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INVESTMENT SERVICES

Weekly Relative Value

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WEEK OF OCTOBER 15, 2024

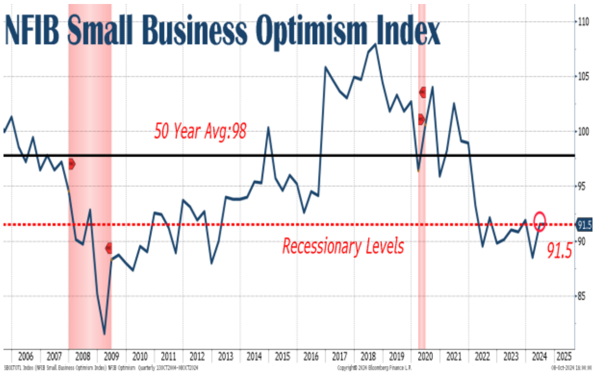
"U" Is for Uncertainty

There are 33 **MILLION** small businesses in America, and they generate 44% of the gross domestic product (GDP). They employ 61.7 million people, or 46.4% of the private sector.

And while many of the mega cap tech companies have posted strong financial results, U.S. small firms' profits have been falling for the past three years.

In September, a "net" 17% of small firms reported declining sales and a "net" 34% of small firms reported lower earnings. Over the past 40 years, outside of the pandemic, such levels have only been seen during the Great Financial Crisis.

Another way to take the temperature of small businesses is to look at the NFIB optimism index, which declined to 91.5 in September. To put the 91.5 on the NFIB headline in perspective, the long-run norm going back to 1975 is 98. Today, the index is at levels that in the past occurred only in **RECESSIONS**.



THIS WEEK

- SOMETHING DOES NOT ADD UP!
- WORK WEEK SHORTENS
- DEEP POCKETS OF UNCLE SAM
- CROSS CURRENTS
- I REMAIN ENCOURAGED
- CLAIMS SPIKE HIGHER!
- THE PROBLEM CHILD
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

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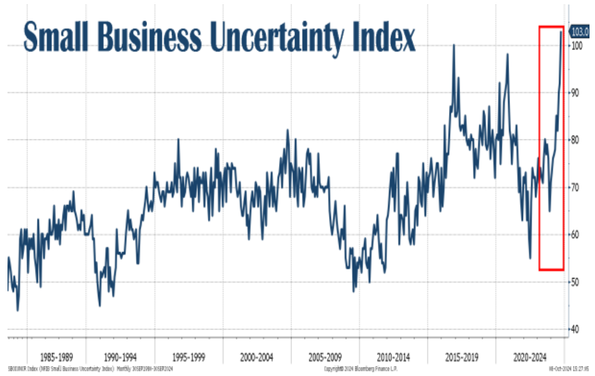
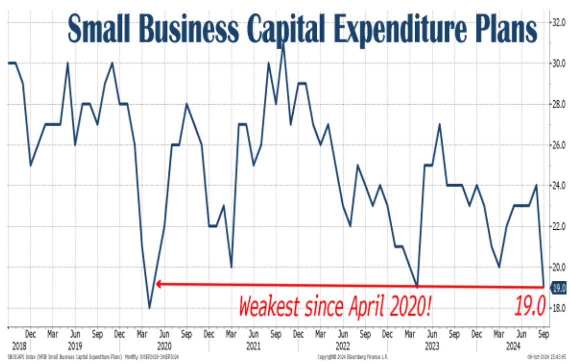
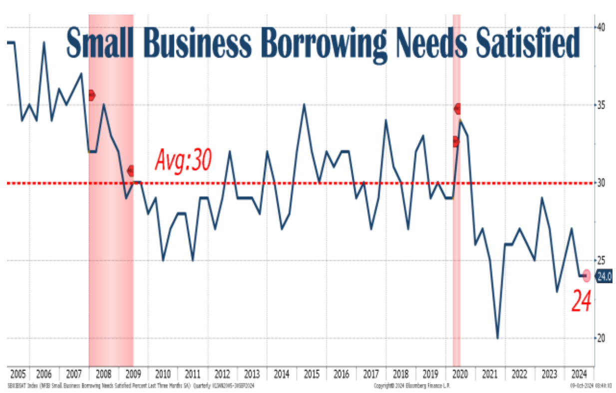
What was truly noteworthy was the surge in the "**UNCERTAINTY**." The Small Business Uncertainty Index rose for a third straight month by 11 points to 103, the highest **ON RECORD**. In June, the index stood at 82.



