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INVESTMENT SERVICES

Weekly Relative Value

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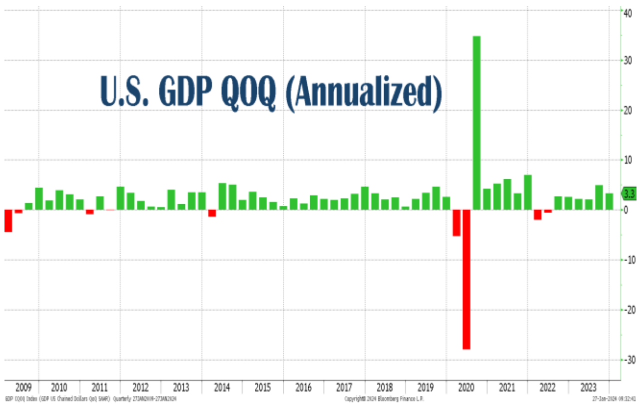
The Recession That Didn't Come!

"A widely predicted recession never showed up. Now, economists are assessing what the unexpected resilience tells us about the future." — The New York Times

Anyone in need of an ego check should try their hand at economic forecasting.

At the beginning of 2023, 85-90% of the economist community predicted a recession! A year ago, even the Fed staff predicted a recession for late 2023. In fact, it was the most widely anticipated recession that didn't come.

According to Bureau of Economic Analysis, U.S. gross domestic product (GDP) grew at a torrid 3.3% annualized pace in the fourth quarter. This was well above the highest Wall Street forecast of 2.5% and blew the median forecast of +2.0% out of the water.



According to government data, the growth was widespread with no weak links:

- Personal consumption was +2.8% quarter-over-quarter annualized, showing strength in both goods (+3.8%, from 4.9%) and services (+2.4%, from +2.2%). Specifically, there was a jump in healthcare spending and a surge in RV purchases.
- Investment came in slightly positive at +2.1% (down from +10.0% in the third quarter), mostly driven by non-residential fixed investment (+1.9%, up from +1.5%).
- Inventories were a positive contribution. The lack of inventory destocking means growth will be subtracted in the first quarter instead.

THIS WEEK

- FAKE GROWTH!
- COOL BREEZE IN THE WINDY CITY
- PRICES DROP TO TWO-YEAR LOW!
- THE HOLY GRAIL
- CLAIMS RISE
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

- Despite the soaring dollar, net exports went from neutral to a big contributor, adding +0.4 % to headline growth in the fourth quarter.

  At the risk of sounding like a conspiracist, that's a suspicious number. There was nothing in the data flow leading up to this print that pointed to such strong growth. This was possibly due to December 2023 being the warmest on record, (40 degrees compared to the norm of 33 degrees) causing a rise in activity (think more construction, more leisure, more retail spending, more transport, etc.) and potentially leading to a flawed seasonal input.

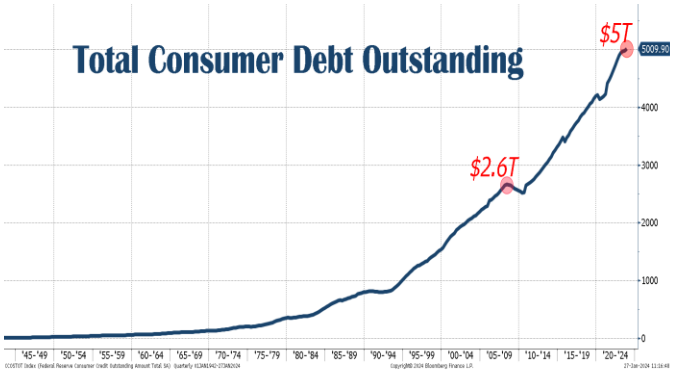
  Here's the potential distortion: the government statisticians are using December seasonal factors to massage the data and render them comparable sequentially when it felt more like March outside. In other words, the seasonal input may have been flawed.

  Bottom line: As my Dad often said, "*son, when something looks too good to be true, it usually is."* The fourth quarter GDP print was probably more of a weather report than economic report and is probably due for a hefty revision. Still, that doesn't matter to the immediate market outlook, or factor much into the Federal Open Market Committee's (FOMC) thinking.

FAKE GROWTH!

