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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF SEPTEMBER 9, 2024

Recessionary Thumbprints

"A report from the American Statistical Association this year warned that ***declining survey response rates and shrinking budgets were putting government data in increasing jeopardy."***
— "Leaked Reports and Political Heat Are Testing Trust in Economic Data"
The New York Times (NYT)

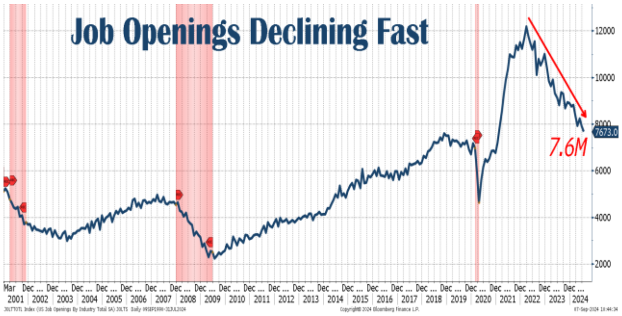
The U.S. economy is primarily driven by consumer spending. As long as people have jobs and incomes, they will likely find a way to consume, even if it means leveraging the credit card or Buy Now, Pay Later programs. However, if one loses their job, spending will come to a screeching halt and the consumer driven economy will slow. Thus, jobs are the "glue" to spending and the economy.

Last week, the economic news was dominated by various employment data releases including July's job openings, ADP (private payrolls only), Challenger job cuts and hirings and last but not least, the August non-farm payroll report. I will discuss some of the key takeaways from each of the releases below.

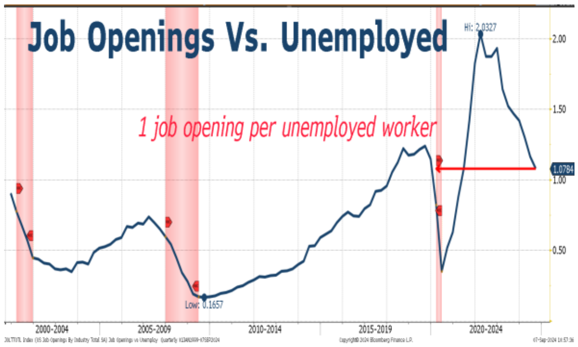
First, the latest Job Openings and Labor Turnover (JOLTS) data showed that job openings continued to decline at a rapid rate. U.S. job openings dropped to 7.67 million in July from 7.91 million in June, the lowest level since January 2021. Since the March 2022 peak, job openings have declined by a **MASSIVE** 4.51 million or 38%.

Since 2000, such sharp drops have only occurred three times, the Dot Com bubble, the Great Financial Crisis and the pandemic. All of them ended with a sharp economic downturn.

THIS WEEK



Meanwhile, the ratio of job vacancies to unemployed workers fell to 1.07 in July, in line with 2018 levels.



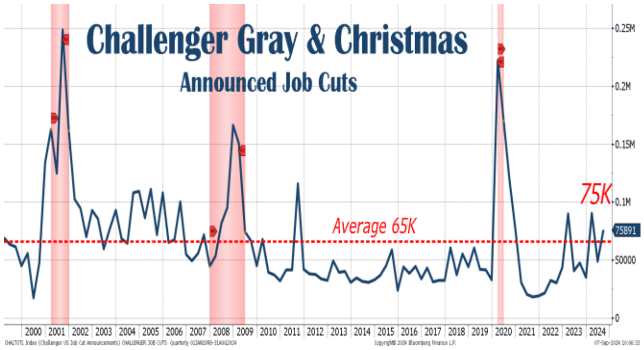
Bottom Line: Based on this metric, the U.S. labor market is now weaker than it was before the pandemic.

The worst part is that this is happening when the consumer has been depleted. The rate is now less than half of what it was in 2019 and is holding record levels of credit card debt!

IT'S CHALLENGING OUT THERE

Meanwhile, U.S. employers announced 75,891 job cuts in August, a 193% increase from the 25,885 cuts announced in July. The 75,891 pink slips were the most for any August since the pandemic in 2020. Before that, try August 2009. To put the 75,891 firing announcements into context, that is +33% higher than the average of all Augusts in the past. So much for the robust or "normalized" labor market narrative.

