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Weekly Relative Value

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WEEK OF FEBRUARY 10, 2025

A Cat in the Hat Moment

Last week we experienced a "Cat in the Hat" moment. Mom and Dad leave for the day. All hell breaks out, and then, before Mom and Dad get back, the whole house is cleaned up like nothing happened.

Source: X

President Trump said on Friday, January 31, that there was “nothing” Canada or Mexico could do to avoid the 25% tariff hike. It was a fait accompli …until it wasn’t. I should have smelled a rat and enjoyed my weekend. How stupid of me.

Most Americans are unaware, but Mexico accounts for 23% of total U.S. food imports, and Canada supplies roughly 50% of all U.S. crude oil imports. Moreover, both countries together are critical to the entire North American manufacturing supply chain — and both countries together represent 30% of all global shipments that come into the U.S.

As I highlighted in last week’s *Weekly Relative Value* – “The Trump Trade War Begins,” food and energy prices would have soared if Trump fulfilled his threat to slap a 25% tariff on Canada or Mexico.

While its very true that the trade war would do “much” more damage to Canada and Mexico than to the U.S., suffice it to say that the tariffs would be extremely damaging to the U.S. economy.

THIS WEEK

- TRADE WAR MOVES TO CHINA
- VOLATILITY SOARS!
- SECOND LARGEST TRADE DEBT IN HISTORY
- HOUSING INVENTORY SOARS!
- OPENINGS GET CLOSED
- CROSS CURRENTS
- MARKET OUTLOOK AND PORTFOLIO STRATEGY

SUBORDINATED DEBT: (SIMPLIFIED)

Partnership has its perks.
Hand over the hard parts.

TELL ME MORE!

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No region on earth is more economically integrated than North America — thanks in part to Trump himself, who renegotiated the 1990s North American Free Trade agreement into the modernized United States-Mexico-Canada Agreement.
This agreement was, in part, intended to reduce U.S. reliance on Chinese suppliers by making Mexico's lower-cost labor more accessible to American manufacturers. Automotive and other companies have built vast, intricate supply chains in which many components cross the borders multiple times. High tariffs would throw a wrench in this finely tuned machine.

Maybe someone whispered the following in President Trump's ear:

"Mr. President, Mexico accounts for 23% of total U.S. food imports, and Canada supplies roughly 50% of all U.S. crude oil imports. *Food and fuel prices will soar* ***. The low-end household who voted for you would feel as if they had been punched in the face.*** *And Sir, did you know that the bottom 20% of wage earners spend close to 50% of their after-tax incomes on food and energy?* ***Remember, you promised lower food and energy prices on day one.***

So, Mr. President, ***maybe you should call Trudeau and Sheinbaum and give them a reprieve*** *and if necessary, do it again and again until this issue fades away with nobody noticing.*

We'll go after China instead. You can keep your tariff promise and not crush the little guy."

Trump understood the risks. If he went through with this tariff, he would have faced the mother of all plunges in his public approval rating because his campaign pledge was to bring down prices at the grocery chains and gas stations. He merely would have screwed the consumer much like Joe Biden did, but this time without stimulus checks. Surely, this is why he backed off, despite saying on Friday the 25% tariff (10% on Canadian oil) was a done deal.

But let's face it, we didn't need all the drama to get our friends to the South and to the North to agree to these initiatives. So why go through all the tariff bravado to only end up with cosmetic changes in Canada and Mexico?

I believe that President Trump will be selling the story and images of troops on the border, a few helicopters in the air, a Fentanyl czar (seriously?) as a very big win. It seems to me that this was a way to further bolster his ego and tough-guy image and most of all improve his poll rating. And it may work. We'll have to see if this "wag the dog" strategy ends up improving his approval ratings. (Did you see that 1997 classic with Robert De Niro and Dustin Hoffman?)

