LINIAM | CAPITAL

Market and Economic Update

November 11, 2022

Lower Yields and Equity Prices Lie Ahead

While still too high, Inflation has likely peaked and should trend lower

- Covid policy response led the money supply to surge, but with current tightening it is now flatlining and should halt inflation.
- Homes prices have peaked and housing costs should follow (shelter costs are the biggest component of the CPI).
- Manufacturing and service sector input prices have slowed dramatically in recent months.
- The labor market imbalance and other supply chain constraints are easing, and wage growth appears to be slowing.
- The new Congress is likely to restrain the Biden Administration's deficit spending urges that have contributed to inflation over the past two years.

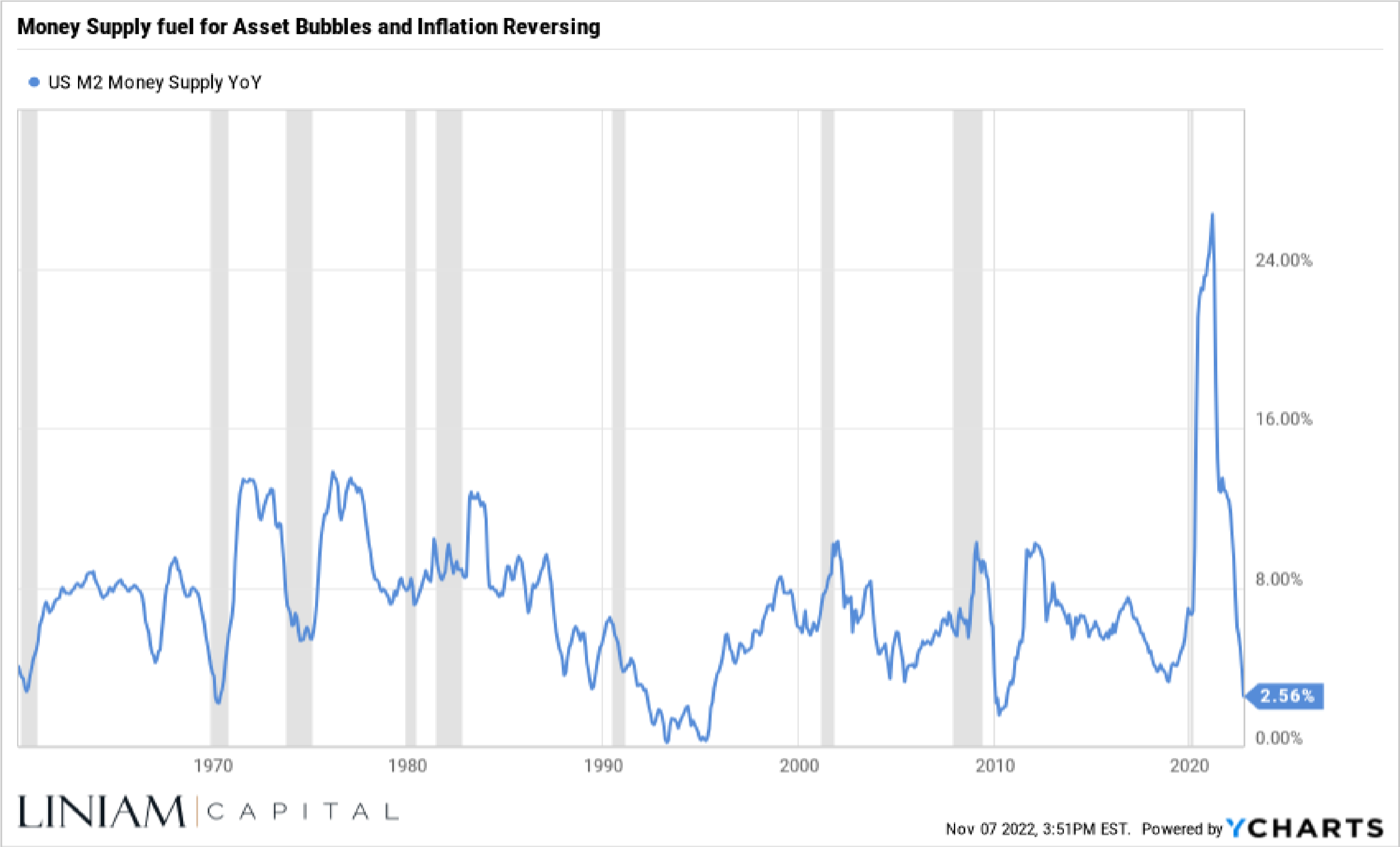
Economic growth has stalled, and additional downside is likely next year due to the lagged effects of higher interest rates

- Layoff announcement are beginning to accelerate.
- Leading economic indicators continue to trend lower and point toward recession in the coming year.
- The deeply inverted yield curve is sending a strong recession signal for the next 12 months.

