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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF MARCH 26, 2024

Running Out of Gas

"Consumers say they still feel stretched. They are balancing a lot and having to make trade-offs to meet the needs of their families… We expect consumers will remain highly value conscious." — Christina Hennington, Chief Growth Officer, Target

Retail sales are incredibly vital for gauging the economic health of the U.S. This is because consumer spending, or personal consumption expenditure (PCE), accounts for two-thirds of gross domestic product (GDP).

The February retail sales data showed a partial rebound from January's surprise decline, with the headline at +0.6% month-over-month compared to the expected +0.8%. What's more, this came off the baseline of the disappointing January report being revised even weaker to -1.1% month-over-month (from -0.8% initially). When January and February retail sales are combined, retail sales are down by -0.5% compared to December. Moreover, retail sales data have been revised down in each of the past four months.

In actuality, the decline in "inflation adjusted" retail sales (i.e., volumes) was even worse than the headline nominal numbers suggest. In real terms, when deflated by the Consumer Price Index (CPI), retail sales were up an anemic +0.1%! Taking into consideration the January revisions, volumes are shrinking at the concerning pace of -1.6% year-over-year. Highlighting the extent of the slowdown, the six-month annualized growth rate of real retail sales now stands at -2.8% and is at a -5.3% annualized pace over just the past three months.

Note: This is important because it's the "real" inflation adjusted data that impacts real GDP.

Most importantly, the key control sales metric, which plugs directly into the GDP report, showed a goose egg with no change whatsoever. On a real basis, the control group was a negative -0.4%.

THIS WEEK

- INTEREST IS ADDING UP
- CORPORATIONS ARE ALSO UNDER THE GUN
- …AND IT'S NOT DENMARK!
- WHERE TO FROM HERE?
- LIES, DAMNED LIES AND STATISTICS
- THE HOUSE THAT ROARED
- A MYTH
- THE DOTS
- IS THE BOND MARKET OVERREACTING?
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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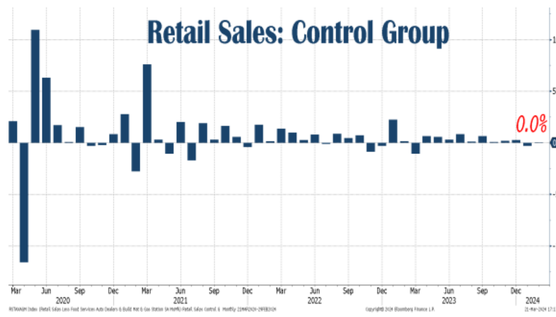
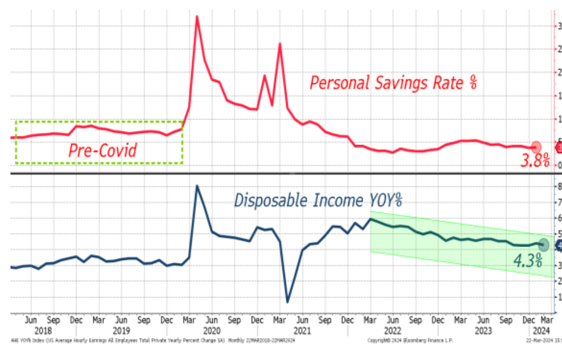


Frankly, the consumer slowdown is, and was, to be expected as savings have fallen to 3.8% — or half of the pre-pandemic levels. At the same time, disposable income growth has continued to descend from a peak of 6% growth to 4.3% today. And in real terms, work-based pay is starting to sputter again, a message that was loud and clear in the most recent payroll report. In other words, the tailwinds for the consumer are over.

