alloya INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

WEEK OF FEBRUARY 26, 2024

Cross Currents

"I have never seen so many cross currents in the markets and economy as I see now."
— Peter Boockvar, CFO, Bleakley Financial Group

Before I get into this week's commentary, I wanted to remind long time readers and newbie readers alike why I write the *Weekly Relatve Value*.

First and foremost, my niche is in identifying economic and market tail risks that are not widely highlighted and or discussed in the mainstream media. Undoubtedly, this brings up bad news from time to time. Some people would prefer not to hear this. That said, the ultimate goal is to educate and inform credit unions (all investors) about these potential risks with the end goal being to guide them into making attractive risk reward decisions within their balance sheets and investment portfolios.

Yes, I err on the side of caution and look at the downside of risks and what can go wrong. That's how I roll.

However, if you want to just hear about the good news, there are plenty of strategists and promoters out there telling you to "throw caution to the wind" and "step on the gas" regardless of where we are in the economic and market cycle.

Finally, I truly believe there should always be an audience for those who specialize in brake lights and the left-right turn indicators (aka risk management). After all, a car is more than just a speedometer.

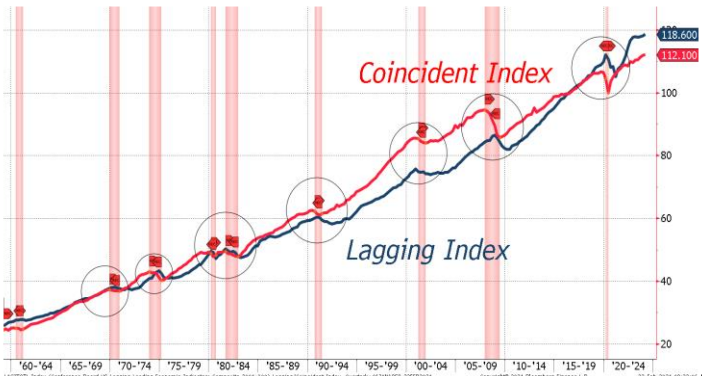
THIS WEEK

- THE A.I. GOLD MINE
- THE MAG 7
- UNAFFORDABILITY HOUSING CRISIS LINGERS
- THE TALE OF TWO CLAIMS
- CAN YOU TRUST THE DATA?
- YOLO TO DELINQUENCY
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

Now onto this week’s commentary.

*“While **no longer forecasting a recession** in 2024, we do **expect real gross domestic product (GDP) growth to slow to near zero percent over the second and third quarter.”***
— Justyna Zabinska-LaMonica, Senior Manager, Business Cycle Indicators

A big reason everyone is talking about a “robust economy” is due to the Index of Coincident and Lagging Indicators. The problem is with that is they do not tell you where the economy is going. Coincident and lagging indicators only tell you where the economy currently is (or just was). But that is yesterday’s news. As you can glean from the graph below, since 1960, not once did either the lagging or coincident index warn of an impending recession. Not once.



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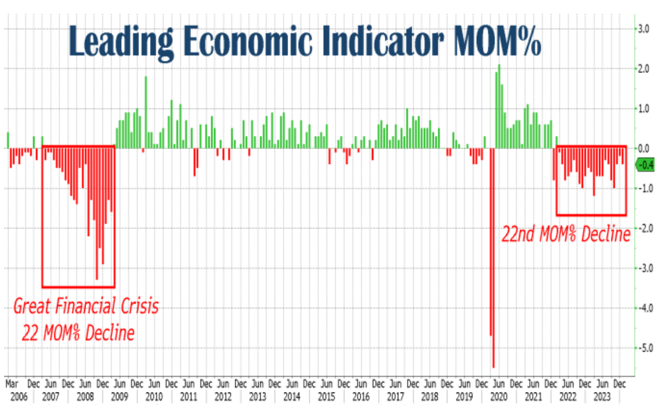
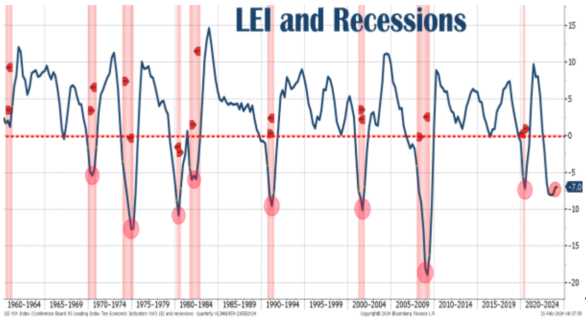
What matters more is where the economy is heading. As such, it’s better to focus on the Conference Board's Leading Economic Indicators (LEI). As shown graphically below, the LEI continued its decline in January, dropping 0.4% month-over-month (notably worse than the -0.1% month-over-month expectations). This was the twenty-second straight month-over-month decline in the LEI (and twenty-third month of the 25 months), which is the longest streak of declines since “Lehman” and the Global Financial Crisis.



