Weekly Relative Value

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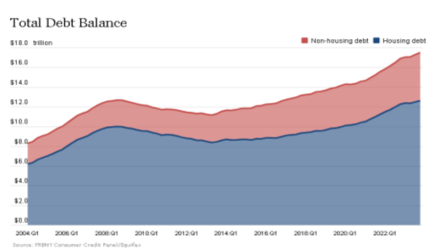
WEEK OF FEBRUARY 12, 2024

Addicted to Debt

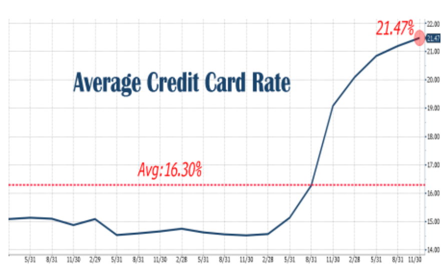
U.S. households continue to increase their leverage. According to the New York Federal Reserve, the fourth quarter saw household debt surge by $212 billion, hitting a peak of $17.2 trillion! It's amazing that people are willing to do this in the face of the most pernicious rate-cycle since the early 1980s.

The debt increase was driven by the following:

- Credit card debt was up +4.6% on the quarter and +14.5% year-over-year**,** pushing it to $1.13 trillion. A year ago, we were flagging the $1 trillion barrier falling.
- Auto loans surged by $2 billion, reaching $1.61 trillion.
- Mortgage lending was up just +2.8% to $12.25 trillion. This will be negative by the first quarter of 2024 as the chilling effect of high rates on the housing supply (and demand) continues.
- Student loans have climbed to $1.6 trillion.



Within a span of 36 months, household debt has climbed 23%! The big culprit is revolving credit as credit card debt has exploded at a +20% annual rate in each of the past three quarters. In 2023, consumers ran over $6 trillion through their credit cards. Most of it was paid off by the due date with no interest due (collect those miles and points). However, that is happening less as unpaid balances are running at nearly a +15% year-over-year rate, carrying a record high credit card interest rate of nearly 22%.



THIS WEEK

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- WHEELS DEFLATE
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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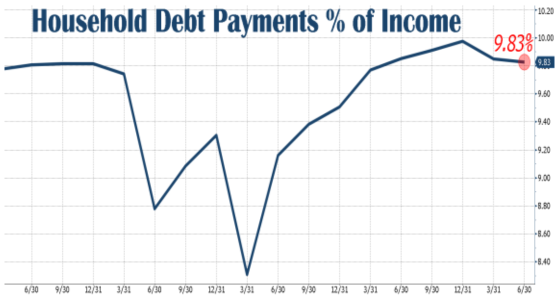
On a per capita basis, the household sector was burdened with a record $4,000 per capita credit card obligation in the fourth quarter. This doesn't even include the "Buy Now, Pay Later" (BNPL) craze. BNPL loans rose by $25 billion in the fourth quarter and by $47 billion, or 9.3%, year-over-year. BNPL loans are short-term loans subsidized by the merchant. They are interest-free for the customer, and the entire loan has to be paid off in four or five payments. However, if you miss a payment the interest rate jumps to 22.5%!

Why would households be taking on so much high-cost debt if they are so flush with "excess savings" and facing such a "healthy" labor market, as many a pundit asserts? While the majority of economists see nothing here, I personally cannot see how this "kick the can down the road" scenario ends very well.

These figures are worrisome, but there is a silver lining. Despite an additional $4.5 trillion in household debt since the pandemic onset, households **in aggregate**, so far, are managing their debts effectively relative to disposable income. Debt service commitments have ticked up to 9.83% of disposable income, which is slightly below pre-pandemic averages.

This is most likely due to a combination of term debt (e.g., fixed-rate 30-year mortgages, rising incomes, rising employment and, perversely, rising interest rates as many households are now earning high returns on their cash). However, the longer interest rates remain at these levels, the greater share of debt will rollover into higher coupon instruments and push these numbers much higher very quickly.



At the same, it's common knowledge that during the free giveaways, most of the tsunami of cash distributed to the bottom 90% has been spent. And the personal savings rate in the U.S. has collapsed from over 5% to 3.7%, which is less than half the pre-pandemic level and far below the historical norm of around 9%. In essence, Americans have thrown caution to the wind as they've spent every last dime, and more. So, instead of **delayed gratification** (savings before spending), apparently, many Americans have this backwards. Indeed, the "YOLO" mentality has infiltrated the mindset of Americans.

