INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF APRIL 22, 2024

Something Will Have to Give

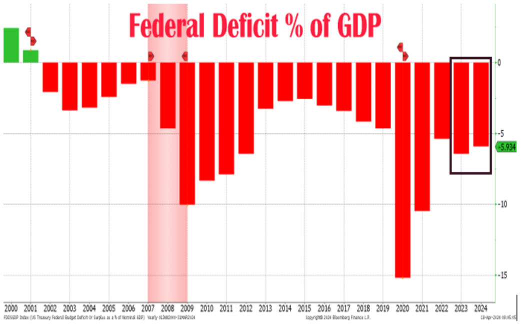
"The exceptional recent performance of the United States is certainly impressive and a major driver of global growth, but it reflects strong demand factors as well, including a fiscal stance that is out of line with long-term fiscal sustainability."
— 2024 April World Economic Outlook, International Monetary Fund (IMF)

Last week, the *Financial Times* published an article titled, "U.S. Deficit Poses 'Significant Risks' to Global Economy, Warns IMF." It's well worth a read.

The federal deficit is expected to top 7% of the gross domestic product (GDP) this year. Never before has the fiscal deficit been so large when the economy is not in a recession. So, the robust economic growth in the U.S. has nothing to do with "American exceptionalism" but everything to do with the government's relentless intervention into the economy.

All told, in the past year alone, government intervention has been responsible for half of the GDP growth! The other half came from the drawdown in personal savings, as well as the credit card boom.

For comparison, the U.S. fiscal deficit is more than triple the average of 2% in the rest of the developed world. So, if you're wondering why the U.S. economy has outperformed, now you know.



Here are a couple of examples of fiscal spending and why the U.S. economy has not succumbed to the 500-basis point Fed rate hike:

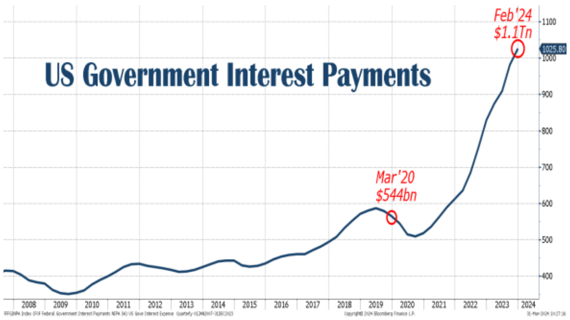
THIS WEEK

- THE WEALTH EFFECT AND CONSUMER
- THE U.S. CONSUMER SURPRISES AGAIN
- IS FRUGALITY SETTING IN?
- INFLATION, INFLATION, INFLATION!
- THE MISLEADING INDEX?
- INTEREST RATES DO MATTER!
- CONSUMER CREDIT ERODES
- MARKETING OUTLOOK AND PORTFOLIO STRATEGY

- The Biden Administration subsidies (Inflation Reduction Act and the Chips Act) have increased spending on the construction of manufacturing facilities, which are up an amazing +32% year-over-year.
- The state and local government sector has been on a massive spending binge. Publicly funded construction expenditures are off the peak but still running at a huge +17% year-over-year pace.

Bottom line: The bull market in economic growth boils down to the heavy hand and generosity of Uncle Sam! We're in an economic environment where government deficits are the catalyst for private sector growth. In contrast to monetary policy, fiscal stimulus has an immediate impact on the economy. Deficit spending essentially increases income for consumers and businesses.

Deficit spending isn't free of course. The annual interest expense on U.S. debt reached $1 trillion this month and now exceeds total defense outlays. Worse still, if rates remain unchanged at current levels, the interest costs will approach $1.7 trillion by the year's end.



Last words go to Pierre-Oliver Gourinchas:

"It raises short-term risks to the disinflation process, as well as longer-term fiscal and financial stability risks for the global economy."

