alloya INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
SVP, Director of Institutional Fixed Income Sales

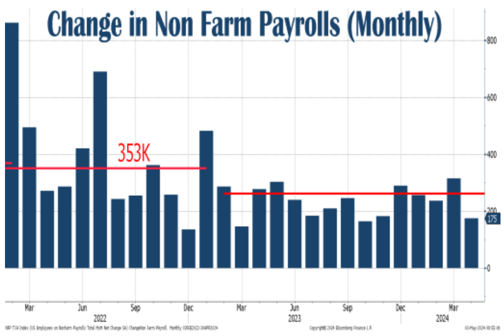
WEEK OF MAY 1, 2024

The Lag Kicks In!

"The Fed is prepared to respond to an unexpected weakening in the labor market."
— Jerome Powell, Federal Reserve Chairman

Finally, after some bizarre payroll reports, the non-farm payroll report bore some resemblance to reality. The Bureau of Labor Statistics (BLS) reported that in April the U.S. added just 175,000 jobs, which is nearly a 50% drop from the upward revised 315,000 (was 303,000). Notably, this was the smallest increase in six months and a huge miss to the consensus estimates of 240,000. In addition, there were downward revisions of -22,000 to the prior two months.

I should stress that almost half of the increase in the headline payroll report was due to the birth-death model even though business insolvencies have surged more than +30% year-over-year while new business formation has declined -5%. If you strip out the suspect birth death skew, payrolls only rose +40,000!



While payrolls were a huge miss, the unemployment rate also rose more than expected, from 3.8% to 3.9% compared to the estimates of an unchanged print. As shown below, the unemployment rate has now risen 0.5% from this cycle's low of 3.4%. Moreover, the broad U-6 measure also inched up to 7.4% (highest since November 2021) from 7.3%.

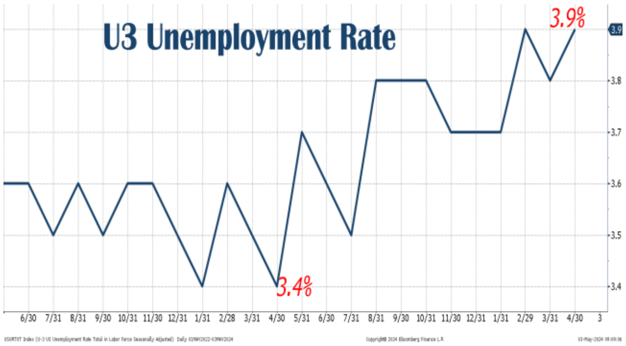
According to the Sahm Recession Indicator (named after economist Claudia Sahm, the start of a recession occurs 100% of the time when the three-month moving average of the unemployment rate (U3) rises by 0.50 percentage points or more relative to its low during the previous 12 months.

THIS WEEK

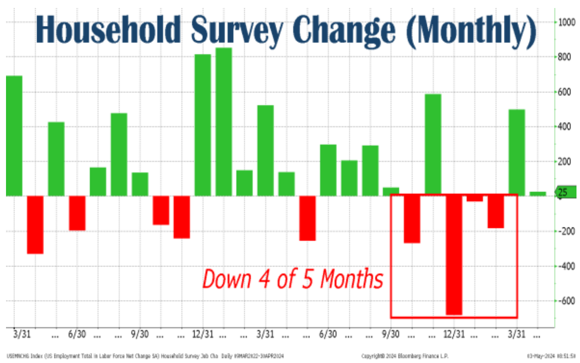
- PREPARE FOR DOWNWARD REVISIONS
- JOB OPENINGS TUMBLE!
- HIRINGS AND QUITS CRATER
- THE WEALTH EFFECT
- THE K-SHAPED ECONOMY
- DEFLATION AT WALMART?
- SERVICE SECTOR CONTRACTS
- POWELL PUSHES BACK ON RATE HIKES
- MARKETING OUTLOOK AND PORTFOLIO STRATEGY

SUBSCRIBE

As shown below, the unemployment rate hit a cycle low of 3.4% and is now at 3.9%. If history is prologue, a recession is imminent. Or "will this time be different?"