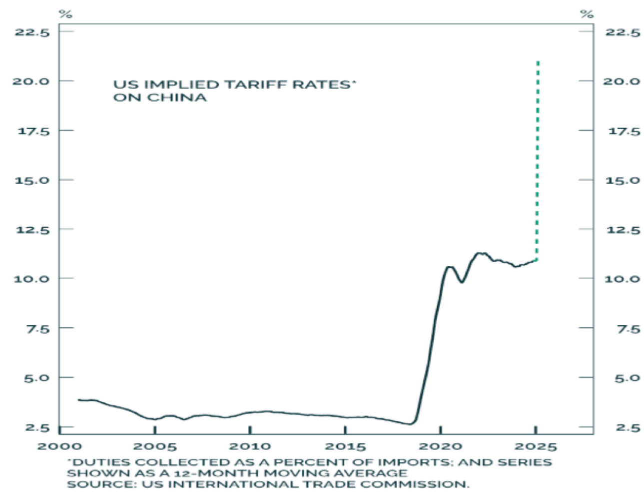
Bottom Line: This was a ruse all along. So, forget the 30-day reprieve —the reality is that a 25% tariff hike on these countries is NOT happening. He can't implement his tariffs because the inflation shock this generates, even if temporary, will drive his approvals lower and kybosh his ambitious fiscal plans (which are likely in jeopardy in any event).

TRADE WAR MOVES TO CHINA

The trade war now moves to China as it did in 2018 and 2019.

How large are U.S. import tariffs on China after the new tariffs are added to existing ones?

The following chart shows that the effective U.S. import tariff on China will double and exceed 20% after new tariffs come into effect.



Additionally, there will also be an investigation into Google for alleged antitrust violations (now that may bite…) while weighing a probe into Apples's app stores and fees. Keep a firm eye on the yuan, which may well emerge as another tool in this game of tit-for-tat trade action.

We've seen this movie before, so don't expect Xi to roll over. Indeed, China called the bluff and retaliated by announcing 15% tariffs on U.S. coal and liquefied natural gas and 10% on oil and agricultural equipment.

China also imposed export controls with an immediate effect on some rare earth metals — tungsten, tellurium, bismuth, molybdenum, gallium, natural graphite, iridium and neodymium. These rare earth elements are key ingredients for glass, LED lights, magnets, batteries and catalytic converters, and they are used in everything from cell phones to cars.

And did you know that China controls about 80% of global supply of rare earth elements, and nothing stops China from a complete shutdown of all rare earth elements? Suffice it to say, technology companies and the military would be quite unhappy.

This could get interesting if Trump follows through with his threat:

"If we can't make a deal with China, then the tariffs would be very, very substantial."

Bottom line: This is the problem with trade wars. If you back someone into a corner, they can get creative and find other options. Limit chip access and some Chinese company creates DeepSeek. It's generally inefficient and unnecessary, raising prices for everyone**.** No one wins a trade war.

VOLATILTY SOARS!

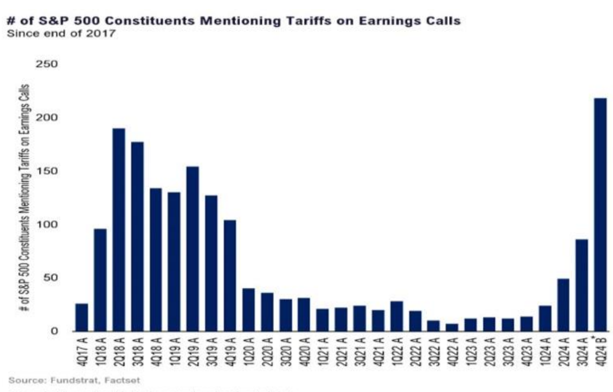
*"Mr. Trump's weekend tariff broadside against a pair of neighbors **has opened a new era of economic policy uncertainty that won't calm down until the President does**. As we warned many times before Election Day, **this is the biggest economic risk of Donald Trump's second term**."*
- Excerpted from "Trump's Tariffs and the Dollar," The Wall Street Journal

Welcome to the zany and volatile world of Trump 2.0. As shown below, economic policy uncertainty is at a record high. Ditto for trade and immigration uncertainty. Total chaos. Nobody can forecast. Nobody can plan. For better or for worse, this is what Americans voted for. Never a dull moment, to be sure.

