Weekly Relative Value

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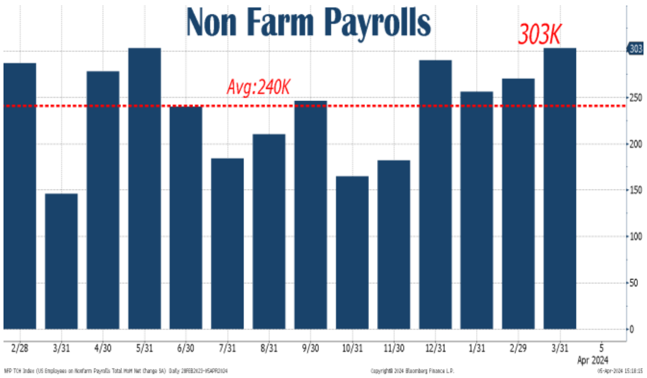
WEEK OF APRIL 8, 2024

Jobs Roar Again

"If service inflation shows signs of picking up in the Consumer Price Index (CPI) and personal consumption expenditures (PCE) reports later this month, Fed 'patience' might run thin. *…Risk assets ignored the rates move until this week since Jan and Feb could be glossed over as noise. But* ***if the economy is staying too hot, the market should question Fed cuts and the specter of Fed hikes comes back to the market****."*
— Priya Misra, Portfolio Manager, JPMorgan Chase

Once again, the non-farm payroll report surprised to the upside with the headline coming in at +303,000 compared to the consensus forecast of just over +200,000. Since last May, this was the best monthly tally. And not only was it hotter than last month's revised number of 270,000 (was 275,000), but it was above the highest Wall Street estimate of 290,000. And unlike previous reports, there were upward and not downward revisions to the prior two months — totaling +22,000.

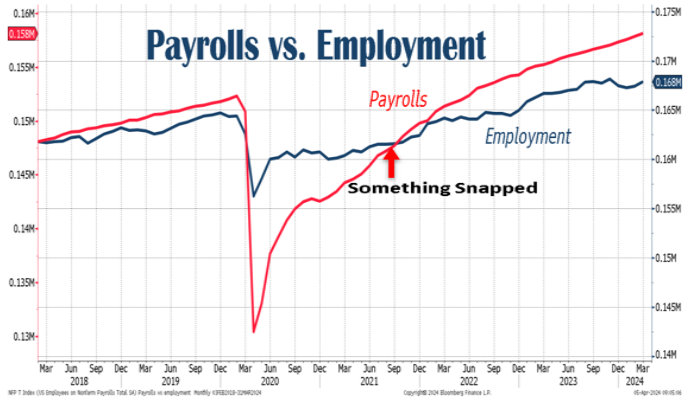
I should also remind readers that in the past year, the headline has beaten consensus views 75% of the time. However, this is a façade because the revisions have been fast, furious and squarely to the downside, totaling -484,000 since January 2023, or the equivalent of more than 15% of the average headline figure.



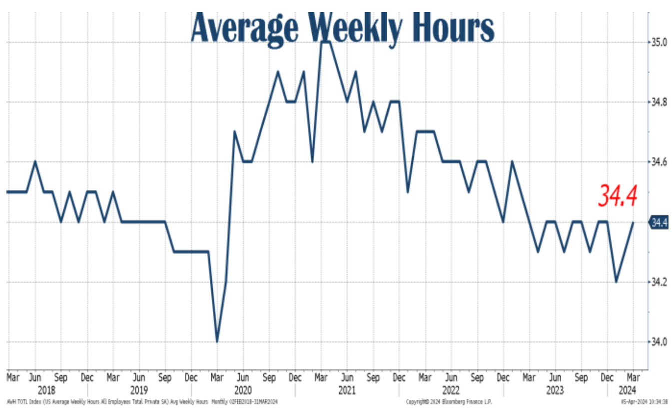
THIS WEEK

- THE CONSUMER IS KING
- U.S. TRADE DEFICIT WIDENS AGAIN
- CONFUSING & CONFLICTING DATA
- MARKETING OUTLOOK AND PORTFOLIO STRATEGY

