alloya
INVESTMENT SERVICES

Weekly Relative Value

Tom Slefinger
Market Strategist

WEEK OF DECEMBER 23, 2024

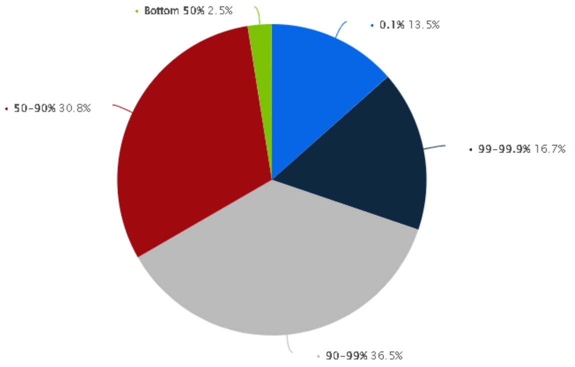
The Special K Economy

*"Lower mortgage rates will make housing more affordable and allow more homeowners to refinance. Lower corporate bond rates will encourage investment. **And higher stock prices will boost consumer wealth and help increase confidence, which can also spur spending**." - Former Fed Chair Ben Bernanke, Washington Post Op Ed, 2010*

The “wealth effect” theory postulates that rising asset values (stocks and real estate) leads to increased consumer confidence and higher consumption levels.

After the Great Financial Crisis, Ben Bernanke, then Fed Chairman of the Federal Reserve, implemented two “emergency” monetary measures — Zero Interest Rate Policy (ZIRP) and Quantitative Easing (QE). As quoted above, Bernanke felt that these measures would shore up consumer confidence, spur spending and stabilize the economy after the 2007-2008 Great Financial Crisis.

While we were told these policies would be “temporary,” they have since morphed into a permanent policy tool for well over a decade. And as Bernanke had predicted, asset prices have surged, creating a tremendous wealth effect over the same time period. This has also led to the greatest wealth inequality ever seen in this country.



Source: Visual Capitalist

THIS WEEK

- THE WEALTH EFFECT AND CONSUMPTION
- MORE CARS, LESS FOOD!
- LUCY, CHARLIE BROWN AND FOOTBALL (AGAIN)
- BETTER THAN EXPECTED
- LOOKING INTO 2025
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
TELL ME MORE!

SUBSCRIBE

Here are a few facts about the wealth distribution in America.

- The top 0.1% (the filthy rich) own 13.5% of the net wealth in America.
- The top 10% richest own 66.5% of the net wealth.
- The 50-90% bracket (the lower-middle and middle classes) own 31% of the net wealth.
- The bottom 50% make up the lowest share, accounting for 2.5% of the net wealth in America.

"Bull markets are born on pessimism, grown on skepticism, mature on optimism, and die on euphoria."- Sir John Templeton

THE WEALTH EFFECT AND CONSUMPTION

Consumption represents 70% of economic growth in the U.S. economy. Categorically, as the consumer goes, so goes the economy.

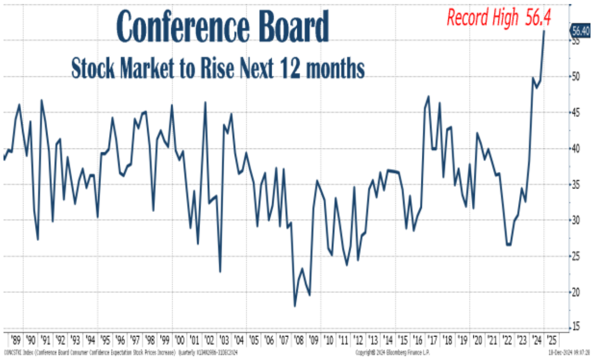
Now let's discuss a few basic facts about how different income and wealth brackets drive the consumption and economic growth in America:

- The top 20% of U.S. households by income drive over 40% of consumption growth — the same as the entire bottom 60%.
- The top income quintile owns 50% of the domestic household equity stock and has a strong and positive correlation between spending and stock market returns.
- The middle 60% of the income distribution contains all the credit-dependent households. Asset values have limited effect on consumption. Instead, the sensitivity of spending to wage growth rises as income falls.

