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Weekly Relative Value

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WEEK OF JANUARY 27, 2025

Donald Trump: Season 2

Now that Donald Trump has taken office, markets and the economy forget about the Federal Reserve. America's outlook will depend much more on how, and to what extent, the President puts his plans on everything from tariffs to deportations into action.

What to expect? That's a difficult question. My belief is that Trump is going to break things. Sometimes that will be good, and sometimes that will be bad.

Let me start off by saying that everyone seems fixated on Trump's so called "inflationary" policies. They point to the prospect for broad-based tariffs, immigrant deportations and deficit-financed tax cuts. The consensus believes these policies will add to inflation and the nation's debt load. At the same time, this is the same policy mix that happened from 2017 to 2019, and there was no significant inflation impact.

Let's discuss tariffs. Tariffs are often described in nationalist terms, like "putting tariffs on China." This actually means "putting a tax on domestic consumers of goods from China."

According to the newswires, President Trump is set to place a 25% tariff on Mexico and Canada by as soon as February 1. This would risk a major disruption to the manufacturing sector, especially autos, through the entire continent, not to mention housing, in view of the fact that one-third of U.S. homebuilding softwood lumber needs are shipped south from Canada.
Interestingly, Trump has already dialed back his rhetoric on China, recently stating that he would impose 10% tariffs on Chinese imports. The figure is far below his previous threat of 60%.

THIS WEEK

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SUBORDINATED DEBT: (SIMPLIFIED)

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In the same vein, Trump backed off tariffs on Colombia after reaching a deportation deal (the shortest trade war on record).

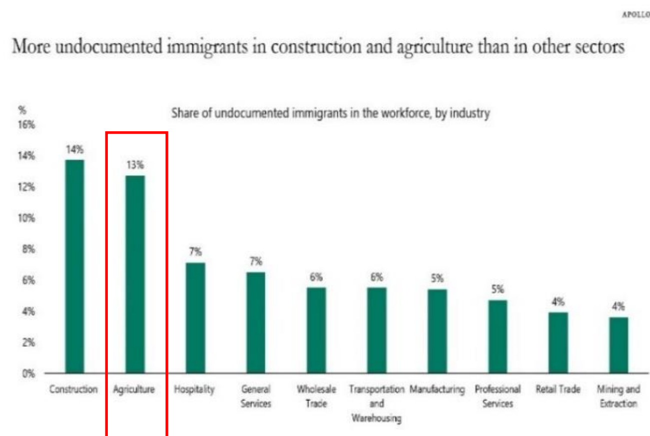
So, does Trump want higher tariffs, or is he using them as a negotiating tool?

Furthermore, if the tariffs are enacted, it is unknown how much of the tariff burden will be shared by consumers. Tariffs are paid when goods arrive in a country, not when they are sold in stores. Thus, a 10% import tax does not necessarily mean a 10% increase in the consumer price.

Tariffs apply to the goods section of the economy. Often the tale around tariffs gives the impression that the whole economy is affected. But imports of goods are a relatively small part of the economy, and the inflation impact needs to be considered in that context.

I also find it somewhat disingenuous that "*inflationistas*" don't discuss the "disinflation" impacts from deregulation, a freeze in civil service employment and "drill, baby, drill."

While I believe Trump will follow through on deportations, I expect less rather than more. Ejecting millions of people from the U.S. is logistically difficult because the resulting labor shortages would be too economically damaging. To wit: Immigrants comprise about 75% of U.S. agricultural labor. About 13% of farmworkers are undocumented. If you're complaining about grocery prices, ask what happens without their economic contribution. Frankly, I believe and truly hope that immigration can be reformed without draconian measures.



With regard to trade, Trump is correct. The trade relationship we have with China is unfair. But he's wrong regarding which side is getting ripped off. We get consumer goods that improve our lives and are expensive to produce. They get paper dollars that do nothing and cost us nothing to produce.

We sacrificed some manufacturing… so what?

Do we really want people in tedious dead-end jobs? From my perspective, the shift from manufacturing to services to knowledge-based jobs is good. Further, because we don't have a relative advantage in manufacturing, why not let someone else do it? We will import the goods, export the finance, and watch inflation and interest rates come down.

