Weekly Relative Value

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Tom Slefinger
Market Strategist

WEEK OF JANUARY 6, 2025

The Golden Age of America?

"Every single day I will be fighting for you, and with every breath in my body. I will not rest until we have delivered the strong, safe and prosperous America that our children deserve and that you deserve. ***This will truly be the golden age of America."***
– President Elect Donald Trump

Economic and market trends were anything but predictable last year, and I expect more of the same in 2025.

Year 2025 Roller Coaster Ride

As Wall Street predictions roll in, virtually all pundits, strategists and economists are forecasting a strong economy and rising equity markets for 2025. The consensus year-end target for the S&P 500 is 6,725 or +14% higher than the close for 2024.

I think many people are automatically expecting a four-year economic boom and another 10-20% upside year for the S&P 500 just because President Trump has guaranteed to deregulate and lower taxes. After all, this is what happened during Trump's first term, up until the pandemic, so why would anybody expect anything different?

However, as a word to the wise, take these predictions with the prescribed grain of salt. The *"smartest people in the room"* year after year have been *consistently wrong about*

THIS WEEK

- CREDIT CARD DEFAULTS SURGE
- RINGING IN THE NEW YEAR WITH A NEW RECORD HIGH!
- THIS ISN'T SUPPOSED TO HAPPEN
- WHAT, ME WORRY?
- HOUSING REMAINS FROZEN
- BONDS ARE OUT OF WHACK
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)

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everything, and never more so than in 2024. For example, the Wall Street consensus expected the S&P 500 to increase 3% — which was a mere 21% off the mark. More significant was the seventh consecutive year of erroneous forecasts.

Here's something else to consider. Not once in history has the consensus ever predicted a down year for the stock market, even though this has happened over the past century 28% of the time. In other words, Wall Street is ALWAYS bullish because well…they have to be.

I do not pretend to be able to predict the future. My only forecast for the coming year is that we will experience an eventful year with many unpredictable twists and turns.

First off, while investors have turned outright giddy over the incoming pro-business, pro-growth Trump Administration, no one really knows what impact the Trump policies will have on economic growth, inflation and the markets because some of Trump's proposed policies would boost growth and reduce inflation over time, while other policies would have the opposite effect.

"The new administration is likely to bring significant change that could further support the recovery in deal-making and capital market liquidity. That could include replacing U.S. government agency leadership with personnel less inclined toward heavy regulation."- JPMorgan Chase

Undoutedly, it's a safe bet that Trump will be pro-business. This alone could unleash the "animal spirits" that drive business investment, innovation and economic growth. Definitely a positive.

Economic growth would likely also be boosted if the Trump Administration and the Republican Congress succeed in permanently extending the corporate and personal income tax cuts that will otherwise expire in 2025.

At the same time, a reduction of excessive and counterproductive regulations would probably support economic growth and competition, thus lowering inflation over the longer term. Good stuff all the way around.

Trump also has ambitions to increase production of oil and gas by three million barrels per day. Assuming this can be done without negatively impacting the environment would likely lower energy prices while freeing up discretionary cash flow. This too would be a positive in lowering prices while freeing up discretionary consumer spending.

But it's important to highlight that faster growth and lower inflation from tax policies, deregulation and other pro-business measures will take time to materialize. In fact, believe it or not, there are only 11 months to extend the tax cuts before midterm campaigning begins. Barring the most effective Congress in U.S. history, it will take most of 2025 to extend the 2017 tax cuts.

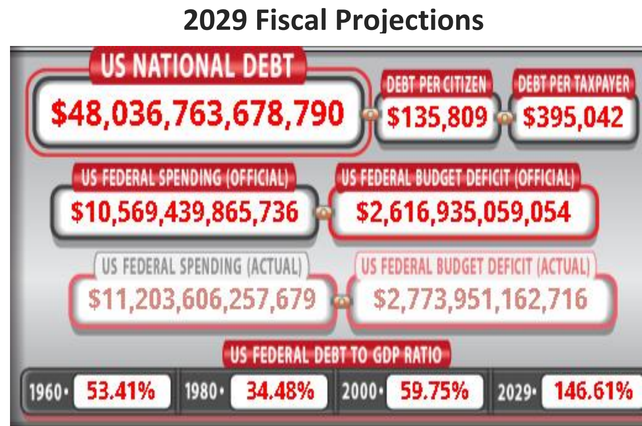
Moreover, as for all the talk of strong economic growth and "American Exceptionalism," it's not A.I. It's not even so much the consumer, which has admittedly hung in, at least for the top one-third of the income and wealth strata. Rather it's the debt-funded sugar high that was propelling the U.S. economic engine.

