Weekly Relative Value

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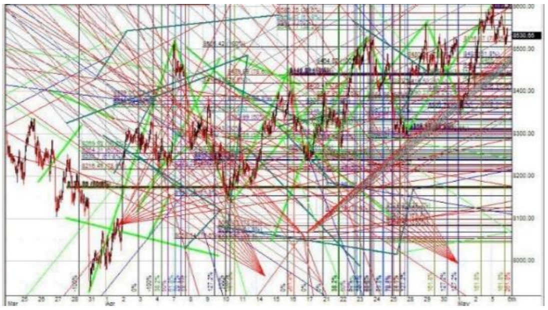
WEEK OF NOVEMBER 4, 2024

Volatility!

"You hope and pray every day that our political leaders in this country can find a way to work together and work on solutions for the country and not be so bifurcated as we have been." — David Marriott, Chairman, Marriott

We are **ONE** day away from one of the most highly contended and contentious elections of our lifetime (or at least in my time on Earth). Based on everything we hear and read, it appears that the turnout could be the largest ever. Over 76,000,000 Americans (48% of registered voters) have already cast their vote! And if the polling experts are correct (**BIG** assumption!), the winner of the election will come down to a handful of counties in the battleground states. So, who will win? Will it be a "red sweep," "blue wave," or a "split" government?

And what does it mean for the economy and markets? There are many proposed policies impacting debt/deficits, taxes, tariffs, inflation and regulation on the table. Depending on the outcome of the election, so many scenarios could unfold. The graph below provides a view of the various election outcomes and market scenarios.



THIS WEEK

- NO RECESSION IN SIGHT
- MIXED NEWS ON INFLATION
- JOLTED!
- FISHY WITH A CAPITAL "F"
- WEAK PAYROLL REPORT
- IT'S THE STOCK MARKET, STUPID!
- A BLESSING AND A CURSE
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

Seriously, there are exceedingly high odds that we could wake up on the morning of November 6 and not know who won the election. If so, this could make the period of political uncertainty following the 2000 Gore vs. Bush election a walk in the park.

If you recall, uncertainty during that election lasted a good month before the Supreme Court ultimately declared Bush the victor. Although he received 540,000 fewer votes nationwide, he walked away with a win of five electoral college votes… including all those "dimpled chads" in Florida.

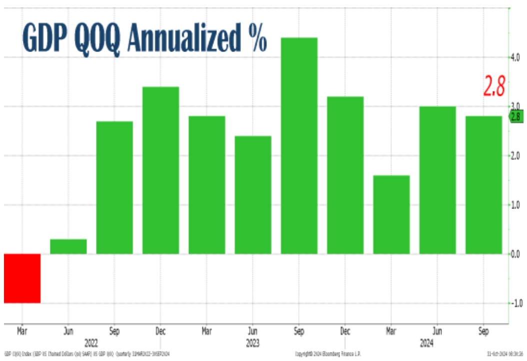
Bottom Line: This will be the mother of all contested elections, especially with the uncertainty from all the potential recounts, legal challenges, fake controversies and conspiracy theories on social media. As such, the "theme" for the coming month may well be elevated "volatility" across all asset classes.

Here is my advice regarding tomorrow's election: Unless the pollsters are wrong again (I repeat, a distinct possibility), and this is a blowout election with a clear-cut winner, we will likely not know who won the electoral college vote on Election Day. So, don't stay up all night on November 5 and get some sleep.

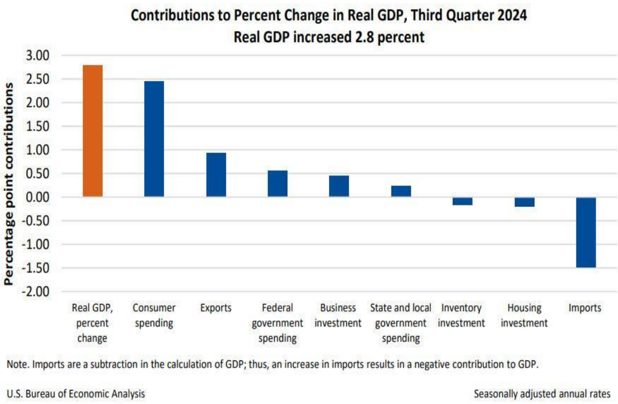
NO RECESSION IN SIGHT

Last week was replete with key economic data on gross domestic product (GDP) economic growth, inflation, the labor markets, housing, trade and consumer confidence. Below I will discuss some of the key findings.