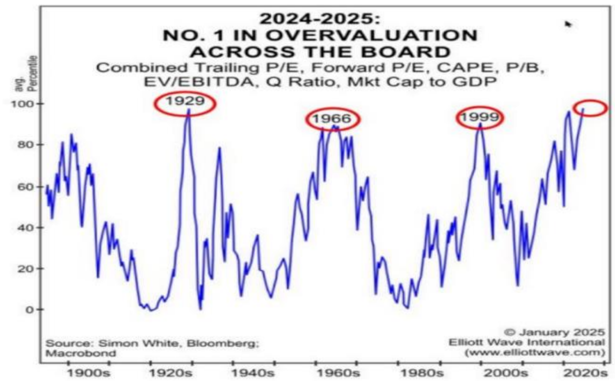
So how do you invest in an era of uncertainty and whipsawing markets?

My advice: Be sure to look both ways before crossing the street — or you may be run over by a speeding truck.

As for the business sector, the word “tariff” has thus far shown up in more than 200 earnings calls among S&P 1500 listed companies, and the tariff uncertainty could very well end up freezing capital investment plans. With a lag comes hiring intentions, which already are on a sharp downward path.



And because markets hate uncertainty, the markets’ risk premium will widen. That is not very good news for an S&P 500 trading at one of the highest valuations in recorded history.

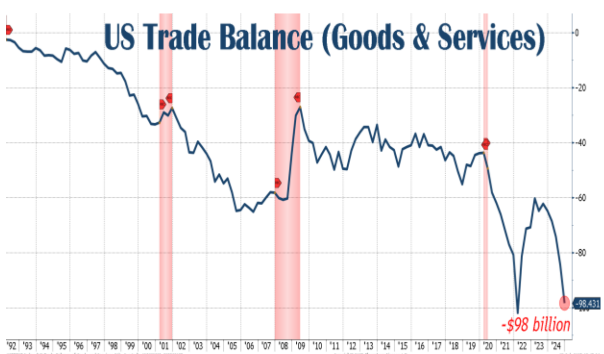


Bottom line: Trump seemingly has not realized that his reelection had much to do with the anti-Biden/Harris sentiment after four years of ineptness on many fronts. In other words, Americans did not vote to embark on a global trade war. Most people would prefer stability in their lives, not elevated and rising uncertainty that would lead to higher prices and impinge on their jobs and real incomes.

SECOND LARGEST TRADE DEFICIT IN HISTORY

"Three decades of connivance by the U.S. government – which bridged with ease any political divide – and Corporate America, under the failed doctrine of globalization, ***have destroyed much of the manufacturing base so that corporate profit margins could fatten by chasing cheap labor, lax environmental laws, and preferential treatments in U.S. and foreign tax codes"*** *- Wolf Richter, CEO, Wolf Street Corp.*

The U.S. trade deficit (exports minus imports) in goods and services in the year 2024 exploded by 17% from the prior year, to $98.4 billion in December from $78.9 billion in November. This is the second largest trade gap (for both goods and services) on record. And when you look at the situation by country, the culprit was, you guessed it, China. Imports from China ballooned at a +20% in December after surging +10% the month before.



As an aside, the trade deficit ("net exports") is a negative for gross domestic product (GDP). Exports are added to GDP; imports are subtracted from GDP. So, it's interesting that the first estimate on Q4 real GDP showed no net drag on growth from foreign trade even though, before our eyes, we can see that the real trade deficit widened at a +20% annual rate and should have easily reduced GDP by nearly 50 basis points. Stay tuned.

