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Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

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A Potemkin Economy

"The world is set up for a soft landing. The market certainly perceives there's a very, very high delta to a soft landing. My own view is it's a little more uncertain than that." – David Solomon, CEO of Goldman Sachs

"Potemkin village" is named after Russian nobleman Grigory Potemkin. After conquering and annexing Crimea from the Ottoman Empire, Potemkin was then charged with colonizing this new territory. Folklore has it that the empress Catherine the Great, Potemkin's supposed lover, wanted to tour this newly acquired colony. At that point, colonization efforts had stalled. However, to save face and avoid embarrassment, Potemkin had fake façade villages built throughout Crimea to cover up his lack of success in colonizing Crimea. In essence, he had deceived the empress into believing that things were better than they were.

Although the legend has since been debunked by historians, the phrase "Potemkin village" is used today to describe a situation in which an unattractive reality is hidden behind an impressive façade. The end goal is to deceive people into thinking the economy and markets are better off than they actually are.

Source: Google

Fast forward to today, it should be well known by now that the the economy and financial markets continue to operate under massive government-injected medication.

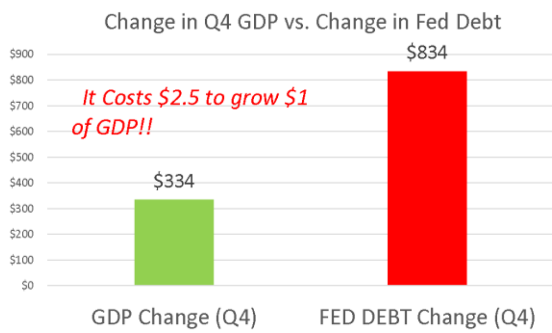
Last week, it was reported that the fourth quarter gross domestic product (GDP) rose 3.2%. In dollars and cents, nominal GDP rose from $27.61 trillion in the third quarter to $27.94 trillion in the fourth ($334.5 billion).

THIS WEEK

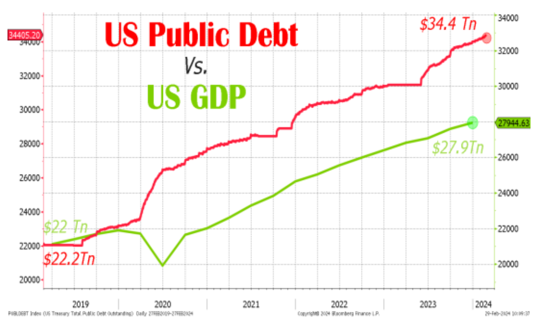
But where did this growth come from? Why debt of course, and ***a lot*** of it.

The U.S. Treasury's records show the national debt escalated from $33,167,334,044,723 on September 30, 2023, to $34,001,493,655,565 by December 31, 2023.

In other words, it took $834.2 billion in debt during the third quarter to grow the U.S. economy by $334.5 billion. Therefore, it took $2.50 in debt spending to generate $1 of GDP.



Shocking you might say. But this is nothing new. From 2019 to 2023, gross federal debt rose from $22 trillion to $34.4 trillion ($12.4 trillion), whereas GDP expanded by only $5 trillion. Over this period, debt-to-GDP expanded from 107% to 123%. Think about that. A $12.4 trillion government debt explosion was responsible for over 80% of the overall increase in economic activity.



Moving on. Now let’s consider where the economy would be today without the massive intervention by the Federal Reserve acting as the country’s largest hedge fund.

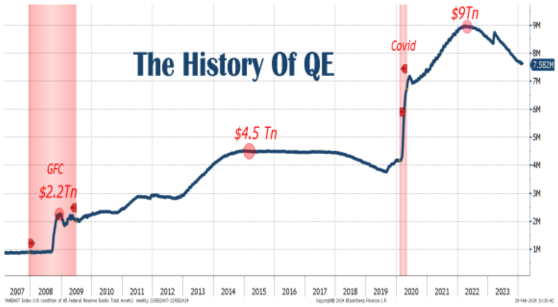
For some historical perspective, before the 2008-2009 Global Financial Crisis (GFC), the Fed’s balance sheet stood at aproximately $800 million and consisted of AAA-rated securities like T-bills and Treasury notes (and gold reserves). There were no mortgage-backed securities (MBS) on the balance sheet.

