WEEK OF APRIL 15, 2024

# Weekly Relative Value


**Tom Slefinger**
*SVP, Director of Institutional Fixed Income Sales*


## Why is Small Business in a Funk?

*"Owners continue to manage numerous economic headwinds."*
*— Bill Dunkelberg, Chief Economist, National Federation of Independent Business (NFIB)*

The Magnificent Seven isn't quite what it once was, but the Fabulous Four is (Nvidia, Microsoft, Amazon and Meta) and makes up 31% of the Nasdaq — and just two (Nvidia and Microsoft) have accounted for more than one-third of this year's overall advance in the S&P 500.

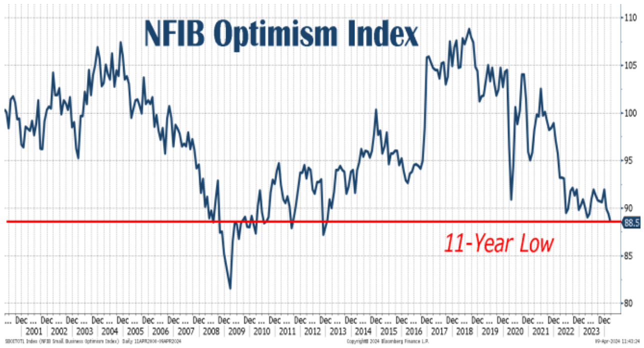
While A.I. is all the rage, just remember that the Magnificent Seven, nor the stock market, represents the economy. In other words, don't confuse the stock market with the economy.

Rather, it is the small businesses that embody the economy. As shown below, the small business community is vital to the economy, contributing 44% of the country's economic activity and creating two-thirds of net new jobs.


Source: NFIB

The NFIB reported last week that its small-business optimism index declined to 88.5. As shown below, this is the the lowest level since the U.S. economy climbed out of the worst financial crisis ever and is the third monthly fall-off in a row (and seventh in the past eight months). Not to mention that confidence is now well off the cycle highs of 104.0 and below the long-run average of 98.0 (data back to 1974).

### THIS WEEK



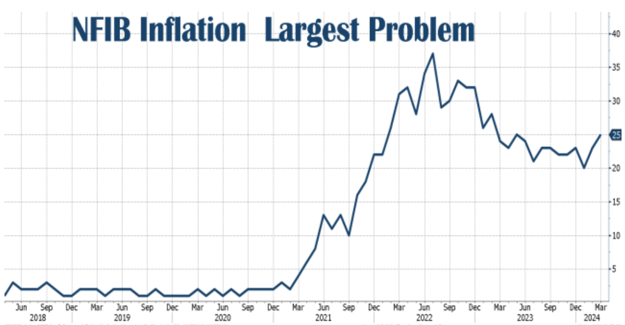

The underlying details were as squishy-soft as the headline.

*"Inflation has once again been reported as the top business problem on Main Street and the labor market has only eased slightly." — Bill Dunkelberg, Chief Economist, NFIB*

To wit:

1) For all the talk of a strong payrolls report last Friday, hiring components left much to be desired. The NFIB reported that small businesses' hiring plans in March were shockingly the weakest since May 2020.

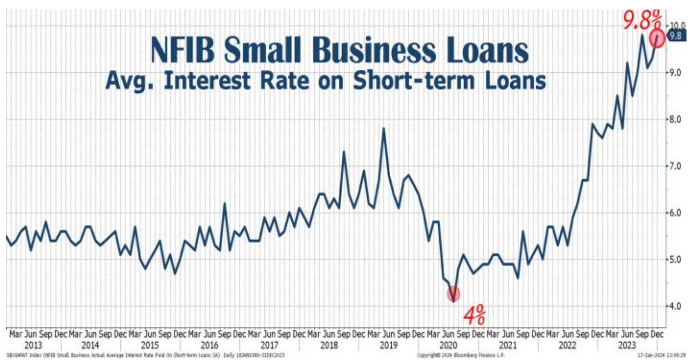
2) The worsening sentiment among small business owners directly correlates to the rise in consumer prices in the first two months of the year. Rising gasoline prices at the pump, inching closer to the politically sensitive level of $4 a gallon, have likely also contributed to the souring mood. Twenty-five percent of business owners identified inflation as the largest issue, highlighting the impact of increased costs for inputs and labor.




