alloya INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

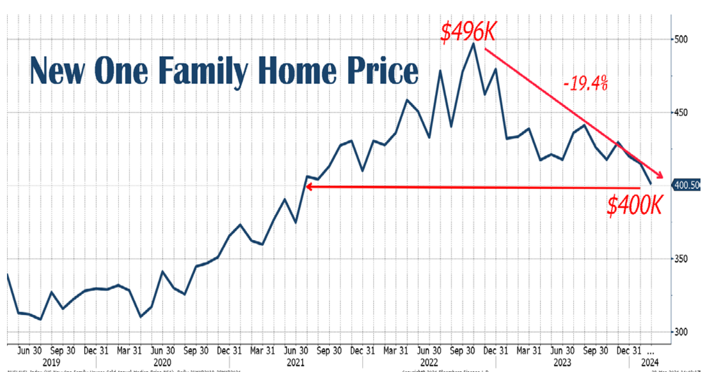
WEEK OF APRIL 1, 2024

Lower the Price and They Will Come

"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

New home sales dipped -0.3% month-over-month in February to +662,000 annualized units, which came as a surprise to the consensus expecting a +2.3% run-up to +677,000. Sales in the Northeast (-31.5%) and Midwest (-2.4%) were notably soft.

Meanwhile, builders are doing what they can to move inventory by some heavy-duty discounting. The median price dropped -3.5% month-over-month and has deflated in each of the past three months, and in five of the past six. From 2022, new home prices are down by 6.3%. Compared to the peak in October 2022, the median price has dropped by 19.4%. At just over $400,000, the median new home price has dialed its way down to the lowest level since June 2021.

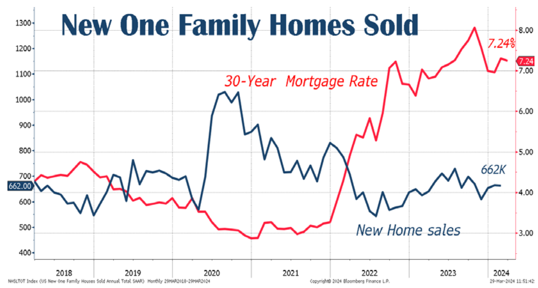


It's also important to note that the new home prices shown do not include the substantial costs of mortgage rate buydowns that homebuilders use to stimulate sales in this market where sales of existing homes have plunged. Mortgage rate buydowns lower the monthly payment but do not lower the contract price of the house. Prices here also don't include other incentives, such as free upgrades and other incentives on top of it to make deals. These prices also show that homebuilders are building smaller homes with less expensive amenities at lower price points.

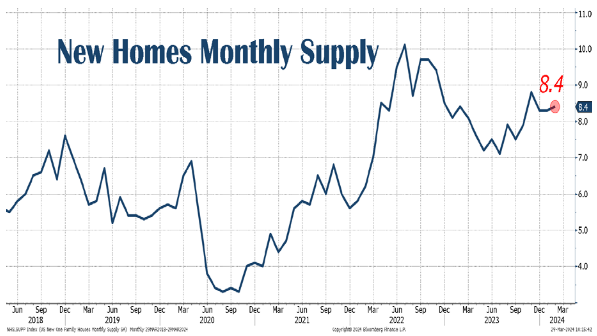
THIS WEEK

This aggressive sales approach on the part of homebuilders has led to prospective homebuyers favoring new homes over existing homes. As displayed in the graph below, compared to February 2019, new home sales were down only 4.8%, despite the 7% mortgage rates. On the other hand, existing home sales have plunged by nearly 20% during the same period.

Homebuilders are competing directly with existing (resale) homes. They're in the business of building homes, and they cannot try to outwait this market, as many potential home sellers are trying to do. The fact that sales of new houses are hanging in there despite 7% mortgage rates shows that homebuilders are running circles around homeowners trying to sell.

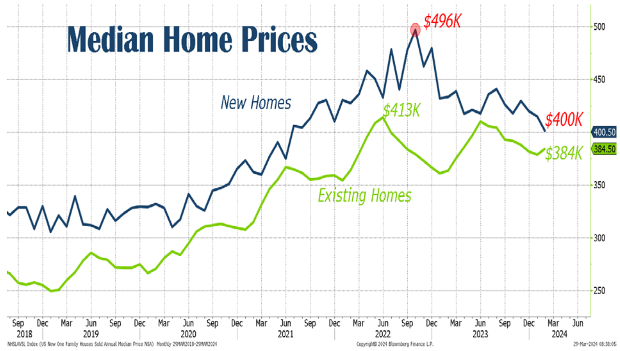


Meanwhile, the inventory of new homes got a touch worse, edging up to an 8.4 months' supply of unsold homes from 8.3 months in December. This will further encourage builders to make deals.