And the trade-off of this unprecedented sugar rush? $1 trillion in new federal debt every 100 days**,** bringing the total to a gargantuan $36.2 trillion, up $8.5 trillion, or a stunning 30%, since Biden's inauguration.

Unless something changes, in four short years, as shown below, we will be saddled with $48 trillion in debt; the deficit will be $2.6 trillion, and debt to gross domestic product (GDP) will soar to 146% of the economy.

Moreover, if tax cuts are made permanent and other fiscal promises are implemented without ways to pay for them, the public debt could increase by an estimated $8 trillion over the next decade. That, too, would stoke inflation, which would increase long-term interest rates and crowd out future investment, undermining growth and possibly causing a stock-market correction.

2029 Fiscal Projections



Source: U.S. Debt Clock

So as the year begins, the $36 TRILLION dollar question is what will the Trump Administration do? Will they proceed with their pro-growth strategies of lowering taxes while driving debt and deficits ever higher? Or will the GOP revert back to their roots of being the party of “fiscal responsibility”?

Further, even if Trump pushes the pro-growth policies, the reality is that the thin Republican majority in the House of Representatives (Republicans have the slimmest House Majority since 1931) means that Trump cannot necessarily count on his party's full support for all his policies, especially those that would add substantially to the public debt. Several GOP House members know the math: running near-$2 trillion deficits, in excess of 6% of GDP, is simply a path to financial ruin, even for economic powerhouses like the United States. As this week's Barron's points out:

> *"The nonpartisan Congressional Budget Office projects annual budget deficits continuing around that level through the end of the decade, then rising gradually to $2.9 trillion by 2034. That assumes the Tax Cut and Jobs Act of 2017 expires at the end of 2025, as scheduled. But President-elect Donald Trump has made renewal of the signature tax cuts of his first term a priority, which would add an additional $4 trillion to the national debt above the CBO estimates.* ***That is not going to stand."***

Thus, it is going to be very hard to pass legislation without support from some Democrats.

Further, with gross interest expense on U.S. debt now running at a record $1.2 trillion (and rising every day), surpassing defense and health spending as U.S. government outlays, with just Social Security spending ahead of interest on the debt, I believe the Treasury will no longer spend like a drunken sailor.

Much has also been written about Elon Musk and Vivek Ramaswamy heading up the Department of Government Efficiency (DOGE), with a mandate to seek trillions in spending cuts. However, most of the federal government's spending is in interest rate payments or entitlement programs, with Medicare and Social Security alone accounting for 38% of total expenditures. Republican efforts to cut entitlement programs have always ended in political disaster.

Thus, while there is no question that the ability to pass large spending cuts would significantly reduce Treasury issuance, it looks highly implausible. Republicans will be lucky to get their act together and pass any meaningful cuts, let alone trillions.

Moreover, if, by miracle, Donald, Elon and Vivek achieved their goals of trillions of spending cuts for the sake of some "greater good" down the line, they may be in for the surprise of their lifetimes. Because for a debt-funded economy like the U.S., even the smallest hiccup in issuing trillions in debt means an economic slowdown and weaker markets.

Moving on. There is no denying that high tariffs, trade wars, and a decoupling from China will be inflationary and harmful to growth. The extent of the damage, however, will depend on the size, timing and scope of the tariffs and other protectionist policies.

Finally, draconian restrictions on immigration such as mass deportations could do much more damage than good by increasing labor costs and heightening the risk of labor shortages in key sectors.

To wit: According to Labor Department numbers, 44 % of the 2.4 million farm laborers in the U.S. are undocumented migrants. Trump's so-called "border czar" Tom Homan has said he wants to deport at least nine million immigrants along with their families regardless of citizenship status.

But is this really what the country wants?

