Weekly Relative Value

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A Blow Out Number

Of all the macro data I review, employment is the most important by far. Very simplistically, if people are working, they are spending, boosting the economy and hopefully contributing to their 401(k) retirements.

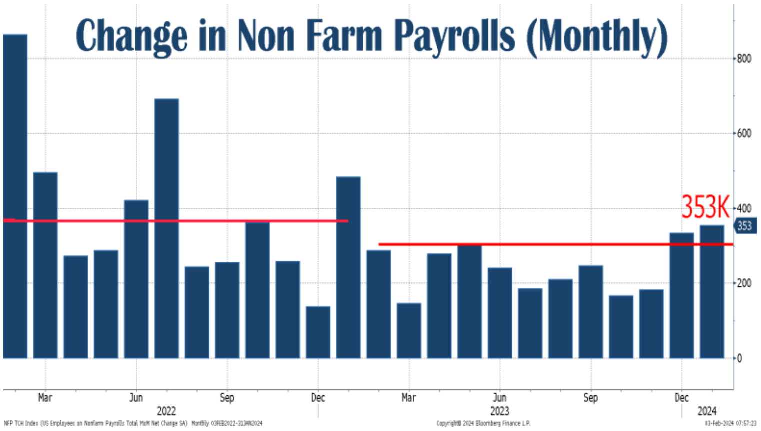
With that said, let's review last week's bevy of employment data.

Before we dive into the weeds, let's start with a few definitions:

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

The household survey is, well… a survey of households, and they for sure know whether they were working or not.

Last Friday, the January **non-farm payroll survey** shocked every economist in the world. According to the Bureau of Labor Statisitics (BLS), U.S. employers added 353,000 jobs last month, which was double the expected 185,000 and much higher than even the highest forecast of 300,000! In addition, the BLS revised jobs higher by a substantial 126,000 for the prior two months.



As shown in the graph above, it looks as if jobs have accelerated. While this all sounds great, what was notable once again was a huge dispersion between the establishment and household surveys.

THIS WEEK

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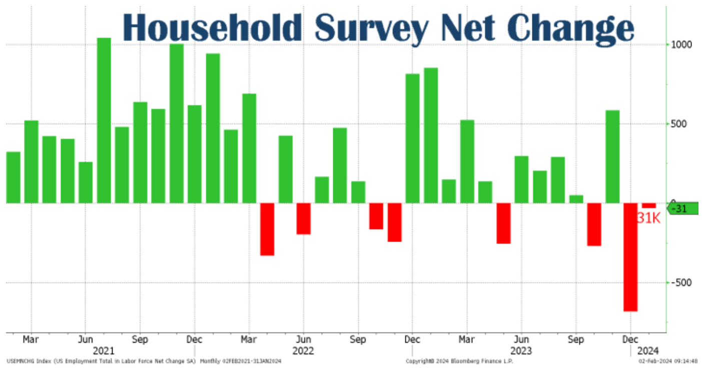
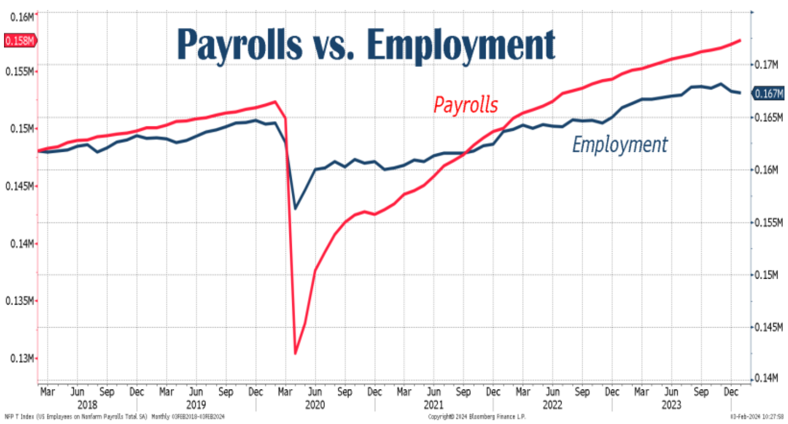
The companion **household Survey** showed a complete disconnect as employment dropped -31,000, following a -683,000 fall-off in December.



