Weekly Relative Value

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WEEK OF MARCH 24, 2025

Not So Great Expectations

"All these great expectations
Meet these grave revelations…"
—The Outsiders, "Great Expectations"

The Trump Administration has driven "uncertainty" surrounding trade, tax and fiscal policy to unprecedented levels. We are truly in unchartered waters, and no one knows what will happen next. Economist John Maynard Keynes introduced the importance of modeling "uncertainty" into gross domestic product (GDP) projections. Simply put, higher uncertainty leads to lower consumption, investment and economic growth.

In the same vein, economist and statistician Milton Friedman blazed the trail when it came to using consumer "expectations" to explain the impact on personal consumption. Friedman's theory, presented in his book *A Theory of the Consumption Function*, argues that people base their consumption decisions on their expectations of their long-term, or "permanent" income, rather than just their current income.

This is why the latest University of Michigan consumer sentiment data is so important. This venerable survey offers insights into consumer attitudes and spending behaviors. Because the U.S. economy is consumer-driven, consumer attitudes can have a direct and powerful impact on future economic activity.

THIS WEEK

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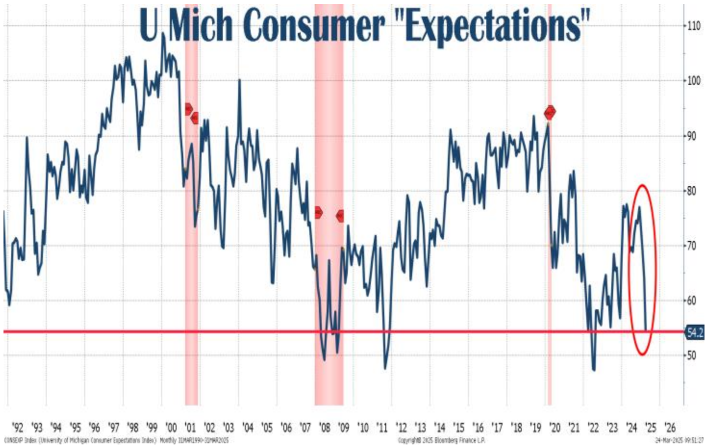
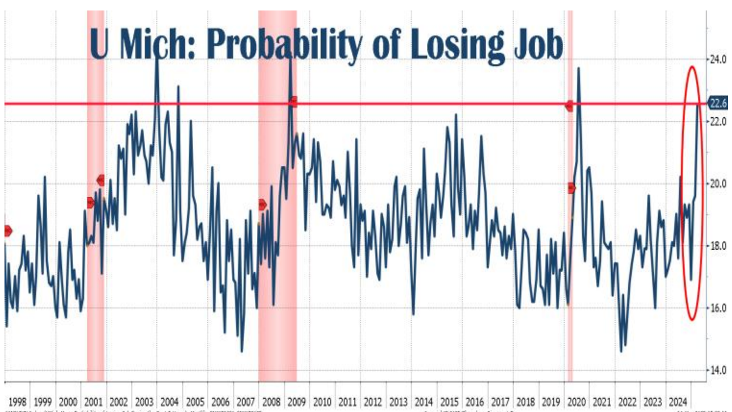
The University of Michigan Index of Consumer Expectations sank -10 points in March, to its lowest level since July 2022 and the third lowest level in 13 years. This spells a future of very subdued growth in consumer expenditures.



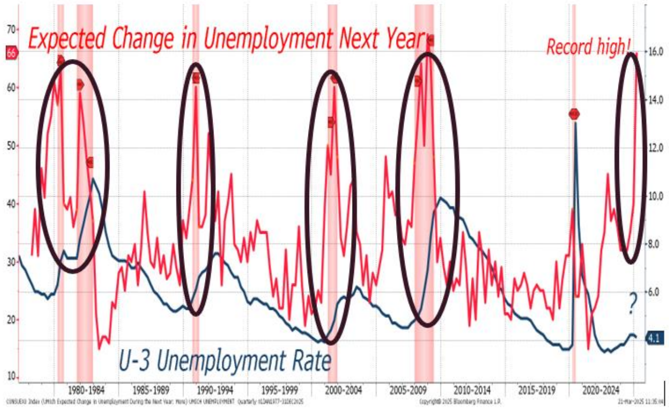
Another chart worth pondering is that nearly 23% of Americans fear job loss in the next half-decade. Perhaps this is the dark side of the AI craze. This suggests that wage growth will be anemic as worker confidence recedes and in turn should lead to a theme of rising savings rates, which are depleted and in dire need of being rebuilt.