Clearly, it's the top 20% of Americans that have the greatest impact on consumption, and unquestionably, the top two income quintiles account for the lion's share of spending. Moreover, they spend more when the stock market is up. As of Q3 equity, holdings soared at a +25. % annual rate to a record +$65.4 trillion, which is about eight times the pace of organic personal income growth.

With upper income households' increased spending leveraged to the stock market, the stellar returns of the equity market performance in 2024 and 2025 has turbocharged an already strong wealth effect among wealthier households. This has kept aggregate consumption expenditure rising. Simply put, consumption and growth has been fueled by a large wealth effect! Who needs a job?

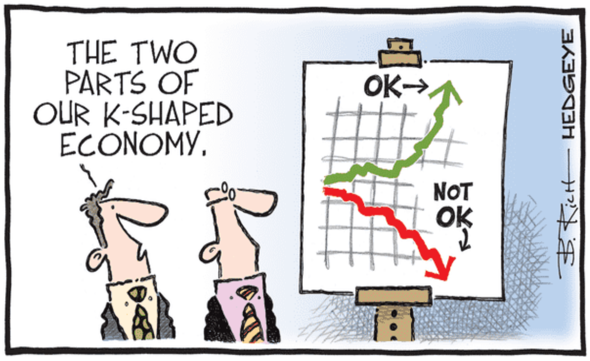
Moreover, the forward-looking picture regarding portfolio returns matters a lot to consumption behavior. If consumers expect their wealth to fall, they're less likely to spend. But according to the Conference Board's consumer confidence survey, households have never been more bullish (see graph above). A full 56% of respondents expect stock prices to rise in the next year rather than staying flat or going down despite the most extreme level of valuation in U.S. history.



CONCSTKI Index (Conference Board Consumer Confidence Expectation Stock Prices Increase) Quarterly 01JAN1986-31DEC2024 Copyright© 2024 Bloomberg Finance L.P. 18-Dec-2024 09:07:28

Meanwhile, there has been mounting evidence that middle-and lower-income consumers (no equities, do not own a home and rent) are feeling increasingly stretched and stressed. This is why: In terms of good old-fashioned disposable incomes, growth slowed to a +2.3% annual rate in Q3, from +3.6% in Q2, and the softest pace since the first quarter of 2022. Imagine that. Income gains have risen one eighth the pace of asset price gains.

While the rate of inflation has declined, higher prices are a painful reality affecting the lives of millions of Americans, from soaring grocery bills to sky-high restaurant tabs. Unlike the wealthier households who have benefited from rising asset prices, the inflation unleashed by the Fed has crushed the low-earning folks. Thanks, Ben, Janet and Jay!


THE TWO PARTS OF OUR K-SHAPED ECONOMY.
OK→
NOT OK↓
HEDGEYE
B. Rich

Bottom Line: The U.S. has a K-shaped economy based on income and wealth. The *"Haves"* are doing swimmingly well while the "*Have Nots"* struggle.

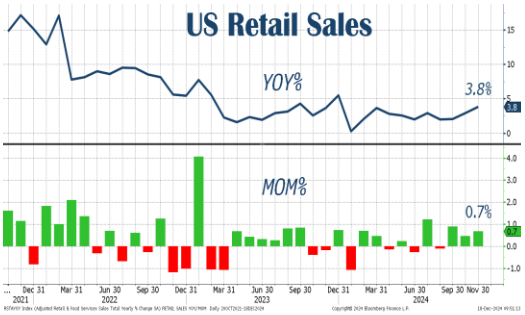
Looking ahead to 2025, it's more than obvious that the macro-outlook is now hitched to the unpredictable dynamics of financial markets rather than the other way around. With accounts fully exposed to equities, cash levels at historic lows and bullish sentiment off the charts, what could possibly go wrong?

From where I sit, the stock market is the biggest single risk to the economy. Should the equity markets crack, the wealth effect would reverse, and consumption and economic growth would likely slow, even if not dramatically.

MORE CARS, LESS FOOD!

