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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF JANUARY 8, 2024

A Truly Depressing Achievement

*"The U.S. gross national debt — the combination of both the debt held by the public and intragovernmental debt — **hit $34 trillion Friday**, which is barely three months after it hit $33 trillion. **A truly depressing 'achievement.'**"*
— Maya MacGuineas, President, Committee for a Responsible Federal Budget (CRFB)

First, as we go to press with the first edition of the *Weekly Relative Value* in 2024, I want to take this opportunity to wish everyone health and success in every meaning of the word for 2024. And most of all, let's hope and pray for world peace.

My request for you is to challenge me and keep me on my toes! I savor debates and emails with your thoughts and opinions. Even at the ripe young age of 66, I am always hankering to learn from all of you while doing my best to provide you with my personal insights to help make well-informed investment decisions.

Looking back, this past year was a tumultuous one with many twists and turns. Three Fed hikes, a regional banking crisis, the longest United Auto-Workers' (UAW) strike in a quarter century and two near government shutdowns only start to tell the story.

Now, as we gaze through our crystal balls to search for the future economic outcomes, the one thing we are constantly reminded of is that there will be unexpected "good" and "bad" surprises in the coming year. Indeed, as Yogi stated so eloquently, "forecasting is difficult, especially about the future." It truly is a humbling profession.

THIS WEEK

- DEBT AND DIMINISHING RETURNS
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- THE MANUFACTURING MALAISE
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SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
TELL ME MORE!

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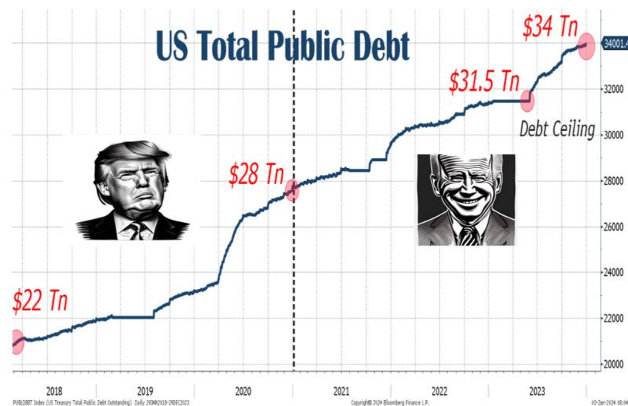
To wit: A year ago nearly 90% of economists and pundits had forcasted a recession in 2023. (Yes, I too thought a recession was a high probability event.) As we now know, it did not happen. In fact, the latest reading of economic growth, the third quarter gross domestic product (GDP) data, came in at a robust 4.9% annualized rate!

So, why did the vast majority get it wrong? Why did the recession not come last year? The answer is as clear as day: Uncle Sam indulged with reckless spending. Since the debt ceiling was raised in June 2023, the debt has jumped by over $3 trillon to stand at a mindboggling $34 trillion and counting (check out the graph below).



The fiscal deficit in 2023 widened so much that it alone added more than an estimated 4%, or a two-thirds share, of the 6%+ nominal growth incurred last year. The deficit now stands at -6.3% in a fully employed economy. This has never happened before. Deficits are supposed to decline during periods of a fully employed economy. Now, please take a minute and imagine what the consequences will be should the U.S. economy fall into a recession.

While some might be quick to blame the spendthrift Democrats, the aggreious spending has been a bi-partisan keg party. Both parties are spending like drunken sailors. They have different priorities and ways of spending, however, both love to spend money we do not have.

In the graph above, you can see that during the last three years of the Trump Administration, public debt grew by $6 trillion. Since Biden came into office in 2020, the debt has risen an additional $6 tillion. From 2016-2023, the total debt has spiked by $15 trillion, or by 80%! This stuff is just breathtaking!