No one had ever heard of quantitaive easing (QE) or zero interest rate policy (ZIRP). Then things radically changed as Ben Bernanke (aka Heliopter Ben) impemented arguably the geatest monetary experiment of all time by slashing rates to zero bound, implementing QE and expanding the Fed’s balance sheet to $2.2 trillion.

But Bernanke didn’t stop there. He kept going in an effort to stimulate spending via the fabled “wealth effect.”

By 2014, four years after the GFC was over, the balance sheet doubled once again to $4.5 trillion. In doing so, he essentially institutionalized QE. Again, outsise of academia, nobody had ever heard of QE prior to 2009. Today, what was once a highly controversial and "temporary" fix, has become mainstream normal.

Next thing you know, in the wake of the COVID-19 pandemic, the balance sheet exploded to nearly $9 trillion, and the Fed then accepted all types of public and private debt, regardless of credit quality. Today, the balance sheet still stands at an amazing $7.5 trillion — with $2.4 trillion in mortgage-backed paper.



Many might have assumed that this Modern Monetary Theory (MMT) chicanery occurred under the free spending Democratic party. That would be wrong. All of this happened under the tenure of two Republican Fed Chairmen!

Most importantly, it begs the question, A.I. boom or not, where would the economy and the market valuations be today absent massive deficit spending and a massive Fed balance sheet, which still stands at roughly 10x the pre-GFC level?

Bottom Line: Like the Potempkin village, the economy and markets are not as healthy as they appear. A house of straw is being held together by relentless government support from both the fiscal and monetary policy levers.

So much for free market capitalism!

TRAPPED!

"Little wonder 'debt debasement' trades closing in on all-time highs, i.e. gold [at] $2077/oz and bitcoin [at] $67,734." – Michael Hartnett, Chief Strategist of Bank of America

Today's administration and previous adminstrations have funded their priorities (e.g., tax cuts, infrastructure spending, social spending, etc.) via borrowed money – facilitated and supported by the Fed.

"In the context of higher interest rates, without effective fiscal policy measures to reduce government spending or increase revenues… Moody's expects that the U.S.' fiscal deficits will remain very large, significantly weakening debt affordability."

Currently, U.S. government debt stands at nearly $34.4 trillion. Think about this: since June 2023, the last two $1 trillion jumps occurred in about 100 days!

With the huge debt now existing, if the Fed decides to suppress inflation by raising rates, it thereby also increases the cost of the existing debt and thus shrinks the amount of government spending from its available tax income. So, given the huge federal debt, rate changes not only directly affect private business vitality, but also government spending levels.

Then, too, does anyone really believe the Fed would raise rates as the 2024 election approaches? Instead, the Fed will be inclined to support the administration that selected the Fed's members by lowering rates.

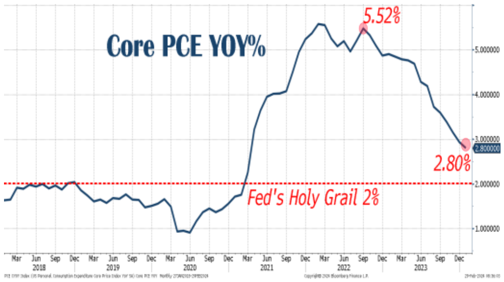
Bottom Line: The Fed may in fact like to keep rates higher for longer, but that aim runs directly into the need of the U.S. Treasury to finance our debt and deficit. The cost of interest is turning into a material portion of the deficit problem. In short, rates must come down because the Treasury needs them to come down to finance the government. And when they come down, the marginal buyer of the U.S. debt will be — you guessed it — the Fed, which means more expansion of the money supply (by definition).

The Fed is trapped and everyone knows it.