"Something will have to give."
— Pierre-Olivier Gourinchas, Chief Economist, IMF

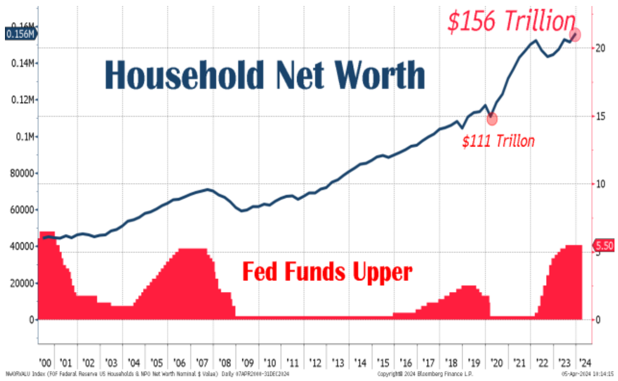
''Something" indeed, monsieur!

THE WEALTH EFFECT AND CONSUMER

Since the first quarter of 2020, the net increase in financial wealth (equities and real estate) stands at +$45 trillion or nearly 150% of GDP! This stash of wealth may well be the greatest force behind consumer spending. In other words, the wealth effect is replacing current income as the driving force behind spending.

This record wealth accumulation, along with the increasing number of retirees whose consumption significantly depends on their assets, has underscored the importance of the wealth effect. In fact, studies show that the swelling in household net worth (housing and financial) has been so sharp that it has been responsible for around 60% growth in consumer spending over the past two years.

Thus, asset inflation has proven to have been a strong antidote to tighter monetary policy, the end of the fiscal stimulus (as it pertains to the prior stimulus checks) and the more recent moderation in wage growth.



Bottom line: At present, elevated and rising stock and home prices are making it more difficult for the Fed to reduce demand. Thus, the Fed raising rates is their attempt to take away the punchbowl. What comes next is diminishing asset values to achieve the goal of slowing demand relative to supply. This will lead to the final leg to bring down inflation towards the 2% target.

Further, the disappearance and negative turn in the wealth effect would necessitate cuts, likely deep ones. But that is for another day.

THE U.S. CONSUMER SURPRISES AGAIN

U.S. retail sales for March came in at an extraordinarily strong +0.7% compared to the +0.4% consensus estimate. Not just that, but February was revised higher to +0.9% from +0.6%. The ex-auto segment boomed +1.1%, more than doubling the +0.5% consensus forecast.

The key "retail control" group that feeds right into the consumer spending segment of the GDP data jumped +1.1% and that was nearly triple the +0.4% print the market was bracing for. On top of that, February was revised up to +0.3% from flat.

However, the retail sales are from the retailers' point of view. They're not adjusted for inflation and deflation, just like Walmart doesn't adjust quarterly earnings to inflation.

In real (inflation-adjusted) terms, retail sales rose a decent +0.3%, and this followed a +0.5% bump-up in February. This also followed a four-month string of declines, mind you. Because January was so weak to kick off the first quarter, real retail sales still contracted at a -3.5% annual rate (having shrunk now in three of the past four quarters). That said, the momentum is positive heading into the second quarter and should boost the GDP figures nicely.

From a sector standpoint, the results were rather mixed. Online shopping was the big winner, with a +2.7% spike, the largest gain since January 2022, and added more than 50% of the total retail sales growth. Of note, gasoline stations saw a price-induced +2.1% pop after a +1.6% rebound in February. Even still, total retail sales were still up +0.6% outside of this gasoline effect.

Also worth highlighting is the fact that Americans are now spending vastly more money eating and drinking out than at grocery stores. They are willingly paying for the “experience” or the convenience rather than just the food. As I tell my wife more than she wants to hear, they could save a lot of money by eating at home or packing a lunch, but no, the Drunken Sailors are going for the experience and the convenience.

Bottom line: As discussed above, a huge catalyst for consumers opening their wallets is the “wealth effect” (the gift that keeps on giving).

