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INVESTMENT SERVICES

Weekly Relative Value

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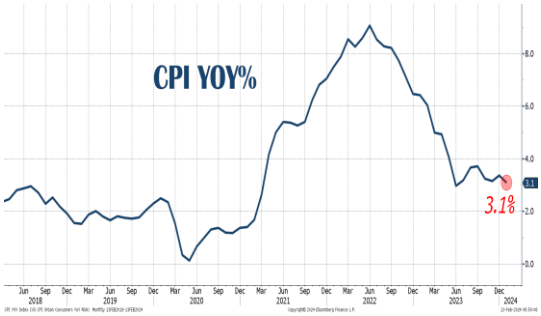
WEEK OF FEBRUARY 20, 2024

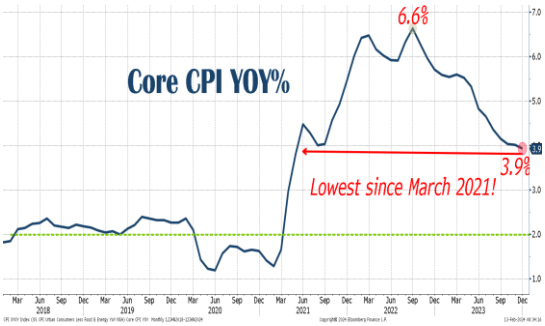
Don't Flip Out!

"Let's not get amped up on one month of CPI that was higher than it was expected to be."
— Austan Goolsbee, Chicago Federal Reserve President

The Consumer Price Index (CPI) data for January came in hotter than expected. The headline (all items) was +0.3% compared to the consensus estimate of +0.2%. The year-over-year inflation rate was widely anticipated to drop to +2.9% from +3.4%, but instead it only eased to +3.1%. While not as good as expected, inflation has plunged fom over 8% since June 2022!



The key "core" index (all items excluding food and energy) was a disturbing +0.4% month-over-month — the highest reading since last May. The core rate, which is dominated by the lagging shelter metric, remained stuck at an uncomfortable +3.9% instead of receding to +3.7% as the consensus had penned in. Fed Chairman Jerome Powell recently stated that it is the core that matters the most and what the Fed has to see is just "good" and not necessarily "better" numbers to start the process of cutting rates. The last three core readings were 4%, 3.9% and 3.9%. In other words, progress has stalled — as in "not good."



THIS WEEK

Shelter costs continue to be the "big elephant" and are still complicating the Fed's inflation fight. The Owners' Equivalent Rent (OER) is the single largest component of the CPI with a weight of 27%.

In January, the OER rose an unprecedented .56%. This was the biggest increase since last April, and accelerating from the pair of +0.4% prints in each of the prior two months. What was weird was that the primary rent (8% of the index) rose only 0.36%, the smallest increase since August 2021.

Please read: People do **NOT** pay OER. Roughly 64% own their own home, with 36% renting. Those who own their homes do not pay rent, they pay a mortgage. It truly is a nonsense statistic. It boils down to a question posed to homeowners as to what they think they can rent their unit out for.

"If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?"

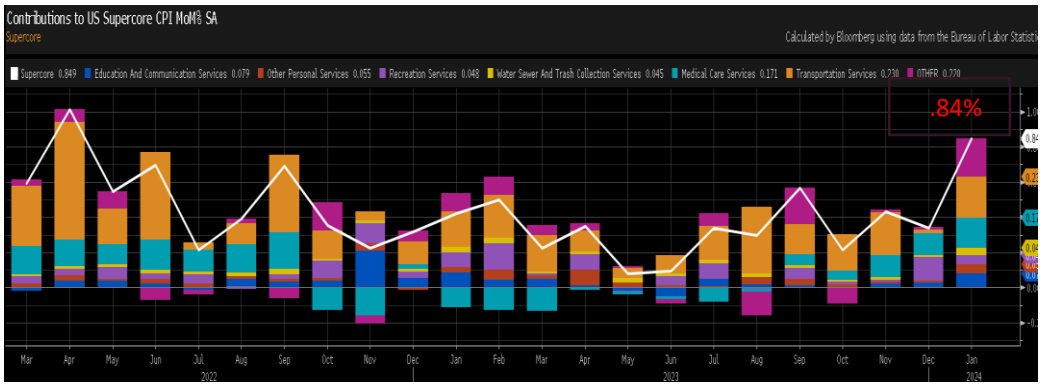
Imagine that the highest weighting in the CPI comes down to this one question.

