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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF OCTOBER 21, 2024

Consumer Sentiment Sinks

THIS WEEK

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- DAMN INTEREST RATES
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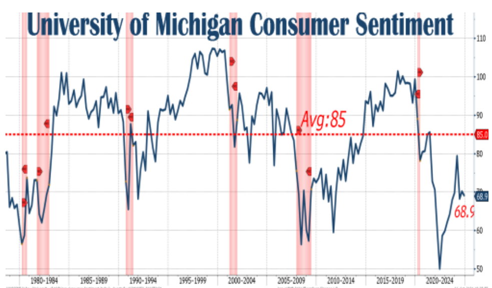
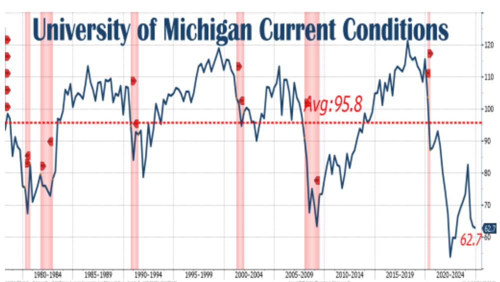
The venerable University of Michigan Consumer Survey is considered a crucial economic indicator used to gauge U.S. consumer confidence levels every month. It measures how people feel about their personal finances, business conditions and buying power. It essentially acts as a leading indicator for potential changes in consumer spending and the overall economy.

With that said, a few blemishes showed up in the University of Michigan Consumer Sentiment Index for October. The index slipped to 68.9 from 70.1 in September. For some historical perspective going all the way back to 1952, the 68.9 headline compares very unfavorably to the long-run average of 85. In fact, the confidence level is actually at, or below, each of the past 11 recessions of the past seven decades.

But hey, based on everything I read, the consensus expects a "Goldilocks' soft landing." Indeed, fully 76% of investors see a "soft landing" for the economy while a mere 8% predict a "hard landing." Only 19% of portfolio managers even see a recession as a "tail risk." Harry Houdini would definitely be proud.

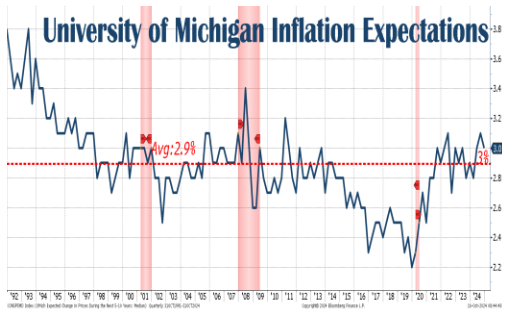


When looking at the underlying components, the "current conditions" subindex fell back to 62.7 from 63.3 in September while the "expectations" component dipped to 72.9 from 74.4.

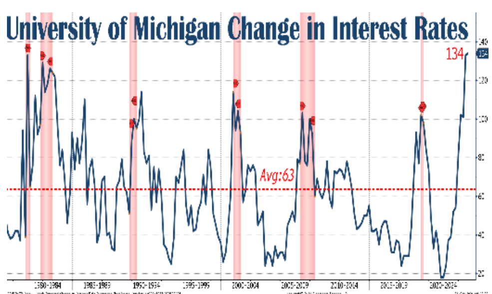


The percentage of respondents who see higher unemployment (31%) in the coming year is more than double the share of those who see joblessness going down (15%). In other words, it may be unwise to think that the September payroll report was nothing more than a statistical mirage.

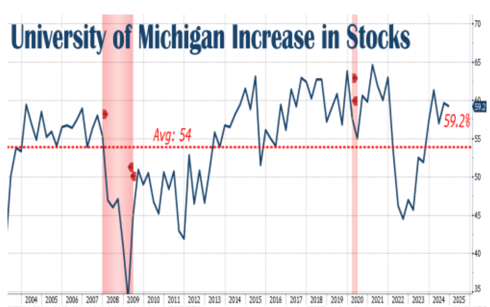
On the inflation front, median inflation expectations for the next five years edged down a tad to +3.0% from +3.1%. That said, it is encouraging to see that the folks who actually make up the economy aren't bothering to listen to Wall Street's nabobs of negativity when it comes to the inflation landscape.



Surprisingly, just 20% see rates going up (the lowest in four decades) while 54% see rates still going down (tied for the second-highest share ever). However, this did not help the sentiment index.



