

War, Oil Shocks And Bond Sector Vulnerability

- Negative Treasury market reaction to September payrolls appears overdone
- Risk of Middle East war/oil price spike is rising
- Even a doubling of oil prices would not necessarily spark recession...
- ...although financial conditions would tighten
- Corporates are most vulnerable to an oil shock and related “growth scare”

Economic and Treasury market sentiment is swinging wildly with each new payroll datapoint. A key question is whether the robust September jobs report simply reflects normal volatility in the data or represents the start of a re-acceleration in hiring and GDP growth.

Seasonal adjustment and survey size issues raise question marks over the accuracy of the official September figures, which appear inconsistent with the overall message from the broader labor market data. Quits and hiring rates in the JOLTS survey are still in a downtrend, while the ISM economy-wide employment index is hovering below 50 (Chart 1). The Kansas City Labor Conditions Indicator, which is a composite of 24 indicators, continues to point to rising unemployment in the coming months.

Moreover, most of the payroll gains in September occurred in what we have termed “catch-up” sectors – largely non-interest sensitive sectors that have been struggling to regain the jobs that were shed during the pandemic (leisure & hospitality, health

care, education and state & local government). These sectors have provided a strong hiring tailwind since the end of 2022 (Chart 2). Hiring in these sectors appeared to be gradually fading this year up to August, before jumping suspiciously in September. They added 190k jobs as a group, accounting for almost three-quarters of total payroll gains in September.

We predicted in last week’s report that the moderating hiring trend in the catch-up sectors would likely continue, consistent with the softening JOLTS job openings data for these industries.¹ “Revenge travel” appears to be peaking according to consumer

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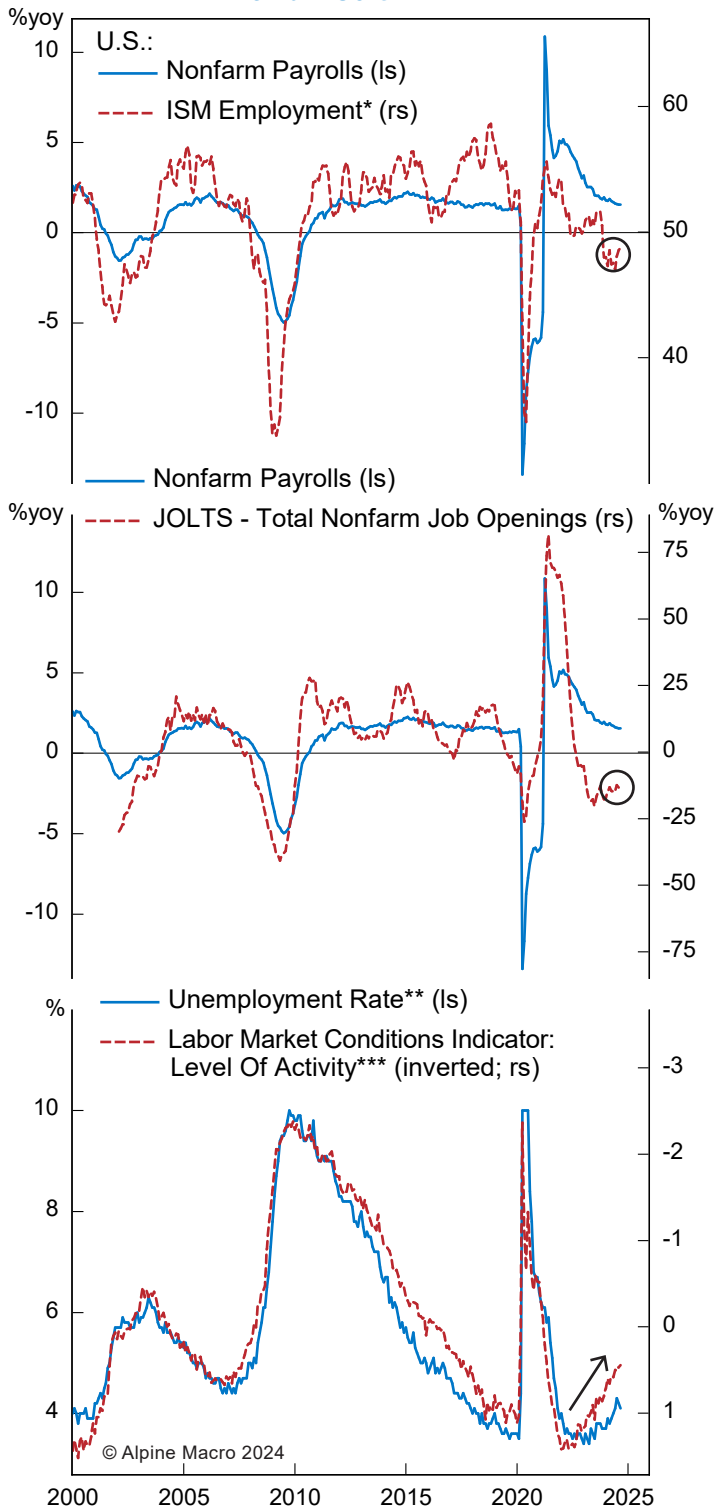
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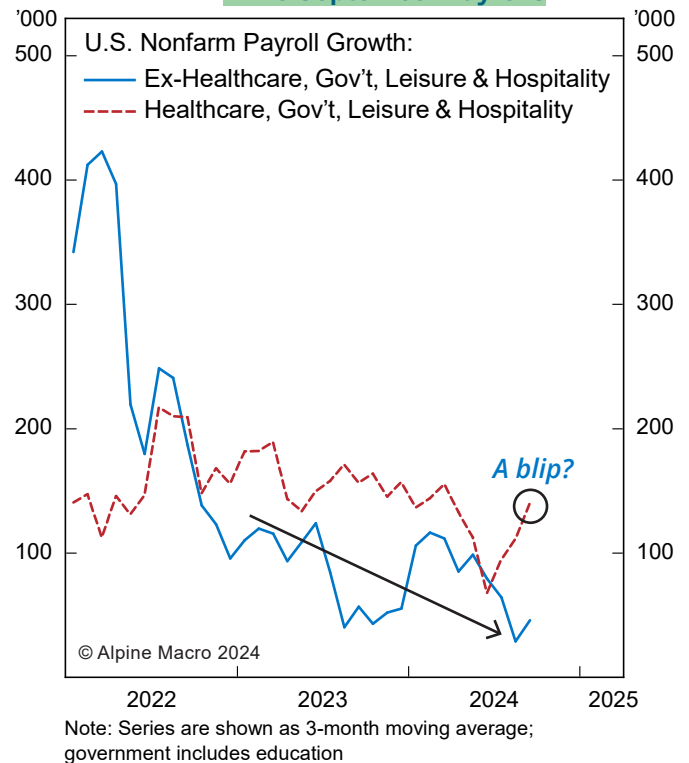
¹ Alpine Macro *U.S. Bond Strategy* “U.S. Economic Slowdown? What To Watch And Where To Hide” (October 3, 2024).