Simply put, the OER is imputed (aka guesswork). It's little wonder that the former Fed Chairman Alan Greenspan referred to the CPI as a "flawed statistic." Thus, the significant month-over-month rise in shelter costs, which heavily influences the overall CPI due to its substantial weighting, casts doubt on the real-world accuracy of these figures. The concern is that this error could become cause of a Fed policy mistake.

Moving on, outside of the unexplainable shelter costs, there were increases in a wide swath of the services last month.

- Medical care insurance premiums rose +0.7% month-over-month in one of the steepest increases in the past 30 years.
- Motor vehicle insurance premium rates spiked an additional +1.4% month-over-month, extending the huge increases posted since early 2022 (+20.6% on a year-over-year basis).
- Airline fares also rose +1.4% (biggest gain in five months) and came atop a +0.9% December boost.
- Delivery services rebounded +0.5% on the month.
- Recreation services came in at +0.4%, which followed an outsized +1.1% bump-up in December.
- Hotels/motels pushed through a huge +2.4% price increase.

And adding insult to injury, the so-called "supercore" CPI (exluding energy and rental rate) rose an outsized 0.8% month-over-month. The year-over-year trend is back up to an eight-month high of +4.4% from +3.9% in December. This is one of the Fed's key metrics since it signals what's happening in cyclical services (a prime focus for the Fed).



Before we jump to any conclusions about "sticky" inflation and abandon the disinflation theme, there were silver linings in this nutty CPI report:

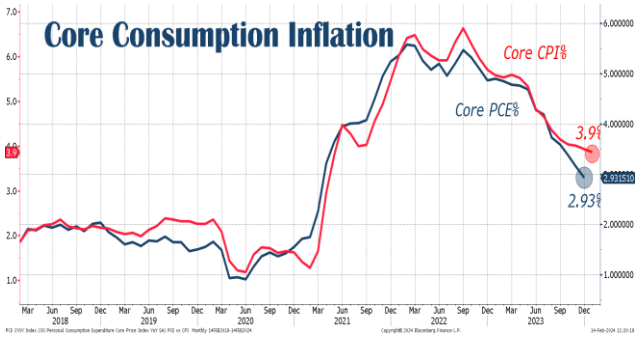
- The CPI (excluding shelter) only rose +0.1% for the second month in a row. The year-over-year trend slowed to +1.5% from +1.9% in December and +5.7% a year ago.
- The core CPI (excluding shelter) was +0.2% month-over-month for the fourth month in a row. The year-over-year trend stayed at +2.2% — about half the +4% pace a year back.
- New vehicles were flat while used car prices dropped on a monthly basis by the most since 1969. On a year-over-year basis, cars/trucks fell -3.4% — the biggest drop since March 2022.
- Energy also continued to fall.
- Core goods (the things you can actually see, touch and feel) in the CPI fell -0.3% month-over-month and have been down three months in a row. The year-over-year pace has turned negative (-0.3%) for the first time since July 2020.

"The Fed will view this as another reason to wait until May or June, but the direction of trend is still lower… With much of the increase due to housing, it's a waiting game to see when those costs will come down."
— Kathy Jones, Chief Fixed-Income Strategist, Charles Schwab

If you strip out shelter, the CPI rang in with a mild +0.1% gain and the year-over-year trend was sliced to +1.5% from +1.9% in December. A year ago, this was +5.7%! Likewise, the core index (excluding shelter) was +0.2% and the year-over-year trend stayed at +2.2%, or about half the +4% pace last year. In other words, stripping out the suspect OER data, the other 73% of the CPI was up less than +0.2% month-over-month. Ergo, from my perch the CPI report, after all the slicing and dicing, was less scary than it looked.