To be honest, I rather liked the old days of globalization in the 2000s when you could get stuff dirt cheap at Walmart. Alas, it seems like everyone has become Lou Dobbs, arguing for protectionism. My biggest fear is a damaging trade war where no one wins.

A 2019 study by economists from the Federal Reserve Bank of New York, Princeton University and Columbia University analyzed the effects of Trump's tariffs through late 2018. Their findings were clear:

"Our results imply that the tariff revenue the U.S. is now collecting ***is insufficient to compensate the losses being borne by the consumers of imports****."*

Let's talk about taxes. It is pretty much a done deal that we will make the 2017 tax cuts permanent. But the devil is in the details, and the problem is with the execution. The Republicans do not have a big majority in the House. There will be defections, even about taxes. And I don't believe Trump will enact other costly campaign promises, such as reducing taxation of social security benefits and tips. Given the dire budget outlook, some Republicans will balk at added tax cuts without offsetting spending cuts, which will be hard to agree on.

Here's something else to think about. Lower corporate tax cuts, if they come to fruition, will allow companies to maintain their margins without resorting to price increases. For some weird reason, these points are never covered by Wall Street economists or in the media. It's inflation, inflation and inflation.

Also, people are assigning a ZERO probability to the new administration solving the debt problem. While the deficit cannot be quickly erased, if the country moves away from its current fiscal *"profligacy"* to fiscal *"conservatism,"* bond sentiment would be greatly improved.

Moreover, the incoming Treasury Secretary Scott Bessent seems like a pretty sharp guy. He was CIO of Soros and is considered one of the best macro and rate traders in the world. While Bessent is no Milei (reformist President of Argentina with a chainsaw approach to spending), I truly hope that meaningful cuts, not just trimming around the edges, can and will happen, because frankly, they need to.

An initial step to getting the federal debt under control means deficits need to decline to a point where debt grows no faster than the gross domestic product. That would stabilize the situation, and from there we could work on longer-term solutions.

If not, the debt will become intractable, unsustainable and downright scary.

Moreover, if Uncle Sam does not fix the debt problem, the bond vigilantes will. So, from where I sit, one way or another, there may well be much more progress on the debt front than anticipated today.

Bottom line: None of us should be sure what is coming.

The broad consensus is that the Trump policy planks will be *"inflationary"* and that rates will remain *"higher for longer*."

I'm not so sure. If my contrarian "guesses" prove prescient, expect continued disinflation, lower interest rates, slower growth and definitely more volatility as markets and the Fed struggle to adjust to Trump's pronouncements and actions.

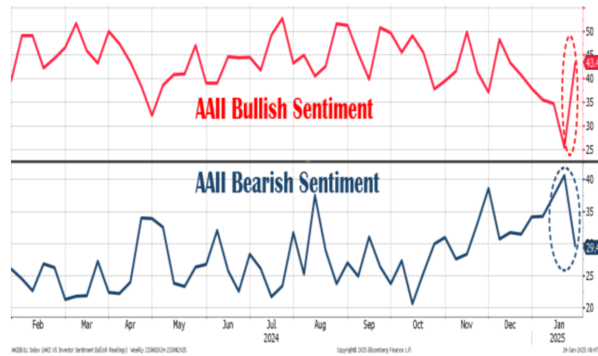
Stay tuned. The show has just begun.

PRICE IS WHAT YOU PAY, VALUE IS WHAT YOU GET

"What the wise man does in the beginning, the fool does in the end." - Warren Buffet

As for the stock market, bullish if not euphoric sentiment, complacency, market positioning, and valuations have not disappeared.

The most recent AAII Investor Sentiment Survey (see below) of retail investors saw the bull camp swell +18 % to a seven-week high of 43.4%, while the bear share plunged -11% to 29.4%. The Investors Intelligence folks reported that the bull camp expanded +3 points this past week to 45.2% while the bear population receded to 30.6% from 32.2%.



Economist David Rosenberg notes that 70% of the household financial asset mix is in equities, roughly 10% is in bonds with the rest in cash.

