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INVESTMENT SERVICES

Weekly Relative Value

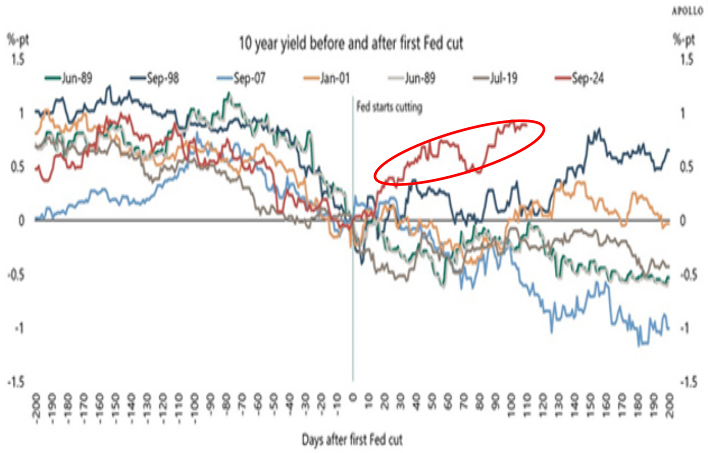
WEEK OF JANUARY 21, 2025

Why is the Bond Market in a Funk?

> *"I will act with historic speed and strength and fix every single crisis facing our country." - Donald Trump*

On September 18, the Fed began rate cuts with the 10-year at 3.63%. Today, it's at 4.60%, which marks a +97-basis point increase. This is the first such occurrence over the last 40 years covering 11 cutting cycles. In the previous 10 cycles, the 10-year Treasury note yield declined by an average of 103 basis points after the first rate. In other words, the market is now moving in the exact opposite direction as the Fed.

Torsten Slok, Chief Economist at Apollo Global Management Inc., shows this in the spaghetti-like chart below. The lines show the 10-year Treasury yield before and after the last seven rate cutting cycles. It's messy, but you can see the general pattern: Long-term rates began falling months before the Fed started loosening, then flattened or kept falling afterward. The red line shows the latest cycle behaving differently. Long-term rates didn't just rise; they *turned on a dime* almost as soon as the Fed acted in September.



Here's a close-up of the mover in long-term rates versus the Fed rate cuts:

Tom Slefinger
Market Strategist

THIS WEEK

- WHAT WE KNOW ABOUT DONALD TRUMP
- TARIFFS ARE COMING!
- IT'S THE DEBT, STUPID!
- DISINFLATION CONTINUES FOR NOW
- TAME TO THE CORE
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SUBORDINATED DEBT: (SIMPLIFIED)

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Hand over the hard parts.

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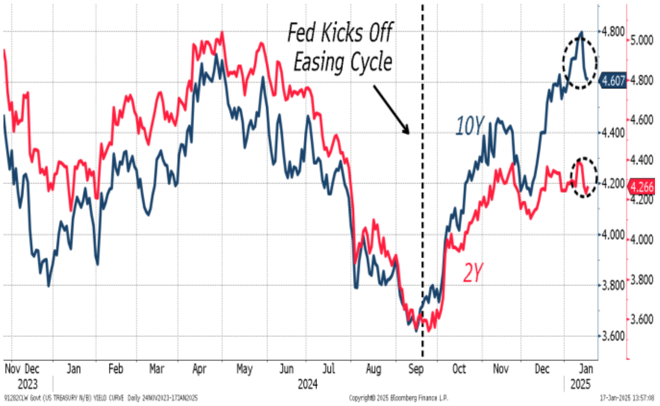


Mortgage and other kinds of private debt typically follow Treasury yields, so this isn't what the Fed should want to see, if its goal is to delay or at least soften an economic downturn. To wit:

- Mortgage rates, in the past four months, have surged nearly +100 basis points.
- The average interest rate in the investment-grade corporate bond market has shot up +70 basis points.

It would be one thing if this were solely due to improved growth expectations or even shifting inflation views, but that is not the case.