Fully 37,403 (third most on record and an all-time high for any August), or about half of the layoffs, came from "cost-cutting" — which dovetails nicely with the disinflation theme.



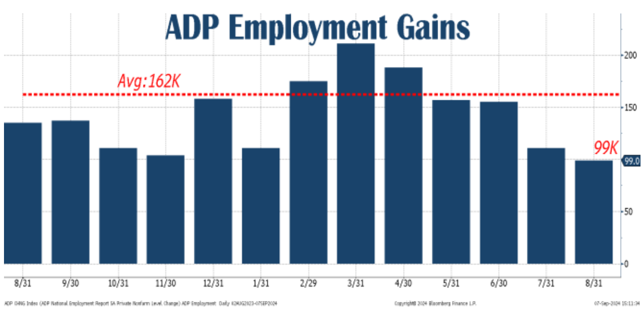
Notably, tech firms announced 39,563 job cuts in August, the most in 20 months.

Hiring **FELL** to the lowest since data began in 2005. Hiring announcements slumped -21.2% from year-ago levels and, at 6,101, were the lowest for any August on record (80% below the norm in the past going all the way back to 2004). This truly underscores the extent to which demand for workers has weakened — even as businesses continue to hoard labor.

For more on how the jobs market has become much more challenging, have a read of this *NYT* article, "The Hot Labor Market Has Melted Away: Just Ask New College Grads."

SOFT UNDERBELLY

The ADP private sector payroll data were super-soft with the headline coming in at +99,000 for August compared to the +145,000 consensus estimate. To make matters worse, July was revised down -11,000 to a +111,000 increase. This was the weakest headline since January 2021 and the softest back-to-back performance since July-August 2020.



The softness was broadly based:

- Large companies (500+ employees) added just +42,000, a big haircut from the prior three-month average of +51,000 and the lowest number since last January.
- Mid-sized companies (50 to 499 employees) slowed to +68,000 in August, and that compares to a three-month mean of +72,000.
- Small businesses (fewer than 50 employees) fell by -9,000 and are off -6,000 over the past three months (and the year-over-year trend has throttled back to a microscopic +0.2% from +1.8% a year ago). Note: This is a tried, tested and true recession indicator because it is small businesses that are in the weeds of the economy. Small businesses typically adapt much more quickly to shifting economic circumstances compared to bigger firms.

Sector-wise, virtually every sector is seeing a notable slowdown — including trade/transportation/utilities, health/education, construction and outright declines in technology and manufacturing

Bottom line: The ADP data should tell everyone all they need to know. Employment is not yet collapsing or contracting, but it most definitely is cooling.

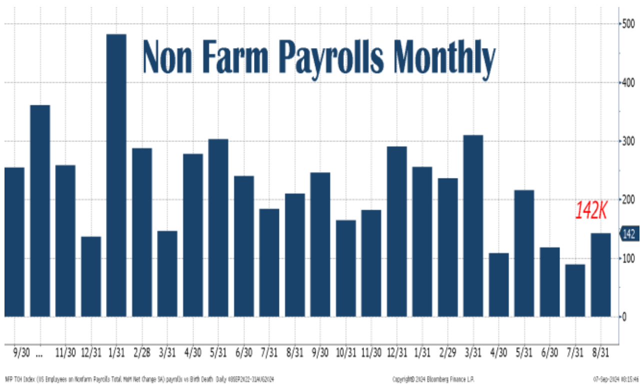
IT WASN'T THE WEATHER!

Those claiming that July's non-farm weakness was all a weather story are now wiping the egg off their face. Non-farm payrolls for August came in at +142,000, which was below the consensus of 165,000.

Moreover, the **BIG** story continues to be revisions. To wit: June and July jobs reports were revised **LOWER** by a combined 86,000 jobs.

Think about this, in June, payroll growth was originally reported as 206,000. Two months later, it's down to 118,000. It could easily end up below 100,000.

Likewise, the July jobs report was revised lower by 25,000 jobs, from 114,000 to 89,000. This means that the July jobs report was the **WEAKEST** jobs report since the pandemic in December 2020.



Effectively, the initially reported payroll numbers have become almost meaningless. For example: 16 of the last 17 months of job (non-farm payroll) numbers have been revised downward. The last seven months were **REVISED DOWN** by **OVER** 360,000.