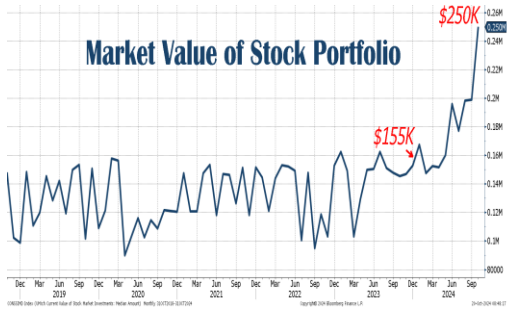
I also wonder why the consumer feels so gloomy when their views on the stock market are extremely bullish. Nearly 60% of those surveyed see the S&P 500 remaining on a one-way ticket north. This is at the exceedingly high end of the historical range.



Further, the University of Michigan asks about the size of a respondent's stock portfolio (including ETFs, mutual funds, and retirement funds). The answer only includes those who say they own stocks. Note that they report it as a three-month average.

The three-month average was up $51,000 in September. Since year-end, the market value has risen from $155,000 to $250,000 (or 61%). What in the world… Is everyone buying Nvidia?

Regardless, if this data is accurate (I have no reason to believe it isn't), you would think people would be uncorking champagne!



At the same time, Americans' expectations about their financial situation over the next five years dropped to the lowest level in 11 years. Their current financial situation compared with a year ago fell to near the lowest level since 2011. Over the last 60 years, such depressed levels have only been seen in recessions.

Bottom line: Typically, you would see high and rising sentiment when there are record highs and a booming economy, however, not these dreadful sentiment prints. Thus, the survey data in both the household and business sectors is historically out of whack with what the headlines propagate in regard to markets and the economy.

What explains the discrepancy?

I believe it's the widening wealth gap. It's a recovery for the rich on the backs of the less well to do.

For 67% of the nation (the asset holders and the homeowners), the economy (the stock market) has been good to very good, which is offsetting inflation.

For the renters and struggling homeowners fed up with property insurance, food and other inflation, the economy borders on miserable.

Nevertheless, the latest survey responses raise some questions about the "consumer resilience" narrative.

RETAIL SALES SURPRISE?

Despite the gloomy consumer sentiment readings, retail sales came in hot in September. The headline came in at +0.4% (+0.3% expected). Additionally, retail sales (excluding autos) came in at +0.5% month-over-month (+0.1% expected). The gains were reasonably broad based. Even still, on a year-over-year basis, retail sales continued to decline to 1.7%, which is the weakest level since January.

For the third quarter, sales accelerated to a +5.3% annual rate from +1.8% in the second quarter. Now, the -0.8% contraction in the first quarter is now in the rear-view mirror.

The most important facet to this report was the “core control” metric, which feeds directly into the consumption in the gross domestic product (GDP) data**.** This showed an outsized +0.7% month-over-month pickup, significantly higher than the consensus view of a +0.3% gain.

This is where the good news ends.

Adjusting for higher prices is key in interpreting the retail sales data. When you do that, every dime of growth can be accounted for by price inflation. On a "real" basis, retail sales are down 0.9% over the past year. This is well below the historical average of 2%, and they have **CONTRACTED** in 26 of the last 29 months.

In other words, the vaunted U.S. consumer is little more than a mirage of inflation.

“Credit cards are becoming Americans’ lifelines against high inflation: Over half of cardholders who’ve maxed out a credit card or come close (54%) blame inflation or high prices. Other top reasons include emergency expenses (38%) and carrying a balance or having credit card debt (32%).” — Bankrate

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Additionally, this data must be analyzed against consumer credit card debt levels, delinquencies and defaults in order to have a better sense of the retail data as an expression of consumer health. And on that score, credit card debt now **EXCEEDS** savings! The delinquency rates on credit cards and auto loans look a lot like they did in 2008. There are new 15-year highs across the board, and "real" wage growth is **LESS** than 1%.

So, when one looks behind the headline data, it appears many consumers are **CHOKING.** However, the media and brokerage community continue using words like "strong" and “healthy balance sheet," which folds into the headline narrative.

Finally, while I'm not a conspiracy guy, here's another strange thing about the retail sales data. As witnessed in the September labor market data, there seems to have been a record high seasonal-adjustment skew. On an "unadjusted basis," retail sales fell a shocking 7.5% month-over-month. This means that without the biggest positive September seasonal adjustment in history retail sales were dismal.

