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Weekly Relative Value

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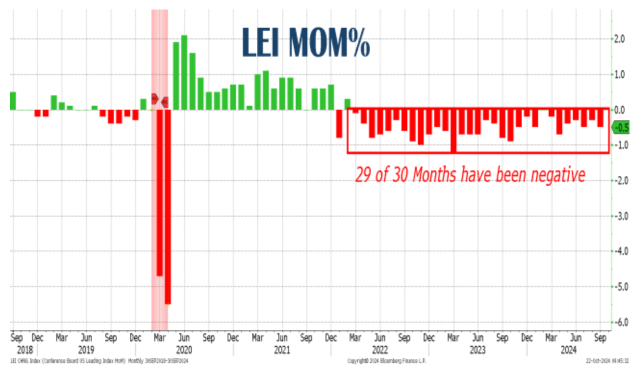
WEEK OF OCTOBER 28, 2024

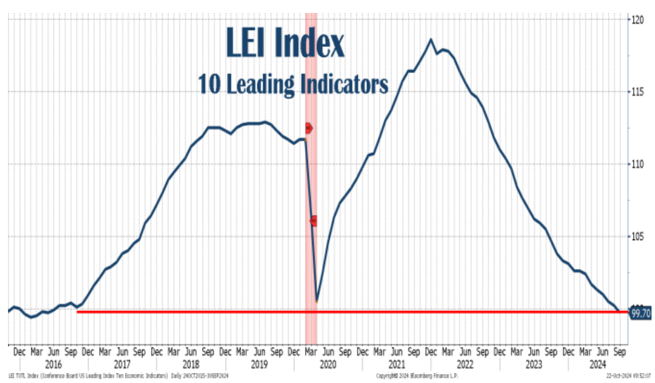
Should You Follow the Lead?

The Conference Board's Leading Economic Index (LEI) is a composite index that predicts turning points in the business cycle and the economy's near-term direction. The LEI is made up of 10 indicators including average weekly hours in manufacturing, average weekly initial claims for unemployment insurance, manufacturers' new orders for consumer goods and materials, ISM Index of New Orders and manufacturers' new orders for nondefense capital goods (excluding aircraft orders).

In September, the LEI shrunk -0.5% month-over-month, undercutting the consensus forecast of -0.3%. Not just that, but August was marked lower to show a -0.3% decline from -0.2%. You have to go all the way back to February 2022, the month preceding the Fed's "Volckeresque" tightening cycle, to see the last time the LEI showed a pulse.



This was the seventh consecutive negative reading and an eight-year low.



THIS WEEK

- WINTER WINDS IN CHI-TOWN
- BEIGE IS BLUE
- DIFFICULT TO FIND A JOB
- DEMAND DESTRUCTION!
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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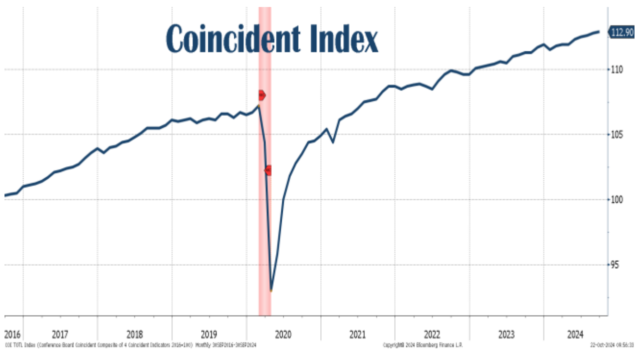
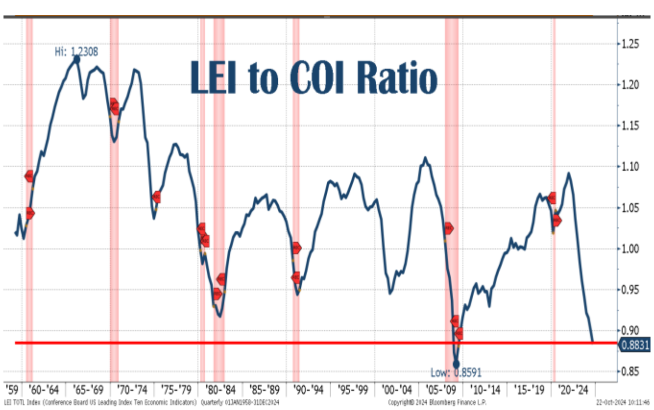
As shown below, the U.S. economy has never escaped a recession when the LEI has been trading at such low levels.