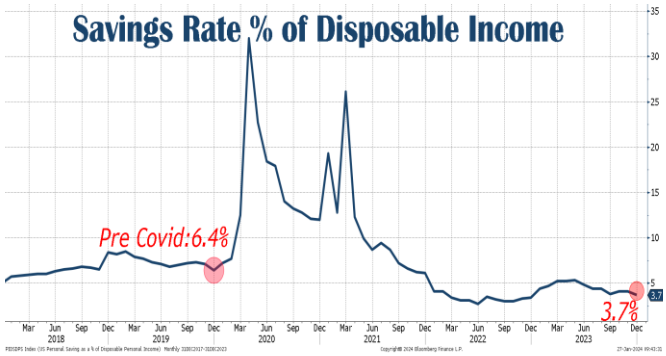
Whether the GDP growth number was realistic or not is less important than what funded the said growth. GDP was fueled by in a word: DEBT!

First, U.S. households spent! They even dipped into their savings or borrowed to keep spending. In fact, **consumer spending increased five times more than income** did in December! Think about that. Does that sound healthy? Sustainable? In fact, total consumer credit, (revolving and non-revolving debt) hit an all-time high of $5 trillion! At the same time, interest rates on this debt have surged. In essence, consumers are spending recklessly and using debt, especially credit cards, to do so.



Thus, the U.S. consumer continues to dissave to extend their consumption streak with the savings rate dropping to 3.7%, under half the historical average. A recession was averted as Main Street took a feather out of Wall Street's cap — leverage! Does that seem like a good thing?

Further, if the consumer is resilient and their financial situation is so sound, why have the retailers gone bonkers on gimmicks to stimulate sales? The "Buy Now, Pay Later" services, which are not included in the consumer debt, increased to record levels during the holiday-shopping season.



Moving on. As has been discussed in this space for many months, the U.S. Government continues to spend like a drunken sailor. And while some may blame the Democrats alone, that would be dead wrong. Make no mistake, this is a bi-partisan keg party with Republicans in on the deal.

After driving two-thirds of nominal growth in prior quarters, the fiscal thrust continued in the fourth quarter **with government consumption and investment rising +3.3%. This accounted for 20% of the growth over the past quarter**.

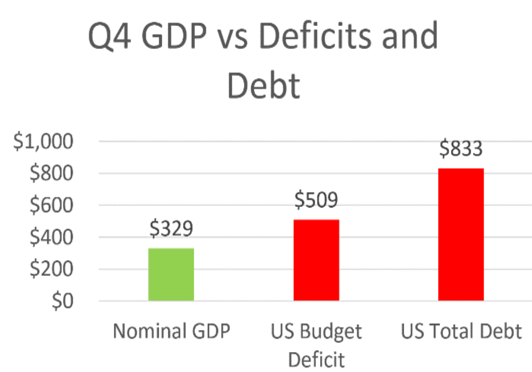
But be careful when someone from the government says I'm here to help.

The graph below shows the fourth quarter change in GDP (nominal dollars) along with corresponding increases in the debt and deficits (keep in mind that the the last time the U.S. actually had a surplus was in the last century).

The results, for better or worse, speak for themselves. While the fourth quarter GDP rose by $329 billion to $27.939 trillion, a respectable if not made up number, the more distrubing trend over the same time period is that the U.S. budget deficit rose by more than 50%, or $510 billion.

And the cherry on top, the increase in public U.S. debt in the same three month period was a stunning $834 billion, or 154% more than the increase in GDP.

In other words, it now takes **$1.55 in budget deficit** to generate **$1 of growth. Or if you prefer,** it takes over **$2.50 in new debt** to generate $1 of GDP growth!



Source: Congressional Budget Office

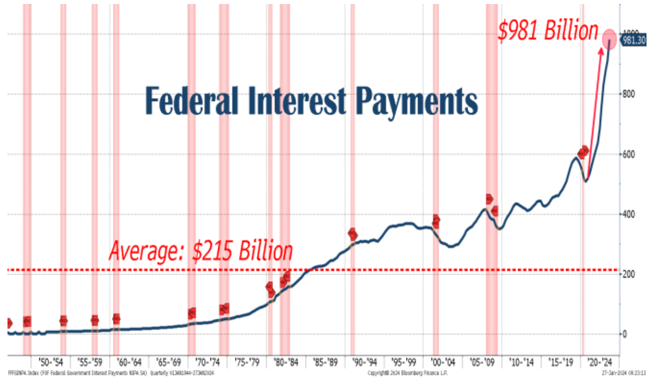
Big Picture: Last year, the U.S. Government debt rose by over $2.6 trillion to a whopping $34 Trillion. Despite full-employment and solid growth, the fiscal deficit increased to $1.7 trillion (nearly 7% of nominal GDP). A ballooning deficit like this in the context of 6% nominal GDP growth is unprecedented outside of recessions. At this point in the cycle, the U.S. Government should be running surplusses not deficits! Further, this deficit spending is big reason why inflation rose post-COVID-19.