THE PCE IS KEY

While the January CPI was an unwanted surprise, many still maintain that inflation is broadly on a downward trend, and that the January inflation surprise likely won't translate to the Fed's preferred measure, the personal consumption expenditures price index (PCE). This is because there are some key differences between the CPI and the PCE. To wit: Shelter has a lower 20% weight in the PCE compared to the .40% in the CPI. Also of note, medical care services, which were an important source of strength in the CPI, are calculated in the PCE using different inputs altogether.

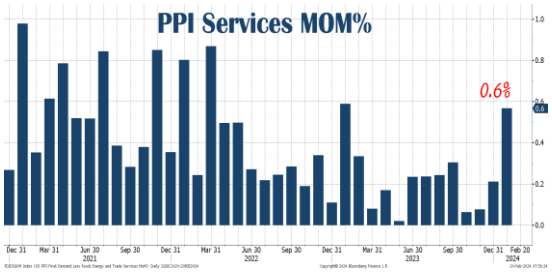


As one can glean from the graph above, those differences have kept inflation, as reported by the core CPI, well above that in the core PCE index. At the end of 2023, the core CPI inflation rate was +3.9% year-over-year, but the core PCE inflation rate was +2.9%. Over the past six months, the trend in the core PCE deflator was +1.9% (annualized) compared to +3.6% for the core CPI. Rarely, and I mean rarely, has the divergence between two inflation indices been this wide.

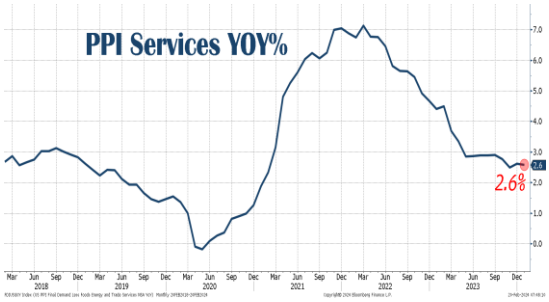
UGLY PPI

Normally, the Producer Price Index (PPI) report does not move markets, but the market is on tenterhooks over inflation. After an outsized increase in the CPI for January, the PPI registered a +0.3% month-over-month increase (consensus was +0.1%). Making matters worse, the core PPI jumped +0.5% (consensus was +0.1% as well).

What was truly disturbing was the +0.6% month-over-month jump in services. This was the sharpest increase in six months. Also, goods deflated -0.2% and have been flat or down in each of the past four months.



Despite the ugly monthly data, the broad year-over-year trends are still in a downtrend. The headline PPI is now +0.9% compared to +5.7% a year ago. The core PPI is now +2.6% from +4.4% a year ago, and the services are down to 2.6% year-over-year from +4.5% a year ago. The year-over-year trend in services is still disinflationary and is continuing to deflate in the goods sector. That said, the Fed is certainly not going to like this number one bit.

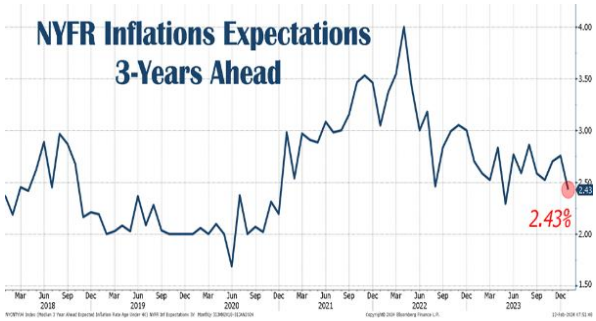


Bottom line: Disinflation is not a straight-line path as the CPI and PPI report obviously prove. We will know in the coming months if these inflation readings were early-year noise or whether there has indeed been a stalling out, or even reversal, in the impressive progress that has been made on the disinflation front. Simply put, we need further confirmation from potential data revisions (seasonal distortions) and the Fed's preferred inflation measure, the core PCE (due on February 28) before drawing any conclusions.

