

Weekly Relative Value

WEEK OF AUGUST 25, 2025



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The Doves Rule

The big day arrived as Fed Chair Jerome Powell delivered what will be his last speech from the wilds of Wyoming at the Jackson Hole Symposium. In advance of his speech, there were many questions about how dovish he would be. And Jay Powell surprised many with a notably dovish tilt. Below are the key comments (highlights are mine) from his speech:

*"Inflation had moved much closer to our objective, and the labor market had cooled from its formerly overheated state. **Upside risks to inflation had diminished.** But the unemployment rate had increased by almost a full percentage point, **a development that historically has not occurred outside of recessions.**"*

*"Overall, while the labor market appears to be in balance, it is a curious kind of balance that results from a marked slowing in both the supply of and demand for workers. **This unusual situation suggests that downside risks to employment are rising. And if those risks materialize, they can do so quickly in the form of sharply higher layoffs and rising unemployment.**"*

*"The effects of tariffs on consumer prices are now clearly visible. We expect those effects to accumulate over coming months, with high uncertainty about timing and amounts. The question that matters for monetary policy is whether these price increases are likely to materially raise the risk of an ongoing inflation problem. **A reasonable base case is that the effects will be relatively short lived—a one-time shift in the price level.** Of course, 'one-time' does not mean 'all at once.'"*

*"One possibility is that workers, who see their real incomes decline because of higher prices, demand and get higher wages from employers, setting off adverse wage—price dynamics. **Given that the labor market is not particularly tight and faces increasing downside risks, that outcome does not seem likely.**"*

*"Another possibility is that inflation expectations could move up, dragging actual inflation with them. Inflation has been above our target for more than four years and remains a prominent concern for households and businesses. **Measures of longer-term inflation expectations, however, as reflected in market- and survey-based measures, appear to remain well anchored and consistent with our longer-run inflation objective of 2 percent.**"*

THIS WEEK

- MORE SIGNS OF LABOR MARKET WEAKNESS
- WILL WE FOLLOW THE LEAD?
- HOUSING MARKET REMAINS BROKEN
- BUILDERS KEEP ON BUILDING
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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Putting the pieces together, what are the implications for monetary policy?

*“Nonetheless, with policy in restrictive territory, **the baseline outlook and the shifting balance of risks may warrant adjusting our policy stance.**”*

Historically, announcements at Jackson Hole have moved markets. Last Friday was no exception. After Powell’s comments, rate-cut odds for September spiked from ~70% earlier in the day to around 90%. (They were 85% at the end of last week.) Two full cuts are discounted by year-end and a cumulative of five rate cuts by the end of 2026. (A terminal rate of 3.0% is being priced in by markets.)

The bond market took off with the two-year Treasury yield, which is more sensitive to Fed policy, cratering and finishing the trading session 10 basis points lower (3.69%) after Powell’s speech.



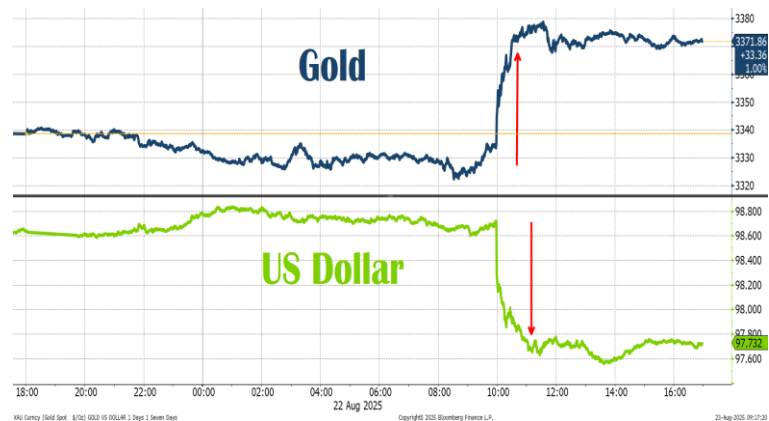
Likewise, the benchmark 10-year Treasury yield plummeted and settled nine basis points lower on the day at 4.25%. Hopefully this will help lower mortgage rates, which the beleaguered housing market desperately needs. (See commentary below.)



Equity markets soared to record highs.



Gold surged to a new record high of \$3,371 per ounce while the U.S. dollar took a beating, with the DXY Dollar Index slumping by nearly -1.0% on Friday to finish the week back below the 98 mark.