"This is a higher concentration of risk on household balance sheets than in the late 1990s. It's unprecedented."
- David Rosenberg, Founder and President, Rosenberg Research

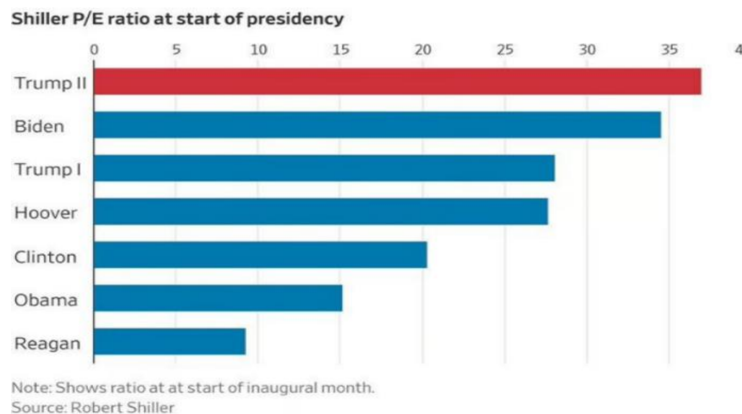
While equity markets are downright giddy, the "equity risk premium" (ERP) — the excess return that equities provide over a risk-free rate — has shrunk to its lowest level since 2001 and is now slightly negative.

According to Rosenberg, the valuation on the S&P 500 is only logical (versus the historic norm) if corporate earnings surge +70% from where they are today (to $457 on earnings per share). In other words, seven years of profit growth is embedded in the current "price" of the S&P 500. If investors have no difficulty with that expectation, this market definitely is for them.

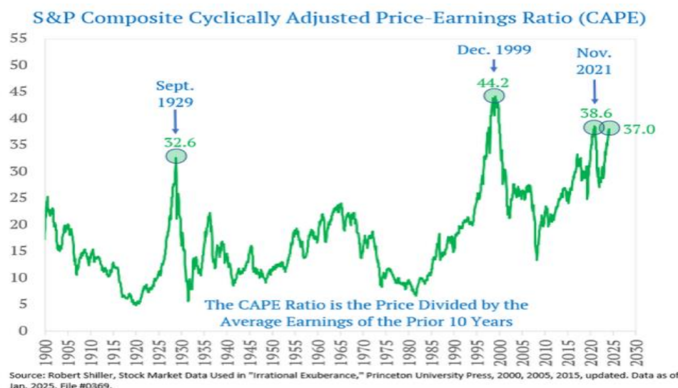
While sentiment and momentum can clearly carry the day, valuations over the long run matter — a lot! Have a look at "Make America Cheap Again" (*The Wall Street Journal*). I believe it is worth reading for investors who believe long-term exceeds lunchtime tomorrow.

"Of all the measures of the market's priciness, ***among the most reliable is the cyclically adjusted price/earnings ratio*** *developed by Yale University economist Robert Shiller, since it looks back a decade and adjusts for inflation. On that basis,* ***American stocks are 83% more expensive than when Bill Clinton first took the oath of office, 145% more than when Barack Obama first did and a whopping four times Ronald Reagan's starting point. They even are a third pricier than at the start of Trump's first term."***

- "*Make America Cheap Again", The Wall Street Journal*



Tom here: The stock market's cyclically adjusted price-to-earnings (CAPE) ratio clocks in at 37.0, having expanded from 32 times a year ago and 27 times two years back. The last time valuations were so high was at the beginning of 2022, a year in which the S&P Index fell by 20%. Before, the CAPE was that high in 2001 — the start of a major bear market. In fact, in the last century, the CAPE multiple has been this high only 3% of the time.



*"**Asset manager GMO recently forecasted that the return of U.S. large capitalization stocks will be negative 5.2% annually over the next seven years after inflation**. It would be like putting money into a CD today and having the bank pocket almost a third of it when it matures in 2032."*
– Danielle Park, President and Portfolio Manager, Venable Park Investment Council

Tom here again: In November, a couple of Wall Street banks projected ten year returns in the low-to-mid-single digits. The above relationship is the reason.

Bottom line: Good luck out there! As we saw in 2024, momentum-driven markets can be powerful beasts and overwhelm valuations and fundamentals. However, please remember that the return on an investment is significantly a function of the price paid for it. For that reason, investors clearly should NOT be indifferent to today's heady market valuations.