The Bureau of Economic Analysis (BEA) came out with a surprise when it reported in its first assessment of Q3 GDP that the U.S. economy grew at a 2.8% rate, which is down from 3.0% in Q2 and below the consensus forecast of 2.9%.

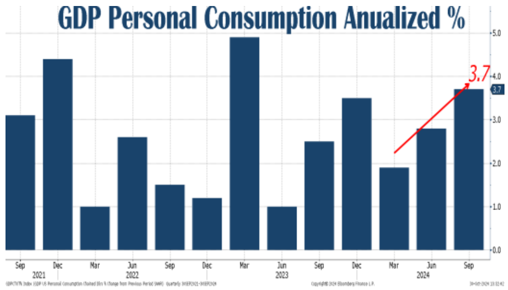


As the BEA notes, the increase in the third quarter primarily reflected increases in consumer spending, exports and federal government spending. Imports, which are a subtraction in the calculation of GDP, increased.



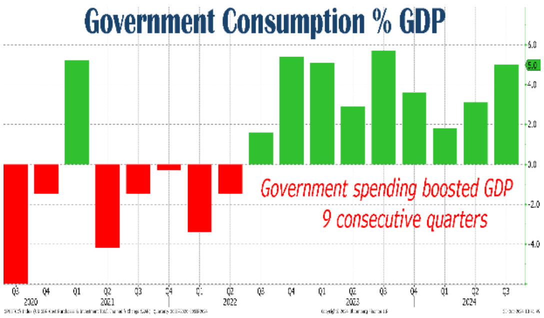
While the overall number was weaker than expected, looking at the components, personal consumption surged more than expected by rising 3.7% compared to the 3.3% expected and 2.8% in Q2! The quarter personal consumption added 2.46% to the bottom-line number, up from 1.90% and accounted for 86% of total growth in Q3! The energized consumer keeps on spending.

There was not one component on the consumer side that declined. There was tremendous strength in the goods sector with motor vehicles rising at a rate of +9.7% annualized, furniture/appliances at +8.8%, recreational goods at +8.2% and clothing at +3.8%. Services were less strong but still decent. They were led by transportation at +4.4%, restaurants at +3.9%, and recreation at +3.5%.



In addition to the all-important consumer, Uncle Sam continued to support growth expanding at a +5.0% annual rate in the quarter. In a sign of the times, there was a huge +14.8% annualized spurt in defense spending — the largest defense spending in over 20 years!

As shown below, the government has contributed to "growth" for nine consecutive quarters, and Q3 saw the biggest addition in the past year.



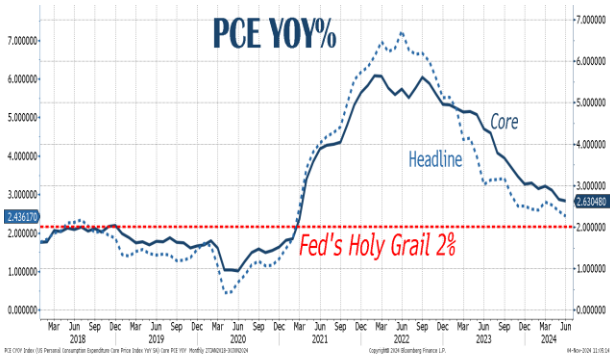
But with government debt fast approaching $36 trillion (120% of GDP), and interest costs now exceeding what the U.S. government spends on national defense, how long can this egregious out of control government spending continue? This is especially true if interest rates stay elevated. $50 trillion of debt at 4% interest rates? That's not unthinkable. There is a nontrivial chance that we will see that outcome by the end of the decade.

Personally, I'm frustrated that debt is barely an issue for either candidate. I do know why — they talk about the issues they think will motivate their voters. But the harsh reality is that we won't fix all those other problems unless we get the debt under control. We're spending way beyond our means and living on debt. At some point, the bond vigilantes will emerge with a vengeance.