3) The net share of businesses that have increased employment in the last three months remains stuck in negative terrain (-2%), and has been at, or below, zero for the past year. Meanwhile, those that plan to increase payrolls shrunk to 11% from 12% in February, 14% in January and 16% in December. This was the smallest share since the depths of the pandemic back in May 2020.


4) The share citing "poor sales" as the most important problem rose to 8% from 7%, the highest since March 2021.

5) With financing costs the highest since the 1990s, Capex plans slumped to an 11-month low of 20%, receding for the third straight month. The majority of small businesses are not expecting the economy to "improve." This metric has been stuck in deep negative terrain for the past three years. Just 4% believe now it is a good time to expand while more businesses are reporting lower earnings than those seeing gains. Ditto for revenue (real sales volume expectations are at their worst since May).




**Bottom line:** Small businesses represent the heartbeat of the economy, so the rampant pessimism really throws cold water on the "strong economy" narrative. This also ratifies the fact there has been nothing fundamental to the recent break-out in the stock market, which continues to ultimately be driven higher by nothing more than momentum and "animal spirits."

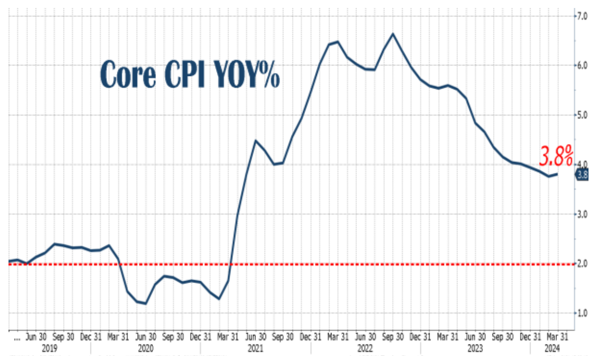
## I'M STILL STANDING

*"44% of the American public cannot come up with $1,000 in an emergency. They live paycheck to paycheck, and they rent." — Jim Bianco, President and Macro Strategist at Bianco Research*

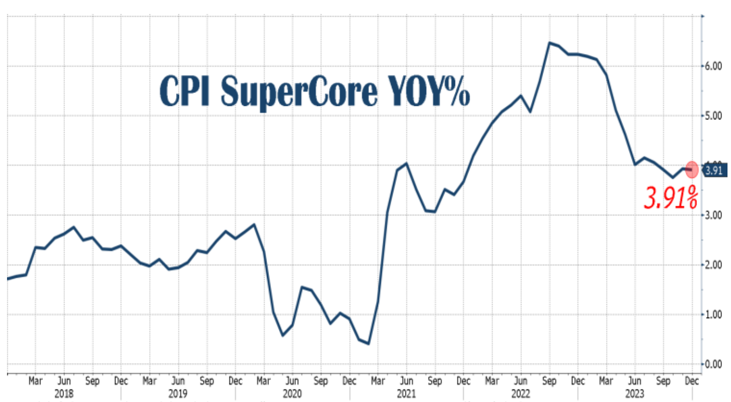
Inflation behaved badly again in March. January was terrible, but it was kind of written off as maybe one of those January blips. February was bad, and so the January-blip story began to fall apart.

The March headline and core Consumer Price Index (CPI) came in above expectations of +0.3% on both indices, but only by a hair's breadth. The headline was at +0.38% to the second decimal, and the core was at +0.36% — this was a narrow miss. On an annualized basis, headline CPI rose by 4.6% in March from February. Core CPI, which excludes food and energy, rose by 4.4% annualized in March from February.