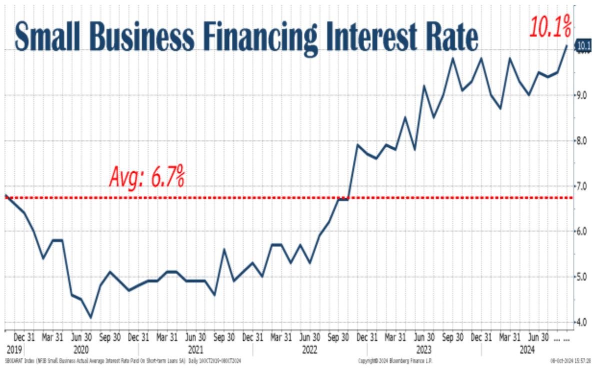
The reason for this uncertainty could be partly based on a number of factors (e.g., high prices, economic outlook, future fiscal/monetary policy confusion, election uncertainty, etc.), but the one thing we know about uncertainty is that savings take preference over spending. Indeed, the hallmark of this report was that capital spending plans slumped from +24 in August to +19 in September and is now tied for the weakest pulse since April 2020.



We also know that one of the biggest hurdles for small businesses is tough credit conditions. To wit: Only a "net" 24% of those surveyed say their borrowing needs have been satisfied over the past three months.



Furthermore, even with the Fed's rate cut, small companies have not benefitted as the average interest rate hooked up to an astounding 10.1% from 9.5% in August to the highest since February 2001. This is nearly 300 basis points above the average level of the past five years, which is an off-the-charts gap and attests to the fact that swaths of the economy are still operating under the conditions of a massive rates shock even after the recent jumbo rate cut out of the Fed.
It's safe to say that the small business community is having a difficult time with the higher cost of financing and would welcome some rate relief.



With uncertainty at such high levels, it's hardly surprising that small businesses have not been in a hiring mode with the hiring plans index at the lowest level since February 2020. Also, ADP data shows small businesses (1-49 workers) have been reducing workers for five months!

Bottom line: Small businesses are struggling. Inflation, elevated interest rates, falling earnings and election uncertainty all make a tough environment for small businesses to successfully operate.

It's important to stress that small businesses are the backbone of the U.S. economy and have a larger impact on economic and employment growth than large businesses.

SOMETHING DOES NOT ADD UP!

"It's remarkable to see a one-month 3% jump in government jobs. Perhaps these are the hall monitors for the polling booths. Or perhaps these numbers are just wishful thinking. One thing is for certain, the Fed gets a hall pass next month when the ugly post-Hurricane numbers come out" — Andrew Zatlin, Managing Director, Southbay Research

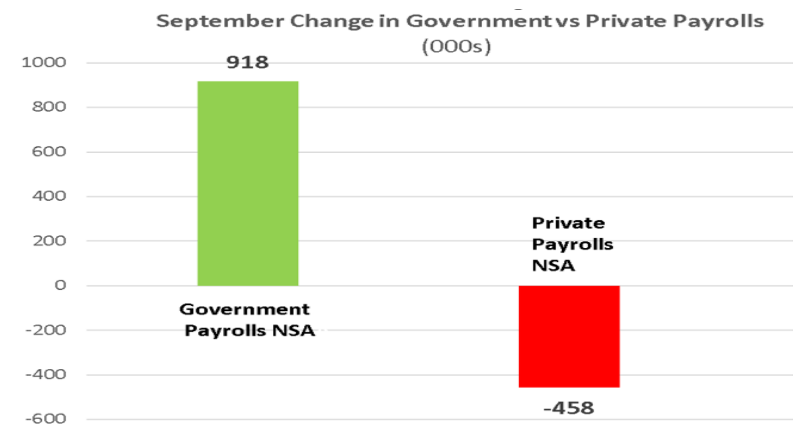
The Bureau of Labor Statistics' (BLS) math is often strange. This past month was a real doozie.