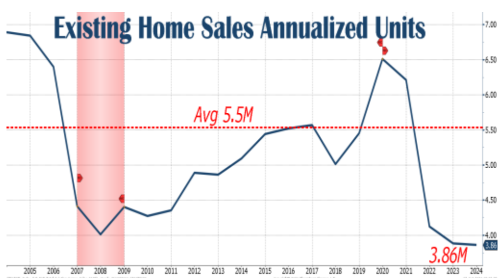
Bottom line: Take your pick. Is retail spending "hot," or is inflation eating into personal incomes more than many think?

That said, investors will now begin to question whether the Fed has much more to do on the easing cycle in light of economic reports like this.

HOMESICK

"We expect affordability to remain the primary constraint on housing activity for the foreseeable future, and we now think full-year 2024 will produce the fewest existing home sales since 1995." — Fannie Mae

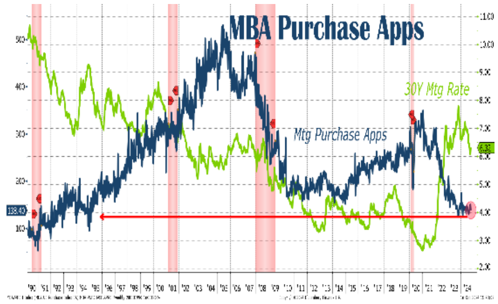
Sales of existing single-family houses have plunged by about 26% from 2018 and 2019, and by about 34% from 2021. In 2023, they fell to 4.09 million homes, the lowest since 1995. From January 2024 through August 2024, sales are tracking 2.5% below 2023. And if that decline continues, sales will drop to about 4.0 million homes. This demand destruction is worse than during the depth of the Great Financial Crisis as millions of people lost their jobs and mortgages blew up.



Despite mortgage rates dropping to a near 6%, there has been little demand through September. Now, mortgage rates have bounced off the September lows since the rate cut, and demand has collapsed further even as inventories have been rising all year.

It's not just the challenges of saving for a down payment and elevated mortgage rates that are making homeownership unaffordable. Rising insurance costs also mean homeowners are struggling more to fit their monthly payments into their budget. To wit: According to Intercontinental Exchange, the average mortgage payment, which includes principal and interest as well as property taxes and homeowners' insurance, hit a new record high of $2,070 in August. This is up 24% from before the pandemic.

The lack of housing activity was once again confirmed last week by the plunge in weekly home purchase applications from already historically low levels. The Purchase Mortgage Applications Index has stayed in the same historically low range since the beginning of 2023

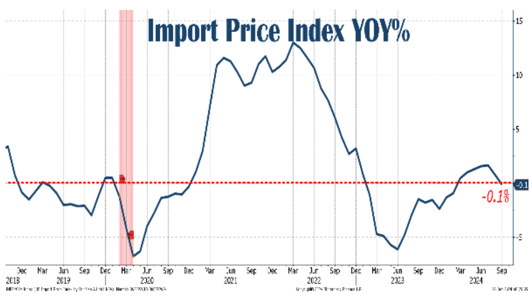


Bottom line: Prices are too high, and people have gone on a "buyers' strike," and they are staying on strike. Lower prices are exactly what buyers are waiting for — lower prices, lower mortgage rates and higher wages.

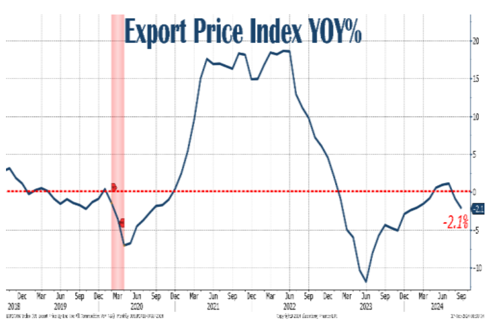
PUTTING THE "DIS" IN INFLATION

The export and import price data raises doubts on the dubious hotter than expected September Consumer Price Index (CPI) data.

Import prices fell -0.4% month-over-month, and that swung the year-over-year pace to a fractional negative reading (-0.1%) from +0.8% in August. For the third month in a row, import costs (excluding fuel) came in below +0.1% month-over-month. Would you call that inflation?



Meanwhile, export prices dipped -0.7% month-over-month after a downwardly revised -0.9% August print. This pushed the year-over-year trend further into deflation terrain to -2.1% from -0.9%. Would you call that inflation?



Bottom line: September's import and export price deflators show that there are no signs of price pressures in the goods sector — including consumer goods. This is another data point leaning against the disappointing CPI print and some good news for the bond market.

MOTHER'S MILK IS SOURING

Why does the market keep going up?
Cause they keep buying it.
Why do they keep buying it?
Cause it keeps going up!