It was driven by ugly inflation in "core services," which dominates consumer spending. "Core services" CPI jumped by 5.6% annualized in March from February. Core price increases were concentrated in rents, auto insurance premiums, and medical costs. The headline CPI also got a boost from energy prices.




The "supercore" services CPI — "core services" **without** housing — jumped by 7.5% annualized in March from February. It was the same red-hot increase as the prior month, on top of the 11.6% spike in January. So, it is not just housing that drives services inflation. On a year-over-year basis, the "supercore services" CPI has stalled at 3.91%.




Additionally, the rent of a primary residence CPI jumped by 5.0% annualized in March from February after the 5.7% jump in February, and the 4.4% jump in January. The rent CPI accounts for 7.6% of overall CPI. It is based on rents that tenants actually paid. The Owners' Equivalent of Rent (OER) CPI jumped by 5.4% annualized in March from February, roughly the same as in the prior month, after the 6.9% spike in January. The OER index accounts for 26.7% of overall CPI.

**Bottom line:** If there's any one single reason why interest rates aren't already falling, it's because inflation has stalled out and is at risk of a reacceleration.

## THE STORY BEHIND THE CPI

Here is the story behind the CPI data. Auto insurance premiums had another massive run-up (thanks to the bull market in theft). The +2.6% month-over-month surge was the third highest on record. Medical care services rose +0.6% and were up close to this amount in four of the past five months. The dual rental metrics came in at +0.4% month-over-month and are still exerting an upward skew to the inflation data. To nobody's surprise, energy prices spiked +1.1% in March (more coming in the April data).

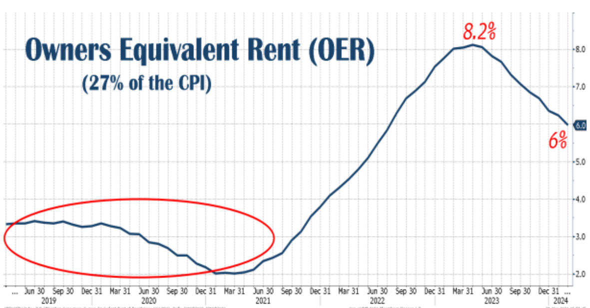
Strip out these segments, and the Fed can't do a bloody thing about it. The headline CPI (including energy) came in at +0.2% month-over-month, and the core was up a grand total of +0.1%! On a year-over-year basis, the headline inflation rate on the former slowed to +1.4% from +3.4% a year ago, and the core rate (the latter) to +1.0% on the nose from +3.7% this time a year ago. Stripping out rents, auto insurance, medical services and energy, CPI would have come in at +0.15% month-over-month. Beyond that, the report showed a broadly deflationary trend in core goods prices (-0.2% month-over-month).

**BOTTOM LINE:** The March CPI disappointed the consensus, and the bond market responded accordingly. But here is the big inflation story in the U.S. — three items that the Fed has no control over: auto insurance, health care premiums and the Bureau of Labor Statistics (BLS) treatment of rents. All of the other CPI components came in at the grand total of +0.2% month-over-month in March, and the core was just +0.1%.

The follow-up Producer Price Index (PPI) and the core import price data showed the CPI to be the odd man out, but this is what the media and myopically focused Fed officials pay exclusive attention to. But, again I ask what the Fed can do to combat non-economic factors like auto insurance, physician services and rents (a hugely lagging indicator in the CPI) without utterly destroying the economy?

## A FLAWED STATISTIC

The OER is the single largest component of the CPI with a weight of 26.7% as of February 2024. Rent of a primary residence is 7.6%. Together, shelter comprises 36.2% of the CPI.




OER is based off the question:

"**If someone were to rent your home today, how much do you think it would rent for monthly, unfurnished and without utilities?**"

In other words, it is an assumption on an excel spread sheet. Based on imputations, some claim OER is not a "real price."

Here's the key point: People do not pay OER. Roughly 64% own their own home while 36% are renting.

The people who own their own home do not pay rent, they pay a mortgage. Most homeowners refinanced at lower rates, many at or near 3%.