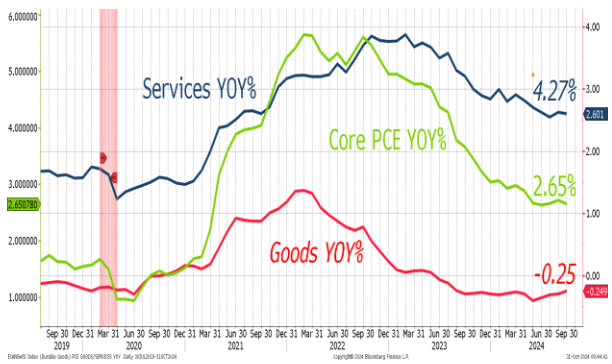
Bottom line: Let's face it, it is not difficult to generate economic growth with policies that promote asset inflation (and the "wealth effect" on spending from that) and mammoth fiscal expansion (with back-to-back years of 6%+ deficit-to-GDP ratios). Approximately 40% of the GDP gains this cycle have come from these two sources alone. That said, one of the final snapshots before Election Day shows that America is on solid footing with no recession in sight.

MIXED NEWS ON INFLATION

The headline personal consumption expenditures (PCE) deflator came in as expected at +0.2% month-over-month. This took the year-over-year rate to +2.1% from +2.3% in August. The core index (excluding food and energy), which carries even more significance, rose +0.3% but that failed to trim the year-over-year rate that remained at +2.63% — that is disappointing.



As shown below, goods prices (-0.1%) dipped for the fifth month in a row and are now down -0.25% year-over-year. Service prices (so much of it imputed) rose +0.3% month-over-month, which was the strongest increase since last March. Year-over-year, service inflation is 4.27%.



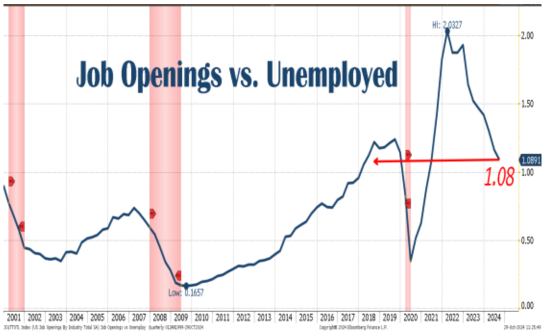
Bottom line: There was something for everyone in this report, bond bulls and bond bears**.** That said, from my perch, and illustrated in the graphs above, the fundamental inflation trend is still heading lower and that is the real key.

JOLTED!

Job openings fell sharply in September and were revised down in August to just 7.443 million. This was a drop of over 400,000 openings month-over-month. For the year, openings are now down 1.9 million. This is a signal of continued labor market weakening and slower hiring ahead.

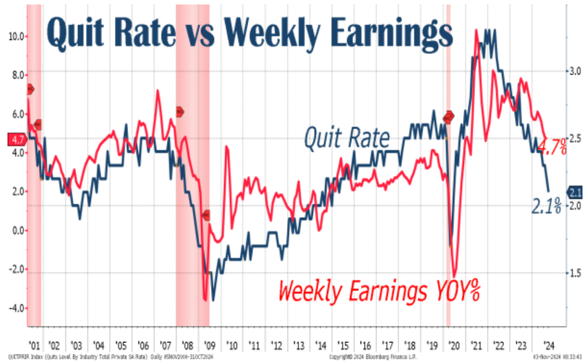
The most recent data for August has been adjusted **DOWN** by 179,000. I should also note that monthly job openings data has been **REVISED DOWNWARD** in 15 out of the last 20 months, the most in at least **15 YEARS**. Makes one wonder what else will be "revised" down in the labor market.

Additionally, there are now fewer than 1.1 posted job vacancies for every worker counted as unemployed in September, which is well below the pre-pandemic level. Suffice it to say, the labor markets have normalized.



Further evidence of a weakening labor market was witnessed with layoffs jumping by 160,000 in September to 1.83 million, the second highest in four years. Monthly layoffs have increased by 540,000 (or 42%) over the last three years. As a result, the layoff rate, measuring the number of layoffs as a percentage of total employment, rose to 1.2%, which is the highest since December 2020.

Finally, for the all-important private-sector, the hiring rate ticked up to a still-low level of 3.8%. Also, tack on the fact that the best leading indicator there is when it comes to assessing worker confidence and future wage growth showed that the quitting rate was 2.1%, near a 10-year low. Thus, companies remain reluctant to hire and those that have jobs are sitting tight. The job-hopping craze of the pandemic are long gone.



