Weekly Relative Value

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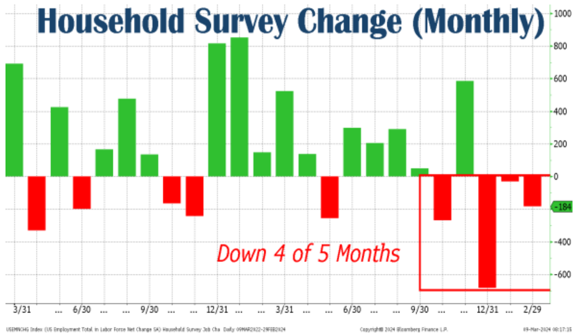
WEEK OF MARCH 11, 2024

Death, Taxes and Revisions

"The downward revisions to previous months gains leave recent growth looking less strong than previously thought. Alongside the rise in the unemployment rate to a two-year high and a much weaker rise in wages, there is less reason now to be concerned that renewed labor-market strength will drive inflation higher again."
— Andrew Hunter, Deputy Chief U.S. Economist, Capital Economics

Last week, we received a bevy of labor data. The Bureau of Labor Statistics (BLS) reported that a whopping 275,000 jobs were added in February, smashing the median estimate of 200,000. While February was a strong print, it is just a placeholder until next month's downward revision. This is because January's blowout 353,000 print was revised sharply lower to just 229,000, down by a whopping 35%.

And as usual, there was an ugly divergence between the establishment survey (payrolls) and the household survey (actual number employed), which declined once again and slide down to 160.968 million from 161.152 million, or down 184,000.



The household survey showed the third contraction in a row, totaling -898,000. Over the past 70 years, such a decrease only occurred in the context of an economy heading into, already in or crawling out of a recession.

Not just that, but all of the slide in household employment was again in full-time jobs — dropping -187,000 in February and down an incredible -1.78 million over the past three months. So, for all the talk of a robust labor market, what has really happened is that the country has morphed into a part-time consultancy. The economy has not managed to

THIS WEEK

- MORE CRACKS IN THE LABOR MARKETS
- WORKERS STOP QUITTING
- IT'S A CHALLENGE OUT THERE
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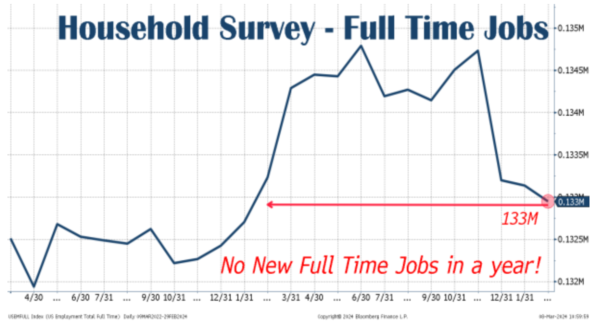
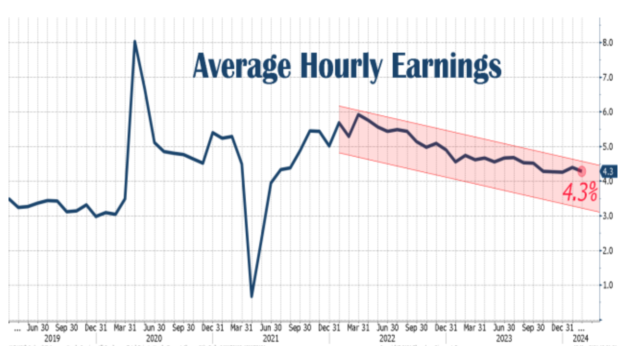
generate one net new full-time job over the past year. How does that translate into resilience?



The Sahm Rule: The start of a recession is when the three-month moving average of the national unemploymnet rate (U-3) rises by 0.5% or more relative to it's low during the previous 12 month period.

