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INVESTMENT SERVICES

Weekly Relative Value

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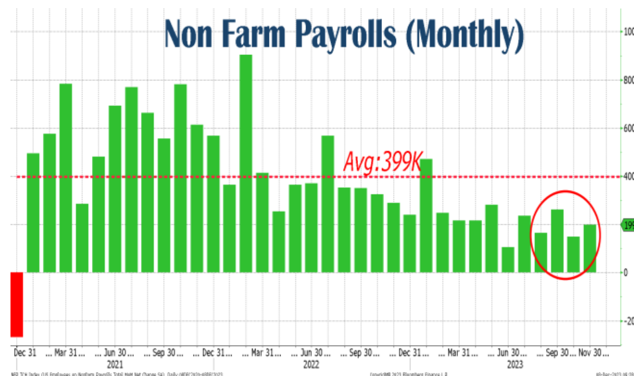
WEEK OF DECEMBER 11, 2023

Less Than Meets the Eye

"Strong number, solid wages and higher participation** should **keep the soft-landing narrative alive**. We knew that strikes would add to this number. **Some of the near-term Fed rate cuts will get taken out but we think people will buy the dip**. **Not many had the opportunity to buy 10-year Treasuries at 5% but even 4.25% is not a bad level heading into a slowing growth and inflation world.

— Priya Misra, Portfolio Manager, JP Morgan Investment Management

The total number of job gains in November came in at 199,000, which is above last month's 150,000 and above the consensus forecast of 183,000. Given that the survey has only a 40% response rate, along with the historical inaccuracy of this data, perhaps the best way to look at the situation is to look at how the labor market is unfolding over a longer period of time. As shown below, the pace of job creation has slowed from the average job growth over the past two years (+399,000). No carnage, to be sure, but definitely a cooling trend.



Moreover, when one digs a bit deeper and peels back a couple of layers off the onion, there was less verve than the headline suggests.

First, as has been the case every month this year, the previous month's data was revised lower with September down by 35,000 to 262,000 and October remaining flat at 150,000**.** Year-to-date payrolls have confronted net downward revisions this year totaling -372,000!

The last time there were such high downward revisions was in November 2020. Going all the way back to 1990, downward revisions of this magnitude have only occurred with the economy either heading into, already in or crawling out of a recession.

THIS WEEK

- WHAT A JOLT!
- BEIGE TURNS BLUE
- BRIDGE TO NOWHERE
- WAS INFLATION "TRANSITORY"?
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)

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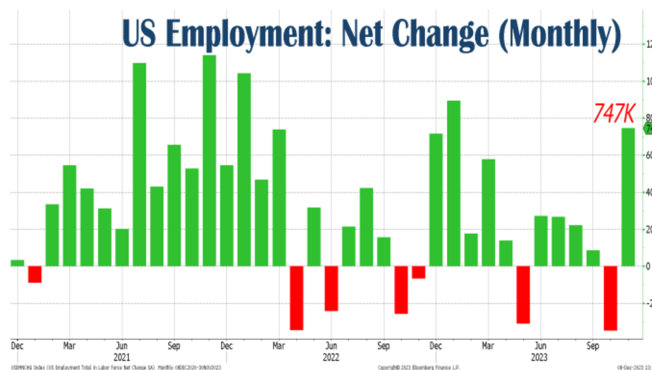
Second, nearly +50,000 of that headline contained returning strikers in the automotive and entertainment sector. The government sector added +49,000 while the education and health sector cranked out a whopper of +99,000 new jobs. In a bizarre twist, the leisure and hospitality sector reported a +40,000 surge in jobs. The reason this was bizarre is because it was completely at odds with the ADP private payroll report (released earlier in the week) that showed a -7,000 loss. And the thing about the ADP is that the survey has a 100% response rate, which the Bureau of Labor Statistics (BLS) certainly does not (more like close to 40%).

*"If you strip out the strike impact, over the last two months, **private payrolls averaged 118,000.** That compares with a six-month average of 130,000. So the direction of travel is weaker. The pace is "relatively soft" and will probably be welcomed by the Fed." — Omair Sharif, Founder, Inflation Insights, LLC*

And last but not least, the nonsensical birth-death model (excel spreadsheet) once again tacked on +102,000 jobs.