FISHY WITH A CAPITAL "F"

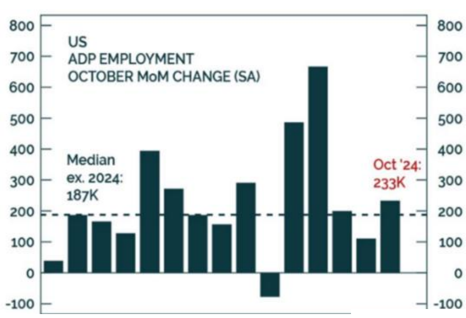
"Even amid hurricane recovery, job growth was strong in October… Hiring at U.S. companies accelerated sharply in October with the strongest payrolls gain in over a year, highlighting surprisingly strong labor demand."
— Nela Richardson, Chief Economist, ADP

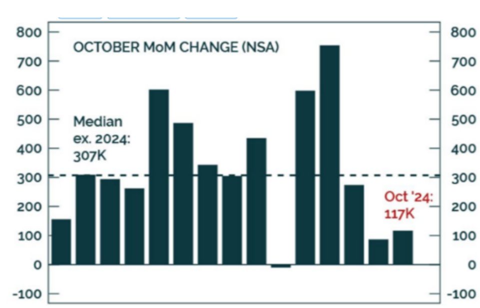
Despite the weak Job Openings and Labor Turnover Survey (JOLTS) report**,** according to the ADP Research, private payrolls increased by 233,000 in October, twice the consensus expectation of 111,000! Manufacturing was the only sector to lose jobs while education services, health services, trade and transportation posted some of the strongest advances.

But this report looks "fishy" with a capital "F!"

The seasonally adjusted (SA) gain was +233,000, which was double the consensus forecast. However, the non-seasonally adjusted (NSA) gain was a mere +117,000. The +116,000 differential was the widest on record. Normally, the NSA number is above the SA number for October, but for whatever reason, it was not this. The average spread in all Octobers in the past was actually -105,000.

In other words, if you applied the normal seasonal adjustments of the past to the headline print it would have been closer to +128,000, and very close to the consensus estimate instead of the +233,000 number we had to digest.





Source: ADP

Bottom line: It was another "fishy" ADP report. The seasonally adjusted print was stronger than in a typical October but the raw print without any adjustments was much weaker. Something doesn't add up.

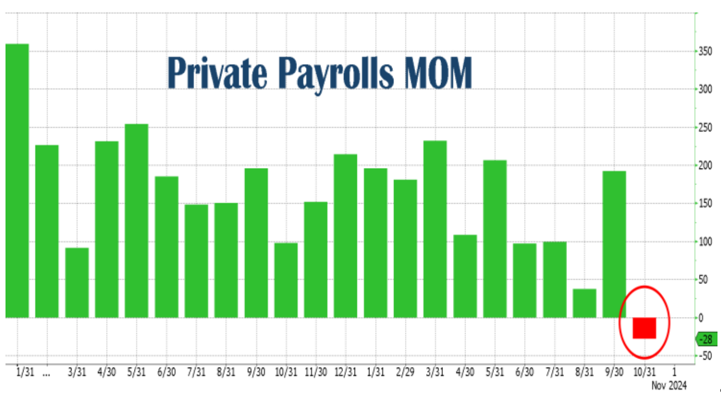
To modify the famous Mark Twain refrain: **There are lies, damned lies, statistics… and seasonal adjustment factors**.

WEAK PAYROLL REPORT

"It is likely that payroll employment estimates in some industries were affected by the hurricanes; however, it is not possible to quantify the net effect on the over-the-month change in national employment, hours, or earnings estimates because the establishment survey is not designed to isolate effects from extreme weather events. There was no discernible effect on the national unemployment rate from the household survey."
— Bureau of Labor Statistics (BLS)

To end the week, the BLS reported that monthly non-farm payrolls were a skimpy 12,000, which was a huge drop from the pre-revision of 254,000 in October (revised naturally lower to 223,000) and just 13,000 away from a negative print. But if one excludes the 40,000 government jobs, private payrolls were in fact negative to the tune of -28,000. Private payrolls were down from the 223,000 pre-revision last month and had the first negative print since December 2020. To be sure, a some of the drop was due to the one-time events including the Boeing strike and Hurricane Milton.

