alloya INVESTMENT SERVICES

Weekly Relative Value

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Market Strategist

WEEK OF MARCH 3, 2025

Uncomfortable Truths

*"A balance of payments **'needs to balance'** because it is essentially a record of all transactions between a country and the rest of the world, meaning that **every payment made by a country must be offset by a corresponding receipt, resulting in a net total of zero;** in other words, **the total value of a country's exports and inflows of capital must always equal the total value of its imports and outflows of capital**, making the balance of payments inherently balanced when all transactions are accounted for." - AI generated*

President Trump and his economic team believe that the United States has been ripped off by the rest of the world for decades, and that, in turn, explains why we have a huge trade deficit.

Indeed, the U.S. has been running a massive trade deficit, which shows that the U.S. is exporting less than it imports. But this should not be surprising at all, because the U.S. economy is supported and driven by mass consumerism.

As is well-known, 70% of U.S. economic growth comes from consumption. There is not another country on the planet that relies so heavily on the consumer driving economic growth. Thus, one would expect an enormous appetite for domestic and imported goods. The simple reality is that the U.S. spends more than it earns year in and year out. That is the story behind the trade deficits. Why is that so hard to understand?

While the U.S. has been running trade deficits, that is only half of the story.

THIS WEEK

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SUBORDINATED DEBT: (SIMPLIFIED)

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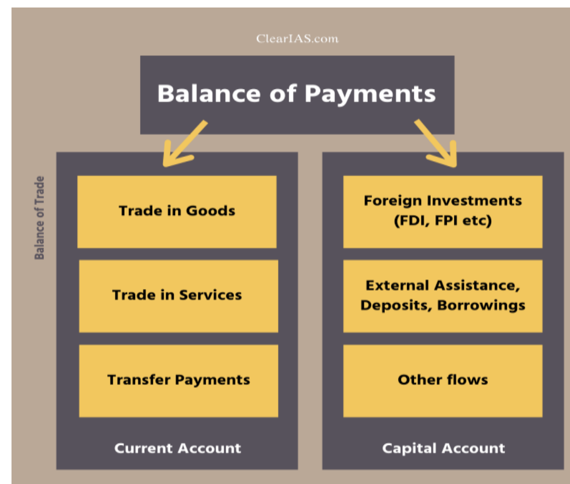
To understand trade accounting dynamics, one needs to understand the balance of payments. The balance of payments is the difference between money flowing into a country versus flowing out of the country. As shown in the following graphic, the balance of payments has two main components:

- **Current Account**: primarily the value of imports versus exports.
- **Capital Account**: investment flows, which include foreign direct investment, portfolio investment and other capital investments into and out of the country.



The current account (trade deficit) must be balanced by an equal surplus on its capital account. This means that investment in U.S. securities and assets has been a huge counterweight to the trade and balance of payments deficits. Here are the facts (and the facts don't lie):

Foreign ownership of U.S. equities is ~$18 trillion. Does anyone know that? Forget retaliatory tariffs. Maybe other countries should start dumping these U.S. stock market holdings and send the S&P 500 into a full-fledged bear market. That would surely catch President Trump's attention.

- Foreign investors own over $4 trillion of U.S. corporate bonds. Thus, another offset of our trade deficits is the support that global investors provide lower cost funding for the business sector.
- Foreign investors own $8.5 trillion of U.S. Treasury securities. Again, this is how the capital account surplus (the mirror image of the current account deficit) helps keep interest rates lower than they otherwise would be.
- Total foreign investment plus direct investments in the U.S. including equity and debt is $50 trillion! Ah… I see, this is how the rest of the world takes advantage of the United States. Sure thing. Imagine all the economic activity and jobs this investment supports. But nary a mention of this, ever.

Meanwhile, U.S. total investment abroad is ~$30 trillion, or nearly half of what the rest of the world has placed into the United States in terms of exposure to stocks, bonds and "bricks and mortar" direct investment.

So, foreign investors have plowed more than $20 trillion into the U.S. versus what America has placed into international markets and economies. But the reason why nobody complains abroad is because the rest of the world understands how the balance of payments actually works.