Bottom line: Powell's belief is that 1) the tariff effect on inflation will not be lasting (thankfully, he did use "transitory"), 2) there are greater downside risks to the labor market, 3) inflation expectations remain well anchored, and 4) there is minimal risk, as the labor market softens, that tariff-related price increases will translate into wage inflation.

Let me add this: In the latest set of Federal Open Market Committee minutes, the Fed staff stated the following:

"The staff's inflation projection was slightly lower than the one prepared for the June meeting, reflecting the downward revision to the assumed effects of tariffs on imported goods prices."

"The staff expected that the rise in the cost of imported goods inclusive of tariffs would be smaller and occur later than in their previous forecast."

"The staff continued to expect that the labor market would weaken, with the unemployment rate projected to move above the staff's estimate of its natural rate around the end of this year and to remain above the natural rate through 2027."

"The staff continued to view the uncertainty around the projection as elevated, primarily reflecting uncertainty regarding changes to economic policies, including trade policy, and their associated economic effects. Risks to real activity were judged to remain skewed to the downside in light of the weakening in GDP growth seen so far this year and elevated policy uncertainty."

Simply put, the Fed's economics team stated the following:

- 1) The inflation forecast was CUT, not raised.
- 2) Tariffs will add less inflation over the near term than initially thought (which means profit margins are at risk).
- 3) The chaotic government policy has raised "uncertainty" while creating downside economic risks.
- 4) The unemployment rate is expected to rise above natural rate by year-end and is expected to stay there through next year and the year after that.

The last point is key. If the jobless rate moves above its natural rate, it means that the labor market will materially weaken and remain weak through 2027. If so, tariffs will have no upward pressure on wages. Simply, put, there is no sustainable inflation without a corresponding wage response. If so, we are left with a blip on the downward inflation trend.

Bottom line: The Fed's staff's view is also my view and explains why I have remained bullish on the Treasury markets. Moreover, based on what the Fed economics team had to say, which occurred before the surprisingly weak July jobs report, the Fed should start cutting rates immediately and should not stop until the funds rate gets to 3.0%, or even lower.

MORE SIGNS OF LABOR MARKET WEAKNESS

The Bureau of Labor Statistics (BLS) reported that initial jobless claims jumped in the last week, rising by 11,000 to 235,000, the highest since June 20. Initial unemployment claims are somewhat above the middle of a 200,000 to 250,000 range where things have been for over three years.

However, the relentless rise in continuing jobless claims continues, and in the latest week rose to 1.972 million, up from 1.942 million to the highest point since the pandemic crash.



But the underlying labor weakness is worse. The problem with looking at continued claims alone is that benefits expire. When people lose their benefits, they are still unemployed but uncaptured in continued claims. Most states offer 26 weeks unemployment, with some less. To adjust for the loss in benefits, one needs to factor in long-term employment over 26 weeks.

The monthly average of continued claims plus 27+ week unemployment is 3,778,000 through July. That's up from a low of 2,513,000 in September of 2022. And 3.8 million is understated because not all states offer 26 weeks.

Bottom line: Look beyond the stable (for now) initial claims to see what's really happening. The labor market is much weaker than the Fed and Wall Street economists realize or want to admit. The slow rise in continued unemployment claims severely understates the actual unemployment problem. Once you lose a job, it takes an increasingly longer time to find one.

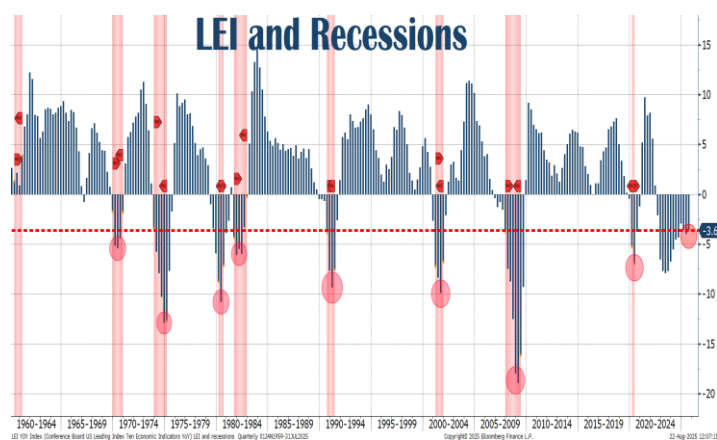
WILL WE FOLLOW THE LEAD?