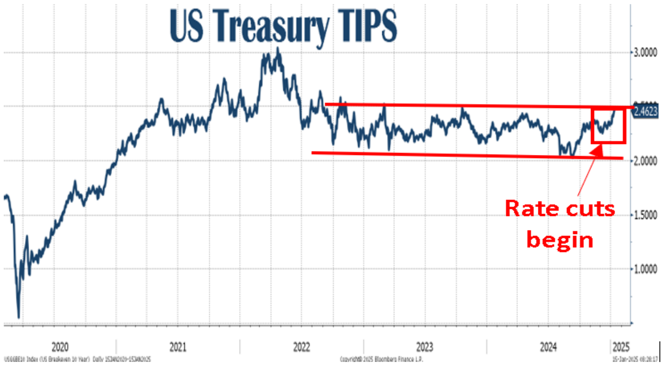
This begs the question, why and what does the reaction really mean?

Why have yields risen so much since the Fed started easing?

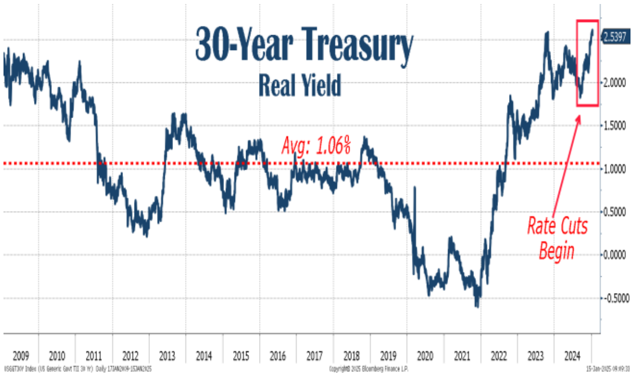
Some believe that the Fed has made yet another policy mistake by easing too soon before the inflation genie has been put back in the bottle. Fair enough, but while inflation is top of mind, inflation expectations are a small part of the recent surge in long-term rates.

To make this point, have a look at the **Treasury Inflation Protected Securities (TIPS) Breakeven Rate**. The 10-year breakeven rate measures the difference or gap between 10-year Treasury Note and TIPS.

Simply put, this is the yield that will protect investors from inflation. While the TIPS have moved higher since the "Fed pivot" began, the move has been less than 40 basis points so far but is still in the range of the past four years.

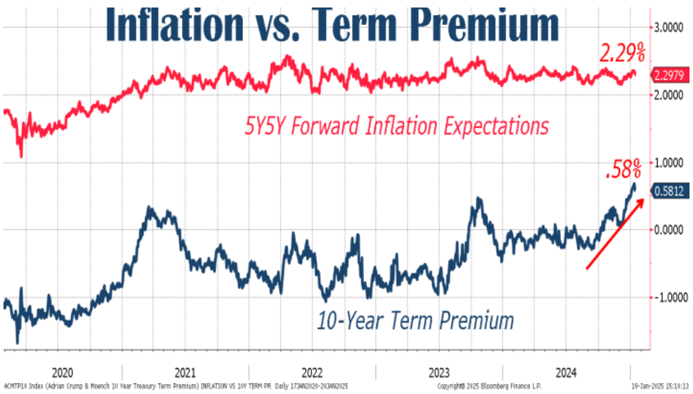


Now take a look at 30-year REAL yields. This is the yield AFTER accounting for inflation. Since rate cuts began in Q3 2024, real yields are up over 50 basis points. **If real yields are rising, it's clear that there are other major drivers of rates than just inflation.**



Moving on. The *"5-year, 5-year forward inflation expectation rate"* refers to the market's predicted average inflation rate over a five-year period that begins five years from today, essentially looking at the expected inflation rate five years into the future for a period of another five years. **Currently, this rate is around 2.30%, essentially the same level since September, when nominal 10-year Treasury yields hit their nearby lows of 3.65%.**

Now take a look at the *10-year term premium*. Despite the tame inflation expectations embedded in the 5-year/5-Year forward rate, the term premium has surpassed the post-pandemic HIGHS. **The current term premium for the 10-year note is 65 basis points, up from -29 basis points in mid-September. This means that 10-year yields are 58 basis points higher than what can be justified by Fed policy expectations.**



Bottom line: The sharp yield backup is all about Trump, and the uncertainty doesn’t only involve tariffs but also involves deficit-financed tax cuts.

