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INVESTMENT SERVICES

Weekly Relative Value

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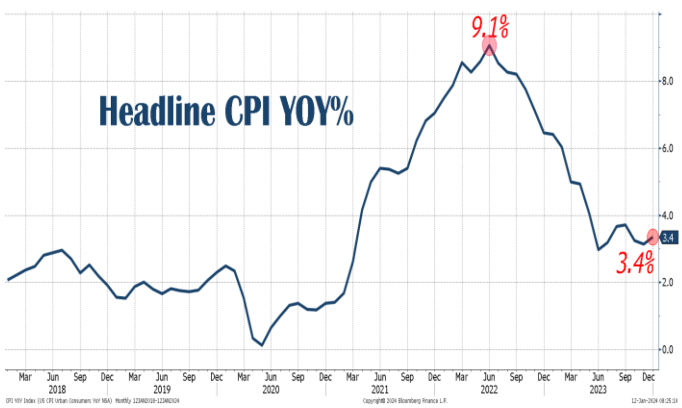
The Devil is in the Details

"We're beginning to see significant progress in the third, innermost layer of the onion, too. Core services inflation has come down after peaking early last year. One factor contributing to this is slowing shelter inflation, as the growth of rents for newly signed leases returns to pre-pandemic norms. And the inflation rate for core services excluding housing has also slowed considerably."
— John Williams, New York Federal Reserve President

THIS WEEK

- KEEP YOUR EYES ON THE PRIZE!
- MR. BOND GET THIS!
- BANK WOES
- PUSHING ON A STRING
- NOT GOING TO HAPPEN!
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

The headline December consumer price inflation printed hotter than expected, pushing the year-over-year headline Consumer Price Index (CPI) up to +3.4% (from +3.1% prior and the +3.2% expected). As shown below, the headline CPI was running red hot a short while back, nearly annualized at 9% year-over-year.



The Bureau of Labor Statistics (BLS) pointed to shelter as the source of the increase. As I've highlighted numerous times before, the shelter component is **33%** of the BLS CPI index, **42%** of the "core" CPI and **20%** of the core personal consumption expenditures (PCE), making it the largest part of the index and the key to the direction of inflation.

In December, the rent of primary residence, which is the cost that best equates to the rent people pay, jumped another 0.4% month-over-month and is still rising 6.4% year-over-year.

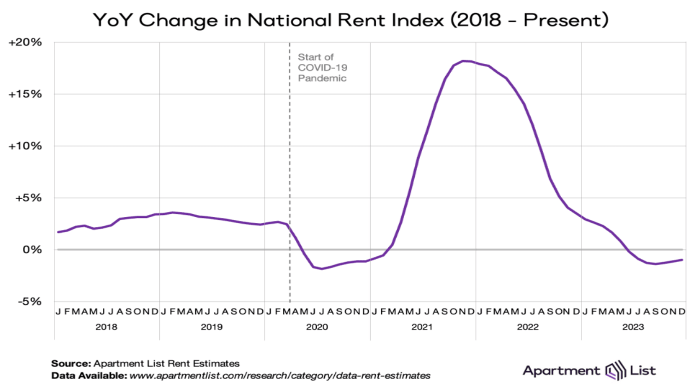
"Apartments across the country are slightly cheaper today than they were one year ago. This stands in sharp contrast to the prevailing conditions of 2021 and 2022"
— Apartment List

As always, the devil is in the details.

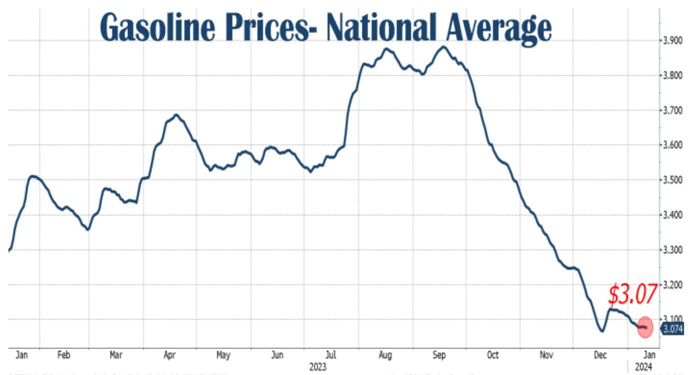
We know that the BLS rental numbers are bogus because they operate on a very long lag. For example, consider the widely followed Apartment List National Rent Report. This index captures price changes in new leases, which are only later reflected in price changes across all leases (what the CPI measures). As such, it is a leading indicator of the BLS CPI housing and rent components.