I should add that the burgeoning trend of "Buy Now, Pay Later" (BNPL) programs, which have become a pseudo-extension of disposable income, are not included in this data. For context, during the 2023 holiday shopping season, BNPL sales hit $17 billion. **BNPL users spent 48% MORE than those who chose alternative payment methods during Black Friday sales.** Adobe Analytics data reported that on **Cyber Monday, BNPL accounted for $940 million in transactions — a 42.5% increase from the previous year and the most significant usage in a single day.**

At the same time, credit card debt continues to rise. BNPL is just spending on top of spending; it hasn't come at the expense of credit card usage. Some may view this as a sign that the consumer is confident and willing to buy more than they can afford. I, on the other hand, believe that this is a sign of consumer recklessness and desperation.



Further, if you are looking for anecdotal evidence that shows consumer sentiment, consider what Matthew Friend, the CFO at Nike, had to say:

"Competitive environment and channel dynamics are more challenging than we can remember."

Separately, Lululemon reported that visits to U.S. stores slowed, and they are anticipating a lower-than-expected sales outlook for the first quarter and the full year.

Also, Darden Restaurants warned investors that low-income customers were quickly reducing their spending. Just weeks ago, budget retailer Dollar Tree warned of declining ticket prices.

"Consumers are a little soft coming into the year." —Calvin McDonald, CEO, Lululemon

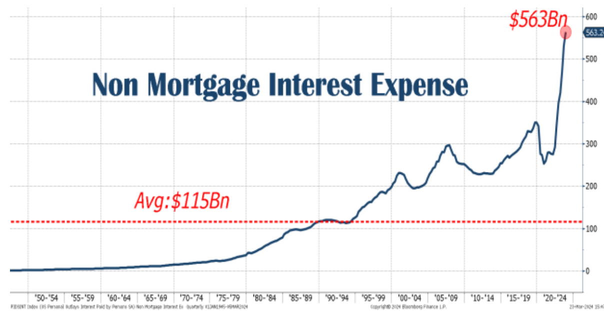
Bottom line: For the first two months of the year, inflation adjusted retail sales were deep in the hole and confirmed that the dip in consumer goods spending seen in January was not the "weather noise" so many Wall Street economists had argued. Moreover, unless spending goes gangbuster in March, it is becoming increasingly clear that the U.S. consumer is running out of gas and is now poised to drag on growth this quarter.

INTEREST IS ADDING UP

"High interest rates are a major burden on many American families. Revolving credit card rates have soared above 20%, generating hefty bills on interest alone. Consumers' monthly payments on credit cards, auto loans and other forms of nonmortgage debt are soaring. Those payments reached $573 billion in February, according to the Bureau of Economic Analysis, and, in a big shift, they are approaching the $578 billion in mortgage payments. Rates for new mortgages are so steep that many people simply can't afford a house at all. The cost of debt is just too high."
— Jeff Sommer, Columnist, New York Times

The one thing we know is that total outstanding credit card balances have surpassed $1.1 trillion, auto debt is now $1.6 trillion and household debt has expanded to $17.3 trillion. While consumer debt explodes higher, rates on auto loans are reaching unprecedented levels. Credit card rates are as high as 25%, used cars are as high as 14% and new cars are as high as 10%.

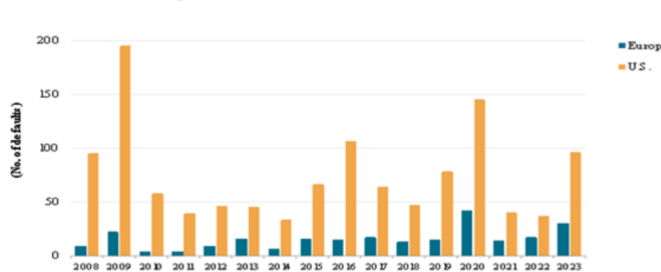
Even with so many mortgage borrowers having locked in generational lows in 2020 and 2021, the reality is that for the entire household sector, **roughly $3 trillion of non-mortgage debt rolls over every yea**r. Additionally, the share of disposable income being siphoned off into debt-servicing expenses has surged to the highest level since November 2007.