**Chart 1 Labor Market Indicators
Remain Soft**


*80/20 average of the non-manufacturing and manufacturing sector surveys

**Truncated at GFC high

***Source: Kansas City Fed

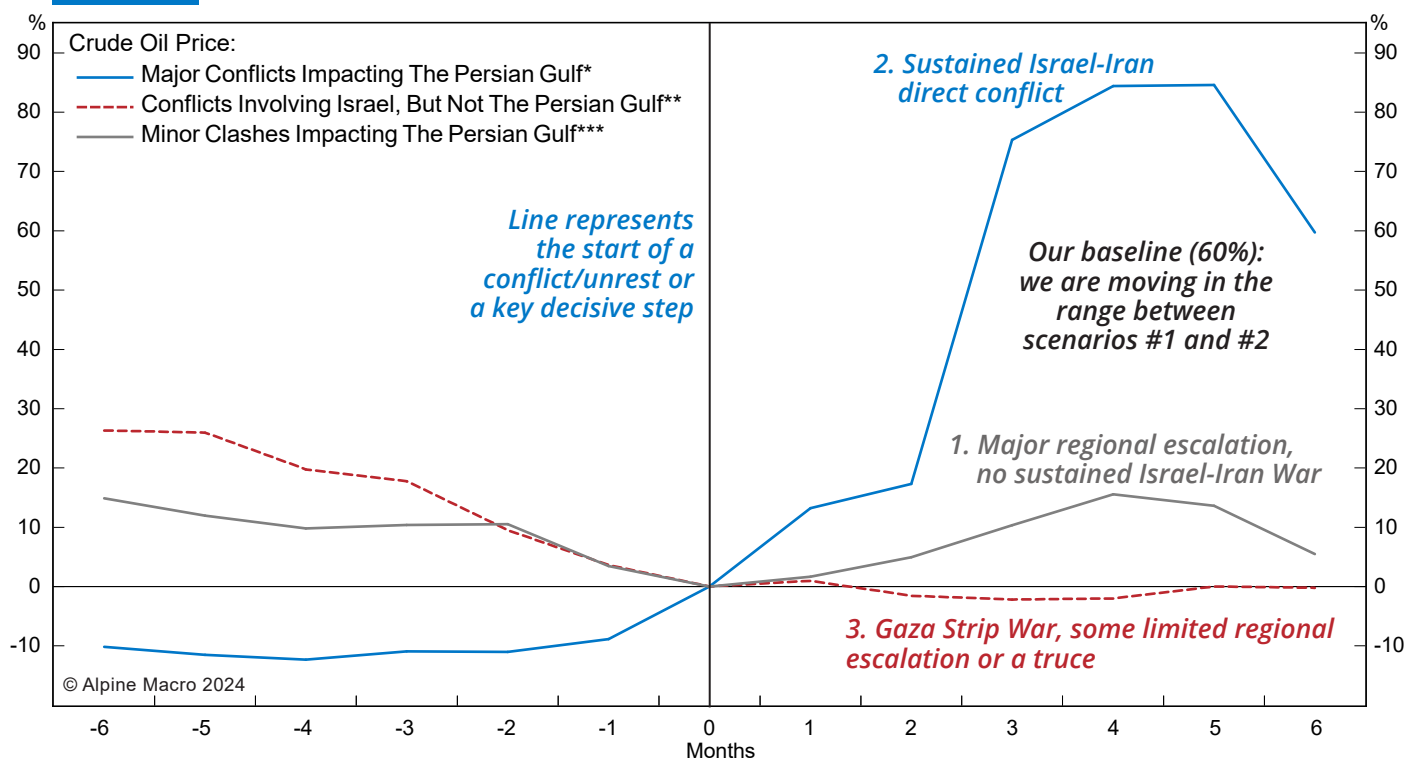
**Chart 2 "Catch-Up" Sectors
Drive September Payrolls**


spending on food & accommodation. Moreover, pressure is building on state & local governments to scale back spending and hiring, in line with moderating revenue inflows. Pent-up surgery demand, which has been driving health care spending, should also wane over time.

The bottom line is that September's payroll surge looks more like a "blip" than a trend change.

Recent data on spending have admittedly been surprising to the upside, but our macro view has not been fundamentally altered. We concluded in last week's report that the overall thrust of the economic data remains consistent with a soft landing (i.e. no recession or re-acceleration in growth).