This "real time" index showed that rents peaked in the Summer of 2022, and have been trending downwards since. Indeed, the rental market ended 2023 with a fifth straight month of **negative** rent growth. Nationwide, the median rent fell by 0.8% in December. Year-over-year, rents are down 1% whereas the BLS data shows that rents are increasing to 6.4%!

In other words, in the "real world," shelter measures were **flat** or **negative.** Therefore, the BLS model has yet to account for the flat-to-deflationary trend in real-time rental prices. I would guess the model will catch up to reality by early summer.



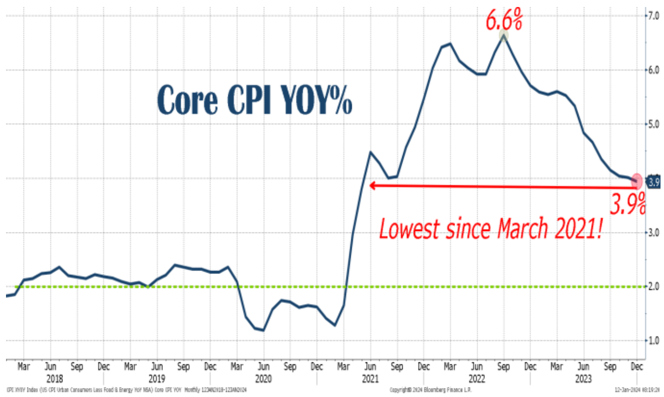
Also, be sure to consider the energy component. A large proportion of the rise in the headline was due to energy prices, which went from -2.3% month-over-month in November to +0.4% month-over-month. Digging a little deeper, according to the BLS, gasoline prices rose +0.2% in December. However, in reality, prices at the pump fell -0.8% in December. Hm... Given that sort of discrepancy between reality and the fairy tale world of the BLS, it was no wonder the data was ignored by the bond market (much like non-farm payrolls).



And then take a closer look at vehicle prices. According to the BLS, "used" auto prices rose 0.5% but the Mannheim Idex declined -0.5%. Call me a bit skeptical.

Moving on. The core inflation (CPI excluding food and energy) was in line at +0.3% month-over-month. Remaining unchanged month-over-month, it has slowed from +4.0% to +3.9% on a year-over-year basis — the lowest level since May 2021.

As a reminder, shelter represents 40% of the core CPI. Over the past year, shelter costs have risen 6.2%, **which accounts for over two-thirds of the total increase in the core CPI.**



Beyond that, core goods prices went from outright deflation of -0.3% month-over-month to flat in December. This was due to a big recovery in apparel prices (up to +0.1% from -1.3% in November). I'm guessing this reflects fickle Black Friday/holiday period pricing strategies. **Overall, from a policy perspective, there is not much to worry about from core goods prices; they're running at just +0.2% year-over-year.**

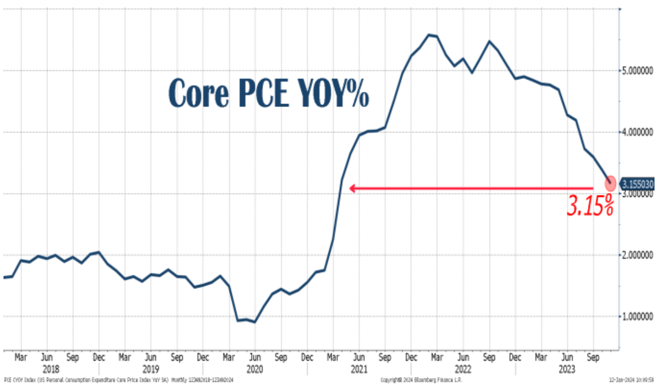
On the services front, there was some marginally good news for the Fed. The newly christened "correct" measure of inflation (the so-called Powell super core), which excludes **76%** of the item-weights in the full CPI, was down to +0.40% month-over-month while the year-over-year came in at 3.91%. Progress.

KEEP YOUR EYES ON THE PRIZE!