The most important part of this report, and one of the indicators I'm glued to at the moment, is delinquencies. As noted above, **in aggregate** everything looks fine now. And when you turn on the TV, or read the paper, you have people that speak in these platitudes, "oh the economy's great" or "we're in a recession." But it's a lot more nuanced than that.

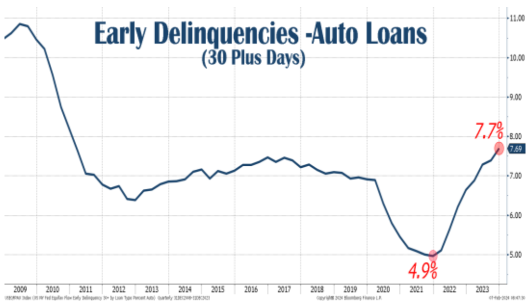
While the vast majority of Americans are paying their bills on time, averages can be very distorting and may not reflect what is happening at the margin – and that's where the change occurs.

If you drill down below the surface, you will find more signs of a bifurcated economy where the top 10-20% of the consumers are doing just fine. These people are traveling, they're going out for dinner, they're going to concerts and sporting events. And a lot of money is being spent on the upper end.

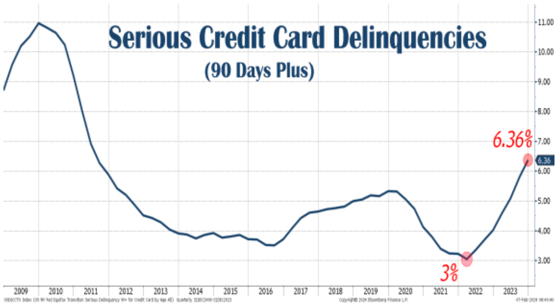
On the other end of the spectrum, many consumers in the bottom 50% of the income spectrum, and especially those in the lower income group, are already in a recession and struggling to maintain their lifestyles. Not just that, but consumers are clearly prioritizing their spending on needs, not wants (e.g., on food, beauty, health care-related stuff, etc.). The lower income consumers are also being a lot more discriminating in terms of how they spend, and they're focused on value. When McDonald's, which is selling $1 cheeseburgers, is telling you that a quarter of their consumer base is being choiceful, you have to pay attention.

This stress is becoming evident in a rapid rise of credit delinquencies. According to the New York Fed, total delinquencies and delinquency transitions (toward more "seriously" delinquent status) rose for all segments barring student loans (where government support is still providing relief at the margin despite all-out write-offs being taken off the table by the Supreme Court).

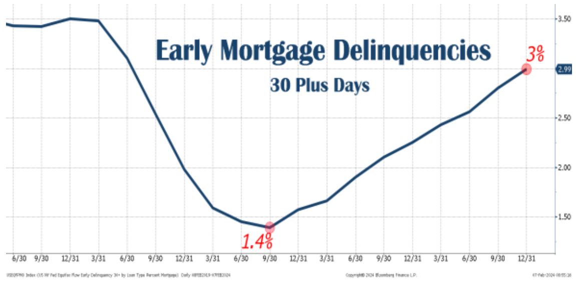
Notably, auto delinquencies (30+ days) popped to 7.7% from 7.4% in the third quarter and 6.6% a year ago. This means that auto delinquencies are now at their highest rate since coming off the highs from the Great Financial Crisis back in 2011. Clearly, those record high auto payments, and the resumption of student loan payments, are now causing some problems, especially within the younger 18–39 year age cohort and sub-prime sector. According to Fitch Ratings, the percent of subprime auto borrowers at least 60 days past due on their loans rose to 6.11% in September, the highest level since 1994.



Credit card delinquencies are even worse. The early-stage (30-day) delinquency rates for credit cards have risen from 5.87% a year ago, to 8.01% in the third quarter and to 8.52% in the fourth quarter. One in every twelve holders of credit cards is missing their payments! Serious credit card delinquencies (90+ days) are at 6.36% and are now more than 2% higher than on the eve of the pandemic. Within the last two years, the credit card delinquency rate has exactly doubled. The last time credit card delinquencies were this high was in the second quarter of 2011, when the unemployment rate was 9.0%, not 3.7%!



