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INVESTMENT SERVICES

Weekly Relative Value

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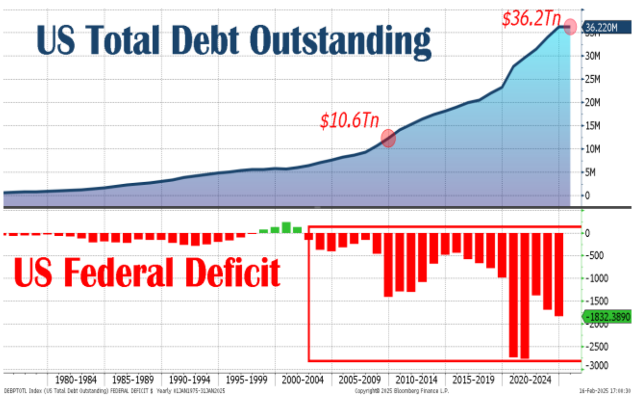
American Exceptionalism?

"It is not that I am not a fan of American exceptionalism. That is like saying I am not a fan of the moon being made out of green cheese — it does not exist. Powerful states have quite typically considered themselves to be exceptionally magnificent, and the United States is no exception to that. The basis for it is not very substantial to put it politely."
- Noam Chomsky, Linguist & Political Philosopher

The national debt was $10.6 trillion in the beginning of 2009 when the Great Financial Crisis "recovery" began. Now it's $36.1 trillion. That is 3.5 times more debt!



Spending has surged +18% over the past year! Through the first four months of the 2025 fiscal year, the deficit has ballooned nearly +60% to $840 billion. Annualized, that equates to $2.5 trillion, which is truly "exceptional."

Is this America? Home to private enterprise?

Before 2009, we never saw anything remotely close to a deficit of $840 billion. Even in 2008, when Lehman collapsed, the deficit for the entire year was $680 billion.

When I started in the business in 1981, investors were literally freaking out about a budget gap of $167 billion for the whole year — or 3.5% of the gross domestic product (GDP). Today, the U.S. is running a deficit over 7% now — for a third year running in a fully employed economy.

THIS WEEK

It took a MASSIVE $2.2 trillion in public debt to create $570 billion in GDP growth in 2024. In other words, it took $3.90 of debt to generate $1.00 of economic growth.

Almost one-quarter of last year's economic growth came purely and solely out of Uncle Sam's generosity. So, when you hear about how great the U.S. economy is doing compared to everyone else in the world (American Exceptionalism), just remember that the superior growth is due to the long arm and deep pocket of good ole' Uncle Sam.

Bottom line: U.S. growth is not a miracle; it is fully DEBT-driven. The U.S. economy may have escaped a recession and became the envy of the world, but this is a low-quality expansion. I am far less impressed than the cheerleaders you see dominating the airwaves. At some point, global investors will lose confidence in our debt-financed prosperity, and then the chickens will come home to roost.

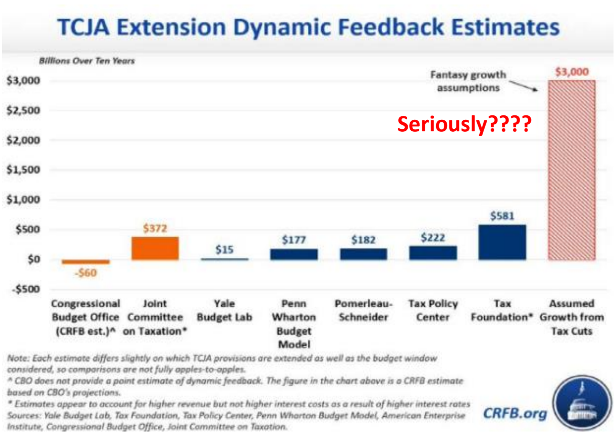
FANTASY MATH

"The rich are always going to say that, you know, just give us more money and we'll go out and spend more and then it will all trickle down to the rest of you. But that has not worked the last 10 years, and I hope the American public is catching on." - Warren Buffett, Chairman & CEO, Berkshire Hathaway

Despite the mountain of debt we sit on, the U.S. House Republicans have proposed a $4 trillion debt limit increase and $4.5 trillion in tax cuts. This would increase debt in 2034 to 126% of GDP.