"The risk of much weaker growth, as consumers seek to rebuild a savings buffer in response to concerns about job security, now looks elevated." — Samuel Tombs, Chief U.S. Economist, Pantheon Macroeconomics

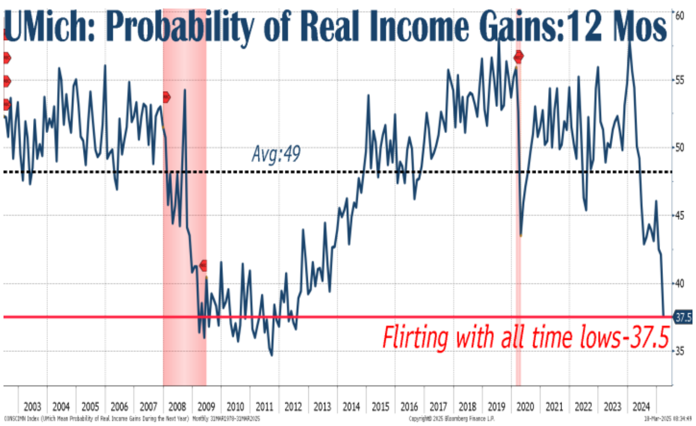


The next graph shows the correlation between expectations of higher unemployment and the actual unemployment rate. Looking back to 1977, the graph shows that there is a powerful correlation between expectations of higher unemployment and the actual unemployment rate.

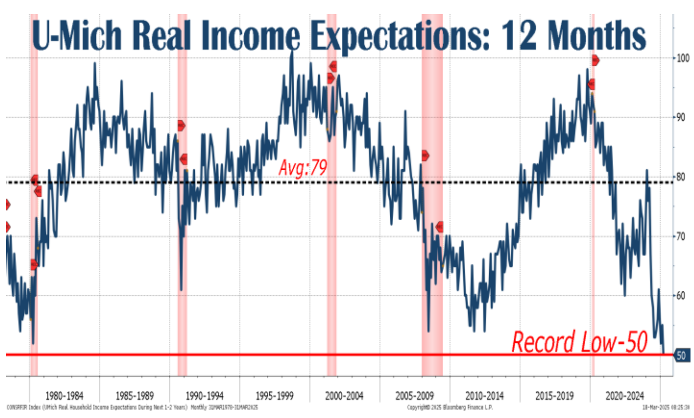
The graph clearly shows that expectations of higher unemployment have historically led to higher levels of unemployment and recession. (See oval shapes.)



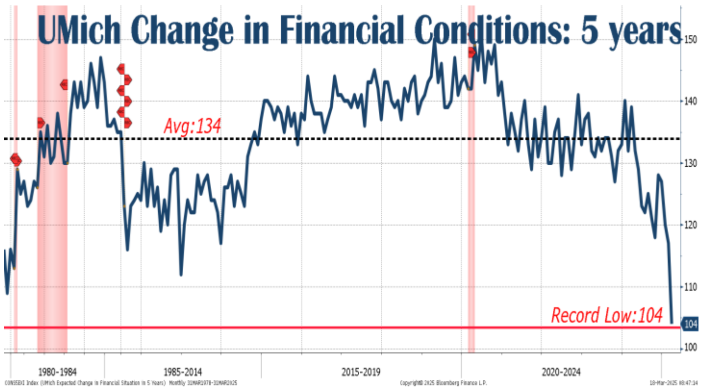
Nervousness over the job market outlook has translated into the weakest expectations for income gains seen in nearly 13 years.