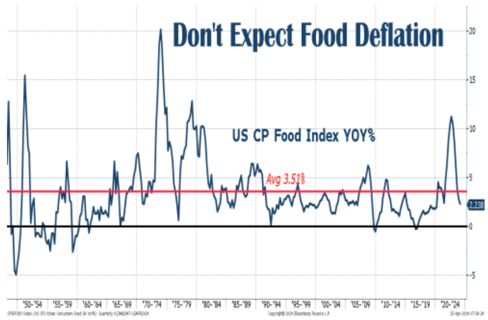
**Bottom line:** The CPI is totally screwed up as a measure of inflation. This is why the Fed makes monetary policy decisions based on the core PCE index.

## FOOD FOR THOUGHT

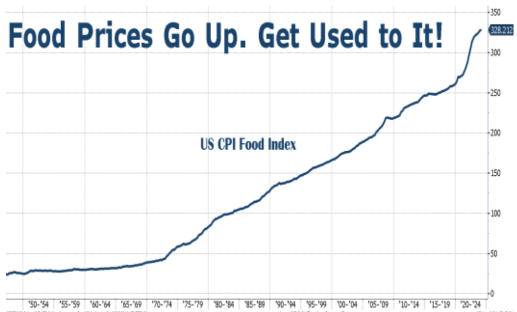
Meanwhile, inflation feeds directly into the political debate. Oddly, though, that debate now appears centered on food, over which politicians and central banks have very little control. To wit: The independent presidential candidate Robert F. Kennedy Jr. accused the Biden Administration of “trying to gaslight us into believing that inflation is coming down,” and offered rises in the price of butter, eggs, milk, peanut butter and toilet paper in rebuttal.

All of these prices are indeed higher than at the beginning of Biden’s term but that doesn’t mean it’s “gaslighting” to say that inflation is coming down, because it is.

Further, it’s not obvious how much the government policies have to do with it. The graph below shows how food inflation has moved since the 1950s. It had its worst spike in decades in 2022, but at present, food prices are rising no higher than they typically do. Also, note that outright deflation is exceedingly rare.




All the postwar presidents experienced food inflation. None oversaw falling food prices. And that should not be surprising. The BLS food price index goes all the way back to 1913. Prices have not grown any cheaper for any significant length of time since the Great Depression.




**Bottom line:** We should be glad that there’s no food price deflation at present, as history suggests that only an economic depression can deliver that. This would not be a good political argument for Biden to use, but maybe we should all keep some perspective.

## FROM 2% TO 8%

Jamie Dimon, in his letter to JPMorgan Chase shareholders, discussed the range of scenarios he envisioned for inflation and interest rates over the longer term and the potential causes. He also cautioned about running a business based on "economic prognosticating."

*"Instead,* ***we look at a range of potential outcomes for which we need to be prepared.*** *Geopolitical and economic forces have an unpredictable timetable — they may unfold over months, or years, and are nearly impossible to put into a one-year forecast. They also have an unpredictable interplay: For example, the geopolitical situation may end up having virtually no effect on the world's economy or it could potentially be its determinative factor."*

Here's what Dimon said in his letter about inflation, interest rates and quantitative tightening and easing. All of the following factors appear to be inflationary**:**

- Ongoing fiscal spending ("…occurring in boom times – not as the result of a recession – and they have been supported by quantitative easing, which was never done before the great financial crisis.")
- Remilitarization of the world
- Restructuring of global trade
- Capital needs of the new green economy
- Higher energy costs in the future (even though there currently is an oversupply of gas and plentiful spare capacity in oil) due to a lack of needed investment in the energy infrastructure.

*"**There is also a growing need for increased spending as we continue transitioning to a greener economy, restructuring global supply chains, boosting military expenditure and battling rising healthcare costs.** This may lead to stickier inflation and higher rates than markets expect."*

*"It seems to me that every long-term trend I see increases inflation relative to the last 20 years**. Huge fiscal spending, the trillions needed each year for the green economy, the remilitarization of the world and the restructuring of global trade — all are inflationary. I'm not sure models could pick this up."***

Dimon is preparing for interest rates of 2% to 8% or even more.

