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Weekly Relative Value

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WEEK OF DECEMBER 16, 2024

The Pendulum Swings Back

In last week's edition of the *WRV*, I discussed the bevy of labor market reports released in the first week of December. For a full discussion, please see ***The Job Straw Stirs the Fed.***

As a brief recap, there were 10 key insights from the most recent jobs data:

1. The household survey showed employment falling -355,000 in November after declining -368,000 in October. In other words, employment has declined by 700,000 in two months.
2. Full-time jobs declined by 111,000; part-time jobs fell 268,000.
3. The unemployment rate to the third decimal place was 4.246% — a hair away from 4.3% and at the highest level since December 2021. There are now 800,000 more unemployed than a year ago.
4. Year-over-year full-time employment was "negative" for the just the second time since 2020.
5. The hiring rate fell to 3.3%, the lowest level since the pandemic.
6. Layoffs increased by 27% year over year – the fourth largest reading over the past 16 years.
7. The median duration of unemployment rose to 10.5 weeks — the longest in three years.
8. 40% of unemployed Americans have been searching for a job for at least 15 weeks, the highest in three years.
9. There are now 1.6 million Americans that have been unemployed for 27+ weeks.
10. Wages for production and nonsupervisory employees (working class!) was +0.3% month over month, not +0.4%, and is tied for the lowest reading since last April.

One more thing — government jobs continued to rise (+33,000) in November. Over the past two years, government job creation has been unusually high. To wit: In 23 months since

THIS WEEK

- DISINFLATION STALLS
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- MOTHER'S MILK FOR INFLATION
- COST OF LIVING IS HIGH!
- THE TRUMP BUMP
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SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
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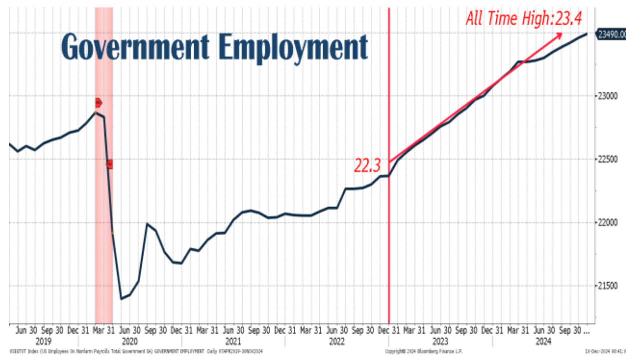
January 2023, the government has created a total of 1.1 million jobs, which has been surpassed only three times on record since 1939.

One might say, “Who cares whether the government or private sector created jobs?”

A job is a job.

However, government jobs mostly don't add new value like private-sector jobs, and over the longer run, they are unlikely to contribute to higher productivity. Thus, the government creating an unusually high number of jobs is not a sign of a strong economy.



As far as the private sector goes, new job postings on Indeed (the number one job site worldwide) fell 38% year over year last week and now stand at the lowest level since August 2020.

Job postings have dropped for nearly three years straight and are now down 49% since the February 2022 peak. As a result, new available vacancies are 5% below pre-pandemic levels.

This is in contrast to October U.S. job openings reported by the Bureau of Labor Statistics (BLS), which have declined 34% since February 2022 and are approximately 8% above the pre-pandemic levels.

However, data provided by Indeed is more current than the BLS-provided series, which suggests U.S. job openings will continue to fall in the coming months.

The labor market is set for more weakness. Perhaps the "soft landing" campers are waiting until the bitter end, when job postings fall below levels last seen in January 2020.

Bottom line: Many media outlets described the latest jobs report as “strong”!

Strong jobs report? Think again.

Unfortunately, if one looks beyond the headline establishment survey number, it’s challenging to find much evidence of a rebound at all.

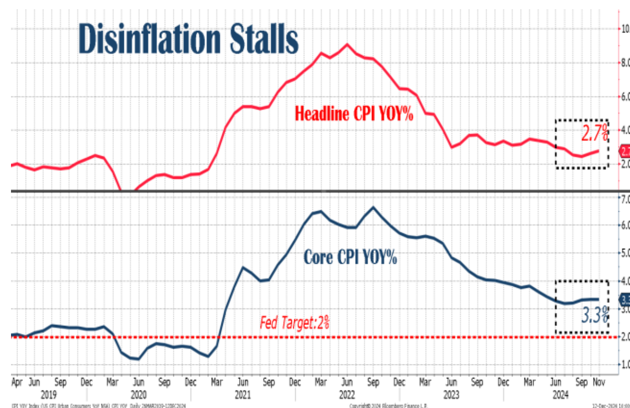
While government jobs continue to soar, the private jobs market is contracting.

