alloya
INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF DECEMBER 4, 2023

Preparing for the Pivot

*"If you see this lower inflation continuing for several more months, I don't know how long that might be — three months? four months? five months? — **you could then start lowering the policy rate because inflation's lower… I am increasingly confident that policy is currently well positioned to slow the economy and get inflation back to 2%."***
— Christopher Waller, Member of the Federal Reserve Board of Governors, Excerpted from "Something Appears to Be Giving"

After exiting the brutal bond bear market in 2022, most fixed income investors anticipated that 2023 would be the "year of the bond." Instead, the bond market was hit by waves of turmoil as a "resilient" U.S. economy prompted the Fed to extend its steepest tightening cycle for another year.

However, that changed last month. On the back of dismal economic data (see the economic calendar below), along with a string of disinflationary data, dovish Fed comments and increased speculation the Fed will start cutting next year, the bond market "rocked and rolled." The beaten-down and detested bond market, left for dead, turned in its best month since the 1980s!

2023 NOVEMBER

SUNDAY	MONDAY	TUESDAY	WEDNESDAY	THURSDAY	FRIDAY	SATURDAY
OCT Data Released Last Week of October Philly Fed Services = Worse = MISS Richmond Fed Services = Worse = MISS KC Fed Services (Oct) = Worse = MISS Dallas Fed Mfg (Oct) = Worse = MISS Chicago PMI (Oct) = Worse = MISS Dallas Fed Services (Oct) = Worse Conf Board Consumer Confidence (Oct) = Worse = MISS			1 ADP = ↓= MISS ISM Mfg↓ = MISS Auto Sales = ↓ MISS	2 Initial Claims ↑= MISS Cont. Claims ↑ = MISS	3 NFP ↓= MISS ISM SRVCS ↓ = MISS	4
5	6 SLOOS Further Credit Cycle Tightening	7	8 NY FED 3Q23 Consumer Credit = Worse	9	10 Univ. Mich Confidence ↓ = Worse	11
12	13	14 NFIB Confidence ↓ = Worse CPI ↓ = Beats (Kinda)	15 Retail Sales ↓ = Worse	16 Initial Claims ↑= Worse Cont. Claims ↑ = Worse Industrial Production ↓ Builder Confidence ↓	17	18
19	20	21 Chicago NAI ↓ Existing Home Sales ↓ KC Fed SRVCS = still (-)	22 Initial Claims ↓ Durable Goods ↓	23	24 S&P PMI = Unchg	25
26	27 New Home Sales ↓ Dallas Fed ↓	28	29	30		© BlankCalendarPages.com

THIS WEEK

- FAST TRACK TO 2%!
- LABOR CRACKS ARE WIDENING
- MORE DISMAL HOUSING DATA
- HUGE DISCREPANCY!
- INFLECTION POINT
- BUY NOW… PAY LATER!
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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Now, the fed fund futures market has a **cut** priced in for May 2024 and the odds for a March cut went to 50% from 35%. For all of 2024, there are nearly five cuts being priced in. If these rate cuts come to fruition, the "higher for longer" narrative would be even more transitory than "transitory" was!

The U.S. 10-year yield, which reached a multi-year high of 5.0% in October, retreated to 4.32% in November. In doing so, the 10-year benchmark has retraced the sharp yield backup that occurred after the Fed meeting in September, which advertised "higher for longer" and stamped that call with a premature addition of one more hike to the "dot plots."

The long bond (30-year) yield was sliced by 60 basis points from 5.09% to 4.49%. Likewise, in the intermediate sector, the 5- to 7-year Treasury benchmark, yields fell over 56 basis points to 4.22% and 4.26%, respectively. Even at the front end of the yield curve (tied to Fed policy), the 2-year yield dropped 43 basis points to 4.68%. In aggregate, on a total rate of return basis, Treasuries returned 3.1% in November. In summary, bonds did have more fun!

But the rally was not just in Treasuries. The entire fixed income market celebrated the past-the-peak rates and inflation view with investment grade corporate bond spreads compressing to just +111 basis points — the tightest since February 2022. For the month, the fixed income U.S. Aggregate Bond Index (widely used as the bond market benchmark) jumped 4.9%!