Assuming you believe in the reliability of September's employment data, let's look at what really is going on with respect to the job market scene.

We all know that the headline of the September employment rate showed +254,000 of jobs added and the unemployment rate dipping to 4.1% from 4.2%, and wages up by +0.4%. Nobody can debate these numbers. However, this is an entire report, not just a collection of widely watched headlines.

The weirdest bit of the payroll report was that the number of **not seasonally adjusted government workers** soared by 918,000 (from 22.54 million to 23.45 million) while the number of **not seasonally adjusted private sector workers** plunged by 458,000!

This was the biggest monthly surge in government workers on record excluding the outlier print in June 2020, which was a reversal of the record plunge from the pandemic collapse months before.



Source: BLS

The household survey showed the same story with a blowout of 785,000 jobs in the government sector. Get this, if not for the nearly unprecedented surge in government employment in September, the unemployment rate would have hooked up to 4.5% and not 4.1%. Are policymakers aware of that factoid?

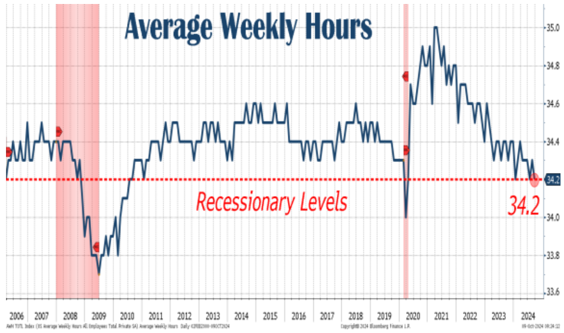
In a nutshell, government jobs have boomed while private jobs have tanked. The thing is a government worker can only be employed by taking tax money paid from a private sector worker. This means we are mostly shifting jobs from the private sector to the public sector. We are becoming a government dominated economy. At the margin, this rise in government bureaucracy makes the nation **LESS** productive and **LESS** prosperous. It is particularly unwise that most of the additional government employment is paid for by massive borrowing.

Bottom line: Sarcastically, as long as the Government continues to add jobs, who needs the private sector to do anything?

WORK WEEK SHORTENS

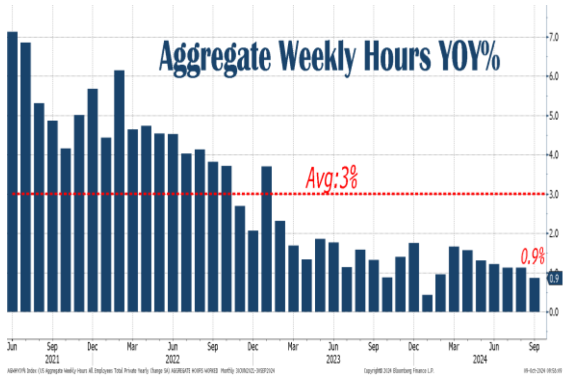
Beneath the surface of the better-than-expected payroll gain, it's important to highlight that while employers may be reluctant to lay off employees (always the last option), employers are reducing the hours worked.

The September payroll report showed that the workweek declined -0.3% decline to 34.2 hours, which is below pre-pandemic levels and consistent with recessions.



Moreover, the shorter workweek more than offset the near +0.2% increase (254,000) in headline payrolls.
The aggregate hours index is a statistic that measures the total hours worked by all employed people. As shown graphically below, in September, the year-over-year trend in the aggregate hours worked index has declined from +3.8% two years ago to +1.3% a year back to now stand at +0.9%.

This means that even with the rise in average hourly earnings, the - 0.3% drop in the workweek means that hours worked (which determines total work-based incomes) only edged up by less than +0.1% month-over-month. This implies that there was flat-to-slightly-negative take-home pay last month. So, while one can easily argue that there is no recession, we clearly are in a growth turndown.