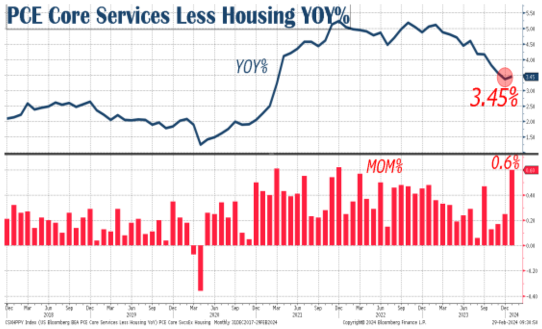
COULD HAVE BEEN WORSE

In confirmatiom of previous inflation metrics (i.e., Consumer Price Index (CPI), Producer Price Index (PPI) and import prices), the personal consumption expenditures (PCE) price deflator took a pause on its recent disinflation trend. The headline PCE was +0.3% month-over-month. More importantly, the core PCE (excluding enegy and food) reading was the highest in a year on a month-to-month basis. While the numbers met consensus expctations, the so-called "whisper" number was much higher. In other words, it could have been worse.

However, the good news was that year-over-year inflation continued its downward glide. The 2.4% headline PCE inflation and 2.8% core were both the lowest since February 2021. A year ago, the core PCE was 5.52%, so the trend is heading in the right direction.



All that said, the Fed will clearly not like the fact that the PCE service sector numbers reamin quite disconcerting. To wit: the "core services" PCE price index spiked to 7.15% annualized in January from December, the worst month-to-month jump in 22 years. Drivers of the spike were non-housing measures as well as housing inflation.



Excluding housing and energy, core service inflation popped +0.6% month-over-month, which was the strongest run-up since December 2021. Even on a year-over-year trend, core service also rose to +3.5% from +3.4% in December, though it was running north of 5% a year ago. Again, this is worrisome because this is where consumers do the majority of their spending. This is why Fed governors have said this year in near unison that they're in no hurry to cut rates but have taken a wait-and-see approach.

Bottom Line: It's believed by many that seasonal early-year quirks appear to have been in play with the recent unfavorable price data — CPI, PPI and now the PCE deflator. Even still, the onus will be on what happens over the next few months.

Also we need to understand that the high base effects are going to fade away right through to July, so further deceleration in the year-over-year trend is going to hinge on the sequential increases. In other words, monthly sequential increases from here on out need to decline to 0.2% or 0.1% for the disinflation trend to continue.

Suffice it to say that the report will embolden the view among policymakers that the eventual move to ease policy will come later, not sooner (unless something breaks in the equity market).

JANUARY INCOME BLUES

"Consumers are likely to rein in spending this year after drawing down the pandemic-related savings, driving the savings rate well below its pre-pandemic levels, and increasing their reliance on credit,"
– Kathy Bostjancic, Chief Economist at Nationwide

The PCE expenditure reports also showed that personal income surprised to the upside in January, jumping +1.0% month-over-month, its best month since July 2021. Surprisingly, spending lagged far behind at +0.2%.

The reason there was such a disconnect between income and spending was because the top-line income number was dominated by dividend income. The problem is that dividend income tends to get reinvested, not plowed into consumer expenditures. In addition to dividends, social security payments spiked +3.5%, which is a significant bump from Uncle Sam.

Most importantly, the wage income picture was gloomier. Disposable personal income — income after taxes — rose a more modest 0.3%, which was a three-month low.

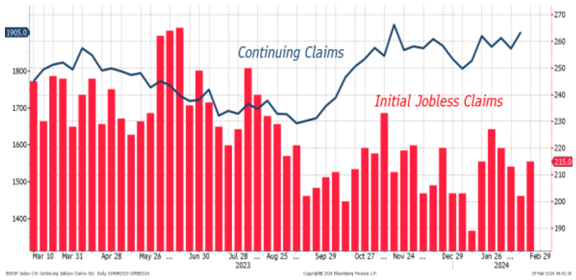
Bottom Line: Strip out dividends and government handouts, personal incomes rose by +0.3% month-over-month in nominal terms. In real terms, personal disposable incomes were as flat as a pancake in January. Simply put, in January, a pickup in prices crushed income gains. Sluggish real income growth could dampen future consumer spending and keep Americans' economic optimism low.

WARNING!