Looking further back, over the past four years, the debt grew by 46% while the economy grew by only 27%. Since 2000, the debt has gone up 500%.

"You cannot continue with these deficits and this debt without having to pay the bill… The Treasury debt maturing over next the 12 months is crazy." — Keith McCullough, CEO, Hedgeye Risk Management

With this kind of fiscal stimulus washing over the land, it's practically impossible to even have any kind of slowdown, much less a recession. In other words, there has not been a recession because Uncle Sam borrowed from your children and borrowed from the future. It also begs the question that if the economy is in such fine shape, then why all the fiscal stimuli?

As they say, all good things come to an end. For the first time ever, with the debt out the wazoo, the total Federal interest payments have now surpassed $1 trillion. And without some help from lower interest rates, the expense is about to go exponential as much lower yielding debt needs to be rolled over at much higher rates over the next 12 months.



In their authoritative 2011 book, *This Time Is Different,* authors Carmen Reinhart and Kenneth Rogoff talk about how a country's debt crisis usually hits suddenly, in what they call a "***Bang!"*** moment that forces previously unthinkable changes.

"Highly indebted governments, banks, or corporations can seem to be merrily rolling along for an extended period, when Bang! —confidence collapses, lenders disappear, and a crisis hits… ***What one does see, again and again, in the history of financial crises is that when an accident is waiting to happen, it eventually does."***
— This Time is Different by Carmen Reinhart and Kenneth Rogoff

Bottom line: We're in wacky tobacky land. This is both scary and unsustianable!

Why do people not see this?

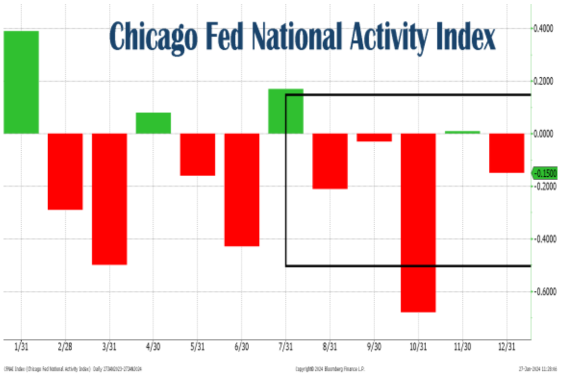
COOL BREEZE IN THE WINDY CITY

The Chicago Fed's National Activity Index (CFNAI) indicator is comprised of a broad set of 85 economic variables, making this an important release to pay attention to.

And for all the hoopla surrounding the fourth quarter GDP data, the December CFNAI failed to ratify that sentiment. In December, this diffusion index came in at -0.15 (consensus: +0.06).

It essentially confirmed the loss of underlying momentum at the year's end. Indeed, this series has been negative in four of the past five months.

On a quarterly basis, it has been below zero in six of the past seven quarters. Note that a sub-zero reading denotes below trend growth (i.e., disinflationary), confirming the direction of the inflation data of late.



The components beneath the surface left much to be desired:

- Production and income have been contractionary for five months in a row.
- Employment has been negative for eight straight months. This flies in the face of the Bureau of Labor Statistics' (BLS) establishment survey and is much more in line with what the household survey comparable is inidicating (no growth at all in the past six months).
- Personal consumption was barely positive, was completely flat for the fourth quarter and declined — a sign of weak forward-looking indicators.

Bottom line: It is quite uncommon to see such a broadly based decline in this Chicago Fed index. This diffusion index has now been flat or down for 14 months. To me, the signal from this metric is clear — there is less than meets the eye beneath the surface of the economy and disinflationary signals remain strong.