Meanwhile, According to Trump, tariffs on Mexican and Canadian imports will be implemented on March 4. Question: If this was his intent, why wait a month? Is this because Canada beat the U.S. hockey team?

Trump also said an additional 10% tariff will be placed on Chinese goods and then threatened to tax U.S consumers of European Union (EU) goods by 25%. (Trump seems emotionally attached to 25% tax rates.) The threat was somewhat incoherent – either applying to all imports, or just autos. However, if Trump intends to tax autos, look for U.S.-produced cars, secondhand cars and auto insurance to soar. Today, cars are ridiculously expensive… Do Americans really want to pay more for their cars?

The idea that the U.S. can use "trade" as a weapon will only end up corresponding to a reduction in capital inflow. Again, this is because the balance of payments must always be balanced. In other words, if Trump wants the trade deficit to be lower, then expect capital inflows into the United States to be lower as well. This, in turn, means that interest rates in the U.S. may end up being higher than they otherwise would be, and risk premia will be higher across the credit and equity markets because foreigners are massive holders of U.S. assets. It scares me to think that the Trump Administration does not know this or does not care.

Source: Google

As discussed previously in this space, President Trump believes that the McKinley tariffs in 1890 ushered in an era of prosperity. This is a pure delusion. The truth is America ended up spending 60% of the time from the summer of 1890 to the summer of 1894 in recession, and the tariffs were rescinded in 1894. (And what do you know, the recession ended.)

As an aside, the *Wall Street Journal* editorial titled "Trump's Tariffs Will Punish Michigan" put it best in its concluding remark:

> *"The President may think tariffs will yield a new economic golden age, but workers, businesses and financial markets may not enjoy the long march to this promised land."*

Truer words have rarely been spoken.

Here's a little more history. In 102 of the 120 months of the 1930s Great Depression, the U.S. ran trade SURPLUSES. How well did that work out for the economy, as the ensuing global trade war plunged the world into the economic abyss?

Moreover, between 1890 and 2024 (I think everyone would agree that is a credible sample size), there has been absolutely no correlation between America's trade balance and the country's economic growth. Zero, zilch, nada.

Finally, we all need to remember that the United States is run on a two-year, not a four-year, political cycle. We shall see what happens in the midterms, just 21 months away, from rolling the economic dice on this ambitious and aggressive tariff strategy.

With all that in mind, the Washington Post-Ipsos poll shows that 73% of Americans consider the macro backdrop to be either “poor” or “not so good.” Fully 53% are not in agreement with President Trump’s trade policies, and perhaps it is because the average Joe and Jane recognize the arithmetic outlined above.

Bottom line: Trade wars are a zero-sum game in which all parties come out as losers as the global gross domestic product (GDP) pie shrinks. As such, the Trump Administration is heading on a slippery slope on its tariff agenda. Trying to eliminate the trade deficit will, by definition, require a decline in the capital account surplus and the investment inflows that come with that (not to mention the possibility of retaliation bringing the world to a 1930s style global trade war).

The term “law of unintended consequences” was coined for what we are living through today.

MAKE UNCERTAINTY GREAT AGAIN

“Everybody’s paralyzed*… You can’t move a factory overnight.”*
- Hassane El-Khoury, CEO, ON Semiconductor Corporation

“A difficult time to invest*.”*- Ken Griffin, CEO, Citadel

“I’m sorry I can’t be particularly positive*.”*- Jenny Johnson, CEO, Franklin Templeton

“The ***chaos*** *that is reigning right now* ***is causing everyone to sit on their hands****.”*-Tom Callahan, CEO, Nasdaq Market

In the world of Donald Trump, CEO optimism is fading fast as the president pushes ahead with trade restrictions, while business-friendly deregulation has yet to materialize. This happened just a month into a presidency that many of them had cheered.

The economy is already decelerating rapidly. And consumer and business confidence is weakening. If Trump wants a recession, tariffs will help.

As a back-check, the index that measures satisfaction over the “government’s economic policy” has steadily deteriorated from 86 in November to 70 this month (the lowest since November 2023).