Bottom line: While risk-averse households in savings accounts and money market funds have clearly enjoyed the fruits of higher rates, interest income has an exceptionally low spending propensity. The gains from higher interest income, like dividends, are typically reinvested and not used to fund vacations, theme park visits or new patio furniture.

CORPORATIONS ARE ALSO UNDER THE GUN

Meanwhile, in the business sector, the interest expense has soared, and defaults surged 80% in 2023. Business insolvencies have soared +36% over the past year. At the same time, new business applications have contracted -6.8%.

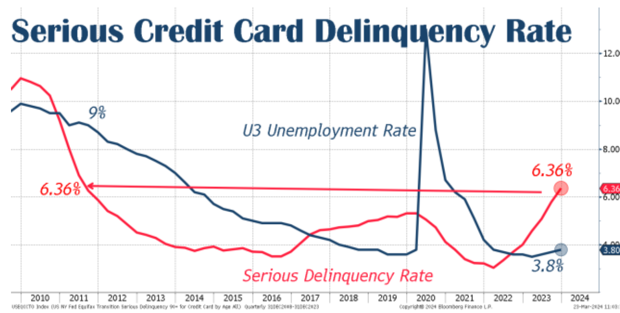


...AND IT'S NOT DENMARK!

"Americans continue to borrow to buy things that they don't earn enough money to afford..."
— Peter Schiff, American Stockbroker

Something smells rotten and it's not Denmark**.** According to the New York Fed, Americans' credit card balances have skyrocketed 40% to a record high $1.1 trillion. Also, most cardholders' rates have risen five-and-a-quarter percentage points during that span because of the Fed's rate hikes. It's no wonder that more people are carrying more debt for longer periods of time**. To wit: Nearly 50% of credit card holders are carrying a credit card balance from month to month — an increase from 39% in 2021**. Emergency or unexpected expenses are the leading cause of credit card debt, with 43% of cardholders saying they're carrying a balance due to an unexpected or emergency expense.

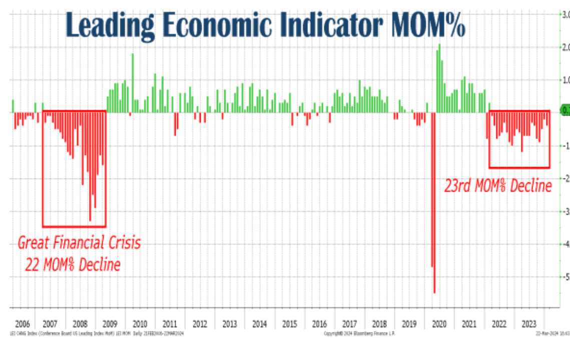
At the same time, **10% of the balances have moved into serious delinquency** (as in, 90+ days past due). This is the most rapid rise of delinquent debt since the third quarter of 2011 when the unemployment rate was at 8% as compared to the 4% rate today.



WHERE TO FROM HERE?

For the first time in two years, the Conference Board's index of leading economic indicators (LEI), inched up +0.1% month-over-month in February (after slumping -0.4% in January), ending an epic 23 straight months of decline. Mind you, the booming stock market was a huge contributor — stripping out that impact, the LEI was actually down -0.1%.

But it doesn't really seem to matter because this time around, the LEI either has really long lags or somehow has become irrelevant. The index typically bottoms just as the recession is ending, but since there apparently has been no recession, it's difficult to tell what the signal actually is at the current time.

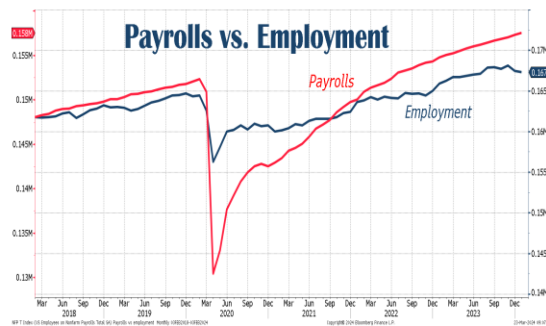


LIES, DAMNED LIES AND STATISTICS

"When all the experts and forecasts agree — something else is going to happen."
— Bob Farell, Former Chief Market Analyst, Merril Lynch

Over the past 12 months, there have been glaring divergences in the major economic data along with broad-based and significant downward revisions in payrolls, industrial production and retail sales!