Get this, excluding government jobs, 11 out of 12 months in 2023 were revised lower. This is the most since 2008!

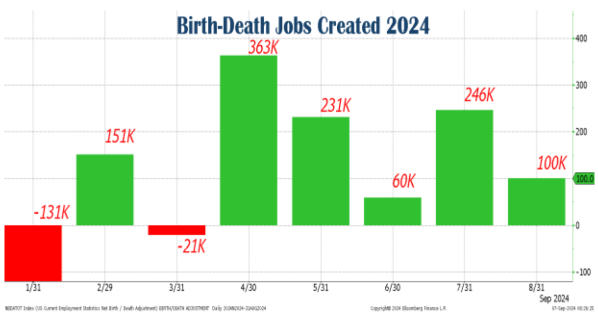
We also now know that job numbers for the 12 months through March 2024 were overstated by 818,000!
So, the idea that payrolls actually grew by 142,000 in August is a stretch given ongoing negative revisions. Just wait until next month when we see the revisions to the August numbers. Frankly, at this point, the jobs data might as well be released on a one-month lag.

Bottom line: The incoming data (especially labor data) is more unreliable and creates extra uncertainty for investors and policymakers

FICTITIOUS JOBS

The Bureau of Labor Statistics' (BLS) birth-death model looks back five years and adjusts the total employment numbers for how many new businesses have opened and how many people work at these new businesses. Incredibly, the birth-death model accounted for 38% of the headline payroll number.

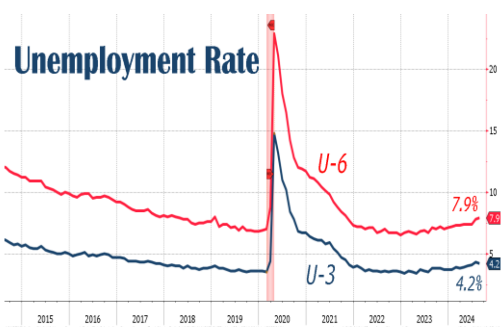
Simply put, it's a guess! So, adjusting for that fantasy, non-farm payrolls really rose by around 42,000 instead of 142,000 in August.



In terms of where the jobs are, the sector composition also left me rather unimpressed. Job declines were reported in manufacturing (-24,000) and retail (-11,000 and down three months in a row) alongside flatness in the transportation and banking sectors. The only sectors of job growth were government and health/education. Enough said.

UNEMPLOYMENT RATE DIPS

As was expected, the unemployment rate did dip as expected to 4.2% from 4.3% in July, but the broadest U-6 measure edged higher to 7.9% from 7.8% to stand at the highest level since October 2021. Both numbers would be way higher still, were it not for millions dropping out of the labor force over the past few years.

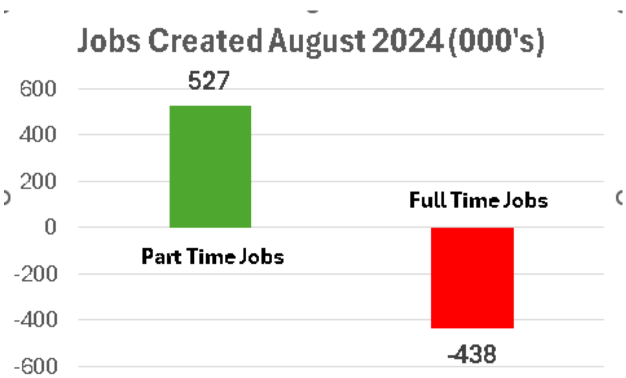


Also of concern, it's clear that should one lose their job it has become increasingly more difficult to find a new job! Historically, when this trend occurred a recession followed (see arrows in graph below).

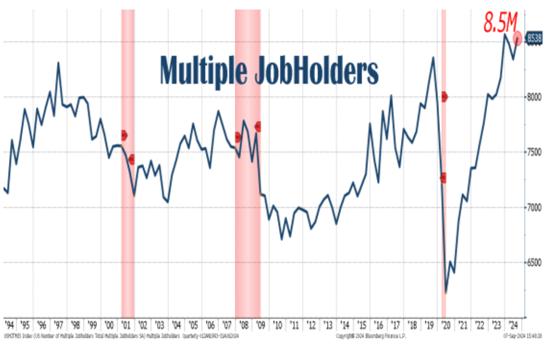
Bottom Line: A lot of folks have been sugar-coating the labor market by saying it has "normalized" but try telling that to the ranks of the unemployed, which have risen +12% over the past year (+775,000). This is eight times the pace of payroll employment growth.

