LINIAM | CAPITAL

Market Update and Outlook

Q1 2023

March 21, 2023

Outlook Summary

Market Valuation:

- US equity market is still historically expensive and the dividend yield is low relative to bonds
- US Treasury yields are off recent highs but remain well above average levels for the past 15 years
- Credit compensation has improved but remains below levels typically seen in recessionary environments
- Alternatives mixed – gold, energy positive, real estate problematic (debt dependent)

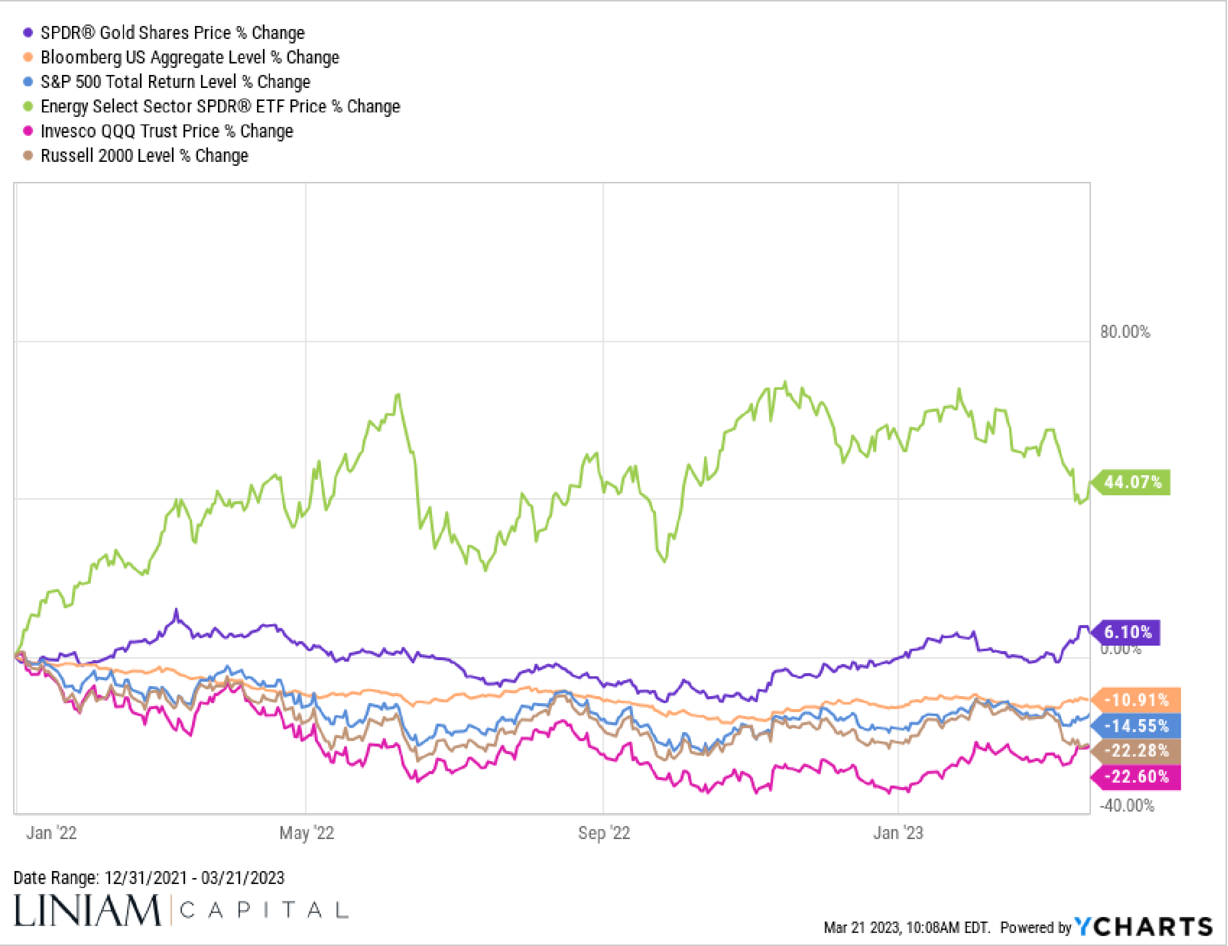
Economic Fundamentals:

- Recession likelihood high in the near term
- Inflation past peak, rate increases nearing the end but persistent inflation levels constrains Fed's ability to ease policy in response to economic weakness
- Banking sector – credit cycle to weaken
- Geopolitical issues and de-globalization

- **Investment Strategy/Portfolio Positioning:**
- Very active Q1 trading interest rate exposures
- Looking for opportunities in the spread sectors
- Credit/Equites to underperform in a more volatile and recessionary environment on a 12-month horizon
    - Will look to reallocate when valuations are more reasonable, or fundamentals compel an allocation change
- Select exposures to low Beta, high dividend, stable business and thematic equites
- Debt encumbrances, financial and global instability could benefit gold

