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Weekly Relative Value

WEEK OF DECEMBER 18, 2023

The Case for 1% Inflation

"It's certainly meaningfully coming down. And I see no reason, on the path that we're currently on, why inflation shouldn't gradually decline to levels that are consistent with the Fed's mandate and targets…I personally don't see any good reason to think that the last mile is going to be especially difficult." — Janet Yellen, Treasury Secretary

THIS WEEK

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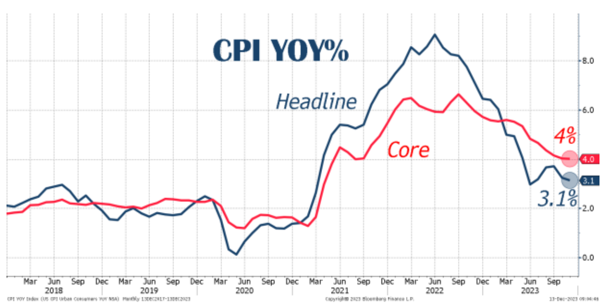
Let me preface the the following commentary on the inflation data in an attempt to eliminate and reduce any confusion or misunderstanding about what "inflation" is or, should I say, is not. To be clear, inflation is NOT about elevated prices. Unfortunately, those are here to stay. For financial markets, it is never about levels, it's always about the change that matters.

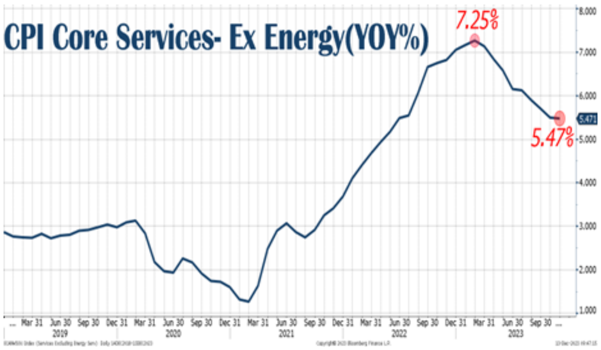
Now onto the data.

The November "headline" Consumer price Index (CPI) came in at +0.1% month-over-month compared to the 0% consensus estimate. The index was driven down by a 6% month-to-month plunge in gasoline prices and the drop in durable goods (i.e., cars, electronics, furniture, etc.). The one upside surprise was the +1.6% pop in used car prices despite the fact that the Manheim used vehicle index dropped -2.1% last month. Year-over-year, the headline inflation rate eased to +3.1% from +3.2% in October, which was as expected.

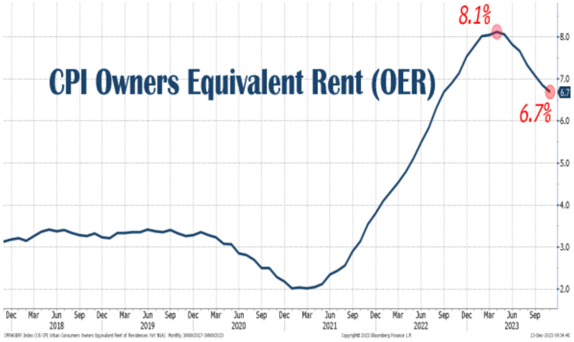
The "core" index, which excludes the volatile movements of food and energy products, was +0.3%. The consensus was spot on at +0.3% (though to the second decimal place it was +0.28%). The core index was pushed down by the decline in durable goods but was pushed up by the jump in core services. Year-over-year, the core rate of inflation remains stuck at +4%.



The CPI for "core" services without energy (65% of the core index) rose 0.47% in November from October and unchanged from the prior month.

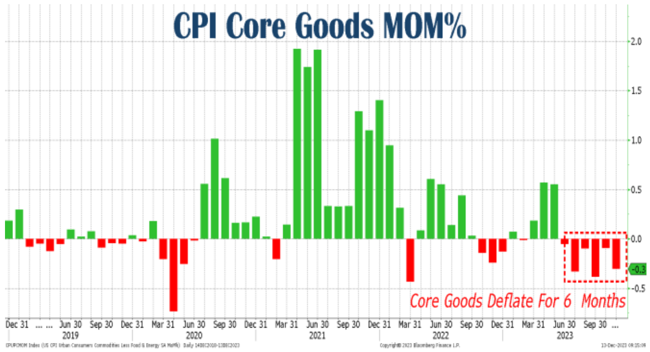


The irritating source of upward pressure on the core index services came from rents (8% of the core index), which rose 0.48%. Also, the Owners Equivalent Rent (26% of the core index) rose 0.5%. Year-over-year, rents increased by 6.9% and the Owners Equivalent Rent rose 6.7%. So while shelter costs are off their recent peak, they still elevated as the year-over-year trends have broken below 7%.