Simply put, the dramatic move in rates boils down to the “term premium.” This indicates extremely high levels of uncertainty, and long-term debt investors want to be compensated for more risk.

This is also why the Fed has done a 180 on not speculating on Trump’s agenda and why it has talked the markets out of policy easing this year.

WHAT WE KNOW ABOUT DONALD TRUMP

Trump, being a real estate mogul, is a big debt guy. He believes in a weak dollar and believes that the rest of the world is ripping off the U.S. Being a debt guy, he likes low-interest rates and low-inflation. I am not sure if his policies are consistent with each other. Deregulation and the Department of Government Efficiency (DOGE) will only go so far, and as for the latter, there simply is not a whole lot of fat for Elon Musk to cut as an antidote to all the tax cut pledges unless he wants to fire the entire federal civil service.

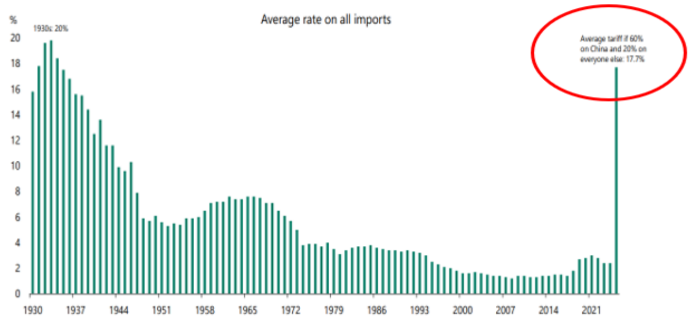
Donald Trump may find out that all of his objectives, if they are met, will not lead to a highly successful conclusion. And if his policies trigger inflation, his legacy will go up in flames along with Jimmy Carter and Joe Biden. The public has no appetite for inflation, a disease that impacts the most susceptible segments of society, the elderly and the poor. And these people do vote.

TARIFFS ARE COMING!

> *"Traditionally, the currency appreciates by 4%, so the 10% is not passed through. Then, we have very elasticities, consumer preferences may change. And finally, foreign manufacturers, especially China, which is trying to export their way out of their current economic malaise, will continue cutting prices to maintain market share."- Scott Bessent, Treasury Secretary Nominee*

While the new Trump Administration is seemingly hell-bent on raising tariffs, the independent, non-partisan Tax Foundation estimates that if 60% tariffs are imposed on China and 20% on everyone else, the average tariff rate will increase to 17.7%. (See chart below.)

The Tax Foundation estimates that overall tariffs could rise to 17.7%



Note: The 17.7% figure represents a weighted average of the proposed tariffs, a universal 20% tariff on all imports and an additional 60% tariff on Chinese goods. These tariffs are applied to the current import values, and considering the share of imports from China, the average rate for 2025 has been estimated. Source: Tax Foundation, Apollo Chief Economist

With imports making up around 15% of the gross domestic product (GDP), the impact will be a jump in inflation, potentially as high as 0.5%. And with core personal consumption expenditures (PCE) inflation above the Fed's 2% inflation target, the Fed could be forced to raise interest rates again.

Bottom Line: It's not the current inflation backdrop that is the issue for the bond market. Inflation expectations are only a SMALL part of the run in yields. Rather it's all the "uncertainty" around government policy from a president who is determined to shake things up across a broad front.

This is why the Fed has taken a pregnant pause about lowering rates.

Thus, more clarity surrounding what President Trump intends to do when in office as it pertains to tariffs is needed. The good news is we will know much more about the tariff situation in the coming days and weeks.

IT'S THE DEBT, STUPID!