— Sven Henrich, Founder & Lead Market Strategist, NorthmanTrader

The S&P 500 has practically doubled these past five years. And when you look at all the valuation metrics (price-to-earnings, price to-book, price-to-sales, CAPE index, etc.), the market is egregiously overvalued. Consider this point: Over the past year, profits grew by just over +5%, but the S&P 500 is up a resounding +34%!

Going forward, Bank of America's equity quant group expects the 2024 third quarter earnings growth to slow to a modest 4%. Notably, this modest profit growth is due to due entirely to a 19% increase in the Magnificent 7 (e.g., Apple, Amazon, Alphabet, Meta Platforms, Microsoft, Nvidia and Tesla) earnings. The rest of the S&P 500, some 493 companies, are expected to post another quarter of flat earnings!

In other words, for all the talk about robust earnings growth, **if one takes away just seven companies, which make up the apex of the AI bubble, there is no earnings growth at all.**

Take a look at the broader large cap S&P 1500 universe. If one excludes just the top 10% of companies, profits are flat. If you exclude the top 50%**,** then profits are falling sharply. Thus, aggregate profits are being inflated higher by a smaller number of large and mega-cap stocks.

Bottom line: Market valuations are extremely overvalued, and earnings growth is muted. Yet, investors have thrown caution to the wind and are "all-in." In fact, investors' allocation to stocks hit 61%, the highest level in at least 40 years. This share has almost **DOUBLED** since 2009 and is in line with the 2000 Dot-Com Bubble levels.

Meanwhile, the market pundits on bubble vision say that valuations only matter when they matter. Fair enough. Bubbles are nearly impossible to time and rich valuations can become even more elevated, but I assure you valuations will matter a lot when the elevator goes straight down.

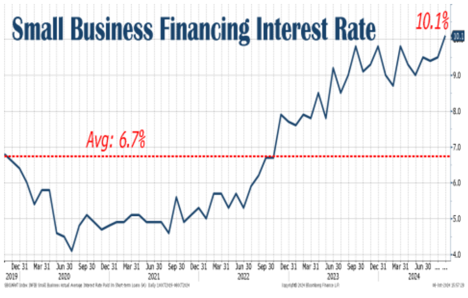
With the U.S. household asset mix lacking diversification and baby boomers having almost 60% of their asset allocation in stocks, I see a concerning trend developing when the bear market strikes.

DAMN INTEREST RATES

The declining earnings are even more apparent by the Russell 2000 small cap stocks. Since the Fed has raised rates, more small companies are struggling to stay in business.

The share of "unprofitable" companies in the Russell 2000 is now at 43%. This is the most since the pandemic, and 41% was seen at the end of the 2008 Great Financial Crisis.

Small companies with no earnings, weak revenues and weak cash flows underperform when interest rates stay higher for longer because they are not able to pay their higher debt servicing costs. And as vividly shown below, they are now facing the highest rates in 20 years.



Bottom Line: While we now know that only a handful of large and mega-cap companies have been driving the rosy profit picture, it is small companies that drive employment growth, not the large and mega-cap companies.

If there is no rate relief, some small businesses will go out of business, some will cut back on investing while others will halt hiring or lay staff off. Thus, the U.S. economy could still be vulnerable to recession as "long and variable" monetary lags work through the system.

Finally, make no mistake about it, small-cap companies are in desperate need of rate cuts!

IT'S A MIRAGE

"Government is not the solution to our problem; government is the problem."
— Former President Ronald Reagan's Inaugural Address, January 20, 1981

Unquestionably, the U.S. economy has surpassed all expectations and the recession has been held at bay. In fact, the latest reading from the Atlanta Fed GDP Now model shows the third quarter GDP running at 3.4%. At the same time, the Beige Book is saying three-quarters of the "private" economy in contraction or stagnation. Go figure.

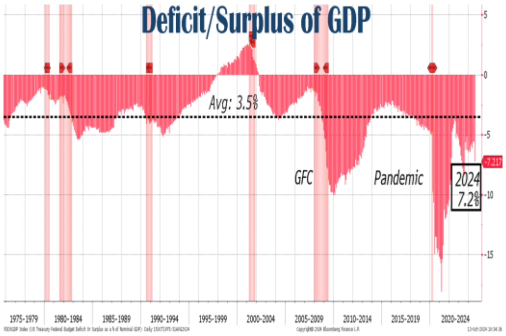
Source: Mish

We also know that the incoming data (e.g., auto sales, home sales, retail sales volumes and industrial production) are running flat or negative on a year over year basis. So where is this 3% growth coming from?

In a word: **GOVERNMENT**!