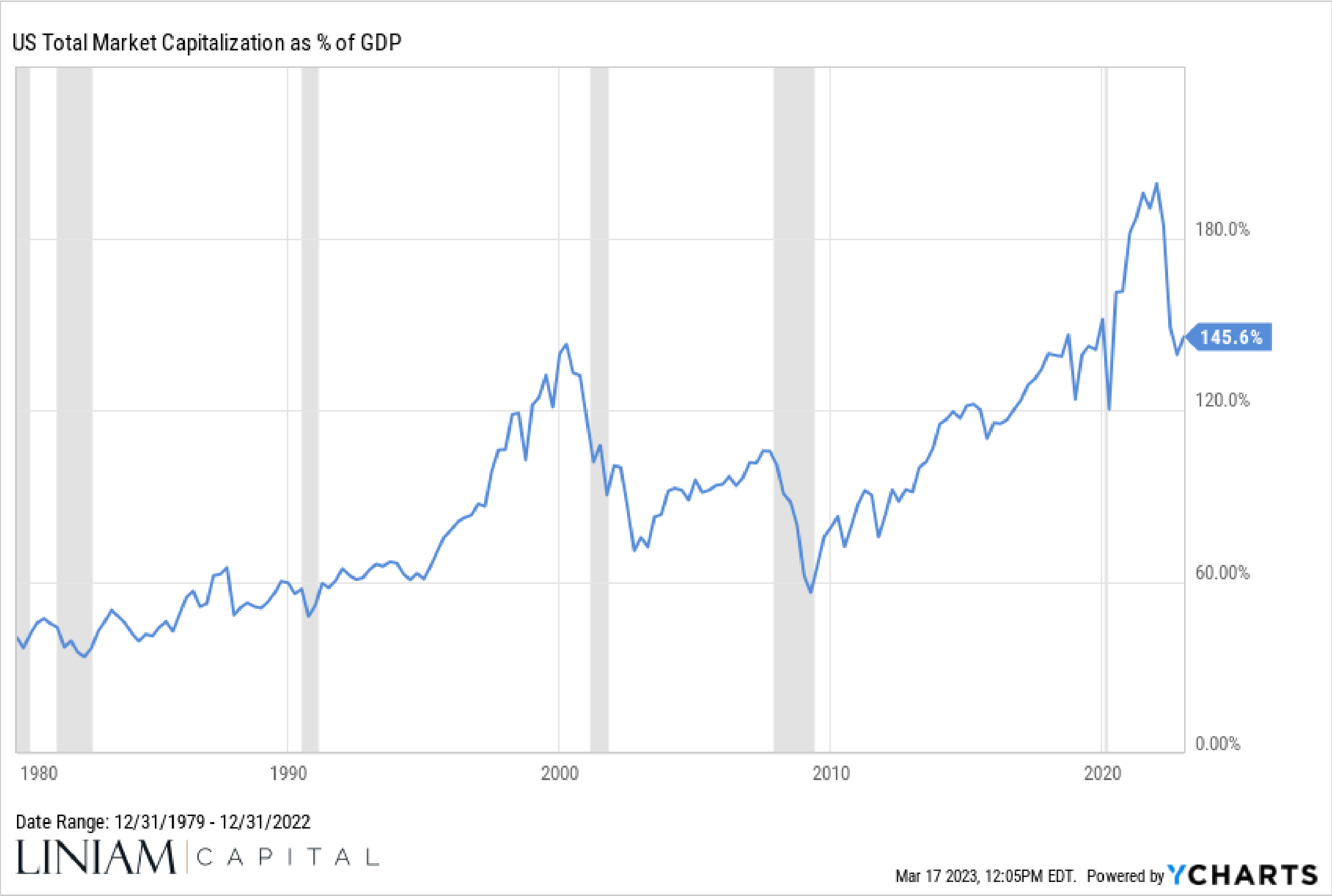
Market Performance

Markets have been quite volatile over the past 15 months. Energy has been a top performer with gains driven in early 2022 following Russian sanctions. Gold has performed well despite real interest rates moving sharply higher. Bonds suffered their worst decline ever last year, but still outperformed equity markets. We anticipate continued outperformance from bonds in 2023.