The last words go to Jamie Dimon:

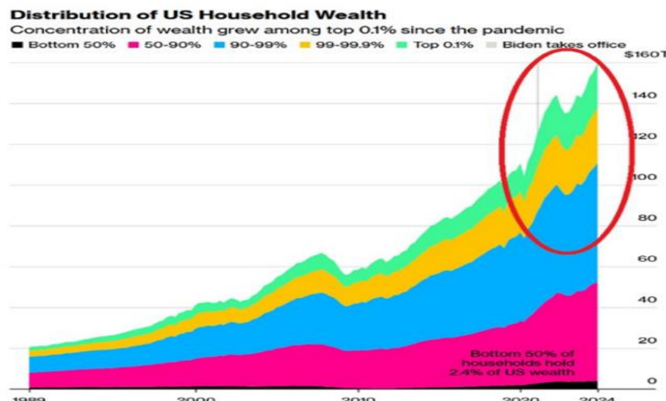
*"**Asset prices are kind of inflated…You need fairly good outcomes to justify those prices**, and we're all hoping for that. I think **having pro-growth strategies helps make that happen, but there are negatives out there and they can tend to surprise you."***
– Jamie Dimon, CEO, JPMorgan at The World Economic Forum, Davos, Switzerland.

IT'S GOOD TO BE KING

As the equity and real estate markets have soared, the rich are getting richer faster than ever before:

- U.S. household net worth has risen ~$56 TRILLION since Q1 2020 and hit a record $160 trillion in Q3 2024.
- The top 10% own $111 trillion of all wealth, accounting for 69% of the total.
- The top 0.1% alone own a massive $22 trillion, (14% of household net worth).
- On the other hand, the bottom 50% holds just $3.9 trillion, or 2.4% of wealth.

This comes as the S&P 500 and the Nasdaq 100 have risen 128% and 166% since Q1 2020 while national home prices have surged ~50%.



Source: Federal Reserve

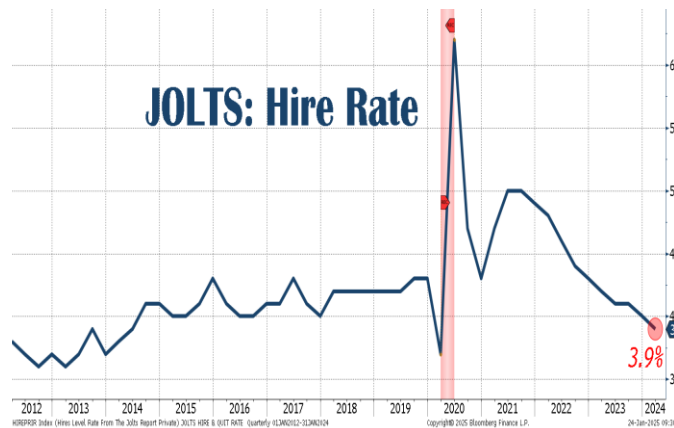
While the rich are doing swimmingly well, a full 59% of Americans aren't in a position to use their savings *"to pay for a major unexpected expense, such as $1,000 for an emergency room visit or car repair."* This is up from 56% a year back.

Bottom line: Ever widening wealth inequality is NOT good for our society and economy because it can create a system where a small group of people have disproportionate power over resources and opportunities, while others struggle to meet basic needs.

JOBS UPDATE

As for the latest on the labor market, it was there for everyone to see in the initial jobless claims data for the January eighteenth week — rising +6,000 to 223,000. But it was the +46,000 spike in the backlog of continuing claims to a three-year high of 1.9 million (up +138,000 in the past year) in the week of January 11. That represents how tough it is for the ranks of the unemployed to land a job after receiving the dreaded "pink slip."

This is happening at a time when hiring rates are in a clear downtrend.