"Claims are still very low by historical standards. We expect that to change soon. The WARN [Worker Adjustment and Retraining Notification] numbers, capturing advance notice of plant closures and mass layoffs, have jumped recently and point to initial claims rising significantly over the next few months." – Pantheon Macroeconomics

The U.S. saw a slight increase in unemployment benefits claims, rising by 13,000 to 215,000 for the week ending February 24, but still remain historically low. This is not consistent with daily headlines of companies increasing announcing layoffs. However, there could be a good reason. According to Danielle DiMartino Booth – an expert on monetary policy, economics and finance – unemployment claims data is somewhat clouded by an increasing trend among large corporations to extend 6-to-9-month severance packages to laid-off employees. As a result, these individuals are not yet filing for unemployment benefits and are still counted as employed due to receiving severance pay.

Furthermore, continuing jobless claims increased by 45,000 to 1,905,000 the previous week, reaching the highest level since November and surpassing market forecasts of 1,874,000. This indicates that hiring plans are coming under the knife, even as companies hoard their labor**.**



Also, as Pantheon Macroeconomics has highlighted in the above quote, WARN notices – an aggregate of advance layoffs – have surged recently but claims haven't. If history is prologue, look for claims to trend higher as more people receive pink slips.

Bigger Picture: According to the Bureau of Labor Statistics' (BLS) household survey report, on a net basis there has not been one full-time job created in the U.S. since last February (actually down -97,000). Think about that! Yet, the widespread narrative is that the labor market remains strong.

The BLS data also shows that multiple job holders have swelled +389,000 since February 2023, accounting for nearly half of all employment growth. Let me reiterate. Employment growth was more than 100% due to the replacing of full-time work with part-time jobs.

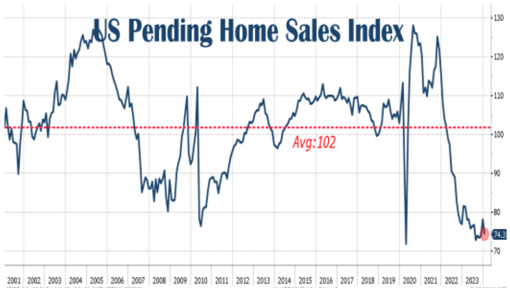
As I discussed in last week's *Weekly Relative Value*, "Cross Currents," I have never seen so many contradictory data points in my four-plus decades in this business. This data inconsistency applies to the labor markets. For example: Should we pay heed to the BLS establishment survey that shows robust job gains, or the BLS household survey, which shows the opposite? Should we believe in the ultra-low initial jobless claims or the high and rising level of continuing claims?

What do you believe?

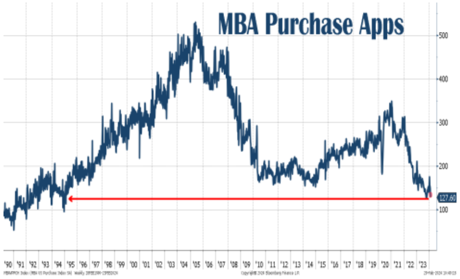
NOTHING PENDING

"…consumers are showing extra sensitivity to changes in mortgage rates in the current cycle, and that's impacting home sales… the timing and number of purchases will largely depend on the prevailing mortgage rates and inventory availability." – Lawrence Yun, Chief Economist, National Association of Realtors (NAR)

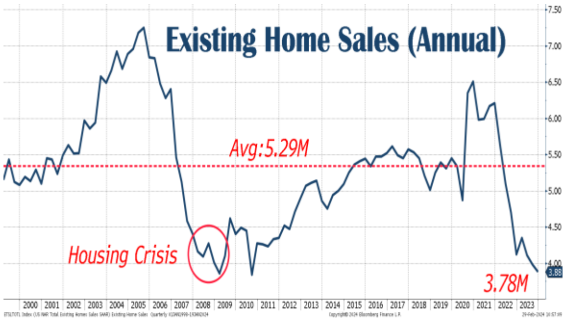
The pending home sales report is a leading indicator of existing home sales given houses typically go under contract a month or two before they're sold. Pending home sales plunged in January, tumbling 4.9% month-over-month (versus +1.5% month-over-month expected). This was made worse by a large downward revision for December (from +8.3% month-over-month to +5.7% month-over-month). That was the biggest month-over-month decline since August, dragging the year-over-year sales decline to -6.82%, tumbling back near record lows.



The lack of buying is also shown in U.S. mortgage applications for home purchases, which fell for a fifth week, nearing their lowest level since 1995.



