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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF SEPTEMBER 30, 2024

Got Gold?

"I didn't see anyone get fired for 9% inflation. I don't really see anyone taking responsibility not just for what that did to the purchasing power of people who have to use the U.S. dollar. That's our legal tender. But the psychological aspect as well."
— Judy Shelton, American Economic Advisor

We all get paid in U.S. dollars and I think the ultimate goal of the government and central bank should be to have sound money that does not show significant depreciation.

However, that is not what is happening.

Here's a very brief history of the Federal Reserve, monetary policy and the U.S. dollar.

In 1913, the Federal Reserve Act granted Federal Reserve Banks the ability to manage the money supply in order to ensure economic stability.

Fast forward to 1944, the U.S. dollar fixed to gold at a rate of $35 per ounce and became the world's reserve currency under the Bretton Woods agreement.

Meanwhile, the U.S. increased its money supply in order to finance World War II followed by the Korean war and the Vietnam war. Hence, the buying power of the dollar was reduced further.

By the late 1960s, the number of dollars in circulation was too high to be backed by U.S. gold reserves. President Nixon ceased direct convertibility of U.S. dollars to gold in 1971. This ended both the gold standard and the limit on the amount of currency that could be printed.

THIS WEEK

- NOTHING IN THE WAY
- HOME PRICES COOL OFF
- REFIS SOAR
- MORE LABOR PAINS
- MANAGEMENT SAYS…
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)
Partnership has its perks.
Hand over the hard parts.
TELL ME MORE!

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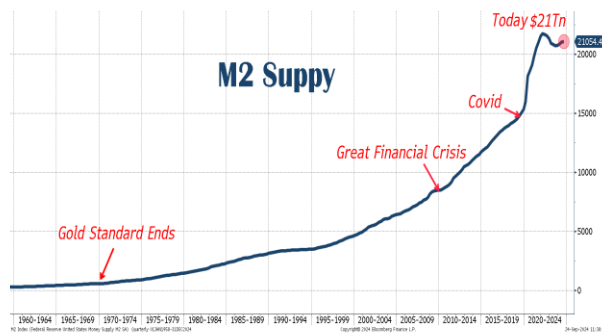
Today, the U.S. uses a government-issued currency that's not backed by gold. Otherwise known as fiat money, its value is derived from the "faith" of the government. In other words, it has value because the government says it does.

For the past few decades, both the Republican and Democratic parties have increasingly relied on fiscal expansion.

Currently, U.S. debt is $35.5 trillion and growing by $280 billion per month! And it won't stop there. The Treasury expects a $16 trillion increase in public debt between 2024 and 2034, without considering any recession risk.

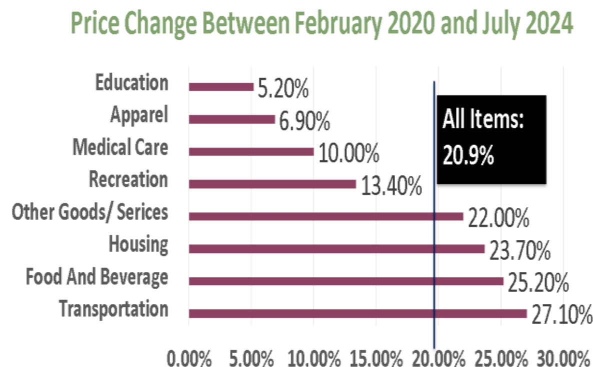
Making matters worse, unfunded liabilities (Social Security and Medicare) now amount to $72 trillion, almost 300% of the gross domestic product (GDP). The enormous government debt of $35 trillion, along with its subsequent additions, has the potential to destroy the currency.

To pay for this debt, the Fed cranked up the printing presses. Over the past two decades, money supply (M2) has skyrocketed from $4.6 trillion in 2000 to $21 trillion in 2024! During the Great Financial Crisis in 2008, Former Fed Chairman Ben Bernanke (aka "Helicopter Ben") turbo charged money supply growth in the U.S. This growth was ramped up in the wake of the pandemic. In fact, around 20% of all U.S. dollars in the money supply, $3.4 trillion, were created in 2020 alone!



This massive monetary experiment, reckless fiscal expansion and the pandemic supply and demand shocks drove the inflation rate to 9% at the peak — the highest level in 40 years!

To the average American, this is what the inflationary spike looks like. From February 2020 through July 2024, prices rose a cumulative 21%. Many of these items are necessities and cannot be substituted away (e.g., housing, food and transportation).