In fact, according to the household survey, there has been no employment growth at all over the August-January period, whereas the payroll survey has shown a huge +1.48 million expansion — a disconnect of epic proportions.

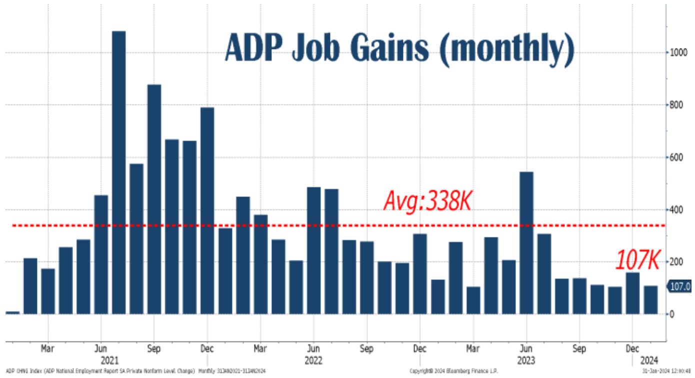
Also, according to the household survey, full-time jobs dropped -63,000 in January after a -1.53 million slump in December. In the six months to January, the economy has lost -1.059 million full time positions while replacing them (not totally, mind you) with +709,000 part-time jobs.



The key takeaway from the reports last Friday is the discrepancy between employment and jobs. Notably, discrepancies like these do not last for years. Indeed, every year, the BLS makes major adjustments to the data and then does not revise history. The charade puts a constant spectacle on monthly job reports.

It also needs to be pointed out that the non-farm payroll data is among the least accurate of any government data as it is constantly revised.

In addition, there has been no confirmation from the separate ADP payroll report released two days prior to the payroll report. The ADP Employment Report was at +107,000 last month. This survey does not have a birth-death model adjustment, however, it does have a 100% response rate (and the prior month was revised down to +158,000 from +164,000). This is the second lowest monthly increase in jobs since January 2021.



Importantly, the BLS collection rate for January's payroll survey was extremely low at 56%. This was one of the lowest response rates on record and 10% below the pre-COVID-19 norm. This means that 44% of the survey respondents did not even report their data in Friday's number. As such, the credibility and reliability of the payroll numbers are something to consider.

There has also been no confirmation from jobless claims at the end of January, which had drifted up to an 11-week high (224,000), while the backlog of continuing claims (2.187 million) is now at the highest level since October 2, 2021.

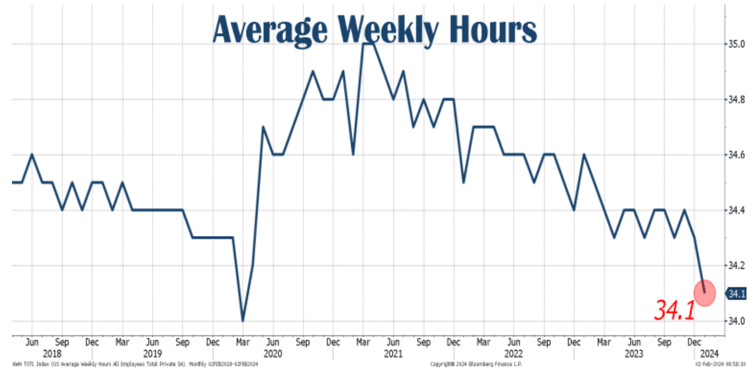
Bottom line: The payroll report was a mystery. Despite the blowout headline, there was a host of non-confirmations in the details. It has been that way for over a year. Look for more revisions to come. As such, we should be looking at the headline with a giant grain of salt.