The Republican growth argument is "everything that's going to happen can pay for tax cuts."

As shown in the following graph by the non-partisan Committee for a Responsible Fiscal Budget, the House is trying to claim a $3 trillion deficit reduction due to "assumed economic growth from tax cuts." This is an order of magnitude larger than any semi-credible estimates and would require fantastical levels of sustained economic growth.



To wit: Getting $3 trillion of "dynamic feedback" would require:

- 75% sustained increase in real economic growth.
- Real GDP would need to be 14% larger by 2035. That's 50 times the average estimate for the Tax Cuts and Jobs Act (TCJA) extension.

Tax cuts can pay for a portion of themselves through faster economic growth. But probably like $200-$300 billion, NOT $3 TRILLION. The $3 trillion dynamic feedback claim is fantasy math. In other words, this is smoke and mirrors.

Bottom line: More free lunch economics. The party in charge doesn't matter. Everybody wants to spend without paying for it. The fact people still think tax cuts are the key to anything approaching real growth is just embarrassing at this point — no intellect or massive bias. One or the other.

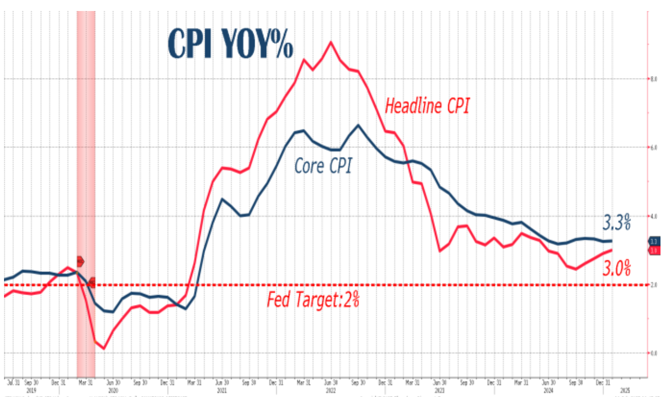
Here's my advice. If the U.S. government is serious about reducing the deficit, they need to cut spending first and bring the deficit down to a maximum of 3% of GDP. Moving forward, any future tax cuts would be offset by spending cuts.

HOTTER THAN EXPECTED

"We don't get excited about one or two good readings, and we don't get excited about one or two bad readings." – Federal Reserve Chairman Jerome Powell

Consumer prices surged more than expected (accelerating for the seventh straight month).The headline consumer price index (CPI) for January spiked +0.5% month over month (consensus was +0.3%) and the core measure at +0.4% month over month (consensus was +0.3%, and the print was double the +0.2% December reading.

Year over year, the headline inflation rate ticked higher to +3.0% from +2.9% in December; the core inched up to +3.3% year over year from +3.2% and considerably above the +3.1% consensus estimate. Bond and stock markets did not like this number one bit, and neither did the Fed.

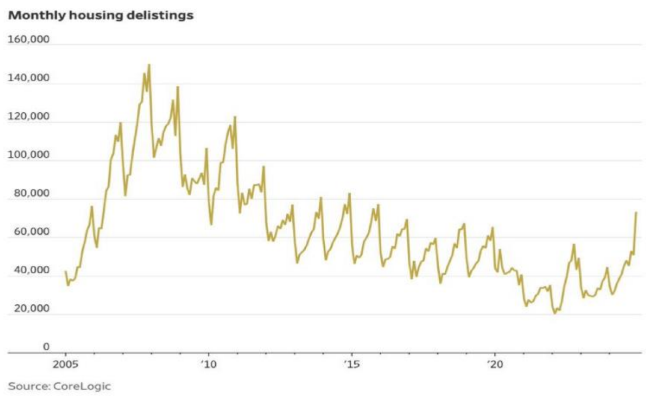


There were numerous culprits, not just one.

- Core goods prices leapt ahead +0.3% month over month.
- Used cars jumped +2.2%.
- Airlines fares increased +1.2% month over month and are running at over a +7.0% year-over-year rate.
- Hotels/motels posted a huge +1.7% month-over-month price gain.
- Recreational services jumped +1.4% (a record increase).