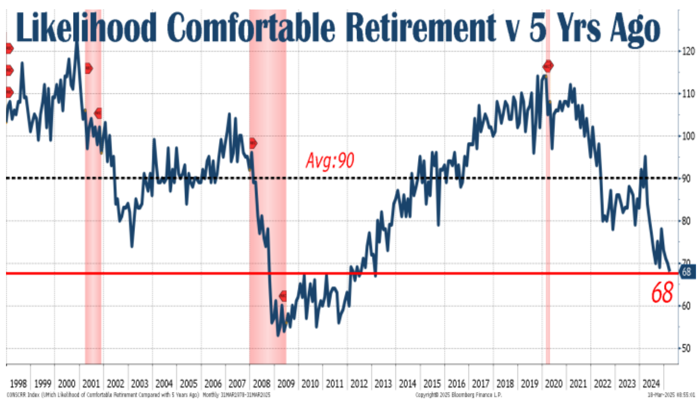
With inflation elevated and inflation concerns hooking up because of the tariff war and supply-chain disruptions, household views for real incomes have eroded to a record low.



That last assertion was reinforced by the measure in the survey examining expectations of personal financial situations — at a record low for the time series of this particular component in the survey.



With the equity bull market on the bubble and households now recognizing that a bear market is a high probability, perceptions of enjoying a comfortable retirement now compared to five years ago have declined to a 12-year low.



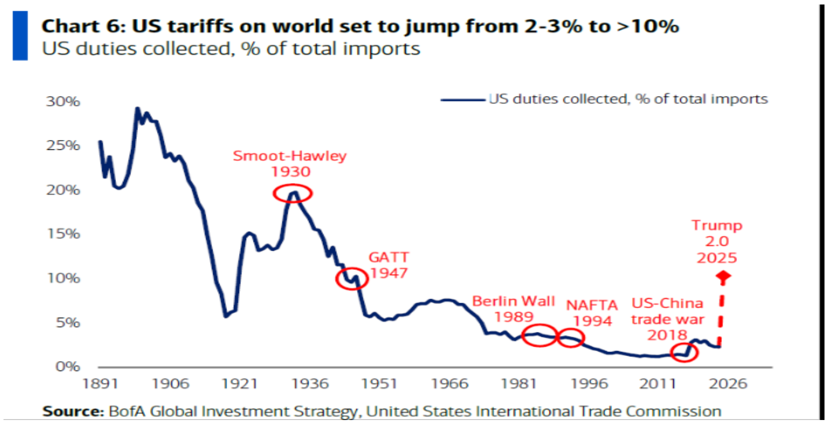
This presages a new cycle ahead of a secular rise in savings.

Bottom line: Expectations influence the consumption function and that is why the University of Michigan consumer sentiment data is so important. In a nutshell, what lies beyond the bend is lower consumption and a rise in personal savings rates. This is bearish for stocks but bullish for the Treasury market.

LIBERATION DAY

> *"I have decided for purposes of fairness, that **I will charge a reciprocal tariff, meaning whatever countries charge the United States of America, we will charge them. No more, no less**." — President Donald Trump*

Trump declared April 2, the day he will impose reciprocal tariffs, as Liberation Day. It is expected that the anticipated "reciprocal" tariffs will cover 13,000 products with 200 countries. Do the math, and that means 2.6 million different items will undergo tariff rate changes. As shown below, the tariff rate will rise to higher than 10% — the highest level in over 50 years!



Then again, a new economic theory has been floated by White House Press Secretary, Karoline Leavitt.