WAGES UP, HOURS DOWN

*"**You definitely want to take the 0.6% rise in AHE with a large grain of salt…** citing the drop in reported hours worked… I think we may be instore for some revisions to the AHE data when the February report is released."*
— Omair Sharif, President, Inflation Insights, LLC

In last week's non-farm payroll survey, there was a sudden jump in wages. The BLS reported that average hourly earnings increased 0.6% from December (and double the 0.3% estimated increase), rising 4.5% year-over-year and blowing away estimates of a 4.1% increase.

However, there was one giant fly in the ointment. Even though wages increase sharply, people still worked less (average hourly earnings are computed by dividing the total worker payroll by total worker hours). In January, the average workweek for all employees on private non-farm payrolls decreased by 0.2 hour to 34.1 hours. A decline of two tenths of an hour does not sound like much, but with employment over 160 million, it is more significant than it appears.

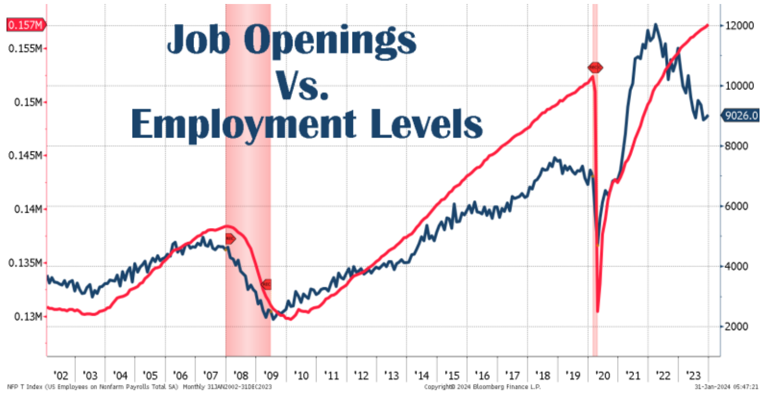


Bottom Line: Over the past year, the average workweek has seen a drop of 0.5 hours and is now at the lowest level since the depths of the COVID-19 crisis. And prior to that**,** it was in November 2008 when the economy was almost a full year into the Great Recession.

ACTIONS SPEAK LOUDER THAN WORDS

*"A mystery permeates the job market: You apply for a job and hear nothing, but the ad stays online for months. If you inquire, the company tells you it isn't really hiring. **Not all job ads are attached to actual jobs,** it turns out."*
— "Job Listings Abound, but Many Are Fake" , The Wall Street Journal

In addition, many pundits rely on job openings as a sign of labor market strength. Indeed, the Fed Chairman Jerome Powell views job openings as one of his favored labor metrics. In December, job openings rose a surprising +101,000 in December to 9.02 million. But before anyone gets too excited, keep in mind that they are down a whopping -2.2 million or nearly -20% from year ago levels.



But there's reason to be skeptical — even the 9 million number is not a portrayal of the real picture.

This is why. Not all job postings reflect an immediate intent to hire. Some companies post these listings to fulfill internal policies to promote diversity or to give the impression of a competitive hiring process when they may already have a candidate in mind. Others use these postings to gauge market conditions, assess talent availability and establish salary benchmarks without plans for actual hiring. Finally, job listings can often become outdated while remaining active on various platforms, creating an illusion of availability. In essence, these practices can lead to a skewed perception of the labor market with "ghost jobs" inflating the number of seemingly available positions.

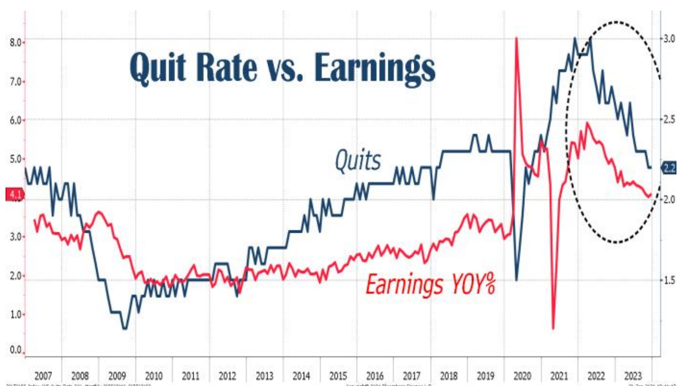
In other words, many job openings may not be real.