DISINFLATION STALLS

> *“Especially given the slowing in shelter, this should be very comfortable for the Fed to lower policy rates 25 basis points in December and continue cutting in 2025.”—Veronica Clark and Andrew Hollenhorst, Economists, Citigroup, Inc.*

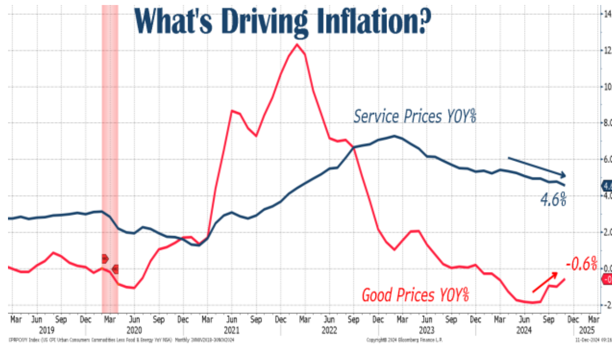
After discussing the labor markets in depth last week, the pendulum has swung back to the Fed’s other mandate of **“maintaining price stability.”** Below, I discuss last week’s Consumer Price Index (CPI) release and the implications for Fed policy.

As was widely telegraphed, the November CPI provided no surprises, with the headline and core both coming in at +0.3% month over month sequentially for a fourth straight month. The 0.3% month-over-month rise pushed headline CPI up 2.7% year over year — the highest since July. The core CPI (excluding food and energy) remained at +3.3% — again, as expected. It has been in this range for the sixth month in a row.

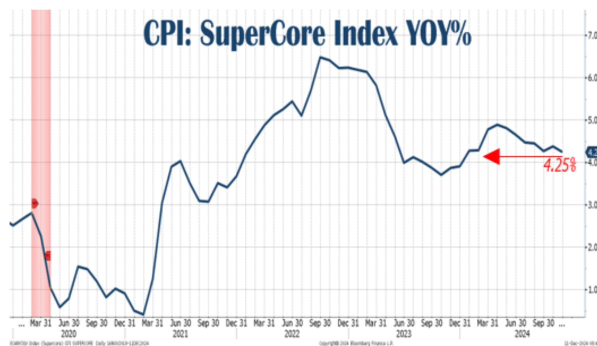


Services inflation has been the primary driver of higher inflation over the past 18 months, but the trend (while still too high) is now declining on a year-over-year basis. At the same time, goods deflation has reversed.

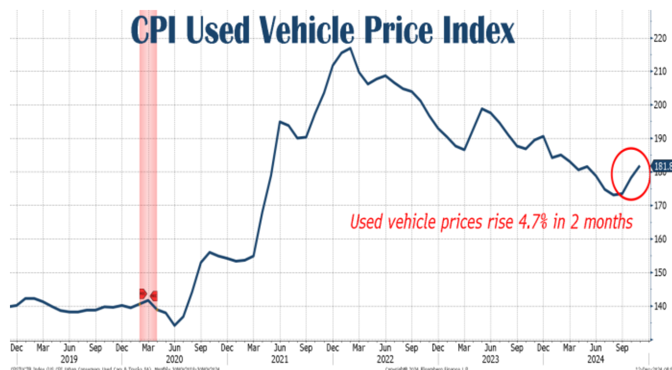
Service inflation was held to a +0.3% month-over-month increase after a pair of +0.4% advances, held down for a change by the shelter components. Both rents and Owners' Equivalent Rent (OER) came in light at +0.2% sequentially which last happened in April 2021 (See discussion below).



One of Fed Chair Powell's favorite inflation metrics — the so-called Super Core CPI (services excluding shelter) rose just 0.19% month over month, which leaves it +4.25% year over year (still too high for comfort but the lowest inflationary print since December 2023).