To wit:

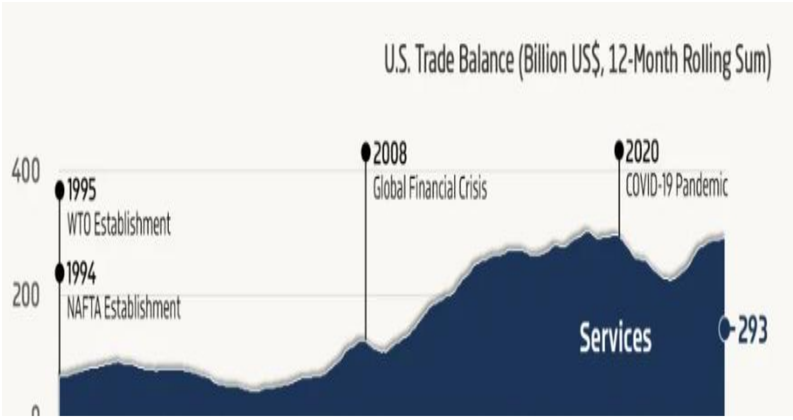
> ***"Not true. He's actually not implementing tax hikes. Tariffs are a tax hike on foreign countries, that again have been ripping us off. <u>Tariffs are a tax cut for the American people</u>.*** *And the President is a staunch advocate for tax cuts." — Karoline Leavitt, White House Press Secretary*

Oh my. I learn something new every day. You simply can't make this stuff up!

The truth is that economists don't agree on much, but they agree tariffs are taxes on consumers and businesses.

As I have discussed previously in this space, the offset to the trade deficit is the capital account surplus, which has been a huge benefit to the United States. The account surplus has led to lower rates than where they would be otherwise, a lower cost of capital and strong asset performance.

In other words, the capital account surplus has overwhelmed the negative economic effects of the goods trade deficit. After all, 70% of the economy is comprised of services, not goods. And it is in services — technology, financial, entertainment, media and medical — where America truly has its comparative advantage and enjoys a nearly $300 billion trade surplus to the rest of the world. (This is where the high value-added jobs are created.) Look at the chart below. The U.S. trade surplus in services is huge, but it is never discussed.



Source: U.S. Census

Bottom line: Americans have enjoyed an enhanced standard of living as we have ridden on a foreign-powered gravy train. The world under-consumes and saves so Americans can over-consume and spend. Our entire consumer-based economy depends on this parasitic relationship continuing. So, while April might be called Liberation Day, it could just as easily highlight how much the U.S. depends on the rest of the world to sustain its economy.

The last word goes to David Stockman:

Donald has no clue that April is going to be an economic demolition derby day, not a liberation day *as he posted in response to the Fed's sensible decision to pause its rate cutting campaign. Of course, Trump was having none of it. In essence, he was barking out loud via social media that* ***the Fed should continue to cut rates and thereby "accommodate" his plan to sharply raise the tariff burden on $3.3 trillion of imports coming into the U.S. — along with the very certain retaliatory burden that would hit $2.1 trillion of U.S. export sales abroad shortly thereafter****."*
– David Stockman, Former U.S. Representative and Former Director of the Office of Management and Budget

PUNKY CONSUMER

"This report says a contraction of GDP in Q1 is more likely… At a minimum, a decline in the growth rate of GDP is all but assured." — Carl Weinberg and Mary Chen, High Frequency Economics

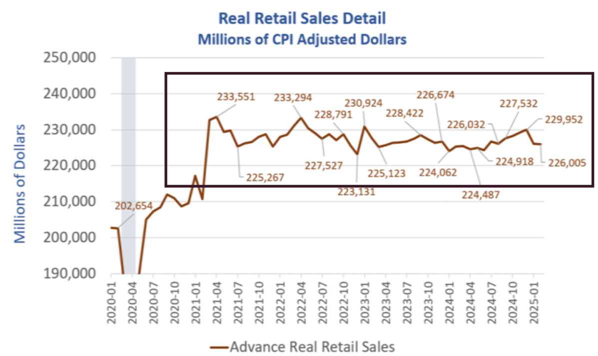
Retail sales had another poor month in February. The headline came in at +0.2% month over month in February versus the consensus forecast of +0.6%. This barely cut into the -1.2% January slide (revised down from -0.9%).

Seven of the retail report's 13 categories posted decreases, notably motor vehicles, which were expected to rebound from a weak January. Gasoline sales, as well as those of electronics and apparel, were also lower. Spending at restaurants and bars, the only service-sector category in the retail report, declined by the most in a year.