To wit: The non-farm payroll is the least accurate and most heavily revised government data release. One big reason for this is that the survey only has a 40% response rate from what was normally 60% or more pre-pandemic. So think about this: Half of the "job growth" this year has come from guesswork and an excel spreadsheet via the Bureau of Labor Statistics' birth-death model.



Also, take a look at the widening divergence between the non-farm payroll report and the employment level from the household survey (which is the same survey that calculates the unemployment rate each month). The non-farm payroll report shows strong and steady job growth whereas the employment survey shows a stagnating job market.

Consider the data below, according to the BLS, payrolls have risen by 2.6 million since March 2023 whereas employment has risen by only 144,000 over the same period. Equally notable, this supposedly robust labor market has not created one net new full-time job over the past twelve months.

Payrolls vs. Employment Gains Since March 2023:

- Non-farm Payrolls: 2,602,000
- Employment Level: +144,000
- Full-Time Employment: -284,000

And did you know that in the past year, the payroll revisions have been equivalent to nearly 25% of the initially reported number! Yet, markets buy into this non-farm payroll number as if it is gospel.

Bottom Line: Nobody is paying attention to these inconsitencies and downward revisions in the labor data. This is not just a testament to how poor the data quality is on the initial release, but also how this soft-landing view is predicated on statistics that clearly are spurious.

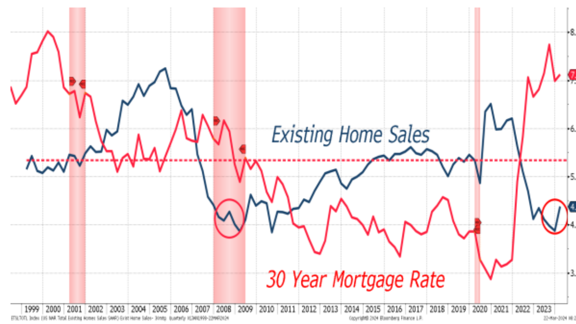
I find this remarkably interesting since practically everyone now considers a recession to simply be out of the question. Could it be that the recession that isn't supposed to happen is now happening?

THE HOUSE THAT ROARED

"Many potential buyers are postponing their purchasing plans in hopes of securing lower rates." — Realtor.com

Buyers came back into the existing home market with February existing home sales soaring +9.5% month-over-month to 4.38 million units at an annual rate, which made a mockery of the consensus estimate of -1.3% to 3.95 million units. This is the highest level and sharpest increase in a year.

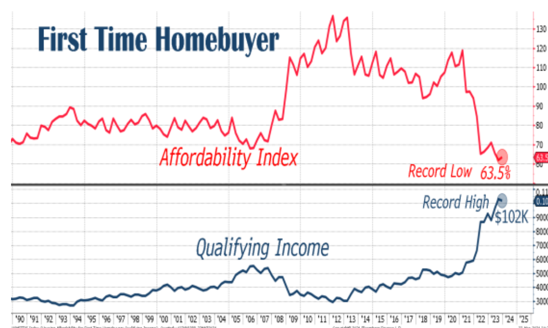
Even still, to put the rise in perspective, sales were down 26% from February 2022, down 29% from February 2021 and down 19% from February 2019. Existing home sales are now back to a level first reached in 1998. In other words, home sales remain at very low levels because homeowners with 3% mortgages are **neither buying nor selling.**



Median prices climbed +1.6% (after seven straight declines) to $384,500. On a year-over-year basis, prices are +5.8%. However, they are down by 7.1% from their recent highs.