> *"What else is different* ***is the impossible debt trajectory, and that it cannot be sustained****.* ***We cannot keep stacking up this debt****… "****What's changed is people are now aware of that to a greater extent, finally****."*
>
> *"Before a recession, usually you're at a good place, at least relative to the historical context, on the deficit as a percentage of GDP.* ***But we're already at recessionary levels of the deficit****, as the official deficit is now about 6.5%, maybe 7% of GDP…And it doesn't include the aid to Ukraine, it doesn't include natural disaster relief.* ***So there's a lot of room for that deficit to go up, and I think we can all agree that that has really dire ramifications."***
>
> *- Jeffrey Gundlach, CEO and CIO, DoubleLine Capital*

Here's a bit of history.

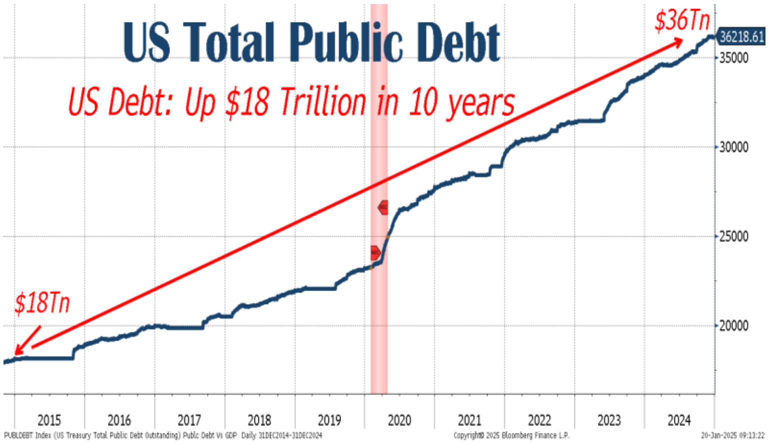
On January 8, 1835, President Andrew Jackson fully paid off the U.S. national debt.

Fully.

Jackson viewed government debt as a moral and economic threat.

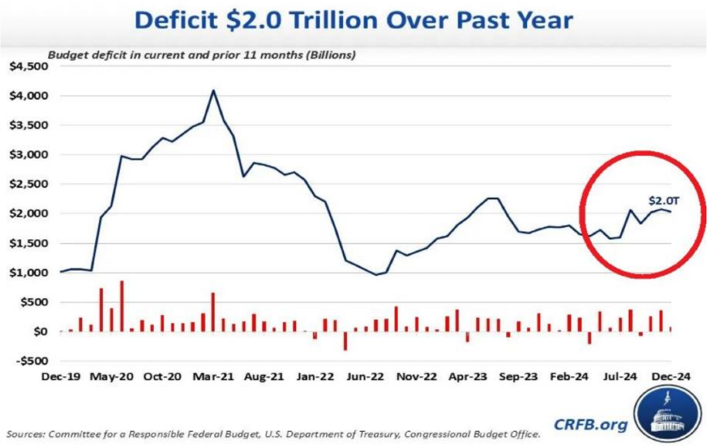
Fast-forward to today, and the scale of America's debt crisis is staggering:

- Over the last 10 years, the U.S. Federal Government Tax Revenue has increased 58% while government spending has increased 93%. **The result: a doubling in the U.S. National Debt from $18 trillion to $36.2 TRILLION.** That's a whopping **$107,000 per U.S. citizen.**

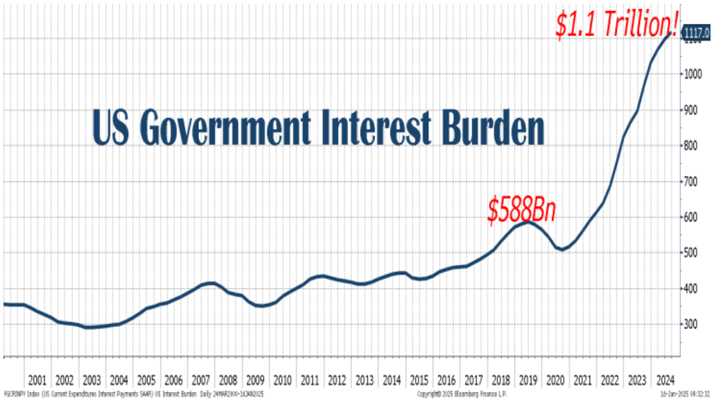


- Over **$2,000,000,000** of debt is added every day. At the current pace, total U.S. debt could hit $40 trillion by February 2026!