The reason investors are continuing to shrug this off is due to the Index of Coincident Economic Indicators (COI). The four components of the COI are payroll employment, personal income less transfer payments, manufacturing and trade sales and industrial production. The COI inched ahead +0.1% to make a new record high, hanging in a positive direction for five months in a row.



When the LEI slippage begins to show outright negative prints in the COI, investors will begin to buy in on any recession call. As things stand, the year-over-year trend in the LEI is running at -4.8% whereas the COI is up +1.4%.

Meanwhile, the ratio of the LEI to the COI has declined each month since February 2022. This represents a bona fide momentum barometer as far as future economic growth is concerned. It is at, or below, the levels that coincided with the past nine official economic downturns back to 1960. It has only been this low one other time in 2008-2009 during the Great Recession**.**



Bottom line: Should you follow the LEI? Historically, the LEI has a "perfect" record in predicting recessions. However, it has taken so long for the impulse to show up this cycle, so investors have begun to dismiss this indicator as an irrelevant relic from the past. Just because the timing may have been delayed in this cycle, delayed does not mean "derailed."

WINTER WINDS IN CHI-TOWN

The Chicago Fed's National Activity Index (CFNAI) is arguably the most comprehensive (85 different variables) monthly barometer of U.S. economic activity. A zero value for the index indicates that the national economy is expanding at its historical trend rate of growth (negative values indicate below-average growth while positive values indicate above-average growth). In September, the index contracted to -0.28. This was far below the +0.50 consensus estimate. And to make matters worse, August was revised sharply lower to -0.01 from +0.12.

This was the fourth straight month below zero, which is important because this data series symbolizes an economy expanding below its potential growth rate. The key three-month moving average of -0.19 (-0.14 in August and -0.08 in July) tied for the weakest reading since the turn of the year. And the diffusion index at -0.16 illustrates, in contrast to the popular consensus and market narrative, an economy that is losing momentum across a broader front.

All four major categories (e.g., production and income, employment, personal consumption and sales) lined up below the zero-line last month. Tell me if employment at -0.03 is consistent with +254,000 on non-farm payrolls… it is not. How does personal consumption running negative (-0.01) for the second month running comport with +0.4% month-over-month growth in retail sales? It does not. Rounding out the segments, the production/income rang in at a dismal -0.21 and sales/orders rang in at -0.03 for back-to-back months.

Yet, the Atlanta Fed's most recent gross domestic product (GDP) scorecard shows the third quarter GDP growing at 3.31%. Suffice it to say, there is no way the CFNAI reading is consistent with the Bureau of Labor Statistics' (BLS) data showing a 3% GDP growth. Moreover, if we had this data in our hands, markets would not be thinking the Fed made a colossal error by cutting rates -50 basis points at the last Federal Open Market Committee (FOMC) meeting and would be pricing in a lot more relief than is currently the case after this recent bond yield hiccup.

Bottom Line: There are huge divergences between the business confidence surveys and the BLS data. No way, no how, is the CFNAI consistent with a government estimate of real GDP growth running anywhere near a +3% annual rate.

BEIGE IS BLUE

The Fed's Beige Book (or the Summary of Commentary on Current Economic Conditions) is a compilation of anecdotal information from bank and branch directors and interviews with key business contacts, economists, market experts and other sources on current economic conditions in each of the districts. It is published eight times per year. By the way, it is called the Beige Book because its cover is colored beige.

As shown in the excerpts below, the most recent Fed Beige Book also failed to ratify any of the alleged "hot" government data that has been released lately.