The one nice wrinkle was the blowout "core control," which feeds directly into the consumption segment of the GDP accounts. This metric bounced +1.0% month over month, which completely offset the -1.0% falloff the prior month (initially reported at -0.8%). While that will be helpful for first-quarter GDP, the jump was largely due to seasonal adjustment issues, according to Omair Sharif, President of Inflation Insights.

It's also important to note that these are "nominal" retail sales. It's "real" (inflation-adjusted) sales that feed GDP. To arrive at "real" sales, subtract 0.2% from the above numbers because the Consumer Price Index rose 0.2 %. In other words, real total retail sales were flat for the month. **<u>Factoring in negative revisions, real sales fell 0.3 %.</u>**

As shown in the graph below courtesy of MishTalk, inflation-adjusted retail sales are are completely flat on a year-over-year basis. Does this represent a strong consumer?



In real terms, even the "core control" group is down -3.0% quarter on quarter (annual rate) with one month to go in the first quarter. That tells you a thing or two about the shifting consumer landscape.

The build-in for Q1 real retail sales is now running at a -5.3% annual rate. So the first-quarter GDP decline, as per the Atlanta Fed Nowcast model, is about more than just record gold imports.

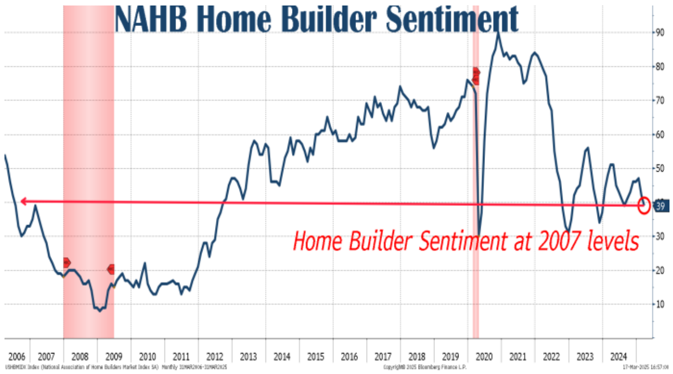
Bottom line: Consumers at all ends of the income spectrum are pulling back on spending. This clearly is a headwind for the economy moving forward.

HOUSE OF CARDS

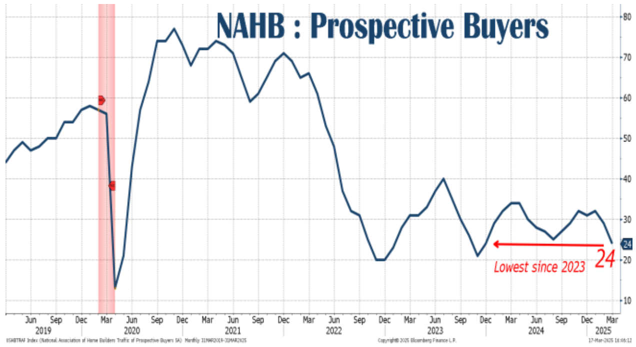
“While demand remains strong, persistently higher interest rates and inflation, combined with a downturn in consumer confidence and a limited supply of affordable homes, made it increasingly difficult for consumers to access homeownership." — Stuart Miller, Co-Chief Executive Officer, Lennar

Negative real retail sales are built into the first quarter, and the survey data shows a contraction in manufacturing activity. Along with that, we continue to receive some super-soft housing data.

The National Association of Homebuilders (NAHB) Homebuilder Sentiment Index was released for March and undercut expectations of an unchanged 42 reading, instead slipping to 39, tied for the weakest tally since December 2023. A 39 reading in the NAHB Index is precisely what we saw in February 2007, and we all know what happened thereafter.