> *“Over the past 10 years the year-over-year core retail sales growth was 5.4% and was 4.3% in November. Also, for context, **the top 20% income decile accounts for about 40% of all consumer spending and highlights the bifurcated consumer**.”*
> *- Peter Boockvar, Chief Investment Officer, Bleakley Financial Group*

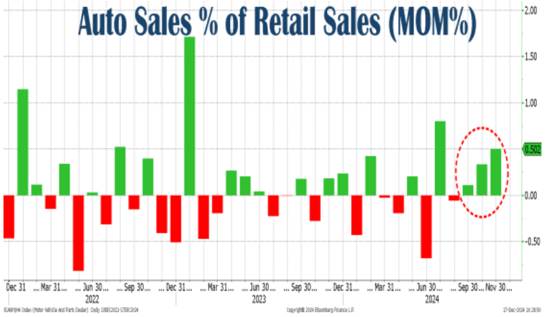
U.S. retail sales came in close to expectations in November at +0.7% (consensus was +0.6% month over month) This marks the third straight advance. There were some modest upward revisions to October as well. The headline beat pushed sales up 3.8% year over year — the highest since December 2023.



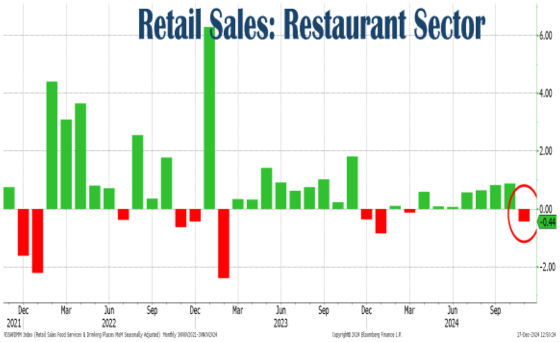
The key “core control” measure that feeds directly into the consumer spending segment of the gross domestic product (GDP) (headline excluding auto, gasoline, and building materials) was right in line with market expectations at +0.4% (following a modest -0.1% October dip).

In nominal terms, the core control sales metric is running at a +3.6% annual rate so far in Q4. That is down from a +5.9% pace in Q3. In real terms, the core control is barely rising at over a +1% annual rate with one month to go in the quarter.

The gain was almost all an automotive story. Auto sales swelled +2.6%, and that followed a +1.8% surge the prior month — the best back-to-back performance in nearly four years. As shown below, auto sales represented 50% of retail sales in the month. The segment excluding automobiles came in light at +0.2% month over month (consensus was +0.4%), as did the segment excluding autos/gas (also half the consensus view).



The really big disappointment in an otherwise decent report was the restaurant sector. Sales receded -0.4% in the first decline since March and the steepest falloff since last January. Understandable for anyone who has dined out recently. Likewise, the grocery chains also posted a -0.2% decline after slipping -0.1% in October. Like the restaurant sector, big-time food inflation is crimping activity whether folks are dining in or dining out.



Bottom line: Thanks to the wealth effect, the consumer is alive and well.

LUCY, CHARLIE BROWN AND FOOTBALL (AGAIN)

> *"It's hard to justify trimming the number of cuts in 2025… unless Fed officials are explicitly accounting for upside surprises in inflation from the incoming administration's policies…this looks to me like they are penciling in tariffs for next year."- Omair Sharif, CEO, Inflation Insights*

As expected, the Fed cut its benchmark rate by 25 basis points to the 4.25%-4.50% target range. Just a reminder, the Fed slashed rates by a dramatic 50 basis points (crisis-like move) less than three months ago and has now lowered the Fed Funds rate by 100 basis points.

While the decision to lower rates was widely telegraphed, the Fed pulled a 180 again, shifting its concern back to inflation after putting the labor market on the front burner over much of the past six months. In fact, 15 of the 19 Federal Open Market Committee (FOMC) officials now see upside inflation risks ahead, up from just three in September. Lucy, Charlie Brown and football again. Thanks, Jay!