Declining inflation and economic activity in the coming months should lead to lower bond yields

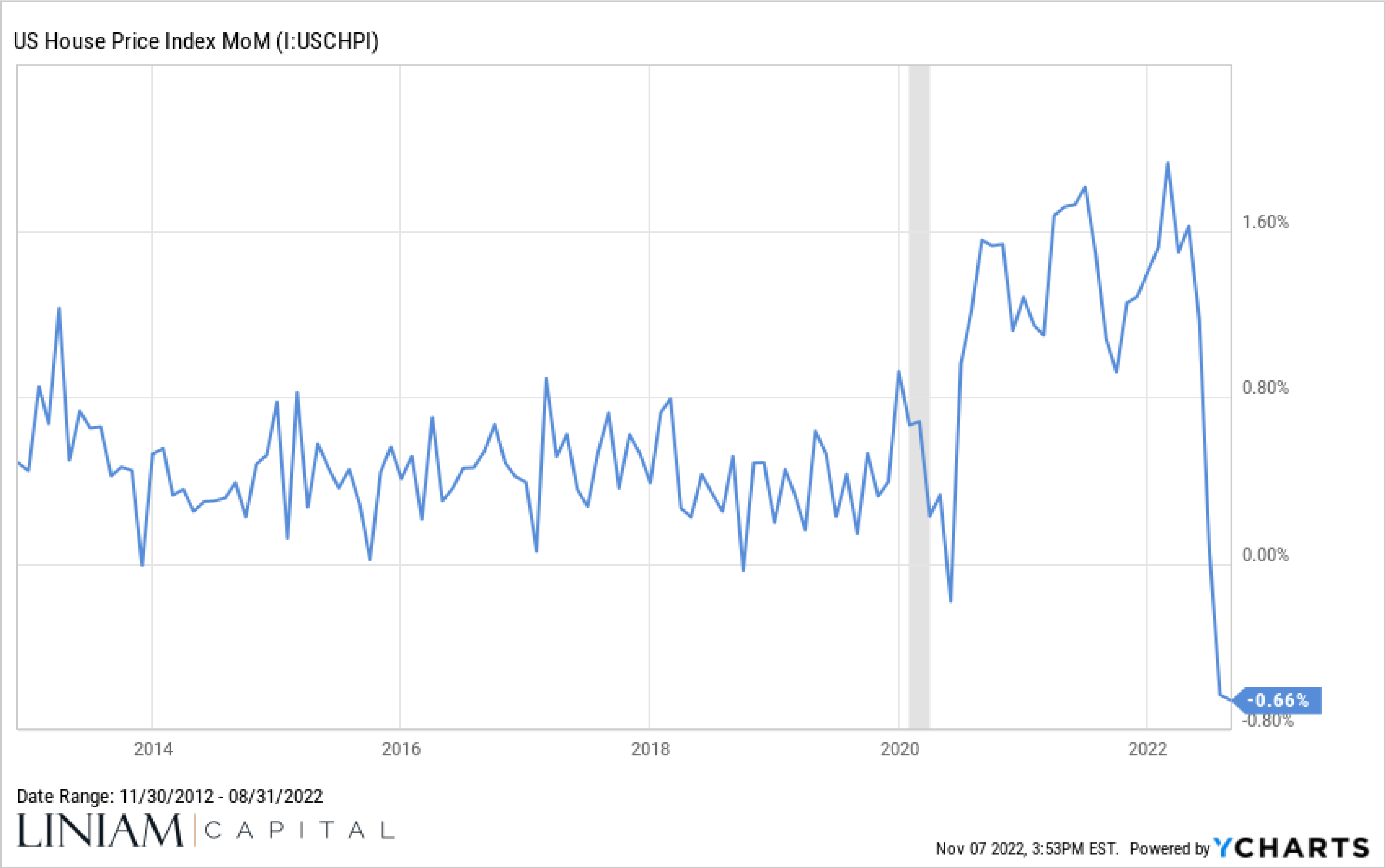
- Fed is still likely to raise short term policy rates in the near term. Once unemployment begins to rise in a sustained manner the rate hikes should end, and historically the interval between the last rate hike and the first interest rate cut is relatively short (six to seven months median experience).
- Equity valuations will benefit from lower inflation and interest rates, but today's valuations remain very high from a historical perspective and the negative consequences of contracting economic activity and reduced pricing power should lead to a decline in earnings that dominates any valuation benefit from rate relief. Further downside is expected.