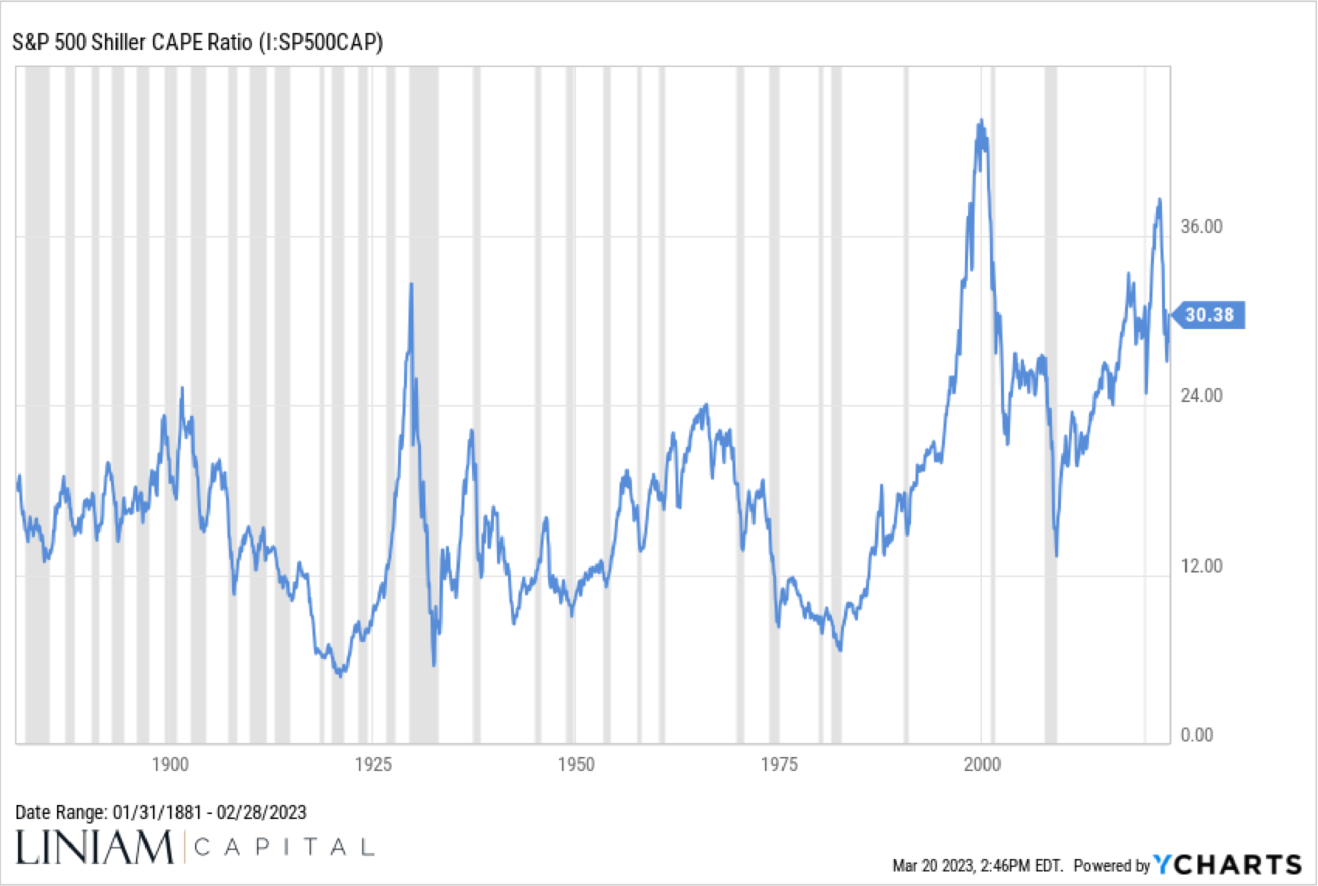
Aggregate Equity Valuations Still Very High

While markets remain well below their high points reached in late 2021, overall equity values remain historically high at 145% of GDP, slightly higher than their peak at the top of tech bubble in early 2000 and well above the long-term average of abut 85% of GDP. Substantial room for further normalization remains.



PE Ratio at a Historically High Level

A similar but different valuation measure is the Shiller P/E ratio which looks at price relative to average trailing earnings. Prior to last year's decline, the P/E ratio had reached its highest levels since the peak of the tech bubble. This measure is not quite as extreme as market cap to GDP. Record profit margins that have exaggerated profits as a share of GDP relative to historical norms.