“What decision do you make? Do you want to go left or right? Are we going to grow the business? Well, I don’t know. Are there tariffs or not?”
- Hassane El-Khoury, CEO, ON Semiconductor Corporation

Bottom line: Maybe going big and bold and upsetting every apple cart in sight may not be the greatest of ideas. Just an interpretation of what this survey is signaling.

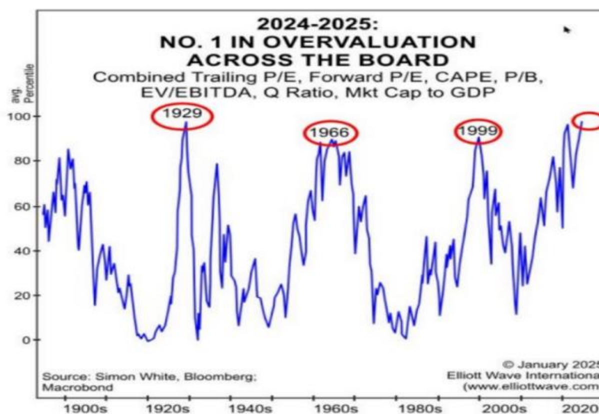
"HE'S BEARISH AS HELL"

"He's bearish as hell."
- Bill Smead, Lead Portfolio Manager, Smead Capital Management

In Warren Buffett's most recent annual letter, the Oracle, while still targeting equities, said that *"*often, nothing looks compelling." Bill Smead interpreted this as, "He's bearish as hell but won't admit it."

All told, Berkshire sold more than $134 billion worth of stocks in 2024, and in the past quarter boosted its record cash pile to $334 billion, almost double the level at the end of 2023. The Oracle isn't even finding his own stock attractive, as he has halted buying Berkshire's stock repurchase plan.

Could it be that Warren is looking at the following graph?

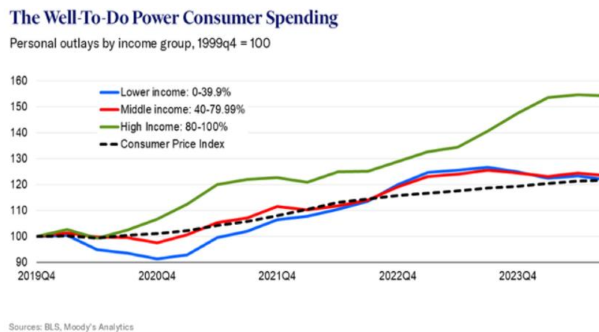


Bottom line: If this stock market BUBBLE should burst, it will have a meaningful impact on consumption and the overall economy.

Why? … Read on.

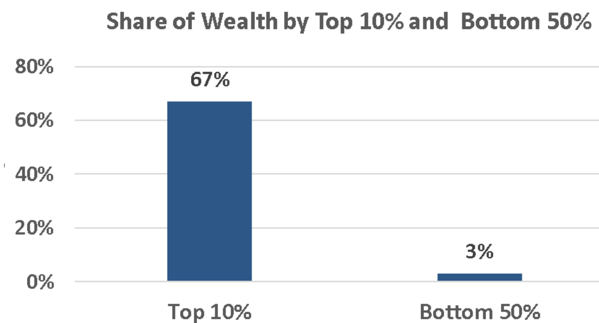
THE WELL-TO-DO AND THE ECONOMY

While most Americans are "pinching pennies," the top 10% are living the life of Riley and spending heavily on everything from vacations to designer handbags.



Much of the well-to-do's outsize spending since 2020 has been driven by their increasing wealth, much of it in stocks (the so called "wealth effect"). The wealth effect can also turn negative if, say, the stock market stumbles.

And there are good reasons to be concerned it might, given frothy valuations and the current problematic economic policy. If the stock market were to hit the skids, so would spending and the economy.



Data: New York Federal Reserve

With the stock market on its back heels the past couple of trading days, it is worth noting how important the well-to-do have been in driving consumer spending and, by extension, the broader economy.

Indeed, in the five years since the pandemic hit, the well-to-do, (those in the top quintile of the income who make well over $250,000 a year), are entirely behind the increase in real (after-inflation) consumer spending.