Unlike the CPI data, the Producer Price Index (PPI) deflated by -0.1% month-over-month in December. As shown below, year-over-year, the annualized rate of PPI is well below the pre-COVID-19 pace of approximately 2.5%. Likewise, the core PPI (excluding energy and food) came in at +0.0%. Bond markets absolutely loved this data as yields plunged in the immediate aftermath of the release.

It is important to remember that the Fed focuses primarily on the core PCE deflator (due for release on January 26) more than the flawed CPI. This is what the Fed uses when it projects its Summary of Economic Projections (SEP), not the CPI. Over the past six months, the core PCE deflator is currently running at a nearly +2.0% annualized rate. This downward trend is likely to continue because the PPI components that factor into the core PCE calculations are different than the

CPI. For example, domestic airfares fell in the PPI in contrast to the increase in the CPI. Likewise, several medical-care services categories in the PPI grew less rapidly than their CPI counterparts. Also, the PCE places only a 20% weighting on shelter costs compared to 40% in the core CPI. And finally, the PCE has a 50% lower weight on car prices (where inflation accelerated) and twice as much on core services excluding housing rents. This is a key reason why the core PCE index could surprise to the downside and move closer to the Fed's 2% target sooner than the "inflationists" and bond bears suggest.



Bottom line: The Fed's preferred inflation gauge is likely to hit or come close to the Fed's 2% target by this March. This, along with signs of deterioration in the labor market, is why the Fed may begin cutting rates that month.

MR. BOND GET THIS!

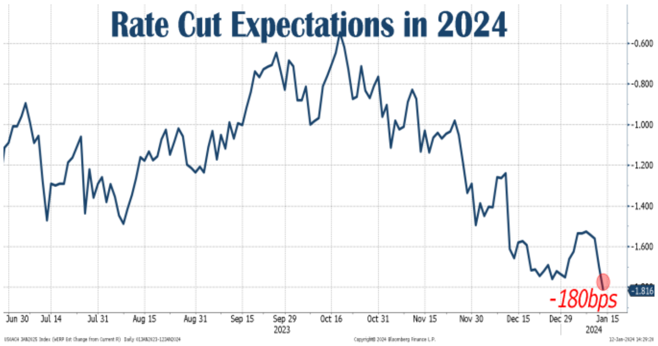
*"I wake up every morning **salivating about the $7 trillion that's sitting in money-market accounts** that's waiting to move…I **think there's a huge, huge runway for fixed income."** — Robert Kapito, Co-Founder, Blackrock (The World's Largest Asset Manager)*

Despite the so called "hot" CPI headline, the immediate reaction to the inflation news was taken as a great buying opportunity and brought the 10-year Treasury yield back below 4%. The yield on the 2-year Treasury note collapsed -12 basis points on Friday to 4.14%, which is down a whopping -110 basis points from the mid-October peak and is dialing back to where it was last May.

Moreover, the federal funds futures barely moved. While it may surprise the perma-bond bears on Wall Street, the swap market is pricing in six rate cuts this year even though the chance of a 25-basis point cut in March is still as high as 80%.

In total, the bond market now expects 180 basis points of cuts in 2024, which would drive the fed funds rate to 3.50%!

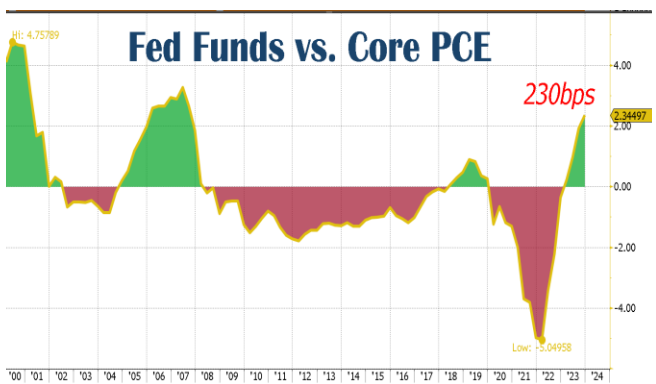
Simply put, the bond guys get this and called baloney on the allegedly "hot" CPI report. I might add for good reason! It was a head fake!



So why is the market so bulled up on additional rate cuts?

The clearest reason for the expectations of further rate cuts is that the BLS's methodology for shelter inflation is overstating rental inflation. This is important because CPI (excluding shelter) has dropped below 2%, and shelter inflation is falling, though at a slow pace. Undoubtedly, the Fed understands this. Likewise, as noted above, the PPI data suggests that the Fed's preferred inflation gauge, the core PCE index, will continue towards the holy grail of 2%.