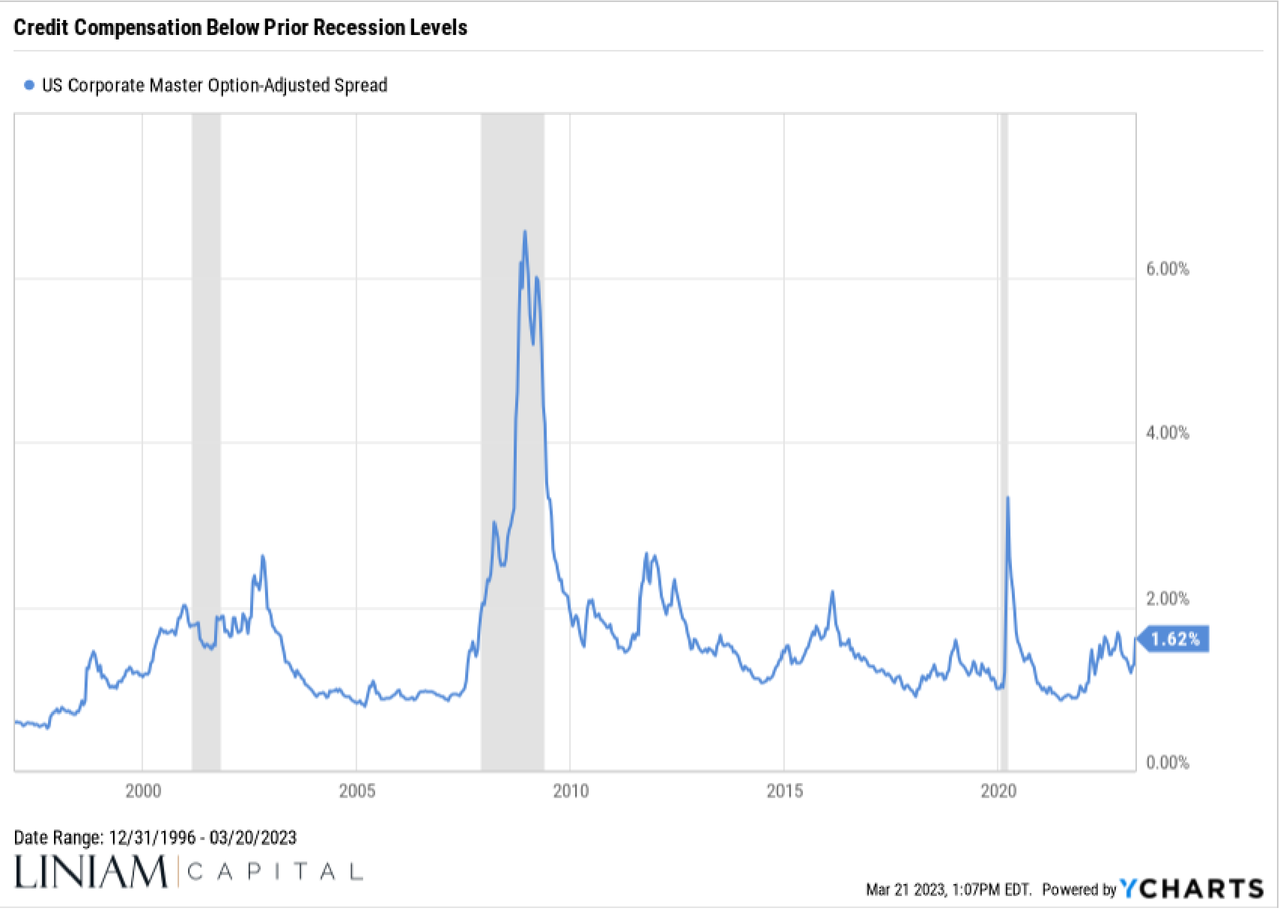


Equity Dividend Income Low vs. Treasury Yields

Equity valuation metrics moved well above historic norms over the past decade in large part because dividend yields looked attractive relative to bonds. That situation changed last year with the sharp increase in bond yields. Five-year Treasury yields now provide the largest positive yield differential relative to equity dividend yields since just before the financial crisis in 2008.

Credit Attractiveness Improving But Still Not Compelling

Corporate credit spreads widened moderately last year, leading corporate bonds to underperform Treasuries. Further spread widening is likely this year, and if it occurs will provide an opportunity to reallocate a portion of Treasury exposure to the corporate market and other spread sectors to enhance returns.