So, just how vibrant is the jobs market?

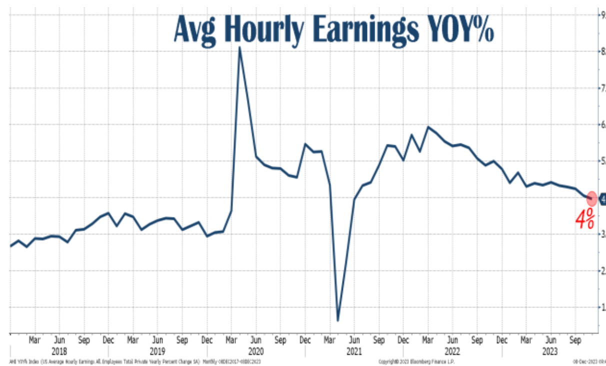
The number was solid, especially when considering that the number of employed workers, as counted by the BLS household survey, surged by 747,000 to 161 million after following several months of disappointing prints including last month's 348,000 drop. This was the third biggest increase in the BLS household employment survey this year.



Also in the good news ledger, the unemployment rate dipped to a four-month low of 3.7% (from 3.9%). Thus, the famous Sahm Rule, which states a recession occurs when the three-month moving average of the unemployment rate rises by 50 basis points or more relative to the lowest level (3.4%) from the previous 12 months, has been sidelined for now.

The drop in the unemployment rate was even more impressive given the jump in the participation rate, which rose to 62.8%. So, even though the labor force boomed by +532,000 in contrast to the October report, all of these folks and then some managed to find a job. Then again, the public sector does seem to have its human resource departments hopping.

Turning to wages, the monthly increase was slightly higher than expected as average hourly earnings for all employees rose 0.4% (0.3% expected) to $34.10. However, over the past 12 months, average hourly earnings increased by 4.0%, in line with expectations and unchanged from the downward revised 4.0% in October.



Bottom line: There can be no denying that the household employment survey stole the show and pointed to a renewed tightening in the jobs market, which was consistent with the higher-than-expected wage number.

At the same time, it is tough to get really excited when there were downward revisions yet again in the establishment survey, a skew from the birth-death model and not to mention the sum of banks, retail, transportation services and temp-help agencies collectively showing a net decline of over -60,000. These economic-sensitive sectors have posted job declines in each of the past six months with a combined decline of -230,800.

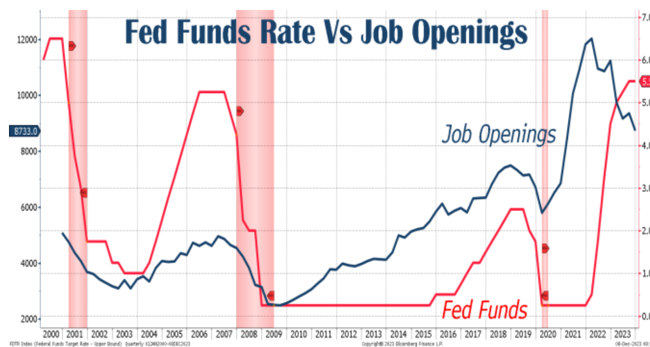
So, how much faith can, or should we place in the data? That said, the labor reports was not supportive of a recession call, and there is no apparent reason for the Fed to cut rates. Then again, it is also a bit premature to say we are out of the woods at this point. With 2023 as the year of the "negative revision," it may require more time than usual to recognize the slowdown in the labor markets. Let's see how the next three employment reports play out before jumping to any conclusion.

WHAT A JOLT!

March 2023: "Some part of the high inflation that we've experienced is very likely related to an extremely tight labor market." — Jerome Powell, Federal Reserve Chairman

While the non-farm payroll surprised to the upside, the Job Openings and Labor Turnover Survey (JOLTS) data for October were weak across the board. Job openings plunged -617,000 and this followed a -147,000 decline in September. Over the past six months, openings have collapsed by -1.6 million to 8.733 million, the lowest level since March 2021.