After Surging, Money Supply Growth Has Fallen Sharply this Year



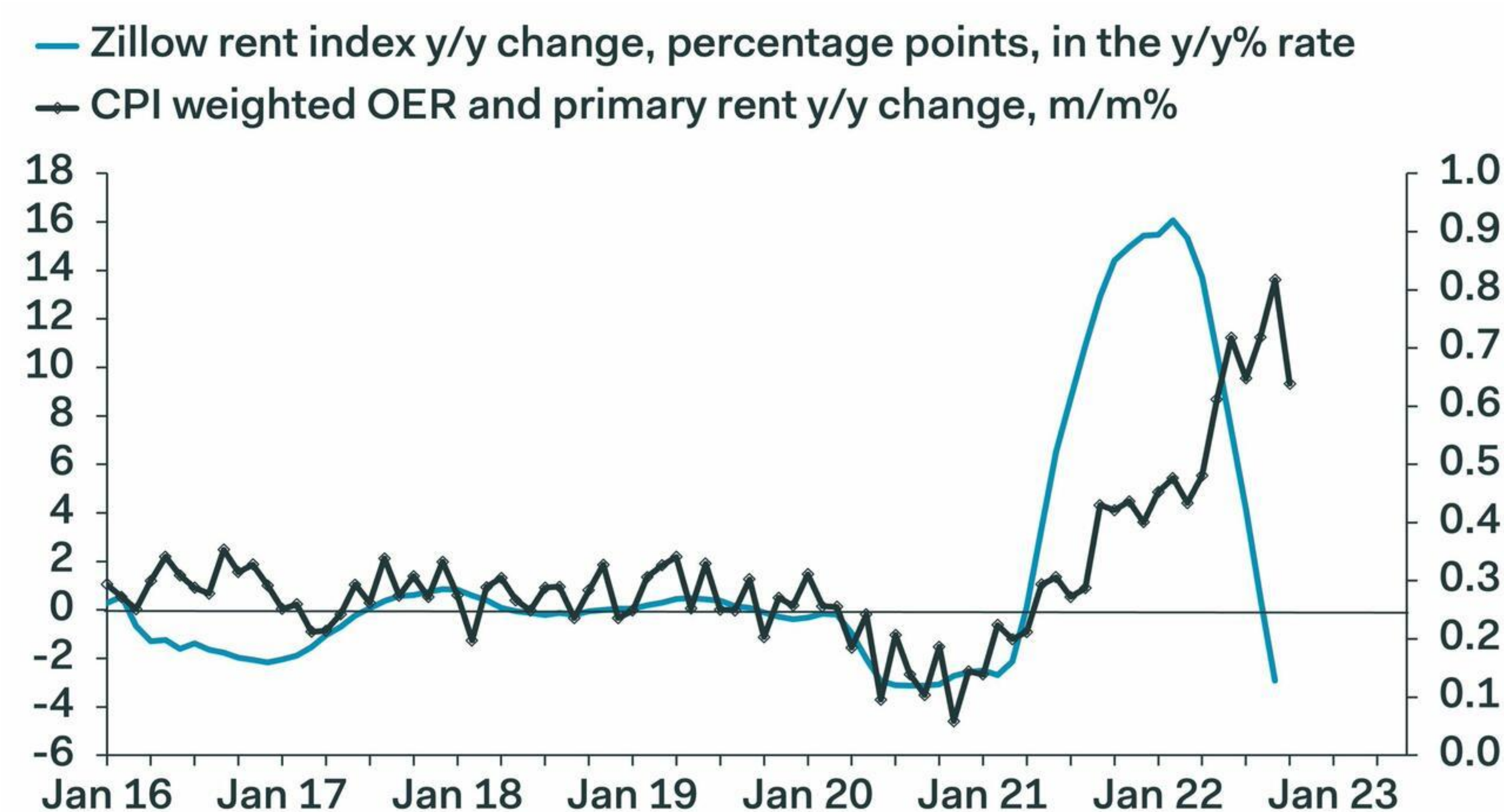
The surge in money supply in response to the pandemic first led to a surge in asset prices (equities, real estate) but ultimately resulted in broad based inflation for goods, services and labor because the Fed misread the initial signs of inflation and kept the monetary spigots open far too long. The rate increases and bond sales this year by the Fed have brought money growth down sharply, cutting off the fuel for sustained inflation.