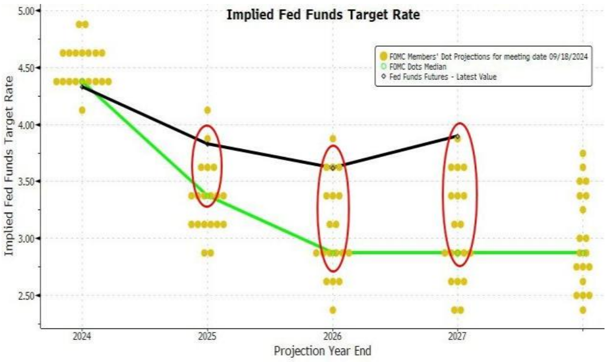
Much of Powell's press conference hinged on 2025's uncertainty (transcript data mining showed the most uses of the word "uncertain" in 2024) and slower pace for cuts going forward. The pace of rate cuts was always expected to slow in 2025, but the Fed is clearly more focused on the inflation threats of some of U.S. President-elect Trump's policies (fiscal, mass deportation and taxing consumers).

As for the changes to the projections from last September, apparently the Fed has decided that Trump's policies will be inflationary. The key was taking up its 2025 headline Personal Consumption Expenditures (PCE) inflation call to 2.5% from 2.1%, core to 2.5% from 2.2%, and a further nudging up in R-star to 3.0% from 2.875%.

This is still a bit strange since Trump hasn't even taken office yet, and nobody knows what he is actually going to end up doing. It's one thing for the Fed to build risks into the forecast and another to make a dramatic change to its actual published inflation projection for next year.

The dot plot showed Fed officials expect "higher for longer" to continue, with 10 members estimating only two 25 basis point cuts in 2025 (down from four in September).

The swaps market is down to just pricing in one more rate cut! It was just three months ago that the Fed encouraged the market to price in 200 basis points of cuts for next year.



Source: Bloomberg

Powell thinks the economy is stronger than expected, revising GDP growth higher to 2.5%, and the unemployment rate was lowered to 4.3%. But as I have opined many times, much of the growth is due to rampant government spending, which is unlikely to be repeated.

He also contradicted himself when he said that the Fed doesn’t react to short-term wiggles in the inflation data and then went on to say how the September and October Consumer Price Index prints were a major cause for the shift in tone and in the projections. Two months! And he acknowledged that November’s inflation backdrop had improved. So, we had two months of aberrations, and that affected policy and the outlook for all of next year? Nonsensical. And then Powell talks about how great the labor market is, but also talks about how many measures of slack are back to where they were pre-pandemic.

Bottom line: If this is really what they think, why on earth did they cut rates at all? Maybe they needed these new forecasts to justify the less dovish tone on rates. Who knows? They probably don’t even know.

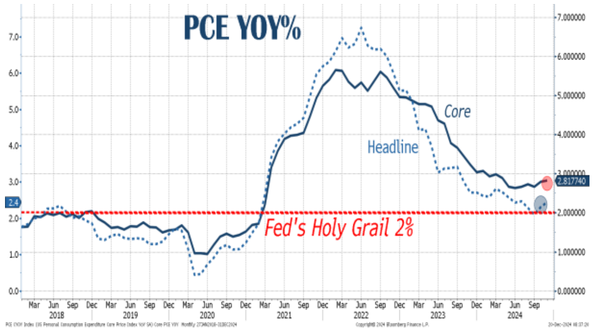
You would have thought that the world has changed dramatically since the jumbo rate cut just three months ago. It clearly does not take much to cause this Fed to swing its view around. I can guarantee that it will shift again.

Moreover, the one thing about the Fed is they are never right about their predictions and are generally on the wrong side. If economic data weakens or some event occurs, they will be cutting more than the market thinks.

BETTER THAN EXPECTED

Two days after the Fed’s decision, the headline and core PCE came in at +0.1% month over month — each undercutting the +0.2% consensus estimate. That took the year-over-year trend in headline PCE inflation to +2.4% (consensus: +2.5%). The six-month annualized headline PCE inflation rate has settled at a bang-on-target +2.0%.

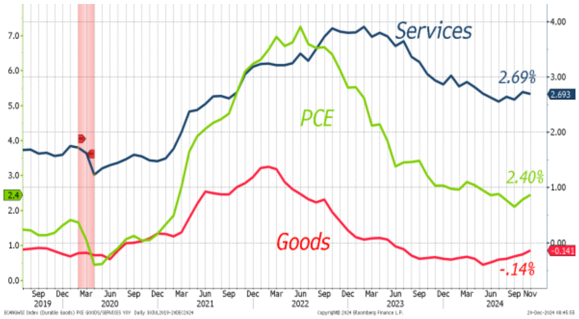
The Fed's preferred inflation metric (core PCE index — excluding food and energy) increased 0.1% month over month — the slowest since May. Year over year, the core index clocked in at 2.8%.