Moreover, there is a 235 basis point spread between the fed funds rate and inflation. The market believes that the Fed will move to bring interest rates more in line with inflation. In other words, the Fed will attempt to normalize rates. This isn't an emergency or a radical approach, but rather a response to its dual mandate of controlling inflation and fostering employment.



Bottom line: The CPI report was not as good as widely expected. However, the bond market dismissed the data and instead focused on the declining PPI data and the underlying downward momentum in inflation.

BANK WOES

Last Friday, the earnings season commenced with the fourth quarter earnings. Some of Wall Street's biggest banks took turns calling an end to the record run for their biggest source of revenue-net interest income. In fact, Wells Fargo predicted a 9% drop in net interest income for 2024 while Citigroup forecasted a modest drop this year. Even JPMorgan Chase, which sees its 2024 haul holding up at 2023 levels, predicts it will drop off over the course of the year.

Adding to the negative impact of declining net interest income, the largest U.S. banks are reporting a sharp rise in bad loans.

"Each of the four banks [ed note: Citigroup, Wells Fargo, JPMorgan and Bank of America] posted one-time charges, dragging down quarterly profits […] ***the four banks charged off $6.6 billion in loans in the fourth quarter, twice as much as in the same period a year earlier****"*
—"Banks Can't Count on Loans for Growth", The Wall Street Journal (WSJ)

To no one's surprise, the commercial real-estate sector has been a big sore spot. The valuations of U.S. offices have plummeted by 35% from a peak in early 2022. Making matters worse, nearly 20% of office space that isn't leased is at the highest level since at least 1979!

"While the charge-offs we took in the fourth quarter were contemplated in our allowance, ***we are still early in the cycle."*** *— Michael Santomassimo, CFO, Wells Fargo*

Moreover, banks cannot count on loan growth.

Get this:

"Higher interest rates are stinging consumers who need to borrow now. Households that built up savings during the pandemic are spending that money down […] ***the banks' results showed that consumers are borrowing more on their credit cards, carrying over higher balances and falling behind on their payments in greater numbers****." — "Banks Can't Count on Loans for Growth", WSJ*

And then there is this little ditty:

*"****Americans have also increasingly struggled to keep up with monthly car payments****, which have jumped in size […]* ***auto delinquencies rose further above pre-pandemic levels at JPMorgan and Wells Fargo in the fourth quarter."*** *— "Banks Can't Count on Loans for Growth", WSJ*

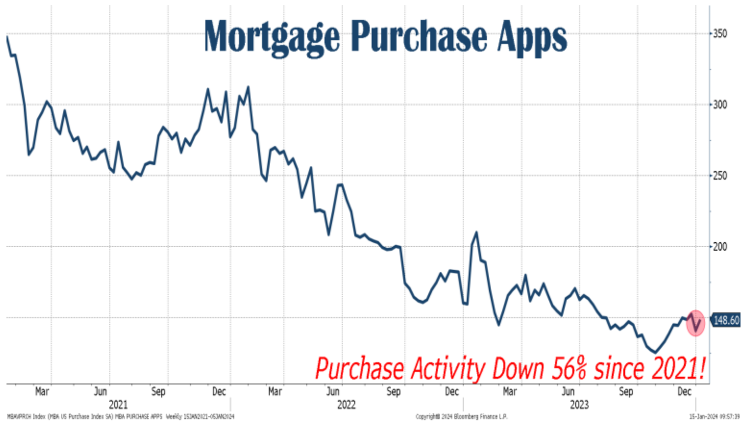
Finally, in the midst of the earnings season, there was this recession signpost. Citigroup announced late last week that it was eliminating 20,000 positions (10% of its workforce). The banks are always and everywhere the leading economic indicators.

Bottom line: The above speaks of a worsening credit cycle. Delinquencies and defaults are rising in a so-called "full employment" economy. What prey tell will happen when unemployment rises to 4.5% or even 5%? In a nutshell, the bank results are another reason why the futures market is expecting the Fed to start cutting in March.