Some of this week's Treasury selloff is justified because recent positive economic data surprises

Chart 3 Wars And Oil Prices

*5 events from 1973-2002

**7 events from 1982-2021

***6 events from 1988-2019

Note: This averages oil prices 6 months +/- from the start of conflict, with value indexed to 0 on conflict start date

temper the need for the FOMC to deliver super-sized rate cuts. However, we think the bear flattening in the Treasury coupon curve is overdone and we are considering extending duration to above-benchmark if the 10-year yield moves much above 4%.

Economic Impact Of Oil Shocks

We have received numerous questions regarding the potential implications a broadening war in the Middle East. Our geopolitical team expects that there will be a major escalation of the conflict in the next 6-9 months (60% probability).²

Israel will retaliate to Iran's latest missile attack in the next month. Severe responses could include air-strikes on Iran's nuclear facilities, oil infrastructure,

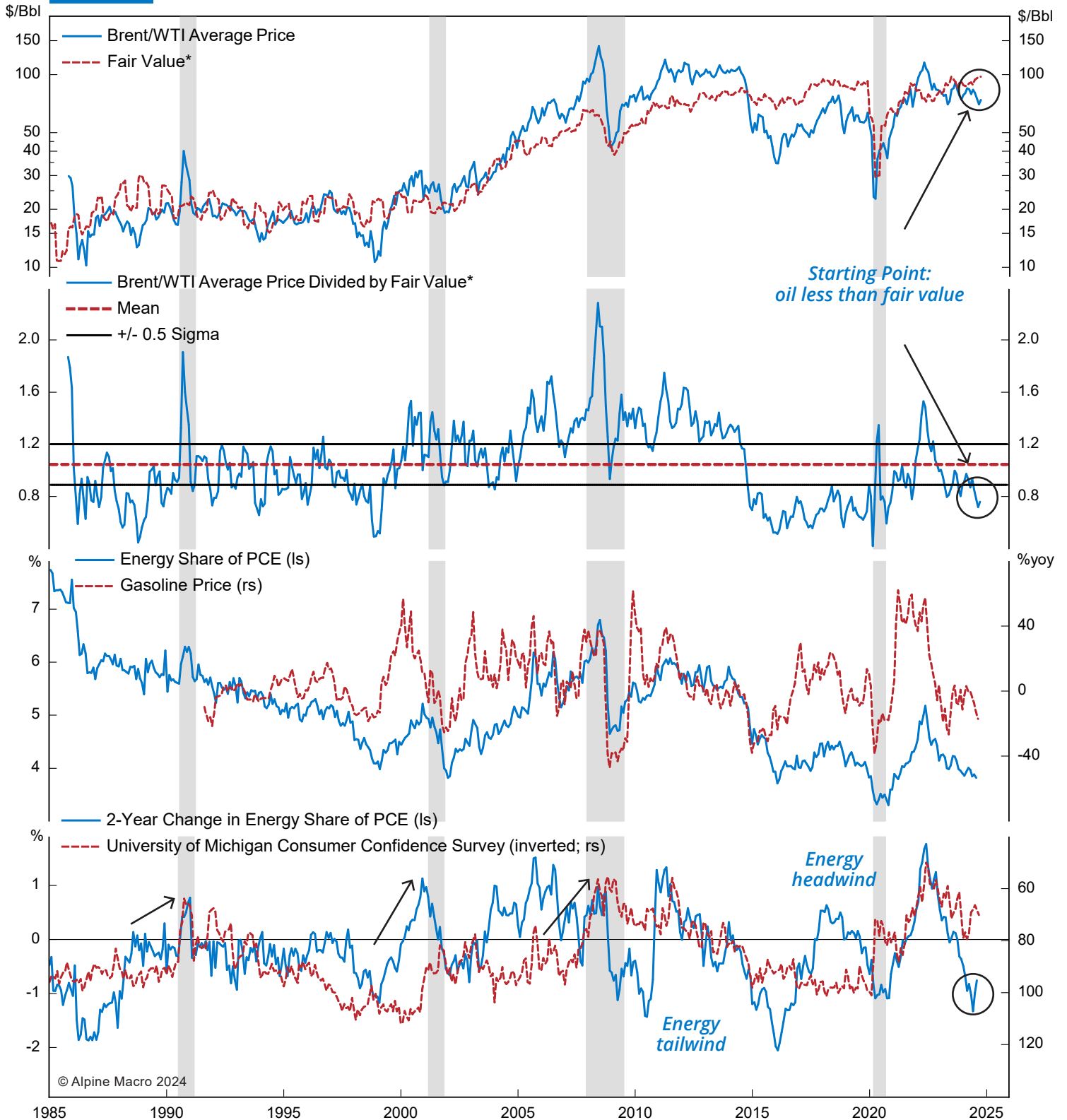
or leadership. This could spark a regional conflict and potentially draw in the U.S. or (far less likely) the GCC states. In this scenario, Iran's threat to close the Strait of Hormuz is a serious market risk.

There are several channels through which war escalation could affect the U.S. This week we focus on the oil channel.

Based on historical precedent, a sustained conflict in Lebanon, Syria, and Iraq (Israel vs. Iranian proxies) could push oil prices up 10-20% over approximately 6 months (Chart 3). A direct Israel-Iran war could nearly double prices, as it would likely impede oil and gas shipments from the Persian Gulf.

2 Alpine Macro Geopolitical Strategy "The Middle East: Major Escalation Is Likely, Either Now Or Later" (October 4, 2024).



Chart 4 Oil Supply Shocks Have Often Contributed To Recessions

*Alpine Macro calculation based on oil demand and the nominal broad trade-weighted dollar

Note: Shaded areas denote U.S. recession



A spike in oil prices would have stagflationary effects on the U.S. and other major countries.

Higher energy prices would obviously feed into headline consumer price inflation (the September CPI data are being published as we go to press). Whether it affects the Fed outlook would depend in part on the extent of pass-through into wages and core inflation. We believe the pass-through would be modest, although it would temporarily push up inflation breakeven rates across the curve.