The ratio of openings to unemployed workers is 1.3 compared to 1.5 prior. For reference, 1.2 was the ratio pre-COVID-19. In other words, there goes Mr. Powell's excess labor demand story.

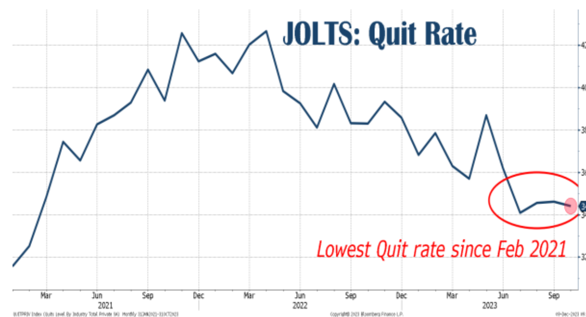


Here's another question. How strong can the all-important consumer be when retailers cut their postings by over -100,000 in October and have been taking down their "help wanted" signs in each of the past six months, to the lowest level since April 2020?

Manufacturing also saw a -14,000 pullback in openings in October to the lowest level since January 2021 (372,000). It has been down in 10 of the past 11 months, even with all those Biden industrial subsidies!

Likewise, the glow is off the leisure and hospitality sector, as job openings in this formerly hot area of the economy have fallen to a four-month low of 1.22 million. New hires sank -105,000 in one of the sharpest declines ever recorded and a sure-fire sign that the "excess savings" file that propelled economic activity in this space for the past year is now in the rear-view mirror.

In addition, the job-hopping craze is over with the number of "voluntary quits" dropping -18,000 after a -17,000 tumble the month before. This metric has plunged a near-record -435,000 between May and October and, at 3.4 million, is the second lowest level since February 2021. This is important because the quit rate leads to wage growth. This is great news for bond bulls who have been longing for the Great Disinflation to take hold.



Layoffs, meanwhile, rose +32,000 in October. Of all the sectors, what stood out the most were the 63,000 pink slips handed out by the financial sector.

Bottom line: Rarely does one see openings down, hirings down, quits down and layoffs all up in the same report. The jobs boom has ended. A chill is in the air.

BEIGE TURNS BLUE

*"**Demand for labor continued to ease,** as most Districts r**eported flat to modest increases in overall employment**. The majority of Districts reported that more applicants were available, and several noted that retention improved as well. **Reductions in headcounts through layoffs or attrition were reported, and some employers felt comfortable letting go low performers**."* — The *Federal Reserve Board's Beige Book*

Despite the better-than-expected jobs data last week reported by the BLS, the views from the Federal Reserve regional banks on the labor backdrop were uniformly weak. There were numerous citations of slower job growth or outright layoffs, an easing in the tightness of the market, far less job hopping and higher employee retention and slower wage trends.

Most importantly, in advance of the November retail sales report on December 14, we also have the Federal Open Market Committee (FOMC) meeting on the same day. There are a wide range of opinions on how holiday shopping fared, but once again, the *Beige Book* provided some very important anecdotes:

Boston: *"Retail contacts had flat revenues on average and restaurants had slightly weaker sales. A clothing retailer experienced a moderate decline in year over-year sales following months of modest growth."*

New York*: "Consumer spending continued to slow… While creditworthy buyers were able to get financing, those with lower credit scores have increasingly found it difficult to secure auto loans.*

Atlanta: *"Similar to the previous report,* ***retailers noted a softening in consumer spending****, which was again described as a normalization from the pandemic's strong pace of growth. Demand for services and luxury goods remained robust; however,* ***lower income consumers continued to trade down****. Automobile dealerships reported that* ***manufacturers were offering incentives for new vehicle purchases, resulting in strong sales, but that the demand for used vehicles ticked down."***

Chicago*: "Consumer spending decreased slightly on balance over the reporting period. Non-auto retail spending was up slightly. Contacts highlighted higher spending on luxury items, new product lines, lower-priced items at outlet stores, and at e-commerce websites. However, a processor of product returns reported that returns of clothing and electronics were down, which is an indicator of lower sales of those items.* ***In the leisure and hospitality sector, spending fell on air travel and hotels****. Light vehicle sales decreased modestly overall."*