INFLATION EXPECTATIONS DROP TO RECORD LOWS

Meanwhile, it appears that households looked right through the CPI report. To wit: The January New York Fed Survey of Consumer Expectations showed the the one-year median inflation view dipped to +3% in January, which is light years away from +4.95% a year ago, and it is now at the lowest level since December 2020. And get this, the three-year median view has dropped to a record low of +2.35% in January. The median five-year expectation remained at +2.54%.

The Cleveland Fed also publishes estimates on inflation expectations. What is interesting is that in a month that saw a "hot" CPI print, the five-year inflation view declined to +2.16% in February — the lowest level in seven months. The 10-year expectation has dropped to +2.14% in February, a six-month low.



Bottom line: These are excellent numbers, yet, they are likely to be ignored by this cautious and "tight" Federal Reserve.

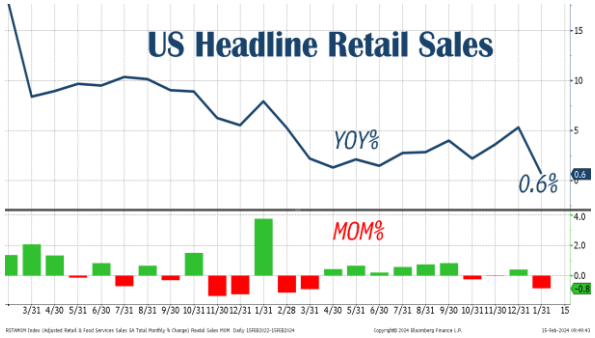
GETTING SMALLER

While Wall Street is seemingly solely focused on A.I. and the "Magnificent 7," it is the small business sector that remains the lifeblood of the U.S. economy. In fact, according to the Small Business Administration (SBA), small businesses create two-thirds of net new jobs and account for 44% of U.S. economic output.

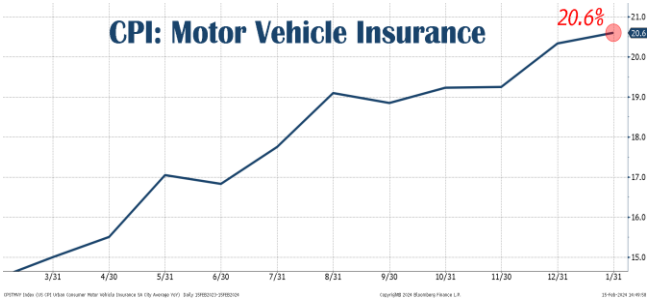
So, while stocks have hit a new high, driven primarily by five stocks, the NFIB small-business sentiment index took a big hit in January, dropping two points to an eight-month low of 89.9, which undercut the consensus estimate of 92.3. Historically, the long-run average is 98. So, the consensus view is that all is hunky-dory with the economy, but this index, which started in 1974, suggests otherwise.

IS THE CONSUMER TAPPED OUT?

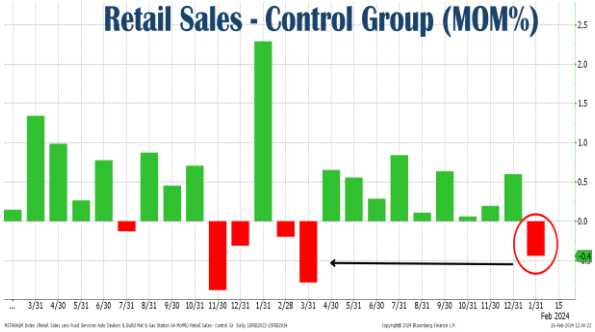
After unexpectedly surging in November and December on the back of credit cards and Buy Now, Pay Later (BNPL), headline retail sales in January experienced a large 0.8% month-over-month drop. This dragged the year-over-year retail sales down to just 0.6 — the worst year-over-year rise since May 2020. I should add that the hot +0.6% initial December reading on the retail sales headline was revised lower to now show +0.4%. More importantly, for all the talk of a resilient consumer, retail sales have now declined in three of the past four months!



