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Weekly Relative Value

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WEEK OF APRIL 29, 2024

A Demographic Time Bomb?

*"There are certainly some big risks that humanity faces. **Population collapse is a really big deal**... the birth rate is far below what's needed to sustain civilization at its current level. **Any nation with a birth rate below replacement will eventually cease to exist**."*
– Elon Musk

I have long argued that "demographics are destiny," and specifically, declining population growth is a major headwind to sustaining long-term economic growth.

Demographics and excess debt are two reasons for the Federal Reserve's neutral fed funds rate (aka the R-star) target around 2.5%.

Of late, some have stated that the neutral fed funds rate is higher than the Fed's 2.65% forecast. Many now point to the fact that the U.S. is experiencing an immigration boom as a source of higher growth and a higher neutral fed funds rate.

But here's the thing: immigration is acting as an offset to a decline in the home-grown native population.

To wit: A new report from the U.S. National Center for Health Statistics showed U.S. births continued a multi-decade slide to levels not seen in more than four decades. There were 3.59 million babies born in 2023, down 2% from 3.66 million recorded in 2022. This number is the lowest since 1979, when 3.4 million babies were born.

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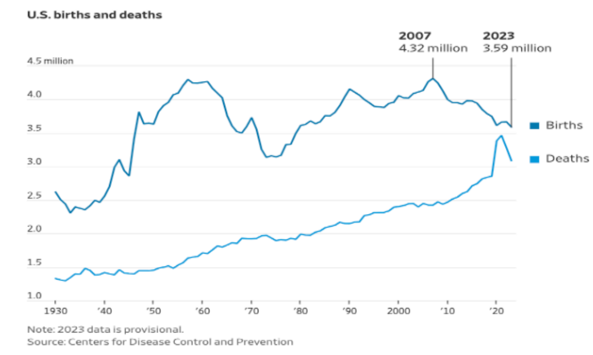
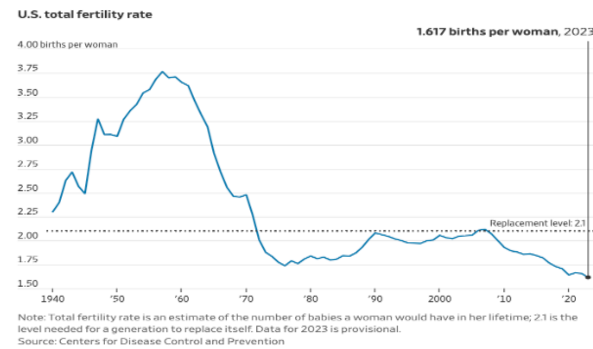
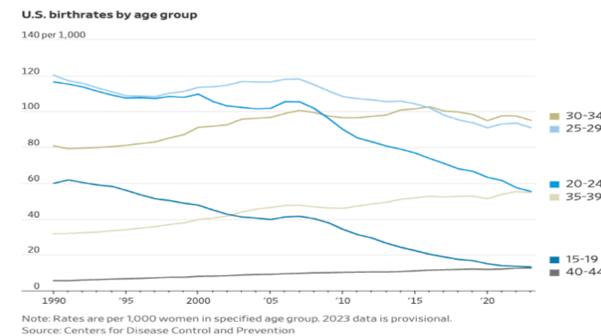


The U.S. fertility rate declined -2% in 2023 to a record low (dating back to the 1930s) of 1.62 births per woman. As shown below, the fertility rate at 1.62 is well below the replacement rate of 2.1.



"People are making rather reasoned decisions about whether or not to have a child at all... More often than not, I think what they're deciding is, 'Yes, I'd like to have children, but not yet.'" – Karen Benjamin Guzzo, Director of the Carolina Population Center

The largest retreat was among younger females as they delay the decision to get married and have children like never before.