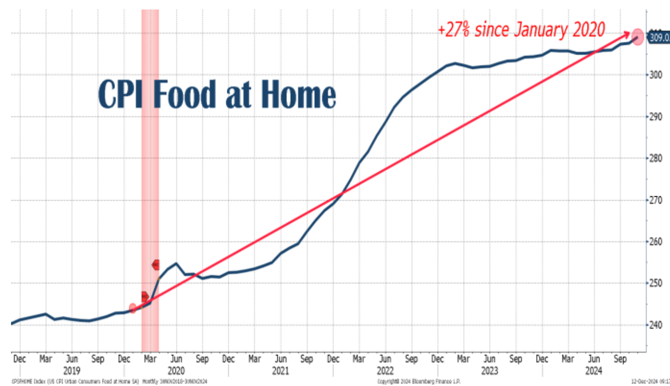
In the goods sector, prices jumped +0.3% month over month, and the "hottest" since May 2023. Leading the pack on this score, which was rather surprising, was a +0.6% spike in new vehicle prices. The increase is likely due to seasonal influences since we know the auto makers and dealers are sitting on a ton of inventory. So, this was not a troubling number at all.



That said, in November, used vehicle prices for cars and light trucks increased +2.0% (after a +2.7% surge in October). Despite the recent run-up, used vehicle prices are still down 3.4% year over year.

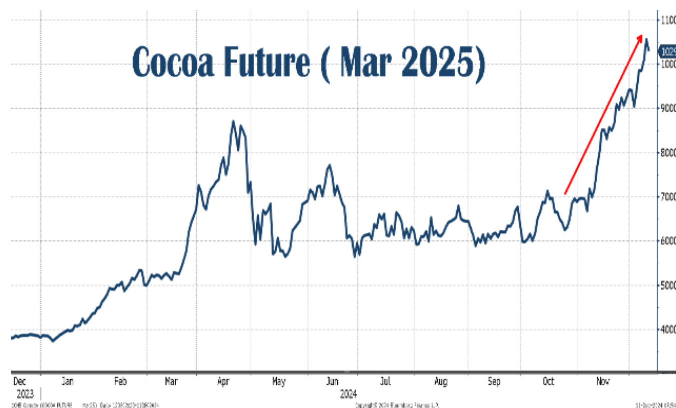
The sharp price increase of used vehicles in November, the third month in a row of price increases, was a big factor in the stubbornly high core CPI rate, having U-turned from a historic plunge that until mid-2024 had been one of the big factors in the cooling of core inflation.

The food sector also threw a monkey wrench in the works this month. The food "at home" index increased 0.5%, and the food "away from home" index rose 0.3% over the month. It seems reports of the price of Thanksgiving dinner falling were more than a bit exaggerated.



As a sidenote, coffee futures have hit record highs, having doubled in the past year and up a resounding +35% in just the past two months on a poor crop backdrop (particularly in Brazil). Tea time anyone?

Same thing for cocoa. Sorry, chocolate lovers.



Bottom line: The good news is that there was no upside surprise, but the not-so-good news is that the disinflation momentum, at least for now, has stalled out.

In the search of the silver lining in this report, the primary source of inflation — shelter costs — are now in the process of cooling off. The problem is that the areas of prior weakness have seen their pricing power spring back to life in recent months. Let's see how long that lasts.

Despite the stalling out of the disinflation trend, for now the Fed will probably still cut this week (December 18). Futures show the odds of a December rate cut are well over 90%, but forward guidance will likely signal a pause, at least over the near term. Markets now see only a couple of rate cuts in 2025 instead of four.

MORE DISINFLATION IN 2025

Will we see a repeat of the 1970s with the Fed easing policy too quickly, triggering a rise in inflation in 2025?

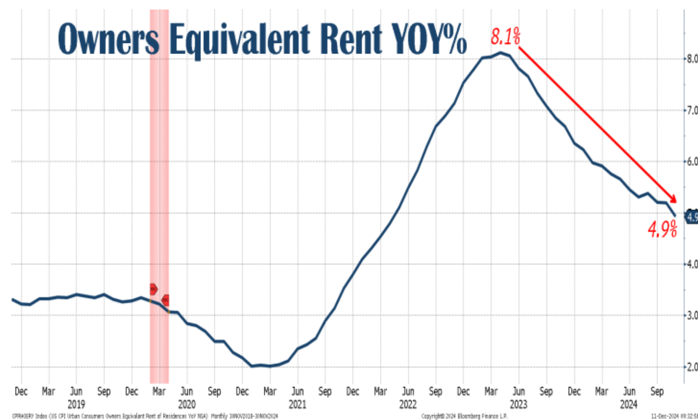
While recent inflation readings show signs that the decline in inflation has stalled, and there is a risk of reacceleration, I remain of the view that inflation will continue to gradually trend towards the Fed's holy grail of 2% over the next 12 months. My optimism stems from the belief that the worst of shelter cost inflation is in the rear-view mirror.