Now consider the price difference between new and resale houses. The national median price of new single-family houses has fallen faster and further than the national median price of resale single-family houses.

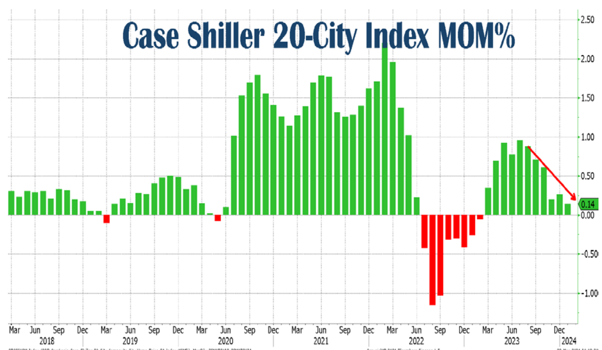
For some perspective, the unusual narrowing price difference – as homebuilders lower their prices more quickly than homeowners – also happened in the leadup to the Great Financial Crisis and lasted a number of years. Prices of resale homes eventually fell so much that they became competitive with new houses again toward the end of the housing crisis in 2012.



Bottom line: Homebuilders are aggressively taking sales away from homeowners. And the price difference between new and resale single-family houses has narrowed to historic levels. What comes next?

THAWING OUT

Following the dive in new home prices, Case-Shiller (CS) home price index came in at half the consensus expectation in January — inching up just +0.1%. (This index is for existing home sales.)



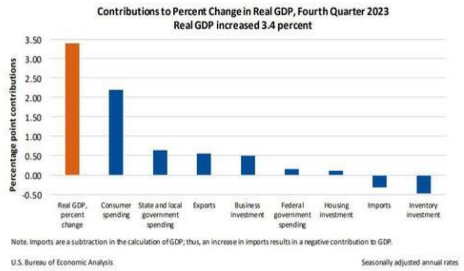
Given that Case-Shiller data lags, I suspect home prices are actually falling. (I know they are in the Sarasota area.) You can tack on the 0% print in the Zillow median list price index in February after six months of decline, alongside the fact that up to 55% of homes being sold are below the offer price – the highest proportion in ten months. Thus, it would appear that the weak housing demand story is catching up to the tight inventory backdrop (in the resale market, not in new housing).

All of this points to a thaw unfolding in residential real estate, and this is now becoming a buyers' market for a change. The question is when this will show up more forcefully in the Consumer Price Index (CPI) data.

HOTTER THAN EXPECTED

"The economy is strong. We see very strong growth. There's no reason to think that the economy is in a recession or is at the edge of one. That means that we don't need to be in a hurry to cut."
— Fed Chairman Jay Powell, in a Q&A session in San Francisco on Friday morning

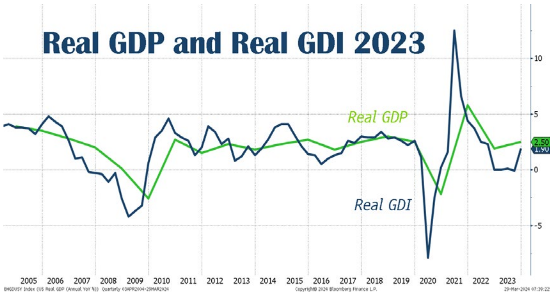
It's ancient history now, but the third estimate of Q4 GDP rose 3.4%, above the 3.2% reported last month and above the 3.2% estimate. The increase in Q4 primarily reflected increases in consumer spending and state and local government spending that were partly offset by a decrease in inventory investment. Imports, which are a subtraction in the calculation of GDP, increased. As shown in the visual below, the biggest contribution by far was personal spending, which contributed 2.20% to the bottom-line GDP of 3.4%, or two-thirds of the total, up from 1.91% in the first calculation.