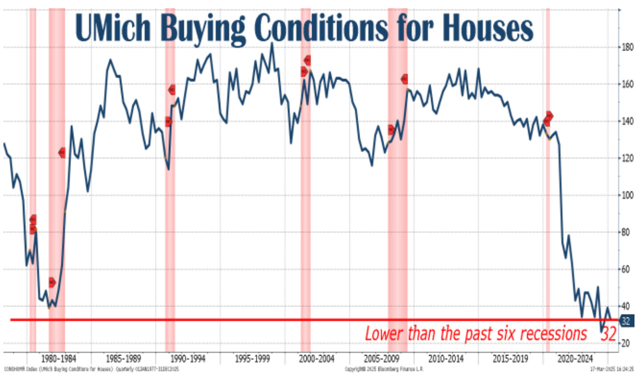
The most important component in the NAHB data from a “leading” perspective is the “prospective buyer traffic” subindex, which weakened from 32 in January to 24 as of March, to the lowest level since December 2023. The weather cannot be blamed for this since every region in the country showed weakness. This is all about punishingly high mortgage rates and overpriced homes along with the cooling taking hold in the labor market.



Also worth noting was that 29% of builders cut home prices in March, up from 26% in February. The average price reduction was 5% in March. The use of sales incentives was 59% in March. Yet, sales incentives and price cuts are having little positive impact on traffic or purchases.

Also in the housing file, the seasonally adjusted annual rate of sales of existing homes on a month-to-month basis ticked up to a rate of 4.26 million units. While there was a small uptick in sales, this was the worst February since February 2009. Overall existing home sales are down by 28% from February 2022 when home sales began their free-fall after prices had spiked to ridiculous levels .

It really says something when the U of Michigan index of home buying plans for March was lower than it was at the depths of all prior six recessions, including the early 1980s when interest rates were firmly in double-digit terrain.



Bottom line: Buyer demand is still dropping. Unless the Treasury market can muster a sustained rally and drive mortgage rates back down, it is next to impossible to find a near-term catalyst for this sector.

WHERE'S THE TRUMP PUT?

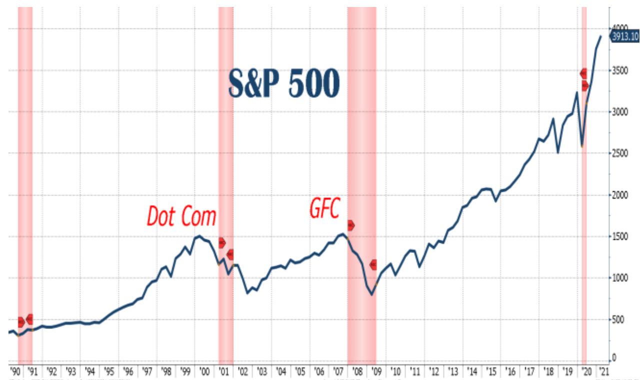
"There's no put… The Trump call on the upside is, if we have good policies, then the markets will go up."
— Scott Bessent, Treasury Secretary

The so-called "Trump put" assumes that the President will do whatever possible to keep the stock market happy. However, since returning to the White House on January 20, Trump's rapid-fire tariff policies have rattled risk markets, dented consumer and business confidence, and raised fears that his second term may not be as market friendly as expected.

Indeed, if you listen to the Treasury Secretary, the administration is now heading in a totally different direction. The stock market has gotten addicted to the government's deficit spending, to the fat profit margins from offshoring production, and to the Fed's erstwhile free-money policies, including trillions of dollars in money-printing, of which $2.2 trillion have so far been un-printed via quantitative tightening.

*"We're **focused on the real economy**… create an environment where there are long-term gains in the market and long-term gains for the American people...The reason stocks are a safe and great investment is because you're looking over the long term. **If you start looking at micro horizons, stocks become very risky**. So we are focused over the medium-, long-term." — Scott Bessent, Treasury Secretary*

They're saying the right things, but this is a BIG OUCH for stocks.



The one thing we know from the past — and this may be even more the case now — a stock market rout after a majestic bubble, if deep enough and long enough, will trigger a recession.

During the dotcom bust, the S&P 500 cratered 50% and the Nasdaq plunged 78%. A recession followed.

Likewise, another huge decline in assets during the Great Financial Crisis led to a recession.