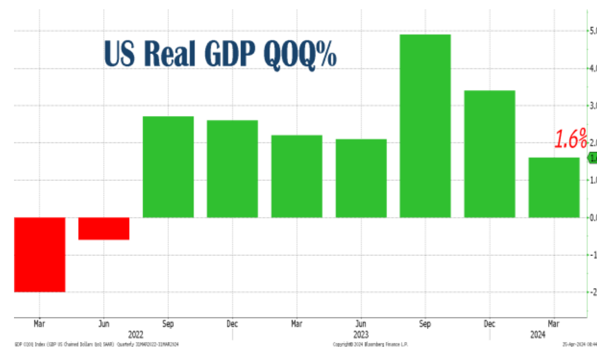
Bottom line: To keep things in perspective, the R-Star is a fundamentally immeasurable quantity subject to enormous uncertainty. However, the basic fact remains that the Fed has its current policy settings tight relative to any estimate of R-star and will need to reduce rates to normalize policy.

That means that the base case for bonds remains a rally is on the horizon, and current elevated yields are a good buying opportunity. The right landing spot for interest rates will have to be worked out in real time and will probably depend more on cyclical dynamics at the time than deep structural factors.

A RARE MISS

It's been a while since real gross domestic product (GDP) surprised to the downside as it did in the first quarter. U.S. GDP unexpectedly collapsed to just 1.6%, down more than 50% from the fourth quarter (Q4) print of 3.4%, the lowest print since Q2 2022 when the U.S. underwent a brief technical recession and a huge miss to the 2.5% estimate.

Compared to Q4, the deceleration in GDP in Q1 reflected decelerations in consumer spending, exports, state and local government spending, and a downturn in federal government spending**.** These movements were partly offset by an acceleration in housing investment. Imports accelerated.



As for the details:

- Consumer spending (69% of GDP): +2.5%, on a 4.0% surge in spending on services but the pickup was fueled largely by healthcare. Spending on goods declined 0.4%.
- Gross private investment (18% of GDP): +3.2%, pushed up by a 5.3% surge in fixed investments, and dragged down by a smaller increase in inventories.
    - Non-residential construction dipped for the first time since Q3 2022.
    - The housing market was a lone bright spot, posting a +13.9% annualized growth rate, the best showing since the Q4 2020. However, with mortgage rates backing up sharply of late, this burst of activity will likely prove temporary.
- Government consumption and investment (17% of GDP): For a change, did not contribute that much with a slowdown to a pace of +1.2%, from +4.6% in Q4 and +5.8% in Q3 of last year.
- The trade deficit worsened a lot, on surging imports. Exports add to GDP. Imports subtract from GDP. The worsening imports dragged GDP down by 0.96%.

Bottom line: Dig deeper into the data, the slowdown in consumption was the biggest culprit once again, with personal consumption rising 2.5%, a big drop from the 3.3% in Q4 and below the 3.0% expected. Taking a step back, consumption has now missed six of the past 10 prints.

Finally, just how red-hot is the U.S. economy really when UPS (the company that ships GDP to the country) posts yet another decline in quarterly revenue, as the company delivered fewer packages in the past three months? Overall, revenue fell -5.3% in the first quarter, with shipping volume down -3.2% in the U.S. Revenues declined -5.3% year-over-year while net income plunged -36% to $1.22 billion.

Also, PepsiCo posted a -2% drop in volume sales. This makes you wonder what it means when the consumer begins to pull back on soft drinks, potato chips, granola bars and cereal.

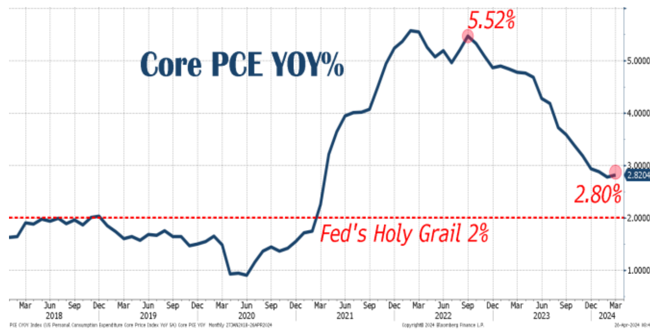
HOTTER THAN EXPECTED

"The hot inflation print is the real story in this report. ***If growth continues to slowly decelerate, but inflation strongly takes off again in the wrong direction, the expectation of a Fed interest rate cut in 2024 is starting to look increasingly more out of reach." –*** *Olu Sonola, Head of Economics at Fitch Ratings*