The companion BLS household survey showed a tepid 25,000 jobs created in April.



If that doesn't convince you that the labor market is now responding with the average 2-year lag to the aggressive Fed tightening cycle, consider this: Of that +25,000 tepid increase in the household survey, +161,000 of that number reflected folks who were forced into part-time work "for economic reasons." As shown below, part-time workers for economic reasons are now at a three-year high of 4.47 million!

Wages also eased back with average hourly earnings rising 0.2% month-over-month, below the expected 0.3% increase and down from last month's 0.3% print.

On an annual basis, the year-over-year trend in wages is down to +3.9% from +4.1% in March, which is the first time since June 2021 that the year-over-year wage trend has slipped below +4%.

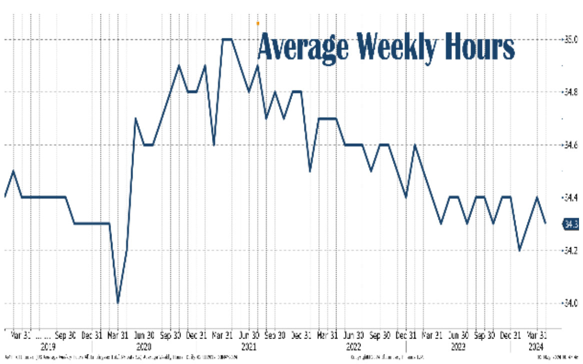
Interesting, even with the highly publicized United Auto Workers' settlement (now in the rear-view mirror), the average hourly wages in manufacturing dipped -0.1% in the first decline in over two years. Likewise, despite the minimum wage hike in California, average wages in the retail sector declined -0.25% month-over-month after a flat March.

Further, the Job Openings and Labor Turnover Survey (JOLTS) showed that the voluntary "quit rate" dropped to the lowest level in three years. It would appear that worker confidence is now declining. Historically, this metric has been a reliable guideline for future wage growth.

Moving on. For the past two years, Powell has focused on wages in the services sector, which are now cooling down nicely. To wit: Growth in leisure/hospitality was +0.1%, education and health was +0.1% and transportation and warehousing came in flat. This is good news for the Treasury bulls.

With wages cooling off substantially, and the workweek contracting, personal income from the labor market dipped -0.1% month-over-month. This should weigh on consumer spending ahead (barring an even larger drawdown in the already depleted personal savings rate).

The underlying takeaway is that companies have over-hired and are now in the process of shedding their labor. The pace of job growth is slowing markedly, and the contraction in the workweek is a telltale sign that the rightsizing of workplace requirements could persist, taking the unemployment rate up further and acting to depress wage growth. If so, in the months ahead, we will no longer be hearing narratives of a red-hot labor market, sticky inflation and "higher for longer."



Bottom line: The April jobs report, from top to bottom, reveals an economy that is losing momentum. Also, keep in mind the emphasis that Powell placed on the Fed's dual mandate at last week's press conference for the Federal Open Market Committee (FOMC) meeting. He stressed that an unexpected weakening in the labor market would be a huge consideration for the start of the easing cycle.

Finally, for those who don't think the Fed can pivot yet again in a more dovish direction, keep in mind that the core personal consumption expenditures (PCE) inflation rate (2.8%) and the unemployment rate (3.9%) are within just 20 basis points of the Fed's latest projections for 2024. When that forecast was published in March, the median dot-plot was still calling for three cuts, not one.