Even in the housing sector, where a large share of mortgage holders are locked into ultra-low rates, consumers are getting behind on their payments. To wit: 30-day mortgage delinquencies are up to 3.0% in the fourth quarter (from 2.8% in third quarter and 2.3% a year back) and are now heading to the pre-pandemic level of 3.5%. While not a multi-year high, it is the highest level since the pandemic/lockdown recession in the second quarter of 2020, when the jobless rate was around 13%.



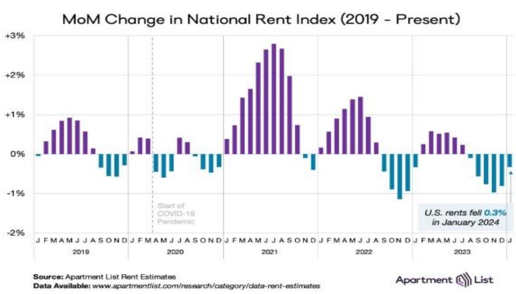
Bottom Line: Americans have followed in the footsteps of Uncle Sam and have become excessively leveraged and addicted to debt. And even more disconcerting, the erosion in consumer credit quality is happening today at a time when the unemployment rate is a near record low of 3.7%. What happens if, pray tell, the Fed gets what it wants, which is a higher unemployment rate in 2024?

WHY I REMAIN IN THE DISINFLATION CAMP

*January 31, 2023: "You mentioned housing inflation. So, the question is when **will these lower market rents find their way into measured rents as measured in Personal Consumption Expenditure Index (PCE) inflation** and we think that's coming and we know it's coming. **It's just a question of when and how big it'll be. So, but that's in everyone's forecast**, I would say."*
— Federal Reserve Chairman Jermone Powell

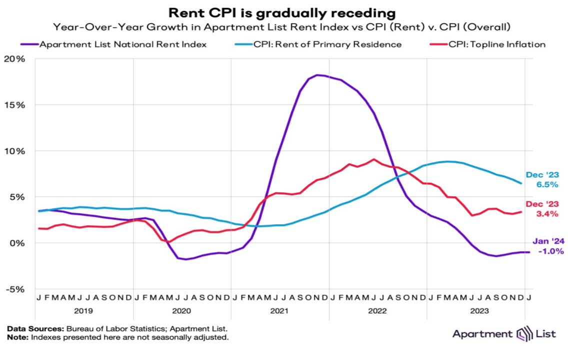
The Federal Reserve's primary inflation metric is the Bureau of Labor Statistics' (BLS) Consumer Price Index (CPI) and Personal Consumption Expenditure Index (PCE). Both are heavily impacted by changes in housing prices and rents. However, due to the BLS methodology, the shelter components of both indices are "lagging" and do not reflect what's happening in real time.

The Apartment List National Rent Index provides a much timelier perspective on changes in new leases, which are only later reflected in price changes across all leases (what the CPI measures). As such, this real time rent data has proven to be a strong leading indicator of the CPI and the PCE housing and rent components.

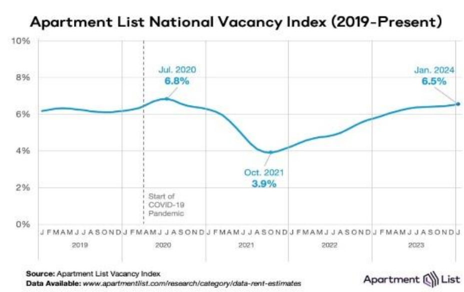


In January, the Apartment List data showed a -0.3% month-over-month decline to $1,373 per month, the sixth consecutive falloff. The year-over-year trend is now at -1.0%, clearly a long way from the peak of nearly 18% since 2021. This is the second sharpest dip we have seen in the history of the index (going back to 2017). Moreover, this disinflation is widespread with rents falling in January in 73 of the nation's 100 largest cities. Prices are also **deflating** in 53 of these 100 cities.

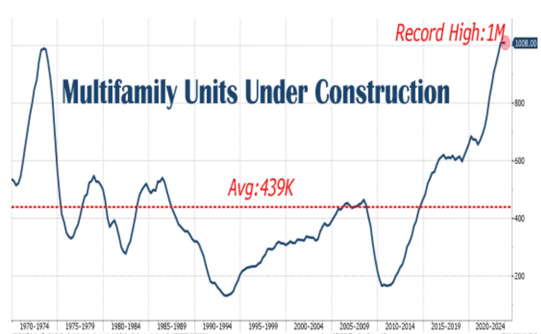
Meanwhile, as shown below, because of the lagging nature of the shelter component, the CPI shows a 6.5%+ pace whereas the Apartment List data shows a 1% decline.