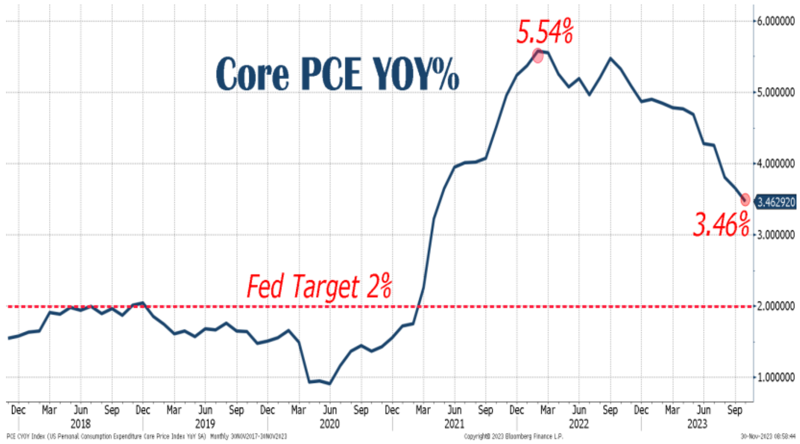
Bottom line: The sharp bullish move in fixed income during November was indeed welcomed, and more importantly driven by the fundamentals. The bond market can see declining inflation and the whites of the eyes of the economy.

FAST TRACK TO 2%!

The headline personal consumption expenditures (PCE) tumbled to +3% year-over-year, the lowest since April 2021. More importantly, the core PCE deflator, the Fed's favorite inflation indicator, decelerated to 0.2% month-over-month and 3.5% on an annual basis. On a one, three and six-month annualized basis, core PCE inflation increased 2.0% (compared to 3.8% prior), 2.4% (compared to 2.4% prior) and 2.5% (compared to 2.8% prior) — all close to the Fed's 2% target.

Also, as I have highlighted previously, the year-over-year trend in the "excluding shelter" Consumer Price Index (CPI) is now a mere +1.5%. This compares to +8.2% a year ago and is even lower than it was pre-COVID-19 when this trajectory was +2.0%. To repeat, inflation is now at +1.5% when shelter is stripped out of the equation. Another way of looking at this is that about 70% of the CPI is already running a half-point below the Fed's target! And yet, the folks at the Fed have been scared of their own shadow.

Remember, one-third of the CPI, 40% of the core and half of service-sector prices, comes from rents. In the CPI data, these rental components are still running around a +7% year-over-year pace. But in real time, rents are deflating. By this time next year, the CPI metrics could be flat, which in turn would exert a huge drag on the headline inflation rate regardless of what the other components are doing.

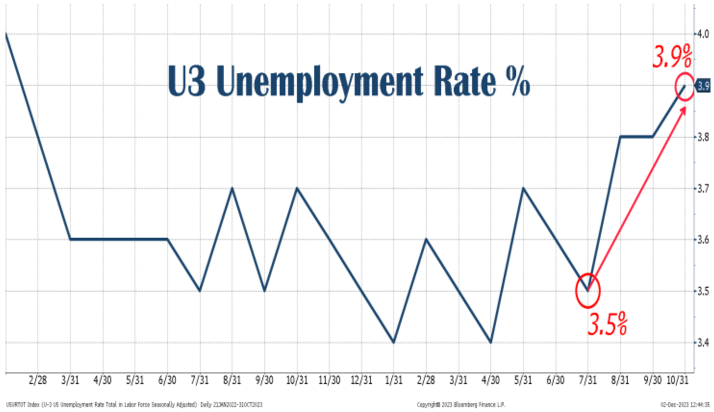


Bottom line: Consumer prices are decelerating — not because of "immaculate disinflation," but because economic activity is slowing. As such, I believe the biggest surprise in 2024 will be that inflation will be proven to be "non-sticky." Also, a rapid decline in inflation towards the Fed's target of 2% will surprise many.

LABOR CRACKS ARE WIDENING

This Friday, the non-farm payroll report for November will be released. While the **payroll survey** has continued to chug along, each month there have downward revisions to prior months and half the growth is coming from an excel spreadsheet (guestimate) from the Bureau of Labor Statistics' (BLS) birth-death model.