In addition, medical care services (6% of the core index) rose +0.6% month-over-month — the biggest run-up since September 2022. Also, auto insurance (3% of the core index) rose 1% month-over-month and has risen a whopping 19% year-to-date.

All that said, there were also definitive pockets of deflation in this report. Core goods (exlcuding food and energy) prices fell -0.3% and have deflated for six months in a row. For some perspective, the last time this happened was seven years ago! Appliances (-1.0%), furniture (-1.9%), home improvement (-0.7%), clothing (-1.3%) and new vehicles (-0.1%) all posted price declines last month. Over the past year, this segment of the CPI has vanished to 0.0% from +3.7% a year ago and +9.4% two years ago. Even the most ardent bears would have to say that is progress!



There were also other pockets of deflation. To wit: Hotels and motels declined -1.1%, and are now down in five of the past six months. Likewise, car rentals dropped -2.2% after a -1.5% slide in October and airfares fell -0.4%, which followed a -0.9% print in the prior months.

Bottom line: Outside of a few sectors like drugs, medical care services, restaurants, used cars and delivery services, there was not a whole lot in this report to fret about.

Note: This week, the key release will be the core personal consumption (PCE). The Fed's favored inflation gauge is forecast to show a soft 0.2% month-over-month rise in November to take the year-over-year rate down to +3.4%. Crucially, that mark would also imply a six-month annualized inflation rate of just above 2%, which is the Fed's stated inflation target. If the core PCE number comes in close to expectations, the buzz over lower interest rates may continue.

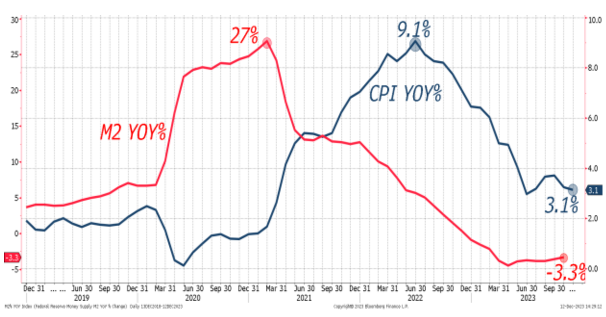
SIMPLE GRAPH, SIMPLE STORY

"Inflation is always and everywhere a monetary phenomenon." — *Milton Friedman, American Economist*

Here's a simple graph that tells a simple story.

If the M2 money supply (amount of currency in circulation including M1 physical cash and checkable deposits) falls, inflation will generally follow on an 18-month lag.

As one can gather from the graph below, M2 has declined 3.3% year-over-year. This rarely happens and when it does, its always been bad news. In fact in October 1921, M2 turned negative, and the U.S. experienced deflation of -16%. It also happened again in the 1930s, which evolved into the Great Depression. CPI later fell by -11%.

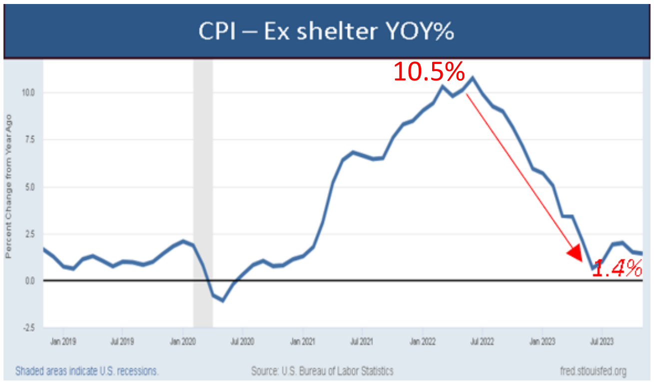


Bottom line: I have pointed this out numerous times in this space but as a friendly reminder, money supply growth matters and it matters a lot, yet many do not discuss this at all. However, if Milton is right and history is prologue, as money supply growth goes so goes inflation — with a lag. Another big reason why inflation is yesterday's news and why purchasing bonds could be a wise investment strategy.