Finally, and most importantly, the BLS payroll number is an "estimate" and was based on a near-record-low response rate of 43%. Before the pandemic, the response rate was over 60%. This means last month's data was largely incomplete and the 254,000 September payroll creation number is likely overestimated. And keep in mind that 75% of the time in the past year, those revisions have been to the downside. This year alone, non-farm payroll employment has been revised down by 293,000 jobs.

These blemishes in the payroll report have not gone unnoticed. To wit: At an ECB conference in Frankfurt, it was encouraging to see Fed Governor Adriana Kugler downplay what was truly a dubious payroll report (citing downward revisions) and signal that the headline is not going to deter the Fed from continuing its plan to normalize the funds rate. Thus, not all Fed policymakers are putting as much faith in the payroll data as is the case with bond traders.

"If progress on inflation continues as I expect, I will support additional cuts in the federal funds rate to move toward a more neutral policy stance over time. " — Adriana Kugler, Federal Reserve Board of Governors

Bottom line: Let me close by stating that the jobs reports have been "garbage" lately, but this one wins the blue ribbon for worst yet.

Again, I need to stress the point that the headline data is an estimate riddled with sampling errors. I am confident something went totally nuts in BLS sampling or assumptions, and the economy did not suddenly add nearly 800,000 government workers in September.

I expect major downward revisions ahead.

DEEP POCKETS OF UNCLE SAM

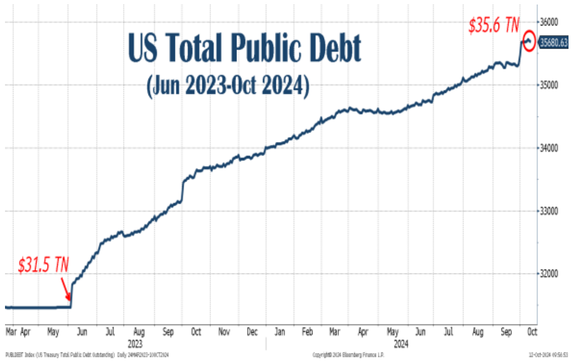
The reality is that while there are wide pockets of weakness in the economy, the Atlanta Fed's GDP Now model is currently showing a "head scratching" real GDP growth of 3% for the third quarter of 2024.

This is quite bizarre because the most recent Beige Book reported that three-quarters of the economy is now in contraction or stagnation mode. The other 25% are seeing their activity growing "slightly." Yet, somehow, that translates into a 3-handle on real GDP growth.

So, what's going on?

There is a wide gap between the weak business survey data and the stronger than expected BLS data because the latter reflects the ongoing government sector spending, especially state and local spending, which is not being reflected in numbers from business polls.

As shown below, U.S. Government debt has soared by over $4.1 trillion in just 16 months and hit a **WHOPPING $35.6 TRILLION**, a new all-time high!



Amazingly the budget shortfall for the 2024 fiscal year has hit $1.8 trillion (7% of the GDP), the highest in three years. In the past such high deficits were only seen during World War II, the Great Financial Crisis and the pandemic lockdown.

If you're wondering why the U.S. economy simply refuses to cool off, it boils down to a secular bull market in government spending. In other words, the underlying weakness in the real economy has been disguised by the deep pockets of Uncle Sam.

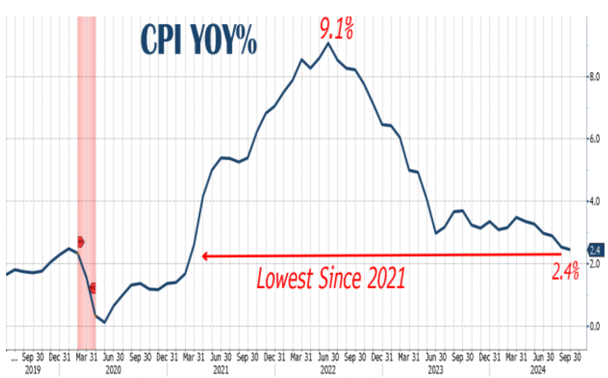
Bottom line: The U.S. has become a Potemkin like economy dependent on massive government spending.

Simply put, you're witnessing the best economy with $4.1 trillion in new debt over the past 16 months!