The services components of PCE fell from +0.4% month over month in October to +0.2% in November, and the trend is clearly down. Services prices (excluding housing and energy) rose 0.2% from a month earlier, the slowest since August.

While goods prices were slightly positive (+0.4%) for the month, this represents a natural and gradual movement after the outright deflation of the past year and change.

I believe the lagged disinflation in services prices is the more important trend and points to further inflation cooling ahead.



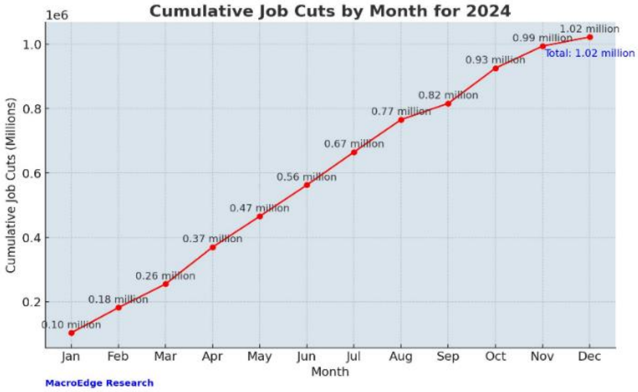
Bottom line: Where the FOMC members see upward price pressures coming from is anyone's guess.

LOOKING INTO 2025

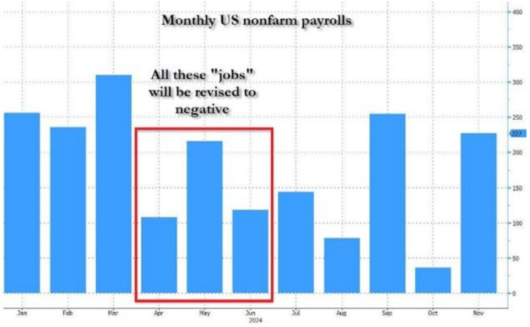
The question heading into next year is how the inflation and labor market data play out. A discussed above, the disinflationary trend, while painfully slow, is intact.

And this is what we know today about the labor market.

- The household survey has experienced two consecutive -300,000-plus plunges in the number of people employed.
- Job cuts surge to wrap up the year on news of major Big Lots and Party City closures (over 1,500 locations), with nearly 70,000 employees impacted by cuts this month. Per MacroEdge, there have been more than one million job cuts in 2024.

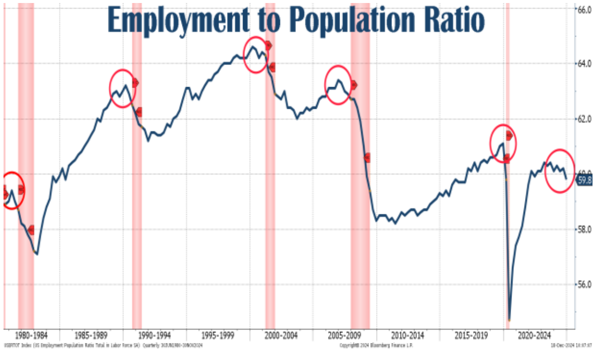


- The Philly Fed's analysis of census data, which is used in calculating the annual benchmark revisions, suggests that employment contracted slightly declined by 0.1% in Q2 instead of growing 1.1% as previously reported. In other words, the 442,000 jobs created in Q2 will likely be REVISED DOWN to negative in Q1 2025, according to the Philadelphia Fed analysis. The quarterly census data is noisy, but it's plausible we will see big downward revisions to payrolls again. To emphasize, official job losses never occur outside recessions. Are we awaiting an announcement of a recession in 2025 by the National Bureau of Economic Research (NBER)?

