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Weekly Relative Value

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WEEK OF SEPTEMBER 23, 2024

Don't Be Fooled!

September 18, 2024: "The U.S. economy is in a good place [...] we want to keep it there... Our intention is to maintain the strength we currently see in the economy."
— Federal Reserve Chairman Jerome Powell

The Federal Open Market Committee (FOMC) opted for a 50 basis point cut to the Fed funds rate instead of a more conservative 25 basis points to kick off the easing cycle. This was the first time in history that the Fed made a jumbo rate cut and treated it like a non-event. This was also the first interest rate cut since March 2020.

According to Powell, the 50 basis point rate cut is an attempt not to get behind the growth curve. Powell said it was an "insurance policy" aimed at perpetuating the "goldilocks" soft landing economy.

Surprisingly, Powell repeatedly stressed what "solid" shape the economy is in, and yet, he immediately discussed the Beige Book, which revealed that over half the country is either stagnating or contracting. Please read that last sentence again!

LABOR MARKETS TRUMP INFLATION

September 18, 2024: "The time to support the labor market is when it's strong, not when you begin to see the layoffs [...] we have begun the cutting cycle now."
— Federal Reserve Chairman Jerome Powell

THIS WEEK

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SUBORDINATED DEBT: (SIMPLIFIED)
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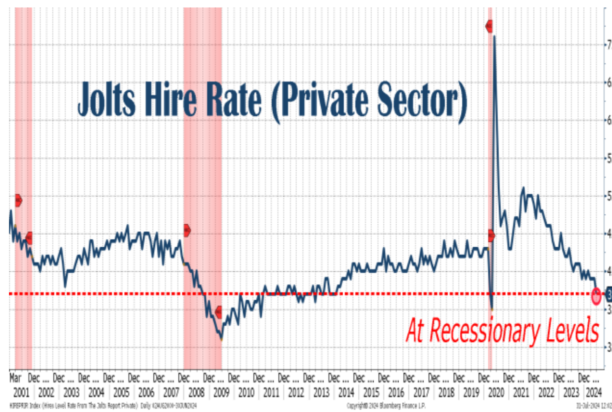
At the press conference, Powell did stress that the downside labor market risks now trump the upside inflation risks. The primary concern is that the plunge in hiring rates will presage a layoff cycle.



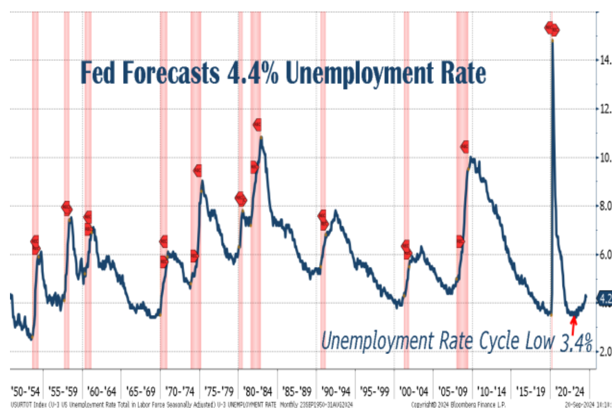
According to the August state-level jobs data, 39 states have seen their unemployment rate shoot up at least 0.5% from the cycle low (up from 31 in July). This is important because it is the increase from the lows on a national basis that, on average, has presaged NBER-defined recessions.

Finally, let's not forget those massive Bureau of Labor Statistics (BLS) revisions, which showed 818,000 fewer jobs were added over the year through March than previously reported. This means employers added about 2.1 million workers, not 2.9 million. Tack on the fact that private-sector job gains have slowed to just +96,000 per month over the past three months, a big haircut from 155,000 at the end of 2023.

All of this makes Powell's comment at the podium last week a bit comical:

> *"I don't see anything in the economy that suggests that the likelihood of a recession, of a downturn, is elevated."*

Despite its rosy glow, the Fed implicitly called for the recession it explicitly stated it was trying to avoid. The FOMC's forecast for the unemployment rate is expected to rise to a peak of 4.4%. If so, that would be a 100 basis point rise from the cycle low of 3.4%.



Taking a look at the graph above, at no time in recorded history has the jobless rate risen 1% from the cycle low without a recession (see red shaded areas).

However, Powell stated that 4.4% still represents a healthy labor market. But that is a tad disingenuous because more than half the recessions in the post-WWII era started with the jobless rate at or near this level. It's not surprising the Chairman didn't mention this.