DEBT AND DIMINISHING RETURNS

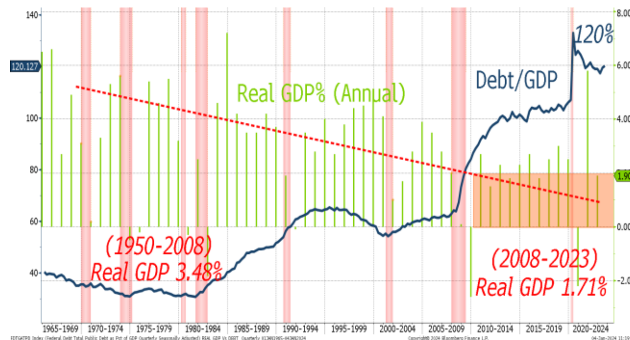
Despite what neo-Keynesians and MMTers say, higher debt does not lead to stronger economic growth. In fact, we know that excessive debt depresses growth. Well documented empirical studies of highly indebted economies indicate that when debt exceeds 80% of GDP, economic growth slows down.

The graph below illustrates the point. To wit: During the 1950s through the 2008 period, debt to GDP averaged from 40% to 60%. Economic growth averaged 3.48%!

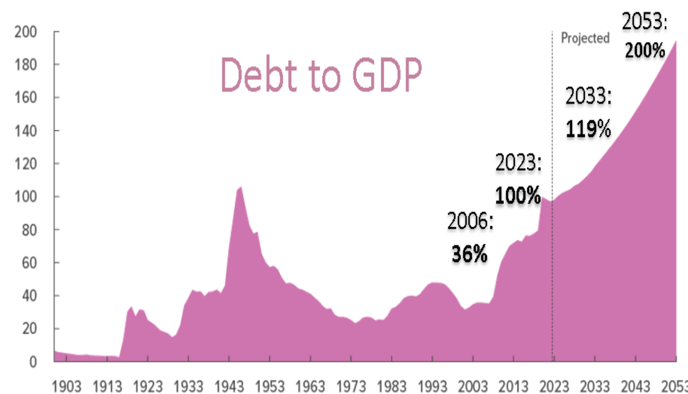
Since 2008, debt has soared above 80% in 2009 to 120% today, and economic growth has slowed to just 1.71%.

There are many risks and threats posed by a high and rising national debt. First, excess debt leads to higher interest payments and slower economic growth by crowding out private investment and public spending that could otherwise be used to improve America's workforce, infrastructure and productive capacity. **According to the Congressional Budget**

Office (CBO), rising debt under current law will reduce income growth by one-sixth and further increases to debt could reduce income growth by as much as one-third.



Sadly, the trend remains very worrisome. According to the non-partisan CBO, if this runaway spending is not addressed, debt to GDP will rise to some truly scary levels.



Bottom line: America just cannot stop borrowing. There is not a single economic reason to add to the debt at the rate we are but sadly our political leaders are unwilling to make the changes we need to turn the fiscal situation around. Our “leaders” fight, pander and take the easy way out while we become increasingly vulnerable. Continuing to refuse to pay our own bills will not lead us to where we need to be as a nation.

At this point, nothing short of a major miracle can prevent a debt crisis. But that’s still a few years away. Meanwhile, the politicians on both sides of the aisle will continue to take the easy route out and kick the can further and further down the road.

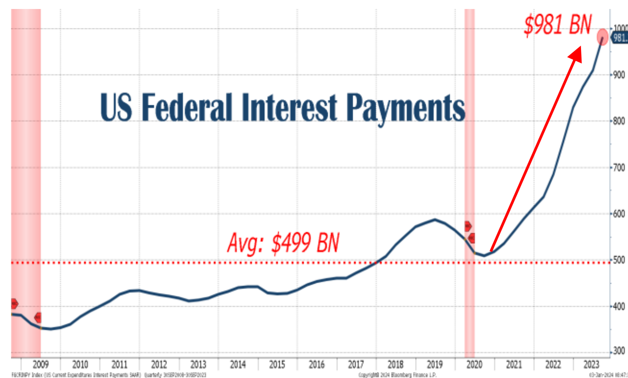
THE COST OF THE DEBT PILE SURGES

As the Federal Reserve continued to keep rates artificially low since 2009, the U.S. government was able to issue trillions of debt without any dramtic impact on interest payments. Now that the Fed has hiked rates, and Treasury yields have doubled and tripled, that dynamic has changed.