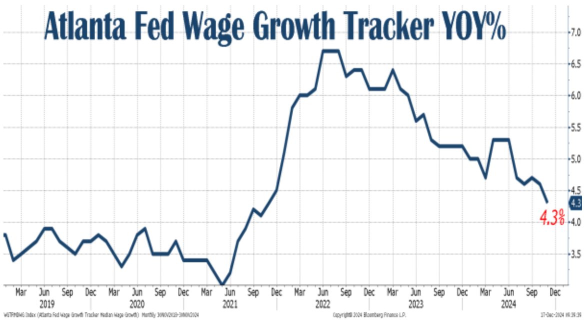


Source: The Kobessi Letter

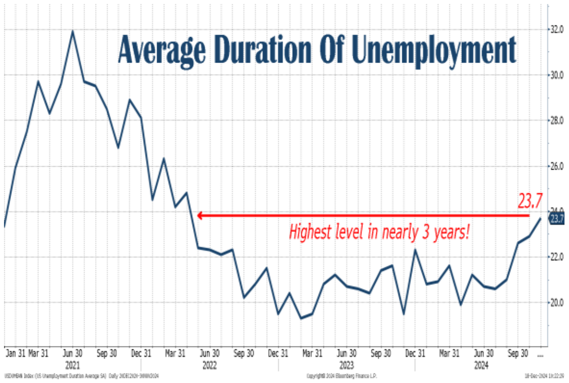
- The employment-population ratio, which measures how efficiently the economy provides jobs, FELL to 59.8 in November, the lowest in nearly three years. A declining ratio means the share of employed people in the U.S. is dropping. As highlighted in the graph below, when the employment-to-population ratio declined as much as it has this cycle, the U.S. economy was heading into recession. Will this time be any different?



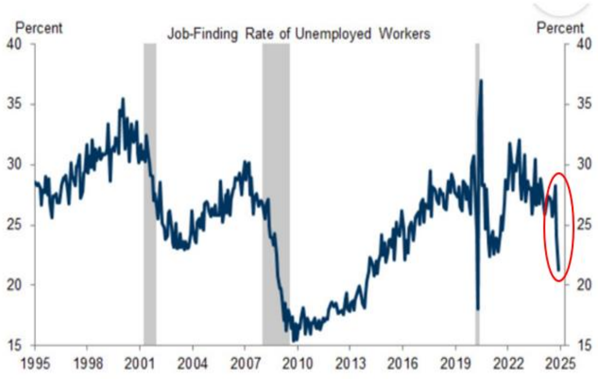
- The Atlanta Fed Wage Growth Tracker has receded sharply over the past three months to 4.3% as of November — a three-year low. The deceleration has been broadly based across job-switchers and job-stayers and most industries and socio-economic groupings. I think it’s safe to say that if the labor market was truly hot, wage trends would not be decelerating as fast as they are.



- The average duration of unemployment has risen to its highest level (23.7 weeks) in nearly three years. This is an early warning sign of things to come.



- The job finding rate of unemployed workers has absolutely crashed over the past two months. Another classic leading indicator for the labor market looking shaky.



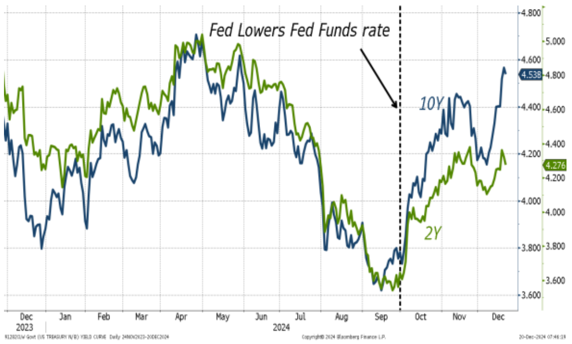
Source: Goldman Sachs

Bottom Line: Together, the indicators imply a very strong warning that something is seriously amiss in the labor markets. From my perch, all of this tells me that when it comes to all of 2025, the Fed will be cutting more than what is currently priced in, which should end up being constructive for the Treasury market from today's elevated yield levels.