In terms of the direct economic impact, it is important to distinguish demand from supply shocks. An increase in the price of oil that is driven by stronger demand is far less damaging than one driven by supply constraints. In the first case, strong economic momentum makes it easier to absorb dearer oil. In the second case, it acts like a pure a tax on growth.

Chart 4 presents a simple model that distinguishes supply and demand shocks. We regressed the price of oil on global oil consumption and the trade-weighted value of the U.S. dollar. Large deviations in the price of oil from fair value are interpreted as supply disturbances. Panel 2 in the chart presents the ratio of the spot price of oil to the model's fair value estimate. Readings above +0.5 standard deviations are considered to be negative supply shocks, while readings below -0.5 standard deviations represent positive supply shocks.

Negative supply shocks have often, but not always, been associated with recessions (shaded periods in **Chart 4**). The U.S. is less exposed to supply-driven surges in the price of oil than it was in the 1970s because oil consumption as a share of GDP

is much lower today. Plus, the fact that the U.S. is now a major oil producer provides some offsetting income.

Nonetheless, it is also important to consider the potential swing in consumer spending on energy when oil prices rise abruptly. An extra dollar spent on energy is a dollar not spent on other items.

The bottom panel of **Chart 4** presents the 2-year change in spending on energy as a share of total consumer spending, along with consumer confidence (shown inverted). The good news is that energy has been a significant tailwind for consumer spending over the past couple of years. The rise in the price of WTI from \$65 to \$74/bbl over the past month is insufficient to “move the dial” on consumer spending power.

The price of oil is currently still below fair value according to the model, but a war-driven jump to \$150/bbl would represent a major negative supply disruption. How would this compare to previous spikes?

Not Like The 1970s

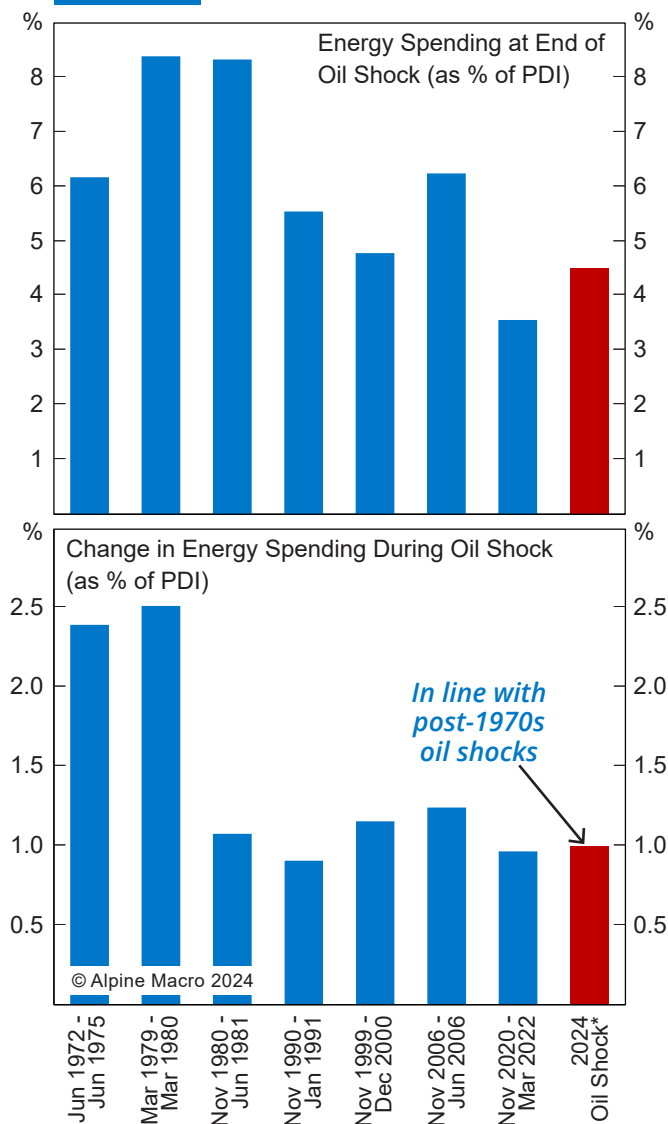
Chart 5 compares the impact on consumer energy spending from oil shocks dating back to the early 1970s. The top panel compares the consumer energy bill at the end of the oil shock (i.e. when oil prices reach the peak). The bottom panel presents the swing in energy spending from trough to peak, expressed as a percent of personal disposable income (PDI).

The red bars in **Chart 5** present our estimates under the assumption that oil prices jump to \$150/bbl by



OMG the consumers will suffer how sad right :)

Chart 5 Oil Shocks In Perspective



*Assuming oil jumps to \$150/Bbl; Alpine Macro Projections

year end. The swing in consumer energy expense would be about 1 percentage point of PDI. This would represent a meaningful shock, although it is far less than occurred in the early 1970s.

The bottom line is that a doubling of oil prices would probably not spark a recession on its own. A recession would occur only if the oil shock occurs at a time when other forces are also weighing on growth.

That said, the combination of war headlines and spiking oil prices would undoubtedly undermine consumer and investor confidence, curtail lending appetite and raise the cost of capital. This would occur alongside increased market volatility and a correction in risk asset prices that includes wider risky spreads. Even though a U.S. recession would likely be avoided, the danger is that real GDP growth slips to a level that triggers recession worries among investors.

What would the implications be for fixed-income sectors?