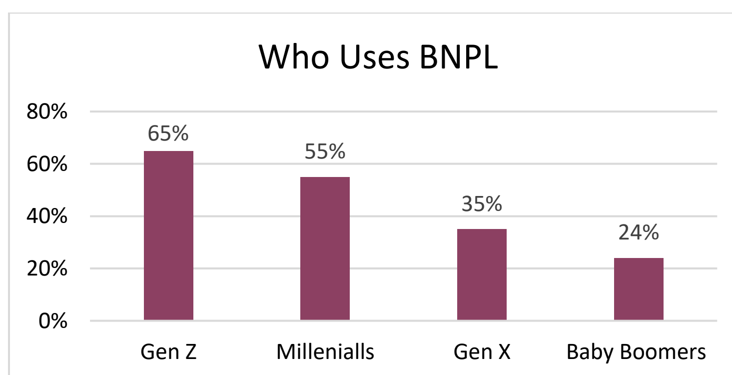
San Francisco: *"Retail sales were flat overall in recent weeks.* ***Reports suggested some pullback in consumer spending on big-ticket items, such as motor vehicles."***

BRIDGE TO NOWHERE

"This is about Main Street. It's about 50%, going on 60% and 70% of Americans not having any money left and needing government handouts increasingly to offset that pressure. Needing more credit cards….If you're paying 22% on a credit card, think about where you must be financially. 'Buy Now, Pay Later' (BNPL)? This is far more dangerous for far more people. This is a Main Street recession that we're just entering."
— Keith McCullough, CEO, Hedgeye Risk Management

It's a fact that Americans like to spend, and many spend to excess. This spendthrift attitude largely explains the recent rapid rise in credit card debt and most recently, "Buy Now, Pay Later" (BNPL) plans**.**

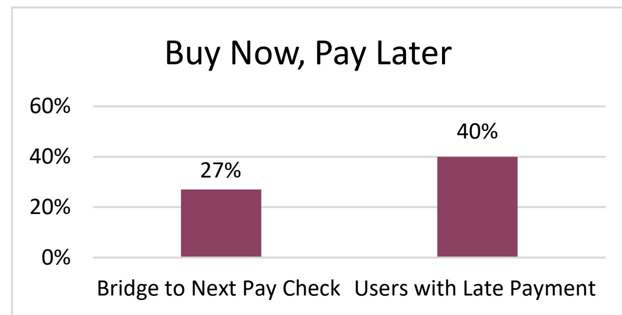
As to who is using the BNPL plans, it's primarily Gen-Z and Millennials — who, by the way, have the least capacity to take on more debt.



Source: Hedgeye

If people were using BNPL as a way to buy a big-ticket item such as a new refrigerator, a mattress or as a matter of convenience that would be one thing, however, many do not. They are using them to defer payments on everyday purchases because they have to. Consider this, 27% of those using BNPL plans are using them as a bridge until their next paycheck.

Over time, the end result is more debt, which if left unchecked can become impossible to service. In fact, 40% of all BNPL users have missed a meaningful percentage of their payments.



Source: Hedgeye

The cartoon below sums it up nicely!

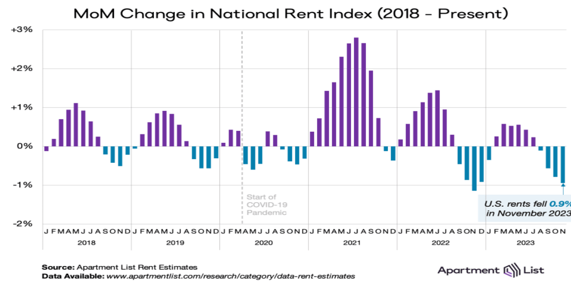
Bottom line: I'm not sure how this will turn out, but I hope and pray that the labor markets remain relatively stable. Otherwise, the massive consumer debt will really come home to roost.

WAS INFLATION "TRANSITORY"?