Bottom line: Don't be fooled by Powell's repeated stress on the "solid" state of the economy. Such an aggressive monetary easing suggests he's more worried than he sounds.

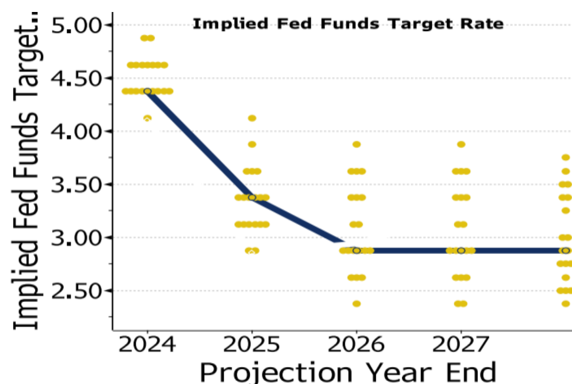
BLINDED BY THE LIGHT

"Take a right at the light, keep goin' straight until night, and then boy, you're on your own."
— "Blinded by the Light", Bruce Springsteen

The most important price in the economy (cost of capital) is decided by a small committee that meets eight times per year in Washington.

We have this concept that the Fed is a group of wise men. The captain is the chairman, Powell. We have this image that Powell's steering an airplane. When he banks to one side, he's fighting inflation. If he banks to the other side, he's worried about labor market conditions.

To show how idiotic this is, have a look at the most recent "dot plots." The median forecast shows another 50 basis points of easing in 2024 (one 25 basis point cut in each of the remaining two meetings) and an additional 1.00% worth of cuts in 2025.



Clearly, there is consensus on the need to reduce rates, yet the individual dots are all over the map. For example, the year end "dot plot" for 2025 shows a spread of 125 basis points. In other words, the Fed has no idea where we're going or where we'll end up.

Why anyone pays attention to the dot plots is a good question to ask since they're always wrong and move around more wildly than Bitcoin.

Bottom line: Please ignore the dots. It's important to emphasize that it was just three months ago that nobody at the Fed was calling for a September cut.

The real signal from the Fed was in the size of the cut, which tells us that the FOMC is concerned that it has been too tight for too long.

THE FED IS BEHIND THE CURVE

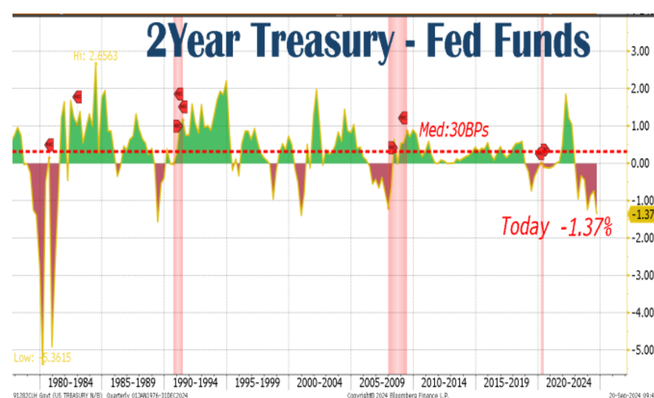
The historical record shows that the Fed cannot finesse the economy nor interest rates. They are always late in raising rates and late in cutting rates. They always will be.

You need to let market forces be deciding the cost of capital compared to being decided by a small committee that meets eight times per year in Washington.

The bond markets meet almost every day. I honestly believe the FOMC should just peg the Fed funds rate to the 2-year Treasury and get out of the way. However, hubris won't allow it because who would put a microphone in front of passive Fed members.

In my opinion, the 2-year Treasury yield is the best guide for where the Fed funds target should be. Not perfect, but better than anything else out there. When the spread gets too wide, the Fed is either overly stimulative or overly restrictive.

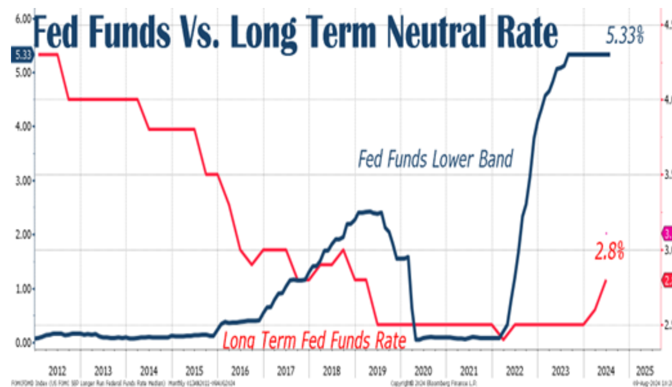
Even after the 0.50% cut, the difference between the Fed interest rates and the 2-year Treasury yields is the highest in over three decades. This means the Fed is still overly restrictive.