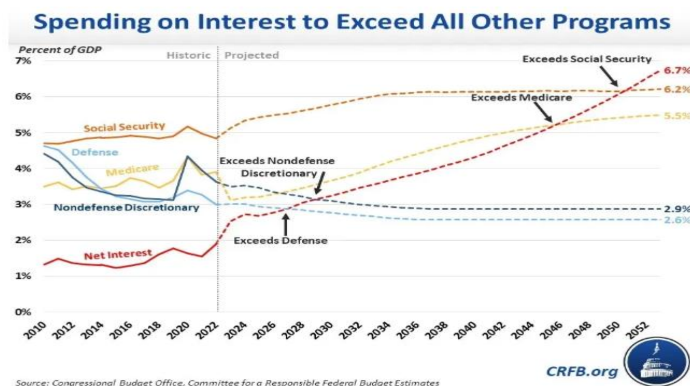
As shown below, interest expense has doubled in the past 19 months and is now approaching $1 trillion!

Unless there is significant relief from lower interest rates, the cost of servicing this debt will only get worse. This is because approximately 75% of Treasuries will be rolling over within the next five years. Most of the maturing debt was

issued when rates were 2-3% lower. If rates stay where they are or rise, the interest bill in the next decade could very well approach an incredible $2 trillion a year.



Last year, as the non-partisan CRFB points out, the federal government spent more on interest than on children or Medicaid. By 2027, spending on interest is on track to exceed defense spending. And by 2051, as shown below, interest will be the largest government program, surpassing Social Security.



Going forward, be sure to keep a close eye on interest payments as a percentage of tax receipts. This metric shows the burden of this debt. In other words, to what extent do interest payments eat up tax receipts, and what's left to pay for other stuff including interest expense?

Currently, payments as a percentage of tax receipts is 37%. This is the highest level in nearly 25 years. History shows that when interest payments eat up close to half of the tax receipts, the rest of the world gets very nervous about the U.S. debt, and then finally Congress gets more serious about dealing with this issue.

Ultimately, interest payments are threatening to eat up everything, and it appears to be the only disciplinary force left that is able to pressure Congress to do something beyond grandstanding.

Bottom line: Until the reckless spending is halted, the cost of servicing the massive debt pile will cause debt to spiral out of control. But again, sadly, neither party will do anything about anything because the political system is totally broken.

DON'T BELIEVE THE HEADLINE!

I want to remind readers that the jobs report is not a number — it is a report. Yet, the media seemingly looks at the headlines jobs number alone to judge the strength of the labor market. That is a big mistake!

This is why.

The Bureau of Labor Statistics (BLS) reported that in December, the U.S. added a whopping 216,000 jobs, smashing estimates of 175,000. With that said, I expect downward revisions to follow. Why do I say that? Because, once again, the BLS revised not just one, but both previous months sharply lower:

- October was revised down by 45,000 from 150,000 to 105,000.
- November was revised down by 26,000 from 199,000 to 173,000.

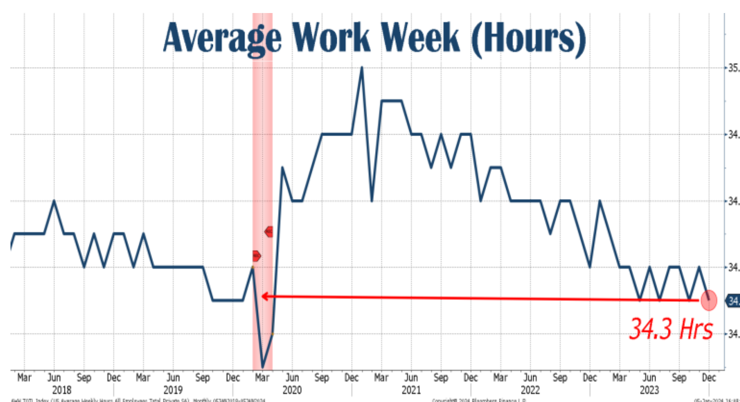
This means that 10 of the past 11 jobs reports have been revised substantially lower. The downward revisions in 2023 totaled an epic -443,000. The equivalent of two healthy months of payroll gains vanished, just like that. The problem for any given trader is that you think you have the number right, but don't at first, then you get pasted and then find out you were right after all a month later when it scarcely matters.

Also, consider that fully 60% of the headline jobs came from two sectors that have nothing to do with the business cycle — health/education and government. The combined share of employment from these two sectors is 30%, and their contribution to the job gain in December was double that.