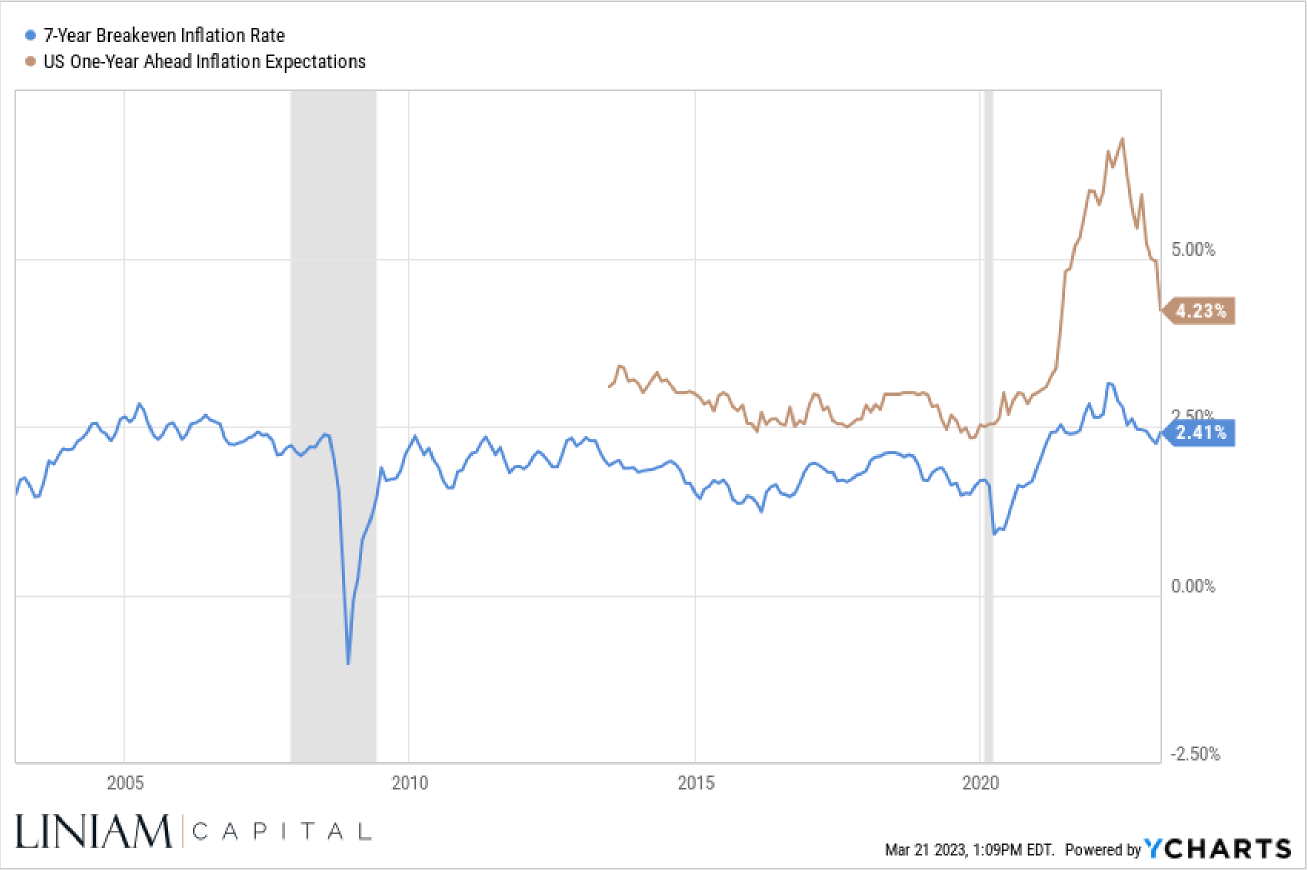


Real Bond Yields Are The Best in a Decade, Still Not Great

10 Year Treasury yields rose from 1.52% to a peak of 4.25% last year as inflation accelerated and the Fed responded by raising policy rates. Real interest rates (interest rates less expected inflation) now sit at post-financial crisis highs and offer reasonable value as the Fed is likely near the end of its rate hiking cycle.

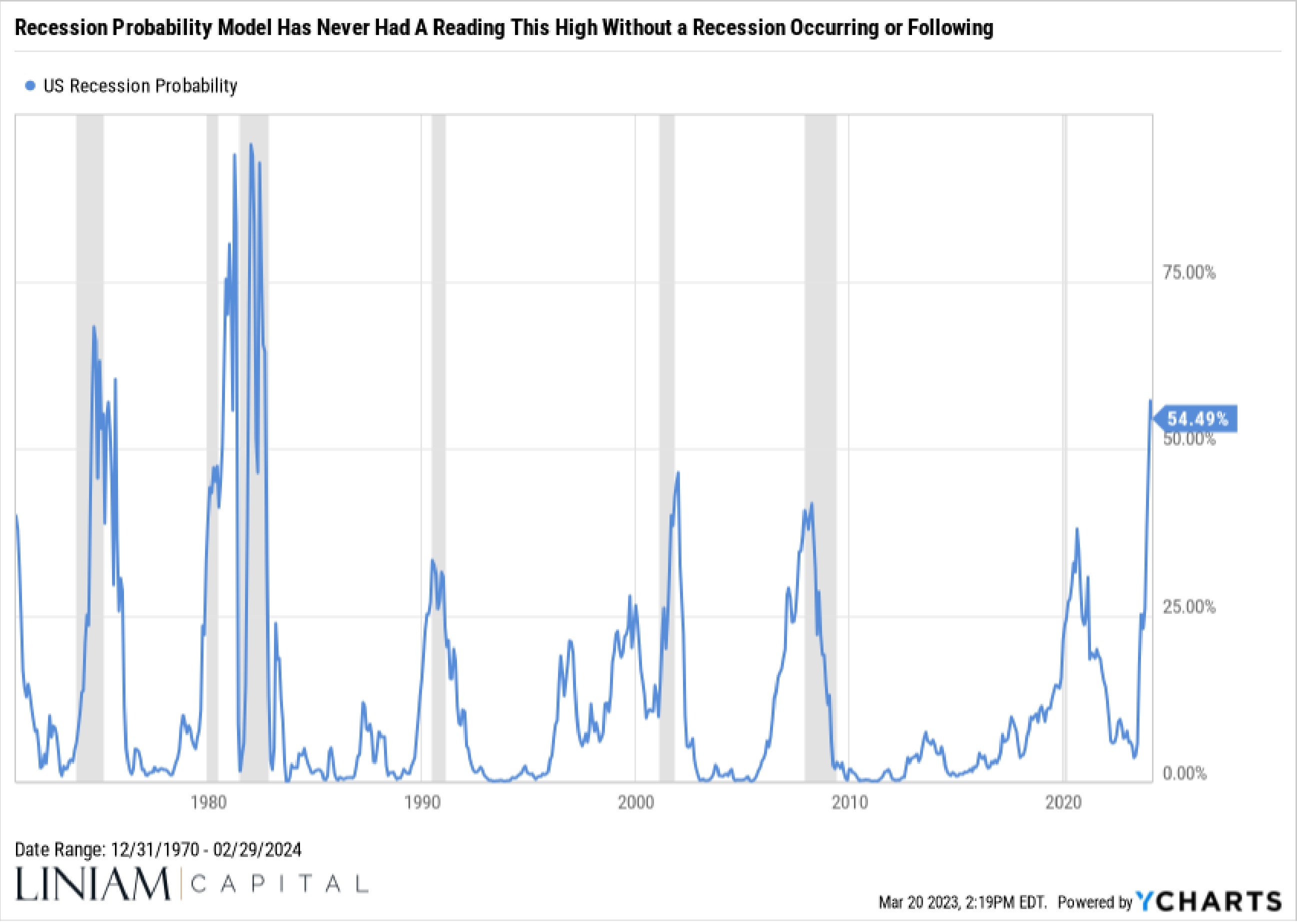
Inflation Expectations Down But Still Above Fed's Objective Level