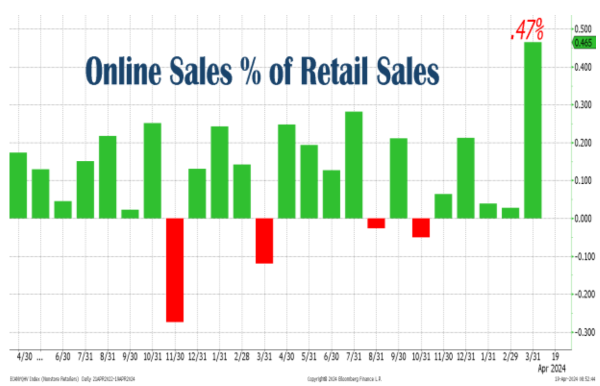
In addition, the U.S. economy has benefitted from the huge wave of six million immigrants in 2022-2023, which has allowed the U.S. population to grow by 1.14% in 2023, the fastest growth since 2005. Most of these people are quickly joining the labor market, making money and spending it.

IS FRUGALITY SETTING IN?

There were a few strange things about that outsized retail sales number for March.

1) Good Friday showed up in March this year and pulled holiday spending upward. Whenever Good Friday was in March, retail sales were up +0.7% month-over-month (as we saw in this report!). The last time this calendar quirk occurred was five years ago when retail sales soared +1.6% and then came in flat the very next month. We shall see if this thesis holds water when the April data is released.

2) Online activity is driving retail sales, along with consignment stores and essentials. Online sales and miscellaneous, which include used merchandise stores (as in secondhand outlets), together zoomed ahead +2.7% month-over-month in March, enough to account for about two-thirds of the 0.7% increase in the metric overall. The rest of the retail sector came in at less than +0.3%. Could it be that consumers are extended and looking for ways to stretch the mighty dollar out?



3) Further strength was concentrated on necessities (e.g., food, gas and drugs). The grocery chains (+0.5%) and drug stores (+0.4%) saw their best showing in many months. And restaurants built on their +0.5% February gain with a

+0.4% follow-through in March.

4) Quite notably, the areas of retail sales that are economically sensitive like appliances, electronics, home improvement, furniture, autos/parts, department stores, restaurants, clothing and sporting goods fell -0.3% and have contracted now in two of the past three months.

Bottom line: Much was made about the hot retail sales data, but it was mostly food, gas and drugs. Furthermore, while the consumer continues to spend, the retail sales report highlighted the new reality of people focusing on cost savings. Even those with means are seeking quality at lower prices and only buying if and when they can get a new deal. This sort of behavior definitely is not inflationary, even if you believe in that headline sales number.

INFLATION, INFLATION, INFLATION!

"Recent data show lack of further progress on inflation…it "will likely take longer for confidence on inflation…and in the meantime it is appropriate to let policy take further time to work."
— Jerome Powell, Federal Reserve Chairman

Inflation, inflation and inflation**.** That is on the brain of every Federal Open Market Committee (FOMC) official. Never mind that whatever inflation is left in the system has come down to just auto insurance, health care premiums and the obscure way the Bureau of Labor Statistics (BLS) treats the dominant rental components in the index.

The headlines screamed that inflation is broadening across all sectors. Really? There were wide swaths of the Consumer Price Index (CPI) that are either disinflating or deflating like toys, sporting goods, recreation services, car and truck rentals, appliances, airfares, home improvement, groceries, communication and delivery services, hotels and motels and pharmaceutical products. If inflation were a story of excess demand, you might expect price pressures in the parts of the economy where spending has been strongest, but that hasn't really been the case, so it's hard to make the connection.

How could it be broadly based when the core goods CPI, the stuff you can see, touch, feel, be observed and measured without the need for statistical imputations, fell -0.2% sequentially and is down -0.7% year-over-year?