PART-TIME NATION

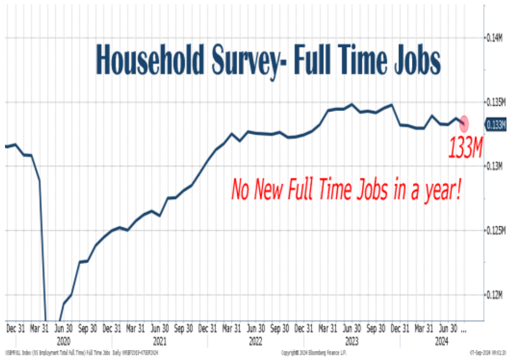
The companion household survey showed a +168,000 increase in jobs. The problem with that +168,000 job gain is that the gain consisted of an increase of 527,000 part-time jobs, offset by a 438,000 plunge in full-time jobs. **This means that since last June, the U.S. has added just over 2 million part-time jobs and lost over 1.5 million full-time jobs.**



Needless to say, part-time jobs pay far less, don't offer benefits and generally lead to a suboptimal outcome for the labor market, one of which is the need to get more than one job. And sure enough, the number of multiple job holders, or people who for whatever reason have more than one job, jumped above 8.5 million and is back to all-time highs. Multiple job holders as a share of total jobs is at 5.4% and tied for the highest level since April 2009.



Meanwhile, full-time employment **DROPPED** by 1 million workers in August on a year-over-year basis, which marked the seventh consecutive monthly decline. Not once in history has the economy failed to enter an NBER-defined recession with this sort of contraction in full-time employment. A perfect eight-for-eight track record back to 1970.

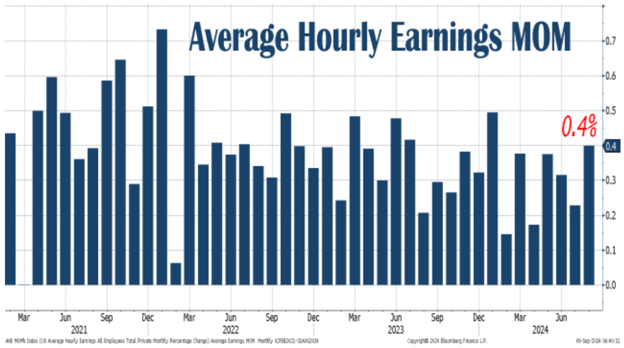


In fact, total household employment is down -0.04% (-66,000) on a year-over-year basis, so it's not even the case that the shift to part-time positions has managed to offset the carnage we have seen in full-time jobs — again, this has only happened in recessionary economic conditions.

Finally, the ranks of the self-employed, usually folks who bridge their period of unemployment by taking on consulting work, jumped +273,000 after rebounding +152,000 in July — a back-to-back surge not seen since July and August of 2020!

WAGES PICK UP

In an otherwise bond friendly report, the only snafu was the +0.4% month-over-month run-up in average hourly earnings (consensus was +0.3%), which doubled the +0.2% uptick in July. As for the outsized wage increase, it was largely (but not solely) concentrated in one sector, technology. The average hourly earnings spiked +0.9% month-over-month in the fastest pace since August 2022. This is interesting since all the headlines are reading that Silicon Valley is laying off staff.



Frankly, it is impossible for me to be worried about "wage inflation" when the unemployment rate is on a rising path (4.2% from 3.8% a year ago) and the voluntary quits rate is on a downward trajectory (12% from 12.8% a year back). Not to mention that wages are only growing right in line with productivity, which is the furthest thing from inflation

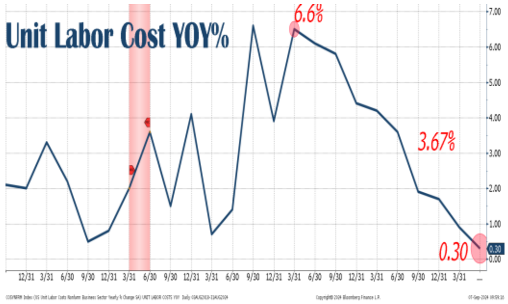
All that said, in conjunction with the rebound in the workweek (back to 34.3 hours from 34.2 hours), work-based income in aggregate managed to rise +0.7% last month in the sharpest increase in a year-and-a-half. While soft overall, this report was not exactly an unmitigated disaster.