Inflation spiked to its highest levels since the 1980s last year. In recent months both short-term inflation expectations and longer-term inflation breakeven rates have come down, though both remain above policy objectives and will act as a constraint of the Fed's ability to quickly back-off its tightening regime.



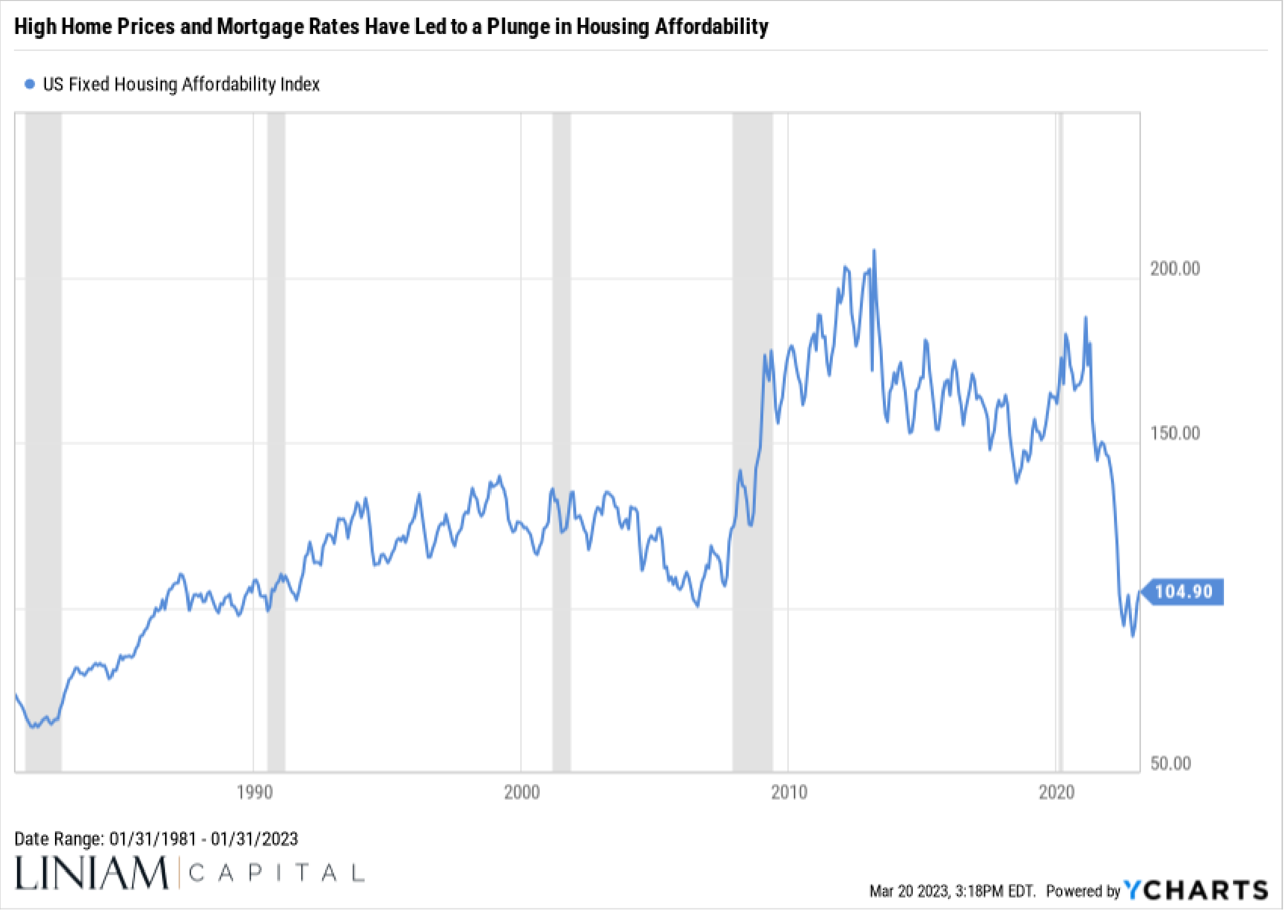
Recession Likelihood The Highest Since The 1982 Recession