This wasn't the only problem with the jobs report. Despite the sharp jump in monthly payrolls, the unemployment rate unexpectedly rose to 3.9%, which is the highest it has been since January 2022 compared to an estimate of a 3.7% unchanged print. Now that the jobless rate is up 0.5 % from the January 2023 cycle low, it messes up the soft-landing narrative because once it rises this much from the lows, the recession nobody ever sees coming arrives.

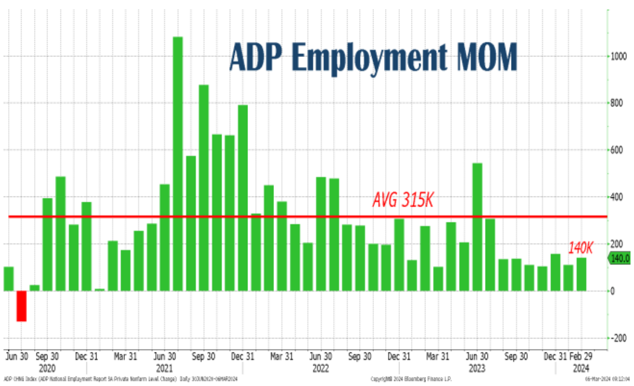
There was some more good news on the wage front, well, if you are the Fed that is. The average hourly earnings growth dipped to 4.3% year-over-year from 4.4%, which was in line with expectations, while the monthly increase was just 0.1%. This was below the 0.2% estimate and down from a downward revised 0.5% print in January.



Additionally, the following chart below shows the National Federation of Independent Business (NFIB) survey of small business hiring plans (in the U.S. it's the small business that are responsible for most of the hiring). This chart should tell you all you need to know about what's really happening in the labor markets.

MORE CRACKS IN THE LABOR MARKETS

Last week, in addition to the payroll report, the February ADP employment report (private payrolls only) was released. The report contained two messages. First, the job market is not yet falling apart. Second, that said, the pace of employment growth has slowed markedly of late. The headline figure was +140,000. When the Fed stopped tightening last summer, the data was coming in north of +300,000. The graph below illustrates how the overall pace of job creation is slowing down rather materially.



The big outlier in the data was in the retail sector, which shed -170,000 of its job openings to the lowest level since April 2020 (540,000). This speaks to the consumer spending outlook.

It was also interesting to note that the one sector driving the stock market and economy, technology, is the area where job cuts are happening. Tech employment slipped -2,000 in February and is now down in each of the past three months. Could it be that A.I. is eliminating jobs in the tech sector?

WORKERS STOP QUITTING

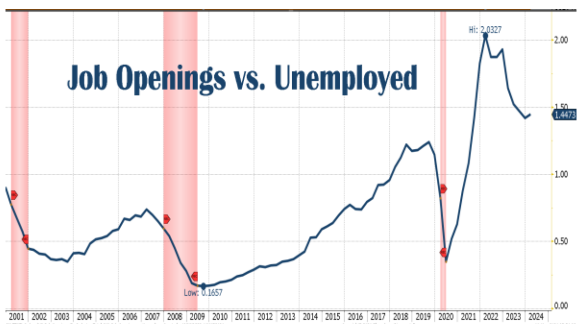
Also in the labor file, the Job Openings and Labor Turnover (JOLTS) data for January showed job openings dipping -26,000 (to 8.863 million), which is the third decline over past four months and is now down -1.56 million from a year ago.

Keep in mind that downward revisions have become commonplace with BLS labor data. In fact, over the past six of the past eight months, job openings were revised lower!

And more importantly, no matter what the "data" shows, let's not forget that it is all just estimated, and it is safe to say that the real number of job openings remains far lower since more than half of it is guesswork. The response rate to the

JOLTS report has collapsed and remains near a record low of 33%. In other words, more than two thirds, or 70% of the final number of job openings, is estimated!