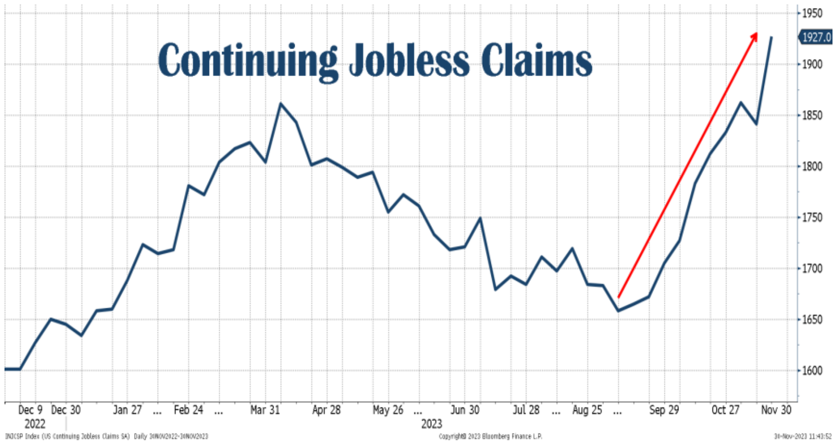
Moreover, at turning points, the **household survey** typically paints the more accurate picture. This survey has shown that job creation has stalled over the past six months and is being flattered by multiple-job holders and camouflaged by the part-time positions for previously full-time positions.



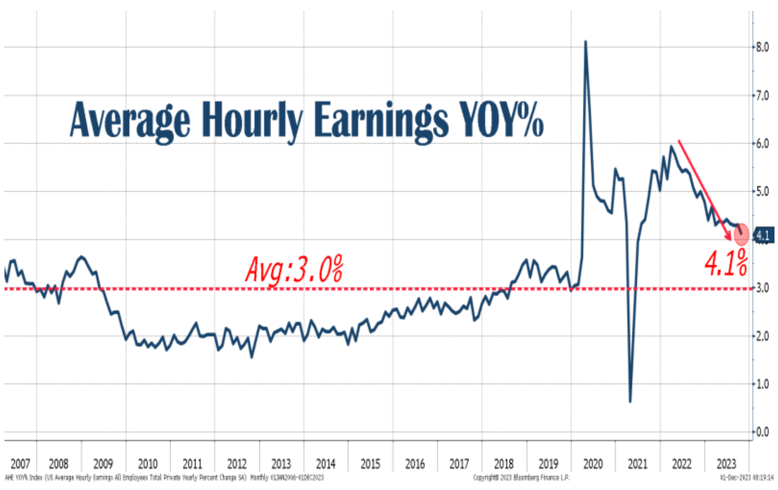
At the same time, the stagnation in household employment has occurred just as the labor force has expanded by more than one million as their lifeline from the prior fiscal stimulus checks has run its course. Against this backdrop, the ranks of the unemployed have expanded by +849,000. This explains how the jobless rate has jumped higher from 3.4% to 3.9%. Over the past 70 years, whenever the unemployment rate is up 0.5% (or more) over a six-month interval, the economy was heading into, already in or crawling out of a recession, 100% of the time.

Also, as more people enter the labor market in search of a job at a time when labor demand is weakening, there will be more competition for the positions being posted.

As shown below, the backlog of continuing claims increased by +86,000 and has now risen +115,000 in the past four weeks to 1.927 million — the highest it has been since November 2021. This is key because it means that while firing rates remain low, businesses are also in no hurry to hire, and this shows up in a rising number of jobless people lining up at the unemployment office.



It also means that, at the margin, the seeds are being sown for a moderation in wage growth. Indeed, after peaking at 6% in early 2022, the pace of average hourly earnings has since slowed to a +4.1% rate and is now tied for the softest pace since March 2021.