The richest 10% of Americans ($250,000+/annually) now make up ~50% of all consumer spending. In 1995, that number was roughly 36%. Spending by the top 10% alone accounted for almost one-third of the GDP.

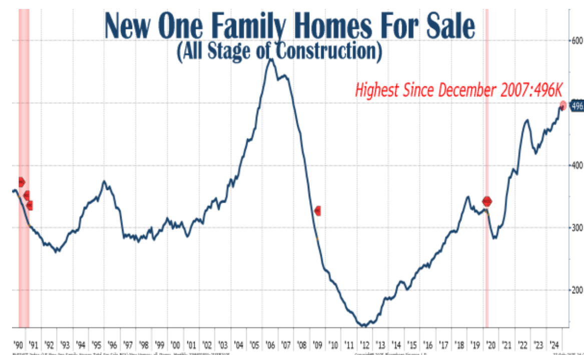
In a Fox interview, Commerce Secretary Howard Lutnick dismissed the recent stock market anxiety over the tariffs, claiming that it was the majority of American citizens and not the S&P 500 that voted for President Trump. Someone should probably inform him that beyond five consecutive years of Banana Republic type fiscal deficits, it was the "wealth effect" on spending that stood in the way of the recession that never arrived.

Bottom Line: The concentration of equities on U.S. household balance sheets and the consumer's sensitivity to shifts in the broad stock market have never been as high as they are today. If the "Wealth Effect on Spending" movie begins to run in reverse, the macro risks are clearly tilted to the downside as the camouflage of running the economy principally on fiscal support and asset inflation comes to a bitter end.

THE ROOF COLLAPSES

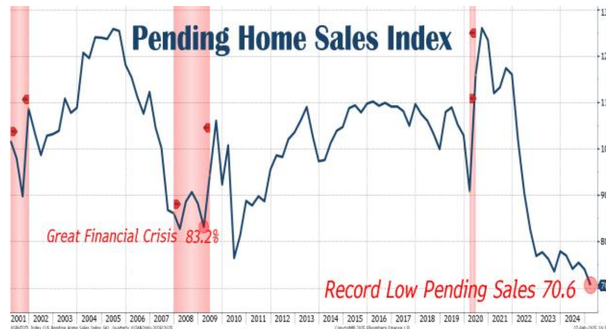
In last week's *Weekly Relative Value*, I discussed downright awful housing starts and existing home sales data. One week later, the roof collapsed on "new" home sales in January, sliding -10.5% month over month to 657,000 at an annual rate. The decline was exaggerated by an upward revision to 734,000 from 698,000 in December. Question: How exactly does one miss the count on a home sale?

Against that backdrop, total inventory (unsold and completed inventory) of single-family homes is now at the highest level since December 2007.



NOTHING PENDING

The day after new home sales were released, pending home sales (a leading indicator of future home sales) were released. It was a doozy. Pending home sales plummeted -4.6% month over month in January and followed the -4.2% pullback in December.



Incredibly, the level of pending sales has not only sliced below the 2020 pandemic recession level but is currently at the lowest level since the series began in 2001. Think about that for a second — pending home sales are LOWER today than they were at the worst part of the 2008-09 Great Recession, which was caused by the housing market! The lowest point in that downturn was 83.2 (in November 2008 — two months after the Lehman collapse), and today, it is at 70.6.

Bottom line: While there may not be a recession in the overall economy, there sure is one in residential real estate. All of the recent housing data — resales, starts, new home sales, pending sales – has been abysmal. Not even the massive gobs of fiscal stimulus could manage to thwart this down cycle. This is another reason why interest rates are unsustainably high. When the most interest-sensitive sector of the economy is hurting this much, it is very difficult to turn negative on the bond market.

CONFIDENCE LOST

"Starting on day one, we will end inflation and make America affordable again." – President Donald Trump

The all-important consumer is not overly optimistic, to say the least**.** Wells Fargo ran a survey that **showed 76% of Americans intend to reduce their spending in 2025.** (The largest pullback was in discretionary categories such as travel, vacations, and home-related expenditures.)