On a year-over-year basis, the LEI is down 7.0% (down year-over-year for 19 straight months) and still close to its biggest year-over-year drop since 2008 (outside of the COVID-19 lockdown-enforced collapse), and just took out the worst reading since the 1981-1982 recession.

Historically, whenever the LEI has dropped to this level, a recession has ensued. In fact that has been the case for the past nine recessions. While no idex is infallible, the track record is something we should all be aware of.



Bottom line: The annual growth rate of the LEI remains deeply negative and decoupled from real GDP. Even though the Conference Board has given up on its recession, the group now sees U.S. growth slowing to nearly zero percent (stall speed). However, given the historical accuracy of the LEI in forecasting recessions (nine out of nine), it may be a tad premature to throw in the recession towel just yet. Time will tell.

THE A.I. GOLD MINE

It's not the economy or the stock market, it's Nvidia, stupid.

How do you make billions in a day? Ask Nvidia CEO Jensen Huang. After reporting much better than expected earnings and forward guidance, Nvidia soared over 16% to a new record high of $795 valuation milestone. In doing so, Mr. Huang's wealth rose by a whopping $10 Billion to $69 Billion in just ONE day! Not a bad day's work, eh?

The utter mania around generative A.I. that has suddenly gripped corporate America led to an explosion in sales of high-dollar and high-margin systems of GPUs (Graphics Processing Unit) for Nvidia. The latest one-day rally in the A.I. darling resulted in the biggest single-session increase for a U.S. company in history, with Nvidia adding $277 billion in market value as the market cap nears the $2 trillion. Putting it in perspective, the increase alone was larger than some of the biggest blue-chip firms, like Coca-Cola. It's also now bigger than the entire S&P energy sector!

And according to Huang, we are still in the early stages and the future looks remarkably bright. Huang said generative A.I. is kicking off a new wave of investment worth trillions of dollars.

*"This last year, we've seen generative A.I. really becoming a whole new application space, a whole new way of doing computing… **A whole new industry is being formed, and that's driving our growth**."*
— Jensen Huang, Co-founder and CFO, Nvidia

Precious few companies of its size have ever managed to post revenue growth of +265% year-over-year. Not only that, but the company forecasts an additional +234% year-over-year revenue stream for the coming three months. Nvidia's mind blowing results and positive guidance hammered home the point of how generative A.I. is proving to be transformative in ways most of us still can't comprehend.

It's important to note that Nvidia is essentially a monopoly and the only company on the planet earth that provides specialized GPUs, which perform mathematical calculations at high speed. These GPUs are needed to power generative A.I. platforms and the big tech companies (Google, Meta, Amazon and Microsoft) cannot seem to get enough of these new chips. Each of these GPUs is worth tens of thousands of dollars, with profit margins nearing a mind-blowing 80%.

Nvidia won't hold its monopoly position to perpetuity, but its main competitors are far behind (AMD and Intel). It has a long rope on its dominance for the time being.

Frankly, there's no precedent for this kind of growth at a tech company as large as Nvidia. For bullish investors it speaks to the power of A.I.

Bottom line: My kids refer to me as #technicaldifficulties. So, I am probably the last person in the world to talk about technology**.** That said, based on everything I've read and heard, there is little doubt A.I. is coming big time. And while I understand Nvidia's importance to the A.I. wave, I also have to ask is Nvidia really worth more than the entire S&P energy sector? These valuations are nowhere near normal.

Questions: Will no one figure out how to make something competitive and sell at a lower price? And will Meta, a gigantic customer (18%) of Nvidia's GPU systems, suddenly discover that it has all the GPUs it'll need, just like it had suddenly discovered that it had way too much office space and way too many employees? All kinds of things can change that might rattle the A.I. mania.

Finally, does anybody remember the "can't miss" dot-com darling Cisco in early 2000?