Bond Sector Vulnerability

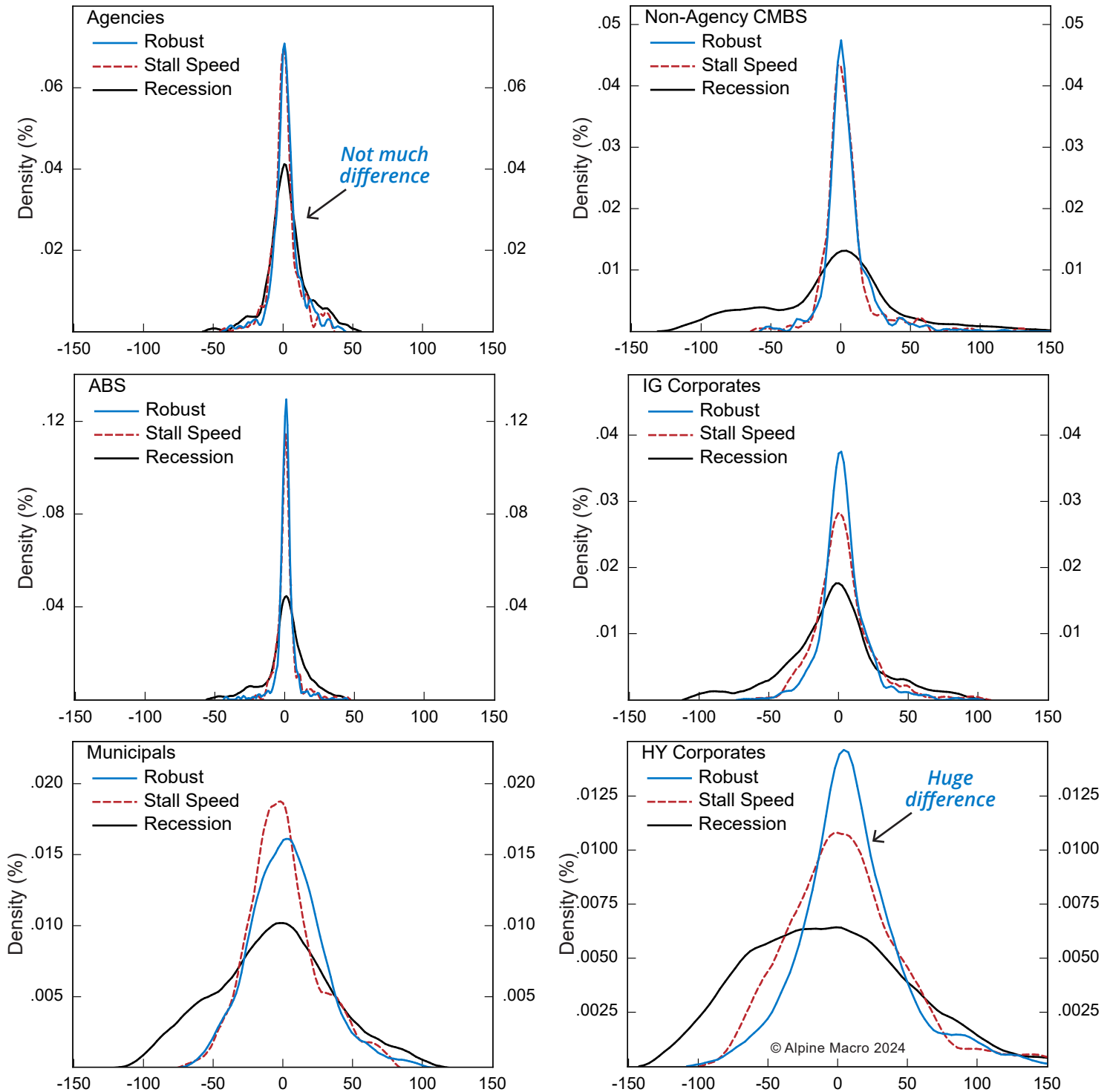
We analyzed excess returns by splitting history into three growth periods: robust (2% or more real GDP growth), recession, and stall speed (between 0% and 2% real GDP growth). Stall speed refers to growth that is low enough the investors begin to worry that the economy could “stall” and topple into a recession.

Chart 6 presents return histograms for the three growth scenarios. The horizontal axis represents the percentage monthly excess return over the duration equivalent Treasury, while the vertical axis represents the frequency of occurrence.³

It is not surprising that the return distribution broadens and is skewed toward underperformance during recessions across all sectors, relative to the robust and stall speed distributions.

More interesting is that for the high-quality defensive sectors, the robust and stall speed distributions

³ Specifically, we present the kernel density of excess returns, which is a smoothed version of a histogram of the underlying data.

Chart 6 Excess Return Distributions Across Three Growth Environments

Note: Robust and Stall Speed are defined as having 2% and over, and 0 to 2% real GDP growth, respectively
 Shown as annualized weekly returns
 Source: Bloomberg Finance L.P.



are very close in shape. In other words, weak-but-positive growth is not a major concern for investors in these areas. As we move down in quality, however, the stall speed distribution becomes progressively more like the recession environment.

Chart 7 presents the difference in average excess returns between robust growth periods and stall speed periods for each sector. The larger the difference, the more growth-sensitive the sector based on this analysis.⁴

The chart highlights the heightened sensitivity of IG and HY Corporate spreads to perceived economic risks.