It's easy to understand why this is happening. The rental market had been rocked over the past three years due to the imbalance between vacant apartments and the number of renters looking to move into them. As you can see in the graph below, early in the pandemic, and amid large job losses and economic uncertainty, many Americans moved back home. Vacancies rose to 6.8%! Then, in 2021 and 2022, when Americans finally decided to move out of Mom and Dad's basement, rent growth exploded higher due to a dearth of inventory and strong demand. That said, after bottoming out in October 2021, the vacancy rate has now moved considerably higher and is approaching a near four-year high of 6.5%, which is light years above the low of 3.9%.



Looking forward, there's good reason to expect that vacancies could rise further. This is primarily due to the unprecedented and massive building supply of multi-family rental units. To wit: Multi-family completions are running close to a 25-year high of around 450,000 annualized units, and the number of houses under construction is flirting near record levels of around one million or double the natural demand for rental accommodation. Amazing! Going forward, there will continue to be an abundance of vacant units on the market in the year ahead.

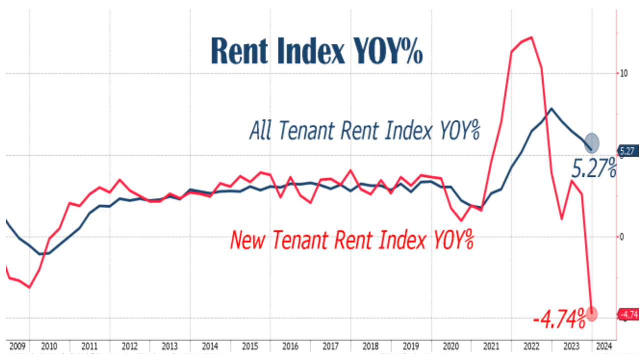


Moreover, according to housing guru Ivy Zelman, the multi-family residential market is in as big of a deflationary mess as the office space is. The excess supply is unprecedented and is going to unleash the mother of all rental deflation backdrops. The lags are finally starting to kick into the dominant components of the CPI, but so far, this is just the thin edge of the wedge.

And the data proves this out. The BLS recently released its New Tenant Rent Index, and it showed market rents nationwide dropping -4.6% on a year-over-year basis in the fourth quarter (-7.2% from the third quarter level!). This was the steepest decline on record (back to 2005)!

To be sure, the lags from actual rents in real-time to the CPI data, which includes the rental agreements that prior renters took on when rents were surging in 2021 and 2022, will take time to infiltrate. Not to mention the fact that the share of the rental population who locked in those prior sky-high rents is far larger than the pool of new renters who currently are coming into the apartment market and benefitting from the deflation in “spot” rents.

As such the “all tenant” index is obviously lagging (5.27%) behind what is happening to new rental rates, but over time, the two lines will end up converging. And at some point, this is going to show up in the BLS numbers within the CPI and the PCE data. In other words, delay does not mean that ultimately headline inflation moves towards 0%. The Fed may disagree, but I am more focused on the destination rather than how long it is going to take to get there.



Bottom line: Shelter costs represent 33% of the CPI, 42% of the core CPI and 20% of the core PCE. The expectation that real time rents will continue to filter into the BLS CPI and PCE data has been and remains a cornerstone of my fundamental disinflation view.

THE YEAR OF THE DRAGON

*“China **will be exporting deflation to the rest of the world**, and you will find various countries dealing with the fact that China has built up overcapacity.” — Chetan Sehgal, Lead Portfolio Manager, Templeton Emerging Markets Investment Trust*

*“China **keeps exporting disinflation to the world**.” — Citigroup Analysts*

*“The most obvious **headline threat is to developed markets**, as China’s moving up the value-added curve into high-end manufacturing.” — Charles Robertson, Head of Macro Strategy, FIM Partners*

Excerpted from China to Export Deflation to the World as Economy Stumbles

Another reason I remain in the disinflation camp is because of what's going on in China. Despite the so-called theme of "deglobalization," which isn't really happening**,** the U.S. still imports well over $400 billion of product from China annually.