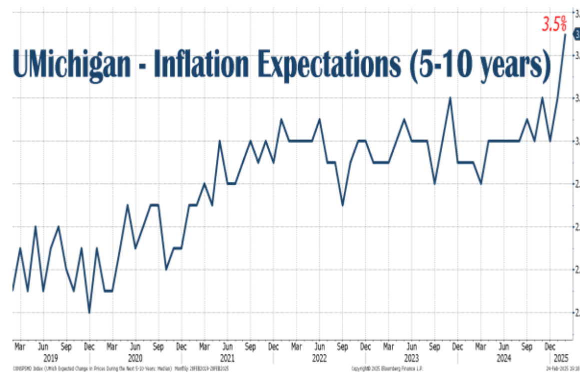
And while the White House may not be aware, the University of Michigan and Conference Board consumer sentiment has taken a nose-dive since the November election. To wit: The Conference Board's Consumer Confidence Survey ® dropped to an eight-month low of 98.3 in February from 112.80 in November:

*"In February, consumer confidence registered the largest monthly decline since August 2021…for the first time since June 2024, **the Expectations Index was below the threshold of 80 that usually signals a recession ahead.**"*

While the present situation shows concern, the really big slide is in the Expectations Index, which plunged from 93 in November to 72.9. This is the index that drives future economic activity. Historically, once this indicator has broken through the 80 level (red line in graph below), recessions have followed.

The decline in sentiment reflects pessimism on the inflation front. Even as President Trump pledged to bring inflation down, very few seem to believe this to be the case. With the potential of additional tariffs driving import prices higher, the median 5-10-year inflation expectation has gone to 3.5% — up from +3.0% from just before the election was held.

Treasury Secretary Scott Bessent has tried to pin what is happening today on Biden. I get it! Everyone likes scapegoats, but this is just a tad deceitful. To be clear, I'm not here to defend old Joe, but I am here to always speak the TRUTH . And the truth is that consumer inflation expectations are now at their highest level since May 2023. The highest this inflation-fear gauge got in poor Joe Biden's term was +3.2%.



Bottom line: It would seem that the consumer is not buying into the White House view that, miraculously, it will escape the effects of the tariffs underway and in the pipeline. My advice to the President is to be aware that the general public does not think his policies are going to bring down inflation as pledged. The public may well be wrong, but the plebs seem to need some convincing.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

*“**This is sobering notwithstanding** the inherent volatility of the very high frequency ‘nowcast’ maintained by the Atlanta Fed.” — Mohamed El-Erian, Chief Economic Advisor, Allianz*

The only reason why the U.S. economy has escaped recession has nothing to do with anything exceptional and everything to do with the five years of massive fiscal support alongside the “wealth effect” on spending. Strip out the “wealth effect” and government life support, and the U.S. economy would be a stall-speed economy.

Based on the incoming data, we have already seen a sharp slide in retail sales, weak guidance out of Walmart, weakness in all housing indicators, a nosedive in consumer sentiment since the election and surprising weakness in the once-hot service sector.

To highlight how disappointing the incoming economic data has been relative to expectations, have a look at the graph below. Last week, the U.S. Citi Economic Surprise Index hit its lowest level since September.

“Recent indicators suggest that economic activity has continued to expand at a solid pace.”

That was Federal Reserve Chair Jay Powell at his semi-annual congressional testimony on February 12.

Little more than two weeks later, the Atlanta Fed Nowcast takes a hatchet to Q1 real GDP from +2.9% at that time to -1.5% today. Either the Fed Chairman needs to seek out a new adjective or Webster’s needs to change the definition. I’m starting to lean towards a May rate cut.

All of a sudden, at a time when nobody is talking about it, recession pressures are starting to build. It could be that the Treasury market saw this a while ago and only recently has the stock market woken up to this prospect of economic stagnation coming our way.

Remember that in response to Trump's policies in his first term, Jay Powell hiked rates four times in 2018, but that is because the tax cuts came in before the tariff file took hold. This time, the Department of Government Efficiency (DOGE) spending cuts are coming first, and the fiscal drag is going to be significant.

Now, even as Fed officials talk "hawkishly," the bond market isn't buying it. Rate cut odds are rising, and this has nothing to do with inflation and everything to do with negative perceptions about the economic outlook. This time, tariffs come first and there is no fiscal room for additional tax relief; all that can be expected is the current tax regime remains in place. A tax extension is different from tax relief.