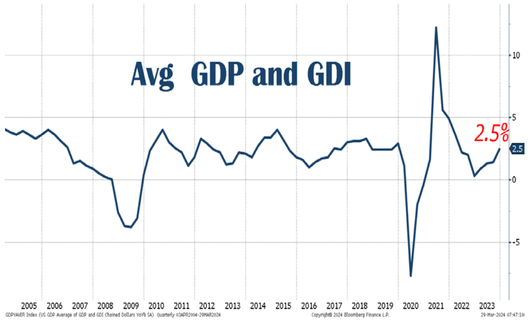
CONFOUNDING DATA

Gross Domestic Product (GDP) gets all the media attention, but many economists and analysts, me included, think Gross Domestic Income (GDI) is a better number. GDP and GDI are two measures of the same thing (i.e., product produced should match sales and income). They do over time, but there is currently a large ongoing discrepancy.

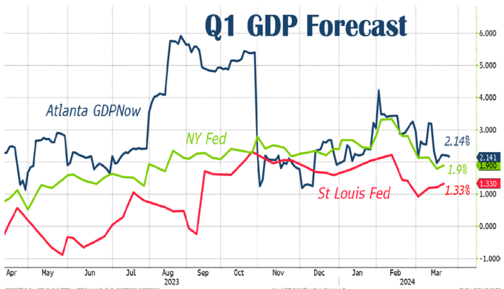
The 2023 annual total for GDP is +2.5% but only 0.5% for GDI. Year-over-year, GDI was essentially flat for four consecutive quarters, while GDP rose 0.7%, 1.7%, 2.4% and 2.9% for the same periods.



So, what's the real story? It's unclear, but given the lags and distortions coupled with the assumption that both indices will converge, the question then becomes which index converges to which index? Perhaps a better representation of growth would be the average of GDP and GDI. As shown below, this average is 2.5%.



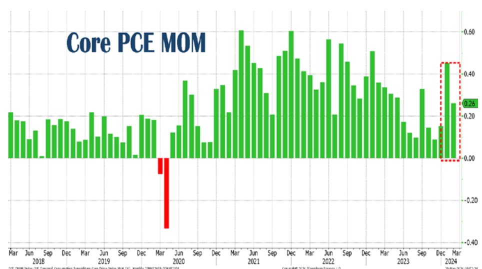
As noted, the Q4 GDP data is ancient history. More relevant to the markets and Fed policy is what happens going forward. While the official Q1 GDP data will not be released until April 25, the current tally shows GDP downshifting. The range is graphically presented below and ranges from a high of 2.14% (Atlanta) to a low of 1.33% (St Louis). Note this is not a *forecast* but a running tally of incoming economic data.



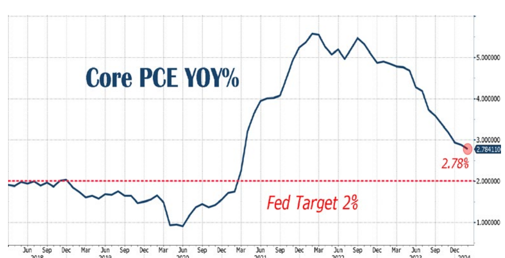
EYE OF THE BEHOLDER

"The fact that the U.S. economy is growing at such a solid pace, and the fact that the labor market is still very, very strong, gives us the chance to just be a little more confident about inflation coming down before we take the important step of cutting rates." - Jerome Powell

One of the Fed's favorite inflation indicators, Core Personal Consumption Expenditures (PCE) Deflator, which strips out food and energy, increased 0.3% from the prior month. That followed a 0.5% reading in January, marking it the biggest back-to-back gain in a year. Over the last three months, core inflation has been running at a 3.5% annual rate. That's up from 1.6% in December and the highest since last May.

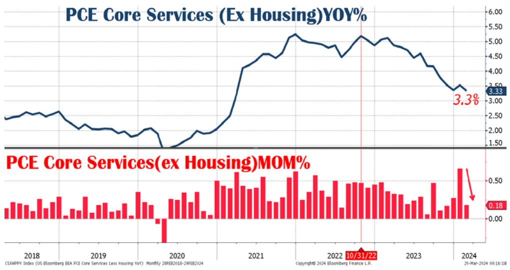


On a year-over-year basis, the core PCE was flat at +2.8% (as expected) – the lowest since March 2021.

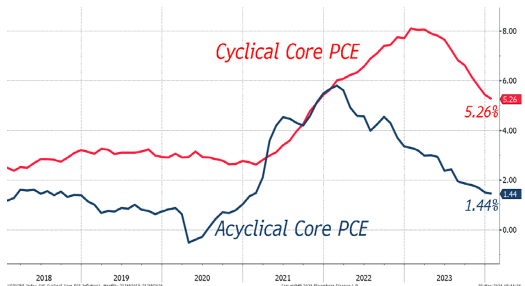


Jerome Powell seemed pleased with the release.