Home Prices Are Likely Leading a Coming Deceleration in Rents



Housing affordability was the first casualty of the Fed's shift to tighter monetary policy early this year, which has resulted in sharply lower building activity and home sales. Home prices have begun to follow the slump in sales activity, which should make its way into the inflation measures (imputed rental cost if living in your own home) with a lag.

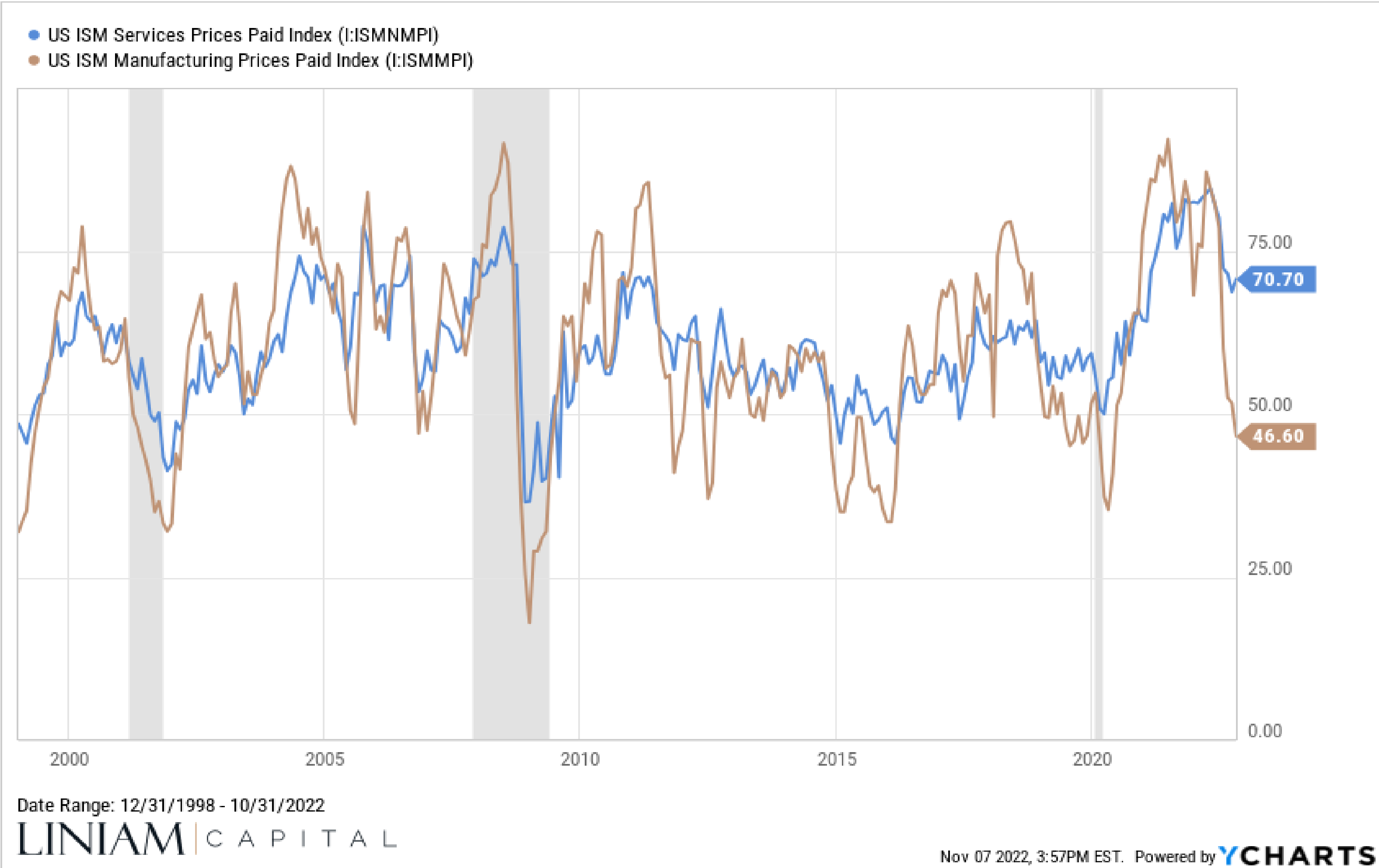
Market Based Data Suggest Cooling Rental Inflation is Here