The Conference Board's Leading Economic Index (LEI) tracks 10 economic indicators that usually start moving before the economy. It's like a weather forecast but for the economy.

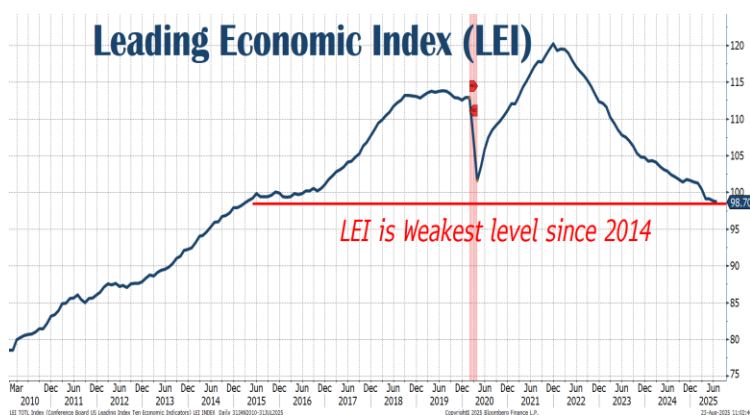
These indicators include:

- New orders from manufacturers
- Consumer expectations
- Jobless claims
- Stock prices.

The LEI for July fell again in July, dipping by 0.1% to 98.7. That might sound like a small move, but the trend is what matters. On a monthly basis, this index has not shown a pulse since last September 2021.



The Conference Board LEI has dropped in 38 of the last 41 months to its lowest in 11 years.

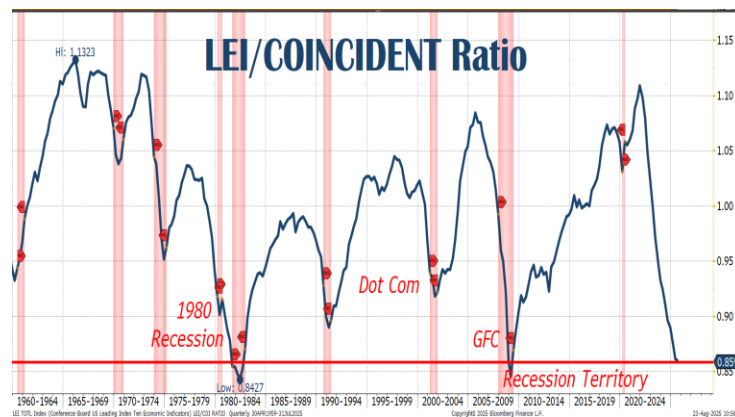


On the other hand, the Conference Board provides the Coincident Economic Index (CEI), which is made up of four indicators that tell us how the economy is doing right now:

- Payroll jobs
- Real income (after subtracting government aid)
- Industrial production
- Business sales

In July, the CEI rose by 0.2%, and over the past six months it went up 0.9%, a sign that the economy is still growing in the moment. But here's the problem: When the LEI is falling while the CEI is rising, it often means we're near a turning point.

That brings us to the LEI/CEI ratio, a comparison of future signals versus present reality. When this ratio falls sharply, it suggests that the momentum in the economy is breaking down. Right now, that ratio is the lowest it's been since the last two major U.S. recessions.



In fact, the only two times this ratio was lower:

- The 1981–82 recession, when inflation and interest rates soared
- The 2007–09 financial crisis, driven by housing and banking collapse

Now, you might ask: If the warning signals are so strong, why aren't we in a recession yet? Because the economy today measured by the CEI still looks solid. Incomes are holding up for now. Consumers are still spending, but this is typical in late cycle environments. I should add that while the Conference Board isn't officially predicting a recession yet, they are forecasting a noticeable slowdown:

- 1.6% gross domestic product growth in 2025
- 1.3% growth in 2026

Bottom line: The economy looks stable right now, but the weakness in the LEI and LEI/CEI ratio is consistent with a stall-speed economy. This doesn't mean an imminent crisis, but it does mean the odds of a downturn are rising.