The aggressive tightening cycle by the Fed over the past year has led to the steepest inversion of the yield curve since the early 1980s when the economy experience one of the deepest recessions of the post-war era. This recession probability model based on the yield curve suggests a high likelihood of recession over the next 12 months.



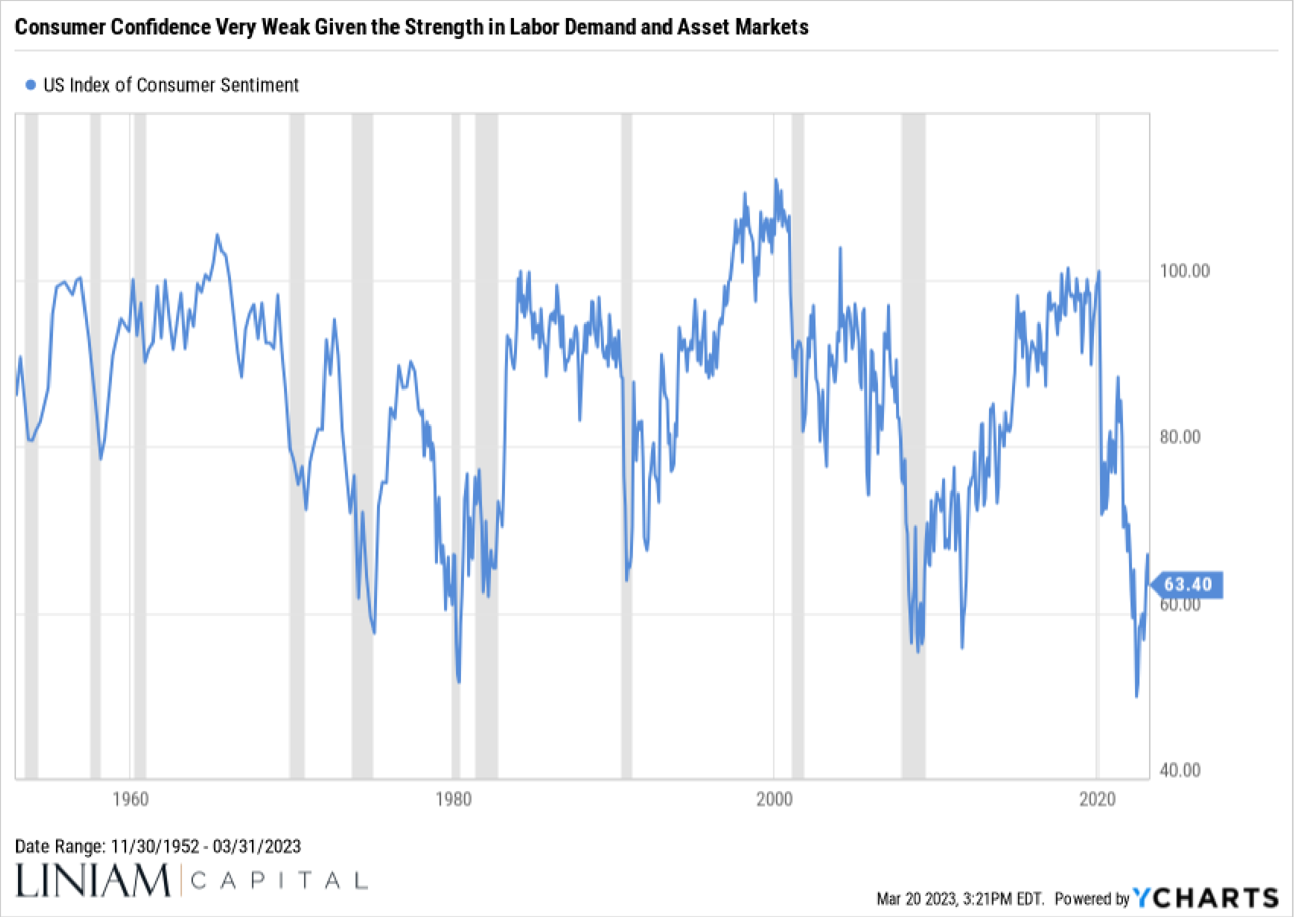
Housing Affordability At Lowest Level In The Last 30 years