Shelter costs (39% of the CPI) have been one of the most persistent sources of inflation in recent years- accounting for nearly 40% of the inflation increase since the pandemic.

The OER of CPI has a 27% weighting in the overall CPI and indirectly measures homeowners' expected rent if they were renting their homes in the current market.

In November, the OER decelerated sharply to +2.8% annualized in November from October. The three-month average decelerated to +3.9% annualized. Both of these increases were the lowest since 2021, after the sharp increases in the prior months.

As shown below, the year-over-year rate has declined to 4.9% —well off the pandemic peak of 8.1%. With the OER representing 27% of the CPI index, this is the key component to the future disinflationary trend.

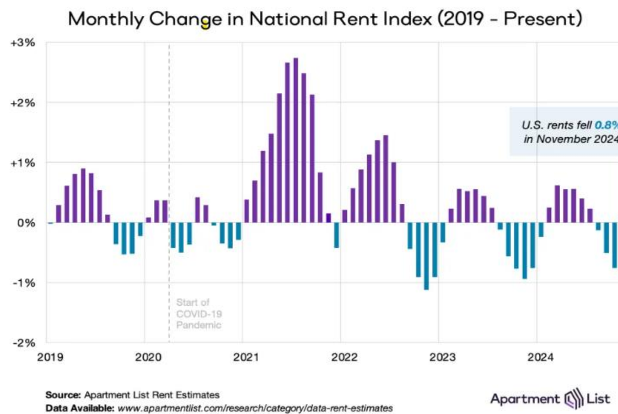


Rent of Primary Residence CPI accounts for 7.7% of overall CPI and is based on rents that tenants actually paid, not on asking rents of advertised vacant units for rent. The survey follows the same large group of rental houses and apartments over time and tracks the rents that the current tenants, who come and go, paid in rent for these units.

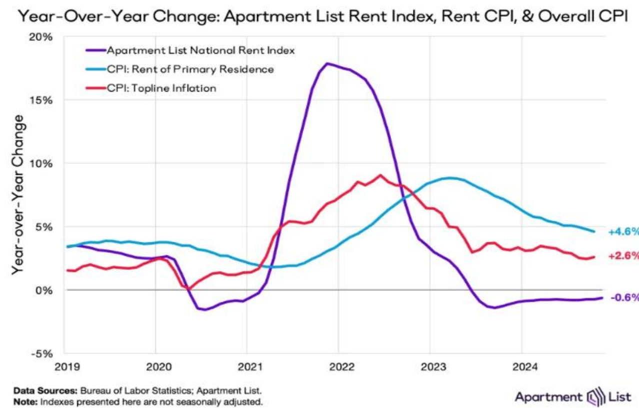
In November, rent decelerated to +2.6% annualized from October. The three-month rate decelerated to +3.2%. Both of them were the lowest since 2021. So, despite the somewhat disappointing November inflation report, we are finally seeing a break in the rental components of the inflation indices.

Moreover, the disinflation in shelter costs is likely to continue into 2025. This is due to home prices flattening if not declining in some areas along with new rents deflating. Indeed, as shown below, rents for new leases fell -0.8% in November and have now declined sequentially for four months in a row.

Meanwhile, the vacancy rate edged up to 6.8%, which is tied for the highest reading since 2017 when the Apartment List data series began.



The trend in rental rates (0.8%) for current leases (purple line) compares to the prevailing 5% pace in the dominant CPI segments (green line), which comprise mostly leases signed in past years at much higher levels. So, slowly but surely, these higher and older rents will fall out of the data and be replaced with new rent data.



Bottom line: After stripping out rents, CPI inflation is running at 1.7%, which is what we can hopefully expect to see in 2025 as the shelter data plays “catch down” to where the trend is in real time.