Bottom line: Having a trade deficit is not bad. A trade deficit reflects a strong consumer-driven economy, with high demand for goods. This can lead to increased economic activity and access to products at potentially lower prices. Additionally, a trade deficit can attract foreign investment, further stimulating the economy by providing capital inflow.

That said, Trump will undoubtedly howl at this report while adding some spice to the latest chapter in the trade war. Most importantly, look for downward revisions to Q4 GDP**.**

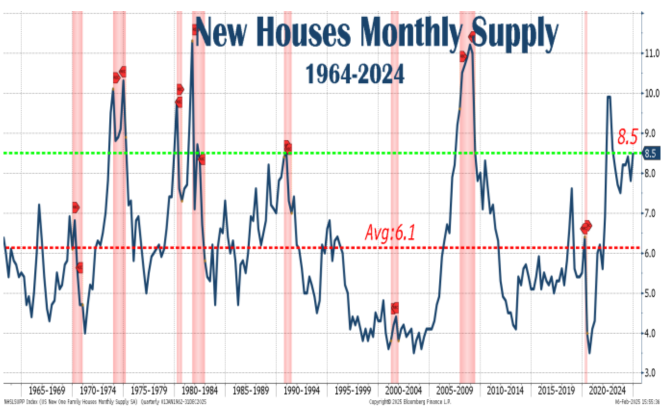
HOUSING INVENTORY SOARS!

As shown in the graph below, the new single family housing monthly supply (the ratio of houses for sale versus the current sale rate) is at 8.5 months. The historical average is 6.1 months.

There's only been five other times in U.S. history where home builder inventory has been this high, relative to sales.

- 1974 recession (9% unemployment)
- 1981 recession (11% unemployment)
- 1991 recession (8% unemployment)
- 2008 recession (10% unemployment)
- 2022 rate hikes

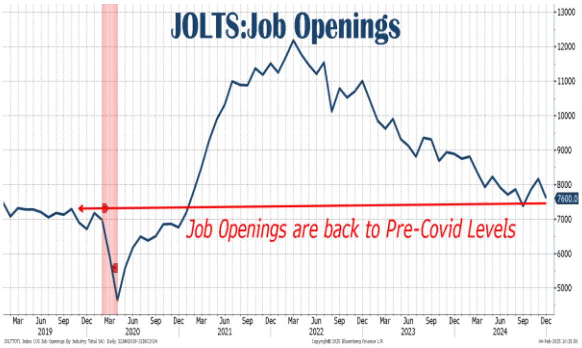
In four of the past five times (80%) inventory was this high, there was a big recession (red shaded bars), with a high unemployment rate. In 2022, it didn't happen.



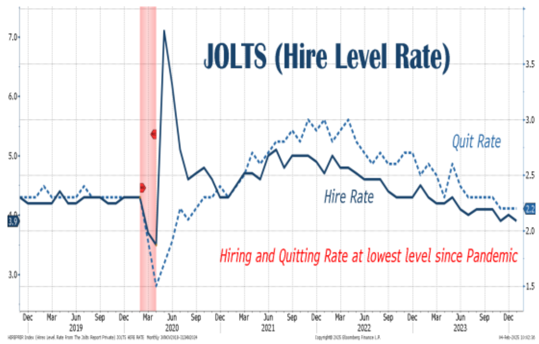
Bottom line: Are home builders signaling something regarding oversupply and capacity that could flip into an economic downturn?

OPENINGS GET CLOSED

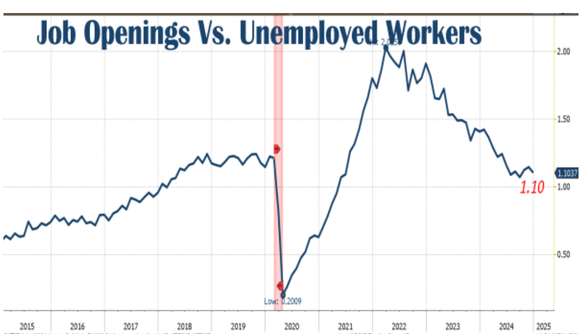
The Job Opening and Labor Turnover Survey (JOLTS) data for December showed that job openings took a whopper of a decline — plunging to 7.60 million from 8.156 million in November. The job opening rate slid to a three-month low of 4.5% from 4.9% in November — the exact same level it was in early 2020, before the pandemic. A virtual collapse in labor demand.