QUITS & HIRES TELL THE REAL STORY

Unlike openings (soft data), which may not be real, quits and hires are actual events (hard data).

In December, the Job Openings and Labor Turnover Survey (JOLTS) data showed that the number of "pink slips" issued has risen +141,000 (nearly +10%) compared to the end of 2022. At 3.6%, the hiring rate is actually below the 4.0% pre-pandemic level.

But what really stood out in the JOLTS report was the fact that the number of voluntary quitters plunged -132,000 in December and has sagged in each of the past four months by a combined -271,000. At 3.39 million, voluntary quits are at the lowest level since January 2021 (down almost -700,000 or -17% from a year ago). At 2.2%, the quit rate is also below the 2.3% pre-pandemic level.



Virtually, every industry is seeing the number of people leaving their job for greener pastures decline. More importantly, quits in the four big drivers of job growth, leisure and hospitality, accommodation and food service, education and health services and retail trade, are all back to pre-pandemic levels. This is a data-point near and dear to the Fed's heart since it leads wage growth (see the graph above).

Bottom line: The hire and quit rates are back to pre-pandemic levels, however, during the pre-pandemic period, the Fed funds rate was closer to 1.5%, not 5.5%. In other words, there is a ton of room for rates to go down to match the Fed's own estimate of "neutral."

MORE GREAT INFLATION NEWS

I continue to hear about "wages, wages, wages" and how inflationary they are, yet the data is pointing the other way.

The Employment Cost Index (ECI) has always been a preferable measure for the Fed since the ECI includes benefits, not just wages. As of the fourth quarter of 2023, the ECI came in at +0.9% sequentially (not annualized) and a nice trimming from +1.1% in the third quarter of last year. You have to go back to 2021, a full year before the aggressive rates cycle, to see the last time total employment costs were running this light.

Meanwhile, unit labor costs (costs per unit of output), which also includes both wages and benefits, barely eked out any increase in the fourth quarter. This followed a -1.1% annualized fall-off in the third quarter.

The year-over-year trend in unit labor costs has been sliced 50% to +2.3% from +4.4% a year ago. By the way, that +2.3% year-over-year percentage number is essentially back to where it was in the first quarter of 2021 when the Fed wasn't even thinking about raising rates.

Nothing inflationary here! The reduction in unit labor costs allows companies to reduce their price increases while still maintaining their profit margins.

Bottom line: There is a very strong positive correlation between unit labor costs and the core personal consumption expenditures (PCE) inflation rate. As unit labor costs cool off, as is now happening, the disinflation in the core PCE should continue.

WHAT IF?

As the debate on inflation, deflation and disinflation rages, along with the Fed rate cuts in the balance, inquiring minds wonder: What if inflation is really 1.4%?

Yes, 1.4%!

To wit: Truflation uses 10 million data points and updates price indices daily. The goal is to provide more comprehensive and timely information compared to traditional government indexes, which rely on stale, massaged and heavily revised data that is only updated monthly.

Using the Truflation methodology, U.S. consumer inflation is +1.4%, not the +3.4% reported in the Consumer Price Index (CPI) data.

Bottom line: What if traders and money managers are trading billions of dollars on bad data?