- During the first three months of the 2025 fiscal year, the three-month fiscal year 2025 deficit rose to $710.9 billion, some $200 billion more than the comparable period in the prior year, or 39.4%. Over the last 12 months, the deficit hit $2.0 TRILLION, or 6.9% of the GDP. **The deficit is rising as if there is a recession.**



- The interest expense on U.S. National Debt **rose to a record $1.15 trillion last year**, an **increase of 97% over the past three years.** The U.S. Government now spends more money on interest than it does on national defense. U.S. net interest on national debt is estimated to hit 25% of total government tax revenue over the next decade.



Amazingly, outgoing Treasury Secretary Janet Yellen maxed out the credit card on the last day as she left the building and then called for the Trump administration to "*take the deficit seriously.*" Yes, you read that right. It's a rather striking (ridiculous) statement to make after overseeing an $8.2 TRILLION debt increase over the past four years.

"Take the deficit seriously." – Janet Yellen, former U.S. Treasury Secretary

As for the incoming administration, Donald Trump has already said in the campaign that super-costly "entitlements" will not be touched. But what will be touched are corporate tax rates set to decline further, a lifting of the $10,000 cap on state and local tax deductions, expanding and indexing the child tax credit, and the elimination of taxes on tips, overtime, and Social Security payments. Tack on the Trump promise to make car-loan-interest deductible and lower taxes on U.S. citizens living abroad, as well as the push for a tax credit for family caregivers. Next will be root beer in all the public water fountains.

If left unchecked, this year's deficit, with three months under our belt, will total $3 trillion which is beyond the pale and explains mostly why the American economy has flashed the illusion of superior economic growth. The Congressional Budget Office's new budget forecasts predict that United States' deficits will total $21.1 trillion over the next decade. That will be piled on to a national debt that currently exceeds $36 trillion. This fiscal largess truly is "exceptional." By 2035, the debt as a share of the U.S. economy will rise to 118% (the largest in history), from close to 100% of GDP currently.

Frankly, there appears to be no effort to rein in fiscal deficits in excess of 6% of GDP to perpetuity. And there is little chance we can "grow" out of this massive deficit, especially since interest costs on the massive debt burden are eating up an ever-greater share of the revenue pie.

This is what the bond market has been fearing. Will there be enough buyers at the "old" (or even today's) price (yield) to absorb all the massive fresh supply of Treasury securities coming our way? Or will there need to be a new "price" to clear the market?

Bottom line: There are many different things impacting long term Treasury yields, but deficit spending is a MAJOR one. Thus, while the markets and the Fed is hyper-focused on tariffs, the apple cart has been upset because of the murky fiscal outlook. Thus, the bond market is justifiably nervous because it is questioning whether there is sufficient domestic and global investor appetite for all the massive debt about to be issued on top of the existing burden.

This debt isn't merely a number. High debt levels limit fiscal flexibility, increase borrowing costs, and heighten the risk of a future financial crisis. There are no free lunches, and this reckless spending will have consequences.

Jackson's legacy reminds us that managing debt is a choice, and the incoming administration faces a critical decision point.

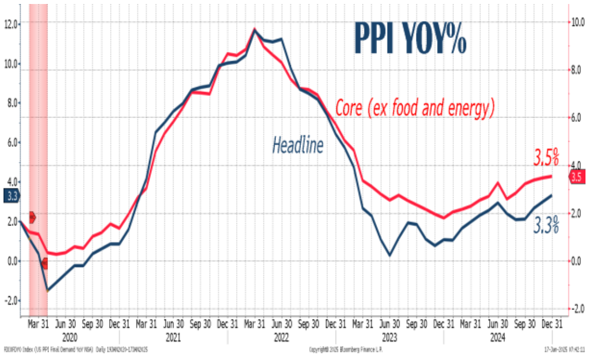
The bond vigilantes are telling Uncle Sam to get his act together.