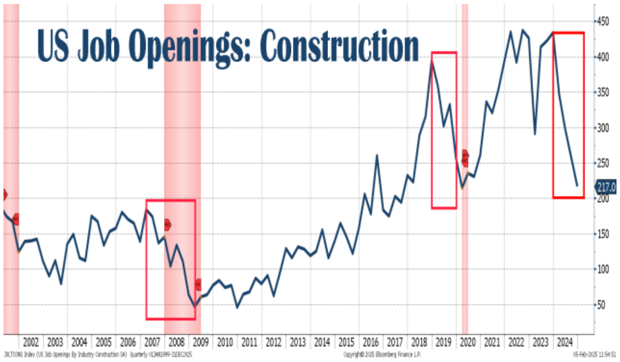
The “hiring” rate stayed at 3.4% for the third month running and is substantially lower than the pre-pandemic norm of 3.9%. The “quits” rate, at 2.0%, for the second month running compares to the pre-pandemic level of 2.3%. The layoff rate, at 1.1%, is comparable to where it was just before the pandemic.



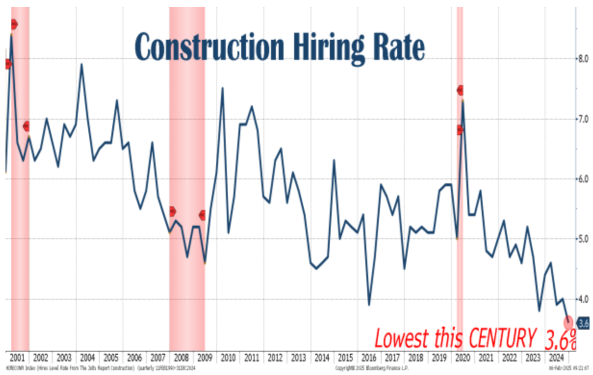
Finally, Fed Chairman Jerome Powell cites this figure a lot: The number of job openings per unemployed person ticked down to 1.10 job openings for each person who was unemployed and looking for a job during the reference period (7.60 million job openings for 6.89 million unemployed people looking for work).



Notably, on a sector basis, what really stood out to me was that construction job openings have plunged and have now DECLINED by over 250,000 in 12 months to just 165,000, the lowest in EIGHT YEARS. Such a drop has never been seen outside of a recession.



Moreover, the hiring rate in the construction industry fell to 3.6% — the lowest level THIS CENTURY! There are lower hires than there was in December 2009.



Bottom line: Jay, Jerome, can we have a word about how y'all are measuring the job market? Or can I talk to the Bureau of Labor Statistics' manager? The JOLTS data that are so near and dear to your heart are either at levels that prevailed five years ago or slacker, when the fed funds rate was at 1.75%, not 4.5%.

CROSS CURRENTS

"This morning's report may be considered a Goldilocks report – not too hot and not too cold…An unemployment rate at 4% is considered very low, giving the Fed reason to keep fed funds unchanged in the near term."
- Jeffrey Roach, Chief Economist, LPL Financial