Furthermore, the three-month moving average has declined to 67,000, the lowest since the 2020 pandemic. This is well below the average of 150,000 monthly private payroll additions seen in 2018-2019 prior to the pandemic.



The worst part?

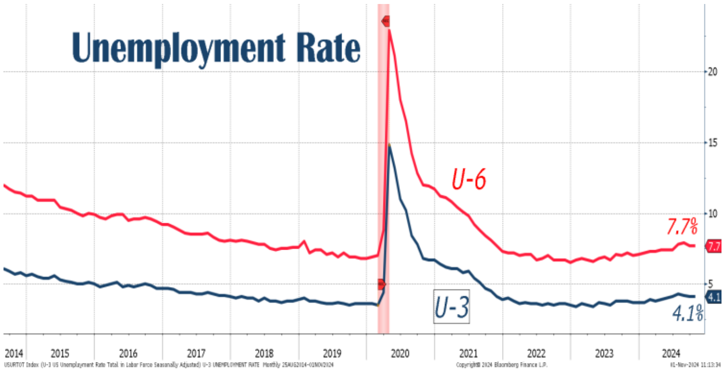
Full-time private sector jobs have dropped by a whopping **1.5 MILLION** year-over-year. Such a drop in full-time private jobs has never been seen outside of recessions.

And of course, there were **REVISIONS**. Employment in August and September combined was 112,000 lower than previously reported. The number of jobs have been revised downward in seven of the past nine months. This means that so far in 2024, the non-farm payroll data has been revised **DOWN** 80% of the time and by a cumulative of -337,000. This makes the numbers increasingly unreliable.

So why does the bond market trade off of these anymore? Regardless, downward revisions speak to a labor market on far shakier ground than is commonly perceived.

Last week, the mainstream Pollyanna narrative was that we should ignore the payroll survey because it was distorted by the hurricane and should focus instead on the household survey. Okay…. but the household survey showed that employment fell by 368,000 alongside a -220,000 reduction in the labor force. While it's true 512,000 people were "not at work" due to the hurricanes, that does not mean they were counted as "unemployed."

The unemployment rate U-3 and U-6 stayed the same at 4.1% and 7.7%, respectively. They were unchanged from last month and in line with expectations. That said, both numbers would be way higher were it not for millions dropping out of the labor force over the past few years.

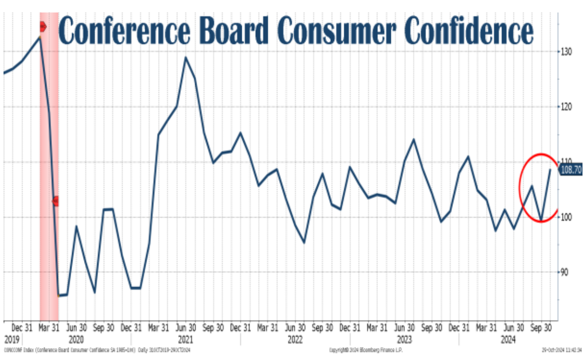


Bottom line: The labor market may not be as strong as it seems. I remain highly skeptical of the BLS monthly reports in general. Even accounting for the effect of hurricanes and strikes, this was a weak payroll report, especially when downward revisions to the past two months are considered. Further, the household survey, which sets the unemployment rate, did not seem to be impacted by the hurricanes. Finally, full-time employment is down by more than a million from a year ago. Don't pin that on hurricanes. Expect more negative revisions to come.

Once again, all of the above is a reminder that real time economic data is not reliable and is frequently revised. Federal Reserve Chairman Jerome Powell's strategy of data dependency depends on undependable data.

IT'S THE STOCK MARKET, STUPID!

The Conference Board's Consumer Confidence Index absolutely hit the lights out jumping from 99.2 in September to 108.7 in October. The nearly 10-point surge was the steepest for any month dating back to March 2021 when the mammoth Biden stimulus checks were mailed out (to anyone who had a pulse). All that said, the surge in this volatile indicator merely brought it back to where it stood at the turn of the year.