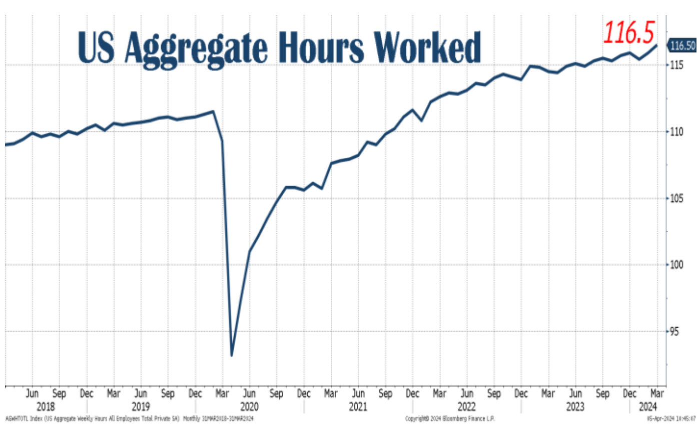
And what made this employment report different than its recent predecessors was the fact that there was a hot +498,000 surge in the household survey (the first monthly increase in four months). Still, as shown below, the data series has a lot of catching up to do.



Adding to the strength at the headline level was the +0.3% expansion in the workweek to 34.4 hours from 34.3 hours in February (consensus was 34.3 hours).

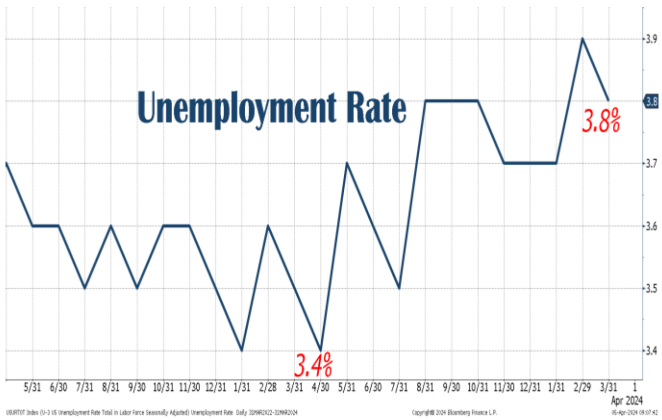


The index of aggregate hours worked (hours worked times employment), the complete proxy for labor market input into the economy, jumped +0.5% month-over-month and that followed a +0.4% rebound in February. For the first quarter as a whole, this key metric rose at a +1% annual rate. Barring a faltering in productivity, it does look as though the first quarter real gross domestic product (GDP) growth will now line up positively.



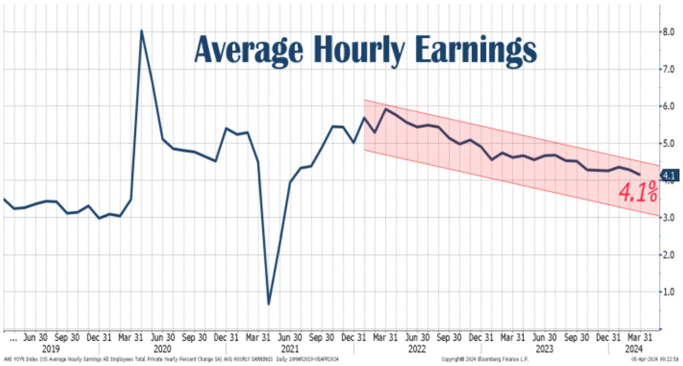
Turning to the unemployment rate, it unexpectedly dipped again, dropping to 3.8% from 3.9%, which was in line with estimates.

For those waiting for a rate cut, this metric is heading in the wrong direction considering that the Fed has penned in 4% as a requirement for its three (barely three) rate cut projections for this year (looking increasingly remote at this juncture).

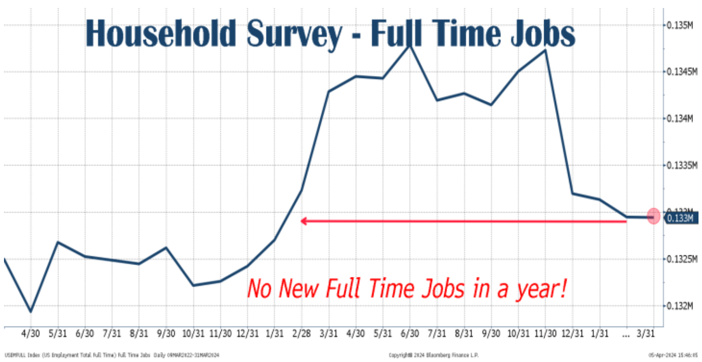


The usual suspects on the positive side in services remained the same: leisure/hospitality (+49,000), education/health (+88,000) and government (+71,000). So, close to 70% of the gain came from just three sectors. This speaks to a certain high level of concentration, but that was just one of a few blemishes on this otherwise stellar report.