Moreover,tariffs, while initially inflationary, will hit the economy hard. To wit: Alcoa announced last week that President Trump's plan to impose a tariff on aluminum imports could cost about 100,000 U.S. jobs and would not be enough to en tice it to boost production in the country.

Factor in less immigration, a cutoff of aid for undocumented immigrants and student loan repayments, and you have a nasty mix of recessionary conditions.

The question for the Fed is when it will begin to shift its attention away from tariff-led inflation fears to concerns over the shape of the real economy.

Jay Powell has continued to report that the labor market is "solid," and that is because he is wedded to just one number: nonfarm payrolls. (Never mind that the Quarterly Census of Employment and Wages data show that because of the flawed birth-death model, nonfarm payrolls have been overstating job gains by +60,000 per month — we'll just sweep that under the table.)

So, for the Fed to shift back to an easing bias, it will have to see evidence of a serious cooling off in the labor market. And we may not have to wait too long.

The University of Michigan Index showed that the share believing that unemployment will rise in the next year was 51% in February**.** The last time the majority believed unemployment was going to increase was back in April 2020, and before that, April 2009. But since nobody wants to hear about a recession any longer, I won't bother to upset anyone and dig any deeper into that file.

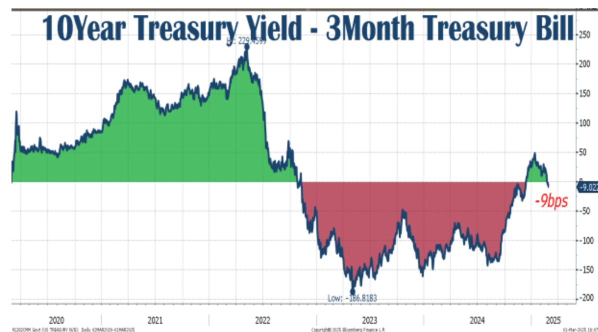
Not surprising, but just 42% of households believe that they will be receiving a wage increase in the coming year. This is a twelve-year low! The reason? Well, one-in-five Americans are fearing a job loss in the next five years, and they surely will not be going cap in hand to their employee for a salary bump.

Big picture: UNCERTAINTY continues as the dominant market theme, but what does the bond market know that we don't know? The 10-year yield closed down by -18 basis points last week. Moreover, in just seven weeks, the 10-year Treasury yield has melted 60 basis points from 4.8% to 4.20%.

As shown below, from a technical perspective, the 10-year Treasury yield has broken through the 50 (pink), 100 (green) and now the 200 day (yellow) moving averages. ***Note: The last time the 10-year Treasury yield pierced all technical levels, yields plunged to much lower levels.***

As the long end of the yield curve has rallied, the yield spread between the 10 and 3-month Treasury bill has turned NEGATIVE (–9 basis points). Yield curve inversions are a recession warning.

In the same vein, the closely watched 2s/10s spread has flattened significantly to 19 basis points.



Futures pricing currently shows an increase in Fed easing odds. Back on February 12, just two short weeks ago, the swaps market was priced for the next cut to come as late as December. Today, the next rate cut is priced for July, and now roughly 2.5 cuts (-60 basis points) are priced in for all of 2025. What say thou, Mr. Powell?

The last word goes to Mr. Lutnick, the U.S. Secretary of Commerce. He made the questionable assertion that the efforts underway to reduce deficits via tariff revenues will result in much lower interest rates. He predicts yields dropping to below 2%. Not that I disagree with his forecast of lower yields…but that is because I remain bearish on the U.S. economy, understanding the economic strength was primarily created by the asset inflation and government spending.

Big picture: Bond yields are attractive, but the uncertainty of potential tariffs is the lingering black cloud that prevents me from going all in at this time.

The jobs data this Friday could very well be the next catalyst to where rates go from here. A weaker than expected print could force yields significantly lower. Stay tuned!

In terms of portfolio strategy, credit unions should continue to maintain a risk-appropriate ladder strategy while buying the dips.

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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