PREPARE FOR DOWNWARD REVISIONS

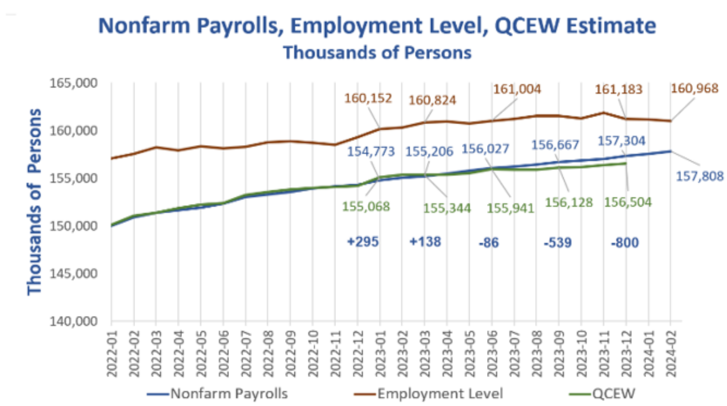
Regular readers may recall that I'm not a big fan of the BLS employment data. The monthly reports are timely but inaccurate and are subject to revisions and modeling adjustments. Frankly, I would say, the employment data is the single most inaccurate, over-hyped, over-analyzed, over-emphasized and least-understood economic releases known to mankind.

As has been discussed numerous times in this space, the biggest problems with the non-farm payroll data is the ultra-low response rate (approximately only 40% of companies respond to the survey) as well as the inflated effect from the birth-death model. In fact, the birth-death model accounted for 50% of the jobs created last year even though the real-time data showed that business insolvencies rose +36% year-over-year while new business formation declined -5%. Think about that.

The overstatement of the non-farm payroll report, to little fanfare, was brought to the surface last week with the dual reports from the QCEW (Quarterly Census on Employment and Wages) and the companion BED (Business Employment Dynamics).

It needs to be stressed that the closely watched non-farm payroll survey covers around 700,000 entities. On the other hand, the QCEW data covers nearly 12 million establishments. This is not a sample, but the entire universe. There are no imputations from a birth-death model. These numbers are real. They are complete.

While lagged, as of September 2023, employment growth was only +1.5%, but the non-farm payroll report that everyone trades off each and every month is up +2.0%. This means that the payroll report has been overstating employment by around 800,000, or nearly 70,000 per month.



Likewise, the BED database, which provided gross hirings and firings, revealed that private employment rose +1.6 million over the four quarters to the third quarter, and that compares to +2.6 million in the non-farm survey. That is a gap of 1.0 million jobs and the QCEW data show there to be a near -800,000 differential. No matter how you slice or dice it, the payroll data has been grossly overstated. The implications are quite significant, and the day of reckoning will come two quarters from now.

So, when the Fed tells us that it is “data dependent,” which data does it refer to? Are they referring to the suspect and historically inaccurate payroll data or the “reality” of the QCEW?

When the QCEW data is released, it will come as a shock to the Fed and to the markets as well.

Meanwhile, the Fed now intends to stay on the sidelines as it closely watches lagging indicators that are subject to major revisions. Yet, the longer it waits, the more it is going to have to do on the rates front. Shades of 1991, 2001 and 2008.

Bottom line: The QCEW data confirmed that the labor market is not tight one iota and proved that the non-farm payroll reports are completely flawed and overstated by historical proportions. Look for significant downward revisions in the not-too-distant future.

As such, I am left with the view that yields hiccups in the Treasury market should be bought in anticipation of what is likely to come our way.

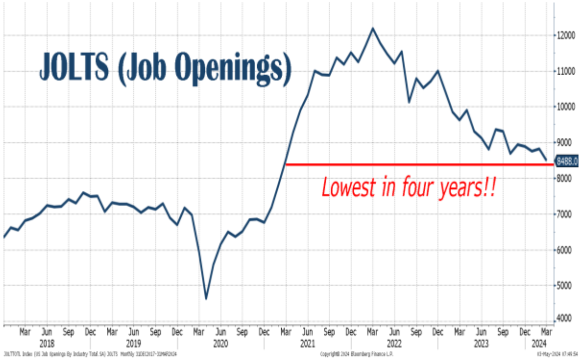
JOB OPENINGS TUMBLE!