At least there was no bombshell from the wage data, matching the consensus estimate of +0.3%. On an annual basis, the hourly earnings rose 4.1%, as expected, and went down from 4.3%. This was the lowest print in almost three years — the last time wages rose by this much was in the summer of 2021.



All the run-up and then some was from part-time employment. The number of part-time jobs soared by 691,000 to 28.632 million, which is up from 27.941 million, while full-time jobs dropped by 6,000 to 132.940 million from 132.946 million. Full-time employment is now down -1.8 million in the past four months! Over the past year, the economy has shed -1.3 million positions while the number of part-time workers exploded by 1.888 million! Never before has this happened without the economy being in a recession, so dare I say that it may well be different this time. Surreal as it sounds.



Also, we have to consider that the +145,000 (after a +290,0000 surge in February) of people that showed up as a "new hire" were actually folks who became "self-employed." So yes, there is a bull market in the labor market data but apparently mostly in consulting work out of the home office.

As I delved more into the details, I also see that within the confines of the household survey, all the gains here and then some came from the very young (+349,000 for the 16-24-year-old group). The employment in the critical breadwinner 25-54-year-old group cohort fell -48,000.

And one added nice wrinkle was the expansion in labor supply. The participation rate edged up to a four-month high of 62.7% from 62.5%. This is preventing wage growth from accelerating even as the trend remains north of 4%.

Bottom Line: Folks can quibble with some of the details, but overall, the jobs report was solid. There is nothing in this report that indicates that the Fed should cut rates. The data is simply far too hot for the Fed and the bond market.

"The tailwind from easing financial conditions is overwhelming and neutralizing the rate hikes from last year… The stock market is up +$10 trillion over the past five months, which is a significant wealth gain for household balance sheets…It's not surprising that the economy is re-accelerating and, therefore, rates will have to stay higher. These factors will all support consumer spending... ***We are sticking to our view that the Fed will not cut interest rates this year."*** *— Torsten Slok, Resident in House Permabear, Apollo Global Management*

THE CONSUMER IS KING

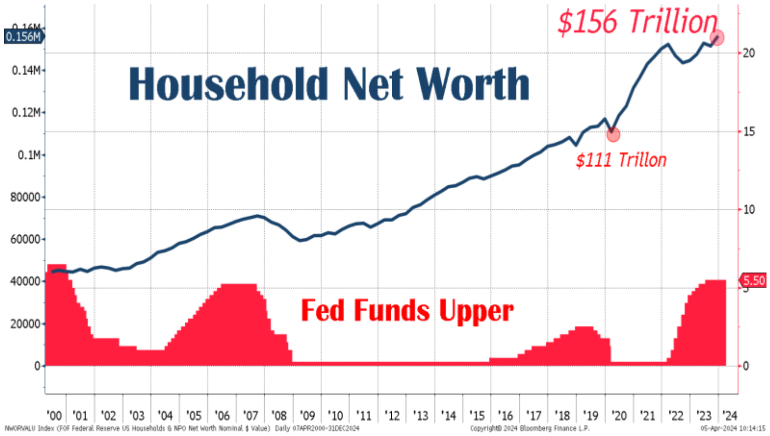
While the economy is hardly rolling over the average of the nowcasts from the Atlanta, New York, and St. Louis Feds, the first quarter real GDP growth is coming in at a +1.96% annual rate. Unquestionably, the U.S. economy has behaved far better than many thought (yours truly included). Obviously, that goes for the Fed as well with the boost to the real GDP growth forecast for 2024 to +2.1% from +1.4%.

Of course, the consumer is the key. As long as consumer spending remains robust, it's hard to bet against the US economy.

Beyond the growth of credit card debt usage (YOLO spending), there are two additional explanations for why the consumer remains strong.