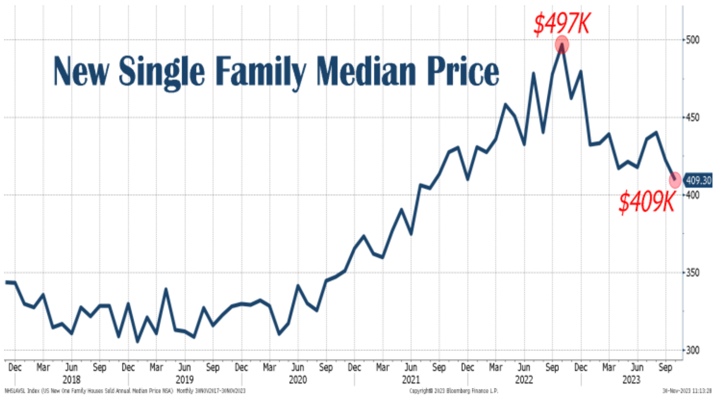
Bottom line: More people are looking for jobs, which have become more difficult to find. The voluntary quit rate has come down so the "job hopping" craze is over as is the prior "great retirement" theme. Wage pressures will soon be snuffed out. This is yet another reason to believe the Fed is done with rate hikes and yet another reason to be bond bullish!

MORE DISMAL HOUSING DATA

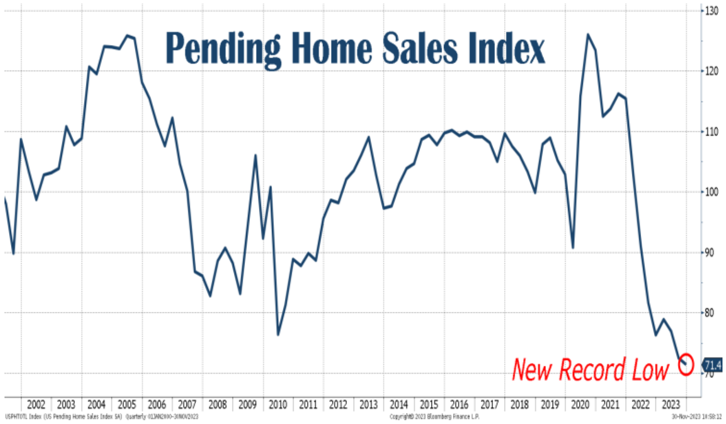
"During October, mortgage rates were at their highest, and contract signings for existing homes were at their lowest in more than 20 years." — Lawrence Yun, Chief Economist, National Association of Realtors (NAR)

In the wake of dismal existing home sales, new home sales were worse than expected and plunged 5.6% month-over-month**.** Making it even worse, the 12.3% month-over-month jump in September was revised down to +8.6%. This is not surprising given that housing affordability is at its lowest since at least the early 1980s. Check out last week's *Weekly Relative Value* for more color on housing affordability – or lack thereof.

The good news is that the median new home price has now fallen 17% year-over-year to $409,300. This is the lowest median price since August 2021.



Also, pending home sales dropped 1.5% month-over-month in October. This left year-over-year sales down 6.6% (negative for 23 straight months)**.** As shown below, the Pending Home Sales Index dropped back to a new record low**.**



By region, only the Northeast saw an increase in pending sales last month**.** Sales fell the most in the West, down 6%, while contract signings in the South and Midwest slipped 1.9% and 0.4%, respectively.

The problem, of course, is that affordability is so stretched that barring an income boom or a double-digit decline in average home prices nationwide, interest rates must drop another 300 basis points to get the affordability ratio back to its long-run mean.

Bottom Line: Pending home sales lead existing home sales by one to two months so the near-term outlook for housing remains bleak. More importantly, housing is a significant contributor to gross domestic product (GDP), with housing's overall contribution typically ranging between 15-18%. Like the yield curve, housing is a quintessential leading barometer for the broad economy.

How long will the Fed be able to keep this “higher for longer” narrative up?

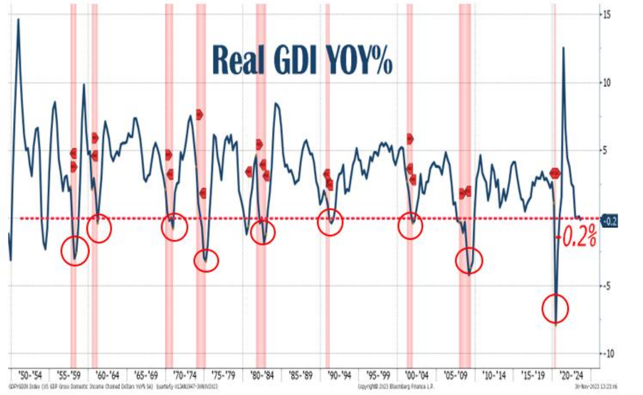
HUGE DISCREPANCY!