Confidence was buoyed by improved sentiment in the jobs market. To wit: Six-month expectations for more jobs rose to their strongest level since December 2022.

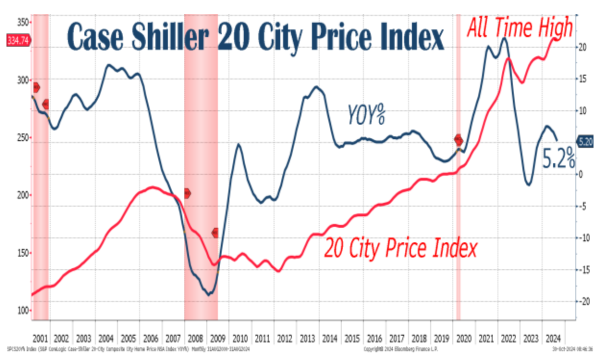
Even more than the jobs market outlook, it was **EUPHORIA** over the equity market that carried the day. The share of U.S. consumers expecting higher stock prices over the next 12 months hit 51.4%. This is the **HIGHEST** rate since this question was first asked in 1987. The percentage even exceeded the Dot-Com Bubble levels. Fewer than 24% of the respondents dared to have a negative view on the market — less than half the bull population. Sentiment is quite literally off the chart! Hopefully, this is not a contrarian indicator.

Bottom line: If you are wondering why consumer confidence shot the lights out in October, wonder no more. As James Carville would say, "it's the stock market, stupid!"

A BLESSING AND A CURSE

"It's going to put a damper on sales – affordability has gone down and the lock-in effect has increased… We think we'll need a sub-5.5% mortgage rate to unthaw the housing market, which probably doesn't happen any time soon unless we go into a recession." — Scott Buchta, Head of Fixed Income Strategy, Brean Capital

Home prices reached new highs, which is a blessing for homeowners and a curse for wannabe homeowners. The Case-Shiller home price data showed a +0.35% month-over-month gain for the 20-city index in August. While prices rose, the more moderate advances helped pull the year-over-year trend lower to +5.2% from the nearby peak of +7.5% in March.

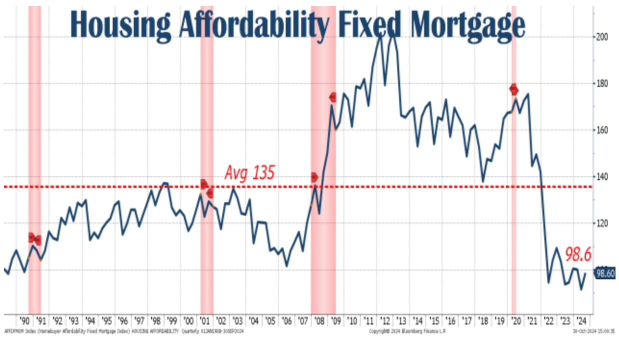


As the Fed telegraphed its rate-cut (and then unleashed it), mortgage applications suddenly soared (after stagnating at multi-decade lows for months) amid optimism that the housing market was back, and affordability might shift back into realm of possibility for many.

But that did not happen as mortgage rates have soared back near recent highs — crushing the optimism that the "American Dream" is back for some.

The jump in rates serves as a double whammy for homebuyers, choking off affordability and discouraging more owners from listing properties. The supply of housing has been kept tight by the so-called lock-in effect. Few homeowners are willing to sell if it means taking on a higher mortgage rate.

The graph tells the tale. The affordability of financing a new home is at an all-time low.



Bottom line: The housing market remains broken. Something has to give. If both home prices and mortgage rates don't come down, affordability will remain a pervasive constraint on new demand.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

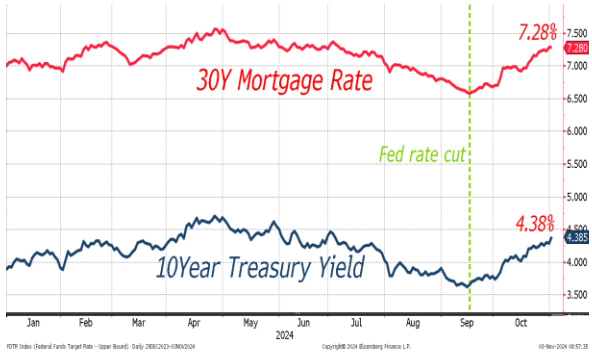
"Things are always uncertain… And we should get comfortable with that."
— Jeff DeLarme, President, DeLarme Wealth Management

Anyone else ready for the election to be over? This uncertainty is exhausting, no matter how you want it to end. But sadly, it won't really end. We will just transition to a different uncertainty over what will happen next. From my perch, no matter who wins the Oval Office, it is what happens in Congress that matters at least as much — and right now, it looks as though the Democrats have an edge in the Senate and the GOP with an edge in the House. For bond bulls, a split government is absolutely vital, so the most damaging aspects of both candidates don't get passed into law.