"Low hires, quits and layoffs are an unusual combination that points to a certain "lock-in" in the job market. For the Fed, that is likely to tamp down wage growth driven by job switchers even if it doesn't slow net jobs growth."
— Daniel Zhao, Chief Economist, Glassdoor

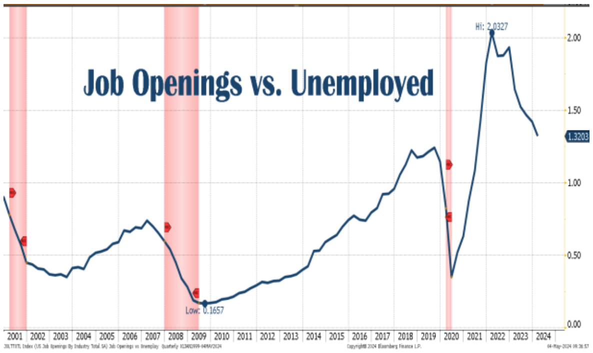
Powell's favorite labor market indicator once again got exciting, and not in a good way.

According to the March JOLTS reported, job openings unexpectedly tumbled by 325,000 —the biggest drop since October 2023 — to just 8.49 million, far below the expected 8.69 million and the lowest number since February 2021 when it last printed below 8 million.

Drilling a bit deeper, job openings declined in finance and insurance (-158,000) but increased in state and local government education (+68,000) because when all else fails, just "hire" more government bodies. Notably construction jobs openings plunged from 456,000 to 274,000, a 182,000 one-month drop and the biggest on record!

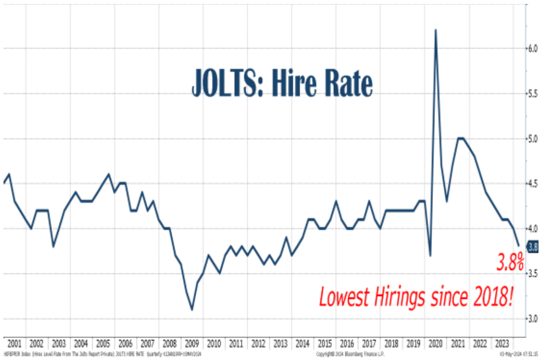


The number of job openings to unemployed dropped to 1.32, a sharp slide from the February print of 1.36, matching the lowest level since August 2021 and almost back to pre-pandemic levels of 1.3.

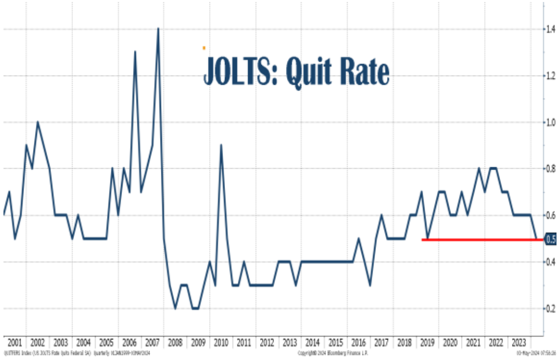


HIRINGS AND QUITS CRATER

Amid the decline of job openings, the number of hires cratered by 281,000 to just 5.500 million — the lowest since January 2018 (excluding the record one-month plunge due to the pandemic) and is now well below pre-pandemic levels.



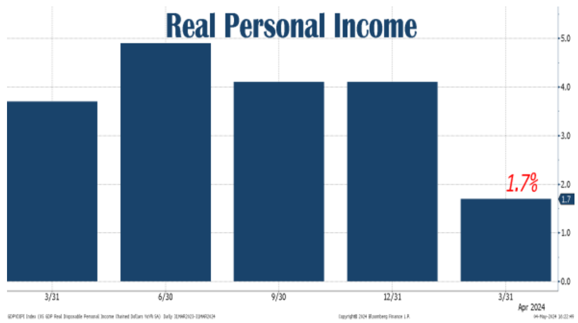
Equally telling was the number of people quitting their jobs. Quits unexpectedly plunged by 198,000, to just 3.329 million — the lowest number since January 2021. This is an indicator closely associated with labor market strength and weakness.