RISE OF THE ZOMBIES

The Fed's tight monetary policy over the last 18 months has been limited in how much "damage" it has done. The reasons being:

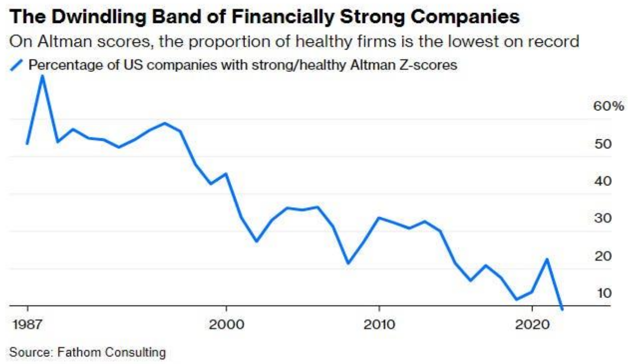
1. Many corporate borrowers had their borrowing set at fixed (low) rates already.
2. Nearly all residential mortgage borrowers had very low rates that were fixed for quite some time.
3. A re-opened economy continued surging with decent business activity, and a consumer that was soaking it all in — employed, well-paid, and even able to tell their boss when they planned to show up for work (if at all). Good times!

This is not to say there was not an impact. Regional banks were caught offsides with their bond holdings. New construction and commercial developments were severely limited. Even though a high proportion of corporate borrowing was fixed, plenty of bank debt was variable and pushed up borrowing costs for millions of small business borrowers. Also, residential sales dried up as buyers and sellers went on strike, basically freezing the housing market.

So, the Fed basically did what it wanted to do. It slowed certain parts of the economy, but it did not put it into a recession. Was this brilliant? No, not really. It takes luck.

Moving on. While many larger companies have prepared for higher rates, many small and marginal companies have not done so. And many of these small companies are not in great financial shape and rely on low-cost debt to keep their lights on.

As one can see in the graph below, according to Bloomberg, when applying the Altman Z score — a formula that is used to predict the probability of a firm going bankrupt — the percentage of "financially strong companies" has plunged from nearly 60% to below 10%, the lowest on record.

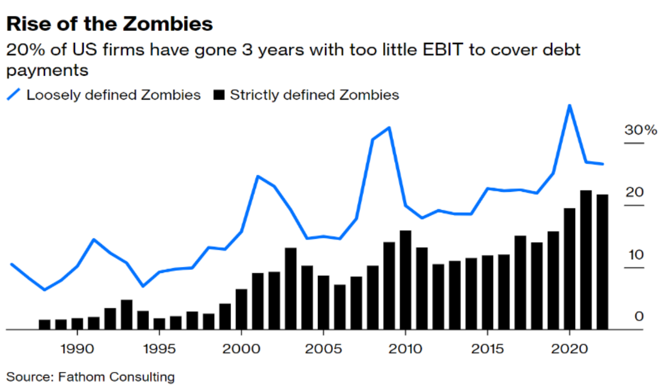


"Zombie companies are inefficient businesses that may be able to meet interest payments on its outstanding debt, but it's not able to pay down the principal debt amount."

So, while the world focusses on the "Magnificient Seven" and American "exceptionalism," lurking in the shadows lies "zombie companies."

As you can glean from the graph below, nearly 25% of companies fit that lovely description. And as I noted above, these companies rely on cheap financing in order to survive.

Reviewing the graph below, the number of unprofitable small caps is near an all-time high at the **peak** of the economic cycle. What do you suppose will happen if the economy slows down or ever is allowed to have a recession?



Bottom line: The "secret" of the resilience of the U.S. economy has largely been due to marginal companies being able refinance at lower rates. Currently, even though credit spreads are tight, the absolute cost of refinancing existing debt is approximately 300-500 basis points higher than when much of that debt was issued. As such, the Fed's draconian rise in rates since March 2022 is an existential risk to many of these less than credit worthy companies.

Bottom line: Without help from the Fed in lowering rates, many small companies are in jeopardy of falling into bankruptcy. This could upend the current mantra of "interest rates don't matter!"

HOW'S THE CONSUMER DOING?