The BLS birth-death model added +92,000 too! In 2023, fairy-tale "birth-death" model added 1.3 million jobs to the payroll report data. Think about that — 4% of the payroll growth in 2023 came from guesswork by the BLS, not from the official polling of establishments (which itself is suspect given the historically low response rate of just 40%).

Wages, which were expected by many to drop, actually came in hot as average hourly earnings rose 0.4%. This was above the 0.3% estimate, rose to 4.1% from 4.0% and negated any expectations of a decline to 3.9%.

As an offset, the workweek was cut -0.1% in December from 34.4 hours to 34.3 hours, the lowest since April 2020 when the economy was in the deep COVID-19 lockdown doldrums (to put it mildly). Thus, from a total personal income standpoint, the slippage in the private sector workweek blunted the impact from higher hourly wages.

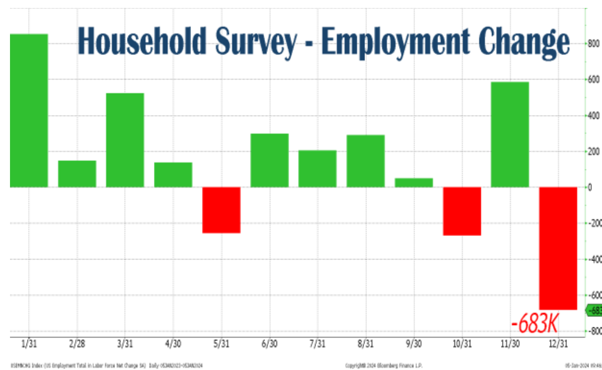


A TALE OF TWO JOBS REPORTS

The BLS payroll survey (sometimes called the establishment survey) is the headline jobs number. It is based on employer reporting.

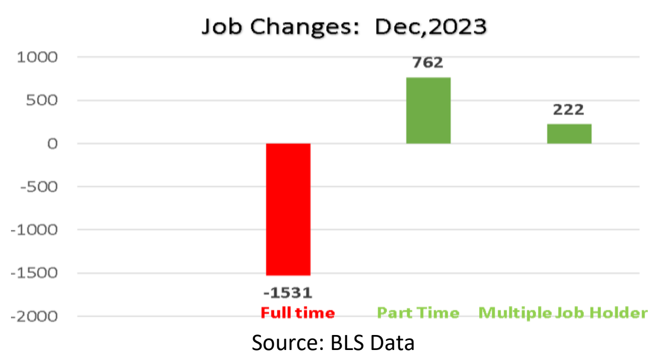
The household survey is a phone survey conducted by the BLS. It measures employment, unemployment and other factors.

In December, the household survey showed a massive -683,000 slide in employment — the steepest falloff since the depths of the pandemic lockdown.



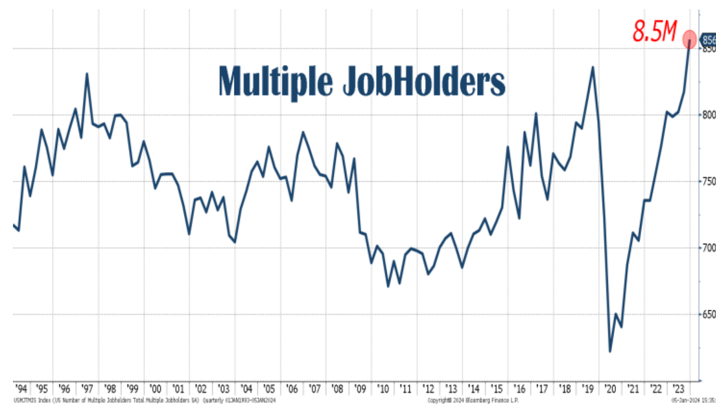
Not just that, but the household survey looks at the quality of jobs gained or lost, and specifically it breaks down the jobs into full-time and part-time jobs. The biggest shocker, and one you won't hear about on bubblevision, is that the number of full-time jobs actually plunged by 1.5 million in December. This was the biggest monthly drop since the record pandemic crash of 14.7 million jobs! And as an offset, the number of part-timers soared by a whopping 762,000, the second highest monthly increase since the covid lockdowns, to 27.794 million. This was also the highest print since March 2018!