Bottom Line: The NAR's outlook shows sales increasing 13% this year, but as the charts above show, unless rates start tumbling soon, look for existing home sales (90% of housing activity) to continue to test new lows.



IRRATIONAL EXUBERANCE: PART DEUX?

"…there has been some attention paid to the fact that the S&P has closed up for 15 of the past 17 weeks — something that hasn't happened in years. However, the classic definition of an uptrend is a series of higher highs and higher lows. The S&P has posted both a higher weekly high and a higher weekly low compared to the previous week in 16 of the past 17 weeks… My data shows that this has never happened before."
– Walter Murphy, Rosenberg Research

There is no doubt that the U.S. equity market has surpassed all expectations. As noted above, the S&P 500 has advanced in 15 of the past 17 weeks. Over the past 50 years, this has happened only once (1989).

The S&P index is up an eye-popping +25% from the nearby October 2023 lows. As prices have soared, valautions are now off the charts. To wit: the S&P 500 has a current price/earnings (P/E) ratio of 28. This compares to a historical P/E multiple of 16. The index's forward P/E multiple is near -21X, which is 30% higher than the historical average of 16X.

Let me add this little ditty. Since the middle of September, the consensus view for 2024 earnings-per-share has declined -1.3% to $242.80 from $246.10. That is a fact, not an opinion. Yet, the S&P 500 has managed to rally a startling +15% in the face of earnings estimates being trimmed!

I believe today's valuations only make sense in the context of 0% policy rates and the Fed's QE program, yet the equity market today is competing with a risk-free T-Bill yield of 5.50%, a 10-year Treasury yield of 4.2%, and quantitative tightening (QT). Simply put, the risk-adjusted return potential is rather poor. Yet, the markets are reaching new records every week. Then again, investing doesn't always have to make sense from a macro perspective. Lady Luck can often play a big role in this casino. Indeed,the fact that the clown at the circus has continued to blow up the balloon without it bursting just yet is impressive.

But it looks like valuation and risk-adjusted returns matter not to the masses. No doubt the FOMO (fear of missing out) trade is alive and well, with frustrated investors seeing their friends, neighbors and colleagues making a pile of dough, now hopping on board the train. At 77, the CNN Fear-Greed Index has moved comfortably into "extreme greed" territory. That just about says it all.

The one thing that we must continue to remind ourselves is that the stock market is not the economy. The economy does not run on sentiment fumes.

Bottom Line: There is a bull market in enthusiasm, excitement and exuberance. And frankly, as long as *animal sprits* and *FOMO* remain alive and well, the upward trend will likey continue. Yet the equity market is totally detached from fundamentals. I have seen this speculative behavior far too many times. Historically, the story does not end well. I personally will patiently wait for a better entry pont.

FRUGALITY RETURNS

Financial markets are trading in their own world, devoid of economic fundamentals, but the consumer is not fooled.

As for the so-called "resilient" consumer, Lowe's reported that same-store sales declined -6.2% year-over-year in its latest quarter (seventh decline in the past eight quarters) and is now focused on reducing costs. As to forward guidance, the company sees no rebound in sales, estimating a -2.5% decline.

And it's not just spending on house projects. Macy's, the biggest U.S. department store, announced disappointing top-line and bottom-line results while guiding lower. To improve the bottom line going forward, the company announced that it is closing 30% of its stores.

Heretofore, the consumer has relied on draining savings, epic credit card borrowing binge, and "Buy Now, Pay Later" strategies to pay for their spending ways. However, these earnings updates from Lowe's and Macy's do not highlight the strong consumer narrative.

In a sign of the times**,** college students are now stepping up their bets on online gambling sites to repay their loans. Have a read of "The TikTok Generation Turns to Sports Betting to Chip Away at Student Debt" from the *Wall Street Journal***.** You really cannot make this stuff up, but it does speak to a certain level of desperation.

If you don't think that consumers are strapped out, have a look at "Food Is Taking a Bite Out of Your Income. These Consumers Are Getting Creative."

The opening sentence said it all:

"Eating rice and beans instead of meat. Planning out meals a month in advance. Trying to raise more food in backyard gardens. Americans are changing the way they eat, shop and live to cope with a stretch of record food inflation."