At the same time, this massive money printing experiment and fiscal largess drove asset prices higher (e.g., stocks, real estate and precious metals).

As shown graphically below, the big winner has been gold, which reached a new record high of $2,675 per ounce this past week. Over the past year, this barbaric relic is now up more than +40% — topping both the Nasdaq (+38%), S&P 500 (+34%) and the Dow (+25%).

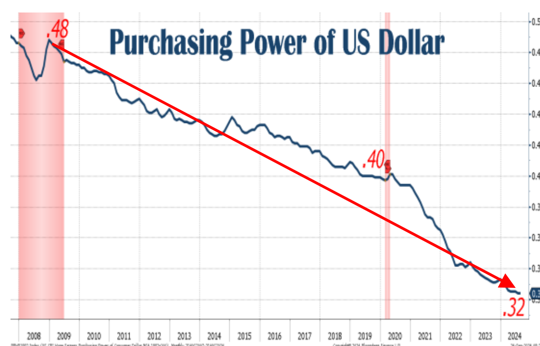
For those Americans that own assets, the price appreciation and wealth effect has more than offset the inflationary spike.

Sadly, the bottom 50% have no assets and have not benefited from the wealth effect.

The rising prices have reduced the purchasing power of consumers because a fixed amount of money affords progressively less consumption. Thus, the Fed, in its reckless money printing era, has impoverished those who rely on their paychecks to make ends meet.

As the graph below displays, the purchasing power of the "not so mighty U.S. dollar" has been steadily declining from $0.48 at the end of 2009, $0.40 pre-pandemic and now to only $0.32 today. In other words, the purchasing power of the U.S. dollar has declined by 33% over the past 15 years!

Unless you own a bunch of Nvidia, the "Magnificent 7" stocks or gold, the standard of living for many Americans has been destroyed over the past 15 years.



Consumers lose purchasing power regardless of whether the inflation rate is 2% or 4%. They simply lose it faster at a higher rate.

Going forward, let's say the Fed were to get down to 2% and another administration comes in for eight years. Eight years at 2% inflation is still 16% higher. This is significant. And that's on top of what we just had.

Think about this: If you buy a house, hold it for ten years while there's 2% inflation and you sell it at a 20% higher nominal price, you didn't gain a thing.

Where to from here?

Honestly, it's quite unlikely that anything will change. The Fed's policy will likely continue as it has in the past. If so, the dollar's purchasing power will continue to decline. And once purchasing power is lost, it is lost forever because central bankers won't let you get it back.

Fed Governor Chris Waller inadvertently made that perfectly clear in a recent CBNC interview.

> *"What's got me a little more concerned is inflation is running softer than I thought."*

He's "concerned" after we experienced a 21% jump in the cost of living since February 2020?

Tell that to the shopper at Walmart or Dollar General.

Bottom line: I think most Americans would agree that there's something really wrong with official central bank policy that deliberately seeks to debase the money every year by 2% and keeps claiming it's accountable for price stability.

Got gold?

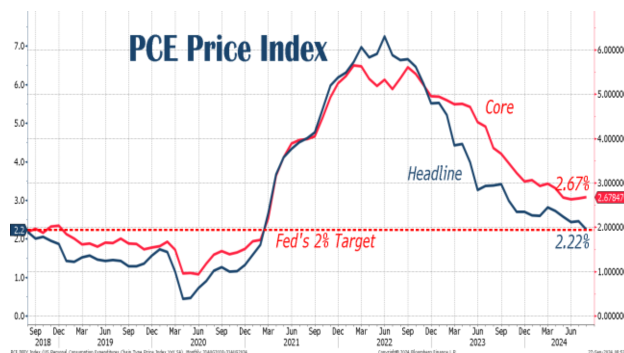
NOTHING IN THE WAY

In a perfect world, the Fed and U.S. government would emphasize a stable and strong dollar policy. But sadly, that is not the world we live in.

So, despite the discussion above, it's critical to understand that the Federal Reserve monetary policy is driven by the "rate of change" of inflation and **NOT** price levels.

Last Friday, the Fed's favorite inflation indicator, the Personal Consumption Expenditures Price Index (PCE), for August was released. The headline index rose a less than expected 0.1%, which drove the year-over-year rate to 2.2%.

Likewise, the core price index rose a less than expected 0.1% month-over-month, which means that the core PCE number has come in at +0.2% or lower in each of the past four months. This last happened in June 2020. Four months of data is not a blip, it is a pattern. It is a trend.