Real U.S. GDP growth in the third quarter was revised higher to a ripping +5.2% annual rate from the initial release of +4.9%. This occurred even with the estimate of consumer spending being trimmed to +3.6% from +4.0% initially.

Everything else was revised up – from housing to non-residential construction, to government, to spending and capex. Net exports and inventories also added some. However, the strong growth was front-loaded in July and the economy lost momentum as the quarter drew to a close.

Moreover, because inventory data nets to zero over time, real final sales (RFS) are the bottom-line estimate of GDP. And while RFS were a very strong 3.7%, it was far less than the headline 5.2% that the media will be crowing over.

And get this, real gross domestic income (GDI) came in at a much softer +1.5% annual rate as the gap between this metric and real GDP continues to widen. The year-over-year real GDI is now at -0.2%. As shown below, in the post-WWII era, real GDI growth has never slipped below the zero-line without the economy being in a recession.



Bottom Line: GDP and GDI are two measures of the same thing. GDP measures the value of products produced and GDI measures income from sales. The numbers should match and do correlate over time. Currently, the difference between the measures is stunning. We should pay more attention to this, but we don't because people like the instant gratification that comes with the initial release of GDP. GDI is only released in later revisions.

If one believes, as I do, that GDI is a better measure of the economy than GDP, a very reasonable case can be made that the economy went into a recession and/or is still flirting with a recession. Regardless, the key takeaway from this release is that the economy is not likely humming the way the media presents.

INFLECTION POINT

Long standing Fed hawk and Fed Governor Christopher Waller helped bolster rate-cut bets when he said the current level of policy looks well positioned to slow the economy and bring down inflation. A wave of other Fed officials, from Austan Goolsbee (Chicago) to John Williams (New York), to Michelle Bowman (Fed Governor), to Loretta Mester (Cleveland) and to Raphael Bostic (Atlanta), echoed very similar sentiments.

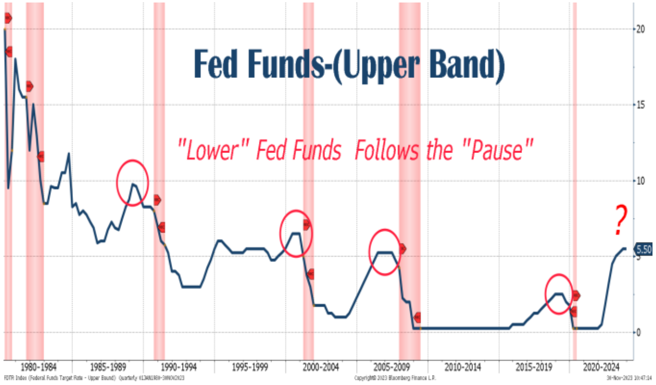
"I'm sensing greater clarity about a few important currents. Our research and input from business leaders tell me the downward trajectory of inflation will likely continue. Our intelligence leads me to believe economic activity will slow in the coming months." — Raphael Bostic, President of the Federal Reserve Bank of Atlanta

Following the dovish Fed rhetoric, legendary hedge fund manager Bill Ackman said the easing will start even earlier than traders anticipate.

"I think there's a real risk of a hard landing if the Fed doesn't start cutting rates pretty soon."
— Bill Ackman, CEO, Pershing Square Capital Management

Note: As a reminder in the Federal Open Market Committee's (FOMC) September forecasts, Fed officials anticipated hiking rates once more this year, which they haven't done so far, and anticipated cutting rates by half a percentage point in 2024. They will update those forecasts at their December 12 and 13 meeting.

The Fed is now in *pause* mode. Following every tightening cycle, a pause takes place that lasts an average of 10 months before the first rate cut takes hold. This was true in 1990, 2001, 2007 and 2019. This cycle is likely no different. This is why May 2024 is being targeted as the month that the first rate cut is priced in the futures market.



I should add that while futures are pricing in rate relief next year so far, it's limited to just 100 basis points of cuts, which is the "minimum" the Fed ever does even when a recession is averted.

So, how low can rates go? If "mean-reversion" is the "iron law" of the markets, then a mean-reversion of the inverted yield curve to the norm of the past 10 to 20 years would require an ultimate move down in the fed funds rate to below 2% and a 10-year Treasury yield below 3%.