The surge in asset prices is having an impact on the consumer and it is significant. Household net worth, courtesy of the bull market rally in equities and the rebound in existing home prices (where there is a dearth of supply), has ballooned +$11.6 trillion in just the past year (+8.0% year-over-year). This is incredible — almost the equivalent of half the annual GDP growth. This is how the personal savings rate has gone from 4.7% to 3.6%.

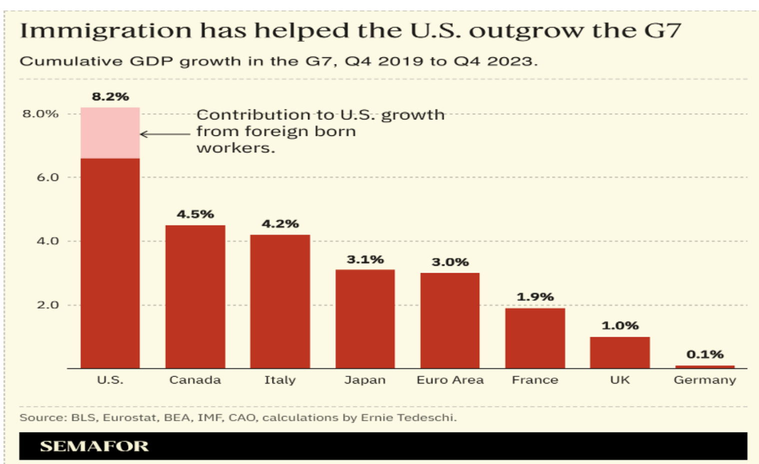
It stands to reason that there will not be any Fed easing until this wealth effect fades. This means it will wait for the inevitable correction in asset values. We have seen this play out too many times in the past to ignore what likely lies ahead.



Second, illegal immigration is in full-fledged boom mode. It is estimated that as many as 2.5 million immigrants entered the country in in 2023, the highest level in the last two decades. Since Biden became President, approximately 5 million undocumented people have crossed the border. Since these immigrants are not documented and are likely working under the table, their income is going unreported. But their spending is being reported. Some food for thought.

By adding millions of new workers to the labor market, the immigration surge has lifted payrolls and growth, according to recent research. In an analysis published earlier this week, Ernie Tedeschi, former Chief Economist for the White House Council of Economic Advisors, found that the post-pandemic pickup in immigration accounted for at least one-fifth of the increase in U.S. gross domestic product since the end of 2019.

There has been a second angle this time courtesy of the Congressional Budget Office (CBO), which recently "calculated" that illegal immigrants will boost U.S. GDP by $7 trillion in the next decade.



Finally, many are not discussing the impact that increased labor supply has on disinflation, which comes from improved labor supply. To wit:

> *"**The emerging consensus: a surge in immigration**. It not only explains inconsistencies in the jobs data but **suggests the economy can keep adding plenty of jobs without overheating**. That in turn **would let the Federal Reserve still consider interest-rate cuts**."*
> *— "The Jobs Numbers Aren't Adding Up. Immigration Helps Explain Why", The Wall Street Journal*

Bottom Line: The problems at the Southern border have become an albatross for the White House. The president himself has said he would "shut down" the border, given the power.

Here's the thing. If Biden were to successfully cut down on the flow of migrants, these latest studies suggest it would deal a blow to hiring and growth. Thus, the politics and the economics are colliding.

The data shows that immigration is good for the economy and is a big reason why U.S. growth exceeds growth in other countries. What this country needs is an immigration system that works well, treats foreign- and native-born workers fairly and is widely seen as sustainable.

Last words go to Federal Reserve Chair Jerome Powell:

> *"I will say, over time, though, the U.S. economy has benefited from immigration. And, frankly, just in the last, year **a big part of the story of the labor market coming back into better balance is immigration returning to levels that were more typical of the pre-pandemic era."***

U.S. TRADE DEFICIT WIDENS AGAIN

> *"While net exports should subtract from first quarter GDP growth, this likely will be due in part to strength in imports, which reflects firming in domestic demand." — Daniel Silver, Economist, JPMorgan Chase*

The trade deficit widened for the third straight month, as the U.S. imports rose $68.9 billion more than it exported in February, the widest since last April. U.S. exports rose in February — by a whopping $5.8 billion — but imports rose faster, surging by $7.1 billion.