Will he? We may know soon.

DISINFLATION CONTINUES FOR NOW

While the previous week was all about the labor markets, the key market focus this past week was the consumer and wholesale inflation data.

First up for the week was the December Producer Price Index (PPI) inflation. The PPI measures inflation by the costs to producers. Unlike the Consumer Price Index (CPI), which tracks what consumers pay, the PPI looks at prices paid for raw materials and goods before they are sold to consumers. Because it measures price changes before they reach consumers, some people see it as an earlier predictor of inflation than the CPI.



The "headline" PPI was below expectations rising +0.2% month over month (consensus: +0.4%) and half the +0.4% prior November pace. Due to base effects, the year-over-year trend in the headline PPI increased to +3.3% from +3.0% (consensus was at +3.5%).

The core PPI (excluding food and energy) was unchanged month over month, leaving the year-over-year core PPI flat at +3.5% (consensus: +3.8%).

While both the headline and core PPI on a 12-month annualized basis are at the highest level since mid-2023, the six-month trend in the headline was at a +2.8% annualized pace, and the core (excluding food/energy) at +2.4% was the slowest since November 2023.

Bottom line: The PPI data will go a long way in helping ease the recent inflation anxiety. Disinflation momentum remains the name of the game.

TAME TO THE CORE

"For the Fed, this is ***certainly not enough to prompt a January cut…But, if today's print were accompanied by another soft CPI print next month plus a weakening in payrolls, then a March rate cut may even be back on the table."*** *- Seema Shah, Chief Global Strategist, Principal Asset Management.*

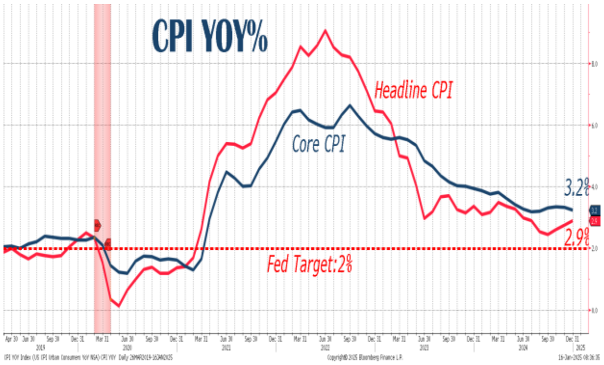
In the wake of the PPI release, the December CPI showed that the headline came in at +0.4% (consensus was +0.4%). Notably, the +0.4% print on headline was almost entirely due to a +2.6% surge in energy costs, the heftiest increase since August 2023.

The core (excluding food and energy) was light at +0.2% - **the smallest increase in the core index since last July**.

On an annualized basis, headline inflation went from +2.7% in November to +2.9% in December (as expected), with the core coming in at +3.2%. (It was +3.3% in November, and +3.3% was also the market expectation.)

While the headline number is important for consumers since these are the prices consumers pay, **for the Fed and the markets it is always about core** since that better reflects underlying demand conditions. (Food and energy are typically influenced by global supply factors.)

In other words, unless the Fed members want to don some blue jeans and grow some crops, they have little impact on food prices. The same story holds for energy price. I doubt Powell and crew will be drilling for oil anytime soon.