Accurate or not, the modest decline in the number of job openings in January meant that the number of job openings was 2.739 million more than the number of unemployed workers (which the BLS reported was 6.124 million). This is up modestly from last month's 2.621 million. Said otherwise, in January, the number of job openings to unemployed workers rose to 1.45.



However, what was more interesting was the number of quits. The number of people quitting their jobs tumbled again, sliding by 54,000 to 3.385 million, which is below the 3.4 million level reported in Feb 2020, just before the COVID-19 shutdown. This metric is an indicator that is traditionally closely associated with labor market strength as it implies that the working class is becoming just a tad less confident and emboldened.

Moreover, there was no silver lining with the number of workers hired, which slumped by 100,000 to 5.687 million. Hirings have now declined on four of the past five months (down -687,000 over the past year).

IT'S A CHALLENGE OUT THERE

Also in the jobs file, the Challenger report highlighted that layoff announcements rose +8.8% year-over-year in February from already-elevated levels. This was the highest reading (84,638 pink slip announcements) for any February since 2009 when the economy was knee deep in the worst recession since the Great Depression.

Nearly two-thirds of the layoffs are coming straight from economic developments (e.g., bankruptcy, closings, cost-cutting, demand downturn, economic conditions, financial losses, consolidation and restructuring).

At the same time, Challenger hiring plans plunged -64.2% year-over-year in February to 10,317 — the lowest figure for any February in eight years!

Bottom line: Hopefully, the Fed is looking beneath the veneer of yet another stellar, but likely to be revised lower, payroll headline. The labor market, contrary to popular opinion, is contracting.

ADDS UP FAST!

U.S. national debt now stands at **$34.4 trillion**. In the past four months, another $1.1 trillion was tacked onto the total. All while the government's debt (and deficit) is on track to balloon further. In fact, every 30 seconds, another $1 million of debt is added, leaving an increasingly larger mess for future generations to clean up.

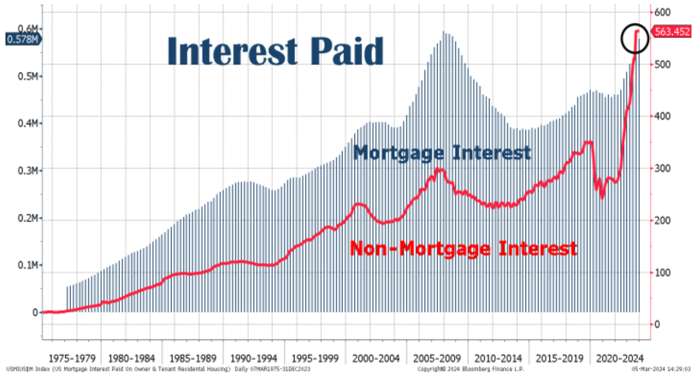
It was one thing to issue debt when rates were near zero, but that is clearly not the case today. As highlighted previously, the interest cost of the surging massive government debt has gone parabolic and is fast approachng $1 trillion!

But it's not just Uncle Sam who is now paying for the Fed's draconian 550 basis point rate rise. As shown below, the interest cost of serving the rapidly growing burden of consumer debt has now reached record high levels as well.

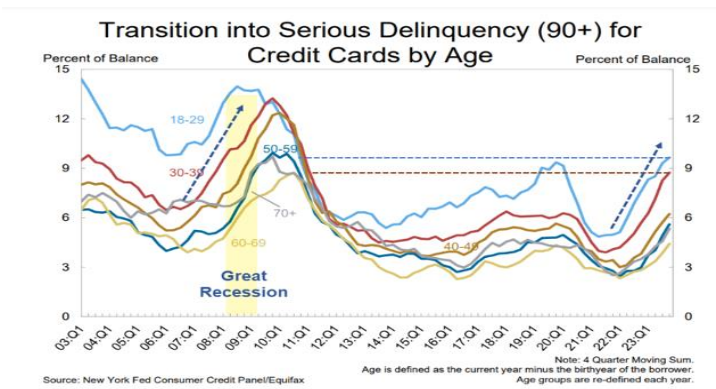
In fact, U.S. households are now paying a whopping $573 billion on consumer debt (e.g., student loans, credit cards and auto loans). That's a record high and within a hairs breath of the interest costs ($578 billion) paid on mortgage debt. Going back to the 1970s, this has never happened before.