Underscoring the disinflation momentum, the three-month trend in the PCE price deflator is running at a +1.5% annual rate and the six-month trend is at +1.9%. It was the same story for the core PCE. The three-month pace is now at +2.1% (annualized) and the six-month trend is at +2.4%.

The disinflationary trend was broadly based as services were held to a mere +0.2% month-over-month gain (what happened to “sticky?”) and has accomplished this in three of the past four months as well.

Durable goods prices deflated outright by -0.2% sequentially after dropping -0.3% in July. They have now been roughly flat or negative in each of the past six months.

Non-durables fell -0.1% month-over-month (deflation readings in three of the past four months) as well and the year-over-year trend dipped into negative terrain (-0.2%) for just the second time since December 2020.

Bottom line: While the rate of change of inflation doesn’t help the two-thirds of struggling Americans who are “living paycheck to paycheck, it’s truly questionable whether Wall Street or the Fed really care.

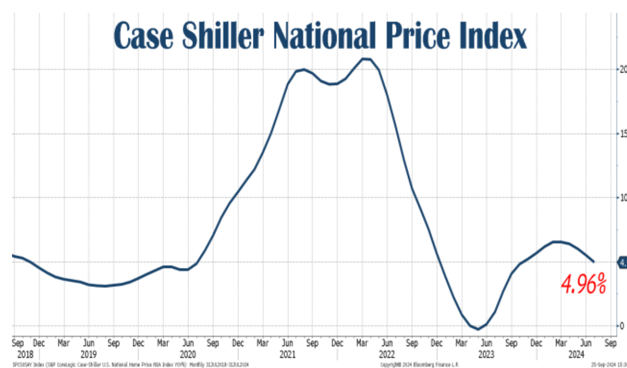
Regardless, all of the pundits who claimed that inflation (the rate of change) will remain “sticky” will need to wipe some egg off their face.

And yes, there is nothing that will prevent the Fed from continuing to cut rates.

HOME PRICES COOL OFF

House prices are finally — finally! — starting to cool off.

The key S&P CoreLogic Case-Shiller 20-city price index, which tracks the resale housing market, only eked out a +0.27% sequential gain —the softest pulse since the turn of the year. This pulled the year-over-year pace in the overall index to a nine-month low of +4.96% from +5.50% in June.



Even better, the three-month trend in the Case-Shiller home price index, which was running as high as +5.1% at an annual rate last March has now been pared to +2.6% (weakest trajectory since March 2023).

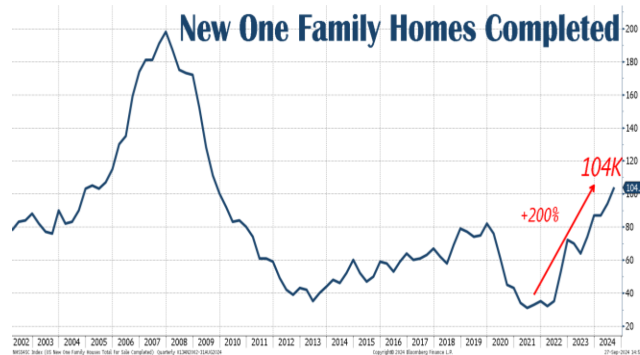
Meanwhile, new home sales fell -4.7% month-over-month in August to 716,000 annualized units. The only region that had any strength was the southern states. Sales spiked +2.7% after an +8.0% rebound in July and are back to carrying the load after a brief lull.

But try to tell a realtor in the Northeast about how great the housing market is, and you may get punched in the face as sales in the region sagged -27.3% month-over-month to a three-month low. Sales activity in the Midwest slumped -5.8% and are down in three of the past four months — tied for the lowest level since last February. The West suffered its worst performance since June 2023 and is down -17.8% month-over-month to a three-month low.

However, the supply of homes started and finished is the **BIG** story.

Inventory of new completed houses jumped by 46% year-over-year and by over 200% since mid-2021. In August, inventory was at 104,000 houses, the highest since November 2009. Finished houses are essentially move-in ready spec homes. But builders have a lot of capital tied up in these houses and are incentivized to move the inventory quickly.