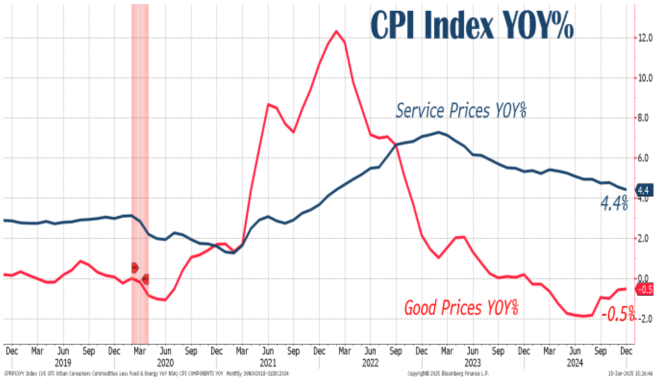


In breaking down the CPI index, core goods prices were barely changed (+0.1% month over month), still running in modest deflation terrain (-0.5% year over year) and have been printing negative for twelve months in a row.

On the services front, while rents and owners' equivalent rent (OER) are off the boil, they both came in at +0.3% month over month (after smaller +0.2% increases in November), but they still provided a source of upward pressure on the core index (even as the new-tenant rental measures have been deflating steadily).

Minimal further progress on 12-month inflation readings has led to calls to slow or stop reducing the policy rate.

However, I believe that inflation will continue to make progress toward the Fed's 2% goal over the medium term and that further reductions will be appropriate. The reason I remain constructive is that most of the stickiness in inflation is coming from imputed prices, which is one-third of the core price basket. Shelter costs are expected to decline to reflect real-time levels. Moreover, base effects could bring the year-over-year inflation reading down by March if the next few months don't pop up.



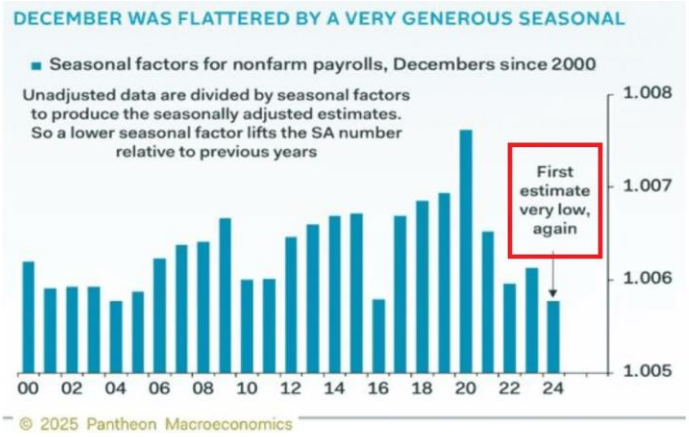
Most importantly, the Fed's preferred gauge, the PCE price index, sources price data from the PPI and the CPI. With the CPI and PPI in hand, forecasters who do the math now expect core PCE prices to have risen 0.17%. (This annualizes to nearly 2%.) This would hold the 12-month rate at 2.8% and lower the six-month and three-month annualized rates to 2.3% and 2.2%, respectively, or very nearly at the Fed's target. Remember, this is the price metric that the Fed uses in adjusting monetary policy. The PCE report is released at the end of the month.

Bottom line: Financial markets have had nothing but inflation on the brain after a recent blip, but the stock and bond market loved this report. The S&P 500 Index popped +2.9% and the Nasdaq Composite rose +2.5%. The 10-year Treasury enjoyed a rare rally with the yield declining -13 basis points and has now slid almost -20 basis points from the nearby high. Who knew that all it would take was for the core CPI to come in the grand total of 0.1 % below market expectations to provoke such a powerful bond market rally? You would have thought we discovered a cure for cancer!

BACK TO EMPLOYMENT

I keep reading and hearing about how strong the labor market is, but from my perch, it is an illusion.

As I noted last week, much of the +256,000 headline increase in December came from the birth-death model (+104,000). On a "non-seasonally" adjusted basis, the economy effectively LOST 81,000 jobs in December. December's "seasonal adjustment" increased the number by 337,000 jobs (256,000+81,000). As shown below, this is because of a very low seasonal factor, the lowest in over 20 years. Expect more job revisions ahead.



There was an array of other labor market indicators that were in line with each other (showing a cooling jobs market) and that were completely inconsistent with the message from the payroll survey. In other words, the payroll report gets all the attention, but the attention may not be well deserved since it appears to be an outlier.