I keep hearing people claim that the bond market is obviously pricing in a recessionary set of rate cuts.

While it is clear the market believes the Fed is behind the curve, given the extreme inversion between the Fed funds rate and 2-year Treasury yields, I disagree that this means a recession is priced in.

Just averting a recession and getting the economy back to where it was in 2019 would mean dragging the Fed funds rate down to 2%.



Bottom line: Of course, the Fed is behind the curve! This is what happened on the way up. Being late is what they do!

Long story short: The market is pricing in that the Fed will ease back to a neutral stance, not deeply into stimulative territory. In other words, expect more rate cuts, and faster than the Fed projects.

CUSTER'S LAST STAND?

*"The level of debt on the consumer is very high, and so **I expect to see weaker economic data in the coming reports**… I still think **there's a good shot that the history books will say September of 2024 was the start of a recession**."*
— Jeffrey Gundlach, CEO, Double Line Capital

Headline retail sales surprised to the upside, gaining +0.1% in August compared to a consensus expectation of a -0.2% falloff. Excluding autos, it did come in light at +0.1% compared to the +0.2% market expectation. It slowed from the +0.4% prior pace of expansion. Excluding autos and gas, retail sales increased +0.2% while the consensus was +0.3%.

The key "retail control" group that feeds directly into the consumer spending of the gross domestic product (GDP) data was right in line with estimates at +0.3%. All in, a better-than expected report.

Moreover, the general slowdown in consumption is underscored by the year-over-year trend, which decelerated to +2.1% from +2.9% in July. Does that trend look healthy to you?

Beneath the headline, the sector details the only two areas showing verve were miscellaneous retailers (+1.7%) and online shopping (+1.4%).

Notably the areas of the economy tied to the economic cycle continued to retreat. To wit:

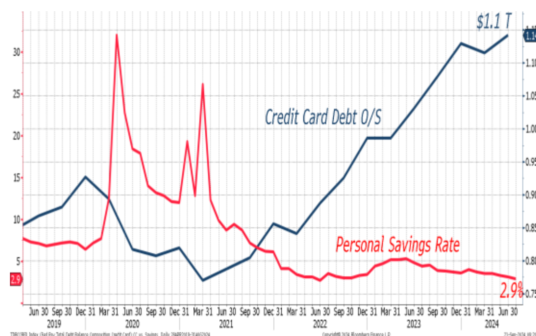
- Autos: -0.1% (The second pullback in three months.)
- Gasoline: -1.2% (It was negative in three of the past four months and running at -6.8% year-over-year.)
- Furniture and Appliances: -0.9% (The largest decline since March.)
- Clothing Stores: -0.7%
- General Merchandise: -0.3%
- Grocery Store Sales: -0.6% (The worst showing since January 2023 as consumers "trade down" to private label brands.)

Anecdotally, in view of last Friday's bombshell earnings miss and downward full-year revenue guidance from none other than FedEx (whose share price was hammered -15%), one can be forgiven for having a slightly dourer view of the economic backdrop than what is being portrayed by the government statistics. The company ships GDP around the country, so the fact that it guided its top-line lower serves as an amber light for the macro bulls.

Bottomline: For all the talk of consumer resilience, when you smooth out the monthly wiggles, all that remains is +2.1% year-over-year growth in nominal retail sales**.** Inflation-adjusted (real) spending declined -0.1%, the second falloff in the past three months. Real retail sales (volumes) have been shrinking in each of the past five months and are down -0.5% year-over-year. Not much worth getting excited about.

Not to mention for a long time after the pandemic, U.S. consumers' "excess savings" stockpile from lockdown periods and government transfers kept spending detached from the interest rate cycle, lengthening the famous "long and variable" lags of monetary policy.

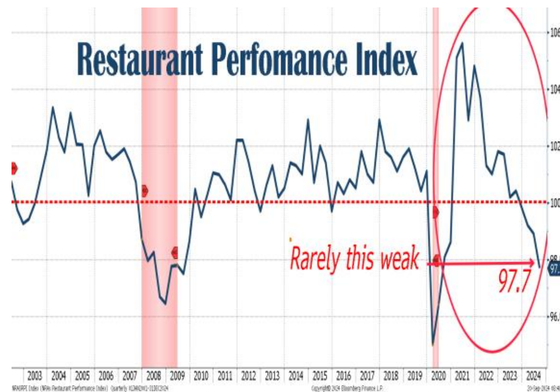
However, with credit card debt at historically high levels, personal savings rate at historical lows, delinquency rates rising and the unemployment rate on an upward trajectory (with negative implications for future wage growth), we may well have witnessed the equivalent of Custer's last stand when it comes to this elongated consumer cycle.