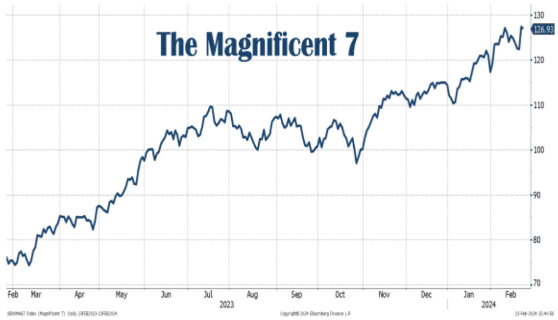
THE MAG 7

"Never short-sell bubble stocks when they are on a roll. But that doesn't mean you have to own them."
— Rob Arnott, Founder, Research Affiliates

At nearly $12 trillion in market cap, the Magnificent 7 (Apple, Amazon, Alphabet, Nvidia, Tesla, Meta and Microsoft) have driven the S&P 500 to record highs, accounting for 27% of the total market cap, and over 100% of all earnings growth last year.

Because of these seven stocks, the S&P 500 index is now knocking on 30% gains over the last 12 months. Yet overall, more stocks are now down than up. In my way of thinking a +30% year-over-year surge in the S&P 500 doesn't sound right or logical with earnings per share growth running at nearly 1/7 of the pace of the price gains.

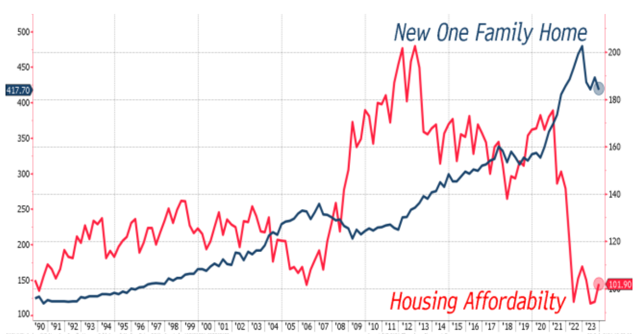
There is no question that the S&P 500 is littered with some of the greatest in the world, but the stock valuations are not so great. This has been and is clearly in a momemtum driven rally. Unquestionably the animal spirits can drive the S&P to even higer levels. However, the market is stretched with a whole lot of optimism priced in. Saying the Mag 7 and S&P 500 are expensive is an understatement. Just ask Warren Buffett as Berkshire's cash hoard swelled last quarter to a record-high $167billion. Why? Because he can't fnd attractive investment opportunities.



Bottom Line: What is happening with the Magnificent 7 may be akin to what happened with the Nifty-Fifty. This infamous group of 50 companies were considered strategic, "buy and hold forever" picks before they crashed in 1973. In fact, many of the Nifty-Fifty technology companies didn't survive (e.g., Polaroid, Digital Equipment, Boroughs Corporation). This is all part of human nature. Investors are prone to over-extrapolate and give in to the temptation to join the herd.

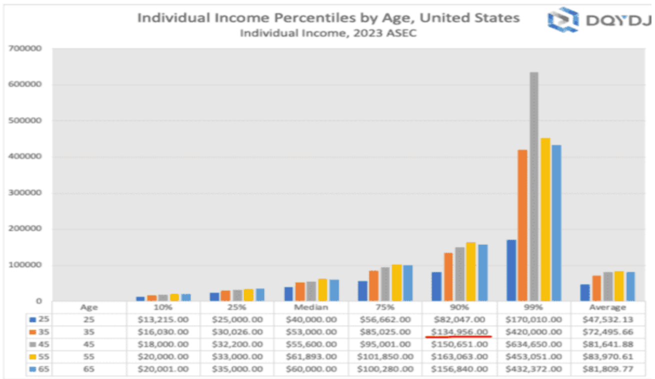
UNAFFORDABILITY HOUSING CRISIS LINGERS

Though mortgage rates are down from the highest levels in a generation, they are still more than twice as high as in 2021. And even though median prices on new homes have declined from $479,500 to $413,000, the affordability crisis remains unresolved.



