INVESTMENT SERVICES

Weekly Relative Value

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Too Many Unknown Unknowns

"There are unknown unknowns."
- Donald Rumsfeld, Former U.S. Defense Secretary

In my opinion, the incoming economic data over the next two to three months will be trumped (yes, pun intended) by the fiscal, tax, immigration and trade policies emanating out of the White House.

While speculation runs rampant, at this time, no one really knows what these policies will be and when they will go into effect for months to come. As the former U.S. defense secretary Donald Rumsfeld famously stated, "There are **unknown unknowns.**" Indeed, a load of uncertainty is what we have on our hands.

As we move forward though, I do believe that Trump will have a devil of a time getting his countless tax cuts legislated. So, while Wall Street quickly took out the 2016-2018 GOP playbook after this election, I do not believe the House GOP, which, believe it or not, is relatively fiscal conservative, will be keen on more deficit financing stimulus given that U.S. debt and deficits have reached disturbing and astronomical levels.

As you know, I have serious concerns about the U.S. over indebtedness and addiction to borrowing. Debt accumulates until it can't. Then we face a reckoning.

Indeed, the U.S. Government has already dug a hole too deep, and it could get worse, much worse. New tax cuts were promised on the campaign trail – that the taxes on tip income would be cut, for instance, as would the taxes on Social Security benefits and overtime hours, while auto loan interest was promised to be made tax deductible. In addition, Trump has said he wants to lower the corporate tax rate to 15%.

THIS WEEK

- THE STOCK MARKET IS BROKEN
- QUICK PITCH ON GOLD AND BITCOIN
- CONSUMERS REVOLT AGAINST HIGH PRICES
- MORE ON THE K-SHAPED ECONOMY
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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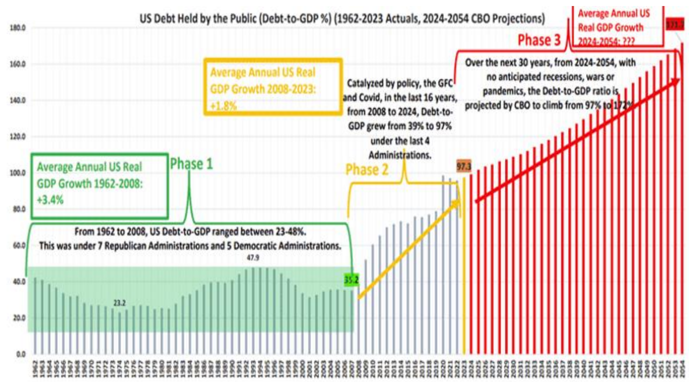
These ideas all add up to a lot more than $4 trillion-plus that the extended 2017 personal tax cuts would cost. There are a lot of Republicans who are going to balk at some of those numbers in terms of the deficit and debt.

As shown below, the Congressional Budget Office (CBO) projects that added debt to the gross domestic product (GDP) will go from 100% of debt to GDP to 170% over the next 35 years! Keep in mind these projections from the CBO have a really good track record of being wrong. Wrong in the sense that they underestimate what debt-to-GDP ratios end up being. We're obviously on a really unsustainable path.



Source: Hedgeye

Many people are hoping that Elon Musk and Vivek Ramaswamy's newly created Department of Government Efficiency (DOGE) will be successful in reducing waste, fraud and abuse in government spending. The supposed goal of DOGE is to radically shrink the federal bureaucracy, with three main objectives: eliminating regulations wherever possible, gutting a workforce no longer needed to enforce said red tape, and driving productivity to prevent needless waste.

"The Department of Government Efficiency will be epic."- Elon Musk, CEO, Tesla

Musk has claimed he can help Trump cut $2 trillion in federal spending, one-third of the $6.8 trillion budget. Yet, about two-thirds of the federal budget goes towards mandatory programs, such as Medicare and Social Security. Another 23% goes to national defense, and another 14% goes to interest. So, wake me up when we are ready to have a real conversation about solving the federal deficit problem since it requires higher taxes and lower entitlements, neither of which the American public wants, or political leaders will even suggest. Everything else is rearranging the deck chairs.

Mr. Ramaswamy's proposals are even more bizarre, at least the ones he made when he ran for president. He proposed eliminating 50% of all federal jobs in year one and 75% by year two.