December 3, 2023: "It's increasingly clear the 'transitory' inflation story WAS correct. On market-based metrics (you know, ACTUAL PRICES,) we've averaged 2% for all of 2023. Note that even the Fed's 'market-based' metrics are corrupted as they include Owner's Equivalent Rent for shelter."
— Danielle DiMartino Booth, CEO and Chief Strategist, QI Research

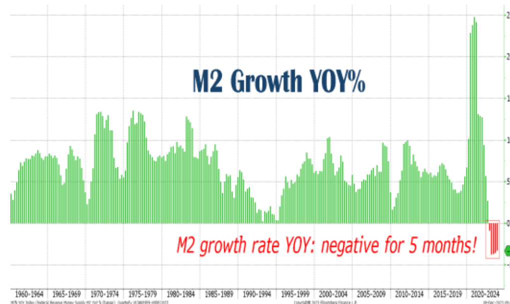
Here are six reasons why inflation is yesterday's news:

1. The headline inflation rate is over 3.0%, but when you strip out the flawed shelter the Consumer Price Index (CPI) inflation rate (excluding shelter), the headline index is +1.5% today compared to +8.2% a year ago. Also, it is worth noting the inflation rate (excluding shelter) is lower today than it was pre-pandemic, and yet, the fed funds rate is at 5.5% today compared to 0.25% in March 2022.

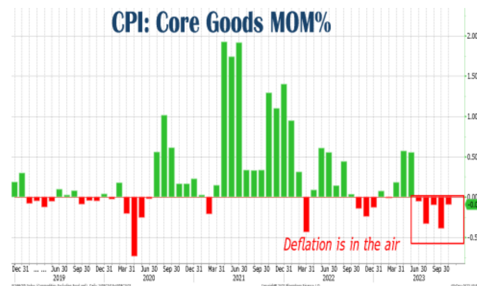


The current data shows rents deflating over the past four months. This means that the 30%-plus of the CPI called "rents" is set for the mother of all turndowns as the high frequency data replace the stale data. Both headline and core inflation could be unwinding to below 1% a piece this time next year.

2. The M2 money supply growth rate is down -3.3%. There is minuscule growth in commercial and industrial (C&I) loans and real estate credit. Auto loans have collapsed at an epic -6% annual rate and all other forms of personal lending have declined -5%. Mortgage-backed securities (MBS) outstandings have fallen at an -8% annualized pace. How can one create inflation when money and debt is weakening?

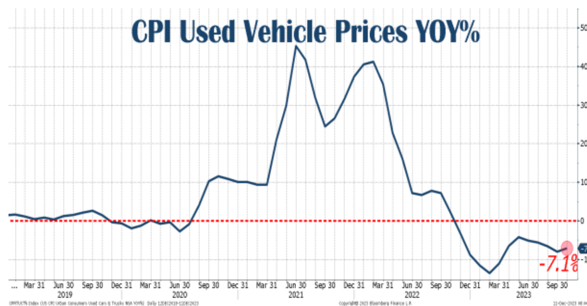


3. Due to the implosion in real estate, China's economy is the weakest it has been in decades. That said, China remains an export behemoth with total exports at a record $3.5 trillion. And these exports are deflating at nearly a -10% year-over-year pace. As China tries to export itself out of a downturn, someone else's import costs are falling out of bed at the same time. This means that 40% of the CPI that is comprised of "goods" is ripe for a period of deflation!

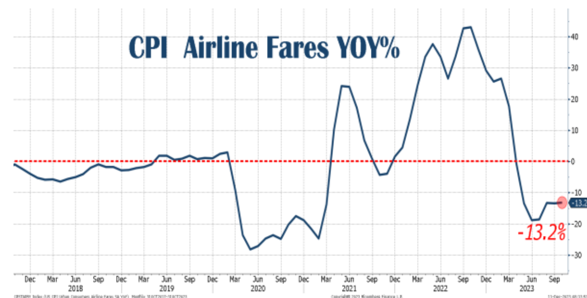


4. Commodity prices have plunged. Of note, gasoline prices have fallen nearly 25% ($1 per gallon) since early September!

5. Auto prices are coming down. Used cars, the posterchild of pandemic inflation, have deflated for the past year. And J.D. Power just reported that new motor vehicle prices have declined -3.6% year-over-year.