PUSHING ON A STRING

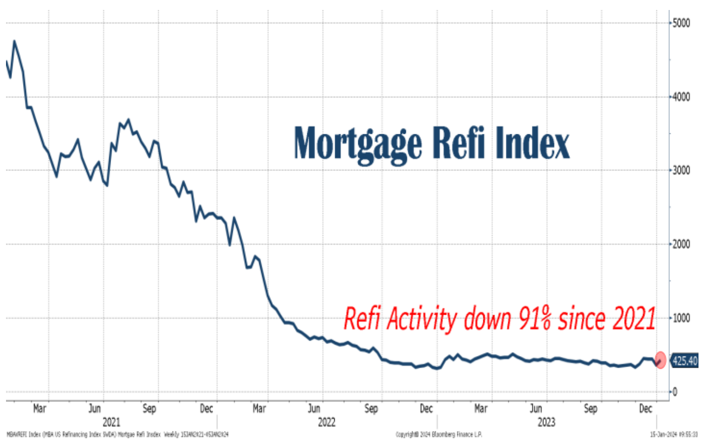
"Mortgage demand jumps nearly 10% to start the year, even as interest rates tick up again."
— CNBC

What a joke! Yes, mortgage applications to purchase a home rose 6% from the prior week, but the recent uptick barely shows in the graph below. In fact, purchase activity is still below where it was just two short weeks ago. Moreover, since 2021, applications to purchase a home are down a whopping 56%!



Meanwhile, even with mortgage yields declining more than 100 basis points from the peak, everyone is locked into the ultra-low rates of yesteryear. Thus, the cashflow boost from refinancing remains embarrassingly close to near-zero. Compared to the same week in 2021, they were down by 91%!

Let's face it, who would want to refinance a 3% mortgage rate with a 6.7% mortgage rate?



This is a completely sclerotic housing market. Home prices are way too high for these kinds of mortgage rates, so the market is essentially frozen. Sellers do not want to sell at prices that they could sell the home for, and buyers refuse to pay those prices. It is a buyers' strike as sales of existing homes have plunged and it is not getting better in any significant way.

More to the point, in 2021 and early 2022, everyone and their dog wanted to “lock in” the low mortgage rates while they still could, even at 4%. Those buyers, largely Millennials and Gen Zers, trampled all over each other and outbid each other, and thereby bid up prices in a historic manner.

Now, the opposite is here. People are either waiting for mortgage rates to come down to maybe 5% or ideally 4% with 3% dangling out there as the big carrot. Or, they are waiting for home prices to decline.

Bottom line: “Pushing on a string” is the insensitivity to interest rates. Households being locked in their mortgage at historically low rates prior to the Fed tightening cycle works in both directions. Unless rates either come down by a lot or home prices deflate, “pushing on a string” will be one of primary themes this year.

NOT GOING TO HAPPEN!

One of the benefits of being in this business for 40 years is the invaluable experience and lessons learned from living, investing and trading through the various economic and market cycles. In addition, I’ve lived through many crisis events including the collapse of Continental Illinois, the savings and loan crisis, the Long-Term Capital Management (LTCM) crisis and the housing bubble.

More to the point, I shake my head when I hear that the Fed will be reluctant to cut rates early because of a concern that premature easing will ignite inflation as was the case back in the 1970s. Likewise, I keep hearing from pundits that the U.S. economy is built for inflation as was the case back then. Where does this stuff come from? Frankly, maybe I’m wrong, but I don’t see any comparison between the 2020s and the 1970s.

Here are my top 10 reasons why we are NOT heading back to the 1970s!

1. **Demographics:** The median age was 28, not 38. Household formation averaged 1.5 million annually in the 1970s, compared to 900,000 over the past decade.

2. **Debt:** The total debt-to-GDP ratio in the 1970s was 150%. Today, it sits at an eye-popping 335%. This fiscal blowout represents nothing more than a future taxation burden on society. Nothing inflationary about that.

3. **Wages**: High-profile wage settlements in response to the pandemic price surge are not likely to be repeated. This is because unionized labor is 6% today. In the 1970s, unionized labor was at at 20%. No comparison.

4. **Productivity:** In the 1970s, low productivity drove utilization rates to narly 90%. Today, they are under 80%. Inflationary pressures are not comparable.

5. **Global competition**: Despite friction with China, cross-border trade volumes are ten times higher today than they were in the 1970s.