Imagine that DOGE eliminates 50% of the estimated two million government jobs. This would likely drive unemployment higher, reduce consumption and possibly tank the U.S. economy. It's another example of how every action leads to a reaction. Another way of putting it is that one person's waste is another person's income. I seriously doubt this will happen.

There could also be unintended consequences from whatever changes get implemented. To wit: Newswires reported that DOGE would be examining new ways for Americans to file taxes. This in turn sent H&R Block and TurboTax parent Intuit sharply downward.

Undoubtedly, there is waste, fraud and abuse in Washington. And I truly hope that DOGE will be successful in creating greater efficiency and driving the fat out of federal government spending. That said, I believe these changes will be relatively small and glacial in nature.

Regarding the immigration policy, I also have a hard time believing the rhetoric that Trump will deport all of the undocumented immigrants in this country. The way it's proposed, we could reduce the size of the labor force by an estimated 8-10%. And we're in an environment where Americans are retiring out of the workforce and immigrants are the ones taking their place. With depressed immigration, the economy could lose a lot of people in the labor force that would clearly put a strain on a lot of employers and presumably push up labor costs.

Here's an example: Imagine most of the bricklayers in a country were migrants, who then are deported. The lack of labor would prevent houses being built. This would push up house prices and create unemployment amongst native-born electricians, decorators, mortgage brokers and real estate agents.

Did Americans vote for higher prices? I don't think so!

Moving on. Donald Trump will definitely pursue strategies that he can enact through executive order. And as we saw last time, deregulation will be the first thing he does. While there could be some long-term consequences, deregulation is business-friendly for equities and disinflationary for bonds. Financials and energy companies should be primary beneficiaries.

In addition to "dereg," Trump can independently raise tariffs. Trump has been adamant that he wants to increase tariffs by 60% on China and impose a blanket 20% jump for everyone else. Tariffs are like sales taxes. They're paid by American consumers, not foreign producers. The billions the government is taking in comes out of the pockets of Americans.

"I'm a Tariff Man." – Donald Trump, President-Elect

Yet, one should not underestimate what people like Trump and his just-announced choice of commerce secretary Howard Lutnick believe. To wit: Lutnick stated the following in a CNBC interview last Tuesday:

"We'll make a bunch of money on tariffs, but most everybody else is going to negotiate with us."
– Howard Lutnick, Commerce Secretary Nominee

Trump will tax clothes, toys, food, cars, literally everything coming into the U.S. And the size of what Trump has pledged in tariffs is absolutely massive. Analysts have added up all the tariffs floated on the campaign trail, including goods from China and Mexico and their trading partners, and found the weighted average tariff rate for the U.S. would be 26%, up from the 2.6% it is now. This is just above the rate of the Smoot-Hawley tariffs in 1930 that prolonged the Great Depression. So, it's scary from that perspective.

"…given that concerns about inflation are sort of paramount in the minds of voters, I just question whether there's enough understanding … of how tariffs work… It's tariffs on imports by U.S. companies from China or from Mexico."
– Liz Ann Sonders, Chief Investment Strategist, Charles Schwab

Tariffs of this magnitude would represent a triple shock to the U.S. economy.

1) Higher tariffs would likely backfire and raise consumer prices especially to the lower- and middle-income earners who spend more of their money on items from China than the wealthy. What do you get at Walmart that isn't imported?
2) Competitive currency devaluations: If the U.S. places tariffs on Chinese goods, the Chinese could devalue the yuan to offset the competitiveness hit. This in turn could spark a wave of currencies devaluations and raise the risk of a negative spill back in the U.S.
3) Finally, tariffs could lead to a rate shock, because the Fed is hardly likely to sit idle if it feels that hiking tariffs will rekindle inflation expectations.

"Made in America" sounds great. But it's costly and about to rise steeply if these tariffs are imposed.

And what would happen to other countries around the world if massive tariffs were to be implemented?

China is still in a deflationary property market bust, and the size of the proposed tariffs for an economy still highly dependent on exports would likely be devastating. After all, China is the second-largest economy in the world, and the global reverberations would be significant.

Also, if his trade policy is enacted, the German car industry would be annihilated, so kiss the shaky European economy goodbye. Mexico and Canada, given their intense trade ties with the U.S., are also royally screwed.

Nor should we underestimate the retaliatory responses of other countries. If the U.S. imposes new tariffs under the newly elected Trump government, retaliatory tariffs from trade counterparts are expected, too. And just like the last time in 2016, it will most likely hurt the agricultural sector.