6. Airline prices have plunged to -13.2% year-over-year.



Finally, while food prices remain "high," inflation is also moderating nicely in this sector.

So, as I have been saying for quite a while: inflation is yesterday's story. But don't take my word on my optimistic inflation outlook. The Chicago Fed has published a model, and the conclusions put a smile on my face:

"Inflation will return to near the Fed's target by mid-2024 — and that does not even include any assumption about an economic contraction and what that would mean for domestic demand."

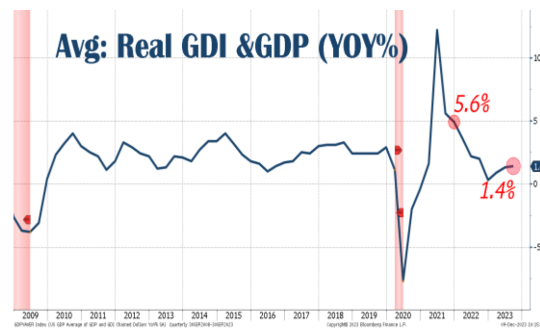
Bottom line: "Higher for longer" may end up being as transitory a theme as "transitory."

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The pace of real gross domestic product (GDP), the spending concept, is now running at an above-trend +3.0% year-over-year. However, the year-over-year trend in real gross domestic income (GDI) is -0.2%. As shown below, the -3.2% gap between real GDP and GDI growth is without precedent, and these two series are perfectly correlated over time.

The question is obviously how this divergence gets resolved. As always, time will tell but what we know from history, and how the economy operates, is that spending follows income and not the other way around.

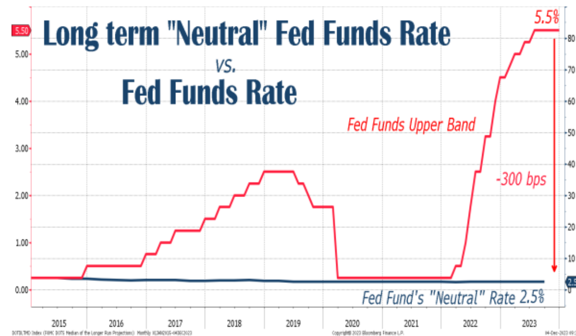
Taking the analysis one step further, the average of the two metrics shows the economy has slowed to a +1.4% year-over-year rate from +2.0% a year ago and +5.6% two years ago. That pace, by the way, is not far off the mark that ended up presaging the recessions in 2020, 2008, 2001 and 1990.



Could it be that the recession nobody sees coming is actually beginning to arrive? People may ask how a recession can occur with real GDP growth popping up at a +5.2% in the third quarter. But 60% of the third quarter bounce was concentrated in July. Folks, that's ancient history! More importantly, we also know that growth slowed sharply as the quarter drew to a close. To wit: The Atlanta GDPNow forecast for quarter four is down to a stall speed of 1.24%.

The **BIG** story still remains with the dramatic decline in Treasury yields. The long bond yield has fallen to 4.30% and is now trading back at levels last seen in August. As is the same for the benchmark 10-year Treasury yield trading at 4.22%. Could it be that Mr. Bond is sensing that the economy is about to be shaken and stirred?

History books tell us that even 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 likely that 500 basis points 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.



In terms of portfolio strategy, for those credit unions that have "excess" cash, the most "tried and true" risk management strategy is to build a risk-appropriate ladder. This all-weather approach works well even in rising rate environments. As shown below, the average return of a simple 5-year Treasury ladder from 1981-2022 was 5.7%. The lowest return was -3.9% occurring in 2022, arguably the worst bear market in the bond market ever! So, while the ladder generated a small unrealized loss, the ladder discipline protected the portfolio from much more sizable losses than we have all read about.

1981-2022	Bull Market 5-Year Annual Return
Average Return	5.7%
Minimum Return	-3.9%

As I noted last week, **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.

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