Here are a few more stats on the labor market:

- **U.S. JOB CUT ANNOUNCEMENTS ROSE to 761,358 in 2024**, the highest since the 2020 CRISIS, according to Challenger data. Excluding 2020, this is the biggest number since 2009, the last year of the Great Financial Crisis.
- **U.S. FULL-TIME JOBS DROPPED BY 1.3 MILLION SINCE JUNE 2023** Full-time jobs fell by 1.26 million over the last 1.5 years. The private sector alone lost approximately 1.5 MILLION full-time jobs. Meanwhile, part-time jobs rose by 1.67 million to near a record, more than offsetting the drop.
- **U.S. GOVERNMENT JOBS HIT A NEW RECORD OF 23.5 MILLION IN DECEMBER**. Government job creation has been wildly outpacing private employment creation. In the past, such a trend has rarely happened outside of recessions.
- **AMERICANS HOLDING MULTIPLE JOBS HIT 8.5 MILLION IN DECEMBER,** near the highest on RECORD. This is up 1.5 million over the last three years. People have to hold multiple jobs to make ends meet.

- **CONTINUING CLAIMS ARE AT THEIR HIGHEST POINT SINCE 2021!**

Bottom line: The labor market is not as strong as advertised. When will the false narrative about how FABULOUS the job market is finally stop? If the public actually understood this instead of just consuming random headlines, they'd have a much better chance to protect themselves.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

> ***"I'm optimistic that this disinflationary trend will continue and we'll get back closer to 2% a little quicker than maybe others are thinking."***
>
> ***"My bottom-line message is that I believe more cuts will be appropriate."***
> ***- Christopher Waller, Federal Reserve Governor***

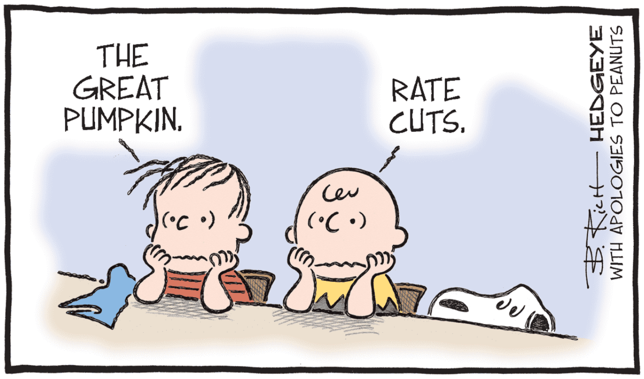
The economic data calendar is light in the coming week, but taking center stage will be Donald Trump's flurry of day one executive orders.

The elephant in the room is an aggressive policy agenda including broadly based tax cuts, deregulation, tariffs, and deportations. This could end up being a case of "buy or sell" in the news and could go either way.

There is tremendous uncertainty when it comes to the bold Trump agenda, and there are numerous moving pieces, not to mention a razor-thin majority in the House, and it remains to be seen whether the fiscal hawks (Freedom Caucus) will be bold enough to resist additional fiscal stimulus.

The widespread economic consensus is that theheretofore proposed Trump policies combined will likely contribute to higher inflation this year and cause the Fed to pause — as the central bank and the rest of us tackle remarkably high uncertainty both about what is coming and the impact on the economy.

As for the Fed, the next meeting doesn't take place until January 29, but investors don't see the likelihood of another Fed rate cut until June 18 (61% odds), and markets are pricing in a year-end federal funds rate more than +100 basis points above the Fed's estimate of "neutral." This is an oppportunity if Mr. Waller proves prescient.



Bottom line: As highlighted in last week's *Weekly Relative Value*, because of all the Trump uncertainty, there is always the risk of a bigger overshoot. Thus, until the crystal ball is clearer on the policy front (and investors reduce their demand for added compensation from rising uncertainty), focusing more on the front and intermediate parts of the curve is likely to prove to be a prudent risk-reward strategy.

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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