Of note: International travel is booming. Travel spending by foreigners in the U.S., which, in the arithmetic of trade, counts as a service export, reached $16.8 billion in February, the highest since before the pandemic.

One factor in the wider trade deficit was a similar surge in Americans traveling abroad, which also counts as a service import. That number reached an all-time high of $15.1 billion in February**.** It's clear that there has been a big boom in later-winter "YOLO" ("revenge-spend") travel, helped along by the strong U.S. dollar.

The question is how long U.S. consumers will be willing to forego savings and run up credit card balances to support this spending, and how much of this discretionary spending is related to the wealth effects as equity portfolios soared in January and February?

Bottom line: The U.S. trade deficit widened in February for the second straight month, coming in at -$68.9 billion against the consensus of -$67.3 billion and January's -$67.6 billion reading. With two months of the quarter now "locked in" (revisions aside), the current account looks set to weigh on growth in the first quarter.

CONFUSING & CONFLICTING DATA

If you're confused about the economy there are good reasons to be. Frankly, since the pandemic recovery began, economic data has become extremely volatile, inconsistent and contradictory. Consider the following divergences between key economic variables in a world-unprecedented:

- Household survey employment: +0.4%
- Non-farm payrolls: +1.8%
- Part-time employment: +3.4%
- Full-time employment: -0.2%
- New home sales: +5.9%
- Existing home sales: -3.3%
- Single-family housing starts: +35.2%
- Multi-family housing starts: -35.9%
- Manufacturing construction (Biden subsidies!): +31.9%
- Manufacturing production: -0.7%
- Real consumer spending: +2.4%
- Real retail sales: -1.6%

Bottom line: There are definitely some mixed messages from the data that the "soft landing" advocates don't seem to be acknowledging. This possibly explains why President Biden's approval rating on the economy has remained near Jimmy Carter levels.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"If we continue to see inflation moving sideways, then that would make me question whether we need to do those rate cuts at all, …There's a lot of momentum in the economy right now."
— Neel Kashkari, Minneapolis Fed President

When one takes a global perspective, an increasing number of countries are either in a recession or are barely skirting by. The Eurozone is in a technical recession. Germany, the Netherlands, the U.K., Sweden, Ireland, Finland and Austria are now in a technical recession. In Asia Pacific, tack on New Zealand. A host of economies are on the precipice thereof, and that includes Canada, Australia, Japan, Switzerland, Italy, France and Spain.

For the time being, the U.S. is the island of prosperity. Indeed, the Atlanta Fed took up its first quarter real GDP growth estimate to a +2.8% annual rate from +2.3%, and that is way too hot for Powell and his colleagues. Of greater importance is the lagged effect of Powell's comments on Friday, and the main message was this: I am in no hurry to cut rates. Not one iota. Why he wasn't this emphatic following the last Federal Open Market Committee (FOMC) meeting? Who knows?

In the inflation file, much of the good inflation news has been due to the goods sector, where PCE inflation has declined from +3.6% year-over-year a year ago to -0.2% right now. If goods prices begin to rise, services will need to provide an offset but the progress in this dominant component of these price metrics has been slow.

The last thing anyone needs is for the goods side to hook back up because the services sector disinflation is hardly occurring quickly enough to please the Fed. We could well be waiting until September, maybe even later, for the Fed to make its move. If so, bonds and stocks will be forced into further readjustment. The picture is not likely to be pretty if the forthcoming inflation data remains stubbornly high.

Powell does seem to be concerned about easing policy too soon and reigniting inflation. He appears to be worried that the latest price data represents something more than just a seasonal quirk and could be a hurdle to further disinflation toward the coveted 2% target.

The run-up in West Texas Intermediate (WTI) to a four-month high is a problem too. Oil is up a blistering +25% year-to-date and there is a risk that, in the near term, this will also spill into the core CPI and PCE deflators. The CRB has broken out to summertime 2022 levels to boot. The CRB index covers 24 commodities from gasoline to sugar to soybeans, and it's up 15% year-to-date. This is a problem. Meanwhile, asset prices, and the economy for that matter, are telling the Fed that it doesn't need to take action yet. Thus, a data-dependent Fed will let the data tell the tale.