*"**Trump has been a long-time advocate for using the stock market as a metric for the health of the economy**, so this is a fairly drastic shift."*
— Ben Harris, Vice President and Director of Economic Studies, Brookings

The biggest spenders — the top 10% of the wealthiest Americans — account for 50% of the consumption in the U.S. Their wealth is largely tied to stocks, real estate, crypto, etc. And if they watch their wealth go up in smoke, they might react, and their decisions move the needle in all kinds of ways:

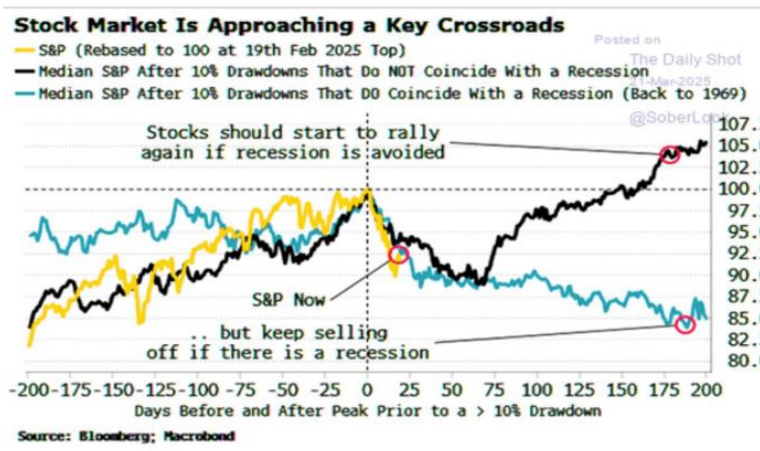
- As households, they may spend less extravagantly (the reverse "wealth effect"), which will ripple through the economy as businesses react with less investment and spending and with job cuts.
- As business decision makers, they may batten down the hatches of their businesses: Cut spending, cut investments, reduce hiring and increase layoffs.

For these reasons, a deep sustained rout in the stock market could trigger that recession. But where is the line? Will the S&P 500 have to drop 40%? 50%? And for how many years? The dotcom bust took about 30 months to play out, from mid-March 2000 until early October 2002. The rout sandwiched a recession from March 2001 to November 2001. It took a year after the recession ended for stocks to finally bottom out.

Bottom Line: Stocks are priced at very precarious, bubble-like levels and extremely vulnerable to a drawn-out rout. And the puts that the market had assumed were there to provide a floor may no longer be there.

MY BIGGEST FEAR!

The equity markets have experienced a technical correction (down at least 10% from their recent high). As the chart below clearly depicts, the future trajectory of the equity market will hinge on whether we enter a recession. If a recession does rear its ugly head, equity markets could fall significantly from these levels.



Source: Simon White, Bloomberg Markets Live Blog

What is frightening and never discussed in the commentary over the "wealth effect" is what would happen in a bear market. It is not the 30- or 40-something age group who are heavily exposed to equities but rather the 70-year-and-up cohort, and time is not on their side.

Including direct equity holdings and 401(k) plans, nearly half of the equity ownership in the United States is owned by the baby boomers. This is twice the weighting just before the dotcom bubble in 2001 and the 2008 Global Financial Crisis. **At over $30 trillion, the exposure has soared three-fold in this age cohort compared to just before the start of the Great Recession and is up six-fold from ahead of the Tech Wreck.**

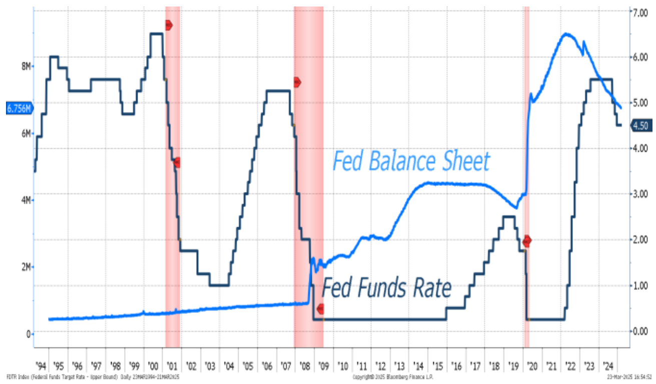
These boomers dominate the stock market today more than ever, and they will not be able to afford to ride out the other side of the mountain. This is where the selling is going to very likely accelerate at the first hints that this bull market is over. Or those that do decide to ride it out will be cutting back their retirement lifestyle spending like it's nobody's business. (Wave bye-bye to cruise lines, tablets/e-readers and cosmetic surgeries.)