*"On balance, economic activity was **little changed** in nearly all Districts since early September, though two Districts reported modest growth."*

*"Most Districts reported **declining manufacturing activity**."*

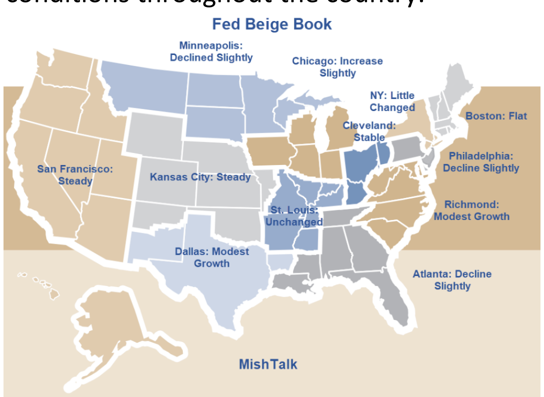
***"Reports on consumer spending were mixed**, with some Districts noting shifts in the composition of purchases, mostly toward less expensive alternatives."*

*"On balance, **employment increased slightly during this reporting period**, with more than half of the Districts reporting slight or modest growth and the remaining Districts reporting little or no change."*

*"Many Districts reported low worker turnover, and layoffs reportedly remained limited. Demand for workers eased somewhat, **with hiring focused primarily on replacement rather than growth**. **Worker availability improved, as many contacts reported it had become easier to find the workers they need**."*

*"With the improvement in worker availability, contacts in multiple Districts pointed to a **slowdown in the pace of wage increases.**"*

Here is a graphical visual of economic conditions throughout the country.

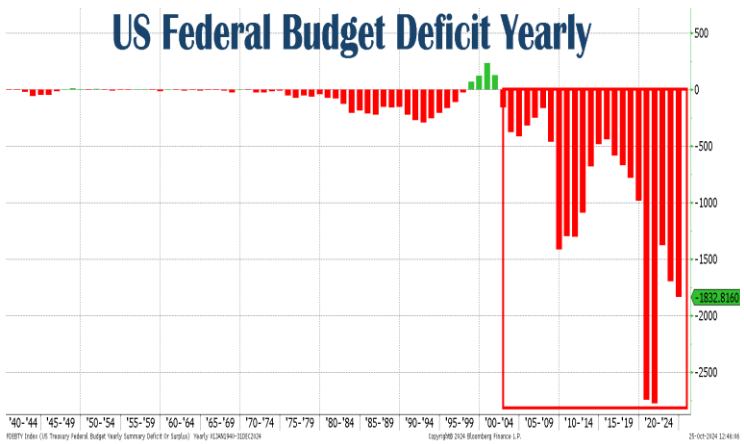


As noted above, the Fed's Beige Book posits that "economic activity was little changed in nearly all Districts." **"Little changed"** should be viewed in context of the worst Beige Book in years. I'm referring to the prior Beige Book on

September 4 where three-quarters of the economy in this report was either contracting or stagnating for the past six weeks.

Yet, the Commerce Department says real GDP growth is running at a +3% annual rate. Come again? Flat must be the new up. Nothing here is remotely close to validating a +3% real GDP growth economy!

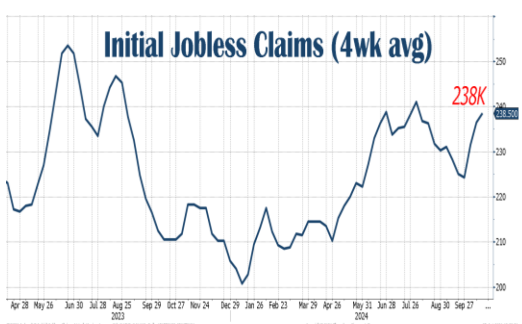
Of course, what may be included in the government's database that is missing in the real-world numbers and the private-sector survey information (including the Beige Book) is Uncle Sam's pocketbook and back-to-back years of running a fiscal deficit in excess of 6% of GDP. As shown graphically below, outside of the pandemic period, the annual deficit of $1.83 trillion is the largest shortfall in the nation's history.



Bottom line: The mirage the U.S. GDP numbers seems to be largely driven by government spending. If not for the massive fiscal spending, the U.S. economy would be near or already in a recession. Further, with the U.S. deficit spending as a percentage of GDP at World War II levels, I think unsustainable is an understatement. Something must change.

DIFFICULT TO FIND A JOB

Initial jobless claims dropped for the second week in a row, however, the four-week moving average rose to the highest level since August 2, 2024. Neither Hurricane Milton nor Hurricane Helene had a lasting impact on new claims.