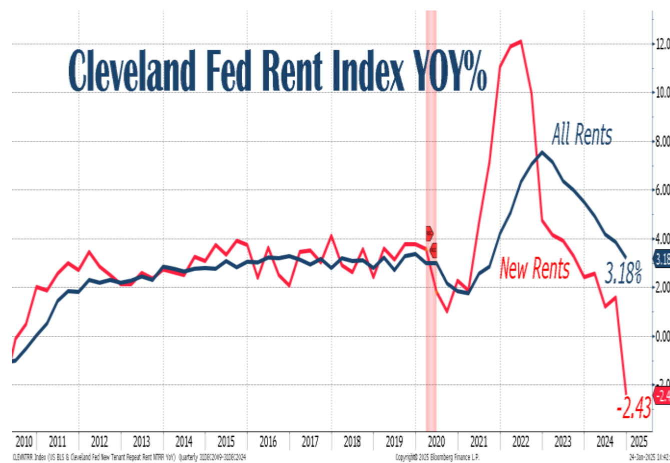
Bottom line: The labor market remains in the "*slow to fire and slow to hire*" mode, but I believe the labor market is much weaker than the media pundits proclaim.

RENT WILL DRIVE INFLATION LOWER!

The Labor Department's "all tenant rent" index, which leads shelter inflation in the consumer price index (CPI), rose at a much slower pace last quarter. It was up 3.2% over the four quarters ending 2024 versus 5.5% one year ago . It's very close to the 3.1% average between 2017-2019.

Likewise, CoreLogic reports single-family rent growth was up 1.5% for the year ending in November, the smallest increase in 14 years!

The Cleveland Fed "new" rents versus that of "all" rents, knowing that new will lead the "all" rents . New rents just came in at -2.43%.



Bottom line: These data points suggest ongoing shelter disinflation is in store for the (lagged) government inflation indices (CPI and personal consumption expenditures (PCE)).

HOUSING UPDATE

"The starting point for 2025 is, you're kind of already starting in a spot with not that much momentum…I don't really see how that thesis reverses and gets more optimistic as long as mortgage rates stay at 7%.
- Rick Palacios Jr., Director of Research, John Burns Research & Consulting

2024 was a terrible year for realtors. Will 2025 be any better?

Existing home sales in December came in better than expected — ringing in at a 4.24-million-unit annual rate up from 4.15 million in November. This marks the third straight monthly increase in a row, and to the best level since February. Still, for the full year, existing home sales were bouncing around the low end of the range of the past 30 years —and are barely higher than sales at the depths of the Great Financial crisis.

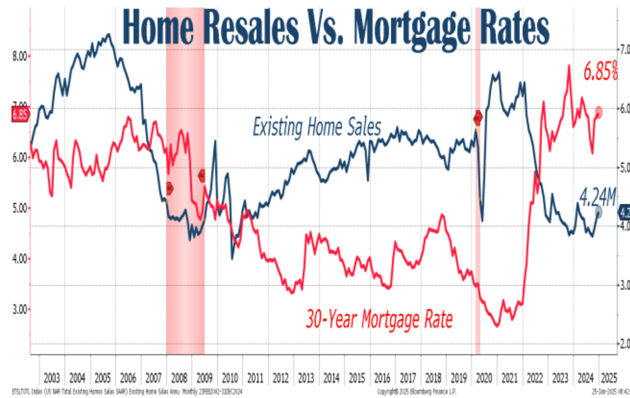
"Full-year 2024 will produce the fewest existing home sales since 1995."
- Doug Duncan, Chief Economist, Fannie Mae

Only we're a much bigger country now...

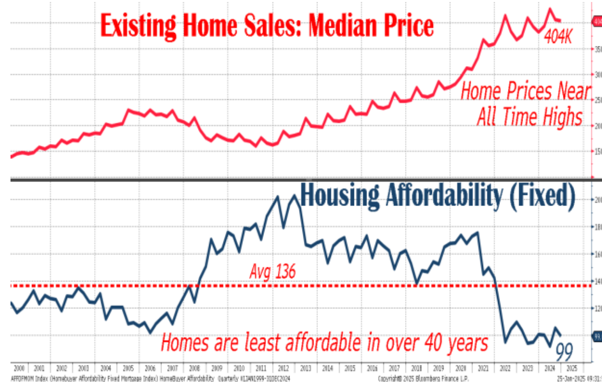
- U.S. population in 1995: 266.6 million
- U.S. population in 2024: 340.1 million

High mortgage costs (the average rate for a 30-year fixed mortgage has hovered between 6% and 8% since late 2022) has made it prohibitively expensive for many Americans to buy homes at current prices.

On top of the higher rates, rising home insurance and property tax costs are also adding to homeowners' expenses.