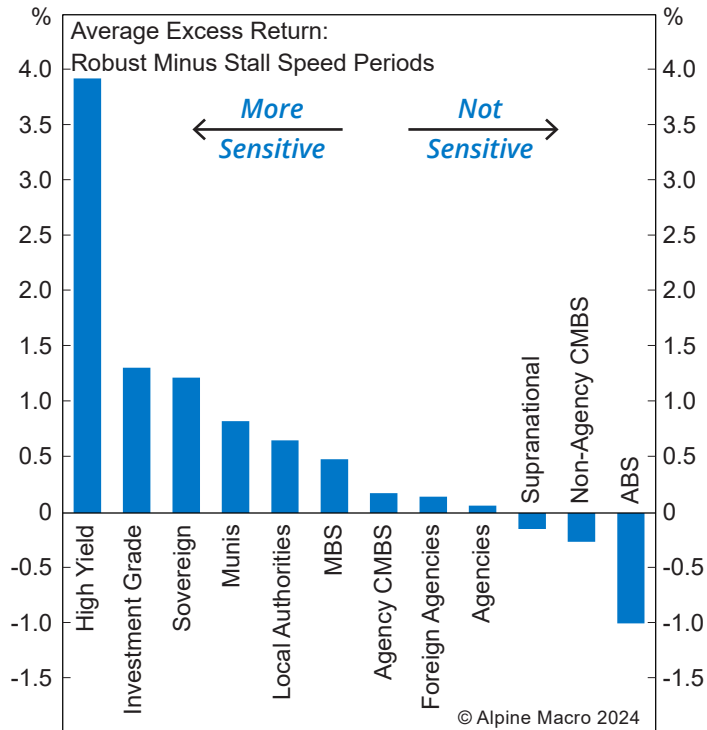
A low median company interest coverage ratio (ICR) and elevated leverage (debt/EBITDA) could make the corporate sector especially vulnerable to an oil shock and “growth scare”, especially given current razor-thin spreads.

Perhaps surprising is the fact that non-Agency CMBS appears to be much less exposed to stall speed than Corporate bonds. The return distribution does not decline and flatten when growth slips into the stall speed zone as much as does IG and HY Corporate returns.

It could be different this time given the post-pandemic hangover that some parts of commercial real estate (CRE) are experiencing. Nonetheless, we still believe that AAA-rated tranches offer a good risk/reward balance and will be well insulated from losses in a downturn. That said, it is best to try to avoid office exposure in favor of the other CRE sectors.

Bottom Line: Our recommended fixed-income allocation, beginning on page 9, is not dominated

Chart 7 Sensitivity To Stall Speed



by the risk of a war and oil shock. Nonetheless, it is designed to provide some protection against a slowdown in growth for any reason, without giving up significant carry versus the benchmark. Indeed, our portfolio yields slightly more than the benchmark without taking any duration risk at the moment. Our barbell strategy involves keeping spread duration short, offset by extending duration in the Treasury sleeve.

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⁴ It makes little sense that ABS returns have been higher in the stall speed periods than in the robust periods. However, this may reflect data anomalies or idiosyncratic events that have distorted the averages.

Alpine Macro U.S. Bond Allocation (Duration: At Benchmark)

1-5 Scale; 3 Represents Benchmark	Allocation Score	Comments
Treasurys	2	
Spread Product	4	
Spread Product Composition:		
IG Corporates	3	Avoid AAA; favor upper-end of BBB
High-Yield	3	
Agency CMBS	5	
Non-Agency CMBS	4	Favor AAA
Government-Related	4	Favor Local Authorities and Agencies
ABS	4	Favor up-in-quality, favor sub-prime autos
Agency MBS	4	
Municipals	4	Favor highly-rated taxables in the belly, and BBB non-taxables at the long end

Note: The allocation score presents Alpine Macro's recommended weighting relative to benchmark. It is based on a five-point scale, with "1" being "maximum underweight", and "5" being "maximum overweight". A benchmark weighting is represented by "3". The underweights and overweights across bond sectors notionally sum to the overall recommendation for spread product versus Treasurys. Our benchmark is the Bloomberg Barclays U.S. Aggregate Bond Index, augmented with High-Yield Corporates and Municipal bonds.

Historical Returns

	Excess Return to Treasuries (Bps)			Total Return (Bps)			Option Adjusted Spread (Bps)				Duration
	Past 5 Days	Past Month	YTD	Past 5 Days	Past Month	YTD	Latest	Past 5-Day Change	Past Month Change	YTD Change	
Barclays Aggregate	10	38	87	-124	-60	385	34	-1	-4	-9	6.2
Treasury Index				-134	-94	294	0	1	-1	0	6.0
IG Corporate	44	122	238	-103	0	517	83	-5	-14	-21	7.1
AAA	40	130	183	-148	-63	346	27	-4	-11	-15	10.6
AA	36	113	160	-123	-33	407	42	-4	-11	-10	8.3
A	43	121	217	-104	-1	496	68	-6	-15	-23	7.1
BBB	46	125	271	-99	7	557	105	-6	-14	-22	6.9
High-Yield	64	173	491	-15	144	876	283	-20	-41	-67	3.0
BB	61	119	369	-22	84	742	168	-16	-26	-53	3.2
B	58	128	396	-14	106	780	274	-10	-24	-63	2.7
CCC	82	441	965	4	412	1384	631	-63	-145	-198	2.9
ABS	6	17	90	-62	-2	463	62	-2	-3	-6	2.7
Government Related	19	52	99	-102	-33	411	45	-2	-6	-5	5.4
Domestic Agency	0	9	31	-77	-23	376	14	-2	-3	-4	3.2
Foreign Agency	0	13	56	-95	-35	405	23	0	-1	-7	3.7
Sovereign	72	192	273	-98	33	505	114	-10	-21	-15	8.7
Local Authorities	18	32	120	-140	-105	374	65	-2	-3	-9	7.8
Supranationals	-3	4	27	-102	-47	386	9	1	-1	-3	3.7
MBS	-8	20	77	-131	-68	396	41	2	-1	-9	5.8
CMBS	1	26	208	-113	-40	549	93	0	-5	-33	4.2
Non-Agency	4	45	315	-100	-9	670	148	-2	-10	-55	3.8
Agency	-3	8	101	-125	-69	428	40	1	-1	-9	4.6
Municipals*	154	187	-131	3	77	232	-55	-25	-31	14	6.1