> *"**We will not be able to harvest our fruits and vegetables and nuts**…And it would **possibly increase food prices tremendously** too…We can't have deportations here because **it would disrupt our food supply for our country**… **Without our people, our farms will come to a stop**."*
> *- Joe Del Bosque, Del Bosque Farms of the San Joaquin Valley*

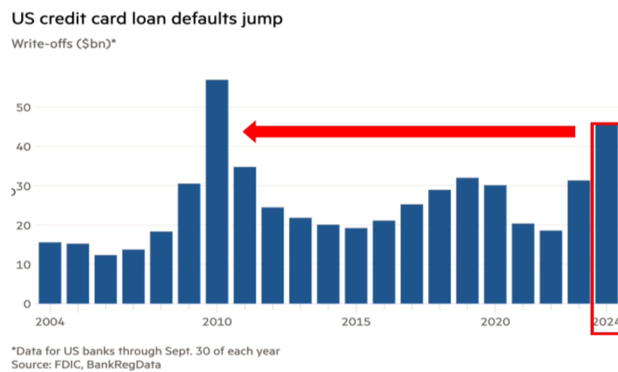
Bottom line: As stated at the beginning, no one really knows what will happen at this point. Only time will tell. It is possible that a mix of pro-growth and disruption policies will occur simultaneously and/or the administration will toggle back and forth, thereby creating heightened uncertainty as well as economic and financial market volatility. Thus, the Trump administration's effects on growth and inflation will depend on the timing and relative balance of positive and negative policies.

CREDIT CARD DEFAULTS SURGE

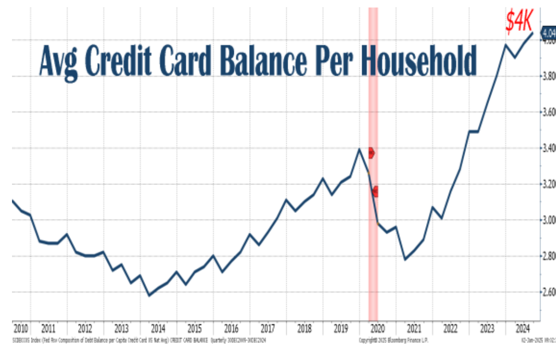
> *"**High-income households are fine, but the bottom third of U.S. consumers are tapped out**…. Their savings rate right now is zero."- Mark Zandi, Chief Economist, Moody's Analytics*

There is this well-ingrained belief that the U.S. economy has become recession-proof, that inflation is sticky, and that there are no glaring financial imbalances to be worried about. Meanwhile, with respect to that last point, I suggest a read of the *Financial Times* article titled "U.S. Credit Card Defaults Jump as Consumers' Finances Buck."

Credit card lenders wrote off $46 billion in seriously delinquent loan balances in the first nine months of 2024, up 50% from the same period the year before and the highest level in 14 years.



Higher balances and interest rates led to Americans paying $170 billion in interest in the year up to September. That sucked up a portion of the excess cash in personal bank accounts, particularly for low-income consumers, meaning borrowers are still struggling to pay back their credit card debts. The bottom one-third of the income strata are completely tapped out and possess a 0% savings rate.



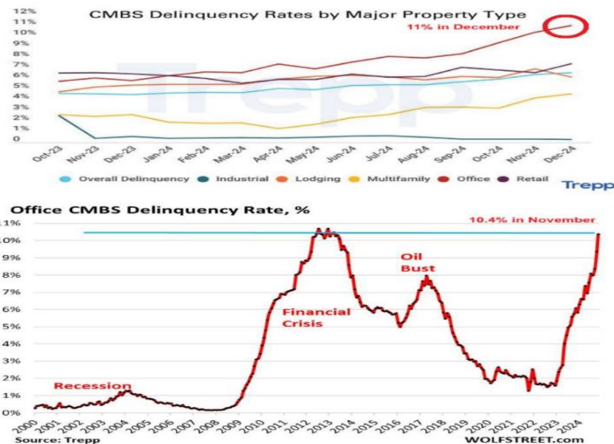
Bottom line: While the well-to-do are doing great, all is not well for lower income groups. Surging defaults provide another hard reason for why Trump won the election. Ivory tower economists keep saying everything looks great. But polls kept showing huge concerns over the economy. The economic polls, not the economists, were right. But who cares if the bottom third is suffering as long as the top 10% keep spending enough to make it appear the economy is humming?

RINGING IN THE YEAR WITH A NEW RECORD HIGH!

"The office delinquency rate rose 63 basis points in December to 11.01%, surpassing the 11% mark for the first time since Trepp began tracking delinquency rates in 2000."- Trepp, Inc.

The commercial real estate sector has been in a world of hurt since the pandemic raised its ugly head. Surging vacancies due to remote work coupled with much higher financing rates has caused commercial mortgage-backed securities (CMBS) delinquencies to soar, and the trend shows no signs of improving anytime soon. In December of 2024, north of $2 billion in office loans became newly delinquent. This drove the delinquency rate to 11.01%, surpassing the previous record high of 10.70%, reached in December 2012.