This price move came against the backdrop of a tight resale market becoming even tighter as the inventory backlog has been pared for four months in a row. The supply has decreased from 3.1 months in December to 3 months in January, and further down to 2.9 months.

Needless to say, this market is not very friendly to new buyers. With affordability now very stretched, it has become nearly impossible for first time home buyers to get a piece of the "American Dream." Also, first-time buyers were responsible for only 26% of sales, which is not surprising.



A MYTH

"Federal debt has grown 8500% from $372 billion in 1970 to $33 trillion in 2023... By lunch debt will soar more... by dinner time, more... and more. I'm not trying to scare you. It's just scary." — Keith McCullough, CEO, Hedgeye

I continue to hear about how runaway fiscal deficits and debts are the primary cause of higher bond yields in the U.S. That is not true. In fact, as shown below, there is a low correlation between fiscal policy and the bond market. The relationship only rises insofar as these deficits generate inflationary pressures. There have been countless times when the U.S. government had runaway deficits during years when Treasury yields have come down.

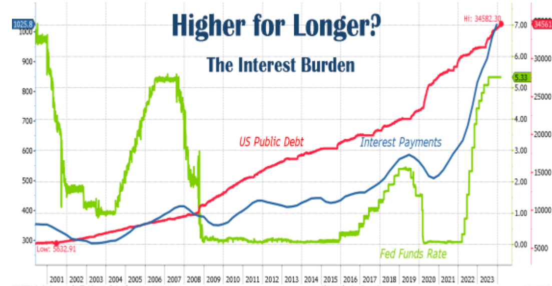
If government deficits and debts are the be-all-that-ends all, how is it that countries like Greece with a whopping 183% debt-to-GDP ratio could have a 10-year yield of 3.41%. Portugal has a 3.06% 10-year yield with a 113% debt-to-GDP ratio. Meanwhile, Italy has a 132% debt-to-GDP ratio and a 3.69% 10-year bond rate.

The current 4.2% yield on the 10-year Treasury is higher than these other fiscal basket cases, and there is only one reason why: Monetary policy has a far more powerful influence on current market rates than fiscal policy (or anything else, for that matter).

Source: Bloomberg

At the end of 2023, the market was pricing in six rate cuts and the 10-year Treasury yield was at 3.8%. While the Fed may have become less dovish at the margin — a small majority of 10 out of the 19 Federal Open Market Committee (FOMC) members are calling for three cuts this year; nine expect two or fewer — the 2024 median dot plot (insofar as it means anything) remained at three moves. But the swaps market now is pricing in just 71% odds of a rate cut by June 12, which is up from 59% a week ago, and 75% odds that we see three moves by the end of the year. Meanwhile, the 10-year Treasury yield is taking a serious stab at both the 100- and 200-day moving averages at 4.2%.

Let me add this. The under-appreciated fact is that the Fed's policy philosophy of "higher for longer" interest rates is putting an untimely and unnecessary squeeze on public finances. This makes "higher for longer" more of a problem for Treasury Secretary Janet Yellen than Fed Chairman Jermone Powell.