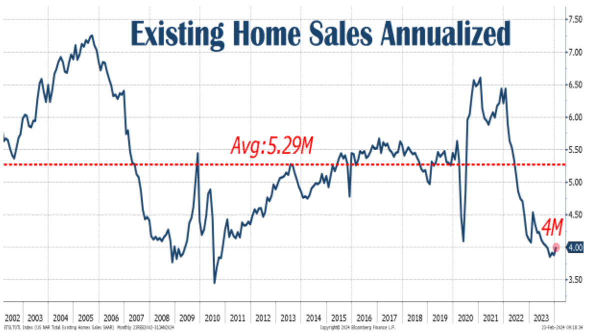
To wit: At the end of 2022 (assuming a 3% down payment and a 7% mortgage rate), a 30-year mortgage payment would have been $3,100 for a median priced home. Today at $413,000, the basic monthly mortgage payment is roughly $2,700. Factor in a 1% home property tax, 2% maintenance and 0.75% home insurance, and you're out $48,000 a year for this new home.

The required income to buy this new home is roughly $126,500 with no other debts. As shown in the chart below, for the older millennial (35 year age group) looking to buy their first house, this seems daunting as only 15% of millennial households exceed this threshold.

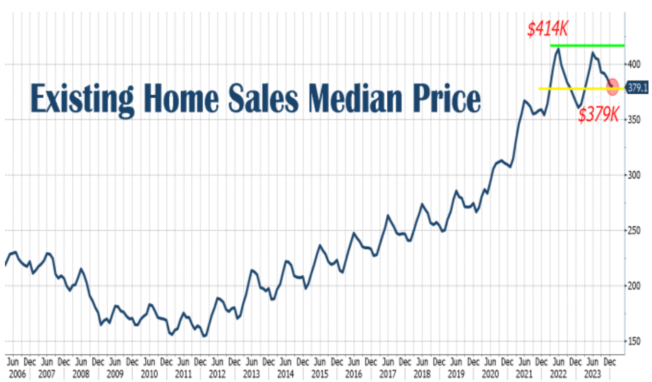


	Age	10%	25%	Median	75%	90%	99%	Average
25	25	$13,215.00	$25,000.00	$40,000.00	$56,662.00	$82,047.00	$170,010.00	$47,532.13
35	35	$16,030.00	$30,026.00	$53,000.00	$85,025.00	$134,956.00	$420,000.00	$72,495.66
45	45	$18,000.00	$32,200.00	$55,600.00	$95,001.00	$150,651.00	$634,650.00	$81,641.88
55	55	$20,000.00	$33,000.00	$61,893.00	$101,850.00	$163,063.00	$453,051.00	$83,970.61
65	65	$20,001.00	$35,000.00	$60,000.00	$100,280.00	$156,840.00	$432,372.00	$81,809.77

The latest existing home sales data for January tells the same story.

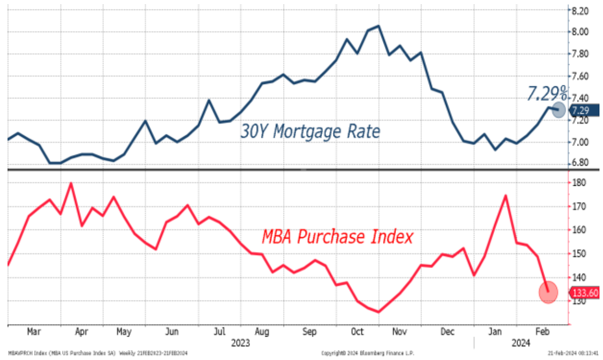


Like new homes, the median price of existing homes – single-family houses, condos and co-ops – declined to $379,100 in January and are now down by over 8% from the peak in June 2022.

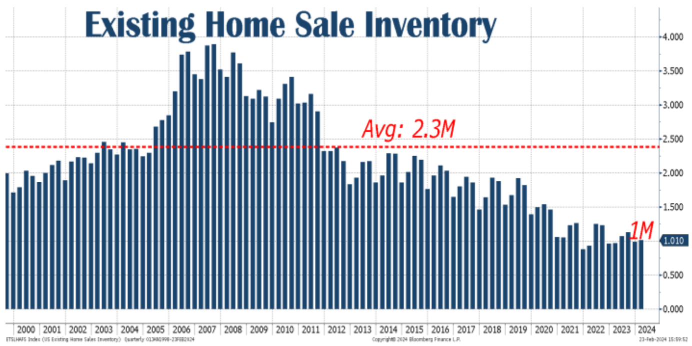


This data was based on deals that closed in January, many of which were made in December and November when mortgage rates were careening lower and falling well below 7%.

But with the Fed pouring cold water on the rate-cut mania, mortgage rates have been rising for weeks, and currently are over 7% once again. Mortgage applications have re-plunged more than 10% to the lowest level since November — the fourth decline in a row. This does not bode well for the housing market going forward.