While this report was clearly disappointing, it's important to note that every year this report is the high print for the year. The reason being is that many businesses raise prices at the start of the year. While the Bureau of Labor Statistics seasonally adjusts the price data to account for this, it is tough to get this right, particularly in the wake of the pandemic. There were also some idiosyncratic factors, like the avian flu impact on egg prices and the jump in vehicle insurance rates.

On a positive note, the U.S. housing market is showing signs of an emerging disinflationary source ahead on the back of a mountain of "shadow inventory." Delistings tend to spike in the winter when fewer people are actively looking for a home. But the trend last December was unusually strong, representing almost one in 10 properties on the market and a 64% increase from the same month of 2023. The jump in delistings indicates that much of the extra inventory that hit the housing market throughout 2024 sat unsold — suggesting there is more pent-up desire to sell than there is pent-up demand to buy.



Likewise, builders are struggling to sell homes even though they are offering to buy down mortgage rates. The number of completed and ready-to-occupy new homes leapt +46% from year-earlier levels in December. This is rather bad news for sellers.

Also note that shares of single-family housing landlords Invitation Homes and American Homes 4 Rent are trading at steep discounts of 33% and 22%, respectively, to their net asset values. **This is a sure sign that investors believe U.S. home prices are subject to a meaningful correction in the coming months. Nothing inflationary about that.**

Moreover, with energy prices down -10% over the past three weeks, there is comfort that coming inflation reports will be tame. Remember that oil prices do also feed into the core, as seen in the sharp run-up of late in airfares.

I should also note that consumers are balking at higher prices and C-suite executives are going to have some tough choices ahead: Raise prices but risk losing market share. For a real-life example of this, have a look at "Kraft Heinz Stock Falls After Sales Slump" in *The Wall Street Journal.*

Similarily, Nestlé reported its weakest annual organic sales growth in more than a quarter of a century, hit by a consumer pullback (organic sales slowing sharply to +2.2% in 2024 from +7.2% in 2023).

As they say, the cure for high prices is high prices. Everyone has a limit, and this even applies to Heinz ketchup and Nestlé chocolate. So, this should serve as a wake-up call to the corporate sector that raising prices while cannibalizing your business is not going to lift your valuation.

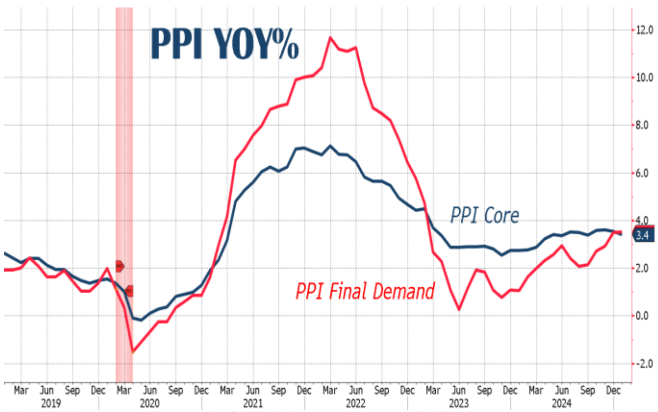
Bottom Line: While the January CPI print was disappointing, the Fed has repeatedly said that nothing changes off one report.

MORE BAD NEWS IN THE INFLATION FILE

"Bad day in the markets today, I bought an asset, and it lost over 20% of its value within less than an hour of purchase. (I bought eggs, some of them cracked during the trip home.)"
- Guy Berger, Director of Economic Research, The Burning Glass Institute

In the wake of the hotter-than-expected CPI report, little relief was provided by the January Producer Price Index (PPI) data. The headline producer price number came in at +0.4% on a month-over-month basis. The bigger news was the sharp upward revision in December to a +0.5% bump instead of the prior initial estimate of just +0.2%. That held the year-over-year trend at +3.5% and up from +3.3% in December.

The core figure (excluding food, energy and trade) also came in hotter than forecasted at +0.3% month over month. And, once again, December was marked higher to +0.4% month over month from +0.1%. As such, the year-over-year trend on the core PPI inflation rate eased a tick to +3.4% from +3.5%.