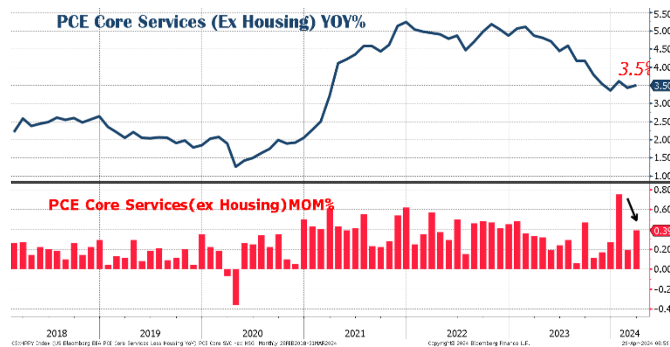
While the economy showed signs of sputtering, the personal consumption expenditures (PCE) core index (aka the Fed's preferred inflation metric) showed inflation coming in hotter than expected.

The core index rose at +2.8% year-over-year versus a consensus expectation of +2.7%. Fed Whisperer Nick Timiraos noted the 3-month annualized core PCE jumped to 4.4%.

Here's the key point. Approximately 70% of the +5.4% pick-up in service-sector prices (much of which are imputed) came from housing/utilities, financial services and health care.



The so-called "supercore" inflation rate (services excluding shelter) rose once again and was revised higher.



HOW MUCH DOES A BURGER COST?

Do you remember when you could buy two hamburgers, small fries and a drink for less than $1 at McDonald's?

I sure do.

When the first McDonald's opened in our area in the early 1960s, a hamburger and small fries were $0.15 each, and a small soda was $0.20. Up until the end of the 1960s, they ran television commercials about getting change back from your dollar.

Times have changed…

McDonald 's Menu Price Changes in 10 Years

Menu Item	2014	2024	% Change
McDouble	$ 1.19	$ 3.19	168%
Quarter Pounder Meal	$ 5.39	$ 11.99	122%
Oreo McFlurry	$ 2.39	$ 4.49	88%
10 pc McNugget Meal	$ 5.99	$ 10.99	83%
4 pc McNugget Meal	$ 2.99	$ 4.99	67%
Filet O-Fish	$ 3.49	$ 5.49	57%
Big Mac	$ 3.99	$ 5.99	50%
Medium Drink	$ 1.29	$ 1.61	25%
Medium Fries	$ 1.59	$ 3.79	138%
Average			**89%**

IS INFLATION OVERATED?

Finally, while inflation is on everyone's mind, contrary to popular opinion, there is no broad-based inflation in the United States. It has become narrowly based in areas that the Fed has no control over.

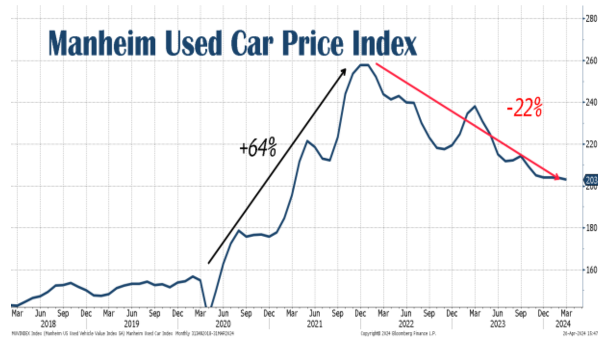
The recent strength in the monthly Consumer Price Index (CPI) data was due to auto insurance (given the surge in claims), rents (the lagged manner in which they are calculated in the CPI) and healthcare premium.

Indeed, the real inflation is in health maintenance organizations (HMOs). Have a read of the *Wall Street Journal* article, "The True Cost of Megamergers in Healthcare: Higher Prices".