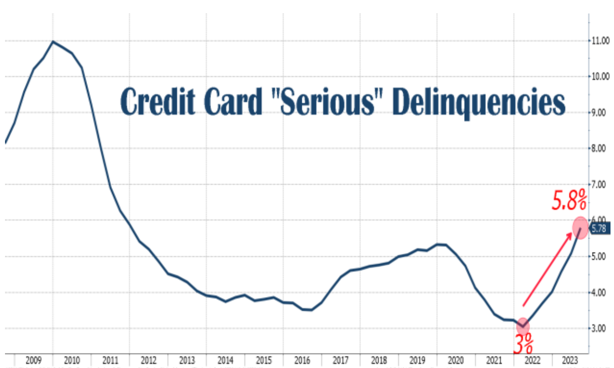
As the "Magnificent Seven" stocks have powered the equity markets higher, let's take a look at how most Americans are doing in the bifurcated U.S. economy.

Savings rates are historically low, credit card debt is at an all-time high, credit card APRs are near all-time highs and delinquencies are rising.

Americans' credit card debt has surpassed $1.3 trillion for the second straight quarter. Putting more purchases on plastic and taking longer to pay off the bills doesn't exactly say much good about the true consumer picture, but that appears to be a minority view.

Meanwhile, even at the poster child for banking sector success, JPMorgan Chase, unpaid credit card balances have jumped +14% over the past year and are also up +9% at Bank of America.

Meanwhile, for the eighth consecutive quarter, delinquencies have now risen to 5.8%, the highest since 2012. These figures are still notably lower than the peak delinquency rates of nearly 11% experienced during the Great Recession.



Bottom line: "Serious" credit card delinquencies have risen to the highest level in over 10 years. This should not be happening in a fully employed economy. That said, the true test will come when the labor markets weaken and jobs decline.

NOT IF, BUT WHEN

*"The Committee **does not expect it will be appropriate to reduce the target range until it has gained greater confidence that inflation is moving sustainably toward 2%."** — Jerome Powell, Federal Reserve Chairman*

As expected, the Federal Open Market Committee (FOMC) voted unanimously to the leave the benchmark rate unchanged in the target range of 5.25%-5.5% for fourth straight meeting while making significant changes to statement.

First, the Fed pushed back aggressively against the dovish market stance:

*"A March cut is **probably not the most likely or what we could call the base case."***
— Jerome Powell, Federal Reserve Chairman

The Fed did leave the door open for cuts at some point.

*"The Committee judges that the risks to achieving its **employment and inflation goals are moving into better balance."** — Jerome Powell, Federal Reserve Chairman*

Bottom line: The key message in the FOMC Press Statement (and in the 60 Minutes interview last night) was that any possibility of further rate hikes has been removed, so bid farewell to the de facto tightening bias. Rate cuts are clearly coming but the comment on the Fed having to be more firmly convinced that inflation is heading to the 2.0% target was a way to push back on a rate cut coming as early as March.

"Well, I think if we — if we came to the view that if — that inflation were — that the six-month inflation numbers, which are very close to two, were in PCE world — if we came to — if that's the — if we thought that is really where we're going to be, then, yes, our policy would be in a different place." — Jerome Powell, Federal Reserve Chairman

There was a time when Powell said that one or two months is not a trend. But six months? Come on. That is a pattern. So, let's just say that if the next six months look anything like the past six months, the headline and core PCE inflation rates and interest rates will indeed be in a different place.

*"The Committee Intends to move carefully, and the Fed is data dependent… **It depends on the economy**. **The Fed will react to the data."***
— Jerome Powell, Federal Reserve Chairman

The concern I have is that this Fed is a reactionary Fed, not a proactive Fed. They are more bent on responding to lagging and coincident indicators (subject to revisions) rather than leading economic indicators. Dangerous. This tells me the Fed may be too tight for too long. Not the first time by any stretch.