The so-called SuperCore – Services inflation ex-Shelter – tumbled significantly as healthcare cost inflation fell and other service prices deflated. The one-month number (+0.2%) slowed from January (+0.7%), but like the core PCE, the three-month number rose uncomfortably. On a year-over-year basis, this index has declined to 3.3%.



Finally, one can look at the core PCE inflation by cyclical and acyclical components. *Cyclical* components include those categories where prices tend to be more sensitive to overall economic conditions. *Acyclical* components include those categories that are more sensitive to industry-specific factors. The cyclical core PCE inflation remains extremely high, although it has fallen from its highs. The acyclical core PCE has declined to 1.44%.



Bottom Line: Like the recent Consumer Price Index and Producer Price Index prints, which is more important: that the general trajectory of inflation over the last year remains downward, or that price gains tick up substantially in the first two months of 2024? That will be the central question for both markets and the Fed.

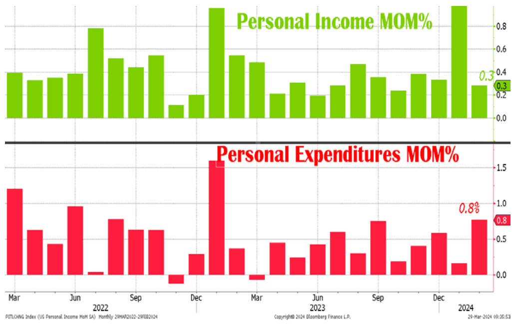
While there's broad-based expectations that those better inflation prints will come about, until that data is released and we get either confirmation or a different view on what the data is going to be, it's kind of hard to gauge exactly where we end up from a Fed policy perspective.

The Federal Open Market Committee dots and fed fund futures points to a June rate cut on the way. But for that to happen, the next couple of months of data will need to look markedly different than the last couple of months.

YOLO SPENDING CONTINUES

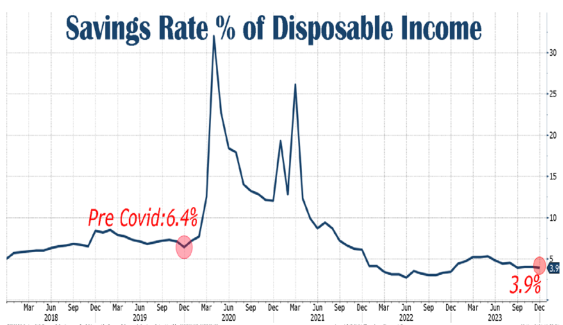
"Clients are generally saving less than they were before the pandemic. Instead of solely planning for retirement, they're focused on "maximizing life now" to make room for more travel, concerts and fun. People already had this attitude that you only live once — and that's been put on steroids…COVID was a big wake-up call that life is precious, so you've got to enjoy it now."
- Carolyn McClanahan, a financial adviser

Consumers keep splurging on goods and services, despite endless expectations that they would run out of steam. There are more people working, and they're making higher income. Yield investors have been receiving 5%-plus in interest on their trillions of dollars in money market funds, CDs, high-yield savings accounts and T-bills. Mom-and-pop landlords received nice rent increases. It all adds up, and folks spent their income and more.



I should point out the heavy spending is still lopsided in services, and among those are insurance, healthcare and housing costs. That doesn't seem to reflect actual production of value, it just means things are getting a lot more expensive and Americans don't have much choice except to eat those extra costs. For example, down in Florida homeowner insurance costs are soaring because of all the natural disasters. The same thing is happening in Texas.

Thus, on a year-over-year basis, spending is once again outpacing income growth. As one would expect with that level of spending, the savings rate collapsed to its lowest since December 2022.



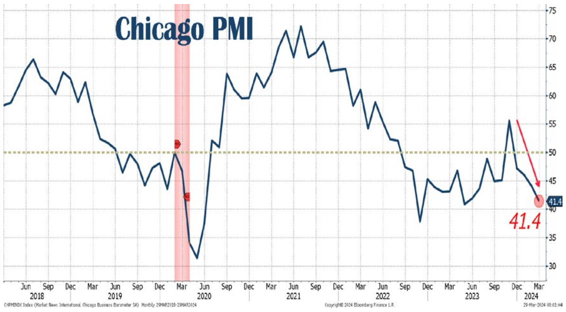
Bottom line: While consumer spending remains strong, the data from the banks is showing credit card delinquencies at their highest since the Great Financial Crisis (GFC) and a lot of debt carry-over, with more making just minimum payments. Likewise, auto repos are up to the highest level since the GFC. Thus, there's a lot of confusing, contradictory data here. Maybe the record-high fiscal spending explains a lot of the contradiction. It's more of the same over-stimulus even after COVID and another sign that the Fed and national debt are drunken sailors shoveling printed money into the economy that leads to these numbers, even with more Americans falling into delinquency.