It is all so surreal. Here is the story behind the CPI data, and it is less problematic than many think:

- The single-biggest reason that the CPI exceeded expectations in March was the surprise jump in motor vehicle insurance. Auto insurance premiums had another massive run-up (thanks to the bull market in theft). Indeed, the +2.6% surge is the third highest on record! While insurance is a very real pain point for Americans, it's hardly the result of recent aggregate supply and demand dynamics. Without that, core inflation would have met consensus expectations, the bond market sentiment wouldn't have taken this turn for the worse and we probably wouldn't be talking about this today.

- Medical care services rose +0.6% and was up close to this amount in four of the past five months.

- The rental metrics (OER and Rent) came in at +0.4% month-over-month, and while off the boil, are still exerting an upward skew to the inflation data.

Going forward, those pressures should be expected to abate a bit.

But let's think about this. What can the Fed 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?

If you strip out rents, auto insurance and health care premiums, which again the Fed can't do a bloody thing about, the headline CPI came in at +0.2% month-over-month and the core by the 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 on this basis (the latter) to +1.0% on the nose from +3.7% this time a year ago.

Here's another ditty:

> *"Government bolsters the manufacturing sector as U.S. warns of overcapacity… China's exports picked up in the first quarter of the year, a sign that Beijing's push to lift growth by propping up manufacturing is getting results, even as the plan ratchets up trade tensions with other parts of the world."*
> — "*China Exports Up as Trade Tensions Rise*", *The Wall Street Journal (WSJ)*

As everyone gazes at services in the various price measures, so imperfectly measured through imputations, what is being forgotten is that nearly 40% of the CPI is made of goods. These goods are already deflating and likely to continue to do so as China exports its excess industrial capacity and home-grown producer deflation to the rest of the world.

Also, opposite to the message delivered by the CPI report, the *WSJ* article titled, "Trucking Oversupply Is Weighing on Carriers' Earnings Outlooks," suggests that prices are not going up.

Here is the opening salvo, which just about says it all:

> *"A push by retailers and manufacturers to cut shipping costs is sending trucking industry hopes of an earnings rebound into a skid."*

Average freight rates are down -6.5% so far this year, and yet everyone has broad-based inflation on the brain.

Moreover, the message from the recent Beige Book was adamant that inflationary pressures have abated, but the Fed is choosing to ignore this 50-year-old report that is chock-full of up-to-date information on the economy from business contacts, not government statisticians. To wit:

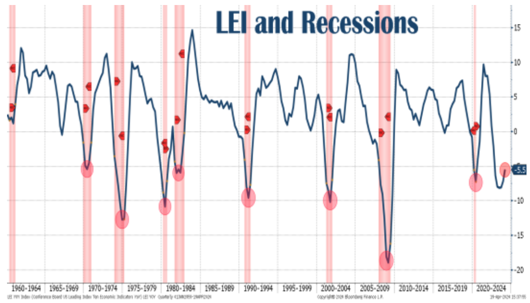
> *"Several reports mentioned weakness in discretionary spending, as consumers' price sensitivity remained elevated.* ***Another frequent comment was that firms' ability to pass cost increases on to consumers had weakened considerably in recent months, resulting in smaller profit margins****."*

My money is with the Beige Book and not the BLS because the information contained in the report comes from those companies that influence the economy.

Bottom line: The inflation data has remained elevated, but this has nothing to do with domestic demand or supply. The big inflation story is down to three areas: auto insurance, health care premiums and the arcane way the BLS treats the dominant rental components. Thus, it is more to do with price increases in areas that consumers can't substitute away from (a de facto tax) and the lagging nature of the dominant rental components. Thus, the "core sticky" price index (inherently insensitive to Fed policy) is the culprit. It is up +0.4% month-over-month for back-to-back months and is picking up in March to a +4.5% year-over-year pace from +4.4% in February. There's your inflation story. The question for the Fed is, what exactly is the appropriate funds rate needed to combat non-cyclical items like auto insurance and health care premiums?