This unusual dynamic is happening because of two reasons. First, many Americans had the good fortune of locking in record low mortgage rates during the pandemic, thus they have been immune and not exposed to the Fed's tighter monetary policy. Second, the pandemc stimulus has ended, savings are depleted and real wages have not kept pace with the cost of living.

To make ends meet, many families have had to rely on high cost debt to maintain their spending habits. What's more, the burden likely isn't spread evenly, since it's typically households with lower incomes and wealth that end up resorting to the costliest types of debt.



The good news, at least for now, is that overall delinquencies in the U.S. are still below pre-pandemic levels, but for credit cards and auto loans, and especially among younger borrowers, are much higher. This has many bankers worried about a future wave of defaults.

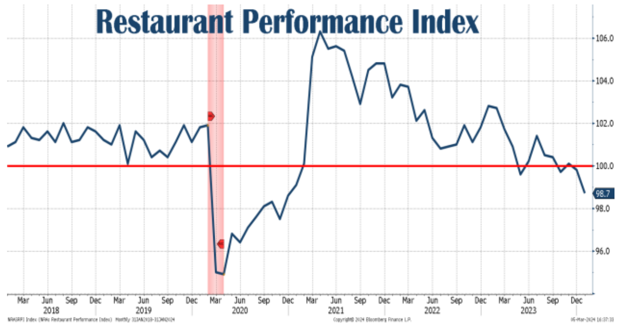


Bottom Line: Significant debt accumulation has artificially boosted economic growth. A $2 trillion surge in public debt, alongside record levels of credit card debt, has propped up consumer spending, concealing a $1.5 trillion increase in the grossd domestic product (GDP)**.** However, now that servicing costs are siphoning disposable income from retail spending, look for a slowing of the consumer driven economy. Likewise, look for the U.S. government to face increased pressures to slow expenditures in the future. Also, look for delinquencies and defaults to continue their upward trend and broaden out within all of the age cohorts.

The people who make you ill cannot make you well; great job, Janet and Jerome.

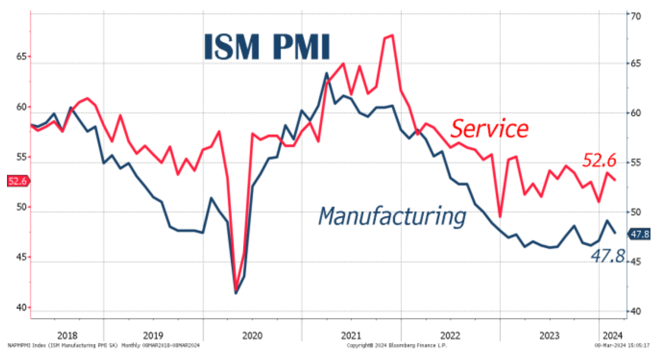
CANARY IN THE COAL MINE

One of the sectors showing the consumer impact of higher interest costs is the restaurant industry. Indeed, restaurant activity has slumped to its worst showing since the end of 2020. People still need to eat, so this is likely constructive for the grocery chains and less so for the restaurant chains.