*YTW used instead of OAS

Detailed U.S. Bond Allocation

	Allocation Score	Yield			Duration			Weight		
	PF	PF* (%)	BM* (%)	Exposure (Bps)	PF*	BM*	Exposure	PF* (%)	BM* (%)	Exposure (Bps)
U.S. Bond Strategy		4.5	4.5	4	6.2	6.2	0.0	100.0	100.0	0.0
Treasurys	2	4.0	4.0	2	7.5	6.4	1.0	29.9	39.6	-9.7
Spread Product	4	4.7	4.8	-6	5.7	6.1	-0.4	70.1	60.4	9.7
Corporate	3	5.1	5.2	-7	5.6	6.6	-1.0	26.0	25.9	0.1
Investment Grade	3	4.8	4.9	-9	6.1	7.3	-1.2	21.9	21.9	0.0
AAA	1	4.4	4.4	0	11.2	11.2	0.0	0.1	0.3	-0.1
AA	3	4.4	4.5	-12	6.9	8.7	-1.7	1.5	1.5	0.0
A	3	4.6	4.7	-8	6.0	7.3	-1.3	9.7	9.7	0.1
BBB	3	5.0	5.1	-9	5.9	7.0	-1.1	10.5	10.4	0.1
High Yield	3	6.9	6.9	0	3.0	3.0	0.0	4.0	4.0	0.0
BB	3	5.9	5.9	0	3.2	3.2	0.0	2.0	2.0	0.0
B	3	7.1	7.1	0	2.7	2.7	0.0	1.5	1.5	0.0
CCC	3	10.3	10.3	0	2.9	2.9	0.0	0.5	0.5	0.0
Government Related	4	4.5	4.5	5	6.0	5.5	0.5	4.2	3.9	0.2
Agency	4	4.3	4.3	6	3.7	3.2	0.5	0.8	0.6	0.2
Foreign Agency	3	4.2	4.2	6	4.3	3.7	0.6	0.6	0.6	0.0
Local Authorities	5	4.8	4.7	7	8.9	7.8	1.1	1.0	0.6	0.3
Sovereign	3	5.3	5.2	8	9.9	8.7	1.3	0.9	0.9	0.0
Supranationals	2	4.1	4.0	6	4.3	3.7	0.5	0.8	1.1	-0.3
Securitized	4	4.7	4.7	0	5.7	5.7	0.0	33.7	25.7	8.1
Agency CMBS	5	4.3	4.3	0	4.6	4.6	0.0	1.1	0.7	0.4
Non-Agency CMBS	4	5.4	5.4	0	3.8	3.8	0.0	0.9	0.7	0.2
ABS	4	4.6	4.6	0	2.7	2.7	0.0	0.5	0.4	0.1
Agency MBS	4	4.7	4.7	0	5.8	5.8	0.0	31.3	23.9	7.4
Municipals	4	3.3	3.3	0	6.1	6.1	0.0	6.3	5.0	1.3

*PF = Portfolio; BM = Benchmark

Source: Bloomberg Finance L.P.

Note: Our methodology incorporates a restriction that the maximum deviation from the benchmark weight is 50%. However, due to the adding-up constraint, the actual weight shown in the table can deviate by slightly more than 50% at times.



Detailed U.S. Bond Allocation

	Contribution to Duration (CTD)			Contribution to Yield (CTY)		
	PF*	BM*	Exposure	PF* ()	BM* ()	Exposure
U.S. Bond Strategy	6.2	6.2	0.0	4.5	4.5	4
Treasurys	2.2	2.5	-0.3	1.2	1.6	-38
Spread Product	4.0	3.7	0.3	3.3	2.9	42
Corporate	1.5	1.7	-0.3	1.3	1.3	-1
Investment Grade	1.3	1.6	-0.3	1.1	1.1	-2
AAA	0.0	0.0	0.0	0.0	0.0	-1
AA	0.1	0.1	0.0	0.1	0.1	0
A	0.6	0.7	-0.1	0.5	0.5	0
BBB	0.6	0.7	-0.1	0.5	0.5	-1
High Yield	0.1	0.1	0.0	0.3	0.3	0
BB	0.1	0.1	0.0	0.1	0.1	0
B	0.0	0.0	0.0	0.1	0.1	0
CCC	0.0	0.0	0.0	0.1	0.1	0
Government Related	0.3	0.2	0.0	0.2	0.2	1
Agency	0.0	0.0	0.0	0.0	0.0	1
Foreign Agency	0.0	0.0	0.0	0.0	0.0	0
Local Authorities	0.1	0.1	0.0	0.0	0.0	2
Sovereign	0.1	0.1	0.0	0.0	0.0	0
Supranationals	0.0	0.0	0.0	0.0	0.0	-1
Securitized	1.9	1.5	0.5	1.6	1.2	38
Agency CMBS	0.0	0.0	0.0	0.0	0.0	2
Non-Agency CMBS	0.0	0.0	0.0	0.0	0.0	1
ABS	0.0	0.0	0.0	0.0	0.0	0
Agency MBS	1.8	1.4	0.4	1.5	1.1	35
Municipals	0.4	0.3	0.1	0.2	0.2	4

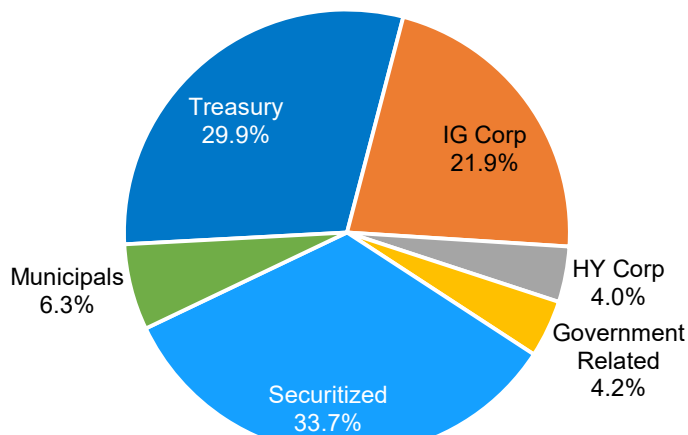
*PF = Portfolio; BM = Benchmark

Source: Bloomberg Finance L.P.