Either governments begin to negotiate ahead of time, or we risk a backlash that could bring the world to a 1930s global trade war. We should pray for the former but still be discounting some non-trivial risk of the latter.

The bottom line: From where I sit, nothing right now is as important as the tariff issue and the other policy planks, which may or may not live to see the light of day. But nobody really knows what Trump is going to do or not do, or what he will be able to do. Possibly Congress will manage to prevent the most damaging debt-busting pledges of the Trump campaign from occurring and that the tariff threat will turn out to be just that – a threat. Or we may end up with a ton of damage to public finances, inflation and the current perception of economic prosperity.

While I do look forward to the day when the crystal ball is less cloudy, for the time being we are in a complete policy fog. Given the extremely uncertain policy outlook, there is simply too much uncertainty. This is no time to play a guessing game and to be taking high risks.

THE STOCK MARKET IS BROKEN

"I view the markets as fundamentally broken. Value is not a consideration for most of the investment money that's out there." – David Einhorn, Hedge Fund Manager

Why would David Einhorn say this?

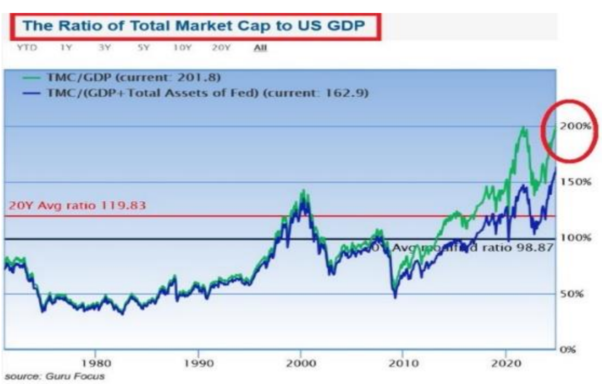
This is why. Passive flows now dominate active management with about $5 trillion flowing into passive funds since 2008. Passive investors primarily track major indices through exchange-traded funds (ETFs) and retirement-savings plans, such as a 401(k). Incredibly, U.S. equity ETFs and mutual funds drew nearly $56 billion in the week ending last Wednesday, the second-largest weekly intake on record. All on election euphoria and nothing else.

The dominance of passive fund flows – estimated at around $20 trillion – means that a significant portion of the market (about 50% of trading) operates without considering fundamentals. In other words, many investors have been closing their eyes and indiscriminately buying stocks without even considering or knowing what they are buying. Valuations at record highs, be damned.

Indeed, as discussed in last week's *Weekly Relative Value* "What Could Possibly Go Wrong?", virtually all valuation metrics from price to earnings, price to sales, earnings yield, cyclically adjusted price-earnings (CAPE) ratio that have stood the test of time show stocks being extremely overvalued.

Below, I show the Buffet ratio, which measures the U.S. stock market value to GDP. Warren Buffet believes that this ratio is the single best measure of whether stocks are overvalued or undervalued. Currently, the ratio has reached 202%, exceeding the previous record of 200% set before the 2022 bear market. The ratio is WELL above the 2000 Dot-Com Bubble peak, not even close. By comparison, the 20-year average is 120%. When the stock market grows much faster than the economy, it suggests that stocks are grossly overvalued.

And based on his recent trading it would appear that Warren Buffet is heeding his own words by selling stocks and raising a record amount of cash. More specifically, it has been reported that between the second and third quarters of 2024, Berkshire Hathaway's cash pile increased 17% to $325.2 billion. Overall, Berkshire sold $36.1 billion worth of stock in the quarter.

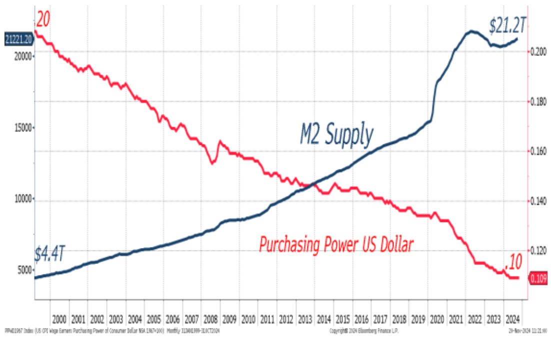


Bottom line: It should really not be lost on anyone that this has not been an "earnings-driven" rally, but rather a "momentum" and "sentiment-driven" rally. That said, investors have never been more bullish than they are today. And as long as the passive inflows continue, the market can obviously move higher. However, with valuations stretched if panic hits and flows reverse, there is a lot of dead space below, and the stock market bubble could burst. It's happened before.