The housing sector is one of the most interest rate sensitive sectors of the economy, and the housing sector has slowed sharply in response to weakened affordability associated with the higher interest rate environment today. Housing tends to lead the broader business cycle and suggests housing activity will remain a source of economic weakness until the rate environment changes.



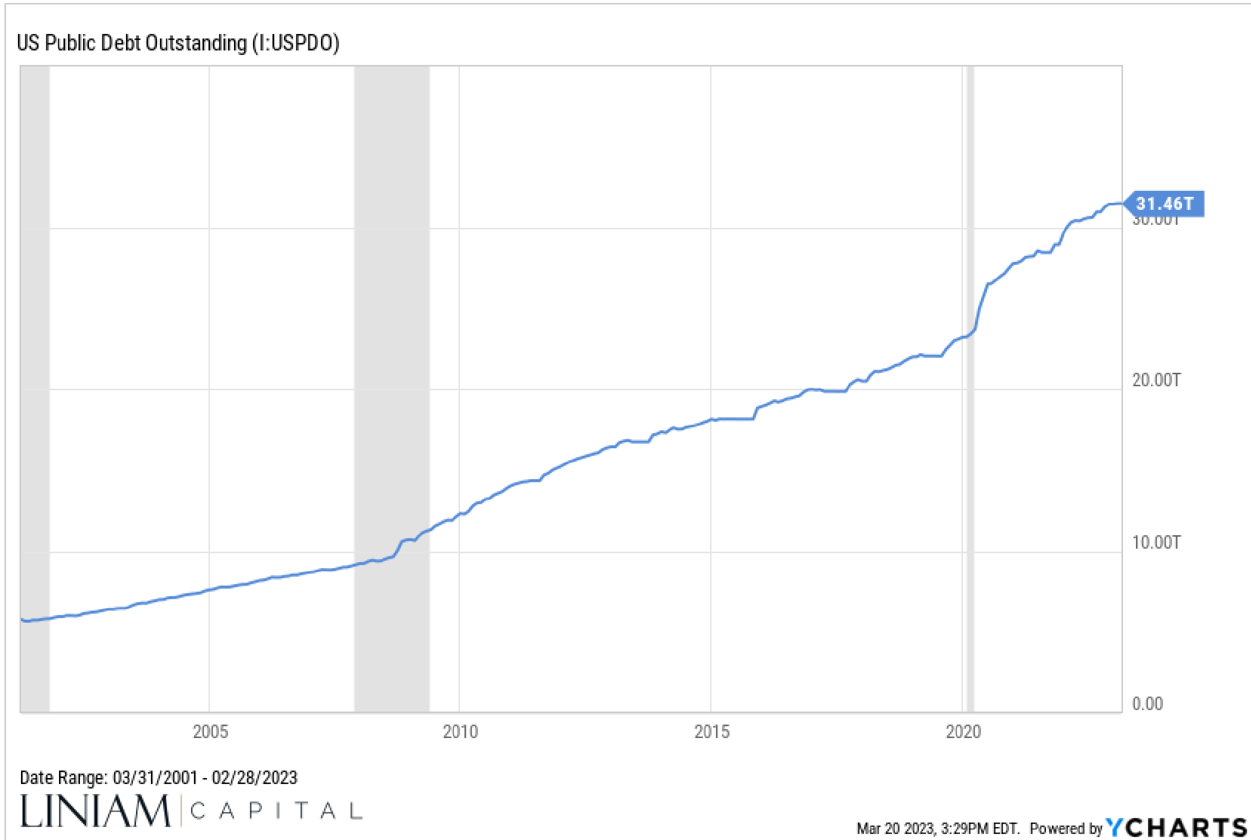
Consumer Confidence Depressed Despite Low Unemployment

Consumer confidence fell sharply last year as inflation accelerated. It remains depressed today despite the apparent strength in the labor market. Labor markets are likely to weaken over the balance of the year, which is likely to weigh on any improvement in confidence.



US Has Never Been More Indebted

Federal debt levels are now approximately $10 trillion higher than was the case before the pandemic. Federal debt (not including unfunded entitlements) sits at a record 120% of GDP and is poised to continue rising. This is a source of potential instability for the markets and a long-term risk for the real value of debt securities and value of the dollar.



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