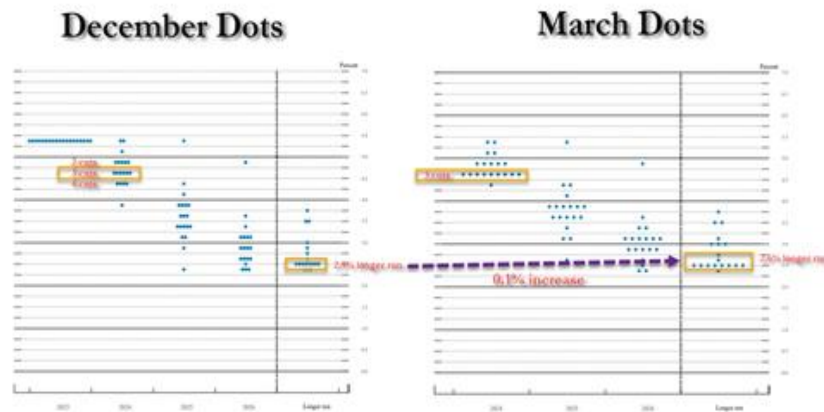


Bottom line: According to the consensus, the culprit of those higher rates, or so the story goes, is the persistent large deficits and high debt burden (over 120% of GDP) carried by the U.S. federal government. But from recent economic history, that logic is completely backwards. By staying too high for too long, the Fed risks setting the flame to America's fiscal tinderbox and dragging down its long-run growth prospects.

THE DOTS

The big positive at the FOMC meeting was that the three rate cuts for this year stayed intact. There was a lot of chatter leading up to the meeting that there would be two moves.

That said, the Fed now expects one less rate-cut in 2025 with rates trimmed to 3.875% from 3.625% and to 3.125% from 2.875% for 2026. And in a new wrinkle, the so-called “neutral” rate has also been increased very modestly up to 2.625% from 2.5%.



Source: Bloomberg

The macro view shows the Fed expects the following for 2024:

- 2.1% GDP growth
- 4.0% unemployment
- 2.4% PCE headline inflation
- 2.6% PCE core inflation

Notably, as of December, their GDP projection made a big jump from 1.4% while their unemployment and inflation projections didn’t change much. This suggests that the committee sees little to no chance of a recession this year. During the press conference, Powell referred to the economy as being “strong” on numerous occasions. I sense he is still living in 2023 when we had a credit card boom, the last leg of excess savings and radical fiscal stimulus. None of these are recurring in 2024.

And the facts are the facts. So far in the first quarter, with one month to go, there have been contractions in three key macro variables: Real retail sales (-5.6% at an annual rate), housing starts (-9.6%) and industrial production (-2.0%). Historically, the average real GDP growth rate was -3.0% at an annual rate when those three indicators shrink. Ergo, while June is some time away, I sense by then we will be seeing a totally different set of projections.

They also expect the unemployment rate will end the year at 4%, down slightly from previous estimates. Additionally, they predict inflation will end the year at 2.4%, which is in line with previous estimates and won't hit the Fed's 2% target until 2026.

Powell also signaled balance sheet reduction will slow, which means less quantitative tightening and more quantitative easing.

"We did not make any decisions today. The general sense of the committee is that ***it'll be appropriate to slow the pace of runoff fairly soon,*** *consistent with the plans we previously issued."*
— Jerome Powell, Federal Reserve Chairman

Powell also dismissed the recent jump in the CPI and PCE inflation in the January and February figures.

Powell added that February PCE wasn't "terribly high."

Bottom line: Based on the Fed's outlook, it's a bit confusing why Powell morphed from hawk to dove. What's the reason to cut? Their own projections say it won't do anything beneficial.

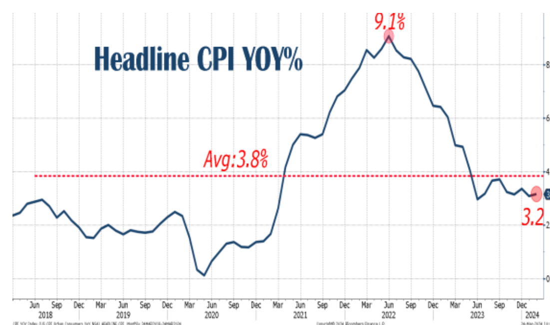
"There's reason to think that there could be seasonal effects there." — Jerome Powell, Federal Reserve Chairman

The answer may be that the Fed views the economy more fragile than their forecasts suggest. And they are keenly aware that lower rates would obviously help many borrowers, not least the U.S. Treasury, along with many leveraged businesses and consumers. Lower rates might spur some construction activity, which, if it expands housing supply, would help bring down inflation. Or then again, it's an election year!