More importantly, the number of people receiving continuing "insured" jobless benefits spiked to 1.9 million, which was an increase of 28,000 from the previous week's revised level and currently stands at the highest since November 2021.

In the last two years, continuing jobless claims have risen by over 500,000 and are running 19% above where they were at this time of the year in 2018 and 2019. And please don't tell me the numbers are low. They aren't. But more importantly, it's major upturns from lows that matter, not the raw numbers.

I should also point out that continuing claims understate long-term unemployment. Most states offer 26 weeks of unemployment benefits. Other than Montana and Massachusetts, continuing unemployment claims die at a maximum of 26 weeks. After someone expires all of their unemployment benefits, the Department of Labor stops tracking them.

There are other signs that the labor market is weakening faster than the media headlines suggest. To wit: While the BLS data showed job postings rising 329,000 in August, the more current data provided from Indeed suggests a downturn is likely ahead. As shown below, job postings are down 27% year-over-year to their lowest since January 2021 and have declined 45% since the February 2022 peak.

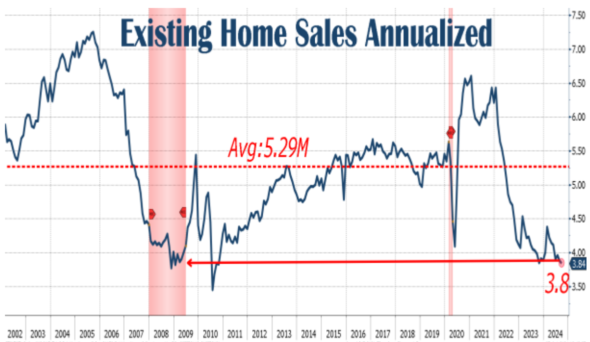
Companies appear to be reluctant to add staff next year. According to the Conference Board's fourth quarter 2024 CEO confidence survey, 26% of survey respondents see a net reduction in the workforce over the next 12 months. This is the highest level since the fourth quarter of 2020.

Bottom line: The labor market is great for everyone who still has a job, but times are tough for job seekers.

DEMAND DESTRUCTION!

"People are only moving if they have to…We'll go a week without a showing, which is a long time compared to even last year." — Nicole Dudley, Real Estate Agent in Phoenix, AZ

Demand for existing homes is wilting further despite surging inventories, supply spiking and much lower mortgage rates. Sales of existing single-family houses dropped to a seasonally adjusted annual rate of 3.84 million, the lowest rate of sales since the worst three months of the Great Financial Crisis and the Housing Bust. They are down by 3.5% from the crushed levels a year ago, down by 38% from September 2021 and down by 29% from September 2019.



Demand destruction has occurred in all regions.

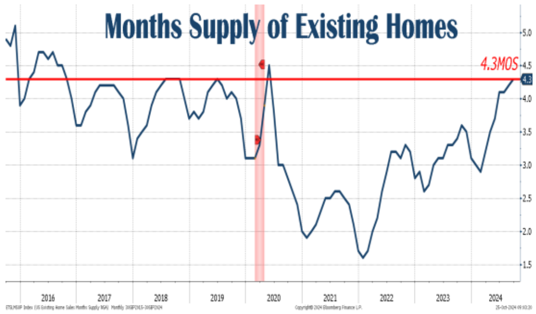
- **Northeast:** Sales fell to a seasonally adjusted annual rate of 460,000 homes, the second lowest since the 1990s and just a hair above July 2010.
- **Midwest**: Sales fell to a seasonally adjusted annual rate of 900,000 homes, the lowest since the Housing Bust.
- **South:** Sales fell to a seasonally adjusted annual rate of 1,720,000 homes, the lowest since the Housing Bust.
- **West:** Sales ticked up to a seasonally adjusted annual rate of 760,000, a little higher than some months in 2023 and 2024. Beyond that, this was the lowest since the 1990s.

Moreover, the impact of the recent spike in mortgage rates is still to come. The sales that closed in September were made in prior weeks and months when mortgage rates were much lower. Since August, the average rate for a 30-year fixed mortgage recently rose above 6.5%

The monthly payment for a $500,000 mortgage at a 6.5% rate is more than $1,000 a month higher than the same payment at a 3% rate. This means that many households couldn't afford to buy their current home again in today's market, let alone move up to a bigger one.