I'm not sure what's going to happen next. But I am sure of two things: What happens next will be what people least expect, and stocks are not going to go up forever, regardless of what people think.

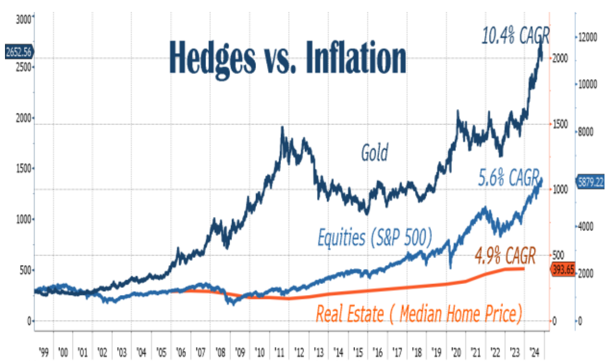
QUICK PITCH ON GOLD AND BITCOIN

Over the past 25 years, the U.S. money supply (M2) has grown significantly, rising from $4.7 trillion in 1999 to $21.2 trillion by September 2024, reflecting a 450% increase. As shown below, this monetary expansion has led to a 50% reduction in the purchasing power value of the dollar.



So how does one protect against the U.S. government's willing debasement of the U.S. dollar?

Historically, asset classes – equities, real estate and gold – have generally tracked the expansion of the money supply. For comparison, over the same period since 1999, gold is up +10.4% on a compound annual growth rate basis. That's quite a bit better when compared with M2's +6.26% compound annual growth rate for debasing the U.S. Dollar. Equities have generated a 5.6% compound annual growth rate (CAGR) while real estate (single-family homes) has appreciated at 4.9% annually.



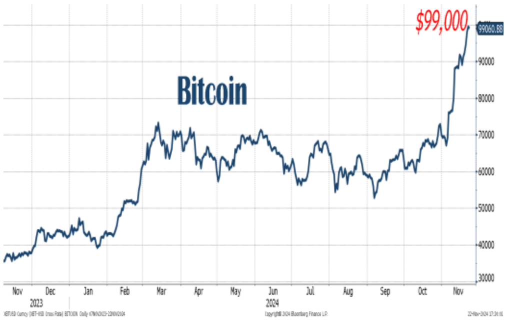
As noted above, if the CBO is correct and the debt-to-GDP ratio increases from 100% in 2023 to 170% over the next 35 years, hard assets (like gold, real estate and equities) will become even more critical to preserving purchasing power and avoiding the impact of inflation.

Others have recommended Bitcoin – digital gold – as a means of hedging against the dollar and protecting purchasing power. As shown below, Bitcoin has spiked since Trump was elected and has more than doubled since late 2023.

"Bitcoin is going to the moon and I want America to be the nation that leads the way."
– Donald Trump, President-Elect

Trump has pledged to make America the "crypto capital of the planet" and a "bitcoin superpower."

Last week, Bitcoin came to a hop skip and a jump away from hitting $100,000. A year ago, Bitcoin was trading at $37,000. Sadly, I own none at the moment.



Here are a few more fun facts about Bitcoin:

- The U.S. government currently holds 203,000 Bitcoin worth $20 billion.
- Total government Bitcoin holdings around the world control $50 billion worth of cryptocurrency.
- 50 million Americans own cryptocurrency.
- Institutional investors own $227 billion worth of Bitcoin (or 11.6% of the total supply).

The question you need to ask yourself, *"What do the largest governments and asset managers around the world know that you don't?"*

Bottom line: If the U.S. Government continues to print money at such a rapid clip in order to avoid debasement in your purchasing power, you need to own hard assets or financial assets, so things like real estate, gold or equities… and Bitcoin.

CONSUMERS REVOLT AGAINST HIGH PRICES

Last week, Walmart soared to a record high on the back of its results highlighting high-end consumers (upper-income households earning more than $100,000) in search of price discounting flocking to the store. In fact, according to management, approximately 75% of Walmart's sales growth came from the $100,000 earning cohort!