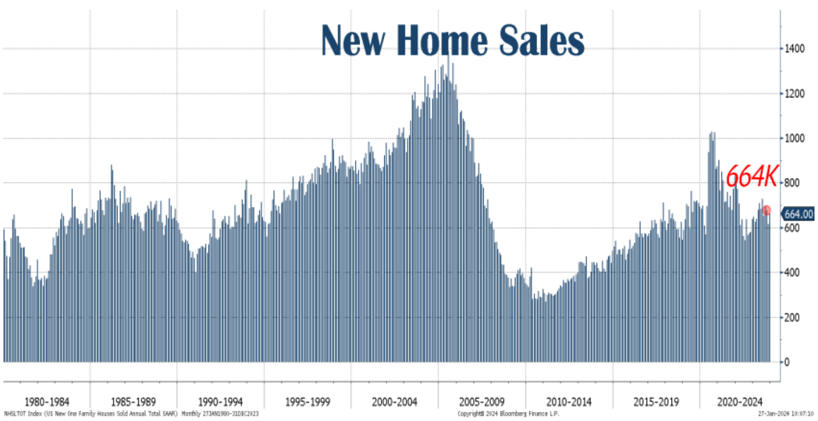
Bullish for bonds.

PRICES DROP TO TWO-YEAR LOW!

As I have discussed numerous times in this commentary, existing homes sales are at record lows, having collapsed by one-third to just 4 million in 2023. The normal level is around 6 million per year. Indeed, 2023 marked the worst year since 2007 for the existing home sales market, cratering -19% year-over-year on top of the -17 % implosion prior.

Unlike existing home sales, which remain in a deep funk because **sellers don't want to sell and buyers don't want to buy**, new home sales sales rebounded in December and rose to 50,000 houses. This is up 6.4% year-over-year and up by 2% from December 2019. Winter is the slow time of the year, so this was pretty decent.

On a regional basis, the Northeast saw sales soar +32% compared to the Midwest (+9.2%), South (+10.6%) and West (-3.4%). The seasonality effect is likely in play from the warm weather — this marks the largest December advance on record, at a time when sales are typically negative.



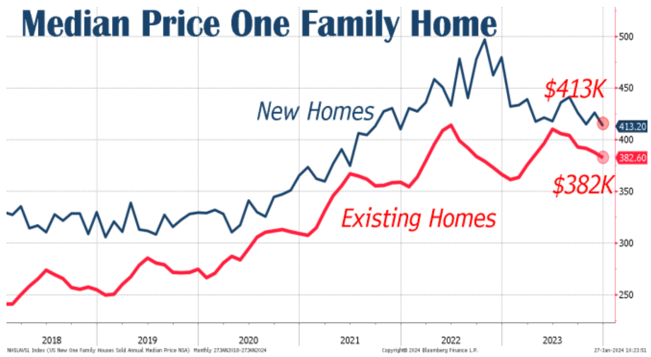
So, what's going on?

Homebuilders have adjusted to the market environment by building smaller houses with fewer and less expensive amenities that sell at lower prices (catering to lower-end consumers). To wit: The share of sales priced at $750,000 or more shrunk to 8% in December and well off the 17% peak back in December 2022. Those priced at $300,000 or less rose to 16% compared to just 10% a year earlier. For those priced at $400,000 or lower, the share jumped 6% to 47%, tied for a near-three-year high.

Homebuilders are also buying down mortgage rates to lower monthly payments. Clearly, the discounting strategy to move products is working as they are taking prospective buyers away from from the unaffordable and sclerotic market for existing home sales.

Meanwhile, the backlog of unsold inventory continues to increase. The total new homes available for sale at the end of the month rose back to its recent highs at 453,000 units, while months' supply remains elevated at 8.2 (though slightly from 8.8 months back in November). The long-run avertage is closer to six months.

As supply rose, it was to no great surprise that the median price of new single-family houses sold in December dropped to $413,200. This is down by about 17% from the peak in October 2022, and is now at the lowest since December 2021. On a year-over-year basis, the trend remains stuck in negative terrain at -14%. In essence, we have never seen this much deflation in new home prices.