HEADING TO 1%?

While many, if not most pundits, have focussed on the above-target headline inflation readings, I'm guessing that very few realize that most of the upward pressure on inflation has come from rental components (shelter alone is 35% of the headline index and 43% of core). For example: In November alone, shelter added a massive 220 basis points to headline and 280 basis points to core inflation.

However, if one strips outs shelter, headline inflation would have come in at 1.4% (back to its pre-COVID-19 level) and below the +7.1% pace a year ago. Likewise, the core (excluding shelter) would be at 2.1% compared to +5.1% a year ago! Surely, even the most zealous bond bear realizes that!



Here's the thing, if the Bureau of Labor Statistics (BLS) data reflected real-time lease data, the shelter component in the CPI would be substantially lower than it is today. The reason it remains so much higher is because the BLS measure of shelter inflation includes both new and existing leases. As such, it has the significant drawback of built-in lags that take time to adjust compared to market-based measures of rental prices. Indeed, the shelter component of the CPI lags real-time rental measures by almost a year.

As you can see in the table below, the difference between the BLS shelter CPI and real-time rental measures has widened substantially. To wit: The BLS methodology shelter prices have risen by +6.5% over the past 12 months while real-time measures average +1.7%. As you will note, all six of the real time rent indices show a much slower rate than the BLS is calculating. In fact, the widely followed Apartment List Rent Index along with Redfin shows -1.1% and 0.1% deflation respectively in rents. Again, the wide discrepancy between real time rent data and BLS data is due to the existing leases in the housing basket of the CPI. But we also know that inevitably, the CPI will catch up to real-time rental measures, which are running 5% lower than shelter CPI at present!

Real Time Rent (I%)	
Core Logic SF Rent Index	2.9%
Redfin Median Asking Index	-0.3%
Zillow Observed Rent Index	3.0%
Apartment List Median Rent	-1.1%
BLS New Tenant Rent Index	2.8%
Cleveland Fed New Tenant Repeat Rent Index	2.7%
Average	**1.7%**
BLS CPI Shelter	**6.5%**

Here's the good news, if the shelter component of the CPI falls below +2% over the next 12 months, headline CPI could decline to around 1% and core inflation could end up at 2%. This means that even without any further underlying disinflationary pressure, inflation will mechanically revert to target.

Despite the glaring headlines and the consensus narrative that inflation will remain "sticky" and "rates will remain higher for longer," I believe that inflation will continue to trend lower as we move forward. For this primary reason, I have remained a steadfast bull on the bond market.

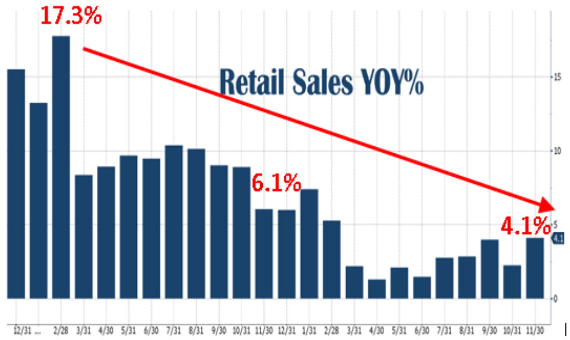
Bottom line: If the assumptions above are correct, the 10-year Treasury note yield could fall to 3.0%, or possibly lower. And the rest of the yield curve from 2s to 30s will witness similar declines.

CONSUMPTION SLOWS

U.S. retail sales surprised to the upside in November advancing +0.3% month-over-month (consensus was -0.1%), though October was taken down to -0.2% from -0.1%. The key "core control" number that excludes autos, gas and building materials feeds into the gross domestic product (GDP) data, which came in at +0.4% month-over-month (consensus was +0.2% so it was double the expectations).

The drunken sailors, as I've come to call them lovingly and facetiously because they just refuse to stop drinking from the punchbowl, continue to spend with reckless abandon. But only some categories of retailers benefitted, particularly the big three that between them account for 50% of total retail sales: Ecommerce operations, auto dealers, and bars and restaurants.

That said, arguably, the best way to look at consumer spending is to look at the longer-term trend, which tends to smooth out the month-to-month zigs and zags. As you can glean from the graph below, on a year-over-year basis, retail sales are running around +4.1% compared to +6.1% a year ago and +17.3% two years ago. Obviously, this is not a disaster, but the trend is heading in the wrong direction. Consumers are in a definitive growth turndown.