With home prices near all-time highs and mortgage rates nearing 7%, homebuyer affordability remains near record lows.



The pathetically low housing activity can no longer be blamed on a lack of supply as the number of homes listed for sale swelled +16.2% in 2024 to a five-year high and higher than 2017 and 2019-2023. That said, it is still early days and far from fully normalizing. At 3.3 months' supply (down from 3.8 in November and 4.2 in October), this is still a seller's market in many, but not all, states. (Read below.)

Another sign of the housing market thawing is active listings – total inventory for sale minus homes whose sales are pending – at 871,500 in December were at the highest level for any December since 2019, having nearly doubled since December 2021 amid the plunge in sale.

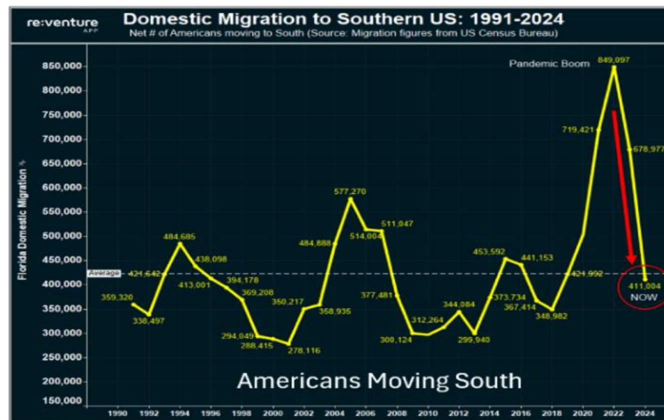
Bottom line: The 50% price explosion between June 2019 and June 2022, on top of the large price gains in the prior 10 years, was driven by the Fed's interest-rate repression and money-printing schemes which have created the number one problem in the housing market today: Prices are way too high!

REAL ESTATE IS LOCAL

Domestic migration from the North to the South has plunged 50% from the pandemic peak. (See graph below.)

- In 2022, 849,000 net people moved south.
- In 2024, 411,000 net people moved south.

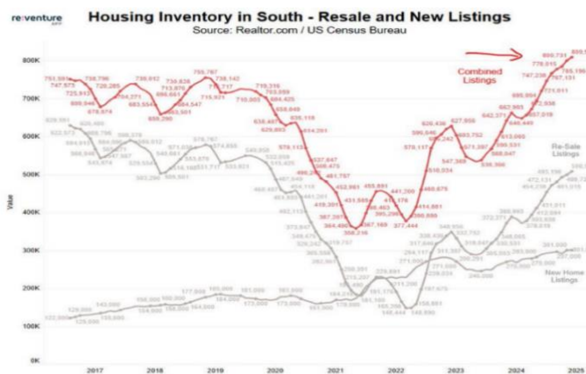
The southern migration is back to pre-pandemic levels. If these trends hold, there will likely be continued issues in Sun Belt housing markets that relied on the big pandemic influx to fuel price growth.



Source: Re:venture

To be clear: People are still moving into the South, but that growth has slowed considerably compared to recent history.

Because of the slower migration south, there are now over 800,000 housing listings (both re-sale and new homes) in the southern states. As can be gleaned from the graph below, that is significantly higher than pre-pandemic levels. If migration levels stay at current levels or decline further, it's going to result in a huge glut of housing inventory hitting these markets.



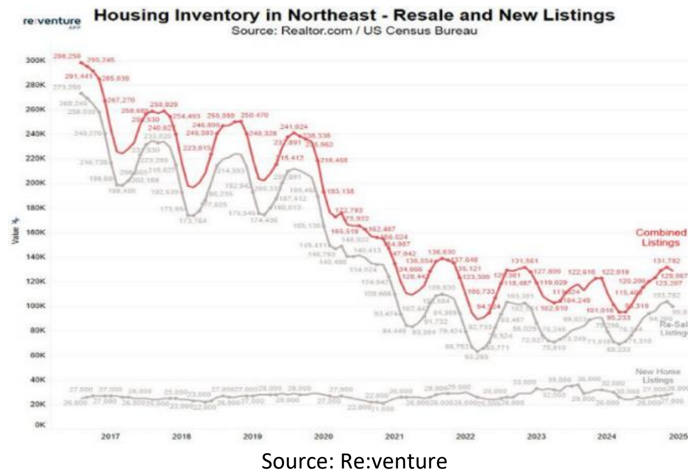
Source: Re:venture

Because home prices surged during the pandemic, many local residents have been priced out of the market. Thus, the bubble-like home prices in the South are heavily dependent on the southern migration.