Bloomberg also reported that *"Walmart's price changes were roughly flat for the quarter."* Nearly 2,000 "rollbacks" were permanently converted to lower prices. Doesn't sound too inflationary from my perch.

The underlying message emanating from Walmart is that consumers are revolting against high prices. Many households have simply reached their limit. This, in turn, means that future price increases will be minimal, or even nonexistent as promotional activity and reductions draw lost customers back.

The deflationary news from Walmart last week was capped off by McDonald's, which is launching a new U.S. value platform in an attempt to woo budget-conscious diners. The new lineup, called "McValue," reportedly includes an offer to buy one item and get one for $1. Mickey D'S will also extend a $5 meal bundle until at least mid-2025. This was definitely not happening during the era of mega stimulus checks in 2021 and 2022, that is for sure.

Bottom Line: It has become increasingly clear that consumers are becoming more frugal and seeking value. This is good news for the disinflationary theme**.**

MORE ON THE K-SHAPED ECONOMY

The K-shaped economy rolls on. While Americans with assets – real estate, stocks and gold – have fared well in the post-pandemic economy, a growing number of households not benefiting from asset price inflation are hurting badly.

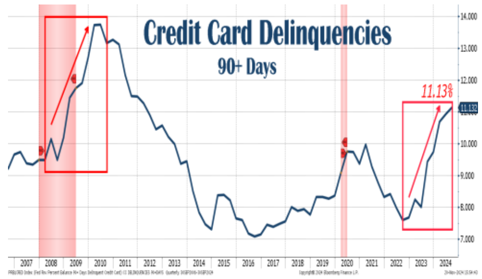
According to the New York Fed, for the second month in a row, the average probability of the household sector being **able to stay current on their debt obligations was around 14%, which hasn't happened since March-April 2020**.

Moreover, **almost 40% of those in the survey claimed that their financial situation today is worse than it was a year ago despite the ripping stock market and ongoing house price inflation**. This is close to double the 23% share saying their financial position is stronger. (Now you know why Biden lost!)

As consumers have been fighting record prices, credit card debt rose jumped by $24 billion in Q3 of 2024 and hit $1.35 trillion – a new all-time record. Over the past three years, credit card debt skyrocketed by $400 billion.

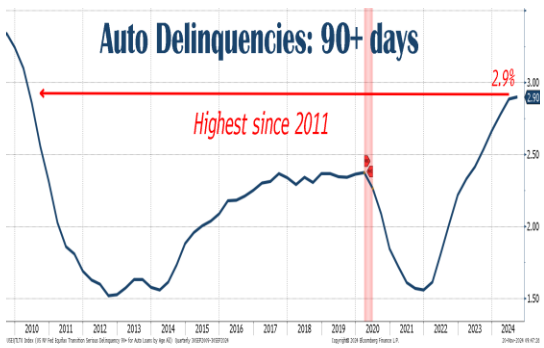
According to TransUnion data, the average consumer balance is $6,329, an increase more than 20% higher than two years ago. **Shockingly, 28% of credit card holders are still paying off last year's holiday debt. Read that sentence again.**

While balances have soared, credit card interest rates have continued to rise, from 14.56% in February 2022 to 21.76 % in November 2024. This represents a 45% increase and, more importantly, a higher cost burden for consumers.



And as shown graphically above, with balances growing and debt service costs soaring, it's not surprising to see that delinquencies have rocketed. The New York Fed survey also showed that serious delinquency rates jumped to 11.1%, the highest level in 13 YEARS. This share even exceeds the 2020 peak and has been rising at a pace only seen during recessions.

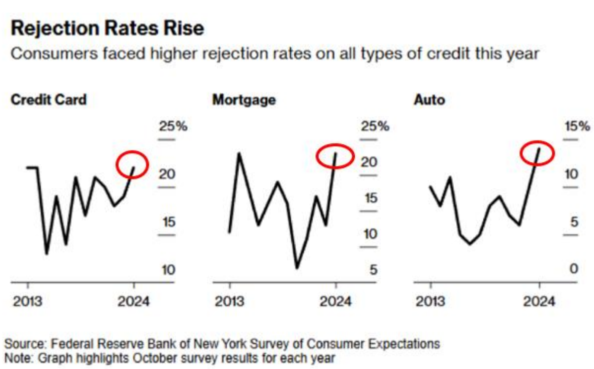
It's not just credit cards – auto loan delinquency rates are currently rising at their fastest pace since the 2008 Global Financial Crisis. The 90-day delinquency rate for auto balances ticked up in Q3 to 2.90%, a level last seen nearly 15 years ago.