The "dot plot" from the March FOMC meeting showed that the 19 participants were nearly evenly split, with nine seeing two rate cuts in 2024, nine seeing three rate cuts and one seeing four rate cuts — leaving the median at three cuts. Along with two worse than expected inflation readings in January and February, many Fed officials have given speeches fretting about the path of inflation and walking back their own rate-cut expectations.

They're fretting that something has changed in the economy. Even the 5.25% to 5.5% short-term policy rates, which were supposed to be "restrictive" and that were widely expected to throw the economy into a recession, have not been restrictive and have not slowed the economy.

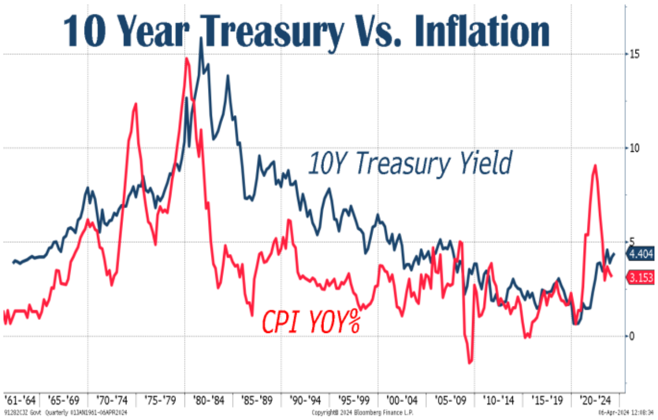
"While it is not my baseline outlook, I continue to see the risk that at a future meeting we may need to increase the policy rate further should progress on inflation stall or even reverse."
— Michelle Bowman, Fed Governor

As a result, the markets now assign just a 48% chance of a rate cut by June. Overall, the swap market has reduced expectations of rate cuts to 2.7 cuts priced by year-end, which is now below the median Fed dot plot. As a reminder, from November into mid-January, there was the rate-cut mania. The federal funds futures were seeing very high probabilities of five or six rate cuts, and even seven rate cuts in 2024, spread over the eight Fed meetings. At the beginning of the year, there were four cuts penciled in. It's interesting how the narrative in the market changed so quickly.

Frankly, we must be prepared for the prospect that the Fed doesn't budge at all this year. What was once a remote chance is now a reasonable probability (that the Fed sits on its hands). For it to change, something will need to break, either in the labor market or in the financial markets.

Talk about a rough week. The 10-year Treasury yield jumped +18 basis points to 4.38% — touching 4.43% at one point — the highest close of 2024. The yield is now up +50 basis points in just the past two months, from February's lows. Last week, the bond markets began to adjust to the more hawkish rhetoric from the Fed. During rate-cut mania in December, the yield had dropped below 3.80%. Now, there's suddenly lots of talk that the 10-year yield will revisit 5%, where it had briefly been in October, on the belief that inflation will be higher for longer.

And then there are some in the bond market that believe inflation rates will be higher than what they'd been before the pandemic. The 2% inflation rate isn't going to happen, and that the super-low interest-rate environment over the past 15 years – culminating in August 2020 when the 10-year yield was down to 0.5% – is over.



If inflation does reaccelerate, folks are wondering what policy rate would actually be "restrictive" if the current inflation rate (5.5%) is not restrictive. Obviously, everyone is just guessing. Inflation has come down a lot, but the path of inflation has been very bumpy, as we have seen. It could turn around and go down again, but inflation frequently dishes out head-fakes.

What comes next is unknown. However, if it does entail higher inflation similar to what we saw in the 1990s, and if the Fed isn't willing to crush the economy to get to 2% inflation, the Fed will keep its policy rates fairly high but not so high as to crash the economy.

Bottom line: While the consensus expects three rate cuts this year, if inflation does not continue to decline, asset prices remain stable and consumer spending remains robust, there is an increasing 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.

While the past weeks have been challenging and the near future is uncertain, if one takes a longer-term perspective, market selloffs may provide attractive entry points for those positioning their portfolios over a one-year horizon. Thus, while it may be tempting to stay in cash today, the markets and sentiment can change on a dime. In other words, unless one has crystal ball and can time the markets (good luck), I believe the most prudent approach is to maintain a risk-appropriate ladder discipline. 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.