Core retail sales (excluding autos and gasoline) also declined -0.5% month-over-month compared to an expected +0.2%. This dragged the year-over-year levels down to their lowest since the COVID-19 lockdowns. The decline in January was broadly based with nine of the 13 categories posting decreases. Notably, auto sales fell -1.7% in the sharpest setback since February 2023. This is not surprising given that the total annualized cost of owning a car (including gas and insurance) has exploded to $12,182 from $10,728 (as per the CPI data). Like homes, autos have become extremely costly and, in some cases, unaffordable.



The critical "core control" measure (excluding autos, gas and building materials) that feeds directly into the consumptive data of the gross domestic product (GDP) data fell to a hard -0.4%.



More noteworthy, on a real inflation adjusted inflation basis, retail sales contracted -1.1% month-over-month — the steepest descent since last February. Year-over-year, real sales are down -2.4%.

In other words, people are not buying as much stuff as the nominal sales data suggests. What is touted as a great consumer demand economy is entirely an inflationary mirage.

Bottom line: Some blamed the inclement weather for the weak sales data, and like the CPI data, one number clearly is not a trend. But it could also be that amid higher borrowing costs, depleted savings and credit card/auto loan delinquencies, consumers are running out of gas. Should this consumer weakness continue, it could be a worrisome sign for the economy.

THE BIG TRAP

*"We find that the **financially fragile are disproportionately likely to use BNPL** at higher frequencies and appear to have embraced BNPL as a regular payment option. Among financially fragile BNPL users, **about 60% have used the product five or more times in the past year, which translates to about 18% of all survey respondents deemed financially fragile** (which includes those who have not used BNPL in the last year). **This implies that financially fragile users are almost three times as likely as financially stable users to use BNPL five or more times** and suggests that high-frequency use may grow if the product continues to be adopted by financially fragile households."*
— The New York Federal Reserve

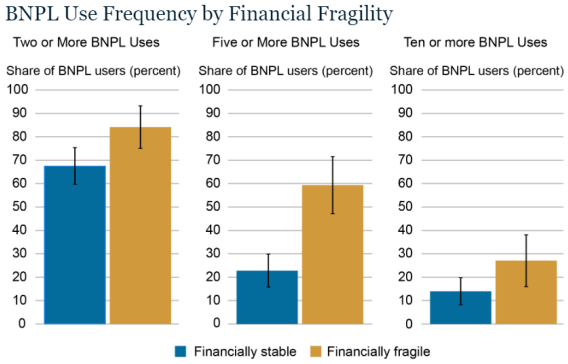
Buy Now, Pay Later (BNPL) is defined as loans that are payable in four or fewer installments and carry no finance charges. They are generally offered to online shoppers at checkout. These plans are increasingly popular and it's another sign of consumer credit stress.

If you use BNPL and pay off the bill in the allotted time, you avoid financing. If you are late on a payment (even by one day), you are charged up to 28% interest on the entire balance retroactive from the purchase date.

Finance is a cruel world, and the weakest are required to pull the wagon. Those who are more financially fragile are now the biggest users of these plans. According to the New York Fed, about 60% have used the product five or more times in the past year, which translates to about 18% of all survey respondents deemed financially fragile.

Furthermore, for the financially stable, BNPL use appears to be more centered on a few purchases and seems to be largely driven by a desire to avoid paying interest on high-priced items.

Meanwhile, the financially fragile appear to use these programs like credit cards and make medium-size, out-of-budget purchases frequently, which, believe it or not, have now entered the restaurant industry (talk about desperation). Imagine going to a fancy restaurant and paying your bill over the next four months. Just crazy stuff.