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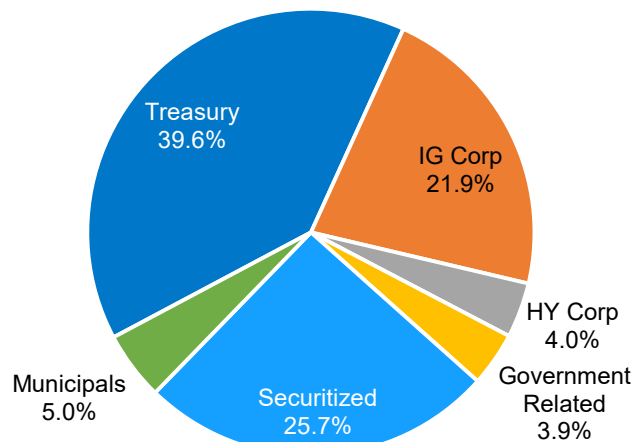
Portfolio Exposure



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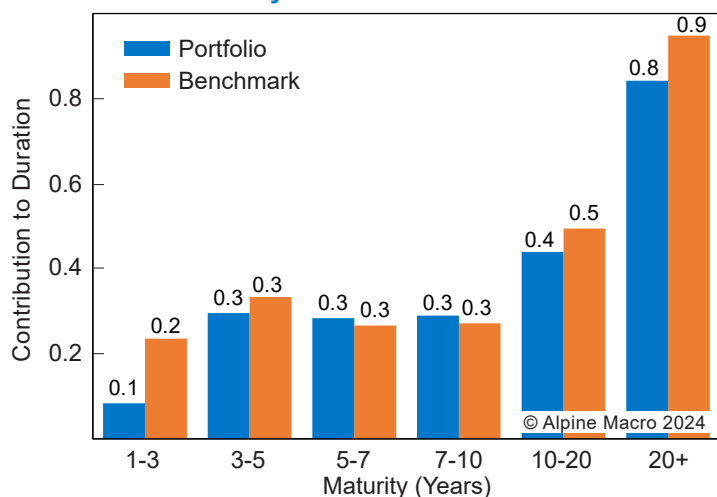
Benchmark Exposure



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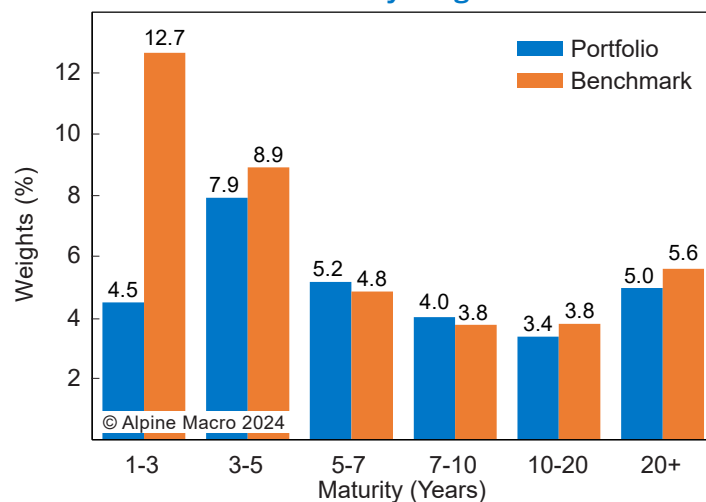
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Treasury Contribution To Duration



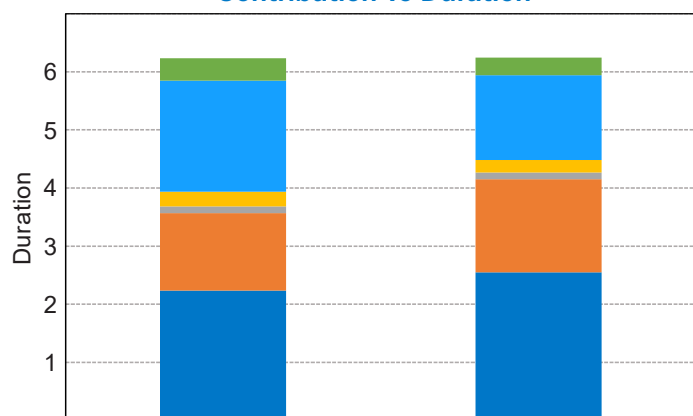
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Treasury Weight



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Contribution To Duration



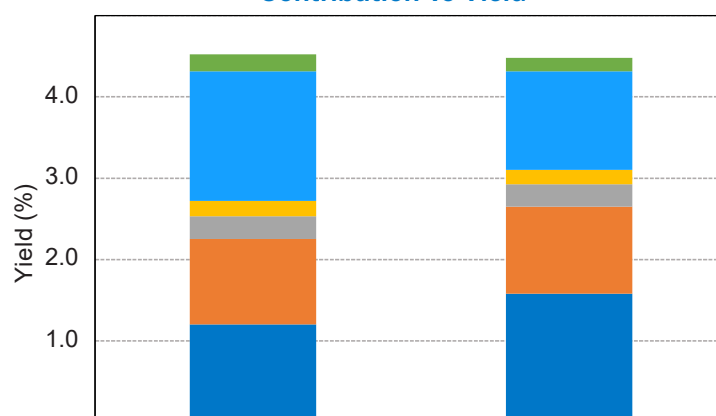
PF
Treasury IG Corp

Source: Bloomberg Finance L.P.

BM
HY Corp

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Contribution To Yield



PF

Treasury IG Corp

Source: Bloomberg Finance L.P.

BM

HY Corp

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