Bottom line: The JOLTS data also showed that hiring and quit rates are both below pre-pandemic levels and that job openings have declined to a four-year low. This means that labor demand is cooling off dramatically and workers are becoming less confident. This in turn explains why the job-hopping craze has totally subsided.

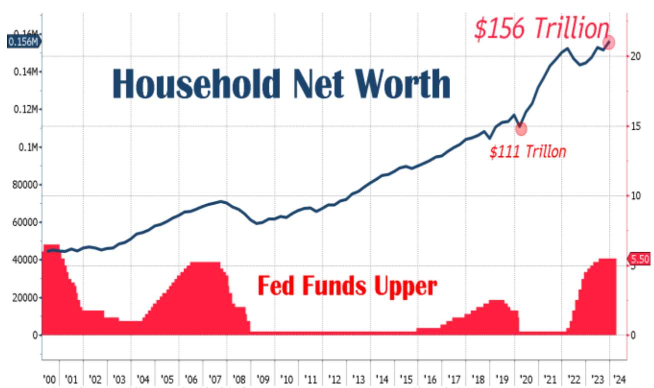
THE WEALTH EFFECT

For all the talk of how strong the economy is, real growth in personal disposable income has slowed to +1.4% on a year-over-year basis from 4.4% for the prior year. Yet somehow consumer spending in the past year has accelerated to +3.1% year-over-year from +1.7% a year ago.



This is the power of the fabled "wealth effect" and nobody responds more to this than the American consumer. The top 10% of the wealthiest Americans own 50% of assets and are responsible for 40% of consumption in the country.

Thus, as real estate and stocks continue to rise over the past year, the massive +$11.6 trillion boom in household net worth boosted consumer spending just from the psychological impact of feeling richer. Indeed, it is widely estimated that over 50% of the expansion in consumer spending in the past year has come from the "wealth effect" alone.



Bottom line: If the Fed wants to dampen demand to hasten the disinflation process, it cannot merely target a looser labor market, it also has to pursue a goal of bringing asset values down to more acceptable levels.

THE K-SHAPED ECONOMY

We have a divided economy where the upper echelons have benefitted from having mortgages locked in at low rates, and the huge positive "wealth effect" from the run-up in inventory-depleted home prices and, up until recently, the booming equity market. On the other end of the spectrum, the bottom end is struggling with high rents and day-to-day living costs. This is known as a K-shaped economy.

Have a look at this *Wall Street Journal (WSJ)* article, "**Grocery Shopping No Longer Involves Just One Trip to the Supermarket**."

To wit:

*"Keeping the household grocery bill under $250 a week now requires stops at Costco, Target, Publix, Sprouts and more… **There are other things I would love to be doing and spending my money on, but right now we need to be focusing on what's truly essential.**" — 35-year-old Augeri, Operations Manager, A Tourism Company*

"Stores are also putting a greater focus on their own private label or store brands, which are typically cheaper than national brand equivalents. Sales of store brands were up 15% for the 52 weeks ended March 23 over the same time in 2022" —AlixPartners

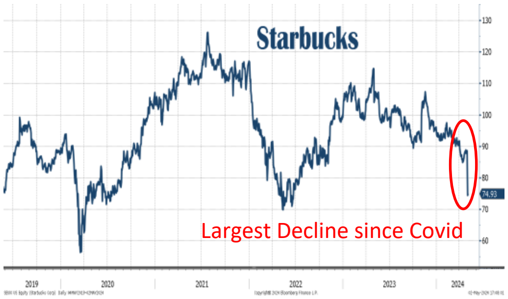
"Roughly two-thirds of the 8,017 Americans consumers surveyed this past fall said they now lean heavily on in-store coupons before or during their shopping trips, compared with the 33% who said they used them in 2021."
— Advantage Solutions, A Retail Marketing Firm

This frugality message was reinforced by this *WSJ* article, "McDonald's Seeks to Make Menu More Affordable for Inflation-Weary Consumers."