Shocking, preposterous and nuts you say?

Keep in mind that pre-COVID-19, the 10-year Treasury yield was sitting below 2%, and the long bond was at 3.5% (more than 150 basis points below where we are today).

Benchmark	10-Year Average	20- Year Average	Today
Fed Funds	1.15%	1.45%	5.55%
10-Year Treasury Yield	2.27%	2.89%	4.19%
30-Year Fixed Mortgage	4.31%	4.75%	7.48%

Bottom line: November was a stellar month for the bond market, and this may just be the beginning. I believe we are at an inflection point with the stage set for the Fed to completely kibosh the aggressive tightening cycle.

The real fun is going to start once the Fed begins the process of unwinding the excessive interest rate rise. History books show that the Fed will begin to cut rates either when the recession starts or a few months prior, so another pivot may be nearer than one thinks.

BUY NOW… PAY LATER!

"Retail executives said shoppers are broadly focused on getting bargains this season. JCPenney rolled back prices on hundreds of items, with some costing the same as they did in 2019." — Marc Rosen, CEO, JCPenney

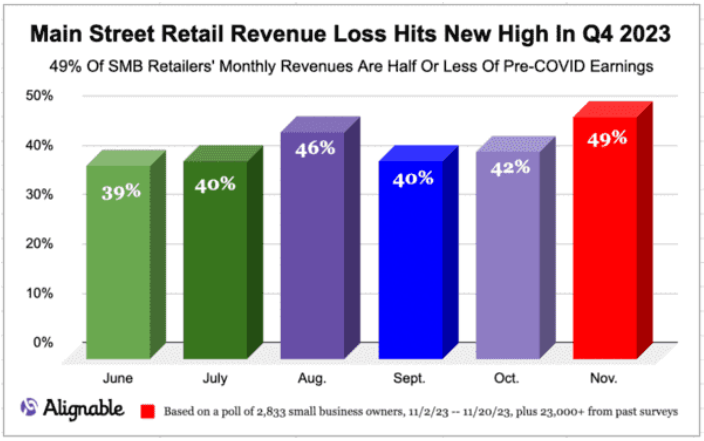
The media highlighted that Black Friday and Cyber Monday sales exceeded expectations. However, the Johnson Redbook survey, which shows the monthly changes in the retail space, showed a -3.3% slump through November 25. This could set the stage for a pretty good bond rally when the retail sales data is released on December 14.

Moreover, for all the talk about Black Friday and Cyber Monday spending this year, the amount from "buy now, pay later" programs rose 19% year-over-year, confirming my suspicion that the largest users are those in precarious financial situations (and who have maxed out on their credit cards). This takes a little bit of the shine off the spending data.

In addition, consumers are becoming much more price conscious and are back looking for bargains, and retailers have accommodated. To wit: At Walmart, the number of items sold with price cuts has soared to a 50% share over the past year, which is a prime example of what is happening to the 40% chunk of the CPI, otherwise known as "goods."

Finally, despite the above expected sales data on Black Friday and Cyber Monday, the chart below highlights that nearly 50% of Main Street retailers say incomes are down 50% or more than they were pre-COVID-19. Unfortunately, this trend continued in November as consumers continued to shop online.

Suffice it to say, it's tough out there for small business. Give a small businessperson a hug, they need it.



Bottom line: Holiday sales have surprised to the upside thus far, but it appears that momentum has slowed significantly. Most importantly, consumers are now expecting discounts. In turn, this will significantly cut retailers' margins. This too is a positive for the inflation backdrop and a reason to buy bonds.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The 10-year Treasury yield fell -27 basis points for the week to 4.19%, hitting a three-month low. On Wednesday, it finally moved out of negative year-to-date total return performance and is now up near +1.0% for the year.

Everyone is wondering how the bond market can be performing so admirably in the aftermath of that eye-popping +5.2% real GDP growth pickup in the third quarter. Please, the third quarter is ancient history. Moreover, monthly economic momentum faded as the quarter drew to a close and the Atlanta Fed Nowcast model just cut the fourth quarter to +1.2%.

In addition, market-based inflation views have been falling impressively — the 5-year Treasury Inflation-Protected Securities (TIPS) breakeven is down to 2.1%. The data from wages, unit labor costs, the CPI, the Producer Price Index (PPI) and the consumption deflators all have confirmed the disinflationary trend. This is a pattern, and it is no longer just about one or two inflation prints.