Let me add this, for all the talk of a resilient consumer and pristine household balance sheets, why have consumer loan delinquency rates risen for the eighth quarter in a row — to 2.53% from 1.93% a year ago? Delinquencies are at the highest since early 2013. The thing is, back then, the unemployment rate was hovering near 8.0%, not 3.7%. Now, just imagine where the delinquency rate goes when the labor market weakens, and the jobless rate hooks up for good.

Bottom line: The consumer is slowing down and so will the economy.

A BLIP, A ZIT!

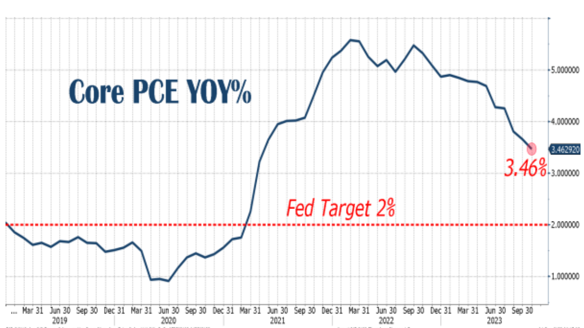
The Federal Open Market Committee (FOMC) communique, the quarterly "dot plot," and Federal Reserve Chairman Jerome Powell's 45-minute confab came as close to as possible in promising early rate cuts as a central bank could ever do. It seems that the Fed has, yet again, pivoted toward easier money.

As for the macro-forecast, the Fed noted that the economy has now "slowed" from the breakneck pace in the third quarter and is now calling for a tepid +3.8% nominal GDP growth next year.

That said, the biggest shift in their forecast was the slice in headline PCE inflation to 2.8% (from 3.3%) for this year and the trim to 2.4% (from 2.5%) in 2024. The core went to 3.2% this year from 3.7%. In 2024, it goes to 2.4%, from 2.6%.

Meanwhile, Wall Street was quick to shred the Fed's forecast. To wit: The Goldman Sachs economic team envisions the core PCE price index slowing to 2.1% by the end of next year, effectively meeting the Fed's 2% target.

If so, we have now learned that eighteen months is the time dimension of "transitory." In the overall annals of economic history, the pandemic inflation spike was a blip, a zit!

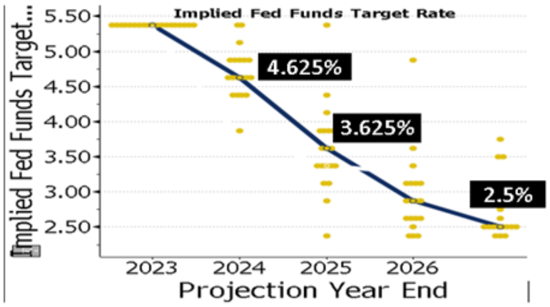


HOW LOW WILL RATES GO?

"You wouldn't wait to get to 2% [inflation] to cut rates…It would be too late. You'd want to be reducing the amount of restriction on the economy well before you get to 2%." — Federal Reserve Chairman Jerome Powell
Excerpted from the Wall Street Journal article, "Fed Begins Pivot Toward Lowering Rates as Inflation Declines."

From my lens, after sifting through the Fed's forecasts and Powell's cadence at the press conference, the entire two-day FOMC meeting was spent discussing one thing, and one thing only, how far and how fast to cut rates over the next two years.

The median "dot plot" change tells the tale, dropping to 4.625% for next year from the prior projection of 5.125%. This would represent around 100 basis points of rate cuts in 2024 as the Fed, for a change, followed the market's lead! By the way, the futures market is now pricing in six rate cuts in 2024! For 2025, the median call was taken lower to 3.625% from 3.875%. The thing is, the Fed always goes further than it thinks at the onset of both easing and tightening cycles.



Source: Bloomberg

I believe that the "dot plots" was just an appetizer. The meal is going to involve a near-complete reversal of this overly aggressive 2022-2023 tightening cycle.

The FOMC has signaled that easing is in the cards but doesn't want the market to get ahead of itself on how far that means rates may move. That's because the neutral real rate (R*) is probably somewhere between 1.5% and 2.5%. This in turn means that at least 300 basis points of easing will be needed to "neutralize" policy.

Big Picture: I have long believed that the pandemic inflation spike was attributable to excessive fiscal and monetary stimulus along with pandemic driven supply and demand shocks. I think we can all agree that we are now in a totally different environment today.