The federal deficit hit a **WHOPPING** $1.83 trillion in the fiscal year of 2024, which ended on September 30. In other words, the government borrowed a staggering $5 billion **A DAY**. Excluding pandemic years, this was the largest shortfall in the nation's history! This was only below 2020 and 2021 pandemic years.

For the second year in a row, Uncle Sam has been running fiscal deficits equivalent to over 6% of GDP. Historically, the federal government runs a 3% to 4% deficit-to-GDP ratio to fight recessions. In today's world, the government is running a 6%+ deficit ratio to keep the GDP and employment numbers chugging along.



And the stimulus is not just coming from Washington. As shown below, state and local governments have been aiding and abetting this burst in economic growth.

That is the hard truth about why the recession has not come. Fiscal stimulus from federal, state and local governments saved the day, and one has to wonder when or if this runaway spending will end.

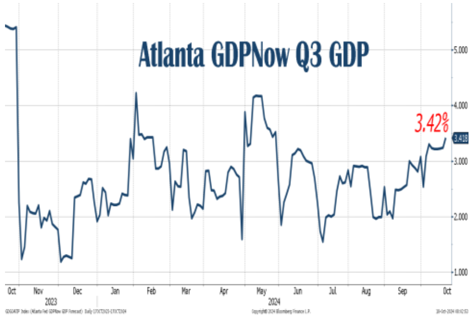
Indeed, on the campaign trail, both candidates are promising even more fiscal goodies from tax free tips, overtime pay, social security benefits, free downpayment assistance, tax deductible car loan interest, student debt cancellation, free home health care, tax-free generators, enhanced child tax credits and business subsidies galore. Meanwhile, the list goes on and on when never before has a country relied on deficit financed fiscal steroids. What does it really say about the true organic state of the U.S. economy?

Bottom line: The U.S. economic miracle is a house of straw built on endless fiscal stimulus. Moreover, should the economy fall into recession, it could create a very real risk of a currency or fiscal crisis.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"But the Fed is cutting for a reason, and it's because they are seeing the economy slow. And that helps the bond market and inflation come down. In each of the last instances where yields initially rose, they eventually fell much lower and we don't believe this time will be any different." — Barry Habib, CEO, MBS Highway

The Atlanta Fed Nowcast has moved to +3.4% real gross domestic product (GDP) growth for the third quarter from +3.2%. The +0.4% month-over-month bounce in retail sales activity did come in as credit card balances are now contracting while weekly earnings were basically flat in September. This suggests that the consumer continues to draw down savings.



Yet, these were some of the findings from the latest Beige Book commentary:

"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."

"Employment levels were steady overall, though there were isolated reports that firms filled only necessary positions, reduced hours and shifts, or lowered overall employment levels through attrition."

"On balance, wage growth was modest, while increases in nonlabor input costs and selling prices ranged from slight to moderate."

"Consumer spending ticked down in most Districts, having generally held steady during the prior reporting period."

"Manufacturing activity declined in most Districts, and two Districts noted that these declines were part of ongoing contractions in the sector."

Does this look like a 3%+ growth economy to you?

Further, as everyone gushes over the latest batch of economic data, I want to again stress that the seasonal adjustment factors for some of the key data this past September look a little wonky.

For example, as noted above, the non-seasonally smoothed retail sales tally last week showed an -8% decline. In past Septembers, this would have coincided with a -0.2% average drop in the seasonally adjusted number. This September the decline of 8% in non-seasonally retail sales somehow translated into a +0.4% month-over-month reading.

The same is true for non-farm payrolls. We experienced the weakest non-seasonally payroll figure for any September in five years. And yet, the seasonally adjusted data showed +254,000 of new jobs added, which was the best reading in six months.

What would Mark Twain say about this?

Moving forward, there are three key reports that remain before the election: The Job Openings and Turnover Survey (JOLTS), the core personal consumption expenditures (PCE) deflator and the non-farm payrolls.

With regard to the market outlook, I am not turning bearish on bonds. However, as I mentioned last week, I will be the first one to say that if the September payroll and retail sales reports were not some sort of seasonal maladjustment quirk, and if the disinflation does not reassert itself, and most importantly, the Fed begins to hint at a "pause," let's just say the near-term outlook for the bond market will dim further.

Bottom line: The recent incoming data continues to be volatile, unpredictable and subject to significant revisions. Let's see what happens over the coming months.

In the meantime, stay the course. Continue to maintain a disciplined risk-appropriate ladder strategy while buying into selloffs.

Stay tuned and have a great week!

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.