Bottom Line: Job quality is declining, with part-time workers and multiple job holders on the rise. The recession may have not yet arrived, but the pressures are rapidly building. I hate to be the bearer of bad news, but it won't help anyone to be sticking their head in the sand as so many Wall Street economists are as they please their masters (pushing against your boss' demands is never a very pleasing development).

MOTHER'S MILK

I would argue that one of the most important numbers released last week (that no one seemed to discuss) was the sharp downward revision in the second quarter unit labor costs (ULC) to a microscopic +0.4% quarter-over-quarter. The year-over-year trend in ULC, the mother's milk for future inflation, has practically evaporated to +0.3% from +0.9% in the first quarter and +6.6 % two years ago.

For some perspective, this is the weakest growth rate since 2013 when the funds rate was sitting near the zero-bound and the yield on the 10-year Treasury note was nearing the 2.5% mark.



Nobody put it better than Fed Chairman Jerome Powell at Jackson Hole:

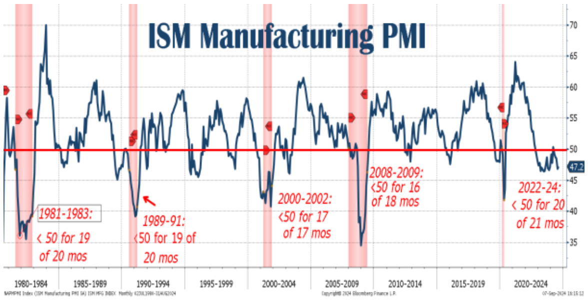
"It seems unlikely that the labor market will be a source of elevated inflationary pressures anytime soon."

Ain't that the truth!

Bottom line: Inflation is yesterday's news!

MANUFACTURING REMAINS IN A RECESSION

The ISM Manufacturing Purchasing Managers Index (PMI) changed little to 47.2 in August from 46.8 in July. The August outcome was the fifth consecutive month of under 50 results, signifying contracting activity in the manufacturing sector. As can be gleaned below, previous contractions of this magnitude have led to recessions.



BEIGE IS BLUE

"Economic activity grew slightly in three Districts, while the number of Districts that reported flat or declining activity rose from five in the prior period to nine in the current period." — The Beige Book

I've been arguing for months that the U.S. economy feels much more like a 1-1.5%, and certainly not the 3% print for the second quarter. After reading the Fed's Beige Book introductory paragraph, I might even be generous with the upper end of my range and should lower it to .5-1% growth outlook.

Whether looking at population or gross domestic product (GDP), more than 75% of the country is either in economic stagnation or contraction. This is up from 40% just four weeks ago.

As for the employment picture consider the following snippets:

"[…] As competition for workers has eased and staff turnover has fallen, firms felt less pressure to increase wages and salaries. On balance, wages rose at a modest pace, in line with the slowing trend described in recent reports …A few Districts reported that firms reduced shifts and hours."

"[…] Employers were more selective with their hires and less likely to expand their workforces, citing concerns about demand and an uncertain economic outlook …Accordingly, candidates faced increasing difficulties and longer times to secure a job."

— The Beige Book

The only area of economic growth I see is from the higher income consumer spending on travel, leisure and hospitality, which includes live entertainment, anything related to AI spending and of course government spending (healthcare, interest expense, defense and the CHIPS Act and IRA).

Bottom Line: This is one of the weakest Beige reports in my 40 plus years in the business. Very rarely has the Beige report been so downbeat, especially on the consumer without the economy being on the cusp of an official downturn.

The message is unambiguous, activity is slowing sharply, the disinflationary momentum is only growing and the labor market commentary remains very pessimistic.