I have also long believed that the long-term secular forces (e.g., aging demographics, massive debt, declining productivity increased technology and globalization) were the primary forces driving rates lower pre-pandemic and will reassert themselves as the economy normalizes. As such inflation, will decline and the economy will slow, and last but not least, interest rates will decline.

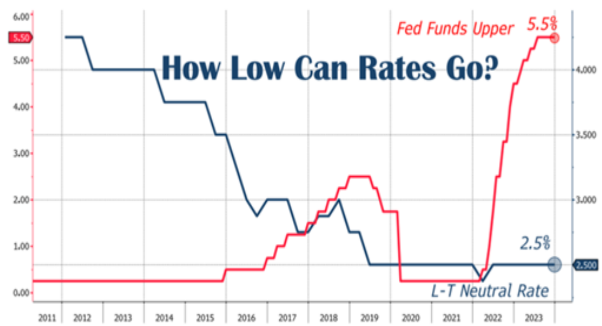
And I must say, I'm happy to be in the same camp as Maurice Obstfeld, former Chief Economist at the International Monetary Fund chief. This is what he had this to say last week*:*

*"[…] the main underlying factors that have pushed real interest rates down since the 1980s and 1990s — **notably demographic shifts, lower productivity growth, corporate market power, and safe asset demand relative to supply** — do not appear poised to reverse strongly enough to drive a big and durable rise in global real interest rates over the coming years."*

Likewise, the Bank of England released a working paper that finds that slowing productivity growth and increasing longevity are putting a persistent secular downward squeeze on the long-term neutral fed funds rate (R*). Here's a little ditty from the white paper:

"Normalizing interest rates and 'higher for-longer' are incompatible."

So rather than listen to the pundits on CNBC, I'll stick with the experts and their view that real interest rates will gravitate downward towards 2.5%. This means that the Fed will have to ease by over 300 basis points from 5.5% to get back to neutral.



Bottom line: In a nutshell, the "higher for longer" narrative is over, and the tightening cycle is in the rear-view mirror. Most importantly, the rates cycle has turned, and the easing cycle is now staring us in the face!

BONDS ARE BACK, BABY!

A couple of weeks ago, I wrote an *Weekly Relative Value* titled, "Bonds Will Have More Fun!" Indeed! Last week, Treasury yields melted across the curve. The yield on the 10-year Treasury dropped to 3.94%, and in so doing, pierced below the 200-day moving average. Looking at the chart below of the 10-year yield, all you can see is dead air all the way down to 3.5%.

Ditto for the 5-year Treasury yield, which has dropped by a whopping 110 basis points from its recent high to 3.91%!

But it was the 2-year Treasury yield that stole the show, plunging 35 basis points (to 4.32%). Since the peak in mid-October, the yield has dropped over 100 basis points. In the past several decades, a move of this magnitude only happened last March amidst the regional bank crisis, and before that, in September 2008 when Lehman, Merrill and AIG went down for the count.

Bottom line: Bonds are back, baby! After three miserable years in a row, I expect the bond market to generate positive returns in the coming year.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

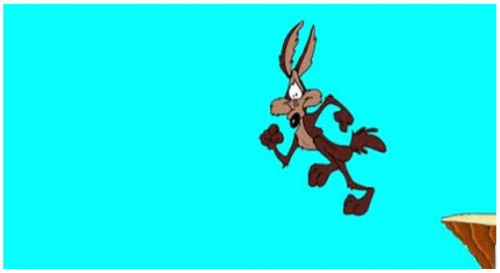
"It may still be a bit naive and premature to believe that […] we get through this rate cycle without any major accidents." — Peter Oppenheimer, Senior Strategist in Global Macro Research, Goldman Sachs
Excerpted from the WSJ article, "Beware the Most Crowded Trade on Wall Street: Next Year's Soft Landing"

The economic community has been waiting for the other shoe to drop for over a year, and yet, the "shop until you drop" American consumer has endured.

The recent cooling in inflation, combined with continued strong spending, has turned bears into bulls with whispers about a soft landing turning into celebration that the economy may avoid a recession. That would be good news indeed!

While it has been unwise to bet against the American consumer, there are reasons to worry that we may be sitting in the calm before the storm. Consumer savings are depleted and credit cards along with Buy Now, Pay Later (BNPL) plans have been tapped like never before. It begs the question of how much consumers will or should I say, can spend in the coming year.