To wit:

***"McDonald's said consumers are tightening their spending** as the burger chain reported lower-than-expected quarterly sales growth. Executives said Tuesday that economic pressure is building on consumers, **resulting in declining restaurant visits across the industry**. McDonald's for months warned of a weakening economy, but **executives said the headwinds so far this year are steeper than anticipated**."*

But there are new signs that suggest frugality is spreading beyond the lower echelons. To wit: Starbucks' sales fell -4% year-over-year. This was the first decline in coffee sales since 2020. Same-store sales, revenues and profits all missed. This is the first sign of stress seen at the higher end of the U.S. consumer space and smacks of an early recession sign when households start brewing their own.



Bottom line: Dismal sales data out of the likes of Starbucks and McDonald's, and yet, the masses believe that the business cycle has been repealed and interest rates don't matter. That fantasy is now facing a critical reality check.

DEFLATION AT WALMART?

Walmart U.S. CEO John Furner gave an interview last week with an interesting section on inflation. Here are a few snippets from the interview:

*"**At Walmart, we are now seeing prices that are in line with where they were 12 months ago**. I haven't been able to say that for a few years now."*

"The last few weeks, we've taken even more prices down in areas like produce and meat and fresh food."

Furner also sees deflation in general merchandise, where some prices are below where they were a year ago.

Yet, despite a recent rise in overall inflation in the past three months, Furner says he remains optimistic.

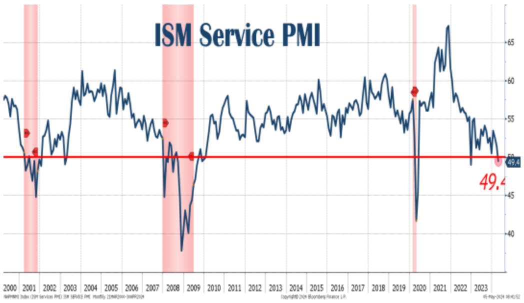
*"What I've learned in the last few years is, it's really hard to predict... **I'm feeling much better about inflation in terms of pricing versus a year ago**, but we're not finished."*

Bottom line: There is a wave of anti-inflation behavior across the U.S., and I believe it is going to be very hard to squeeze inflation out of the economy when consumers flock to the discount stores and private-label products.

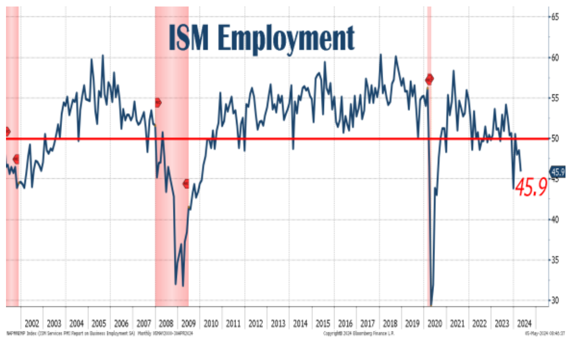
SERVICE SECTOR CONTRACTS

The ISM survey is one of the most venerable measures of economic activity. The original survey by the Purchasing Management Association (now called the Institute for Supply Management) dates back to 1931. The ISM services report measures the economic activity of more than 15 industries measuring prices, inventory levels and employment. Readings above 50 indicate economic growth, while those below 50 indicate a contraction.

The ISM Services PMI report for April came in at 49.4 — the only the second decline in activity since the pandemic-driven crash in the second quarter of 2020. This indicates that the U.S. service sector has now joined the manufacturing sector in contraction mode. As shown below, the number turned below 50 during the 2000-2003 recession, 2008-2009 recession and the 2020 pandemic shock. If, in fact, the number continues to fall and stays below 50, that would signal a recession.



What's driving the ISM Services PMI in contraction? It's the employment. The ISM Services Employment part came at 45.9, and it was expected to come at 49, so that's a big miss. This signals that firms in the service sector are actually reducing the number of employees. The graph below shows that ISM Services Employment goes below 50 during the recession. Given the current level, the ISM Services indicated that job losses in the service sector are forthcoming, and with that, a recession.