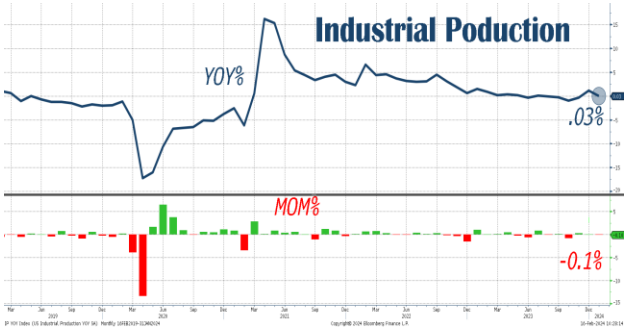
Source: SCE Credit Access Survey.

Bottom Line: It's one thing to spread a major purchase over time, once or twice (e.g., a new furnace or refrigerator), however, it's another thing to spread routine purchases over time or to use as a bridge loan to the next paycheck.

By the way, what ever happened to lay-a-way? Better yet, what happened to **Buy Now, Pay Now**?

PRODUCTION PLOPS!

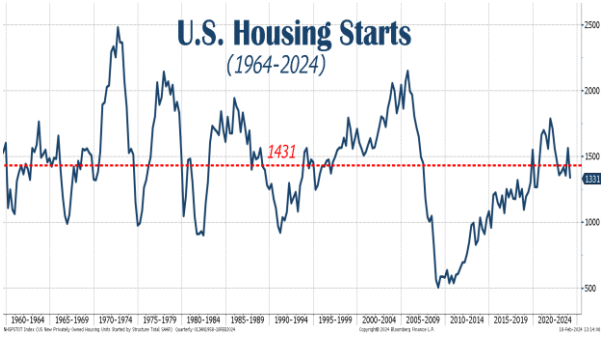
In addition to the weakness in retail sales, industrial production surprised to the downside. Output fell -0.1% month-over-month in January compared to a consensus forecast of +0.2%. Making matters worse, December industrial production was revised downward to flat. The year-over-year trend is now running at +0.0%. The key manufacturing sector fell -0.5%, which is a huge one-month decline in this index. The consensus had penned in an unchanged number.



HOUSING BACK IN BASEMENT

It's a bad start for housing in 2024. Housing starts plunged 14.8% month-over-month in January compared to the expected unchanged number. Building permits also tumbled. They are down 1.5% month-over-month compared to the expected +1.3%, and well down from the +1.8% month-over-month in December. This pushed the housing starts back near post-COVID-19 lows.

As shown below, housing starts are well below where they were in 1959. The average since 1959 is 1,431. So, starts are 9% below the long-term average. We are nearly smack in the middle of immense swings.



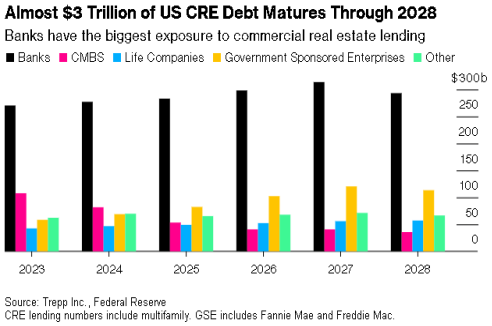
Do not blame the weather! It's January, we know there are weather issues and that should be more than "priced-in" on a seasonal adjustment basis.

Bottom Line: Mortgage rates are down from 7.9% to 7.14%. But the median price is the highest ever. Too many people are stretching to buy a house, needing a huge percentage of their annual income to do so. Until we see a combination of lower prices and lower mortgage rates, home sales are headed nowhere even if they have bottomed out.

THE ALBATROSS

The one albatross for the U.S. economy and banking system is not going away, and it may be getting worse. I'm referring to the office real estate market. The commercial real estate (CRE) office sector faces the triple whammy of falling prices,

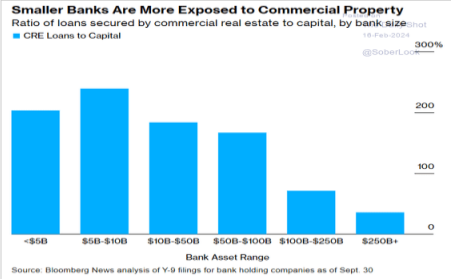
falling demand and rising interest rates. The post-pandemic rise of remote work has crushed demand for office space, and vacancy rates in commercial buildings have soared.