Finally, consider this: Hormel Foods stock price soared nearly 15% last week on better-than-expected earnings. By the way, this company sells SPAM (first introduced in the Great Recession).

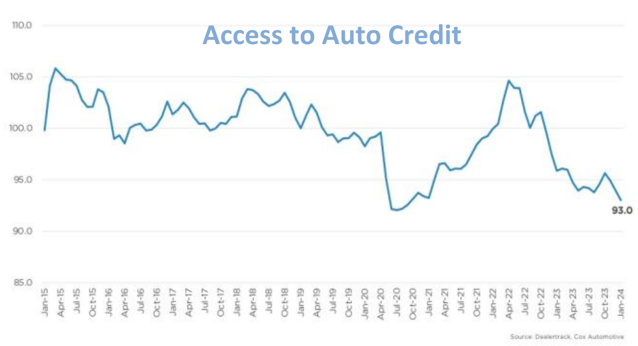
LOAN DENIED

"What people are struggling with is the level of inflation causing them to have to juggle expenses and try to stay current on their loans… It's produced some very alarming statistics that indicate risk has grown in an environment in which lenders have become more risk adverse."
– Jonathan Smoke, Chief Economist for Cox Automotive

The auto loan sector gives you a glance as to how some consumers are being stressed. With much higher rates and auto prices, the affordability of a car, a la home prices, is now out of reach. At the same time, the percentage of U.S. auto loans that are delinquent 90 days or more rose above pre-pandemic levels to 2.66% in the fourth quarter of 2023, per the New York Fed. That compares to 2.37% at the beginning of 2020 and a 15-year averageof 2.16%.

"It just caught me off guard, I've never had a loan denied…The industry is definitely tightening up."
– Car buyer Matt Stuemky

As delinquencies, rise lenders are tightening the screws. According to Cox Automotive, access to auto credit is the lowest since August 2020. This effectively prevents many customers from buying a car today.



Bottom Line: Tighter lending standards breed a situation where consumers can't afford vehicles, so they hold onto their old cars longer. This hurts the dealer community and the overall economy.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

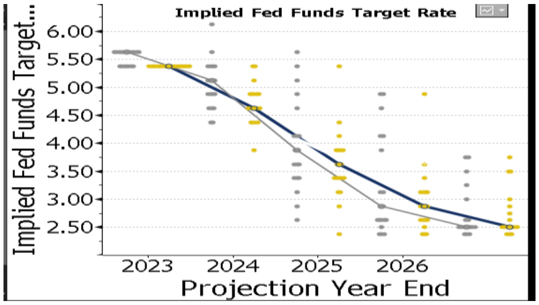
It is a super busy week ahead. Fed Chairman Jerome Powell is heading to Capitol Hill on Wednesday to deliver his semi-annual testimony. One can reasonably expect the Fed Chairman to double down on his message that the central bank is in no hurry to deliver on the three rate cuts projected by the most recent set of dot-plots for this year. Even San Francisco's Mary Daly, who was the one back in December that got the markets in a tizzy over a possible move as early as March, is now touting the consensus "higher for longer" interest rate view. She bluntly said in a *Wall Street Week* interview that "we're not there yet."

At the same time, New York's John Williams reiterated that he expects the Fed to cut rates later this year, data dependent. Meanwhile, Atlanta's Raphael Bostic said recent inflation readings indicate, *"there are going to be some bumps along the way."* Finally, Chicago's Austan Goolsbee cautioned against reading too much into a single month's inflation data.

This week's economic calendar is jam-packed with labor market data including the January Job Opening and Labor Turnover Survey (JOLTS) data, the February ADP employment data and the February non-farm payrolls (consensus is at +200,000). However, should the payroll consensus be accurate, such a number will be far too strong for the Fed to do anything but stay on the sidelines indefinitely. The jobs report will arrive just 12 days before the next Federal Open Market Committee meeting on March 20.

At least fixed income investors are now completely aligned with the Fed's latest dot plots showing three cuts this year. The swaps market has re-priced to a 4.58% year-end funds rate, which is precisely 75 basis points below where the spot level is trading.

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.



Source: Bloomberg

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.