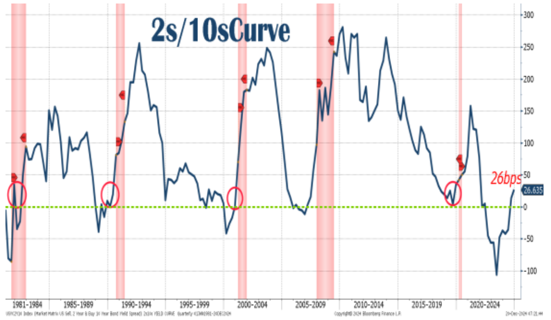
MARKET OUTLOOK AND PORTFOLIO STRATEGY

> *"Tax cuts typically spur growth. Immigration might change how many are in the labor force. Tariffs could raise costs, but they could also spur new domestic investment and deregulation…. If the changes are drawn out over a four-year period, they're much more muted effects than if they all happen like a light switch." Mary Daly, San Francisco Fed*

Bond markets continue to trade nervously as markets are questioning the Fed's ability to sustain its policy easing. In fact, after the Fed commenced its most recent rate cutting cycle on September 30, yields have risen quite sharply across the curve. The 10-year Treasury yield has risen 75 basis points to 4.53%. Even the 2-year Treasury yield, closely correlated to Fed policy, has risen 62 basis points to 4.27%.



The yield curve has reached the steepest levels in over five years on inflation, interest rate and Trump policy uncertainty. The widely watched 2s/10s spread has widened to 26 basis points.



Here are the primary concerns for the bond markets:

- The Trump world of fiscal largess and ever-rising public deficits and debts. Will the House Republicans have the nerve to resist? Clearly, the fiscal hawks in the House, and they are numerous, realize that the current +20% year-over-year trend in government spending needs to be addressed.

- The 2017 tax cuts will not only be extended but made permanent. The Congressional Budget Office will not like that one bit. Trump is also not backing away from his 15% top marginal corporate tax rate.
- Incoming Treasury Secretary Scott Bessent will place less focus on funding the deficit via T-bills and more on longer-dated issuance. This would effectively unwind the Yellen strategy.
- Even as Musk and his Department of Government Efficiency (DOGE) will try to trim fat, the first thing the Trump team is doing is to spend all the leftover pandemic expenditure capacity that has yet to be fully used up.
- Immigration restraint. Immigration accounted for 84% of total U.S. population growth over the past year. The Fed's concern is that curbs would tighten up the labor market and feed into accelerating wage growth.
- Trade wars: Will the self-confessed "Tarriff Man" drive inflation and yields higher?
- The complicated relationship between the incoming President and the Fed Chairman is about to become even more complicated — another source of uncertainty for investors to mull over.

Bottom line: The bond market will be on tenterhooks until there is greater clarity on the policy front. Expect higher volatility until we have more certainty. That said, any *"significant"* yield back up represents an opportunity to, yet again, buy the dip!

HAPPY HOLIDAYS!!

Today marks the final edition of the *Weekly Relative Value* for 2024. The next edition will arrive in your mailbox on January 6, 2025.

I would also like to take this opportunity to thank everyone who has tuned in from time to time over the course of 2024 to read my views on the economy, politics and markets. Thank you for your valuable time and attention!

Finally, on behalf of the Alloya team, I would like to wish everyone a festive and happy holiday season and a healthy and prosperous 2025!

Season's Greetings
JOY
HEDGEYE
B. Rich

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.

The views and opinions expressed herein are those of the author and do not necessarily reflect the views of Alloya Corporate Federal Credit Union, Alloya Investment Services (a division of Alloya Solutions, LLC), its affiliates, or its employees. The information set forth herein has been obtained or derived from sources believed by the author to be reliable. However, the author does not make any representation or warranty, express or implied, as to the information's accuracy or completeness, nor does the author recommend that the attached information serve as the basis of any investment decision and it has been provided to you solely for informational purposes only and does not constitute an offer or solicitation of an offer, or any advice or recommendation, to purchase any securities or other financial instruments, and may not be construed as such.

Information is prepared by ISI Registered Representatives for general circulation and is distributed for general information only. This information does not consider the specific investment objectives, financial situations or needs of any specific individual or organization that may receive this report. Neither the information nor any opinion expressed constitutes an offer, or an invitation to make an offer, to buy or sell any securities. All opinions, prices, and yields contained herein are subject to change without notice. Investors should understand that statements regarding prospects might not be realized. Please contact ***Alloya Investment Services**** *to discuss your specific situation and objectives.*