Even mortgage delinquency rates, while comparatively low at 1.1%, are back to where they were at the peak of the pandemic in the Q2 of 2020.

So, it's no wonder that banks are beginning to slow the flow of credit. The recently released New York Fed Credit Access Survey reveals that, while demand remains largely stable, banks are getting more discerning when it comes to extending new loans.

In fact, rejection rates for credit cards, mortgages and auto loans spiked to the highest in at least a DECADE. In terms of applications to increase overall credit card limits, nearly 50% of such requests were declined by the bank. Those with credit scores below 680 saw overall rejection rates increase to 55% from 47% in February.



Bottom line: The above details of the combined with overall delinquency rates at multi-year highs and continued increases in loan-loss provisioning by the banks pour cold water on the “strong economy” and “resilient consumer” narratives.

Those with financial assets are benefiting from the “wealth effect” to be sure, but signs of strain among households (particularly at the low end of the credit score/income spectrum) continue to emerge.

In fact, a recent poll conducted by Guardian/Harris showed that 56% of households think the U.S. is in a recession. In other words, three out of five Americans think the economy is in a downturn. After all, not everybody is loving Nvidia and Bitcoin.

The New York Fed survey results are important because Wall Street tends to focus on aggregate economic data, but what they seem to forget is that recessions occur because of changes at the margin.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

The bond market is consolidating but showing no sign of a sustainable rally as Fed officials continue to blab about the necessity of normalizing the funds rate while questioning the pace and the magnitude.

Fed Chair Jerome Powell has subtly altered his dovish stance since the recent Federal Open Market Committee (FOMC) meeting. The futures market is now down to a toss-up of another 25-basis point rate cut at the December 17-18 FOMC meeting, from 72% on November 14 (the day Powell said the Fed is now in no hurry to ease policy any further), and 86% in mid-October. In fact, the market-based odds of there being just one or no rate reductions between now and June 2025 have swelled to 28% from just 1% a month ago.

Moreover, there is a growing chorus now of pundits believing 4% is the new terminal rate, and as long as that view lingers, the higher the floor will be on Treasury note and bond yields out the curve (especially given the flat shape of the yield curve). **Only a convincing negative turn in the economic data, especially the jobs market, will get the bond market back on the wheels it enjoyed through most of the summer.**

Understandably, the bond market is concerned about the new policy mix that may be implemented and has reacted by driving yields higher across the curve. The 2-year Treasury yield has risen 80 basis points to 4.22% since the federal funds rate was reduced by 50 basis points. Likewise, further out the curve, the 10-year Treasury benchmark yield has risen by 77 basis points to 4.40%.

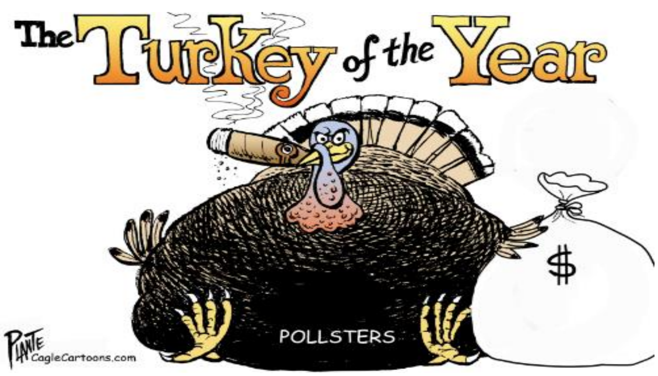
While the bond market has opted to shoot first and ask questions later, I will wait for the time when market perceptions actually become reality. Not sure when that will be, but I sense this will happen either when Trump comes out and says what he is really going to do as President or when we see for the first time, any of his budget-busting reflationary policies fail to pass through the House – or quite possibly both.

Bottom line: As noted last week, until there is more clarity on the policy front, one should anticipate and expect higher volatility than normal over the next two to three months.

In light of the heightened volatility and uncertainty, the most prudent approach to investing excess cash reserves is to continue to maintain a risk appropriate ladder strategy.

Giving Thanks! Let me end by saying as always, I'm thankful for readers like you. I hope you'll be enjoying time with your family and friends this coming week.

Wishing everyone a Happy Thanksgiving!



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.