HOUSING MARKET REMAINS BROKEN

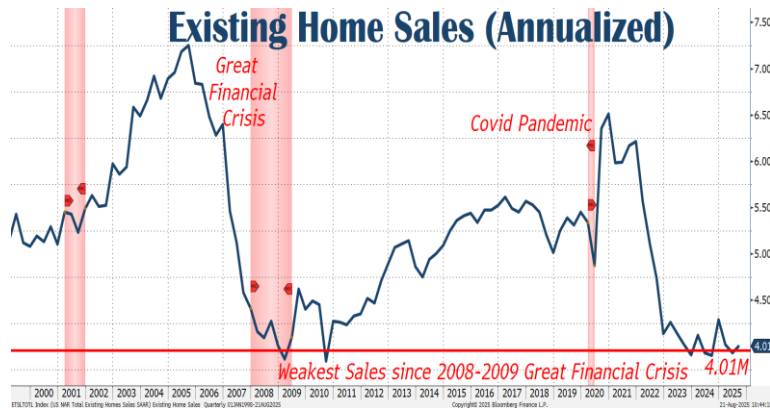
"The ever-so-slight improvement in housing affordability is inching up home sales. Wage growth is now comfortably outpacing home price growth, and buyers have more choices. Condominium sales increased in the South region, where prices had been falling for the past year....Near-zero growth in home prices suggests that roughly half the country is experiencing price reductions...Homebuyers are in the best position in more than five years to find the right home and negotiate for a better price."

— Lawrence Yun, Chief Economist, National Association of Realtors

Sales of existing homes rebounded 2.0% month over month in July (versus -0.7% month over month expected), leaving existing home sales unchanged year over year. There was a modest bounce in the total resale activity from 3.93 million to 4.01 million, but it is still hobbling along the lowest levels since 1995. Resale activity is down by 24% from July 2019 and by 32% from July 2021 thanks to ridiculously high-priced homes and mortgage rates above 6%.

On a regional basis, month-over-month sales increased in the Northeast, South, and West, and fell in the Midwest. Year over year, sales rose in the South, Northeast, and Midwest, and fell in the West.

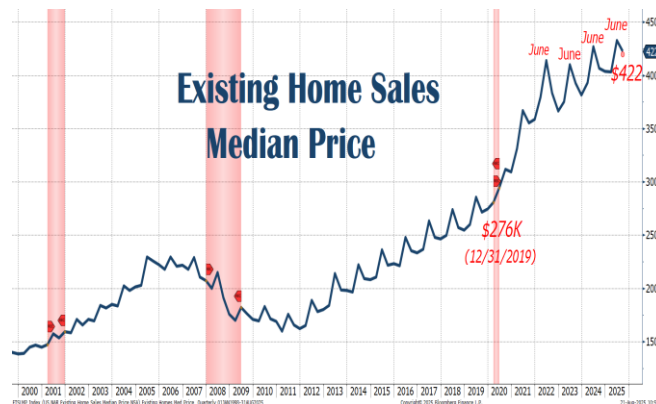
- **Northeast:** 8.7% increase in sales month over month to an annual rate of 500,000, up 2.0% year over year.
- **Midwest:** 1.1% decrease in sales month over month to an annual rate of 940,000, up 1.1% year over year.
- **South:** 2.2% increase in sales month over month to an annual rate of 1.85 million, up 2.2% year over year.
- **West:** 1.4% increase in sales month over month to an annual rate of 720,000, down 4.0% year over year.



The median price of single-family homes fell 2.3% in July from June, a larger than typical decline (from last month's record \$432,700 to \$422,400) and cutting the year-over-year gain to just 0.3%.

But prices fell year over year in the West and in the South. These are single-family home prices by region, month-over-month (MoM) and year-over-year (YoY):

- **West: -1.2% MoM, -1.2% YoY**
- **South: -1.7% MoM, -0.3% YoY**
- Midwest: -6.5% MoM, +3.9% YoY
- Northeast: -1.1% MoM, +0.8% YoY

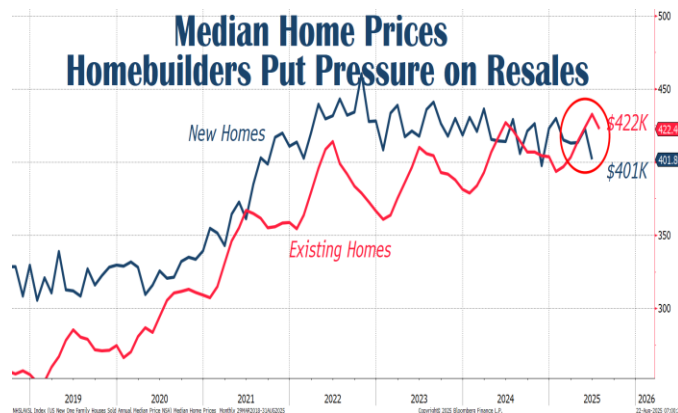


But prices are still too high: In a sign that buyers are balking at high asking prices, 21% of the homes sold were above list price, down from 28% in May.