Here are the key takeaways:

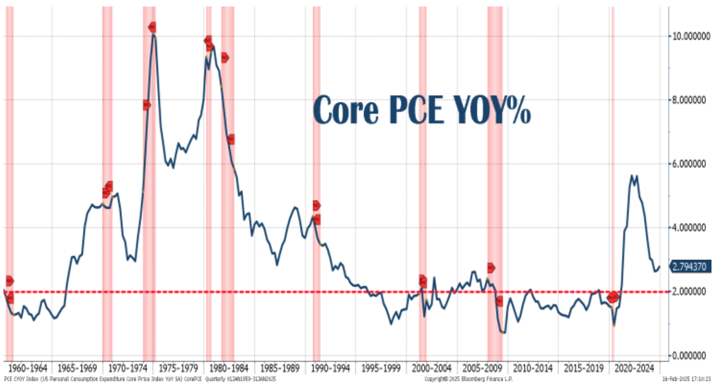
- Goods prices spiked +0.6% month over month, which makes it three in a row of increases of roughly this size.
- Food prices jumped +1.1% and are up for three months running.
- Energy costs soared by +1.7% on top of a +2.2% surge in December.
- The only redeeming feature in the product sector was that finished consumer goods (excluding food and energy) deflated -0.3%. This last occurred nearly 20 years ago!
- Service prices rose +0.3% month over month after a +0.5% increase in December.

Bottom Line: On the surface, this was a bad PPI report, but the 10-year Treasury plummeted on this news. The positive reaction was due to the "number beneath the headline," as explained below.

THE NUMBER BENEATH THE HEADLINE

The inputs from the CPI and PPI that feed into the Fed's preferred inflation metric — the Personal Consumption Expenditures Price Index (PCE) — did not materially raise forecasts for the January core PCE. Indeed, the not-so-great 0.41% core CPI print for November translates to core PCE of just 0.26% (plus or minus a bit), thanks partly to lower weighting of autos and softness in other components derived from the January PPI. Not good, to be sure, but hardly the +0.4% disaster seen in the consumer price report.

More importantly, if this number comes to fruition, the three-month trend will be running at a near-target +2.1% annual rate, and the six-month trend would be south of +2.5% and just over +2.5% on a year-over-year basis .



Bottom Line: The components of the CPI and PPI together suggest we have nearly a 50-50 shot at seeing a +0.2% month-over-month print in the all-important core PCE deflator for January, due at the end of the month (February 28). Stay tuned.

DON'T KNOW MUCH ABOUT HISTORY?

The three statements below from inauguration speech reflect the mindset of President Donald Trump.

"Next, I will direct all members of my cabinet to marshal the vast powers at their disposal to defeat what was record inflation and rapidly bring down costs and prices."

It is hardly likely that a global trade war will bring costs down.

"I will immediately begin the overhaul of our trade system to protect American workers and families. Instead of taxing our citizens to enrich other countries, we will tariff and tax foreign countries to enrich our citizens."

There will be no such “protection” because what the tariffs will do is worsen real wages, and there is not a shred of evidence from Trump 1.0 that trade wars created any growth in industrial sector employment. Industrial production finished 2019 with a -2.0% year-over-year contraction (not exactly a golden age) and growth in factory payrolls was as flat as hot-rolled steel. Facts are facts.

“President McKinley made our country very rich through tariffs and through talent — he was a natural businessman.”

Donald Trump and his team love to draw attention to the McKinley Tariff Act of 1890. What is not mentioned is that the McKinley tariffs in 1890 precipitated a nearly four-year long recession, and by 1894, this “beautiful” tariff was FULLY repealed. You can have your own opinions, but you can’t have your own facts. Not when it comes to the historical record.

Bottom line: When the facts get in the way, as they clearly have in this case, we are in a whole lot of trouble. When it comes to global trade issues, better that Trump sticks to hotels, resorts, and golf courses, which are his stock and trade.

WHY I STILL BELIEVE IN DISINFLATION

"Consumers are really on edge about inflation…They've been through inflation hell and are very sensitive to it."
- Mark Zandi, Chief Economist, Moody’s Analytics

I do not believe in a sustained inflation breakout or in the permanent “sticky” argument simply because there is no public support for inflation — even those without an economics background understand that it is a social disease that has the largest impact on the most vulnerable in society — the poor and the elderly.