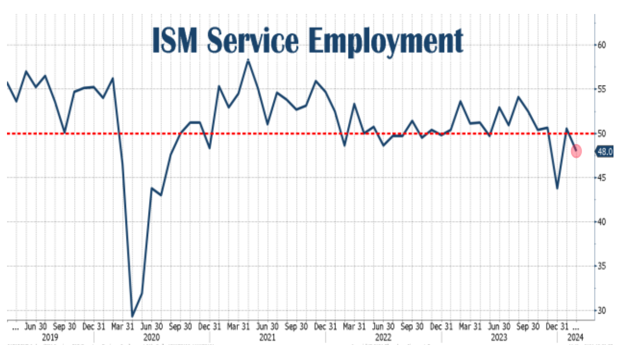


SERVICE SECTOR SLOWS

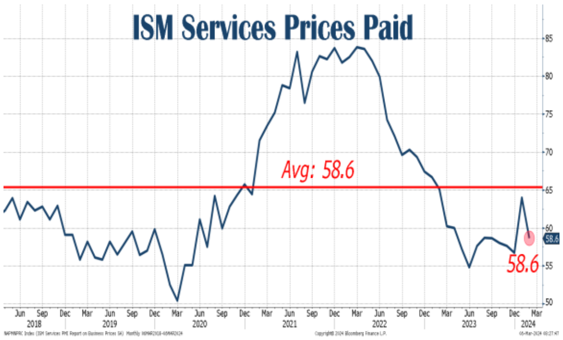
As shown below, the manufacturing sector is still contracting. And now, the heretofore, vibrant service sector is now showing early signs of weakness. In February, the service sector ISM was quite soft. While still above the demarcation line of 50 (separating expansion from contraction) the trend has been decidedly downward.



Notably, within the service sector, the employment segment contracted, having swung from 50.5 in January to 48.0 in February, which is well below the market view of 51.4. The numbers also show that more service-oriented companies are shedding staff (a 21% share) than adding to payrolls (13% share) for the third month in a row.



Also, the non-manufacturing ISM price paid index prices slumped to 58.6 from 64.0 while surprising the consensus that was expecting a 62.0 print. Only 23% of companies in this index were raising prices — compared to 35% a year ago. This arithmetically means that more than three in four are either keeping prices stable or cutting them outright!



Bottom Line: The service sector is slowing, and employment growth has peaked. More importantly, the Service Price Paid Index should help alleviate inflationary concerns at the Fed. However, this Fed has become scared of its own shadow after the inflationary experience it never expected to see in 2021 and in the first half of 2022.

STRESS BUILDS

"Economic and geopolitical uncertainty, continuing inflationary pressures, volatility in market interest rates, and emerging risks in some bank commercial real estate portfolios pose significant downside risks to the banking industry." — Martin Gruenberg, Chairman, Federal Deposit Insurance Corporation (FDIC)

The quote above comes from the FDIC, which reported that that the number of "problem" U.S. banks had jumped +18% in the final three months of 2023, the biggest since the demise of Silicon Valley Bank (SVB). Delinquency rates in credit cards, auto loans and commercial real estate have hit levels last seen nearly a decade ago.

As the consensus view on a "soft landing" or "no landing" for the U.S. economy becomes increasingly entrenched, the credit contraction within the banking sector intensifies. How much longer can middle-market lenders and private credit funds — the so-called "shadow banking system" — be expected to fill this void?

Bottom line: Call me a "nervous Nellie," but I won't mind because that is who I am.

GIVE ME CREDIT

Virtually all Wall Street economists say the U.S. household sector has a fine balance sheet and is flush with job and income growth. Of course, these are aggregates whereas recessions are determined by changes at the margin.

The question arises as to why consumers are persistently engaging in heavy credit usage, especially given the surge in interest rates over the past two years? Outstanding consumer credit jumped nearly $20 billion in January, double the consensus expectation, to a record-high $5.04 trillion.

Once again, almost half of that came via the good ol' credit card — expanding at a near 8% annual rate! — even as delinquency rates move on a discernible upward trajectory.