Meanwhile, the overall U.S. CMBS delinquency rate rose to 6.0%, the most since the 2020 pandemic. The all-time high on this basis was 10.34%, registered in July 2012. The pandemic high was 10.32%, registered in June 2020.



Bottom line: The commercial real estate crisis is real. U.S. office delinquency rates have surpassed the Great Financial Crisis levels. Between commercial real estate defaults and credit card defaults at scary highs, this all feels like a Jenga tower about to topple.

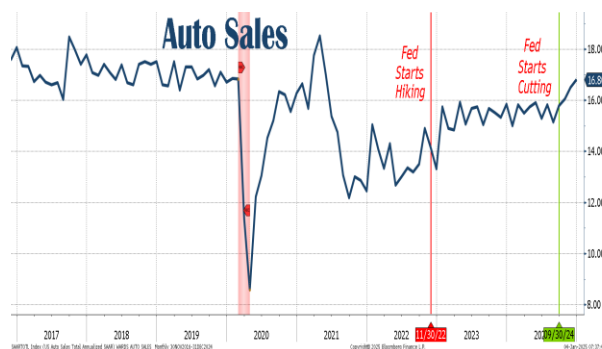
THIS ISN'T SUPPOSED TO HAPPEN

Autos are usually one of the most interest-rate-sensitive sectors in the economy. When the Fed raises interest rates, you would expect car sales to decline. But that is not what has happened during this cycle. Instead, car sales have been going up despite the Fed raising interest rates from 0% to 5.5% over a short period. The source of strong demand for cars has been low unemployment and the wealth effect (significant increases in stock prices and home prices), leading to a higher share of cars purchased with cash.

Combined with the Fed now cutting interest rates, the outlook for car sales continues to be strong. In December, auto sales came in at 16.80 million from November's 16.50 million. In the fourth quarter, vehicle sales grew 24.4% (versus -1.8% in Q3). Consumers likely sought to front-run potential price hikes with Donald Trump's threats to repeal tax credits for electric vehicles and impose tariffs on U.S. imports from Canada and Mexico, which are tightly connected to U.S. auto supply chains.

I should note that sales in December represented a flurry of EV buying ahead of Trump's pledge to terminate the $5600 average tax rebate and impose tariffs on US imports from Canada and Mexico, which are tightly connected to US auto supply chains. But what does all this "pull forward" spending growth mean for this year?

In addition to higher cash transactions, consumers are pushing their budgets to buy vehicles. According to Edmunds, the average auto-loan amount rose to $42,113 in Q4 from $40,713 in Q3, with a record-high share of buyers committing to monthly payments of $1,000 or more.



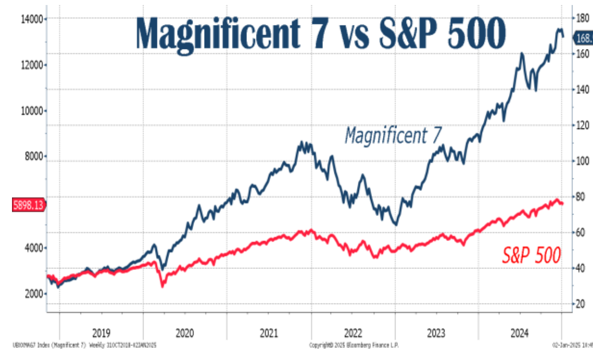
Bottom line: Auto sales thus far have not been negatively impacted by the higher rate paradigm. Let's see what happens in 2025.

WHAT, ME WORRY?

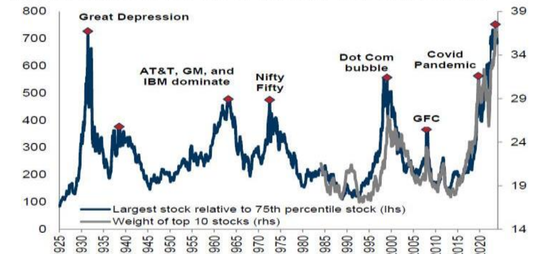
2024 Summary:
- Top 10 billionaires increase wealth by over $700 billion.
- Homelessness reaches all-time high.
- Bang up job as always @federalreserve @SecYellen
- Sven Henrich, Northman Trader

Looking at equity markets, it was largely a speculative and momentum-driven rally with the continued obsession with A.I. and chatbots allowing the Magnificent 7 winners of 2023 extend their amazing run into 2024. The S&P 500 index climbed 24% in the last 12 months, driven primarily by the "Mag 7", which soared 47%.