THE MISLEADING INDEX?

The Leading Economic Index (LEI) used to be a closely watched barometer of future growth, but it has been laughed off as a relic. In March, the LEI fell a hard -0.3% month-over-month to the lowest level since May 2020. However, nobody seemed too fussed about it. Meanwhile, the year-over-year trend, at -5.5%, is at a level that has triggered a recession 100% of the time in the past.

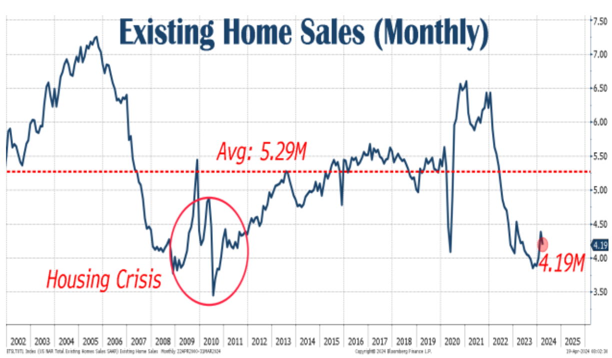


Bottom line: Will it be different this time? Some cause for pause.

INTEREST RATES DO MATTER!

"In the past, if you were middle class, it was almost assumed you would become a homeowner... Today, the aspiration is still there, but it is a lot more difficult. You have to be wealthy or lucky."
— Ali Wolf, Chief Economist, Zonda

U.S. existing home sales declined -4.3% month-over-month in March to 4.19 million units at an annual rate — just about as expected. Sales are now at the very low end of the range of the past two decades. With rates on the 30-year fixed mortgage piercing 7%, the high price landscape is causing further erosion in homeowner affordability.



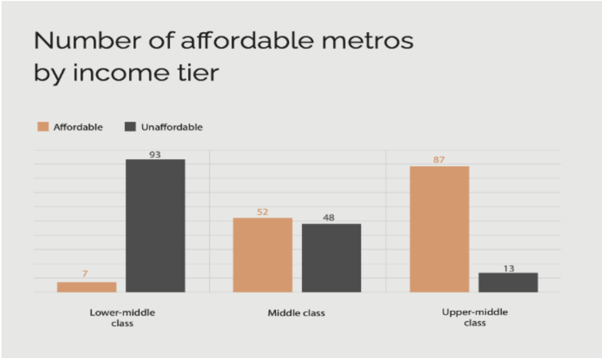
But the housing story is not likely to improve any time soon. That's because home prices remain too high, mortgage rates are back well above 7% after having dipped to 6.6% in December and inventories, while improving, remain low. To wit: Total housing inventory at the end of March was 1.1 million units, up 4.7% from February and 14.4% from one year ago (970,000). Unsold inventory sits at a 3.2-month supply at the current sales pace and is up from 2.9 months in February and 2.7 months in March 2023.

The median selling price increased 4.8% from a year ago to $393,500 — the ninth consecutive month of year-over-year price gains and the highest price ever for the month of March.

According to a new study by Creditnews Research, in 2024, middle-class households **(**those with an annual income of up to $75,000) could afford to buy an average home in just 52 of the country's 100 largest metros. Just five years earlier, they could afford a home in 91 of the top 100 metros.

The situation is far worse for lower middle-class households as they can only afford a home in seven of the largest 100 metros.

In total, 41 out of the 100 metros require a gross annual income of $100,000 or more to qualify for an average home. In 13 metros, an average income of more than $155,000 is needed.



Source: CreditNews Research

Bottom line: There really is nothing much positive to say about the residential real estate market. Yes, the demographics are supportive, but you need to be able to afford a home before you can buy one (unless Ma and Pa dig into their pockets).