The clearest sign of just how broken the housing market is that it has never cost more to buy an existing home versus a new one. Historically, new houses are ~20% more expensive on average than existing houses. Today, they're ~8% cheaper. That explains why builder sales volumes are roughly normal while existing sales volumes are down 25% from pre-pandemic.

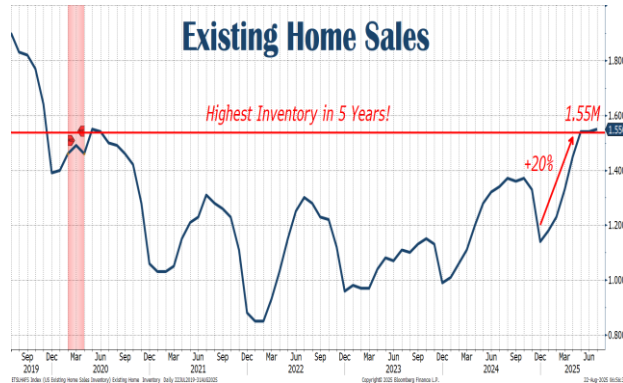
What's happening is that the builders are adjusting to the realities of the current housing market. They've cut prices 13% from peak levels and are giving generous mortgage rate buydowns on top of that. If you factor in mortgage rate buydowns, then new houses are substantially cheaper than existing houses. They're also building slightly smaller floor plans to deliver affordability to buyers. Ultimately, builders are doing what needs to happen for demand to return.



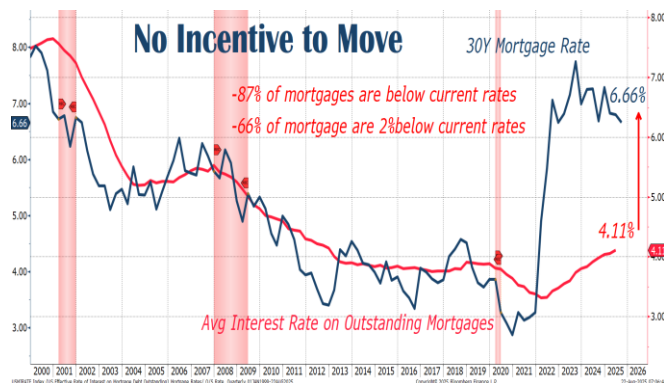
Existing home sellers, on the other hand, are largely ignorant of the realities of the current market. They're often living in the past and trying to capture prices from three to four years ago when they go to sell. This is leading to extremely elevated existing sale prices that don't accurately reflect the current market.

The question is, when will existing home sellers wake up and follow the lead of builders and lower their asking prices? Possibly it will occur when unemployment rises and many homeowners are forced to sell their homes. Whatever the catalyst, I feel confident that new houses will not remain significantly cheaper than existing houses for long. I suspect builders are "leading" the market and signaling that home prices of existing homes will need to drop on a nationwide basis to bring demand back.

The silver lining: As homebuyers refuse to chase prices into the stratosphere, current inventory of unsold homes rose to the highest since May 2020, during the pandemic lockdown. Indeed, the spike in supply of homes for sale this year has destroyed the real-estate industry hype that there's a "housing shortage," which they deployed liberally — and *still* in the media these days — to incite homebuyers to pay these too-high prices.



This means sellers will have to cut prices very soon if they want to sell. Then again, 87% of mortgage holders have rates below current rates, and two-thirds have borrowing costs 2 % below current rates, “strongly” disincentivizing them from moving.