Putting this into context, it means that in 2023, the U.S. has not added a single full-time job (in fact it has lost 34,000), however, there were one million part-time positions added last year. And it is full-time jobs that are the fundamental driver for incomes, spending and confidence.



Source: BLS Data

But wait, there's more! The number of multiple jobholders — those workers who have to work more than one job at a time to make ends meet — surged by 222,000. At 8.565 million, this was the highest print on record! The number of people working part-time for "economic reasons" climbed +217,000 so even that -1.5 million full-time job loss in the household survey is exaggerated to the "high" side.



In addition, while the headline unemployment rate U-3 remained at 3.7%, the U-6 measure ticked higher to 7.1% from 7% in November. Remember, the highlighted U-3 unemployment rate does not include people who are not officially in the labor market but do want to work. As such, the widely followed U-3 unemployment rate does not provide all the information and is understating the degree of labor market slack out there.

Not only that, but it is obviously becoming more challenging for the unemployed to find a job. To wit: The average length of time that the jobless folks have been out of work (even as they have been actively looking for a job) rose to 22.3 weeks from 19.5 weeks in November, and that is the highest since August 2022.

Bottom line: Looking at the payroll report data, the U.S. added 216,000 payrolls in December (which included a record number of double-counted multiple jobholders). However, looking at the household survey data, the number of employed workers actually crashed by 683,000 — the biggest drop in four years**.**

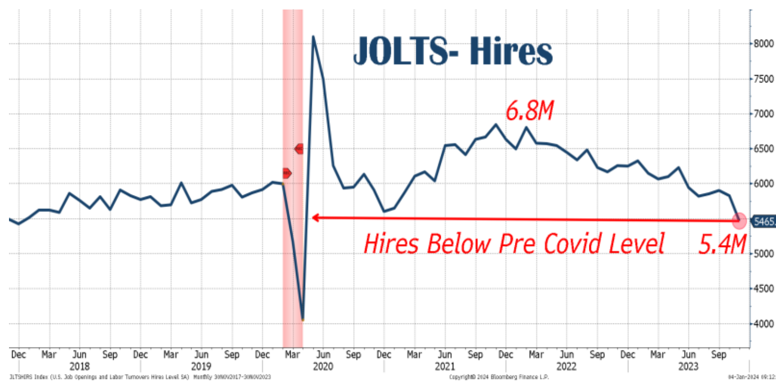
Furthermore, taking a closer look at the composition, the number of well-paid, full-time workers collapsed by a near record 1.5 million, which was offset by a 762,000 surge in part-time workers. As for the balance, it was the 222,000 people who discovered they need to work at least one more job. This attests to strains in the labor market beneath the surface of that specious nonfarm payroll result.

Bottom line: Despite what you may hear, December was **NOT** a great month for the jobs market. Cracks are widening.

ANOTHER CRACK IN THE LABOR MARKET

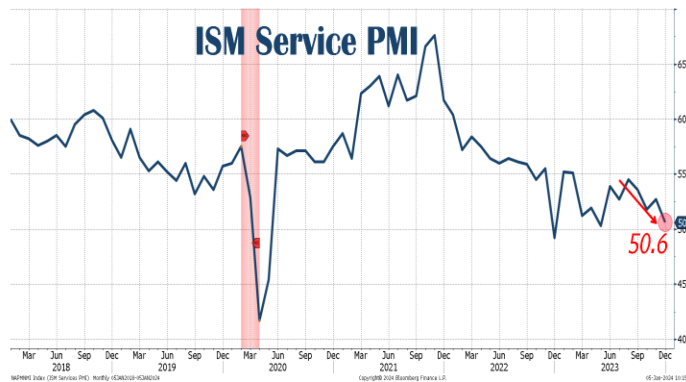
The Job Openings and Labor Turnover Survey (JOLTS) data showed job openings declining for the third month in a row, down by -62,000 and by -707,000 cumulatively from September to November.

More importantly, the definition of a job opening advertisement is so broad but a "hire" is a "hire" and needs no fudging. Hirings sagged -346,000 in November, which was the steepest plunge since those dark days in July 2020. The number of new hires has been sliced -788,000 in the past year to 5.09 million — the lowest reading since April 2020 when the pandemic lockdown recession was in full swing.