EATING OUT IS OUT

Meanwhile, between the price wars heating up in the fast-food space as well as a more defensive consumer mindset, eating out is out as growth has slowed to +2.7% year-over-year (was nearly +10% a year ago).

The Restaurant Performance Index (RPI) is like a health check for the U.S. restaurant industry. When the RPI dips below 100, it signals that the industry is shrinking and many businesses may be feeling the squeeze.



In July, the RPI fell -1.3% to 97.7 points, the lowest level since the 2020 lockdowns. Since 2021, this metric has fallen by 8.0%, marking the largest drop since it was launched in 2002. Such a low level in the index has only been seen during recessions.

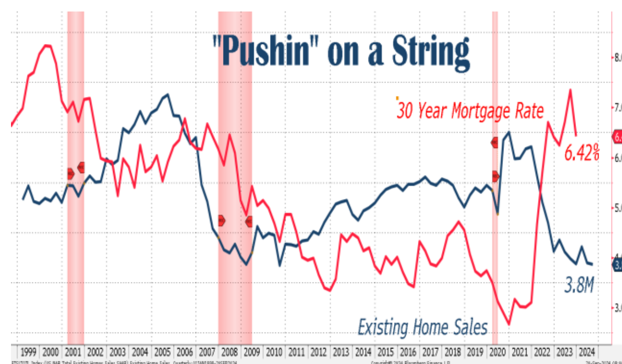
Bottom Line: Americans are pulling back on dining out. Since restaurants are often a mirror of how people are feeling about the economy, this dip could tell us a lot about broader economic challenges ahead.

STILL IN THE BASEMENT

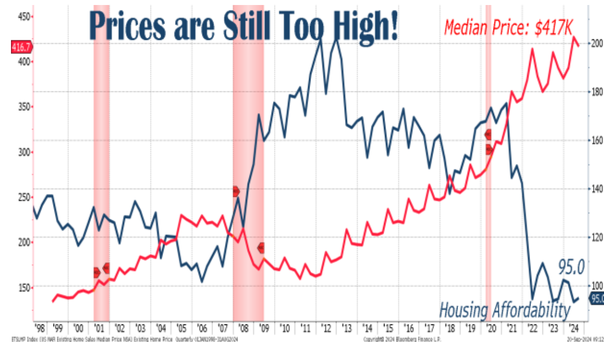
Existing home sales data for August gave us a clue as to why the Fed felt justified in going big this week. Sales fell by -2.5% month-over-month to a 3.86-million-unit annual rate. On a year-over-year basis, resales are down -4.2%, from -2.2% in July. This drop comes despite mortgage rates falling in anticipation of the easing cycle by roughly -30 basis points between July and August and between -70 and -90 basis points since the May nearby high.

Clearly, the Fed will need to do much more to move the needle in a market frozen by the effects of locked-in ultra-low mortgage rates — right now it's pushing on a string.

From a regional point of view, only the Midwest managed to avoid a drop in transactions with sales unchanged for the second month running. The previously outperforming South and West were where the slowdown was concentrated (-3.9% month-over-month and -2.7%, respectively). Although, the Northeast also dropped too (-2.0% month-over-month and back to flat in year-over-year terms after briefly rising in July).



Existing home sale prices continue to rise. The median house is now setting you back 417,000, which is +3.1% year-over-year higher than last August. There was essentially no evidence of a positive impact of lower mortgage rates on the housing affordability index, which improved by a mote but is still hovering close to the lowest score since the 1980s at 95.0.



Median monthly mortgage payments stand at $2,265, only $39 off July's all-time high and eating up 26.3% of monthly income. There was some good news on the future prices front in the form of rising inventories (1.35 million units, +22.7% from one year ago), now sitting at 4.2 months of supply at the current pace — buyers and sellers alike are still sitting on the sidelines waiting for better mortgage rates.

In that context, I will leave you with a quote from Powell from Wednesday's press conference, pointing out that lower interest rates are not the only channel through which the Fed cuts can help ease the affordability crisis; lower rates will also make it possible for folks who are trapped in their homes with fixed mortgages from the zero-bound era to refinance, bringing supply onto the market.