All three of these costs (auto insurance, housing and healthcare) act more as de facto tax increases on consumer purchasing power than anything else.

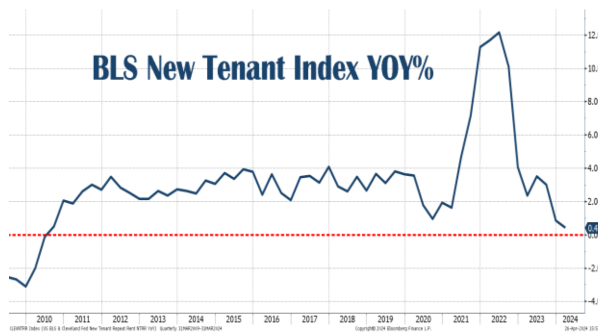
Meanwhile, the things you can see, touch or feel, as in durable goods prices (-0.5% and deflating in each of the past three quarters) and non-durables (-0.6% after a -0.2% dip in Q4) are on a downward trajectory, but nobody seems to notice or care (outside of yours truly).

Hopefully, when the April CPI and core PCE deflator data come out, the downward trend to inflation may resume. For example, the Manheim Used Vehicle Value Index reversed -1.9% month-over-month, down three months in a row off a whopping -13.7% on a year-over-year basis, and the level dialed back to where it was in March 2021.



I should add that one must take the CPI with a huge grain of salt because it is not representative of where current pricing is in the dominant rental data, as the charts below vividly illustrate. The Bureau of Labor Statistics New Tenant Rent Index is now running close to flat on a year-over-year basis for the first time in 14 years, compared to +2.4% a year ago and +12.4% two years ago.

This is also confirmed by the Apartment List data, which shows new rents deflating -0.9% year-over-year in real time, down from +2.3% a year ago and +17.0% two years ago.



Finally, the Fed's own Beige Book is at odds with the government data releases. But the Fed is not listening to its own business contacts.

Consider the contradiction from what Philly Fed President Patrick T. Harker said at the end of last year:

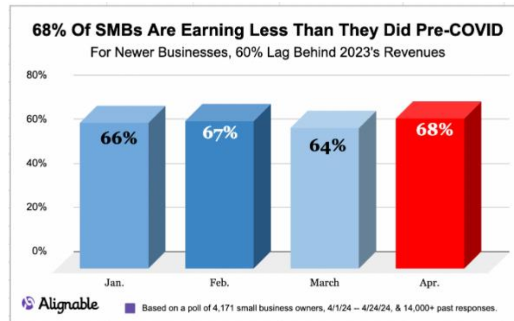
"What we were hearing early on when the inflation was rising, we saw the data but data always lags. But what I was hearing from all our contacts throughout the region was that, yeah things were going up faster than the data was showing — the soft data as we call it. What we're hearing now is the opposite. Things are starting to soften in the economy, maybe faster than the data says. I don't want to make that same mistake twice, of not relying more on the soft data as opposed to the hard data."

Bottom line: I am surprised that so many pundits and even many Fed officials are still fighting yesterday's battle.

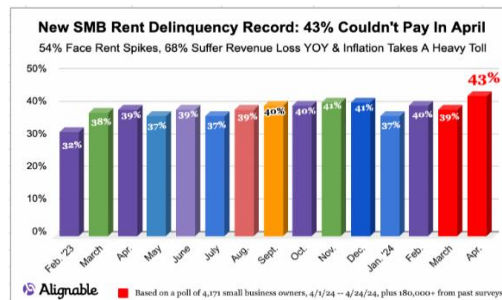
SMALL BUSINESS DELINQUENCIES AT 3-YEAR HIGH

According to Alignable, more than 50% of small-business owners say that their rents are higher now than they were six months ago. Of those, 11% are paying at least 20% more than they did last fall.