While acknowledging that generative A.I. is a future game-changer for productivity, the economy, corporate cost structures, and profitability, the reality is that this time, prices may have pulled *just a little bit too much from the future,* as this breakdown of the Mag 7 versus the S&P shows.



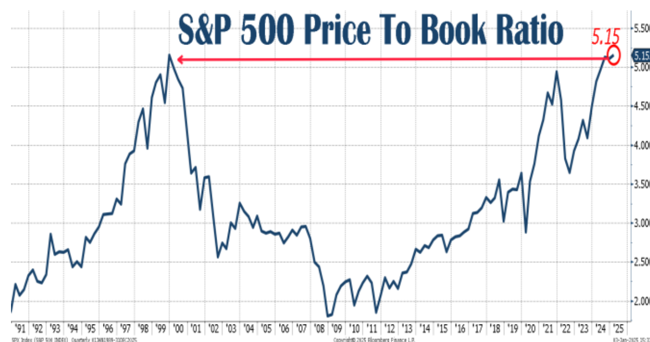
In addition, the finance textbook says that investors should diversify their investments, but there is little diversification today when buying the S&P 500. Never before has so much market influence and impact been concentrated in so few stocks, and at last check, the 10 largest stocks in the S&P now account for a never-before-seen 40% market value of the index. This is DOUBLE the percentage seen seven years ago and is 14% ABOVE the 2000 Dot-Com Bubble. Actually, one correction: it's not *"never before"* — the last time so few stocks had such a big impact on the market was... just before the Great Depression.



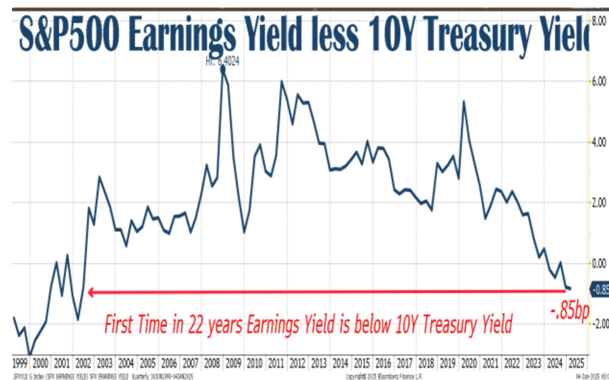
The bottom line is that buying the S&P 500 gives the impression that you are buying 500 different stocks and diversifying your investments. But the reality is that the high and growing concentration in the S&P 500 continues to be a major problem. In short, investors should ensure that their portfolio is not all levered to Nvidia earnings.

Moreover, as I have pointed out (for the millionth time), this market is grossly overvalued and hyperextended. The Buffet Indicator (U.S. stock market to GDP) reached 205%, exceeding the previous record of 200% set before the 2022 bear market. The ratio is also WELL above the 2000 Dot-Com Bubble peak. The 20-year average is 120.

Meanwhile, on a price-to-book basis, the stock market is the most expensive it has been *in history*. The S&P 500 price-to-book (P/B) ratio hit 5.1x and officially exceeded the 2000 Dot-Com Bubble Peak levels. As a reminder, book value is the company's total assets minus its total liabilities. P/B ratio has DOUBLED since 2020.



Likewise, the earnings yield (earnings per share for the most recent 12-month period divided by the current market price per share) is now a measly 3.96%. With risk-free money market funds at over 4% the markets are now pricing equities as a zero risk asset. The earnings yield vs the 10-year Treasury is now the lowest it has been in over two decades.



At this point, overvaluations are being trumped (pun intended) by bullish sentiment and price momentum. People are optimistic — optimistic that Trump will cut the size of government, slash regulations and lower taxes.

Meanwhile, in terms of quelling euphoria, fund managers are underweight cash, and ***expectations*** have never been *higher* for markets. To wit:

"Can the rally continue? Wall Street thinks so."

"On average, analysts are forecasting that the S&P 500 will rise around 10% in 2025*. That includes analysts at Morgan Stanley and JPMorgan Chase, who until recently were bracing for a downturn. John Stoltzfus, chief investment strategist at the brokerage firm Oppenheimer, heads into the new year* ***as the most bullish on Wall Street, anticipating a 2025 gain of roughly 20%****."*

- excerpted from "Wall St. Sees More Gains Ahead After Another Bumper Year for Stocks," The New York Times

