, while prices remain higher than they did prior to the pandemic in 2019, the level of inflation appears to have peaked, and the disinflationary trend has more room to go. Given the weighting of housing in the Consumer Price Index (CPI), if the San Francisco Fed's Report on shelter inflation is correct, by this time next year, rental price inflation could be flat or possibly negative. If so, headline inflation, and perhaps also core, could break below 1% or even approach zero next year.

Also, West Texas Intermediate (WTI) crude oil has declined **-11%** in the past month alone. The impact of the recent downward move in energy prices will not only exert a downward skew on headline CPI but it will also spill into the core from delivery costs, moving and freight expenses, and airfares.

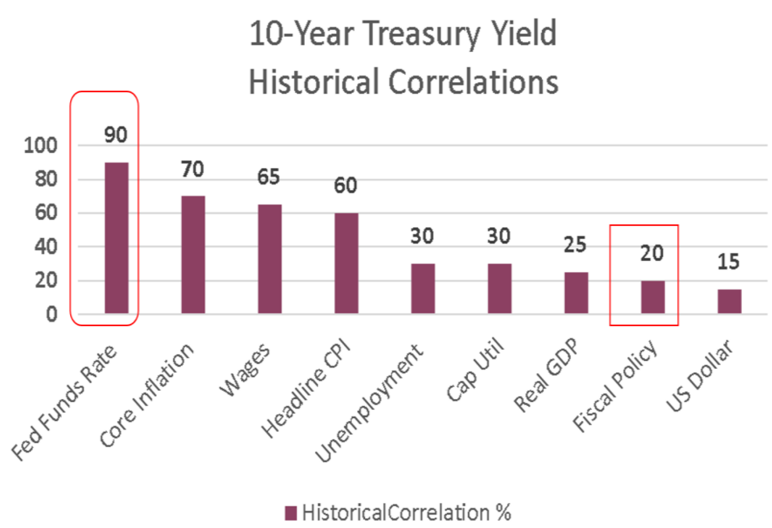


At the same time, the annual downward trend in producer prices (including services) — which leads the CPI — has melted to a mere +1.3%, from +8.2% this time last year. There is so much deflation in the pipeline that is not fully appreciated. But the Fed dares not take a victory lap this early, having been so shamed in that 18-month inflation bulge that peaked in the summer of 2022. Although they should.

Regarding the economy and rates, every Fed easing cycle ends the recession with a fresh refinancing phase. This only happens when the Fed cuts rates to below the average of the prior five to 10-year period. Given where borrowing costs are today compared to where they were over the past five to 10 years, mortgages, personal loans, auto credit and corporate debt rates would need to fall at least 200 basis points to reignite a new positive economic cycle.

If the most anticipated recession of all time finally rears its ugly head, the Fed is going to end up having to cut rates deeply to get the ensuing recovery to gain traction. For investors, if the past is prescient, fixed income should perform well into 2024.

And when asked, “Why are you still bullish on bonds given all the Treasury supply?” My answer is straight forward. Inflation has a 70% correlation to longer-dated Treasury securities, and while fiscal policy does have some impact, its correlation is far lower at 20%.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Interest rates are declining—normally, that would provide a tailwind for home and auto sales. The fact that both markets remain stagnant confirms one thing: U.S. consumers are not in good shape."
— Keith McCullough, CEO, Hedgeye Risk Management

I will state that with everything I wrote last week, nothing has changed even despite those that proclaim that rates will remain "*higher for longer.*" There have been calls for 6%, 7% and 8% yields on 10-year Treasuries and beyond.

Not going to happen!

Homes and autos are out of reach for most Americans. The highly leveraged and debt addicted U.S. economy simply cannot sustain "*higher for longer.*"

Further, while the hawkish rhetoric is still in play, the Fed cannot ignore the recent economic deterioration, which will likely continue into 2024. Sooner or later, the Fed will commence a reversal of its tightening policy and begin the easing cycle. Maybe it starts in May or June, if not March. Simply put, rates have peaked, and a new regime may have started.

Finally, as I have been stating since the first edition of the *Weekly Relative Value* in 2008, in terms of portfolio strategy, for those credit unions that have "excess" cash balances, the most prudent strategy and discipline is to continue to build a risk-appropriate ladder. Market sell-offs provide excellent opportunities to invest in longer duration securities.

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.