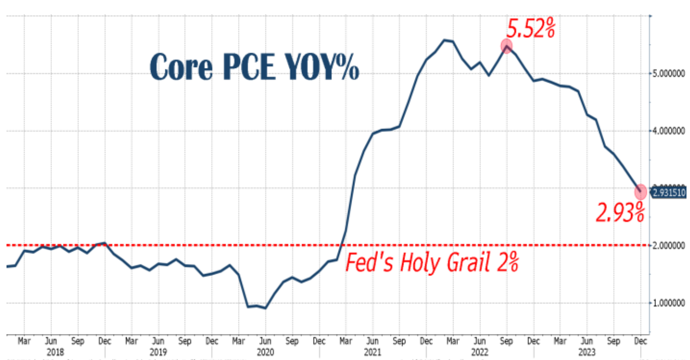


I should add that this would normally be good news for the homebuilders, however, the reality is quite the opposite. Buyers are looking to new-builds as a more affordable option, but that is only because of the incentives aimed at "buying down" elevated mortgage rates.

As D.R. Horton reported in its latest earnings release, they plan to continue discounting homes even though the marginal gains from the discounting strategy will negatively impact margins and profitability. The company is forecasting flat sales despite continued incentives.

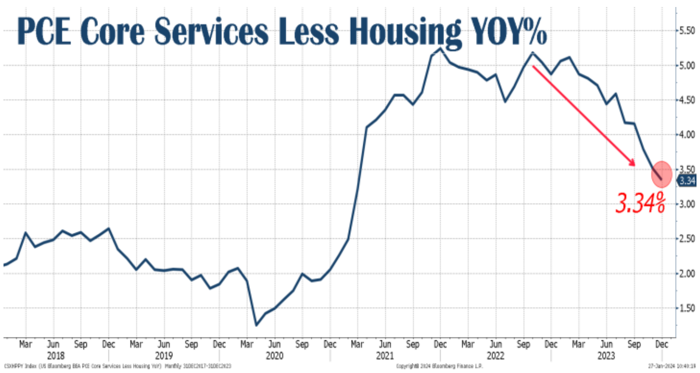
THE HOLY GRAIL

The Fed's favorite inflation indicator, core personal consumption expenditures (PCE), rose 0.1% month-over-month for the second consecutive month, devoid of any imputed guesswork. The year-over-year trend has been sliced from +4.8% a year ago to +3.0% today. The three and six-month annualized pace hit 2% in the second half of 2024 — less than half the pace of a year ago. This is essentially back to September 2020 levels when the Fed was signaling that it would cease raising rates for many years to come (oops). It was "transitory" after all (though it seems nobody wants to believe it)!



Gains in services inflation were tempered by another decline in goods inflation. Core services inflation ticked up in December but still looked well behaved. That said, insurance premiums are one of the areas that are becoming a problem. Hence, the need to continue to see improvements elsewhere.

Even more crucial, from the Fed's perspective, is **services inflation** (excluding shelter). The PCE-equivalent shows that this sub-index has broken down from its "sticky" levels to its lowest since March 2021



Meanwhile, the inflationists and bond bears talk about a return of the 1970s, even though inflation ran above 9% for one-third of that decade compared to one whole month this time around.

They don't want to believe that we have just come off one of the most dramatic declines in inflation from its peak ever recorded in the U.S. The inflation rate, as measured by the core PCE, went from 2% pre-COVID-19 to the 6% peak in the summer of 2022 and is now down to barely over 3%!

And now everyone talks about how the last part of reaching the holy grail of 2% is going to be exceedingly difficult, and that all the easy work has been done. Folks, we are about 90% of the way there. So where does the Fed weigh in on this? This is what the Atlanta Fed said in *"Is the Last Mile More Arduous?"* The answer: ***"the notion […] does not receive compelling support."***

These same people also talk about how **prices** are not falling, even though prices hardly ever go down. As stressed numerous times here, **what matters for markets is the rate of change — the price momentum.**

Bottom line: This is what anchors my dovish view on the Fed and the bullish view on the Treasury market. The longer it waits, the more it will end up having to do. Obviously, there is never any guarantee that I will be right. Forecasting, as discussed above, is an arduous task at the best of times.

CLAIMS RISE

"As long as the labor market remains okay, consumers have money to spend. It's as simple as that."
— Brett Ryan, Senior U.S. Economist, Deutsche Bank

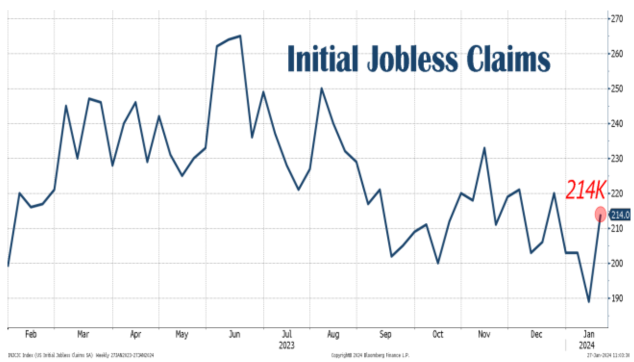
As long as people have jobs, income and security they will continue to spend (some recklessly), and the economy will continue to grow, albeit at a slower pace!