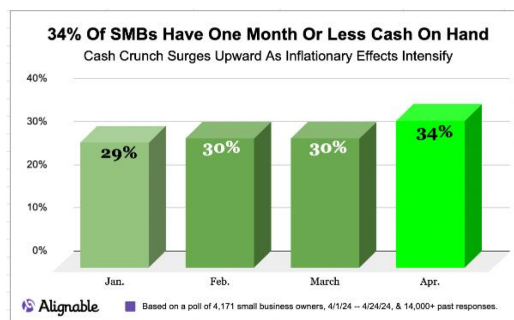
Alignable also found that fewer than a third of businesses founded prior to March 2020 are earning as much or more each month than they did before the pandemic. And among firms founded after the pandemic, 60% are making less than they did a year ago.



As costs rise and revenue declines, many (43%) small businesses are having difficulty paying their rent. Independent restaurants are having the most trouble, with 52% not paying April rent on time. On the other hand, just 20% of small manufacturers are delinquent.



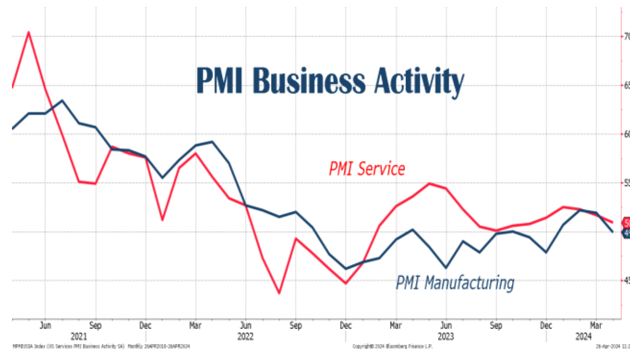
Some 34% say they only have one month or less cash on hand.



Bottom line: Small businesses employ 60 million Americans, account for 1.5 million jobs per year and generate 44% of economic growth. The above could prove to be the canary in the coal mine.

SERVICE SECTOR SLOWS

The April S&P Global Purchasing Managers' Index (PMI) readings were a big downside surprise. U.S. manufacturing activity fell back into contraction territory, slumping to 49.9 from 51.9, a big miss compared to the 52.0 consensus estimate. Services also surprised to the downside, with the index slowing to 50.9 from 51.7 (consensus was also 52.0). While the weakness from manufacturing was not good, the bigger development, at least from my perch, was the weakening in the service economy, given that this has been the pillar keeping the overall economy afloat.



Here is what S&P Global had to say:

"U.S. business activity continued to increase in April, ***but the rate of expansion slowed amid signs of weaker demand****. The latest rise in output was the smallest in the year-to-date* ***reflecting reduced rates of growth and falling orders in both the manufacturing and services sector****s. April saw an overall reduction in new orders for the first time in six months. Companies responded by scaling back employment for the first time in almost four years, with business confidence also waning to the lowest since last November.*

"Rates of inflation generally eased at the start of the second quarter*, with both input costs and output prices rising less quickly at the composite level. That said, manufacturing input cost inflation hit a one-year high."*

Bottom line: These PMI readings point to waning momentum as the second quarter began.

WHY SAVE?

"Yes, the consumer is spending… but they continue to run down their savings in order to do so."
– Peter Boockvar, Chief Investment Officer at Bleakley Advisory Group

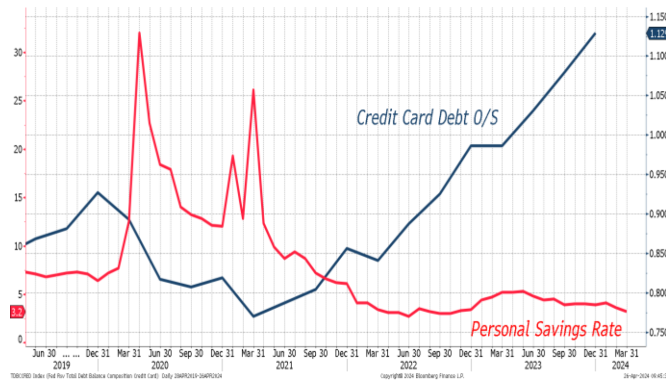
The economic surprise in recent years is the resilience of the American consumer. For the second straight month, PCE rose 0.8% in March, the strongest in more than a year.