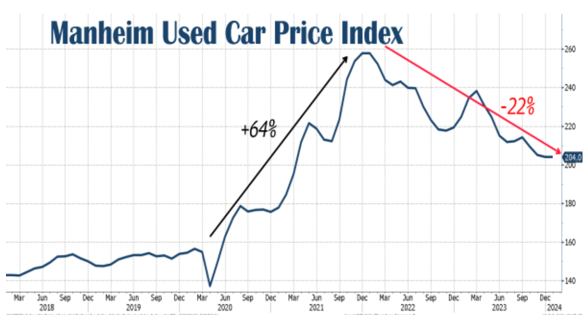
Meanwhile, China's export prices have declined an epic -8.4% year-over-year rate and is flirting near the unprecedented lows reached when the global economy was attempting to crawl out of the Great Financial Recession.

Bottom line: While service inflation has been the problem of late, remember that 40% of the U.S.CPI is goods. Also, please remember that China's deflating export prices are somebody else's declining import price.

WHEELS DEFLATE

Manheim is the largest auto auction house in the U.S. These auctions are where dealers go to replenish their inventories. Supply comes from rental fleets (usually between 2.5-3.5 million vehicles per year), from finance companies that sell their lease returns and repos, from corporate and government fleets, etc.

Used vehicle prices at auctions dipped another 0.2% in January 2024 from December 2023 to $18,074. This is the lowest since March 2021, and prices are down $4,828, or 22% from the peak in May 2022. The plunge has now worked off over half (55%) of the historic and ridiculous 63% spike from February 2020 through March 2022.



Likewise, retail prices have dropped 11% from their respective peaks and have given up about one-third of the historic crazy 55% spike from February 2020 to peak in January 2022.

At the same time, used car inventories are ample and rising on dealer lots.

I should add that new auto sales are showing signs of slowing down. The January sales number was about 15 million vehicles (annualized) and that was well below expectations. Wards, which comes out with that number, did state that there's obviously an affordability problem in autos, just as there is in the housing sector.

Bottom line: Good riddance to the poster child of the pandmeic inflation. Wholesale prices on used cars have now given up 55% of their pandemic spike while retail prices have given up 36% thus far. Like homes, autos have become unaffordabe to many Americans and it now looks like enough consumers are still on buyers' strike, and that's what it takes to put a lid on these crazy prices.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"It would be a mistake to move rates down too soon or too quickly without sufficient evidence that inflation was on a sustainable and timely path back to 2%." — Loretta Mester, President, Federal Reserve Bank of Cleveland

Let me start off by humbly saying that I have not been this confused about the economic and market situation in my 40-plus years doing this. There are just so many conflicting stories, data points and economic cycles that are colliding, which is really creating this confusion.

Indeed, despite the pernicious Fed rate hikes, the U.S. has thus far managed to avoid a recession and remains the island of prosperity. However, no one has blown the doors off the fiscal barn like Uncle Sam has. In the past 12 months, the federal deficit increased by $1.3 trillion. Yet, we only received half that in the gross domestic product (GDP) — about $600 billion. It's even worse for the fourth quarter. There we received just $300 billion in extra GDP for — wait for it — $834 billion of new federal debt. And the worst part is that our grandkids bought it all. And then some.

Here's the bottom line, absent government spending, real GDP growth in the U.S. was actually closer to +1% last year compared to the posted +3%. So much for capitalism! The government's influence continues to expand and is providing this false glow to the underlying economic activity.

Meanwhile, the divergences in the employment data are puzzling, to say the least. The January job gain of +353,000 defies reality because the ADP was +107,000, which has a 100% response rate, whereas the establishment survey response rate was close to a historical low in January at 56%.

At the same time, the household survey showed employment down -31,000, and that followed a -758,000 plunge in December.

Even if you believe the establishment survey, it doesn't tell you what the full-time or part-time split is. The household survey provides much more detail on that front. According to this survey, since the middle of 2023, there have been zero new jobs, and even worse, companies have furloughed full-time staff to part-time. Since last June, full-time jobs are down -1.7 million while part-time employment is up +1.6 million.

Meanwhile, the workweek took a -0.6% nosedive. So, if you side with the establishment survey, businesses are hiring en masse, and then cutting hours worked for everyone at the same time to keep their labor costs contained.

And then take a look at the ISM Services Index, where just three of the 18 industries surveyed said they increased their payrolls in January. This is down from seven in December and from ten in November. This clearly does not square with the payroll number.

Also, have a look at the latest *Beige Book* about the job market conditions in 2024.