6. **Oil:** Does anyone expect crude oil to trade at $800 a barrel? In the 1970s, the U.S. was a net importer of oil and the price of oil skyrocketed tenfoldIn addition, crude production at home is at an all time high. Also, the U.S. is a net energy exporter.

7. **Technology:** The 1970s was a decade of low productivity and high regulations. Let’s face it, technology in the 1970s was a transistor radio. There was no Microsoft or internet yet. No comparison.

8. **The US dollar:** After Richard Nixon closed the gold window, the U.S. dollar went into freefall. Should we be worried about that today? I don't think so.

9. **No playbook:** I was around in the early 1980s and inflation was still running rampant. But then, former Fed Chairman Paul Volcker, the greatest central banker in my lifetime, showed the U.S. and the world how to sqelch inflation. Thus, as a result of the Volcker doctrine, the Fed now has a playbook as to how to stop inflation and has put the inflation genie back in the bottle.

10. **Inflation expectations:** Expectations of high inflation were unhinged in the 1970s. Nearly 20% of the population thought we were going into a future of +15% inflation back then. Today, it's a measely +2%!

Bottom line: I have to seriously ask, why do so many pundits still belive that high inflation is our future and peddle the tale of why we are heading back to the inflationary 1970s?

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Treasury Secretary Janet Yellen is putting the G in GDP. As I have written and spoken about ad nauseam, the nation's wildly irresponsible fiscal and monetary policy trajectory is unsustainable.

To put this in context, **there is $34 trillion in debt. This is up 500% since 2000!** Deficits are running close to $2 trillion per year. The government spending has heretofore disguised the weakness in the U.S. economy, but you cannot continue with these deficits and this debt without having to pay the bill.

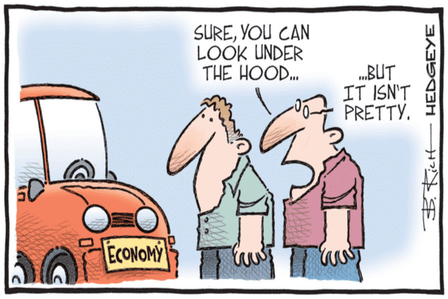
Not just that, but in the real world — the world beyond the oft-revised and government-massaged economic data — things do not look so bullish. To wit: Despite the so-called strong labor data, full time jobs have plunged, housing is in the deep freeze and the consumer is strapped.

Anecdotally, the likes of Home Depot, Walmart and Target all featured declining or slowing sales. Higher income households are "trading down," and C-suite commentary indicates a more cautious outlook.

- **Home Depot:** *"This year reflects a period of moderation… **we continued to see softer engagement in big-ticket discretionary categories."***
- **Target:** "O*ur profit and loss (**P&L) is being impacted by multiple top-line and bottom-line challenges,** including soft industry trends in discretionary categories, moderating inflation rates in essentials and food and beverage and a higher inventory shrink… **this year we've seen more and more consumers delaying their spending until the last moment**."*
- **Walmart:** "*We are more cautious on the consumer than we were 90 days ago at this time… **we may be managing through a period of deflation in the months to come.**"*

The issues are widespread among the retail giants in the U.S., including Nordstrom, Best Buy, Kohl's, Lowe's, Restoration Hardware, Lululemon and Nike.

Looking abroad, Europe is near a recession and China is deflating. Can the U.S. stand alone? It is no wonder the swaps market is pricing in six rate cuts.



I believe the most significant behavior last week was the front-end of the Treasury curve. Despite tough talk from the Fed, the bond market pushed back hard.

Indeed, the yield on the 2-year Treasury note collapsed -12 basis points on Friday to 4.14%. It is now down a whopping -110 basis points from the mid-October peak and is dialing back to where it was last May.

The gap between the 2-year and the 10-year maturity is now down to -21 basis points compared to -38 basis points at the end of 2023. At this rate, the curve will have "dis-inverted" by the end of the month and rest assured, this will cause all sorts of excitement on bubble vision.

The thing is, historically speaking, when the yield curve dis-inverts, the recession no one sees coming is only a couple of months away. Check out the graph below and draw your own conclusions.

Bottom line: One reason I remain a long-term secular bond bull is because of my belief that high rates are simply not sustainable in a credit and debt driven economy. And when one looks at borrowing costs of mortgages, personal loans, auto credit and corporate debt against the pre-tightening norm, interest rates in general will have to fall at least 300 basis points to reignite a new positive economic cycle.

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.