Around $1.2 trillion of CRE debt will mature over the next two years. According to Trepp (a real estate data provider), $2.56 trillion in CRE loans will mature over the next five years, with $1.4 trillion being held by banks. All of that debt will have to be refinanced. That's a big problem for debtors who face much higher interest rates to borrow money on buildings with much lower values.

With rates rising and credit conditions tightening, many loans may face an uphill battle as refinancing becomes more costly, especially if banks and other lenders look to reduce their CRE exposure. This could lead to a vicious cycle of lower property values and larger losses for lenders.

According to a Citigroup, regional and local banks hold 70% of all CRE loans. Additionally, banks with less than $250 billion in assets hold more than 80% of CRE loans.



Bottom line: Rising delinquencies and defaults in the sector could restrict lending, which could trigger a vicious cycle of tighter funding conditions and falling commercial property prices, with adverse spillovers to the rest of the economy.

Fed officials insist that the banking system is sound. Economists claim the issues in the CRE market don't pose a systemic risk. Everything will be alright, they claim. Remember, it is the same people who told us that the subprime problem in 2007 was "contained," inflation was "transitory" and quantitative easing was a "temporary program" that would be unwound. In other words, they have a pretty awful track record.

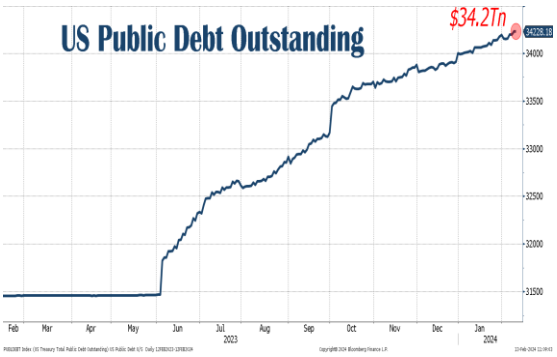
BEWARE OF FAIRY TALES

"But perhaps the biggest fantasy of all is the expectation that anything will happen to resolve unsustainable budgets without a crisis. We are much more likely to continue muddling along, pretending things are just about OK until something cracks. The trouble is that the fiscal system will break and there will be no happy ending."
— "Beware Fiscal Fairy Tales", Financial Times

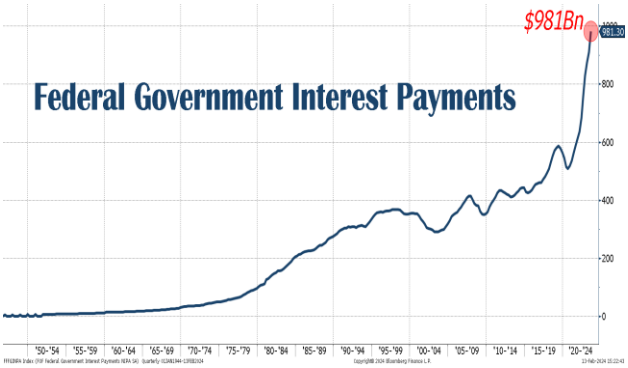
No amount of mathematical manipulation can disguise the biggest problem of all: The national debt now stands a**t $34 TRILLION**, a byproduct of both parties' rampant spending. The Donald Trump Administration took the debt from $21 trillion into the high 20s, and then the Joe Biden Adiminstration bumped the deficit to where it stands now.

In just the past four months, another **$1.1 TRILLION** was tacked onto the total. At $34 trillion, the U.S. debt now dwarfs the nation's GDP ($23.3 trillion). Some may believe this spending can just go on forever, but there are consequences, especially as the debt-to-GDP ratio surpasses 125% — the highest in U.S. history.

Over the next decade, the nation is on track to borrow more than $30 trillion if we extend various expired and expiring tax and spending provisions. In other words, in 10 years, the national debt is going to $50-$60 trillion! No one has bothered to factor in a recession as far as the eye can see.