Source: Ian Shepardson

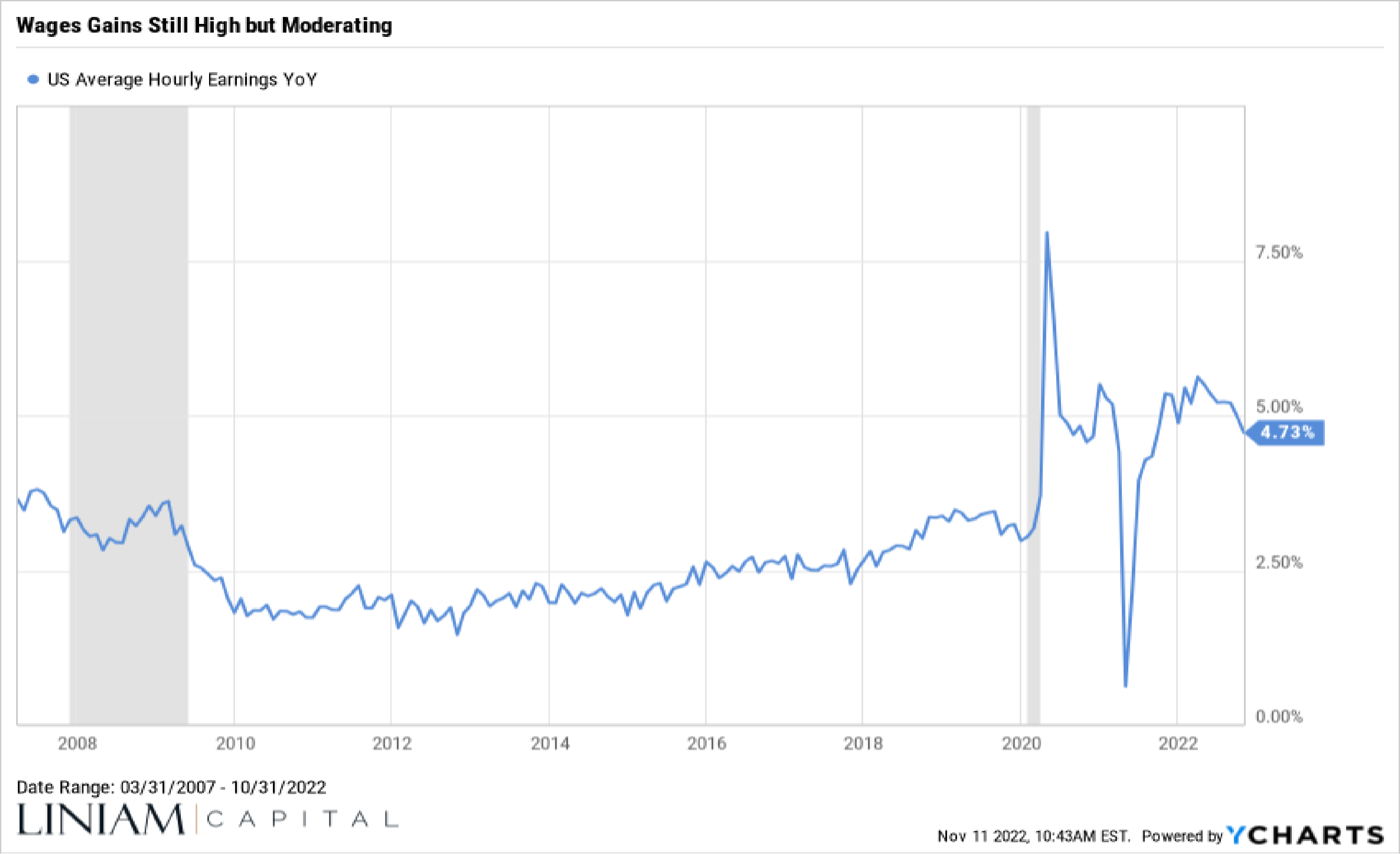
The hokey measure of owners' equivalent rent used by the Bureau of Labor Statistics in the CPI for shelter is the biggest single component of the Consumer Price Index and it appears to be lagging the change in home prices and observable rents from private sources in recent months. While this might persist for a while, rental rates are likely to help bring the CPI down materially in the coming year.