Bottom line: Low-income consumers are already strapped for cash, and wealthier American Baby Boomers may also pull back as a recent stock-market selloff discourages spending.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"The Fed would be MUCH better off CUTTING RATES as U.S. Tariffs start to transition (ease!) their way into the economy. Do the right thing. April 2 is Liberation Day in America!!!" — President Donald Trump

The stock and bond markets clearly went into last week's Federal Open Market Committee (FOMC) meeting expecting a dot-plot with one rate cut or even no cuts, and instead, the Fed stuck with two moves. (Though at the margin, there are fewer now calling for three — eight of the nineteen members see but one cut, up from four in December.)



Nobody was expecting the Fed to trim rates, at least over the near-term, seeing that the Fed is flying blind at the moment. In fact, Federal Reserve Chair Jerome Powell uttered the word "uncertainty" in his press conference 19 times.

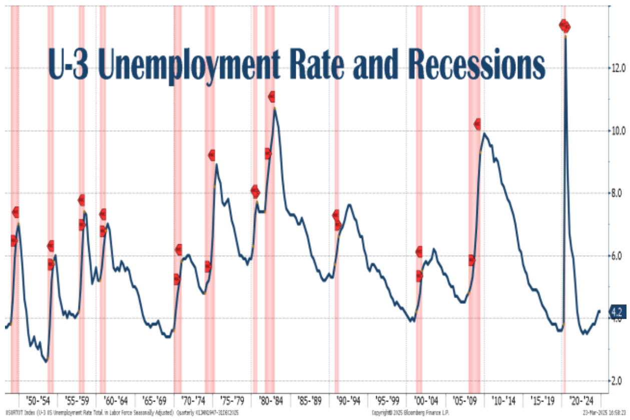
"In the current situation, uncertainty is remarkably high."
— Jerome Powell, Federal Reserve Chair, Post-meeting Press Conference, March 19, 2025.

In times of super-elevated uncertainty, central banks typically sit on their hands. The problem for the economy, however, is that consumers and businesses do the exact same thing. The same thing for investors. Despite the technical bounce very recently in the stock market, the money has been going into U.S. government money market funds this year (+$22 billion) and a lesser +$2.6 billion into longer-dated bond funds.

And while the Fed did cut its growth projections for both this year and next, Powell did his best to put on a happy face over the economic backdrop. **He acknowledged that the hit to inflation from the tariffs does not have a lasting effect, but the dampening effect on economic activity is greater and more sustained.**

So, the Fed was less hawkish than feared. The inflation forecast had a, dare I say, "transitory" feel to it. There was no further movement in long-term neutral Fed funds rate (R-star). And there is a move in the direction of terminating quantitative tightening. Encouraging news for the Treasury market.

Also of great significance, the Fed is projecting that the unemployment rate will reach 4.4% at year end. If so, the unemployment rate would be 100 basis points above the cycle low. Going back to 1948, that has never happened without a National Bureau of Economic Research-defined recession. By the time the jobless rate rises this much, the recession has already been in play, to everyone's surprise each and every time, for five months. So even though the dot plots are still at two cuts for this year, the historical record suggests that we are going to see a lot more because if past is prologue, the recession nobody believes in may well rear its ugly head as early as July**.**



Bottom line: The times, they are a-changin'. The U.S. economy isn't exactly falling apart, but the evidence is mounting that a first-quarter GDP contraction is under way.

In terms of portfolio strategy, stay the course. Continue to maintain a risk-appropriate ladder strategy while buying bonds on (price) 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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