THE SERVICE SECTOR PLUNGED

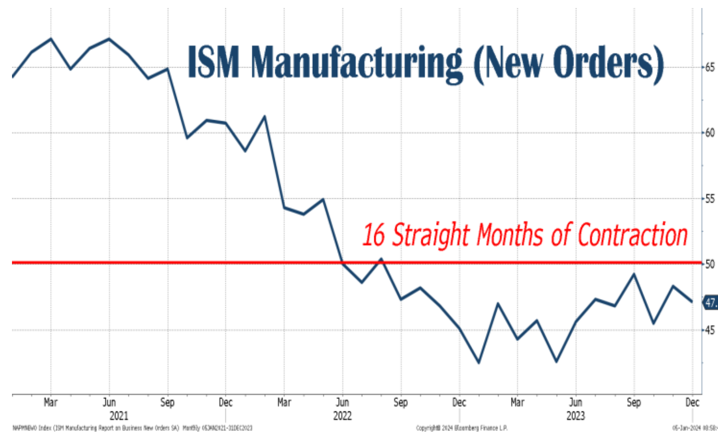
The service sector has been the hottest part of the economy, but the incoming data suggests that things are changing, and changing fast. The Institute for Supply Management's overall gauge of services tumbled from 52.7 to 50.6 (52.5 expected) to the lowest since May 2023. The index, while remaining above the 50 level, indicates expansion, was the second weakest of the year.



New orders dropped (still in expansion though) while employment crashed into the deepest contraction since the pandemic lockdowns. The employment sub index plunged 7.4points to 43.3, the lowest level since July 2020 and another sign of dissipating momentum in the U.S. labor market.

THE MANUFACTURING MALAISE

The manufacturing sector has been in a malaise for over a year. While the latest ISM Manufacturing Purchasing Managers' Index (PMI) data revealed a marginal improvement to 47.4 in December 2023 from November's 46.7. The latest print marks a 14-month decline in manufacturing activity while new orders have remained in a contractionary state for 16 months!



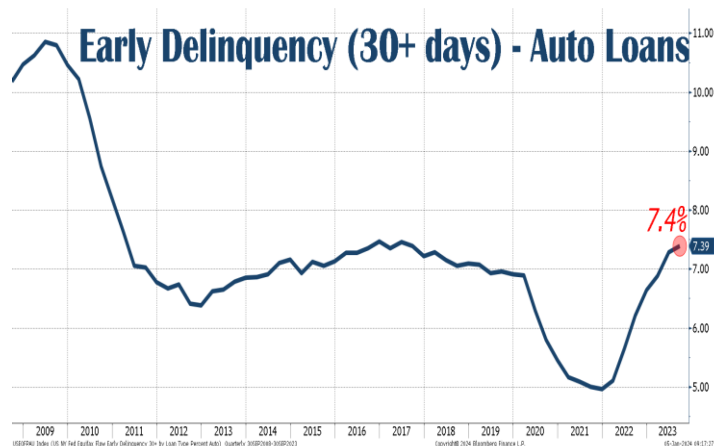
Bottom line: The ISM data represents the economic reality of the business cycle. The protracted nature of this manufacturing downturn really can't be understated. If the job market weakens, there's your hard landing.

GIVING CREDIT WHERE CREDIT IS DUE

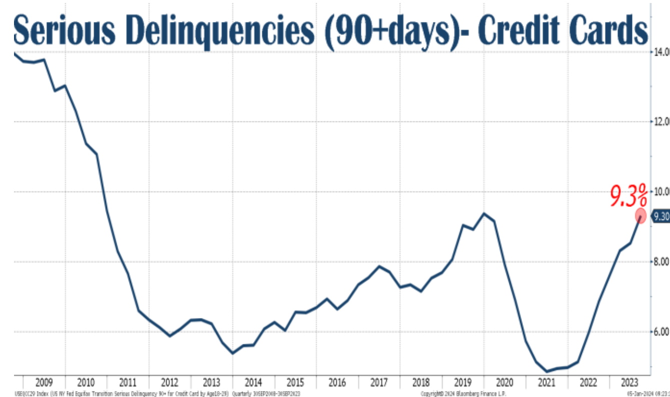
Aggregate households have seen their balance sheets improve but it's important to note that the aggregate numbers are masking what is happening at the margin.