Input Price Increases Down Sharply in Recent Months



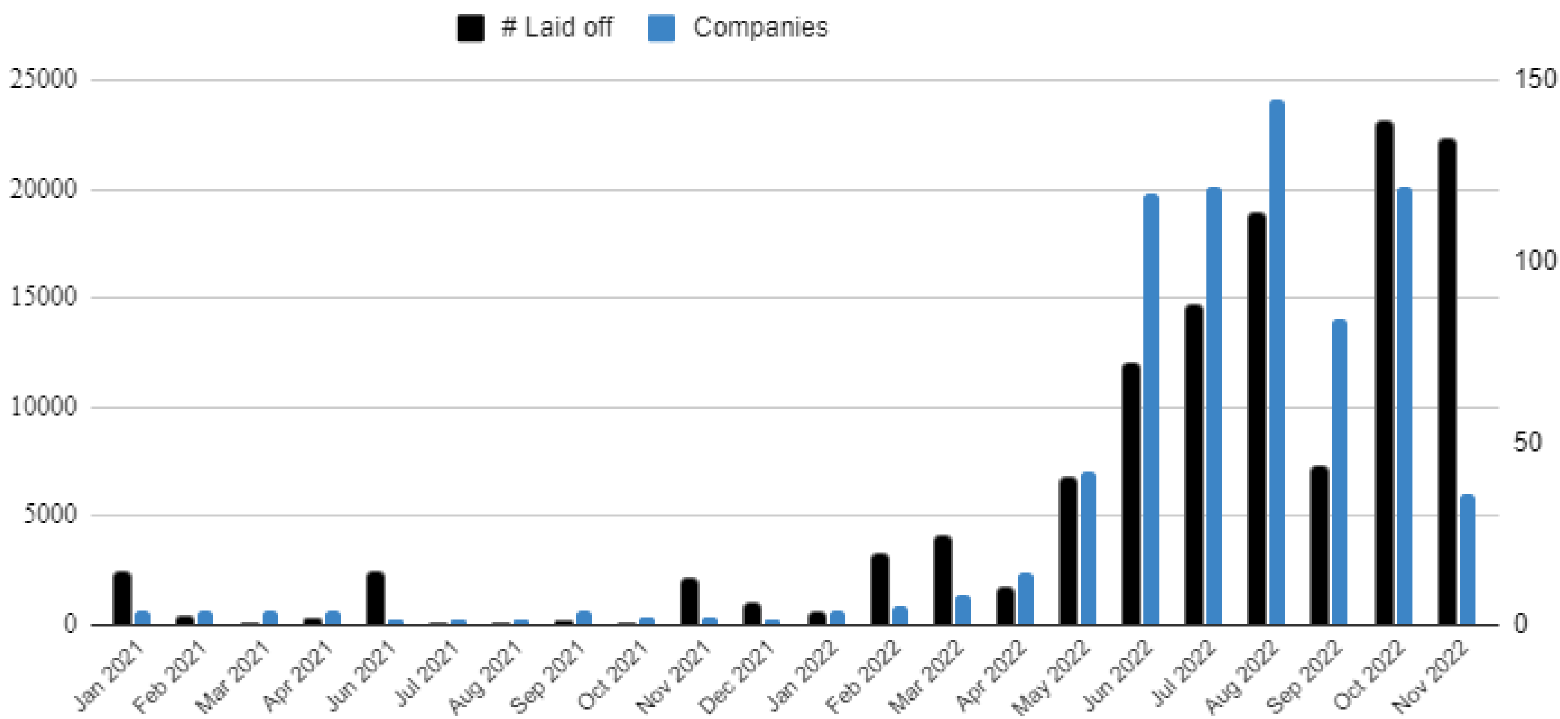
Many measures show supply chain disruptions have eased significantly over the course of this year, and input prices for both manufacturers and service producers have come down sharply in recent months. Cost pressures have remained more persistent in the service sector, likely reflecting greater labor cost intensity. Slower economic activity and reduced labor demand in the coming quarters should work to slow the increase in labor costs.

Wage Growth has Decelerated in Recent Months



While labor market conditions have remained extraordinarily tight through much of the year, job openings peaked this summer and job growth has been steadily declining. Wage gains remain elevated relative to pre-pandemic normal levels but appear to have begun a deceleration in recent months. With indications that labor demand is weakening, we should see further moderation in wage growth in the coming year.