On the income side, government and private wage growth accelerated:

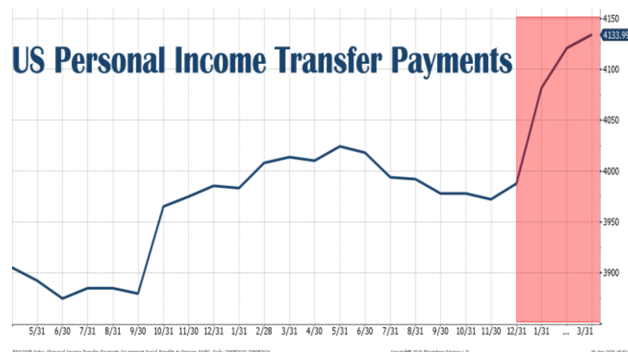
- Government wages rose to 8.5% year-over-year from 8.3%, the highest since December 2022.
- Private wages rose to 5.5% year-over-year from 5.4%, the highest since December 2022 as well.

Meanwhile, spending outpaced that of disposable personal income, which rose 0.5%. It isn't job creation keeping the consumer intact so much as the wealth effect on spending, which the Fed is now leaning heavily against. This encouraged households to take their savings rate down to 3.6% from 4.0% in Q4, 4.3% in Q3 and 5.1% in Q2 of last year. The current savings rate is about 60% below the long-term average U.S. savings rate of 9.0%.

Meanwhile, credit card balances are at all time highs with credit card rates at record highs.



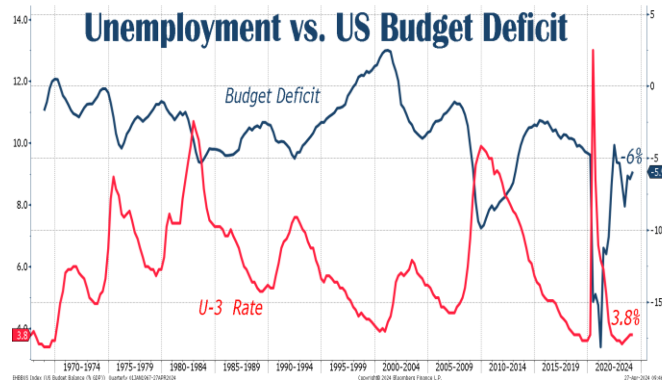
And of course, Uncle Sam continued with a fourth straight month of government handouts.



So, what's behind the "Bidenomics" economic boom?

It's the fiscal stimulus!!

Total U.S. debt has surpassed $34 trillion for the first time. For those keeping tabs, the U.S. added $1 trillion in debt in three months. Indeed, as I have highlighted time and again, the U.S. budget deficit – which is now at 6% of GDP, or a record-high level outside of wars and recessions – is at a level traditionally associated with a recessionary unemployment rate of 8%.



Bottom line: This brings us to the core questions of today, "why save?"

"'Why save?' 2020s era of big government intervention (pandemic = 'stimulus checks', war = 'energy rebates', bank run = 'deposits insured', unaffordable housing = 'student debt forgiveness'… largest deficits ever outside recession." – Michael Barnett

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"There is debate on whether there are cuts at all…The Fed has no choice but to stand down on rate cuts." – Diane Swonk, Chief Economist at KPMG

This week is a doozy for macro catalysts with Treasury quarterly refunding announcement, Institute for Supply Management (ISM) indices, ADP employment, non-farm payrolls and the Federal Open Market Committee (FOMC). With the plethora of labor market data to be released this week and the May FOMC meeting, we should gain a better sense of the true status of employment and the FOMC's mindset.

After a week of volatile data alongside less-than-favorable inflation data, the FOMC stayed in check in its quest for cutting rates. The debate for the Federal Reserve is beginning to shift from how many rate cuts to make this year to whether to cut them at all in 2024.

Swaps traders now see only one Fed rate reduction for all of 2024, well below the roughly six quarter-point cuts they expected at the start of the year. The FOMC penciled in three cuts for this year at their March gathering.

Stay tuned…

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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