Presidencies have buckled under the weight of inflation, and in Trump’s first full month, he didn’t do anything to bring costs down “on day one.” Not that this is his fault (Can he be blamed for the bird flu?), but he needs to be mindful of what tariff hikes and tax stimulus at a time of full employment can unleash and the spinoffs from tariff hikes can be substantial (see “Why Tariffs Will Make Car Insurance Even More Expensive” in *The Wall Street Journal*) — the laws of unintended consequences from engaging in a global trade war.

I also highly recommend a read of the lead editorial piece in *The Wall Street Journal* titled, “Trumponomics and Rising Inflation.” The conclusion said it all

“As a political matter, ***an inflation revival may be the biggest threat to the Trump Presidency****.* ***Mr. Trump was elected as voters reacted to inflation and falling real incomes under Joe Biden****. Real average earnings are flat over the last three months as inflation has bounced up.* ***If this persists, Mr. Trump won’t have a 53% job approval rating for long.”***

RUNNING ON EMPTY?

If the CPI data were an upside shocker in January, the retail sales data for January were an even bigger shocker on the downside. After four months of strong gains, U.S. retail sales were expected to decline in January. And sure enough, retail sales not only declined but actually plunged 0.9% month over month in January versus the -0.2% consensus estimate. That was the biggest month-over-month drop since March 2023.

As always, the key in the retail sales report is the “core control” component (headline excluding gas stations, building materials, and autos), which feeds right into the consumption part of the GDP data. This metric sagged a sharp -0.8%, which also undercut the consensus forecast of +0.3% (wiping out December’s bounce and the worst showing since March 2023) and bodes poorly for the start of Q1 GDP growth hopes.

There were some minor upward revisions to all the December numbers but not nearly enough to offset the downbeat message on the American consumer to kick off the year. The debt-financed cheerful spending spree in the holiday shopping season has been followed by a pretty wicked hangover now that the bills are coming in. We are seeing a debt hangover after consumers took on $53 billion of non-mortgage debt in Q4 to support their holiday shopping habits (compared to a $32 billion debt increase in the fourth quarter of 2023). The bill is now coming in. This is at a time when the 90-day delinquency rate on credit card loans has risen to 11.35% (from 9.7% a year ago), which now stands at a 13-year high.

Admittedly, it remains to be seen just how much of this intense weakness reflected distortions from the L.A. fires. But the fact is that this was the worst retail sales report in at least two years in terms of both magnitude and breadth of the decline (70% of the subsectors were negative.) Notably, online activity is the one area that generally does exceptionally well during bad weather and natural disasters — yet this segment of the retail sales pie plunged -1.9% month over month (the worst drubbing since July 2021). Thus, from my perch this was not a weather story at all, since nevertheless, this was the first setback in retail sales since last August and is the sharpest slide since March 2023.

Bottom line: The consumer is key to the U.S. economy. Indeed, in the wake of the January retail sales report, the Atlanta Fed Nowcast for Q1 2025 was sliced from 2.9% to 2.34%.

MARKET OUTLOOK AND PORTFOLIO STRATEGY

"One of the first meetings I want to have is with President Xi of China, President Putin of Russia, and I want to say, 'Let's cut our military budget in half.' And we can do that."

As discussed last week, the bond market's bugaboo these past few months has been the risk that 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. The Republican-led Congress must pass a spending bill by then or face another government shutdown crisis.**

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

Moreover, Donald Trump's other pledged goodies, not including root beer in the water fountains, like tax breaks on Social Security benefits and tips would need to be offset by restraint measures on the expenditure side including cuts to spending such as on Medicaid, food stamps, etc. to offset any of these tax cuts. This would tamper upward pressure on prices and help bring down long-term interest rates by reducing the issuance of new debt to finance the deficit.

Finally, as noted in the quote above, the fact that Trump has signaled a willingness to meet Xi and Putin both individually and together in order to roll back military spending ("denuclearization" is the latest "beautiful" word) would also go a long way towards putting a dent in the deficit and alleviate pressure on the Treasury borrowing front (along with any crumbs that DOGE can find in the total spending cupboard).

Bottom line: Not everything is pointing in the direction of higher inflation, though this has become the narrative in recent months. 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.

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.