Bottom line: Apparently, six months of proof thus far clearly is not enough for a central bank put to shame by the 9% inflation rate posted in the summer of 2022 and all the ridicule that went along with that print.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Where should rates be? Go back to March 2022, when the Fed first started tightening. At the time, officials thought core inflation would end 2023 at 2.6% and unemployment at 3.5% — close to what actually happened. ***And they thought this would require a federal-funds rate of 2.8% — fully 2.5 percentage points lower than it is today."***

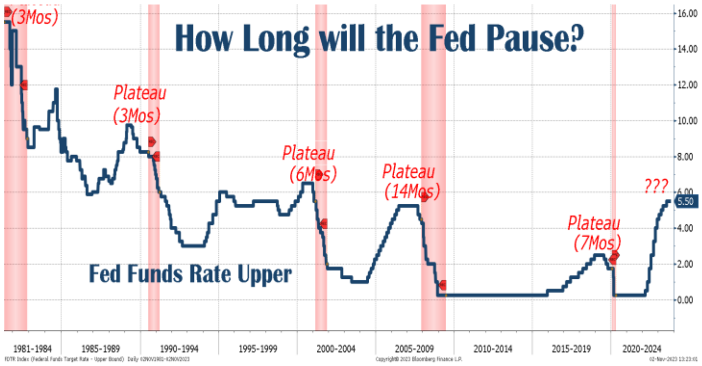
"This doesn't mean the rate should be 2.8% now, but it does mean the rate could be lower than 5.25% while remaining restrictive*. Economists use the Taylor Rule to calculate where the Fed should set rates given actual and target inflation, economic slack and the neutral interest rate, which over time keeps both inflation and unemployment stable.* ***Three versions of the rule calculated by the Atlanta Fed suggest the Fed's target rate should be 3.47% to 4.37%."***

— "Fed Shouldn't Take Too Long to Conclude Inflation Is Beaten", WSJ

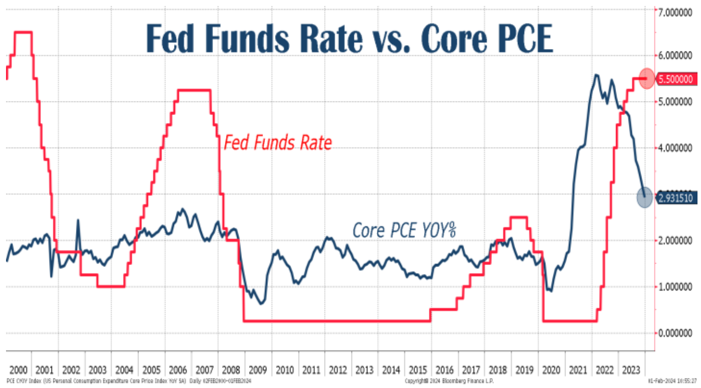
The U.S. economy continues to defy fears that the economy is heading into a recession. The lastest fourth quarter gross domestic product (GDP) report showed the economy growing at 3%. And Friday's jobs data suggests that a recession is not imminent. That said, Powell left little doubt that the Fed will start loosening this year as the post-pandemic inflation surge subsides. This has left bond traders convinced rates will come down at some point, even as questions mount about how far the Fed will go.

The swaps market continue to price in lower rates over the next 12 months.

The only question is the timing and magnitude, and as far as the latter is concerned, history shows that the typical lag from the last hike (July 2023) to the first cut is ten months. So, given that the last rike hike was July 2023, both May and June are in play if the past is prescient**.**



As to the magnitude of rate cuts there is now a 200-basis point spread between Fed funds rate and core PCE. Of course, should inflation continue to fall, the real funds rate rises.



Also remember that there is a near-300 basis point gap between the spot funds rate and the Fed's own estimate of "neutral."

If the Fed does in fact normalize rates, there is a lot of downside in current yields. As shown below, the 10-year Treasury yield could revert back to its 20-year average of 2.89%. Likewise, mortgage rates will drop 200 basis points from current levels.

Benchmark	10-year Average	20-year Average	Today
Fed Funds	1.15%	1.45%	5.55%
10 Year Treasury	2.27%	2.89%	3.86%
30-Year Mortgage	4.31%	4.75%	6.96%

Source: Bloomberg

Bottom line: All paths eventually lead to lower rates**.** As such, I remain bullish on rates. As has always been the case, it is fruitless to try to time the markets. Credit unions should continue to average into the bond market while maintaining 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.