Bottom line: The contraction in the service sector indicates that higher borrowing costs from the Fed may be having a larger impact on business conditions and employment.

POWELL PUSHES BACK ON RATE HIKES

*“**I’d say it’s unlikely the next move will be a hike**… we’d need to see persuasive evidence our policy stance is not sufficiently restrictive… we’re not seeing that at present.” — Jerome Powell, Federal Reserve Chairman*

The Fed acknowledged that “in recent months, there has been a lack of further progress toward the Committee's 2% inflation objective.”

That’s just stating the obvious. But Powell said verbatim that “demand has come down a lot.” Not a little, but a lot.

In addition, the statement changed the balance of “risks” between the inflation and employment goals to “have moved toward better balance.” It would appear Powell’s favorite employment metric, as in JOLTS data with sharply lower openings, hirings and quits, resonated hard.

Thus, while acknowledging that inflation has come in higher than expected in the opening months of 2024, collectively the Fed is not convinced that this bump is going to be sustained. The recent uptick in inflation has been dictated by home and auto insurance costs, the arcane method of how the BLS imputes its rental measures and healthcare services. If you want to know the spark behind the +22% year-over-year surge in auto insurance premiums, the poster child for this year’s inflation pick-up, have a look at this *WSJ* article, “Drunken Driving Deaths Up, Arrests Fall.”

Here's the thing. Auto insurance is not inflation per se but rather a shift in prices that will fade away just as the pandemic-induced surge in everything auto-related did in 2021 and 2022 (remember what car rentals and used cars did back then?). Besides, insurance premiums act more as a de facto squeeze on real household purchasing power than anything else.

Bottom line: Powell pushed back hard on all the questions about the next move being a hike. He was explicit that policy is restrictive, and his base case is that the current setting will be enough to bring inflation back to target. His emphasis was only on the timing, not the end goal. Finally, he must have mentioned at least three times that an “unexpected weakening in the labor market” could drive the Fed to cut rates earlier.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

“Again, the aftermath of giving people money directly — what does that look like when people continue to take on habits in their spending, habits that were formed by one stimulus check, two stimulus checks, three stimulus checks, emergency unemployment benefits extended using FEMA, the rental eviction and foreclosure moratoriums extended temporarily through the Centers for Disease Control. Americans taking out buy-now-pay-later that is growing at a third of the rate at which credit card spending is growing on a monthly basis according to Wells Fargo analysis.
— Danielle DiMartino Booth, CEO & Chief Strategist, QI Research

As noted in the quote above, a lot of stuff got in the way that prevented the recession in 2023. In my opinion, the recession has been delayed, not derailed.

This is why.

Interest rate lags are variable and can range from 11 months to 40 months from the time the Fed starts to tighten to the start of the recession. The average (normal) lag is 26 months. The Fed started tightening when? In March of 2022. When the second or third quarter data comes in, we will have a better sense of how the economy is faring in this higher rate environment.

Meanwhile, the inverted yield curve restricts credit availability, particularly to more financially vulnerable firms, which eventually results in less investment and higher unemployment. In addition, higher credit costs reduce credit consumption, which also reduces investment and causes a higher unemployment rate.

Simply put, the inverted yield curve is the bond market's way of crying uncle that the Fed has gone too far. Thus, an inverted yield curve generally precedes a recession but it, too, is often early.

The effect of the inverted yield curve on the economy has "long and variable lags." In other words, it takes time for the yield curve to actually affect the real economy. Generally, a recession occurs 12–18 months after the yield curve initially inverts. The current yield curve inversion as measured by the spread between the 10-year Treasury yield and 2-year Treasury has now been inverted by almost two years. Further, history shows that a deeper and longer inversion of the yield curve produces a deeper and longer recession.

In terms of portfolio strategy, market selloffs 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.