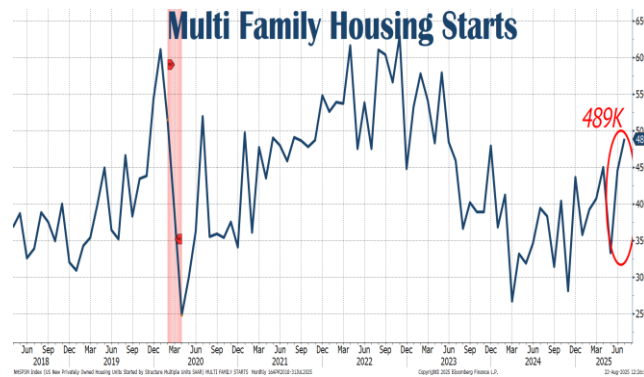
Bottom line: Housing is at an inflection point. While the Fed remains consumed with the impact of tariffs on the Consumer Price Index (CPI) and Personal Consumption Expenditures (PCE) deflator data, it may well be missing the downward pricing pressure from a negative cycle in residential real estate valuations, which appears to be in the beginning stages.

BUILDERS KEEP ON BUILDING

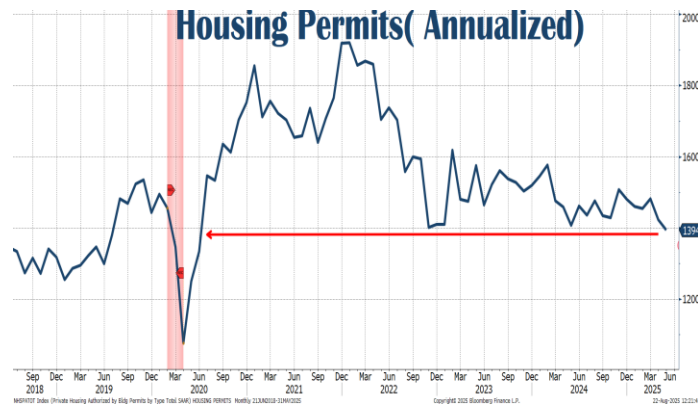
Builders have to build. That is their business.

New housing starts surged +5.2% month over month in July to 1.428 million units (annualized), versus a -1.8% consensus.

However, much of the move was due to the multi-family sector (+10%). Single family starts rose a modest 2.8%.



The big blemish in this report was that building permits fell by -2.8% month over month. Permits lead starts — meaning the former have come in below the latter now in each of the past four months. Contrary to the consensus narrative, the gap between housing starts and permits is a problem for the homebuilding industry and presages a quick reversal in the July starts. Notably, single-family permits have declined at nearly a -20% annual rate so far this year.



MARKET OUTLOOK AND PORTFOLIO STRATEGY

Jay Powell tipped his hat to a rate cut (with potentially more adjustments to come). The question is will this be the reinitiation of a series or a “one and done” reduction? Much will likely depend on the incoming employment data to determine the pace and trajectory thereafter.

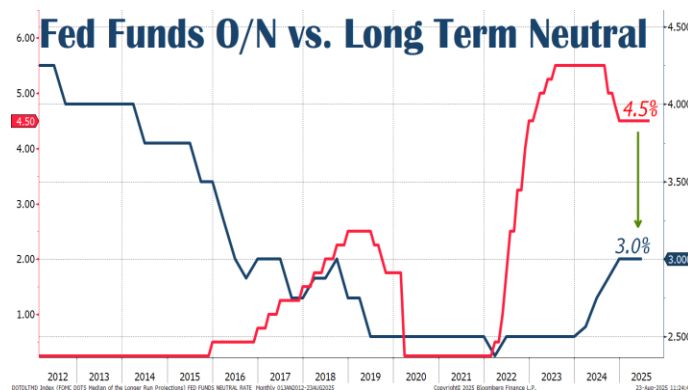
Market-based odds of a Fed cut jumped from ~70% earlier in the day to around 90% (was 85% at the end of last week). Two full cuts are discounted by year-end and a cumulative of five rate cuts by the end of 2026. (A terminal rate of 3.0% is being priced in by markets.)

The 10-year Treasury yield was unchanged on the week in the lead-up to Jackson Hole, ultimately rallying -6 basis points to 4.25%, after Powell’s remarks. The two-year benchmark, which is more sensitive to Fed policy, matched that decline thanks to a -10 basis point rally to 3.71% on Friday to close out the week.

At this point, we have to wait for what happens next because we can see plainly that it touched the bottom at around 4.2% four other times since mid-April and no fewer than eight times this year outside of that brief massive flight-to-quality trade during that tense period around “Liberation Day.” But a break below 4.2% sets us up for 4.0% and then quite possibly back to the 3.6% nearby lows of last September.