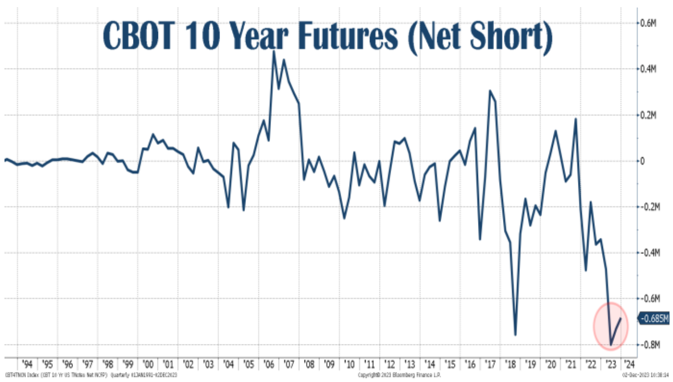
Remember, the most important variable in determining yields across the Treasury curve is the expectation of where the Fed is going. Based on the commentary above, the view on the Fed is being reset once again, and there was very little pushback from Fed Chairman Jerome Powell on Friday (some, but not much).

How about investor sentiment?

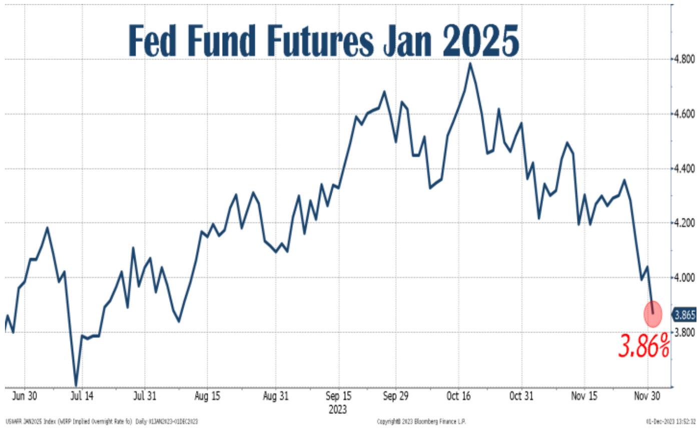
According to JPMorgan, **the most active investors in the U.S. Treasury market are as bullish as they've ever been since 1991.** JPMorgan's Treasury client survey includes 40 to 60 clients, of which 10 to 20 are active clients. Among those, about 70% are speculators and 30% are so-called "real money" (long-term buyers).

For the week ending November 27, the survey found that 78% of active clients were positioned long relative to their benchmark, **the biggest in the history of the survey.** The remaining were neutral. No one was short.

Also worth highlighting despite the JPMorgan survey, from a positioning perspective, only 20% of the record net speculative shorts in 10-year Treasuries futures and options have been taken out thus far. There are still 685,000 contracts (or $68,500,000,000) to go before these bearish bets close and the de facto buying power could be spectacular!



Clearly the majority of fed fund futures traders are of the belief that rate hikes are yesterday's news and lower rates lie ahead.



Bottom Line: The rate hike cycle is coming to an end and the Fed will commence the easing cycle. Maybe it starts in May or June, if not March.

The next question is the magnitude of the looming cutting cycle. History books tell us that if there is no recession, just unwinding the massive monetary tightening would require 300 basis points of cuts. If there is a recession, it is more than likely that 500 basis points of cuts would be needed. Yes, a recession would take the funds rate back toward the zero lower-bound, just as was the case in 2003, 2008 and 2020.

- **To Avoid a Recession:** An average cut would be 100 basis points.
- **Neutral:** An average cut would be 300 basis points.
- **During a Recession:** An average cut would be 500 basis points.

In terms of portfolio strategy, for those credit unions that have “excess” cash balances, all I can say is “timing is a fool’s errand” and the most “tried and true” risk management strategy is to build a risk-appropriate ladder.

Also, while bond yields plunged in November, it’s important to stress that markets do not move in a straight line. **Given the magnitude of the yield decline in November, one would expect some profit taking and a possible short-term back-up in yields. If so, any sell-off provides an excellent opportunity 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.