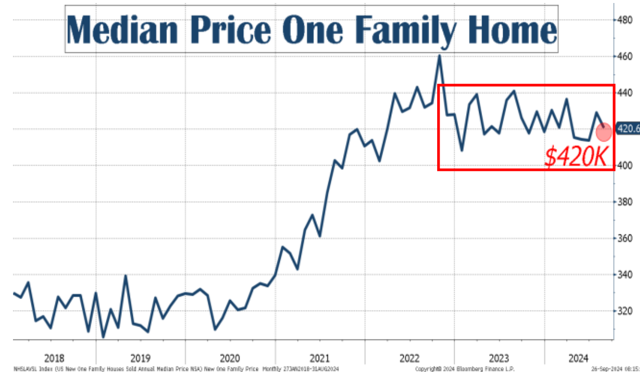
This buildup of spec houses is what the overall housing market needs the most, and it will help resolve the massive dislocations in prices that have befallen the housing market years ago.



Unlike homeowners sitting on vacant houses waiting for whatever, homebuilders have to build and sell houses to keep their businesses growing, and they're doing that. By discounting!

Indeed, median new home prices fell -1.6% month-over-month and have declined now in four of the past five months at a -4.6% year-over-year pace (a big swing from +2.1% this time last year).

The median price has dialed its way back to $420,600**,** which is where it was in March 2022. At $492,700, the average new home value is also back to where it was in March 2022. In other words, there has been no real estate inflation in new homes over the past two years.



Bottom line: Aggressive homebuilders are fast supplying the market with competitively priced houses, which will help resolve the pricing dislocation that has befallen the housing market years ago.

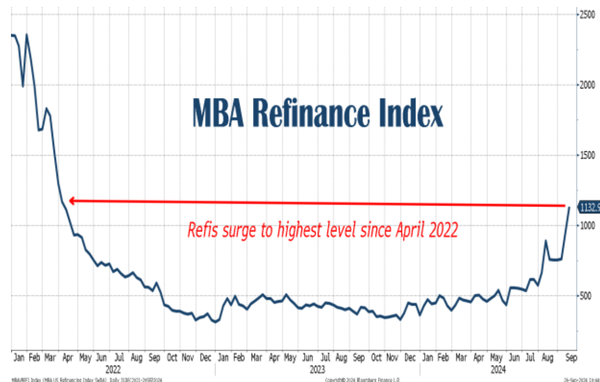
From an investing perspective it is encouraging to be seeing what is happening in real time home prices.

The big question is when will this slowdown in home price inflation begin to show up more forcefully in the dominant Owners' Equivalent Rent (OER) component of the Consumer Price Index (CPI)?

REFIS SOAR

The MBA's Weekly Mortgage Application Survey is finally waking up from its slumber through the week ending September 20.

However, it's mostly a refinancing story so far. Refinancing applications rocketed higher, as the pool of recent homebuyers with mortgages in-the-money grows every week that mortgage rates drop. The refinancing index jumped 20.3% in the week of September 20 to the highest level since April 2022. This was on top of a 24.2% surge in the prior week. Refinancings now make up more than half of total mortgage applications.



Here's an example: The average loan refinanced last week was around $386,000. If it were taken out a year ago and assuming that $4,000 in principal has been paid off in that time, the original loan amount was about $390,000. At a 7.41% rate when that loan was originated, the homeowner would pay $2,700 a month. But refinancing the remaining $386,000 into a new 30-year mortgage at the current 6.13% rate would translate to a payment just under $2,350. That's a saving of $350 a month or more than $4,000 a year.

It's not a huge pool of people — but it certainly is an eager pool of recent homebuyers "dating the rate" from the 7% to 8%+ mortgage rate era.

Bottom line: The current level of refinancing is still well below the average in the past three decades. After all, many Americans are still holding onto mortgages in the 2% to 3% range. Thus, for a more robust response in mortgage purchase activity, we likely need to get back to rates with a five-handle.

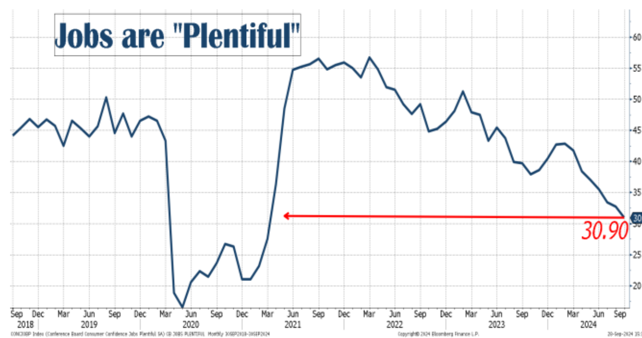
MORE LABOR PAINS

Despite record breaking stock markets, the Conference Board's version of consumer confidence proved to be a real dud in September as the headline came in at a three-month low of 98.7 from 105.6 in August.