Bottom Line: More than one-fifth of discretionary consumer spending in the past year was financed through credit! Who needs income? Or a credit history? Just make sure you have a pulse and head to your local financial institution.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"We will have a hard landing at some point. I guarantee you that. We're all wondering: When does that come?" — Ellen Zentner, Chief U.S. Economist, Morgan Stanley

Monetary policy changes take so long (the lag effect) to show the desired effects, and the Fed tends to overshoot in both directions. They loosen too much and start inflationary booms, then tighten too much and send the economy into a recession. While avoidable in theory, in practice, not so much.

In other words, the consequences of interest rate hikes are felt over time. Higher interest rates have certainly started to cause a lot of problems (i.e., commercial real estate and rising consumer delinquencies). However, if rates are not brought down soon, the level of pain we are experiencing will begin to go up dramatically. The point is that there are cumulative impacts from Fed rate hikes that are built over time, and it's quite possible, if not likely, that we haven't yet seen all of the tightening impacts from the monetary policy changes.

So, what will the Fed do?

We are in a weird situation with GDP growth, employment and other indicators that are generally positive. Inflation, while higher than targeted, is much lower than it was. That said, many on the Federal Open Market Committee (FOMC) are hesitant to lower rates until there is more conviction that inflation has been licked once and for all.

To wit:

"I need to see more progress to feel fully confident that inflation is on a sure path to averaging 2% over time. Only when I gain that confidence will I feel the time is right to begin lowering the federal funds rate to dial back restrictive monetary policy." — Raphael Bostic, Atlanta Federal Reserve President

Bostic's biggest concern is what he calls "expectant optimism" and "pent-up exuberance." Business leaders, at least in his region, say they will leap into action as soon as they see interest rates start falling. He worries this would mean a "burst of new demand" that produces more inflation pressure.

"I asked one gathering of business leaders if they were ready to pounce at the first hint of an interest rate cut. The response was an overwhelming 'yes'… ***If that scenario were to unfold on a large scale, it holds the potential to unleash a burst of new demand that could reverse the progress toward rebalancing supply and demand. That would create upward pressure on prices. This threat of what I'll call pent-up exuberance is a new upside risk that I think bears scrutiny in coming months."*** *— Raphael Bostic, Atlanta Federal Reserve President*

That said, in his congressional testimony (aka Humphrey-Hawkins), Federal Reserve Chair Jerome Powell assured the markets that rate-hiking is in the rear-view mirror and the next move is a cut. Specifically, he stated that he is **"not far"** from gaining the "confidence" to start the easing cycle. The question is timing.

Then again, there are 785 economists working at the Fed, and they still can't accurately forecast the direction of the U.S. economy, interest rates or inflation!

And what about the market?

Market pricing for a June cut is back to almost 100% (92% specifically); from 70% on February 26. For 2024 overall, market pricing is at nearly four rate cuts compared to the three cuts predicted in late February.

Even still, the idea that "market expectations" tell us anything about the economy's future is — or should be — in serious doubt. That's not to say the market is *wrong*. It just changes its mind so often as to be useless. And most of the time, it changes its mind after the fact.

As discussed in previous commentary, here are a couple of economic recaps:

- U.S. retail sales slowed to 0.65% year-over-year growth in January.
- U.S. durable goods slowed to a recessionary -0.62% year-over-year growth in January.
- Core capital expenditures slowed to 0.14% year-over-year in January.

Meanwhile, the Atlanta Fed Nowcast was sliced this past week from 3.0% real GDP growth for the first quarter to 2.5%, the New York Fed cut its forecast to 2.1% from 2.8% and the St. Louis Fed is now at 1.19% from 1.4%.

And corporate America is not too healthy right now.

- The S&P 500 and Russell 2000 earnings have been decelerating for 27 months now.
- The Russell 2000 experienced a net income decline of -34.9% year-over-year in the fourth quarter of 2023 compared to a decline -30.5% year-over-year in the prior quarter.

Bottom line: Given the near-term uncertainties surrounding economic growth, inflation and monetary policy, the most prudent approach to managing your excess cash is to average into the markets while structuring a well-diversified, risk-appropriate laddered portfolio.

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.