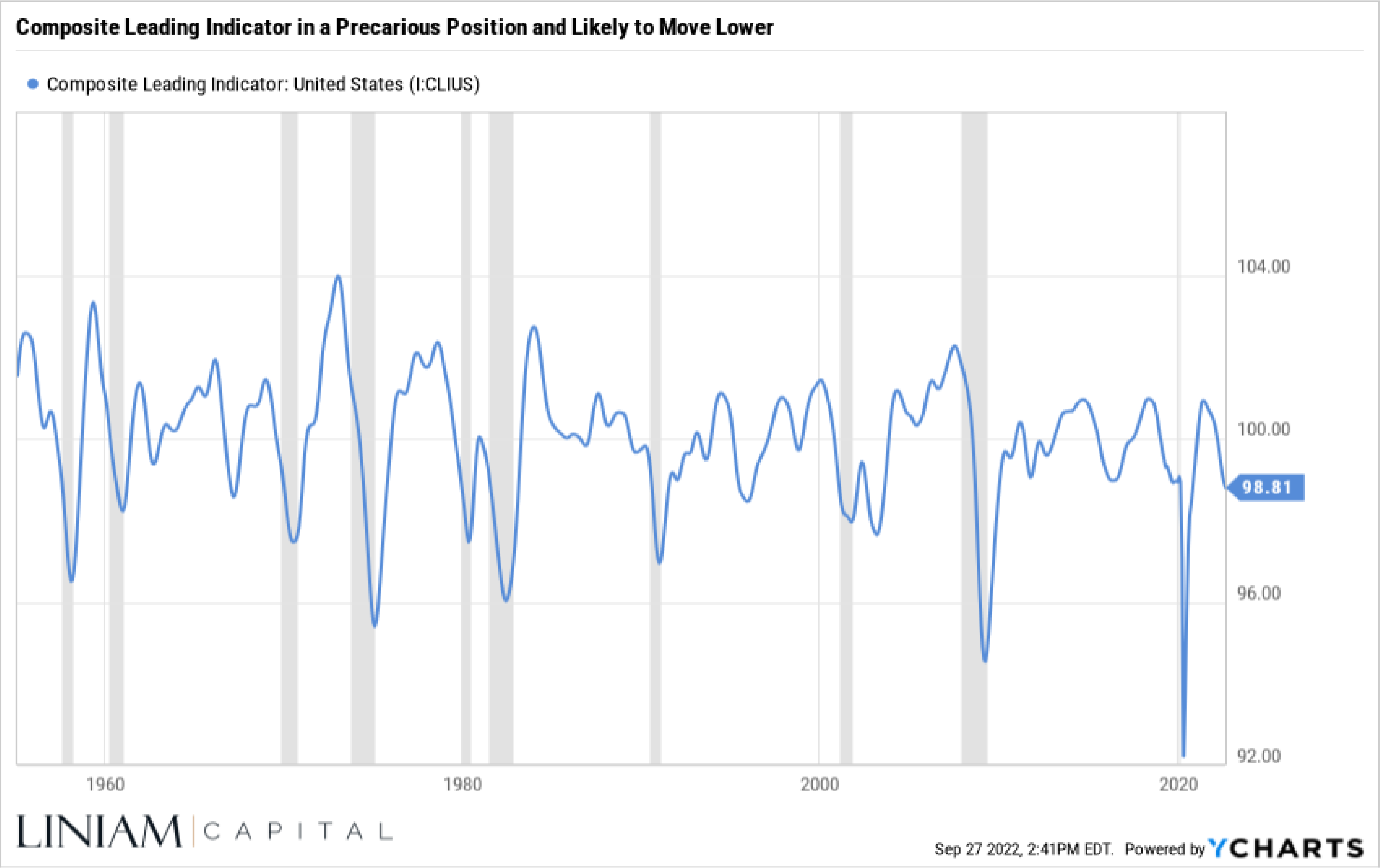
Layoff Announcements are Beginning to Accelerate