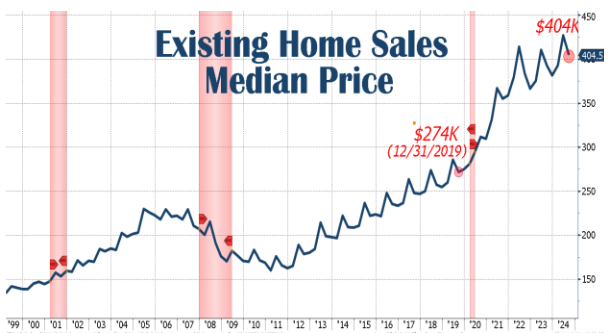
The good news is we are finally starting to see some thawing on the supply side as the number of homes on the market have now risen in each of the past nine months. In fact, unsold inventory jumped to 1.39 million homes in September. This is the highest in four years and it is up by 23% from a year ago.

Given the wilting demand, months of supply jumped to 4.3 months. This is up by 27% from a year ago and the highest since May 2020.



I should note that inventory normally peaks in June and then declines every month for the rest of the year with a low point in December. However, every month since June 2024, inventory has risen instead of falling. In September, inventory even spiked higher. I'm guessing the increased supply is coming from the vacant homes that are now coming on the market. Homeowners that had moved out of the house often years ago did not put it on the market because they wanted to ride up the housing bubble, which has contributed to the inventory shortage at the time**.** Now, they are trying to unload them just as demand has collapsed and prices have peaked (especially in Florida, Arizona, Texas, Tennessee and North Carolina).

As supply increases and demand wanes, median home prices are plateauing and beginning to decline. Obviously, depending on your location, one will see different results. In some metros, prices have plunged like in the Austin metro (-20% from the peak). Meanwhile, in other metros, prices have risen to new highs, as is the case in the New York City metro. Overall, nationally, median prices dropped -2.3% month-over-month in September.



The reversal to a buyers' market was also revealed in the subset of data showing that it is now taking sellers 28 days to find a buyer — well up from 21 days a year ago. This spells a return to a buyers' market and more home price relief ahead.

Even still, while prices have stabilized, the median price of existing homes is still egregiously too high due to the 50% price explosion since the beginning of the pandemic in early 2020, which was fueled by the Fed's free money policy. In fact, we all witnessed the wildest two and a half year price frenzy in the housing market. All good things must end. Now, the grossly overpriced homes have destroyed demand. Buyers are on strike, and they are staying on strike.

Humorously, the National Association of Realtors (NAR) has blamed everything except the "real problem."

For example, last year, it blamed low inventory, and then it blamed the surge in mortgage rates. But now that inventories have surged and mortgage rates have dropped, they need a new excuse**.**

And sure enough, today the NAR is blaming the election:

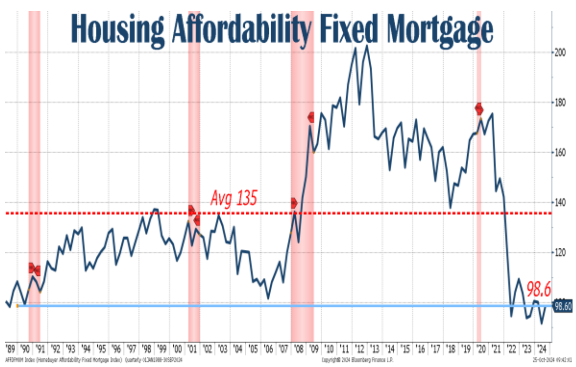
"Perhaps, some consumers are hesitating about moving forward with a major expenditure like purchasing a home before the upcoming election." — NAR

The reality is that even with home prices off the boil, homeowner affordability remains just about as strained today as it was ahead of the 1990-1991 and 2008-2009 recessions when the interest rate landscape was as much, if not, more onerous than is the case today.

Because affordability ratios are a mean-reverting data series, lower interest rates play a lead role in this process**.** Income growth alone won't be sufficient because the labor market will likely be cooling in the coming year, and it will take a long time before wages have risen enough to catch up with the 50% spike of home prices from before the pandemic.