*"Therefore,* ***we are prepared for a very broad range of interest rates, from 2% to 8% or even more****, with equally wide-ranging economic outcomes — from strong economic growth with moderate inflation (in this case, higher interest rates would result from higher demand for capital) to a recession with inflation, i.e., stagflation.* ***Economically, the worst-case scenario would be stagflation, which would not only come with higher interest rates but also with higher credit losses, lower business volumes and more difficult markets****."*

Dimon says to beware of 6%-plus long-term rates in a recession**.**

***"If long-end rates go up over 6% and this increase is accompanied by a recession, there will be plenty of stress — not just in the banking system but with leveraged companies and others."***

*"**Remember, a simple 2% increase in rates essentially reduced the value of most financial assets by 20%, and certain real estate assets, specifically office real estate, may be worth even less due to the effects of recession and higher vacancies**. Also, remember that credit spreads tend to widen, sometimes dramatically, in a recession."*

***"Rates have been extremely low for a long time — it's hard to know how many investors and companies are truly prepared for a higher rate environment**."*

Then had this to say about quantitative tightening and easing:

*"I remain more concerned about quantitative easing than most, and its reversal (quantitative tightening), which has never been done before at this scale."*

***"Quantitative tightening is draining more than $900 billion in liquidity from the system annually — and we have never truly experienced the full effect of quantitative tightening on this scale."***

## HOW HOT IS HOT?

More on the supposedly hot labor market report from last week. Have a look at the type of jobs created:

- The ranks of the self-employed expanded +150,000 in March and by +362,000 in the past year.
- Folks taking on more than one job soared +217,000 in March and are up +492,000 in the past year.
- Part-time workers jumped +691,000 in March and by a whopping +1.9 million over the past year.

Once you strip out the self-employed (are they really working?), multiple job holders (a sign of financial stress) and part-time jobs, employment actually declined by 560,000 in March and by over 2million over the past year. In other words, all of the jobs and then some are part-timers over the past year!

The dirty little secret in Friday's data was that employment in the breadwinning 25-54-year old age cohort saw employment retrench -48,000 while full-time jobs dipped -6,000 and are down in each of the past four months.

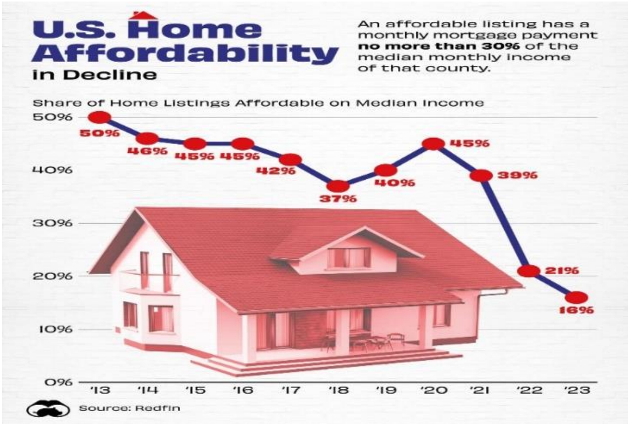
**Bottom line:** Scratch the surface just a little, and there was less to Friday's employment report than mets the eye.

## HIDDEN COSTS OF A HOUSE

*"The insurance really is, I think, just as crippling, if not more so, than interest rates."*
*— Kara Breithaupt, Real Estate Agent, New Orleans*

During the pandemic, millions of Americans purchased homes or refinanced existing mortgages at historically low rates. The average rate for a 30-year fixed mortgage fell below 3% several times in 2020 and 2021.

Now, rates have doubled to over 7%. At the same time, home prices have remained extremely high. According to a recent study completed last year, the median home prices for roughly 575 U.S. counties has risen ***99%.*** Given that the average income earner makes $71,214 a year, it's not surprising that homeownership affordability fell to its lowest level since the 1980s. The graphic below from Redfin tells the story.