Source: Layoffstracker.com

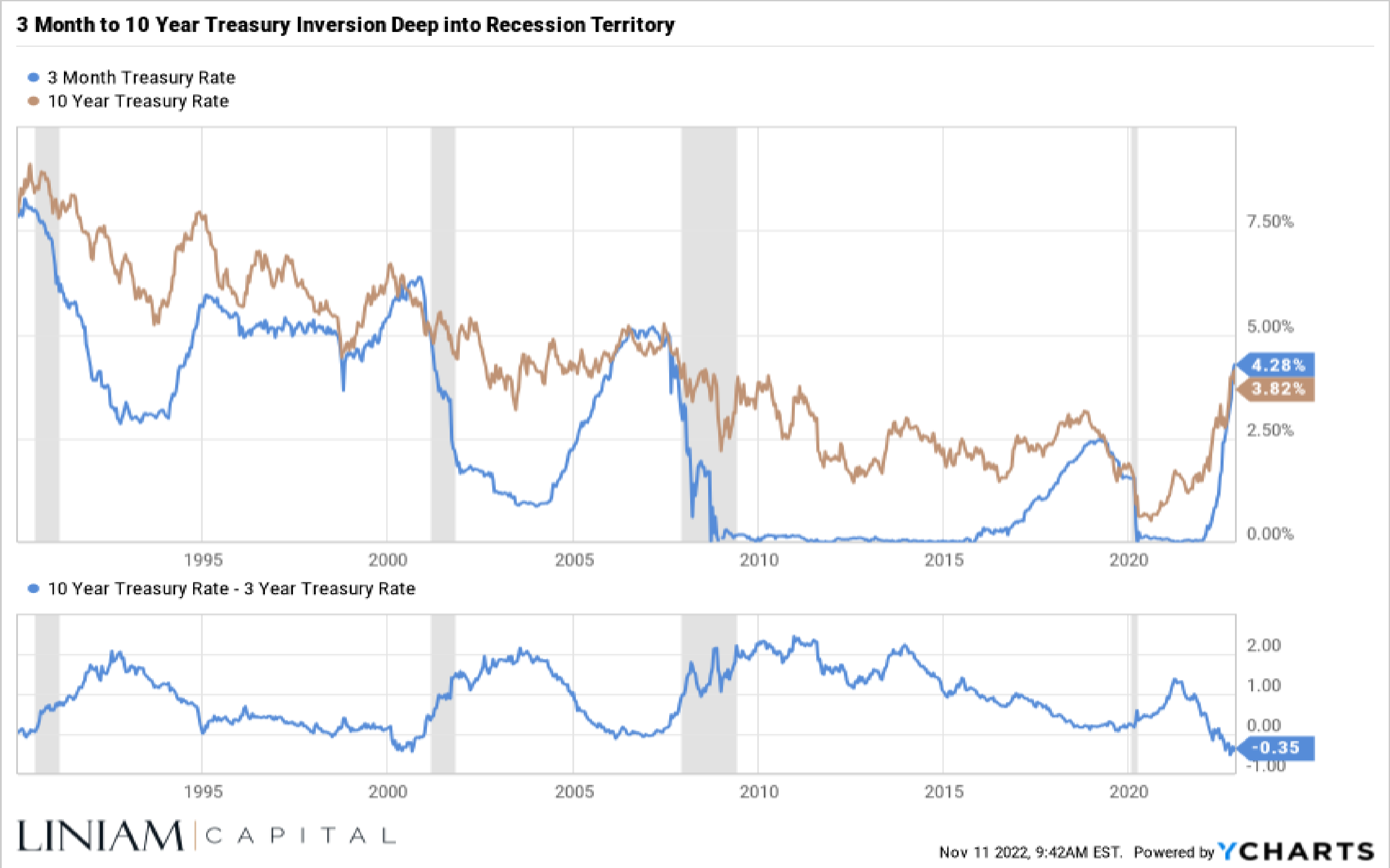
Momentum in the labor market is diminishing. If not for model adjustments, payroll growth would have been negative in October. The unemployment rate rose to 3.7 percent in during the month and layoff announcements have been accelerating in recent months. Bank of America's economists estimate that job losses will push to 175K per month by the first quarter of next year. Those estimates that appear reasonably aligned with the current economic backdrop and would almost certainly put an end to the Fed's rate hiking cycle.

Leading Indicators Deteriorating and Unlikely Near a Bottom



The composite leading indicator is at the threshold of a recession signal and this indicator is likely to continue moving lower based on coincident data and the continued tightening of monetary policy by the Fed. Many ancillary indicators such as negative real wage gains, a sharp decline in the personal savings rate and depressed consumer confidence are not reflective of any impending improvement in the leading indicators.

Strong Recession Signal Coming From the Yield Curve



The inversion of the 3-month to 10-year Treasury curve has deepened significantly and when it is this inverted recession almost always follows within the next year. That is our expectation, and once unemployment begins to rise the Fed will likely begin to reverse the rate hikes put in place this year, supporting bond returns while equities would likely move lower as corporate earnings levels would likely be well below current expectations.

Contact Information

Keith Hembre, CFA

Chief Investment Officer

khembre@liniam.com

612-760-2484

Mark Austin

Chief Executive Officer

maustin@liniam.com

612-760-2454