Meanwhile, sellers are reluctant to list their home because they don't want to swap a 3% mortgage for a 7% mortgage. As shown below, inventories reman near all time lows compared to the long term average.

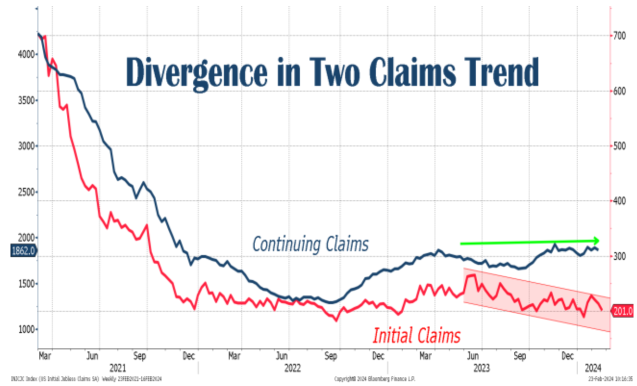


Bottom line: This market is still frozen, marked by rising mortgage rates, even though prices have come off the peak as many potential buyers and sellers are trying to outwait this situation. Howvere, with bond yields ticking up in February, and the Fed pushing back, rate cut expectations and signficant housing recovery is not imminent.

THE TALE OF TWO CLAIMS

The weekly claims data continues to throw up interesting puzzles. The chart below shows a large and unusual divergence in the trend between initial claims (falling) and continuing claims (rising). The likely explanation is ongoing labor hoarding by large firms.

Low initial claims are consistent with low levels of firings, but currently unemployed people are struggling to find work, hence the higher continuing claims. What the chart also shows is that it tends to be initial claims that return to the trend set by continued claims, not vice versa. If history is prologue look for intial claims to rise on average over the coming weeks and months.



CAN YOU TRUST THE DATA?

On the employment front, the Bureau of Labor Statistics (BLS) released the Quarterly Census of Employment and Wages (QCEW) report for the third quarter of 2023, which showed the labor market to be less tight than what was initially thought. The QCEW is a “benchmark” employment report published quarterly whereas the BLS estimate of non-farm payrolls is an “advanced” estimate of the QCEW numbers, which are much more reliable but also much less timely.

The QCEW shows that the BLS non-farm payroll report overestimated annual job gains in September 2023 by almost +800,000. This means there will be a significant downward revision to the non-farm payroll numbers (just like last year), but not until mid-2025. This is why the National Bureau of Economic Research (NBER) takes time to call for a recession.

Bottom line: This will not change the prevailing strong labor narrative, but it is extremely annoying that government data is so often wrong and subject to significant revisions. In the meantime, the markets are trading on bad data. Indeed, the real bear market is in data quality!

YOLO TO DELINQUENCY

The exponential growth in “Buy Now, Pay Later” (BNPL) financing may be masking the stress in lower-income U.S. households.

Per the New York Fed, the average BNPL user is under 40 (Gen Z and Millennials) and has:

- No college education.
- A credit score less than 620 earns less than $30,000 annually.
- At least one credit card application was rejected.
- At least one delinquency of 30+ days in the last year.

Typically, these financially fragile consumers are three times more likely to make five or more BNPL purchases when compared to the more financially stable peers. They also tend to use BNPL financing for as low as $250 or less on most occasions.

Another research report by LendingTree illustrates that one in four users are “bridging paycheck gaps” while one in five are “buying groceries” using BNPL. This shows how financially stretched weaker households are, and that they are relying on BNPL for something as basic as groceries.

What makes the BNPL movement a bit worrisome is that the Millennials delinquency rates for credit cards, according to the SCE Credit Access Survey by the New York Fed, as of September 2023 was 2.9% (highest since 2015). The Gen Z generation is even higher at 3.1% (highest since 2019). For comparison, the well-heeled Baby Boomers and Gen X delinquency rate is 1.1% and 2.1%, respectively.

Bottom line: Most of the BNPL users are lower-income Gen Z and Millennials. BNPL allows them to extend their post-COVID-19 YOLO (“you only live once”) spending wave now that savings have been exhausted (currently at 3.7% compared to the long term average of 8.5%). Further, the exponential growth across many consumer expenditure categories may help explain the so called “resilient” consumer while savings rates are at multidecade lows.