CROSS CURRENTS

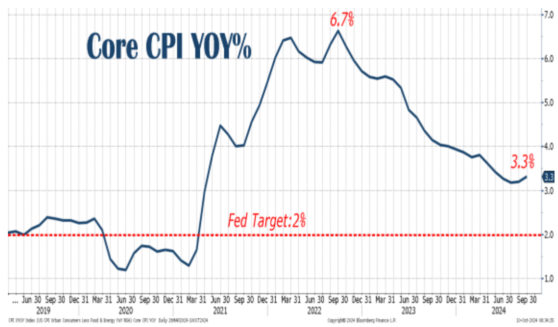
September's Consumer Price Index (CPI) ticked up more than expectations, posting a 0.2% monthly increase. Even still, the disinflationary progress has been quite respectable with the year-over-year headline inflation rate falling to +2.4% from +2.5% and +3.7% a year ago. The last time it was this low was in February 2021, more than a full year before the onset of the Fed's most aggressive policy stance since the early 1980s. Moreover, it is just 40 basis points away from the Fed's target.

Despite the naysayers, when taking a step back, the nearly 7% decline in inflation over the past two years has only happened three other times in the past, the early 1950s, mid-1970s and early 1980s. What makes this deceleration all the more impressive compared to the others is that it did not require a recession this time around.

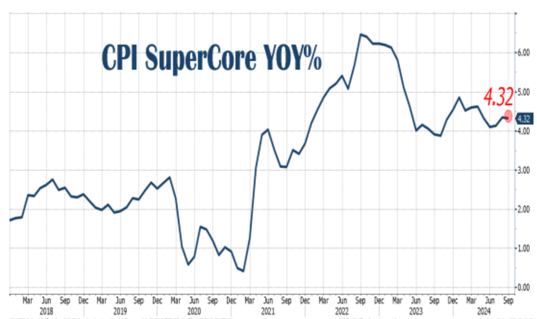


However, as is always the case, what matters most for the markets and Fed policy is the core CPI index. For September, the core clocked in at a hotter-than-expected +0.3% for the second month in a row and year-over-year to +3.3% from +3.2% in August.

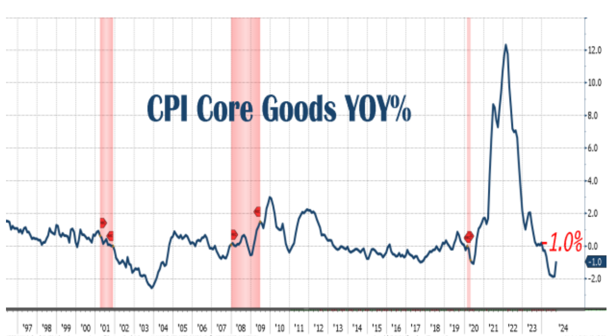
As shown below, even though much lower than the peak of 6.7% rate in 2022, and lower than the +4.1% pace a year ago, the downtrend in core inflation has stalled out now in each of the past four months. The three-month trend in the core CPI is back running above a +3% annual rate (+3.1%) for the first time since last May, which is before the Fed began to set the table for the eventual rate cutting cycle.



Also, Fed Chairman Jerome Powell's favorite reading, the super-core index (excluding energy services that strips out the rental components), rose a hefty +0.4% month-over-month as well, which was the strongest print since last April.



Also noteworthy, the deflation trend in core goods prices came to a thundering halt, rebounding +0.2% after three months of decline and the biggest sequential increase since May 2023.



While the core CPI indices did come in above expected, what was interesting was that the CPI (excluding rent) came in at +0.1% for the third month running. I know we all need a roof over our heads, but it does go to show that the vast components in the CPI are still well behaved. The question is how will the Fed read this?

Fed Governor Christopher Waller noted on Monday that the Fed needs to use more "caution" going forward but echoed Powell's refrain of not overreacting to data and instead looking at the "totality." Minneapolis Fed President Neel Kashkari also spoke Monday in vague terms of "moderate" cuts over coming "quarters," reiterating the fact that this Fed is looking as much as it can before it leaps

Bottom Line: While the Fed has commenced in a new rate cutting cycle, clearly the recent stalling of the disinflationary trend in the core CPI will embolden the hawks on the Federal Open Market Committee (FOMC) to push back harder on further rate cuts.