If the debt is expected to soar from $34 trillion to $60 trillion in 10 years, the deficit numbers aren't going to drop. According to the Bi-Partisan Committee for Responsible Budget (CFRB), the fiscal deficit in 2024 will be $1.5 trillion! Interest costs alone are projected to reach over $1 trillion, which will exceed what we will spend on either defense or Medicare.



The out-of-control spending problem remains primarily due to "mandatory" spending (e.g., Social Security, Medicare and Medicaid), which is expected to grow by 49% from 2023 to 2033. This is essentially on auto pilot unless the Administration and Congress decide to change the law. Good luck to those running on this platform.

Heck, even the Fed Chairman, who normally does not comment on fiscal policy, said the following:

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*"**It is unsustainable.** I don't think that's at all controversial…**Debt is growing faster than the economy.** So, it is unsustainable… **You could say that it was urgent**… And I think we know that **we have to get back on a sustainable fiscal path.**" — Jerome Powell, Federal Reserve Chairman*

Meanwhile, the major trust fund programs are projected to become insolvent, including Social Security in 2033 and Medicare in 2031. As we have seen over the years, expecting our political leaders to fix anything, especially Social Security and or Medicare, is a bit of a pipe dream.

Here's the problem: Under the existing law, doing nothing will result in automatic cuts of 23%, based on CBO estimates. Doing nothing won't protect beneficiaries!

To wit: The two leading presidential candidates have already stated they will not touch Social Security.

"I guarantee you I will protect Social Security and Medicare without any change. Guaranteed." — President Biden

"I will do everything within my power not to touch Social Security, to leave it the way it is." — Donald Trump

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Like all politicians, presidents cannot think past the current election cycle. And sadly, Congress does not see it and will continue doing what it does best, spend money it does not have. If Trump or Biden win, why would this change or not get worse?

Bottom line: These numbers aren't debatable. These numbers are what they are. It's turned into a complete circus, and I'm not being political about it. As Rudi Dornbusch liked to say, a fiscal crisis takes longer to happen than you think it will, and then the crisis happens much faster than you thought it could. Whether it's the current generation or a future one, at some point, the bill will come due on this astronomical debt.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

It is very clear that economic growth is cooling off as we head into 2024, from retail sales, to production, to hours worked and to housing starts. But this Fed is focused on real GDP, non-farm payrolls, headline retail sales and inflation numbers. They don't seem to care much about the devil in the details.

And it's not just the good ole U.S. that's slowing down. Last week, Japan joined France and the U.K. in a technical recession (two consecutive quarters of negative GDP) with real GDP slipping -0.4% in the fourth quarter. This reading came after a -3.3% contraction in the third quarter of last year. The decline pushed Japan from the third spot into the fourth spot on the global GDP ladder (in terms of size). It also looks as if the first quarter GDP is going to be weak, making it potentially three straight quarters of economic slippage.

Despite much weaker than expected retail sales and industrial production data, the CPI, import prices and the PPI came in hotter than expected. So, even though there were woeful disappointments in retail sales, industrial production and housing starts, the bias in Treasury yields has been to the upside. The next test will come at the end of the month (PCE inflation)

Even before last week's trifecta of higher-than-expected inflation readings, the Fed had successfully jawboned the market away from a March cut and thinking that six were needed this year instead of the three rate reductions, as per the December dot plots.

Where rates go from here will hinge on whether the price data was idiosyncratic noise that often occurs at the start of the calendar year. However, if January was NOT an aberration and inflation is poised for a re-acceleration, rate cuts could be taken off the table this year. Further, if the macro-economic numbers don't deteriorate and the equity markets remain strong, a return to an outright hawkish stance cannot be ruled out. This is not a change of view, but rather an acknowledgment that the risks around the view have undergone a shift.

Bottom Line: If the disinflationary trend has reversed, the implications for much higher bond yields over the near term could be substantial but would represent an attractive entry point for anyone with a one-to-three-year horizon. However, if January was just a blip in the disinflation trend, it will be time to load the gun again on bond duration.

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.