However, there may be widening cracks in the labor markets. Clearly, the tech industry is feeling the pinch. In addition to job cuts out of Microsoft, Salesforce announced it is laying off 700 employees (following up on the massive 8,000 cuts it did last year). This joins the likes of Google and Amazon in terms of major tech companies having to trim staff. Per the tracking website layoffs.fyi, the industry is now up to nearly 25,000 in cuts so far this year.

Now, the anecodtal data is showing up in the government data. As January draws to a close, initial claims delivered a +14,000 upside surprise to forecasts, rising from 189,000 to 214,000. Continuing claims jumped +27,000 to 1,833,000.

As an aside, Bloomberg did a nifty analysis showing that the ultra-low level of initial jobless claims has nothing to do with a tight labor market and owes to a variety of non-economic forces that have driven eligibility and qualification rates sharply lower this cycle. After adjusting for these effects, claims are actually at levels that presaged the 1980, 1990-1991 and 2001 recessions! Something to think about. So, despite the narrative that the labor markets are strong, there are plenty of data anomalies. Yet, markets trade billions based on this questionable data.

Also, consider that in the final six months of 2023, the household survey showed no employment growth at all. It was actually worse than that because 1.6 million full time jobs were shed and replaced by 1.6 million part-timers. This development was underscored in the coveted payroll survey, revealing that we closed the year with the average workweek depleted to 34.3 hours. **Companies have been hoarding labor but are furloughing full time jobs (for part-time) and cutting staff hours.** At 34.3 hours (where it was in April 2020), we have reached a point where businesses are now going to have to make some tough decisions. The moment the payroll survey begins to mimic the information embedded in the household survey, watch out!



Bottom line: The return of the claims data to levels more consistent with the pre-December trend suggests there were significant seasonality issues with a range of economic data in December, including GDP.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

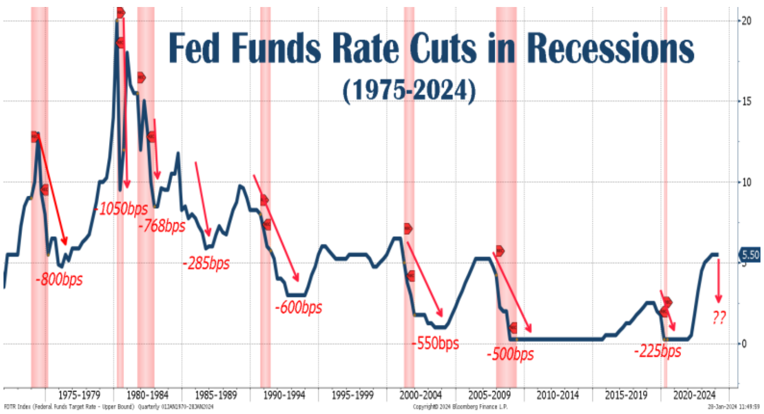
"The stage is set for the Fed to take steps toward cutting rates in coming months. We expect the Fed to begin lowering the federal funds rate target range in March as it attempts to stick a soft landing."
— Stuart Paul, U.S. Economist, Bloomberg Economics

What seemed like a certainty for a March rate cut in the swaps curve a few weeks ago has been pared to just below 50% odds. Now, the first cut is priced in for May, which would be a classic ten-month lag from the last rate hike in July.

But the big picture has not changed, just the timing. There are still five cuts being discounted for all of 2024, as investors continue to challenge the Fed's median dot-plot of just three policy moves.

Only active traders should care whether it's March or May. Credit unions, however, should position their investment portfolio and overall balance sheet for the potential magnitude of forthcoming rate cuts as we move forward.

If there is no recession, getting to the long term neutral rate (2.5%) will equate to roughly 300 basis points of cuts. If we do by chance end up in a recession, the historical average of rate cuts would be more like 500 basis points as shown below.



Bottom line: Avoid timing. Play the long game and continue to buy the dips in the bond markets while maintaining a risk-appropriate and diversified ladder.

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.