A COLD WIND IN CHICAGO

The Chicago Purchasing Managers' Index plunged to 41.4 – its lowest since May 2023 – from 44.0 (and well below the expected bounce to 46.0).

Under the hood was even more problematic:

- **New orders fell at a faster pace**, signaling contraction
- **Employment fell** at a slower pace, signaling contraction
- Inventories fell at a faster pace, signaling contraction
- Supplier deliveries fell at a faster pace, signaling contraction
- **Production fell at a faster pace,** signaling contraction
- Order backlogs fell at a slower pace, signaling contraction

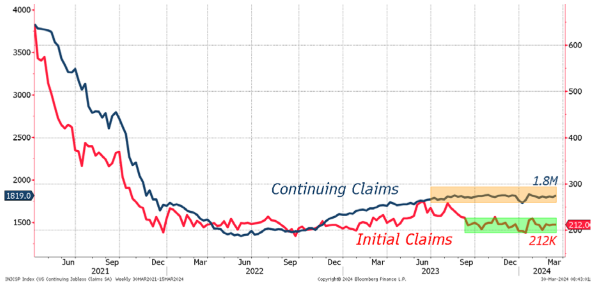


Bottom line: Slower growth, declining production, shrinking orders, falling employment... and accelerating inflation.

MORE CONFOUNDING DATA

Layoff announcements continue day after day and Worker Adjustment and Retraining Notifications (WARNs) – advanced layoff announcements – are on the rise, but initial jobless claims continue to trend along in a very smooth manner.

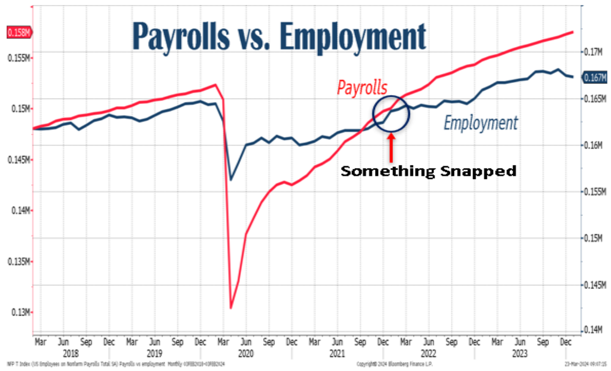
Meanwhile, continuing claims have been flat around 1.8 million Americans for months.



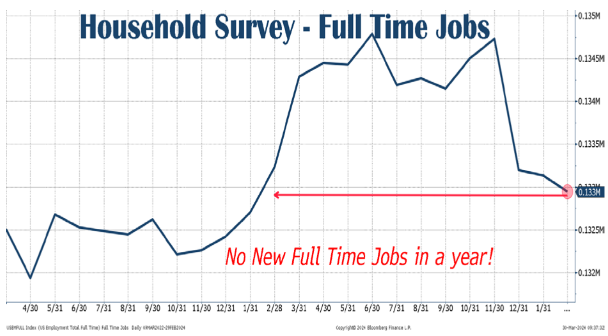
There's also a striking discrepancy between the number of U.S. payrolls (as measured by the Bureau of Labor Statistics' (BLS) Establishment Survey, a far more crude and imprecise, yet much more market-moving data series), and the number of actual Employed Workers (as measured by the BLS' far more accurate Household Survey).

As shown below the two series had tracked each other tick for tick for years, but in March 2022 something snapped, and a wide gap opened and has widened since. In fact, since March 2023, non-farm payrolls (BLS data) rose 2.6 million, whereas those employed (BLS data) increased by only 144,000.

As a reminder, the household survey has no duplication of individuals, because individuals are counted only once, even if they hold more than one job. In the establishment survey, employees working at more than one job and those appearing on more than one payroll are counted separately for each appearance.



Some of this discrepancy could be explained by the record surge in multiple jobholders. To wit: In February 2024, the U.S. had 132.9 million full-time jobs and 27.9 million part-time jobs. This is great until you look back one year and find that in February 2023, the U.S. had 133.2 million full-time jobs, or more than it does one year later! So, all the job growth since then has been in part-time jobs, which have increased by 921,000 since February 2023 (from 27.020 million to 27.941 million).