Years of zero rates, and the Fed balance sheet backstop, led to classic, reckless lending behavior. Now, the folks who had no business loading up with debt are paying the price and so are the lenders, as they remain compelled to divert more of their earnings to loan-loss provisioning.

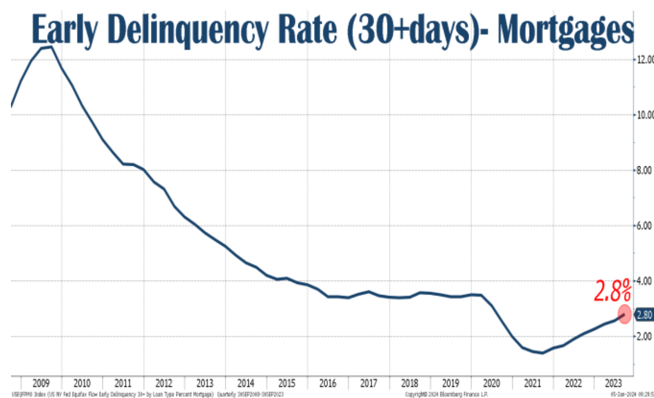
The 30-day delinquency rate for autos has jumped from 5.0% two years ago to 7.4% (this was when the unemployment rate was 5.1%, not 3.7%).



What about credit cards? The delinquency rate (90+ days) has doubled in the past two years to 9.3% from 4.8% and stands at the highest level since the third quarter of 2011 when the jobless rate was 9.1%. Imagine where this metric goes once the jobless rate trends higher from today's tight level.



Even mortgages have seen the 30-day late payment rate rise from 2.1% this time last year to 2.8% today. Still low, indeed, but even back to where it was when the economy was reeling from the pandemic and lockdowns in 2020 when the unemployment rate was 13%.



Bottom line: The fact that there is decay in credit quality amidst continued economic expansion and super-low jobless rates attests to how radically easy monetary policy and bank lending practices were prior to the March 2022 tightening cycle. And sadly, as was the case in the 2000s, the marginal borrower was sucked into the debt vortex and is now paying the price.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"What we're seeing now I think we can describe as a soft landing, and my hope is that it will continue."
— Janet Yellen, Treasury Secretary

I truly hope Janet is right, but hope is not a good investment strategy.

With that said, I prefer to let the data tell the tale. From my perch, while not yet in recession territory, economic growth and inflation continue to grind lower.

As we move forward, employment data is the key to the economy and Fed policy.

And while the employment data is weakening, it is not yet at recessionary levels**.** But as discussed above, the real problem for the labor market has been the collapse in hiring activity. This deterioration has not shown up in the payroll data because of the BLS birth death model assumption, which alone has accounted for 46% of the net increase in non-farm payrolls through the first 11 months of 2023.

Even still, the recent backup in bond yields, the wobbly stock market, and the U.S. dollar rebound all boil down to one thing, and one thing only, a reset of Fed expectations.

Indeed, it would seem as though investors picked up on this one sentence that found its way into the Federal Open Market Committee (FOMC) meeting minutes:

"Many participants remarked that an easing in financial conditions beyond what is appropriate could make it more difficult for the Committee to reach its inflation goal."

This is code for the markets to chill when it comes to front-running the dot-plots — at least for now. What was a 90% probability of a March cut by the swaps market just a week ago, has now been pared to 65%. Instead of 6 rate cuts, the futures market now sees 5 rate cuts.

With that said, we may still see a rate cut as early as March. It certainly can happen. But the employment data has to take a turn for the worse or we need to see the core Consumer Price Index (CPI) and the personal consumption expenditures (PCE) deflator numbers come in lower in the coming months. Beyond that, a financial setback of significance may be required (perhaps the fact that Tech stocks are riding their worst losing streak in a year may be a start).

Bottom line: As we end the first week of the year, the markets expect the Fed to pivot and reduce rates. The question then becomes how soon and by how much. As always, it's wise to avoid guessing and timing. The best way to position the investment portfolio is to maintain a risk-appropriate ladder strategy.

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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