There's more than one vote next week that could rock your financial world. Two days after the U.S. election, members of the Federal Open Market Committee (FOMC) will announce the outcome of their vote on the federal funds rate. The consensus expectation is that the Fed will lower it by 25 basis points.

The key question entering the meeting is what the Fed will (or won't) signal about its plans for future meetings. The tone of the statement and the Powell presser will be far more important than the actual move, especially now with the futures market 50-50 for the January meeting. The swaps curve also believes that a pause is coming at this meeting.

You will recall the Fed's decision in September to slash its benchmark interest rate for the first time in four years. This half-point cut was billed as an aggressive, "jumbo" move. It hasn't quite worked that way yet. Last week, yields on the 10-year Treasury benchmark hit the highest level since early July. Mortgage rates are now higher than they were before the cut.

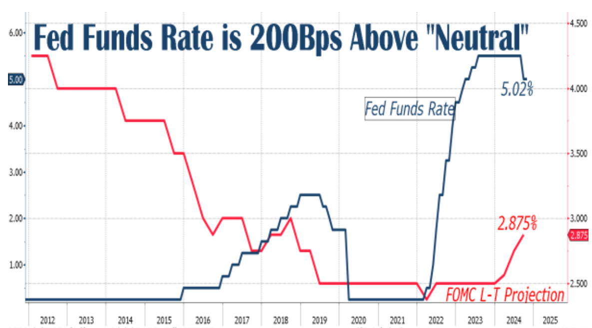


So, what gives? Over the past six weeks, the Treasury market has been undercut by three developments:

1. Signs that the GOP could sweep in the election.
2. A better tone to the incoming economic data.
3. The reduced expectations of what the Fed will deliver.

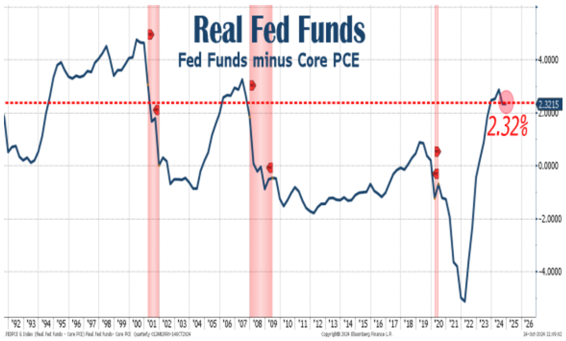
The futures are pricing in -100 basis point cuts through June 2025 compared to as much as -175 basis points just a short six weeks ago.

And to be sure, the pace of economic activity, even with the funds rate now +215 basis points above the long-term neutral projection, gives credence to the notion that the Fed's long-term equilibrium "neutral interest rate" is higher than previously thought. If so, this means that the Fed may well not end up cutting rates this cycle as much as was broadly expected in prior months and quarters.



However, it's also important to note that real GDP growth (proxy for aggregate demand) is more than just decent at +2.7% on a year-over-year basis. Over the past year, the labor markets have weakened, the unemployment rate has climbed to 4.1% from 3.8%, the inflation rate (as measured by the PCE) has dropped from 2.99% to 2.1% and the core PCE from 3.55% to 2.63%.

The supply side of the economy is overwhelming the growth in aggregate demand. In other words, the current supply/demand dynamics should foster lower prices in the weeks ahead. This in turn gives the Fed more leeway to reduce rates. This is a key reason behind taking a positive stance on the fixed-income market. Thus, while my confidence in the dovish rates outlook has been stirred, it has yet to be fully shaken.



Bottom line: The recent incoming data continues to be volatile, unpredictable and subject to significant revisions. This week is unlikely to change that environment. 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.