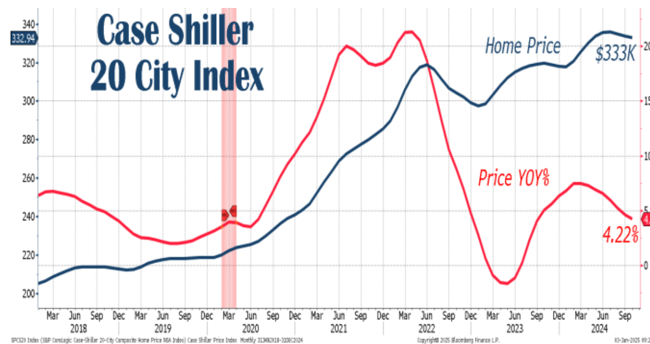
Bottom line: The question is: How much of this is priced in? Stocks rallied relentlessly into the election. I think a lot of it is priced in, if not all. As we head into 2025, my biggest worry is that I highly doubt that the general investing public is fully aware of the extreme concentration risk they have on their balance sheets, especially in the mega-cap tech names. And the problem is, relative to previous bubbles, many more people own stocks this time around than in previous episodes. Retail participation is much higher than it was during the Dot-Com Bubble. Everyone has exposure to stocks, whether in IRAs or 401(k)s or 529s or index annuities. There now is 71% concentration risk of equities on U.S. household balance sheets (which is nearly unprecedented) and only an 8% in fixed income.

As I have expressed previously, I believe a sharp decline in the equity market poses the greatest risk to the economy.

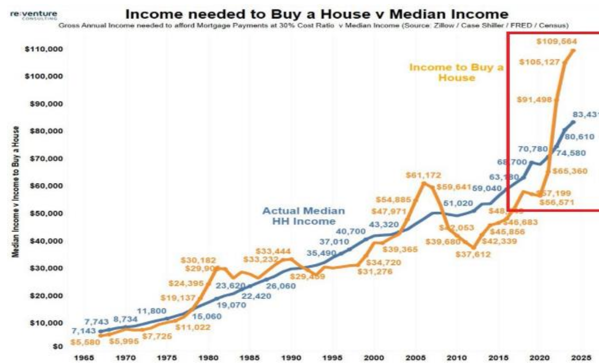
HOUSING REMAINS FROZEN

“Compared to this time last year, rates are elevated, and the market’s affordability headwinds persist.”
- Sam Khater, Chief Economist, Freddie Mac

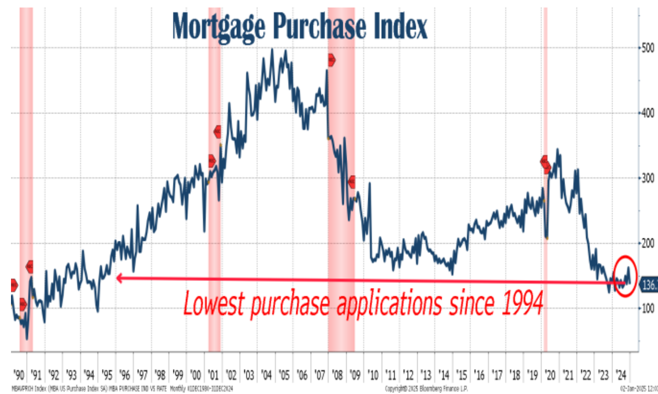
According to Case Shiller, as we ended 2024, home prices are at or near record highs. The national and 20-city Indexes also hit record prices in October.



The average home price in the U.S. is up over 50% in the last five years, more than double the increase in wages. The widening gap between prices and incomes has led to the least affordable housing market in history.



Since the Fed started hiking, housing purchase activity has crashed, as housing affordability is the lowest level ever. In the latest reporting week, mortgage purchase activity plummeted 12.6%. Mortgage applications are an early indication of home sales, so housing activity remains in the frozen zone.



Bottom line: Until affordability improves via lower mortgage rates and/or lower prices, there is no reason to believe what ails housing is now fixed.

BONDS ARE OUT OF WHACK

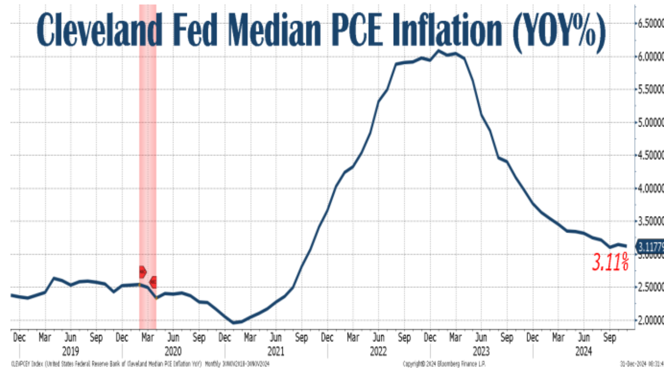
The Fed has freaked out over two not-so-good months of core inflation data. The latest sell-off is because the Fed has decided to ease policy and tighten policy both at the same time. In other words, while they have cut rates, they have provided hawkish guidance as the Fed deliberately pushed fixed-income investors to move from pricing in four rate cuts for 2025 to now barely more than one. This has punished the Treasury market over the past three months.