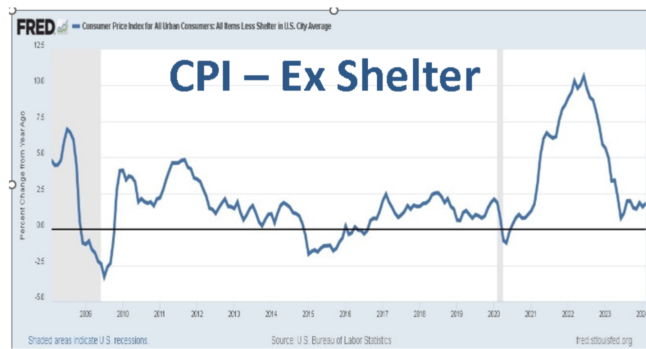
IS THE BOND MARKET OVERREACTING?

It's getting slightly tiring hearing about the "hot" inflation numbers in January and February. Yes, they were "hot" at the headline level, but not so much in the details. This is arguably why Powell was non-plussed about the issue at his FOMC post presentation last week.

Further, it's rather incredible that no credit is given that we are now at +3.2% year-over-year inflation after having peaked at +9.1% in June 2022. Only nine other times in the past century has the inflation rate fallen this hard over a 20-month span, and each time, the economy was either heading into, already in or crawling out of a recession.

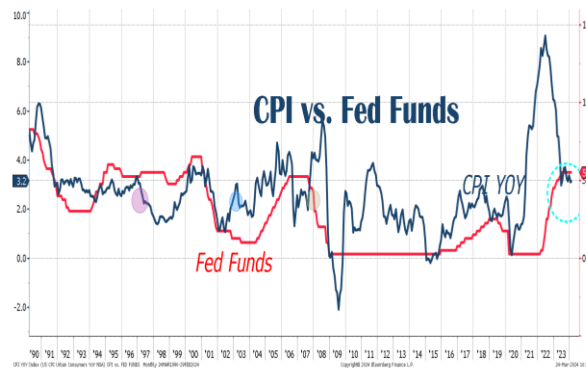


Meanwhile, if the shelter components of the CPI are excluded, which have nothing to do with the prices anybody is paying, inflation is already at 1.8% compared to over 5% a year ago. The core is at 2.2% as compared to 3.7% a year ago.



Anecdotally, consider that IKEA just announced that it is set to cut prices on more than 1,000 products that it sells in the U.S. They also added that more discounting "is to come" because American consumers "are more price aware." The bull market in price gouging is in the rear-view mirror.

One other thing. The current inflation rate is exactly where it was in May 1995 when the Fed was set to cut rates three times over the ensuing eight months. It's where it was in February 2003 when the Fed had already cut the funds rate by -525 basis points to 1.25% at the time. And again, it's half of a percentage point less than where it was in October 2008, when the recession was 10 months old (hence why inflation is a lagging indicator), and the Fed had already sliced the policy rate by -425 basis points (again, to an unexpected 1.0%).



Bottom line: Nothing moves in a straight line. So, we can all pull out our hair because of the latest month or two of unfavorable inflation data (that may be a statistical aberration). When you look at the big picture, the disinflation trend is fully intact. Moreover, remember that the inflation data is lagged, and is, for the most part, driven by aggregate demand.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"Interest rates are declining — normally, that would provide a tailwind for home and auto sales. The fact that both markets remain stagnant confirms one thing: U.S. consumers are not in good shape." — Keith Mccullough, CEO, Hedgeye

Homes and autos are out of reach for most Americans, and the highly leveraged and debt addicted U.S. economy simply cannot sustain "higher for longer." The hard part is timing when the rates reverse.

Instead of focusing on "when," as I've emphasized since the first edition of this publication in 2008, in terms of portfolio strategy for credit unions that have "excess" cash balances, the most prudent strategy and discipline is to continue to

build a risk-appropriate ladder. Market selloffs provide excellent opportunities to invest in longer duration securities. Continue to stay the course.

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.

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