If home prices do the heavy lifting and revert to the mean of 135 (see the red hyphenated line in graph below), home prices could decline by 30-35% from today's levels. If so, the negative wealth effect on spending will ensure that the disinflation momentum remains intact — which in turn, will lead to lower interest rates and bond yields.

While the current housing bubble could burst, a more likely scenario is that home prices decline 10-15% nationally along with mortgage rates declining by 150 to 200 basis points to 5.0-5.5%.



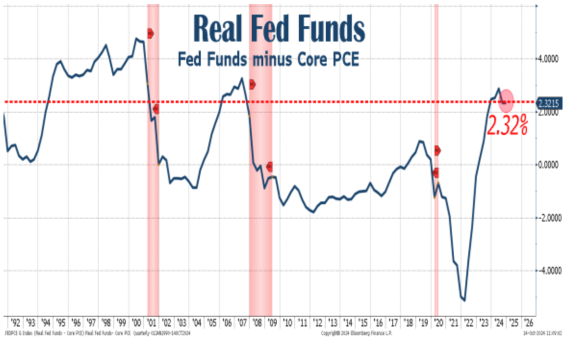
Bottom line: It's not election uncertainty. Home prices are simply too high and that is the reason we are witnessing demand destruction on an epic scale that even home sellers cannot escape. Nearly anything will sell if the price is low enough.

And the homebuilders have figured this out too. They are building and selling houses at a brisk pace by motivating buyers with lower prices, big incentives and mortgage-rate buydowns. This make new houses often less costly for buyers on a monthly basis than the equivalent existing houses. Doing it this way, homebuilders are keeping their sales up even as sales of existing homes have wilted. They are taking market share. Homeowners have not figured it out yet and continue to cling to their aspirational prices.

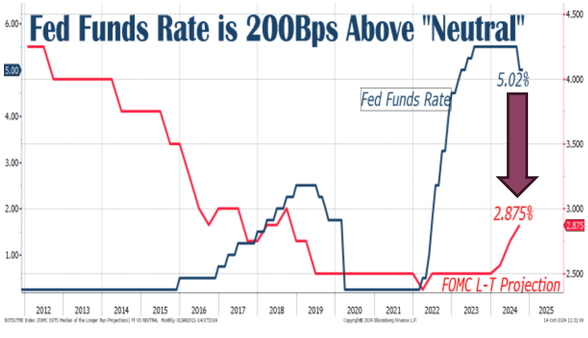
MARKET OUTLOOK AND PORTFOLIO STRATEGY

There are a number of crosswinds affecting the bond market today. Volatility surrounding the pace of rate cuts, and the ultimate end point, has picked up since the yield lows back in September due to a combination a string of stronger-than-expected data and increased talk of the unsustainable fiscal outlook. As shown in the graph below, the volatility of the bond market, as measured by the Merrill Lynch Option Volatility Estimate (MOVE) Index, is at the highest level in the past 12 months.

That all said, I remain on the belief that the long-term trend in interest rates remains lower with or without a recession. And for all the chatter about a "reacceleration" in inflation, underlying details are constructive and the real-time rental deflation is finally starting to show through in the official data. Thus, the Fed will need to continue easing to prevent "backdoor" tightening from rising real rates.



Moreover, the widespread consensus, for now, remains a return to "neutral," which many at the Fed believe to be around 3%.



In terms of relative value, the "belly" of the curve (five to seven years) offers the most compelling risk/return tradeoff at this time. However, I could not fault credit unions for wanting to move towards the front end of the curve (two-year).

Moving forward, there are four key reports this week that will determine what the Fed does or does not do before the November 7 FOMC meeting. Another jumbo rate cut is off the table, so these data-points will determine whether or not we see a 25-basis point trimming in the funds rate or a pause.

- **October 29:** The September Job Openings and Labor Turnover Survey (JOLTS)
- **October 30:** The third quarter real GDP

- **October 31:** The September core personal consumption expenditures (PCE) deflator
- **November 1:** The October non-farm payrolls

Prior to the above releases, swaps are pricing in a more than 80% chance that the central bank will cut rates by a quarter point on November 7. But they also signal strong odds that it won't shift at one of the next two meetings.

Bottom line: The recent incoming data continues to be volatile, unpredictable and subject to significant revisions. This week is unlikely to change that environment.

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.