The 10-year Treasury yield is now up nearly +100 basis points from the nearby mid-September trough, and now at the highest level since late May, which was nearly four months before the Fed's first rate cut. As shown below, this is the first time in history when 100 basis points of rate cuts raised 10-Year Treasury yields by 100 basis points (generally, the two move together directionally, as you can see in the chart).

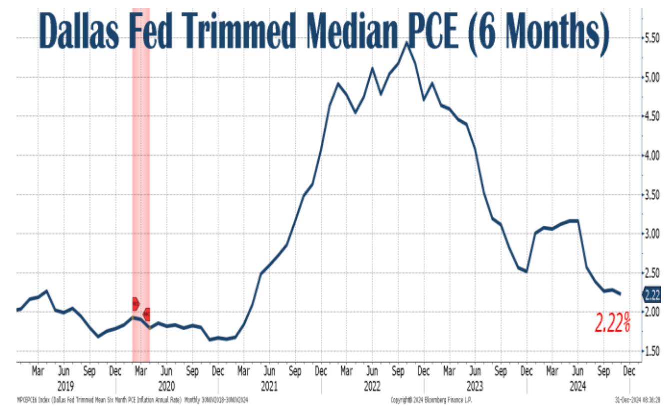
The Treasury market doesn't seem to believe or realize that in six of the past seven months, the core price index has come in at +0.25% month over month or lower, which is fantastic. While the year-over-year trend is stuck, for now, at +2.8%, the six-month trend is down to a +2.4% annual rate, which points to sustained disinflation momentum.

Goods prices in November were up after six consecutive declines, and once-hot services rose less than +0.2% (+0.17%) for the first time since May. The Powell super-core index (services excluding energy and housing) was cut in half to +0.16% month over month (the weakest pulse in six months) from +0.34% in October.

There also was nothing inflationary at all with respect to the wide array of underlying price measures that were published by the Fed itself. The Cleveland Fed's median personal consumption expenditures (PCE) metric came in at +0.2% month over month for the fifth time in the past six months.



The Dallas Fed's one-month trimmed-mean index slowed from +2.9% annualized in October to +1.8% in November, which is a lowly reading last posted in December 2020. Yet, all anyone hears is "sticky, sticky, sticky." The six-month trend in the Dallas Fed index is all the way down to a +2.2% annual rate (the slowest since April 2021) from +2.6% this time last year.



One more thing: the November PCE deflator showed that household insurance premiums, which were surging for most of last year, have stopped going up. And we are seeing a big break finally in the shelter components — now settling into +0.2% monthly increases, or less than half the pace of a year ago. These bloated readings are going to fall out of the data and generate a surprising decline in the headline and core inflation readings well into the new year.

Tack on the flat to negative trends in most of the commodity indices and the strength in the dollar, and goods deflation is likely to be the order of the day, just as service-sector inflation rolls over.

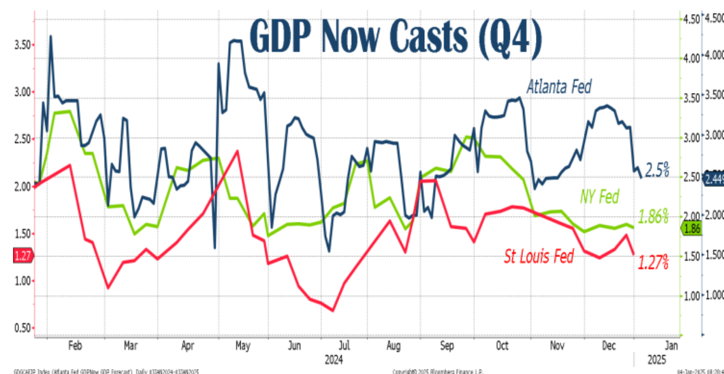
By March, don't be surprised if the core PCE inflation rate will have slowed to 2%, if not lower. At that point, look for the Fed to pivot yet again, and for the 10-year Treasury yield to go back to that habitat it enjoyed towards the end of last summer when the yield was 3.65%.