This is obviously not sustainable.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

“Most participants noted the risks of moving too quickly to ease the stance of policy and emphasized the importance of carefully assessing incoming data in judging whether inflation is moving down sustainably to 2%.”
— January 2024 Federal Reserve Meeting Minutes

There are many nonconfirming, confusing trends and data.

First, GDP growth in 2023 was 2.5% and is in the normal range compared to recent years. The headline unemployment rate is roughly back where it was in 2019. Consumer spending is rising again after the COVID-19 stumble. These suggest the economy isn’t in imminent danger. However, they don’t prove everything is well. Consider the following:

- GDP is looking fine, but gross domestic income (GDI) is in recession territory.
- Manufacturing has been in decline for over a year, yet factory construction is up 75% over the last year.
- Industrial production is down, yet the economy seems to be doing fine.
- Unemployment is well below 4%, yet the labor force is dramatically lower than its pre-Great Financial Crisis high.
- Trade deficit is down, but total global trade levels are down.
- Housing prices have not collapsed at all, but housing transactions have plumetted.
- Core goods inflation is gone, but core services inflation is not.

Also, the Chicago Fed’s National Activity Index (CFNAI) for January showed a cooling of economic activity. This indicator is comprised of a broad set of 85 economic variables designed to offer a more accurate and timely indication of activity levels than the flawed GDP statistic, making this an important release to pay attention to. To start the year, the index came in at -0.3 from a flat (0.0) reading in December. It also helps to clear the confusion regarding the true state of the economy, even with the A.I. related spending frenzy underway.

While the U.S is in an “exceptional” state at present, many advanced economies teetered on the brink of recession or entered one at the same time as U.S. GDP growth accelerated. Considering the large two-way spillovers between global and U.S. growth, a recessionary global economy clouds the outlook for the U.S. in 2024. Can the U.S. economy remain decoupled from what is happening overseas?

Meanwhile, as discussed above, the historically releable LEI and inverted yield curve have been my go-to recession indicators for decades, and one reason I expected a recession in 2023. Today, the curve is as inverted as in the 1980s, and yet we still no recession.

All in all, the conflicting data is maddening to the pessimists and not quite reassuring to the optimists. Suffice it to say, the U.S. economy is filled with uncertainty and major cross currents.

While I have never subscribed to "this time is different," could it be that we are now operating under different rules? We know some things have changed. Federal debt is at unprecedented levels and we are dealing with a demographically driven labor shortage and then of course we have new technologies like A.I.

Meanwhile, bond markets are still waiting on the Fed to cut rates. According to the latest Federal Open Market Committee (FOMC) meeting minutes, the Fed does not seem to be in a rush. They are more concerned about cutting rates too soon compared to waiting a few more months of favorable inflation data. Indeed rate-cut expectations have plummeted since the last FOMC meeting with March now off the table. The total number of cuts for 2024 is down from six cuts to a 50-50 call between three and four cuts.

While the Fed is taking its time, the FOMC members seem convinced that inflation has peaked and will head lower from here.

*"**Many participants indicated that they expected core non housing services inflation to gradually decline further** as the labor market continued to move into better balance and wage growth moderated further. Various participants noted that **housing services inflation was likely to fall further as the deceleration in rents on new leases continued to pass through to measures of such inflation."** — FOMC Meeting Minutes*

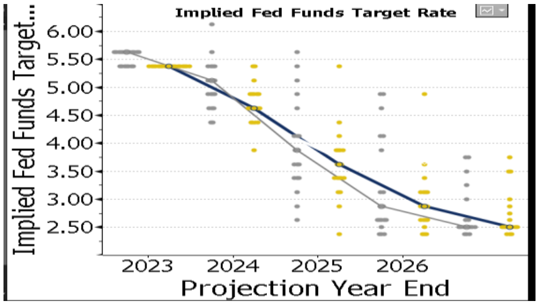
On economic macro data accuracy (or not,) the members expressed some concern that the economic growth is not widespread.

*"While the recent trends prior to the meeting had been remarkably positive, Fed officials judged that **some of the recent improvement reflected idiosyncratic movements in a few series."***

And finally , the Fed sounds a little nervous over financial stability issues:

*"**As valuations across a range of markets appeared high relative to fundamentals** and **house prices increased to the upper end of their historical range."***

Bottom line: The Fed has clearly won the jawboning battle to bring the market back to dot-plot reality. The Fed has not abandoned "when" we see the next policy easing cycle (if it goes to an "if," then Treasuries will be in for even more near-term problems), but is clearly indicating that the move will occur much later in the year.



MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at 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.