MOTHER’S MILK FOR INFLATION

While disinflation has seemingly stalled for the time being, I am not buying into this view that inflation is re-emerging as a problem. Let’s not forget that the root of inflation comes from unit labor costs (ULCs). ULCs (how much a business pays its workers to produce one unit of output) are considered the “mother’s milk for inflation.”

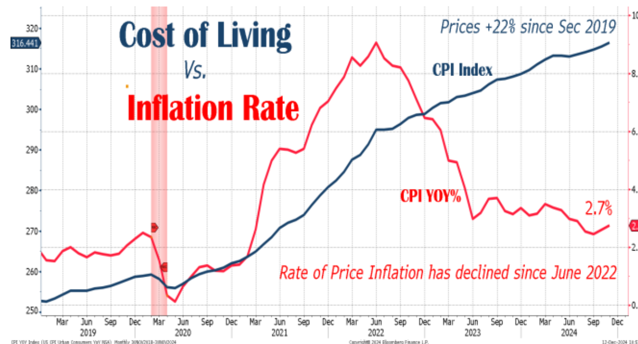
For November, ULCs were marked down to a mere +0.8% annual rate from the initial estimate of +1.9% after a -1.1% pullback in Q2, and the year-over-year trend is running barely higher than +2.0%. Someone in the press should ask Powell about this after next week's Federal Open Market Committee (FOMC) meeting.

This followed on the heels of a -1.1% decline in the second quarter — taking the year-over-year trend to +2.2%, from +2.3% in Q2 and +3.3% in Q1.

Bottom line: This report was a bit of a shocker and may be cause for the FOMC inflation hawks to go back to the drawing board. This is also a message for the pundits believing the Fed should "pause" under the illusion that the economy is still strong (sure, with over -700,000 jobs being lost in the Household Survey these past two months). As for the stock market, it is not exactly part of the Fed's mandate.

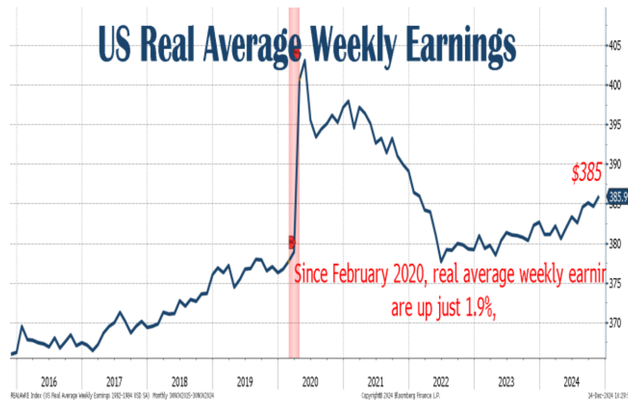
COST OF LIVING IS HIGH!

While there has been significant progress in lowering the rate of inflation, the cost of living is a whopping 22% higher than in January 2020. This means that the prices of all goods and services that consumers spend money on are up, on average, 22%.



These price dynamics have been extremely challenging for the middle to lower income cohorts who spend a disproportionate amount on shelter and food and energy costs. For example, since January 2020, the price of cereal is 30% higher, household electricity is 32% higher, and car insurance is 52% higher.

As shown below, wage growth is only just keeping up with that inflation rate, so low-income consumers have seen their real income stagnate. That's why retailers continue to describe customers as being in bargain-hunting mode and why pricing power is being eroded.



Bottom line: The Fed's CPI measure of year-over-year inflation has declined significantly from the pandemic high, but the living costs for households are still dramatically higher than four years ago. And don't expect prices to decline anytime soon.

As such, many Americans continue to struggle under the weights of high prices. This is undoubtedly a BIG reason why Donald Trump was reelected.