CONSUMER CREDIT ERODES

Consumer credit quality is clearly eroding. This is happening at a time of a sub-4% unemployment rate is rather shocking but is a testament to how financially stressed the household sector is. Again, not on average but at the margin. Take Discover Financial as an example, it reported earnings and their net charge-offs rose across the board.

"The total net charge-off rate of 4.92% was 220 basis points higher vs the prior year period reflecting continued seasoning of recent vintages with higher delinquency trends. The credit card net charge-off rate was 5.66%, up 256 basis points from the prior year and up 98 basis points from the prior quarter. The 30+ day delinquency rate for credit card loans was 3.83%, up 107 basis points year-over-year and down 4 basis points from the prior quarter. The student loan net charge-off rate was 1.58%, up 54 basis points from the prior year and up 6 basis points from the prior quarter. Personal loans net charge-off rate of 4.02% was up 208 basis points from the prior year and up 63 basis points from the prior quarter." — Discover Financial

In addition, its provision for credit losses came in at $1.5 billion, increasing by $395 million from the prior year's quarter ($1.1 billion a year ago) and bringing the total to $6.4 billion over the past year.

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, Bianco Research

The U.S. economy has avoided a recession, at least so far. But that is due to a series of nonrecurring sources of stimulus from fiscal expansion, an epic credit card boom, the dramatic drawdown of excess personal savings and the shadow banking system offsetting the contraction in the traditional banking sector.

Something else happened that prevented the Fed's aggressive tightening from showing up, which is that everyone refinanced at the historic lows in rates back in 2020 and 2021. This made the economy less sensitive to the interest rate shift, to be sure, but that only bought time. In the next three years, especially in the business sector, it is going to be time to "pay the piper" as an epic $7 trillion of corporate debt will be refinanced and likely at much higher interest rates than at the time of origination.

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 take on a different duration than it otherwise would, but we'll save that discussion for another day.

Meanwhile, the Fed is hitting hard from all corners. In a speech last week that didn't mention rate cuts, Fed Vice Chair Philip Jefferson said, "*it will be appropriate to hold in place the current restrictive stance of policy for longer,*" if inflation stays high and sticky. Neel Kashkari (Minneapolis) intimated that the markets now see no rate cuts coming this year. John Williams (New York) and Raphael Bostic (Atlanta) don't see any "urgency" or "mad-dash hurry" to cut rates. Williams actually floated the trial balloon of renewing the rate-hike program!

And finally, Fed Chair Jerome Powell sucked all oxygen out of the room by adding, "*if higher inflation persists, the Fed can maintain the current rate as long as needed.*" In other words, "higher for longer" rates. On the news, the Russell 2000 re-entered crash mode, down -20% from its 2021 all-time high. Indeed, this is about the Fed reducing the wealth effect and removing the froth away from the inflation in assets (equities and housing). Punch bowl, sayonara. It's going to get interesting from here, 42% of S&P 500 companies will report earnings this week.

We entered the year with Fed fund futures pricing in seven rate cuts by December. Yes, seven! However, that expectation has shifted. Bond investors have been steadily marking down the likelihood and timing of Fed rate cuts. Indeed, the futures market has slashed expectations for 2024 to just 1.5 rate-cuts (half of what the Fed's Dot-Plot is expecting).

Yes, 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.

Note: Later this week, the core personal consumption expenditures deflator, the Fed's preferred inflation gauge, is likely to be less threatening — partially because of the differences in how insurance is measured, and the lower weighting for the housing inflation category, which has been disinflating very slowly and should continue to do so. On a month-on-month basis, core personal consumption expenditures (PCE) is widely expected to have increased a not-terrible 0.3%.

Further, if you recall, much of the Fed's move to tighten policy aggressively was premised a chronic mismatch of labor demand and supply. Adding immigration to the work force has helped bring the labor market into better balance.

Bottom line: While the consensus expects one to 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'll come down to the incoming data.

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.

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