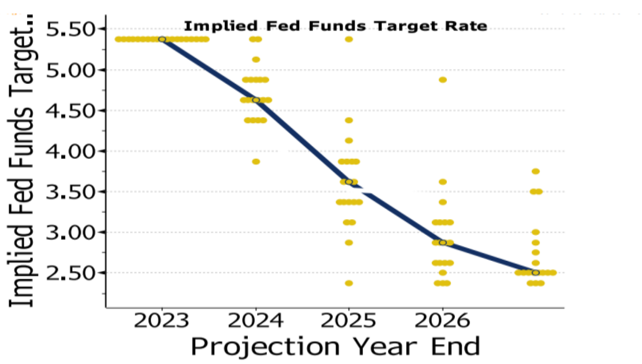
> *"Seven Districts described little or no net change in overall employment levels, while the pace of job growth was described as modest to moderate in four Districts."*

Then the government tells you, no, never mind, it's over 300,000!

I have zero clue how "little or no net change" and "modest to moderate" translates into a blowout +353,000 payroll surge in January. Maybe the statisticians and data massagers at the BLS could provide some answers. I'm all ears.

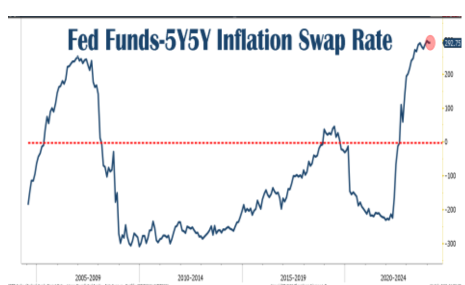
Bottom Line: The markets will always bow down to the holy grail of non-farm payrolls because that is the number that is nearest and dearest to the Fed's heart. Still, while the cuts may have been delayed, Powell said, in his recent *60 Minute* interview, that virtually all of the committee members see the next move as a rate cut**.**

He doesn't see a recession, but that isn't going to stand in the Fed's way to ease policy this year. He emphasized that inflation does not have to get to the 2.0% target ahead of the rate cuts, or even that the pace of disinflation over the past six months has to be sustained. In essence, Powell said that the price data has to be "good" as opposed to having to be as "good" as what we've seen.

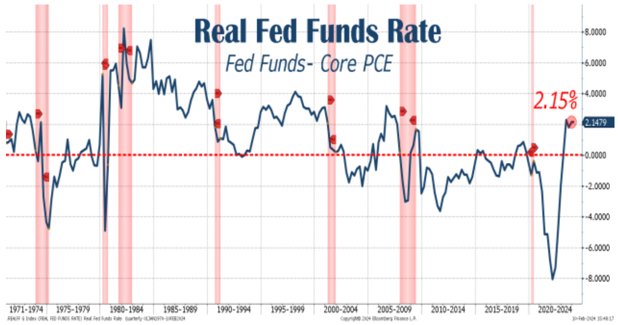


In a nutshell, after being embarrassed by the "transitory inflation" spike during the pandemic, the Fed is waiting for greater confidence that inflation is moving towards their 2.0% goal. The issue for the markets, of course, is the timing. Powell hinted that the first rate cut is somewhere around mid-year, which targets the first cut on either the June 12 or July 31 meeting.

Meanwhile, flat nominal rates combined with falling inflation rates means that the inflation-adjusted "real" interest rates have risen sharply. By one measure, the real Fed funds rate is now at a 20+-year high.



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



While interest rates are not historically high, the scenario becomes interesting when interest rates remained at zero for 15 years and then went vertical in 18 months, creating an interest rate shock. It doesn't impact everybody all at once. And that's important point to understand.

The longer rates stay higher than they were in the 15 years pre-2022, there is still this pernicious impact of higher interest rates. There is a lot of debt that needs to come due this year, next year and the year after, which is going to be refinanced. And every single day, somebody's loan is coming due that was priced pre-2022. Obviously, the commercial real estate market is extraordinarily exposed to this rise in interest rates. Again, not because interest rates are high, but because it follows 15 years of zero.

I should stress that it's not just office buildings that have exposure; industrial and multi-family properties are also at risk. And a lot of these loans that were done pre-2022 were interest rate-only loans. There has been no principal money that's been paid down. So, if you have a 3% loan that's maturing and it's being reset at 8-9%, you're out of business unless you come up with more equity. What small business is not getting financed because the numbers don't work out?

This will not be a crisis, it's death by 1000 cuts. This is a multi-year process that I believe is going to chip away at economic activity and divert more cash flow to interest expenses rather than other things. This, in turn, should dampen economic activity.

Bottom line: If you subscribe to the views above, the odds greatly favor lower rates over time. But please don't try to time the markets as it is fruitless. As such, credit unions should continue to invest excess cash into 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.