Bottom line: Bonds are signaling something is "out of whack" in markets. The Fed has overreacted to inflation, but the Fed is known for flip-flopping time and time again. Don't be surprised if core PCE inflation falls below 2% in March, and the unemployment rate rises. At that point, I sense that the conditions will be ripe for lower yields by the end of the first quarter. Simply put, the Fed has set up the bond bulls for a nice rally ahead.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

As you read this heading into 2025, the gears of the economy continue to slow, cracks are visibly emerging in the U.S. labor market (especially the collapse in hiring rates), delinquencies in all types of credit still rising, and personal savings getting zapped as Americans continue to borrow to fund discretionary purchases.

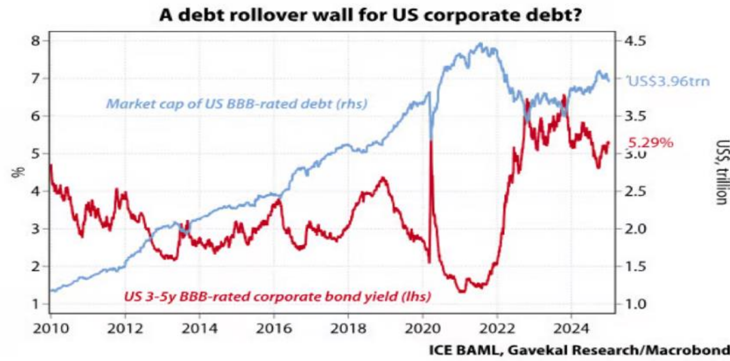
As to overall economic growth, there is a wide divide on estimates for Q4 real U.S. GDP growth. To wit: the Atlanta Fed Nowcast model is at +2.5 % at an annual rate, but the New York Fed is far lower at +1.9%, and the St. Louis Fed is at a lowly +1.3%.



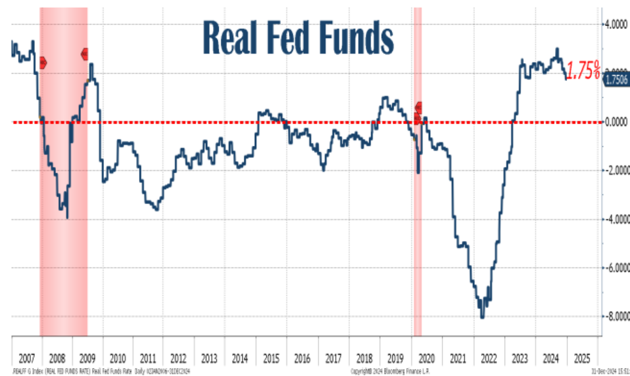
The main risk I see heading into the new year is just plain math. The most highly leveraged and asset dependent economy ever in the history of the U.S. cannot have positive real rates until further notice without there being a larger shock to the financial system at some point. Yes, it is true that we have survived this long with rates at high levels when compared to recent rates, but in my opinion, this will not last.

Indeed, U.S. companies are now defaulting on junk loans at the fastest rate in four years, as they struggle to refinance a wave of cheap borrowing that followed the pandemic. Defaults in the global leveraged loan market — the bulk of which is in the U.S. — rose to 7.2% in the 12 months to October, as high interest rates took their toll on heavily indebted businesses.

And there could be more trouble ahead. As the graph below highlights, a large chunk of the corporate debt issued in 2020 and 2021 comes due to roll-over at much higher interest rates.



As long as interest rates stay on this higher-for-longer path, we are going to run into a very large iceberg at some point, triggering a change in market psychology that will begin a nationwide deleveraging.



Bottom line: I remain of the belief that the long-term trend in interest rates remains lower. The economy does not need a recession for this to happen. For all the chatter about a "reacceleration" in inflation, underlying details are constructive, and 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 interest rates.

While the bond market had another disappointing year in 2025, the good news is that the 10-year Treasury yield at 4.59% now provides generous coupon support for the coming year. In fact, only two other times since 2001 has the 10-year Treasury benchmark finished with yields this high, and in the ensuing year, the total return was +15.5% (2002) and +9.7% (2007), respectively.

From a tactical perspective, the front and middle portions of the Treasury yield curve — given an unpredictable and uncertain near-term policy outlook — offers the best value at this time. Investors can still buy the 5-year and 7-year part of the yield curve yield with respective yields of 4.4% to 4.7%. Still, I could not fault investors for wanting to move towards the front end of the curve with the 2-year Treasury at 4.27%.

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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