However, the story is actually worse. As highlighted in a recent *Wall Street Journal* article, other costs associated with homeownership keep rising. According to Fannie Mae, non-mortgage costs including property taxes, maintenance, utilities and insurance make up more than half of homeowners' overall costs in 2022.

- **Property Taxes**: On average, the property tax for single-family homes in the U.S. was $4,062 in 2023, up 4.1% from 2022, according to real-estate data firm Attom. Some cities had enormous jumps. The highest annual year-over-year jumps were in Charlotte (31.5%), Indianapolis (19%), Kansas City (17%), Denver (16%) and Atlanta (15%).

- **Home Insurance**: Arguably, surging home insurance costs are hitting homeowners hardest of all. Extreme weather conditions and uncertainty about future losses have driven home insurance prices significantly higher even in states less prone to hurricanes and wildfires. To wit: The average annual home insurance cost rose about 20% between 2021 and 2023 to $2,377. According to Fannie Mae, nearly 10% of homeowners were not confident they could afford their home insurance premiums at their next renewal.

    - In certain states, insurers have stopped offering coverage. In some cases, homeowners without mortgages are opting to go without home insurance.

- **Home maintenance fees** have risen. It costs an average of $6,663 a year to maintain a home in the fourth quarter of 2023, up 8.3% from a year earlier, according to home-improvement tech company Thumbtack. The index takes into account regular upkeep like gutter cleaning and lawn care along with occasional expenses like roof repair or maintenance. According to a survey by Clever Real Estate, 42% of those surveyed said they have skipped home repairs or maintenance because of the cost. Not surprising at all given that nearly one in five said they couldn't afford a $500 emergency repair without going into credit-card debt.

**Bottom line:** Ridiculously priced homes along with skyrocketing home-related expenses are stressing homeowners while making it next to impossible for first time homebuyers to attain the American Dream.

## MARKET OUTLOOK AND PORTFOLIO STRATEGY

*"It's very important that if (the Fed) cuts rates, it better not spur more inflation… The American public will absolutely filet that organization if they produce higher inflation. This has the chance of going crazy."*
*— Jim Bianco, President and Macro Strategist at Bianco Research*

We entered the year with Fed fund futures pricing in seven rate cuts by December. Yes, seven! However, that expectation has shifted, with the current probability now down to only 32.4% for just two rate cuts. A month ago, the probability of only two cuts was 10.3%, indicating that the market was still heavily pricing in three or four rate cuts back then.

This vivid shift in market expectations highlights the dynamic nature of the inflation paradigm. Our challenge lies in consistently questioning the quality of the data, calculating what inflation is and where it is headed and then calibrating that to what the Fed perceives —which may be fundamentally different from the underlying economic reality.

Yes, inflation today is higher, but despite all the narratives out there, today's backdrop is not broad-based and has been skewed by a variety of mandated cost increases in the form of health insurance premiums, auto insurance (+22% year-over-year) and the treatment of the dominant rent components.

What is most important is that core goods prices — the stuff you can actually see, touch and feel — are deflating -0.7% year-over-year. However, these items that are measurable and observable receive very little press. The disinflation there compares with a -0.3% year-over-year pace before COVID-19 reared its ugly head.

In the meantime, we are living through a period of fiscal dominance. When you pre-stimulate an economy with $1.8 trillion in deficit spending, the resulting slowdown tends to look different and takes on a different duration than it otherwise would, but we'll save that discussion for another day.

What has not gone away are the cracks emerging in the U.S. economy, where 22 states have already met the Sahm Rule on the recession call. The complacency is so rampant that only 10% of economists see at least one negative gross domestic product (GDP) quarter in the coming year, down from 33% in January.

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

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.

What comes next is unknown, but if it does entail higher inflation, similar to what was seen during 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 two 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 will 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 the 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.