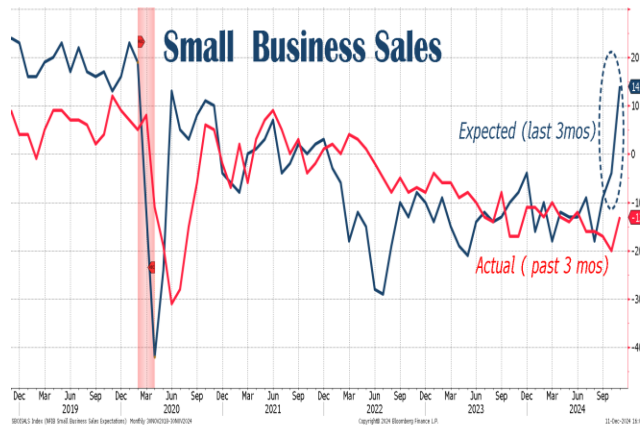
THE TRUMP BUMP

Speaking of the President Elect, the National Federation of Independent Business (NFIB) survey was a response to what the S&P 500, Nasdaq, and Russell 2000 have already accomplished since the election. The NFIB Small Business Optimism Index soared to 101.7 in November from 93.7 in October — the highest level since June 2021 and the sharpest one-month surge in history.

The companion Uncertainty Index also pulled back to a three-month low of 98 from 110, and that was tied for the fourth steepest decline since the series began 40 years ago.

Hopes of what Trump 2.0 will deliver are running extremely high even before he takes office. The net share of business survey respondents who expect the economy to improve shot up to 36% from -5% in October to stand at the best level since June 2020 after the federal government rolled out unprecedented amounts of policy stimulus.

Despite very weak actual sales over the past three months, expectations of "higher real sales" swung from a net -4% to +14% — back to where it was pre-pandemic in February 2020.



Bottom line: The NFIB Small Business Survey in a nutshell: Our sales still stink, but Trump is going to make it all good.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

Bonds had something of an off week, with U.S. inflation data (CPI), showing a welcome cooling in shelter and insurance premiums offset by a pickup in previously deflating segments of the economy. Yields on the 10-year Treasury note rose +25 basis points to 4.4%. At the front end of the curve, twos settled 14 basis points higher at 4.24%.

Notably, the Treasury yield curve from the 3 months to 10 years, after being inverted for 779 days (the longest stretch since 1929) has now normalized into a positive slope. As shown below, whenever the 10 year/three month spread has turned positive, a recession has followed shortly thereafter. Will history repeat, or is it different this time?

So why the selloff?

We are back to inflation hysteria. A day after the CPI confirmed a less-than-hoped for progress with inflation, the Producer Price Index (wholesale prices) jumped more than expected, rising 0.4% in November after a 0.2% gain in October for a 3% year-over-year gain. That said, the reason why goods prices jumped +0.7% was the surge in food. Strip that out, and the headline was just +0.2%. The key was the fact that service sector producer prices came in benign at +0.2% month over month, the smallest gain since last July. All in all, not a bad print, yet the bond market revolted.

Let’s cut through the bull. Inflation undid the Biden Presidency, and the election showed that there is no appetite at all for a return to inflation. If Donald Trump reignites inflation, he will likely suffer the same consequences of Joe Biden. This is the big reason it won’t happen. Also, as the Fed showed in 2022 and 2023, it too will not sanction any return to inflation.

Moreover, the unemployment rate is on the rise and unit labor costs are running just a bit north of +2.0% year over year. This data is not inflationary. Further, beyond the government machinations and imputations, the Fed Beige Book shows a loss of business pricing power and a consumer revolt against prices, not just inflation.

Finally, as for the so-called American exceptionalism and a robust economy, it's important to highlight that "Bidenomics" pushed total U.S. debt to over $36 trillion. It was one giant economic "stealth stimulus" — one which masked the growing stagnation by papering over the slowdown with $1 trillion in new debt every 100 days!

But let's face the facts. It isn't really that hard for the economy to "roar" when the economy is being supported by $2 trillion in fiscal deficits. So much of the economic growth is being fueled by recurring 6%+ deficit ratios. Surreal. That's "American exceptionalism" — the ability to buy economic growth via endless government support.

While it's too soon to tell if Musk's Department of Government Efficiency (DOGE) has real teeth and will become reality, the economy may soon find out if it can stand on its on two legs.

Bottom line: The U.S. may not be in a recession, but the economy is in a growth turndown, nonetheless. Do not believe that this is still a +3% growth economy any longer. The momentum has subsided dramatically, and yet nobody talks about it.

In terms of portfolio strategy, continue to maintain a risk-appropriate ladder strategy while capitalizing on periodic sell offs.

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.

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