I REMAIN ENCOURAGED

"With regard to housing services prices, some participants suggested that a more rapid disinflationary trend might emerge fairly soon, reflecting the slower pace of rent increases faced by new tenants."
— September 2024 FOMC minutes

Despite the discussion above, the encouraging news was that the rents and the Owners' Equivalent Rent (OER) components (40% of the core CPI) are now well off the boil. Moreover, this should be sustained as the backlog of "old leases" when rents were high gets replaced by "newer" leases. This is key: Rent inflation for new tenants leads the official data by 12 months.

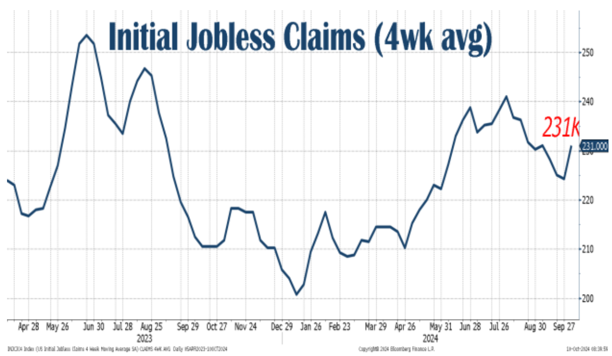
To get a more complete and timely picture of what is going on regarding rents, have a look at the All-Tenant Rent Index published by the BLS and the Cleveland Fed. This index combines both new and existing rents, and typically leads CPI shelter by one quarter and commands a 96% historical correlation.

As shown graphically below, this index is currently running at +4.0% year-over-year, or -90 basis points below the pace of shelter inflation as measured by the CPI. So, if this relationship continues to hold, and assuming there are no offsetting inflation surprises, deceleration in shelter inflation will show up within the next couple of CPI reports. This will push down the headline and the core indices.

Bottom Line: Shelter costs are the largest component of the CPI. Assuming no upside surprises in other components of the CPI index, the "catch-down" in shelter inflation may allow headline inflation to reach the Fed's target by the end of this year. Against this backdrop, the data will continue to evolve in favor of the Fed to continue easing despite increased market chatter otherwise.

CLAIMS SPIKE HIGHER!

The jobless claims data for the week of October 5 supported the bond market after the result of the CPI report. Obviously, the question is how much of this was weather related, but nevertheless, claims jumped to 258,000 from 225,000 — far above consensus views of 230,000. This is the highest reading in 14 months!



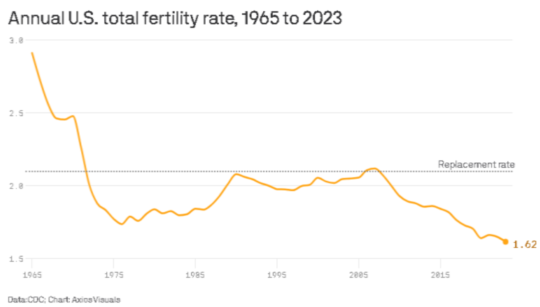
Not to mention that the backlog of continuing claims spiked (September 28 week) to a two-month high of 1.861 million from 1.819 million thus underscoring the fact that the labor market is building up slack.

Also, the problem with continued claims is that benefits in 48 of 50 states expire after 26 weeks. Once a person hits 27 weeks, they are still unemployed but they have no claim. In other words, the number of unemployed Americans could be much higher than what the claims data says.

Bottom Line: There have been many crosscurrents of late, to say the least. However, the Fed's job is to strike a balance between inflation and the labor market. Since monetary policy works with a lag (in both directions), the 50 basis points of additional cuts by year-end projected by the Fed should remain the base case despite markets starting to move against those projections.