Finally, I should remind readers that the BLS had been consistently downward revising virtually all initial job prints in 2023. (Ten of the 11 jobs reports heading into December 2023 were revised lower.) But that's not all. The Philly Fed found out that the BLS had overstated payrolls by 800,000 through December 2023.

Bottom line: The jobs data continues to confuse.

SHOULD YOU FOLLOW THE DOTS?

Short answer, no!

It never fails to amaze me how much emphasis everyone puts on the Fed “dot plots,” as if they truly mean anything. In actuality, what they have done is provide noise and distraction into the analysis of monetary policy, not to mention endless “head fakes” along the way. To wit:

- At the end of 2015, the median “dot” was predicting four rate hikes in 2016. What happened? One hike at the very end of the year.
- At the end of 2016, the under-dot plot was 1.375%. Instead, the fed funds rate closed at the 0.50-0.75% target range.
- At the end of 2018, Fed Chair Jerome Powell was threatening to take the funds rate above the estimated neutral level of 3%. In 2019, the median “dot plot” was calling for three more rate hikes to 2.875%. Yet, the fed funds ended the year at the 1.50-1.75% target range!
- At the end of 2021, after the economy reopened, and nine months after the massive Biden stimulus checks, the median dot plot for the end of 2023 (the year that just ended) was 1.625%! And guess what happened? The fed funds rate ended the year at 5.375%!

I should add it’s not just the “dots”. Look at the accuracy of the Fed’s forecasts back to 2012:

- Fed funds rate: accurate 37% of the time
- Core inflation: accurate 29% of the time
- Unemployment rate: accurate 24% of the time
- Real GDP growth: accurate 17% of the time

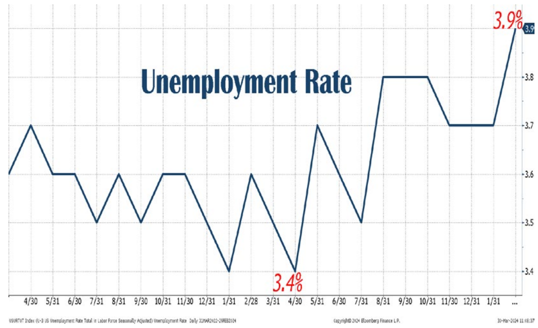
Even still, to this day, everyone is talking about these insane dot plots! To which I say, Who cares? These Federal Open Market Committee (FOMC) officials really have zero clue as to how things are going to play out in the coming quarters and years as the historical record strongly suggests. Ergo, we should probably be spending more time trying to figure out how wrong they will be.

Bottom line: I remain skeptical of the Fed’s forecasts, even though investors treat them (and the dot plots) as gospel.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The latest data shows solid GDP growth, inflation as expected and good consumer spending. What is going to fall out of bed in the next few months to justify a rate cut? Hmm…

You can argue from demographics that maybe this time is different, but history does suggest that when unemployment turns higher following these low points, recession is not far away. The most recent low was 3.4% in April 2023. The unemployment rate has since climbed a half-point higher. That should be a warning sign for the FOMC members.



Could the "lagging effects" of the Fed's tightening raise unemployment and even bring the economy close to recession? Maybe. Despite the Fed's upped gross domestic product (GDP) growth forecast of +2.1% for 2024 (as per a fresh set of projections and dot plots), all the FOMC members think unemployment has bottomed out. Most (13 out of 19) expect it to end this year at 4% or higher.

At the same time, from now to the end of 2026, the Fed is assuming that the median funds rate will decline -150 basis points by the end of next year to 3.875% and by -225 basis points through the end of 2026 to 3.125%. Historically, any move down in the funds rate close to -150 basis points (the forecast by the end of 2025) only occurred because of one thing: the Fed turned its attention towards fighting a recession.

Bottom line: While the consensus expects three rate cuts this year, if inflation does not continue to decline and consumer spending remains robust, there is also a chance that the Fed will not be able to cut rates at all. In other words, it'll come down to the incoming data.

Until the dust settles and visibility improves, uncertainty will be the watchword.

As I have been stating since the first edition of this publication in 2008, in terms of portfolio strategy, for those credit unions that have "excess" cash balances, the most prudent strategy and discipline is to continue to build a risk-appropriate ladder. Market sell-offs provide excellent opportunities to invest in longer-duration securities. Stay the course.