Unlike the government data that frequently gets revised, the Beige Book does not.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

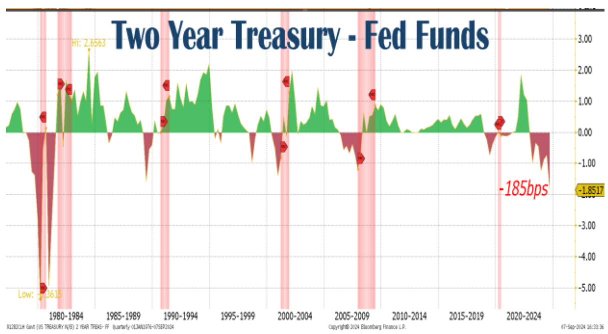
While all eyes are on the stock market and the bulls are biting their nails, the bond market is figuring out the odds of a 50 beeper from the Fed on September 18, which made its way back to a near toss-up after starting the week at 30%. That said, a consensus-seeking Powell may not be able to bring everyone on board with a move that big (though I think it is justified).

Last week, Treasury yields made fresh 14-month lows. The benchmark 10-year Treasury yield is now down 100 basis points since April 2024.

On the front end, the 2-year Treasury yield plunged from 5.04% in April to 3.64% last Friday.

Much is being made of the fact that the 2s/10s yield curve un-inverted last week. History shows that 2s/10s inversions can often lead with a long lag (think of 2006-2007). However, after a lengthy inversion that is then followed by an un-inversion, the recession generally begins within three months after that pivot (see red circles in the graph below). This is just another nail in the coffin on the recession call.

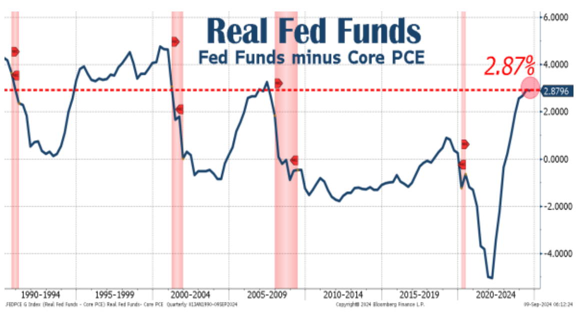
The really important curve to pay attention to is the 2-year and the fed funds spread, which, at -185 basis points, is the most inverted it has been since 2008! This is a clear message from the bond market to the Fed that it has bungled things again, allowing it to fall behind the curve as never before.



Bottom line: The most leveraged economy in the world does not get a "get out of jail card." The lag from the Fed's most aggressive policy tightening cycle since the early 1980s is now infiltrating throughout the economy as higher-for-longer real rates are decisively hurting the U.S. consumer and the labor market.

A delayed economic response to the prior damage the Fed has done does not mean the downturn has been derailed. I heard the same narrative in 2007 when it seemed to take forever for the recession to come, and the same pundits calling for a perpetual "soft landing" or "no landing" scenario back then are doing the same thing today.

That said, the economy does not need to fall into recession for the Fed to normalize rates. As shown below, the inflation adjusted fed funds rate is at the highest level in over 15 years!



Let me leave you with this: The history books show that when the Fed begins the easing cycle it unwinds 80% of its prior tightening. If you do the math, that means that the fed funds rate could decline to 1.75%. If so, the 2- and 5-year Treasury yields would decline to 2% and 2.5%, respectively. The 10-year Treasury yield could fall to 2.75%.

Thus, whether the U.S. economy avoids a recession or not, the path of least resistance is for lower rates across the yield curve.

MORE INFORMATION

For more information about credit union investment strategy, portfolio allocation and security selection, please contact the author at tom.slefinger@alloyacorp.org or (630) 276-2753.

As Alloya's Market Strategist, **Tom Slefinger** leverages nearly 40 years of investment strategy expertise to deliver insightful commentary on the economy and market events to optimize balance sheet performance at the credit union level. With thousands of subscribers, Tom's daily and weekly publications are widely read amongst credit union executives.

Prior to becoming the corporate's Market Strategist, Tom served as the Senior Vice President of Institutional Fixed Income Sales at Alloya Investment Services, a division of Alloya Solutions, LLC. In this role, Tom developed and managed operations associated with institutional fixed income sales in addition to developing investment portfolio strategies, identifying appropriate sectors and securities, and optimizing portfolio performance at the credit union level.

Tom holds a B.S. in business administration from the University of Maine. In addition, he holds a Series 7 and 63 through ISI.