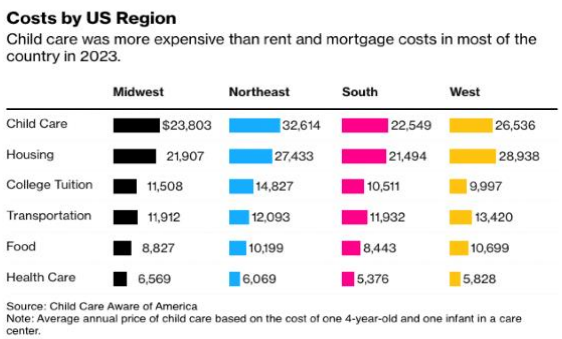
THE PROBLEM CHILD

The total number of births in the U.S. declined an average of 2% per year from 2015 to 2020, then rose slightly in 2021 — but has now fallen off again. According to the CDC, the fertility rate in the United States decreased by 3% from 2022, reaching a historic low. The U.S. fertility rate in 2023 amounted to about 1.62 births per woman — well below the "replacement rate" of 2.1 that would allow a generation to completely replace itself.



This is one of the biggest problems we have as a country. No children. No population growth. No economic growth.

While there may be other reasons for not having children, I know tons of young people that aren't having children because of the prohibitive cost of childcare. As shown below, **childcare costs are more expensive than housing costs in most of the country**…just ask my son!



The U.S. economy needs population growth to grow.

Here's a potential solution: There are plenty of seniors with underfunded retirements. Perhaps a new trend will be living rent-free with a younger family in exchange for childcare services?

Could be a win for all parties.

Bottom line: In my humble opinion, we're going to see all sorts of creative new models to deal with the high cost of living. Sadly, if not, population growth will continue to decline, which will weigh heavily on future U.S. economic growth.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"But the Fed is cutting for a reason, and it's because they are seeing the economy slow. And that helps the bond market and inflation come down. In each of the last instances where yields initially rose, they eventually fell much lower and we don't believe this time will be any different." — Barry Habib, CEO, MBS Highway

The Fed's power is mostly over short-term rates, primarily the overnight federal funds rate. I suspect the Fed thinks its rate cuts at the short end would be accompanied by similar but slower declines at the long end, eventually restoring the yield curve to its normal shape. If that was the theory, it's not happening yet. Long-term Treasury and mortgage rates are actually **up** since the Fed began cutting.

Since the Fed cut rates by 50 basis points on September 19, longer term Treasury yields have risen sharply. As shown below, the 10-year Treasury yield has risen from 4.05% before the Fed rate cut to 4.39%. Mortgage rates take their cue from the 10-year Treasury yield, and they have risen by nearly 40 basis points to 7%.

Likewise, yields on the front end of the curve have risen. The 5-year Treasury yield has risen 38 basis points to 3.92% whereas the 2-year Treasury yield has risen to 3.95%.

While the yield back up seems counterintuitive, it is quite normal to see rates rise after the first rate cut. The first rate cut always triggers a risk-on trade that causes the 10-year Treasury yield to rise on the view that the Fed's cavalry came to the rescue, minimizing recession risk and re-igniting an inflation cycle. This is the market psychology 100% of the time in the past. In fact, going back to 1984, every time the Fed cut rates, the 10-year Treasury yield has risen by 35 basis points just as we have seen this time around.

However, it doesn't matter whether or not the first Fed move is about a recession. From the time of the first cut to the eventual cycle low (including both recessionary and non-recessionary periods), the average decline in the 10-year Treasury yield averages out to be -260 basis points.

At the same time, I will be the first one to say that if the September payroll report was not some sort of seasonal maladjustment quirk, and if the disinflation does not reassert itself, we could well be in for a pause and the next rate cut could be a long way off. If so, the Treasury market could be in for more volatility and weakness ahead.

Moving forward, the key to the timing and magnitude of further rate cuts will be the personal consumption expenditures (PCE) index — the Fed's preferred inflation metric, which will be released on October 31. Currently, the consensus expects the PCE to slow to 2.6% year-over-year.

Bottom line: As I mentioned last week, the recent incoming data has been quite volatile, unpredictable and subject to significant revisions. The month is still young, and a lot can happen. Let's see what happens over the coming months.

In the meantime, stay the course. 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.