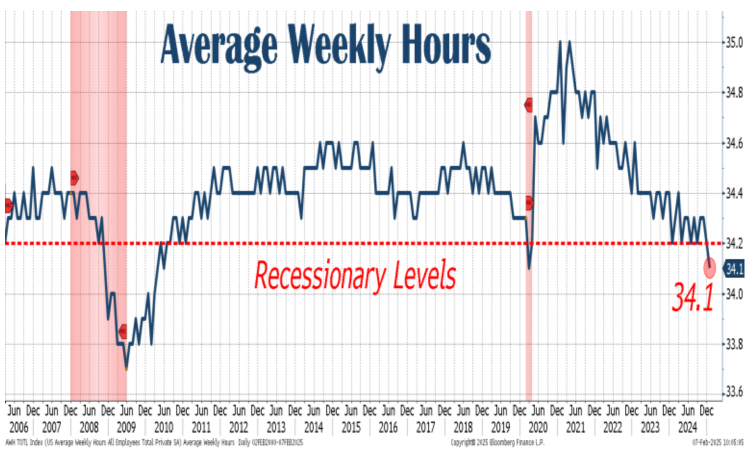
In the most widely anticipated and nerve-racking nonfarm payroll report since the last one and before that the last one and before that … the January headline came in at +143,000 versus the consensus estimate of +175,000.

Between weather shifts, the California fires, the rebuilding impact from last fall's hurricanes and storms, and the benchmark revisions (in both surveys), there was no shortage of crosscurrents.

Here are the key takeaways:

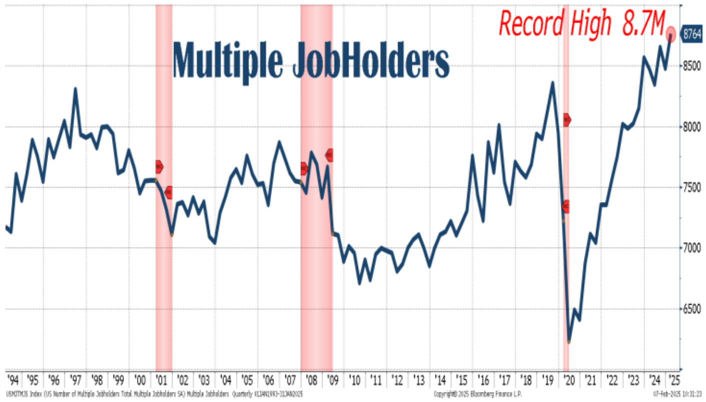
- After seasonal adjustment, the birth-death model added +126,000 to the headline payroll number for January, so outside of that skew, employment in the establishment survey only eked out a +17,000, or near-stagnant, performance for the month.
- There were upward revisions to November and December totaling +100,000 and that blunted the impact of the softer-than-expected January number.
- **Friday's release included an annual update to the employer survey, which showed job growth was 589,000 lower in the 12 months through March 2024 than initially reported.**
- The unemployment rate fell to an eight-month low of 4.0% from 4.1%, further away from the Fed's year-end projection of 4.3% (the broad U-6 measure held at 7.5%).
- Perhaps the biggest surprise was in the wage department. The wage number was hot at +0.5% month over month, but a note of caution on this metric since it reflects the -0.3% falloff in the workweek. Year-over-year average hourly earnings printed at 4.1% year over year, beating soundly the 3.8% estimates.

One depressing impact in the report was the -0.3% month-over-month contraction in the workweek to 34.1 hours, which is the lowest since March 2020, and prior to that, June 2010.



The index of aggregate hours worked, which combines bodies and hours, contracted -0.2% after the -0.1% dip in December to mark the first successive decline since November-December 2022, and before that, try March-April of 2020. This is one reason to fade the view that the labor market is in all that great shape, notwithstanding the 4% unemployment rate.

It was not just the decline in aggregate hours worked, but also the fact that the number of people working part-time for "economic reasons" rose +119,000, which was the sharpest increase since last August. Multiple job holders, which is a contrary economic indicator, jumped +286,000, and that was the sharpest run-up since December 2022.



Bottom line: Powell seems to treat the non-farm payroll survey as the "Holy Grail" when it comes to the labor markets despite relentless and wild downward revisions and an ultra-low response rate. That said, the Fed clearly will not like what happened with the unemployment rate and the wage number. This number supports the central bank's decision to pause over the near term.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

" The president wants lower rates...He and I are focused on the 10-year Treasury and what is the yield of that."
- Scott Bessent, Treasury Secretary

The bond market's bugaboo these past few months has been the risk that Donald Trump's policies take an already problematic fiscal situation and make it even worse.