The present situation subindex took a huge hit — plunging from 134.6 to 124.3, the lowest since March 2021. The "expectations" segment also sagged to 81.7 from 86.3 in August. Those stating that the economy is "good" went down to a ten-month low of 18.8% from 21.1%. Something is amiss with the economic backdrop.

Most importantly, in the labor markets, there are more signs that the labor markets are weakening faster that the unemployment rate or jobless claims suggest.

To wit: The "Jobs are Plentiful" category continued its downward trend with levels fast approaching the pandemic lockdown.



The category "Jobs are Hard to Get" rose again in August to 18.30 and the highest since 2021.

All I can say is that the Fed funds rate was nowhere near 5% back in March of 2021.

Bottom Line: The consumers' perception of the labor market is terrible. Only 30% of Americans in September said that jobs were "plentiful," the least since 2020. Over the last three years, this share has plummeted by 25%. At the same time, 18% of consumers believe that jobs are "hard to get," the largest share in four years.

Such deterioration has never occurred outside of recessions.

Given that the Fed's emphasis has shifted towards the labor markets, if job components of this report are a true indication of what is going on, look for more rate cuts between now and year-end as well as into 2025.

There is no fundamental reason to drop the constructive stance on fixed income.

MANAGEMENT SAYS…

The recent Bureau of Labor Statistics (BLS) data shows consumption remaining strong. Yet, whether it be the Beige Book or the underlying details of the most recent retail sales report, the message of a cautious consumer comes through loud and clear.

Consider the following comments and warnings from various retail management teams on the tough environment.

- **Lowe's:** "*We continue to see persistent pressure in bigger ticket DIY discretionary projects in flooring and kitchen and bath, consistent with the trends that began in third quarter of 2023."*
- **Target:** *"Consumers continue to focus on value as they work hard to manage their household budgets. And while they continue to turn out and shop around holidays and other seasonal moments many are delaying purchases until the moment of need."*
- **Amazon:** *"Consumers are being careful with their spend, trading down, looking for lower ASP products, looking for deals. That continued into the second quarter, and we expect it to continue into the third quarter."*

Does any of that sound like a strong and resilient consumer?

What spending is taking place is being done out of necessity and not in discretionary items. This is good news for the likes of Walmart and Costco (my favorite store) but is a headwind for most of the remaining retailers.

Bottom line: We're living in a world where official data does not reflect reality but eventually the official data will catch down to anecdotal data.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

In the wake of the Fed rate cut, longer-term yields actually rose. Does that mean that the rally is over?

Unequivocally no! The longer end of the Treasury curve always sells off in the aftermath of the first Fed rate cut on the mistaken belief that inflation will be revived. Then reality sets and yields melt like a hot knife through butter.

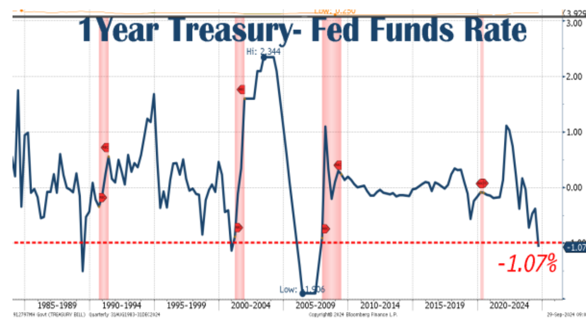
History also shows the early "sell the fact" that engulfs the bond market proves to be an extremely attractive buying opportunity. This is because in disinflation cycles, when the Fed is easing, with or without a classic recession, the trough in Treasury yields is down the road.

Take note: Only half the decline in the 10-year Treasury yield from the cycle peak occurs at the time of the first rate cut.

And I will stress again, you do not need a recession to be bullish on the Treasury market.

In the past, when the Fed begins an easing cycle, it reverses 80% of the prior tightening. If so, the Fed funds rate would decline to 1.75%. Moreover, the 2-year and 5-year Treasury yields would drop to 2% and 2.5%, respectively. So, I will continue to stick with history lessons.

In the meantime, the front end of the yield curve is pricing in 100 basis points of Fed rate cuts over the next year!



Also, as shown below, the yield curve has now pivoted to a positive slope, historically spelling the end of the economic cycle within the next three months. A period of inversion followed by an un-inversion has a 100% record of predicting recessions.

Will history repeat or "is this time different?"

Should the U.S. economy falter, look for the Fed to cut rates more aggressively.

Bottom line: Stay the course and don't freak out over daily or weekly gyrations.

Continue to maintain a disciplined risk-appropriate ladder strategy while buying into selloffs.

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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