While it is possible that there could be a resurgence of migration south, the affordability advantage of Sun Belt housing markets has all but vanished, and now, with a decline in remote work in corporate America, there will be fewer new people moving South.

To be clear: This is NOT a national trend. Home builder inventory, as well as re-sale inventory, is still near record lows in the Northeast and Midwest.

The graph below shows that the Northeast listings (new and resale) are down to 130,000 and still about 60% BELOW pre-pandemic levels. This is further evidence that fewer people are moving South, as the vast majority of southern migration starts in the Northeast.



Source: Re:venture

Meanwhile, the monthly supply of new homes in the South is now up to 8.6 months. That's 48% higher than the long-run, 50-year average. As noted above, the national average is 3.3 months.

- 301,000 new homes for sale in the South versus only 77,000 in the Midwest and Northeast combined.
- 61% of all new homes for sale in the U.S. are currently in the South.

This inventory dynamic is now flowing through to re-sale inventory, which is back to pre-pandemic norms, and above long-term averages.

Bottom line: The end result is that the huge overhang of builder and resale inventory is now pushing down home prices in several southern states. Unlike the Northeast and Midwest, the South is definitely a “buyers” market. I expect home prices in the South to decline in 2025.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

“I’ll demand that interest rates drop immediately…And likewise, they should be dropping all over the world. Interest rates should follow us all over.”- Donald Trump

Speaking at the World Economic Forum in Davos, President Donald Trump said he'll "demand that interest rates drop immediately."

Fed Chairman Jerome Powell won't go along. Nor should he.

Powell remains *"cautious about future cuts."* And there's the problem. Trouble could be brewing, and Trump has repeatedly floated the idea of firing Powell.

He even said of Powell's job, *"You show up to the office once a month, and you say, 'Let's flip a coin,' and everybody talks about you like you're a god."*

When Powell was asked about whether he'd resign if President Trump asked him to in November, **Powell's response wasn't just "No" — it was delivered ice cold, adding... *"Not permitted under the law."*** He's clearly ready for a fight to protect Fed independence.

Suffice it to say, tensions over Fed policy are mounting. While I have been critical of Fed policy over the years. I believe the only thing worse than the Fed manipulating rates is a politician setting rates.

Despite the political theater, the recent spasm in the 10-year Treasury yield from the September lows does not match the current inflation. Instead, the run-up is a function of the uncertainty relating to Trump's policies — corresponding to a rise in the "term premium" as investors seek additional compensation for risk. (See last week's *Weekly Relative Value* for more commentary on the "term premium" and why rates have risen.)

The Treasury market continues on a bear-steepening path underpinned by President Trump's pressure on the Fed to cut rates. At the same time, bond investors are obsessing over large deficits and Treasury Secretary Scott Bessent's drive to tilt issuance away from bills and towards notes and bonds.

In the near term, given the uncertainty surrounding policy, the bond market is susceptible to additional spasms with the 10-year rate potentially rising to 5% or more.

That said, I am hopeful that as we head into spring**,** we will see substantially less policy uncertainty paving the way for lower yields ahead as term premium pressures subside and fundamentals take the driver's seat once again.

It should be stressed that the Fed is 100% data dependent, so the only way that the bond market rally resumes in full force as it did from April to September of last year is 1) the central bank sees definitive signs that the numbers it keys off of show deceleration; 2) the unemployment rate begins to rise again; and 3) core inflation, especially the PCE version, recedes further towards the 2% target. The only thing that really has me unnerved, now and in the future, is how insurance rates play a role in thwarting that process… these are a thorn in my side, just as the dominant rental measures begin to cool off.

Bottom line: Until the dust settles, we are still in a policy bog. Because of all the Trump uncertainty, VOLATILITY is the name of the game. Thus, until investors reduce their demand for added compensation, focusing more on the front and intermediate parts of the curve is likely to prove to be a prudent risk-reward strategy. Any significant sell-off is an opportunity to invest new funds.

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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