Remember, the U.S. is being run on a short-term spending bill. **And the bipartisan deal reached last December 17 has an expiry date — circle March 14 on your calendar because that is the day of the shutdown clock reset — and the new Republican-led Congress must pass a spending bill for the fiscal year or another continuing resolution by then or face another government shutdown crisis.**

This is not front-page news, but according to the Congressional Research Service, a dozen GOP senators and 49 House Republicans — more than 20% of each conference — have never previously voted for a law raising the debt ceiling. That, in turn, means raising the debt limit, a must-do for Trump, may not be as simple as just packaging an increase with the *"one big, beautiful bill"* that Trump wants for his second-term agenda. Many deficit hawks are simply not on board.

If the GOP, fiscal conservatives maintain their courage to salvage the fiscal integrity America once enjoyed, then we are into a phase of acute fiscal drag, which would slow the economy and lower inflationary pressures.

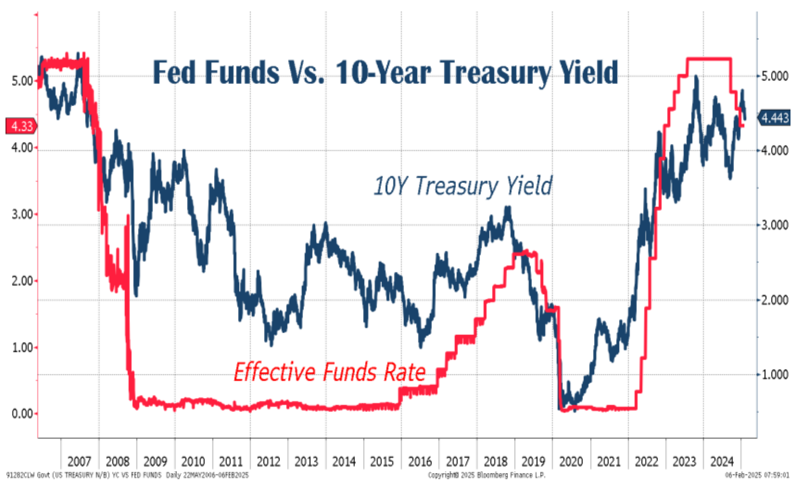
As for the Fed, let's just say that if it were not for Donald Trump, it would very likely still be on an easing path — especially since the fed funds rate is still some +130 basis points north of neutral (i.e., above where it should actually be), the economy (for now) has achieved the holy grail of balance in terms of full employment (at least for now) and the 2% core inflation target (price trends are already there on a three- and six-month basis).

The near-term dilemma for the Fed, as well as the rest of us, is that Trump's fiscal agenda and current tariff policy do carry with them some risk of inflation returning. And a Fed that was totally embarrassed by 9% inflation back in the summer of 2022 is not going to jeopardize its credibility again.

Even still, the Trump Administration realizes that the leveraged U.S. economy cannot maintain high rates for an extended period. Check out this *Bloomberg* article, "Bessent Says Trump Wants Lower 10-Year Yields, Not Fed Cuts."

Well, if they want lower 10-year yields, this is what I'd recommend to the Treasury Secretary:

1. Keep reducing spending.
2. Hold back tax cuts when the economy is at full employment.
3. Continue to accelerate the deregulation push.
4. Stop talking down the dollar.
5. Layoff the tariffs.



Bottom line: While there is tremendous policy uncertainty, I believe the inflation-led bear market ended in October 2023, and while nothing ever moves in a straight line, it does look as though the peak in yields is in.

Real rates (inflation adjusted) in excess of 2.0% are attractive, and sentiment and market positioning are decisively "negative," which is a contrarian positive. So, ignore those folks who say to dump your bonds.

In terms of portfolio strategy, credit unions should continue to maintain a risk-appropriate ladder strategy while buying the dips.

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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