The American Consumer



The key to how weak the economy will be in 2024 will be likely driven by the heretofore strong labor markets. As shown below, a quick rise in 15-weeks-and-over unemployment has correlated with recessions. And if the unemployment rate spikes to 4.5% next year, it might not just hint at a recession but guarantee it. Even in the most mild recession, we could anticipate unemployment climbing to at least 6%. Such a scenario would inevitably lead to rate cuts surpassing 100 basis points by the end of 2024.

In adition, there have been additional red flag warnings (e.g., a sharp drop in the use of temporary help services, fewer and fewer sectors creating jobs) about the employment picture. Thus, a downturn in the labor market could point to a recessionary scenario far more severe than the moderate slowdown anticipated by the market consensus.

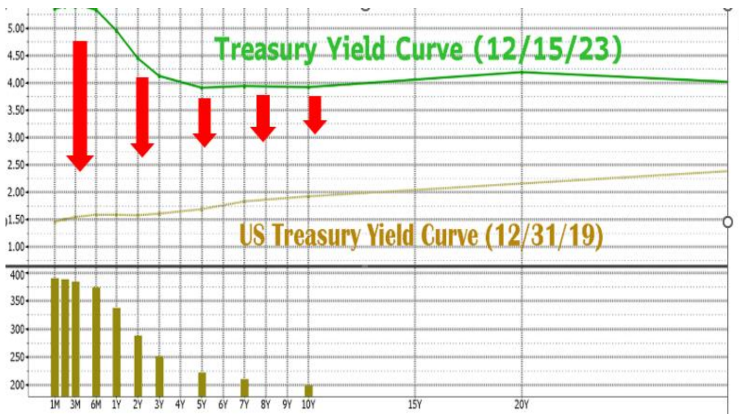
The stock market, or should I say the "Magnificent Seven," (e.g., Apple, Amazon, Alphabet, Nvidia, Meta, Microsoft and Tesla) who were responsible for much of the S&P 500's gains in 2023, surely does not see it but the bond market does.

Remember, the stock market is often driven by sentiment and psychology. You never hear the acronyms "FOMO" or "TINA" from the bond market crowd, who focus on fundamentals and leave the hype behind. Treasury market investors are driven only by economic fundamentals. But it is the bond market that has been the true leading indicator of vitually every economic cycle in the past seven decades.

As we peer into 2024, whether nominal growth is 3%, 2.0% or 1.0%, the bottom line is that the Fed sees a full-on 175 basis point rate-cutting cycle by 2025, which means that the Fed sees something ahead it doesn't like. Even those rate cuts may not be enough. Ergo, the bond market rally will still have legs.

Now, ponder a different trajectory. Suppose that a higher for longer sceanrio in 2024 triggers a sharp recession, spiking unemployment to 7%. We'd likely see a dive in commodities and broader pricing pressures due to weakened demand, potentially slashing inflation below 2%. The Fed's response? Aggressive cuts.

The short end of the yield curve, which is the most sensitive to changes in the central bank's policy rate, could see particularly marked easing next year – probably even greater than the markets are anticapting.

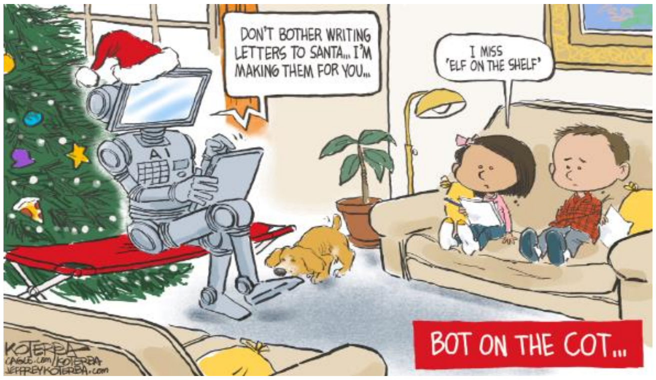


Source: Bloomberg

HAPPY HOLIDAYS TO ALL!

This will be the final version of the Weekly Relative Value in 2023. The next issue of the WRV will be published and distributed on January 9, 2024!

Wishing you and yours a wonderful Holiday season and a happy, peaceful New Year! Safe travels to all those traveling to visit family or taking a vacation to an exotic destination.



MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact

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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.