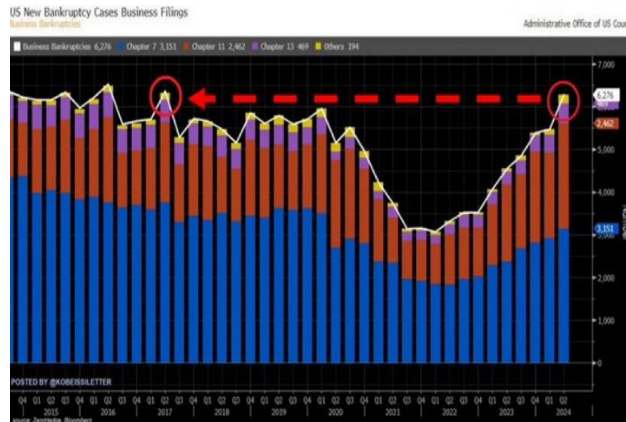
*"**But I think as we normalize rates, you'll see the housing market normalize**. And I mean, ultimately, by getting inflation broadly down and **getting those rates normalized and getting the housing cycle normalized, that's the best thing we can do for householders."***

Bottom line: More rate cuts to come.

BANKRUPTCIES SURGE

Meanwhile in the corporate world bankruptcy filings in the U.S. rose by eight last week, the second-highest week in 2024. The number of Chapter 11 bankruptcies was only higher in the first week of April when 14 companies filed bankruptcy, which is the most in 15 years.

Meanwhile, in the second quarter of 2024, the number of ongoing Chapter 11 cases hit 2,462, marking it the highest in 13 years. By comparison, in the first quarter of 2022, bankruptcies were 60% lower at approximately 980.



Bottom line: Higher interest rates, rising prices and declining consumer spending are behind the surge in bankruptcies.

U.S. companies are ready for rate cuts.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"I wouldn't count my eggs on that outcome (soft landing)… I am a little more skeptical than other people."
— Jamie Dimon, CEO, JPMorgan

In anticipation of the Fed being behind the curve, the bond markets have driven yields down across the curve. The 2-, 5- and 10-year Treasury yields have already declined by 145, 120 and 100 basis points from the recent highs in April.

So, now that the Fed has finally cut rates, is the recent bond rally over?

Not if history repeats!

There have been eight interest-rate cutting cycles since the early 1980s. Each time, bond yields peaked many months before the first Fed easing as fixed-income investors sniffed things out well ahead of time. More importantly, each time, yields kept falling, which often came long after the rate-reduction cycle began.

During this stretch, there were eight easing phases including four recessions and four with the economy slowing but not contracting.

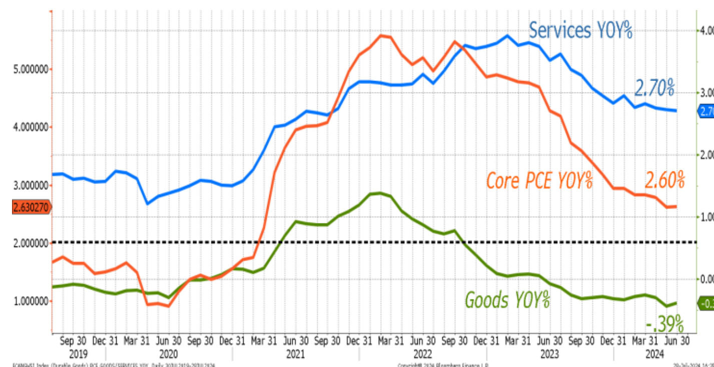
Here's the takeaway: It doesn't matter. On average, the decline in the 10-year Treasury yield from the cycle peak to the first Fed rate has averaged -140 basis points.

History also shows that the yield goes down an average of -150 basis points from the time of the first cut to the lows. So, if the past is prescient, it will take the 10-year Treasury yield down to 2.2%.

In other words, all roads lead to lower yields. Great news for Treasury securities.

Stick with the program. Continue to maintain a disciplined ladder strategy while buying into selloffs. The next big hurdle for the Treasury market will be the personal consumption expenditures (PCE) core index (the Fed's preferred inflation metric) released at the end of this week. The consensus for August has the core coming in at 0.2% month-over-month and 2.7% year-over-year.

As shown below, the core PCE index has already declined from nearly 4.0% to 2.6% year-over-year. Should the index come in below consensus, look for a continuation of the recent bond rally — especially on the short-intermediate part of the Treasury curve.



Stay tuned and have a great week!

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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