However, if you believe in the Fed staff, (I do) the labor markets are weakening rapidly, and the impact of tariffs may well end up being deflationary as higher prices thwart aggregate demand. In addition, declining shelter and housing costs could dwarf any upward move from tariffs. If so, the Fed will have the green light to lower the Fed fund's overnight rate by 150 basis points, from 4.5% to 3%.



Also, with regards to inflation, given the increasing number of imputations in calculating the CPI, data integrity and credibility are becoming more suspect. At this point in time, nearly 60% of the index is imputed.

In the current environment, there may be other sources of inflation that provide a more accurate and timely view of inflation. One alternative source is Truflation. Truflation is an independent research firm that provides real-time accurate, unbiased economic data on inflation. As shown below, their latest daily calculation shows inflation running at 2.12% vs the BLS calculation of 2.70%. According to their methodology, inflation in the U.S. is at the Fed's target of 2%.

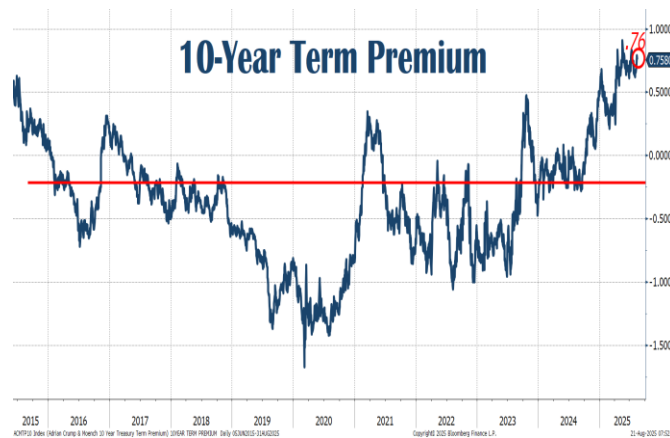


In terms of positioning, arguably the biggest story for the bond market this year has been the steepening of the yield curves across the board. Part of the steepening is due to investors bidding up the front end in anticipation of a Fed rate cut. Year to date the two-year Treasury yield has declined by ~60 basis points whereas the 10-year Treasury yield and the long bond yields have ONLY declined by 33 basis points and 20 basis points, respectively.

In other words, if not for the tariffs and the Big Beautiful Bill, the 10-year Treasury yield would be closer to 3.3% as opposed to 4.3%, and the long bond would be below 4.0% instead of pressing against 5.0%.



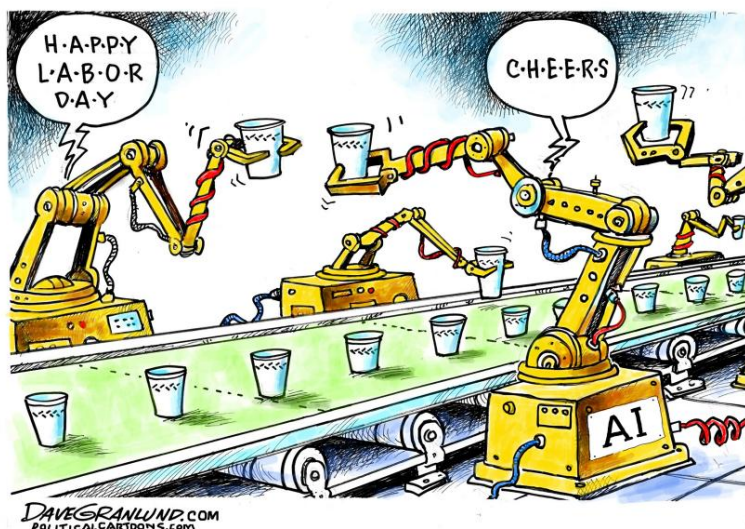
The reason for the steepening of the curve is because market-based inflation expectations (10-Year TIPS) are +35 basis points above the Fed's 2% target. Also because of the Big Beautiful Bill and all its bells and whistles, the fiscal risks embedded in the term premium have jumped by +60 basis points in the past six months.



Steeper curves are great news for the banks and credit unions, but higher rates at the long end are a curse to the interest-sensitive sectors of the economy, primarily in housing, autos and retail.

Credit unions should try to optimize the shape of the yield curve to pick up optimal yield in advance of the Fed lowering rates.

Happy Labor Day!



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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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