JOHN E. SILVIA
DYNAMIC ECONOMIC STRATEGY

"Linkages Between Mispriced Assets: the Bane of Investors Today"

PCBE

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Dynamic Economic Strategy

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Cycle Signals: Outlook for 1H 2022 Growth-Positive, But Moderation, Consumer Slowdown

- Jobless Claims—Continued Decline from early January peak
  - Continuing and continuing claims down from month ago
  - End of federal unemployment enhancement by 25 states did lead to decline in claims
  - Employment: Job gains reflects re-opening decisions—especially for Leisure & Entertainment
- ISM-Manufacturing—Signals of Expansion Continue
  - ISM-Nov. 61.1, above 3Q average, orders, supplier deliveries, and production above break even
  - Employment above breakeven but below 3Q average
  - Prices paid @82.4, indicates input price pressures—26 commodities in short supply
- Factory Orders (Sep.)—Up L3M, Unfilled Orders up L3M
  - Non-defense, ex-aircraft, orders, shipments, unfilled orders up last three months, orders +16.0% YOY
- Building Permits--Single Family up L3M, but Multi Family down
  - Pending Home Sales up in October , Home prices up 19.1% YOY, fastest since 1980s
- Confidence (Conf Bd) Nov. down—Both present and expectations.
  - Net Jobs plentiful up

Cycle Signals: Financials Lead the Real Economy– Indicate Continued Expansion

- Equity Market: SPX 500 @ 4594.62 (11/26/2021), up over a month ago, up 26.6% YOY
  - Global Impact---One-third of S&P 500 revenues earned abroad
  - OECD outlook (Sep. 2021): G-20 growth up 6.1% in 2021, 4.8% in 2022, more than 2.67% in 2019
- Dollar Index: DXY @ 96.07 (11/26/2021), up over a month ago, up 4.7% YOY,
  - Dollar value follows economic strength
  - Trade-weighted dollar below the average of 2019
- Corporate Profits (3Q 2021): Pre-tax profits up over 2Q
  - Profits up 24.7% L4Q, compared to 2.7% gain in 2019
- Ten-Year (1.48%, 11/26/2021) and Two-Year (0.50%, 11/26/2021)
  - Ten-year lower (Omicron hits growth?) and two-year expects Fed move?
- Quality Spreads: IG (AA) and ICE HY Master spreads (11/25/2021)
  - Both HY AA spreads up versus month ago, still optimistic pricing of credit risk

So, What Does All This Mean? Recovery at a Pace Dictated by Government Shutdowns

- **Four Sector Model: Recovery—With Structural Unemployment--Still the Theme**
- Risk –volatility in existing paradigm--versus uncertainty—China, Covid Variations
- Growth: Continued declines in jobless claims and rise in jobs signal expansion
    - China recovery leads Asia, Euro shutdowns, Japan 2-3% next two years
    - Structural Unemployment Persists in the U.S.
- Inflation: Core PCE Deflator (+4.0%, L3M, +4.1% L12M), continues to exceed Fed's 2% target
    - Powell—stay in easing mode, tilt to tapering
    - WTI prices up –energy problems—copper prices signal slower industrial production
- Interest Rates: Benchmark UST 10-Y and 2-Y rate up ---expect no Fed action on rates 1H 2022
    - Near record lows still indicate mispricing of assets
    - Underpricing of risk (AA, High Yield)
- Corporate Earnings: Pre-tax profits, net cash flow up in 3Q 2021
- Dollar: Year-over-year up 4.7%, recent rally signals positive growth relative to other countries

Linkages in the Four Price Sectors?

- **Real Goods Sector**
- Repetitive Fiscal Stimulus
  - Personal Income, Household Wealth in a Recession
  - Growth in State Government Revenues
  - CBO deficit, % of GDP average 2021-2030 above 2021-25
- Repetitive Monetary Stimulus
  - Home Prices Rise Double Digits
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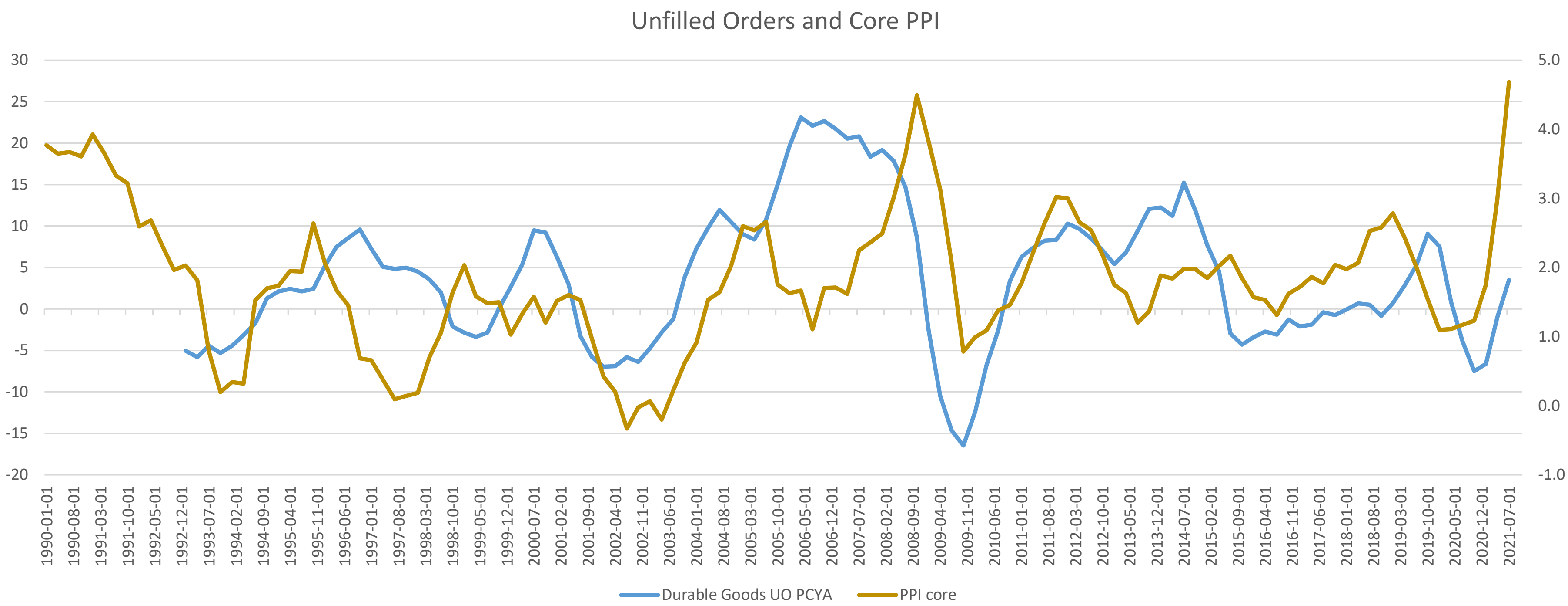
- Net Result, Increases in Aggregate Demand in the Face of Restrained Supply
  - Unfilled Orders

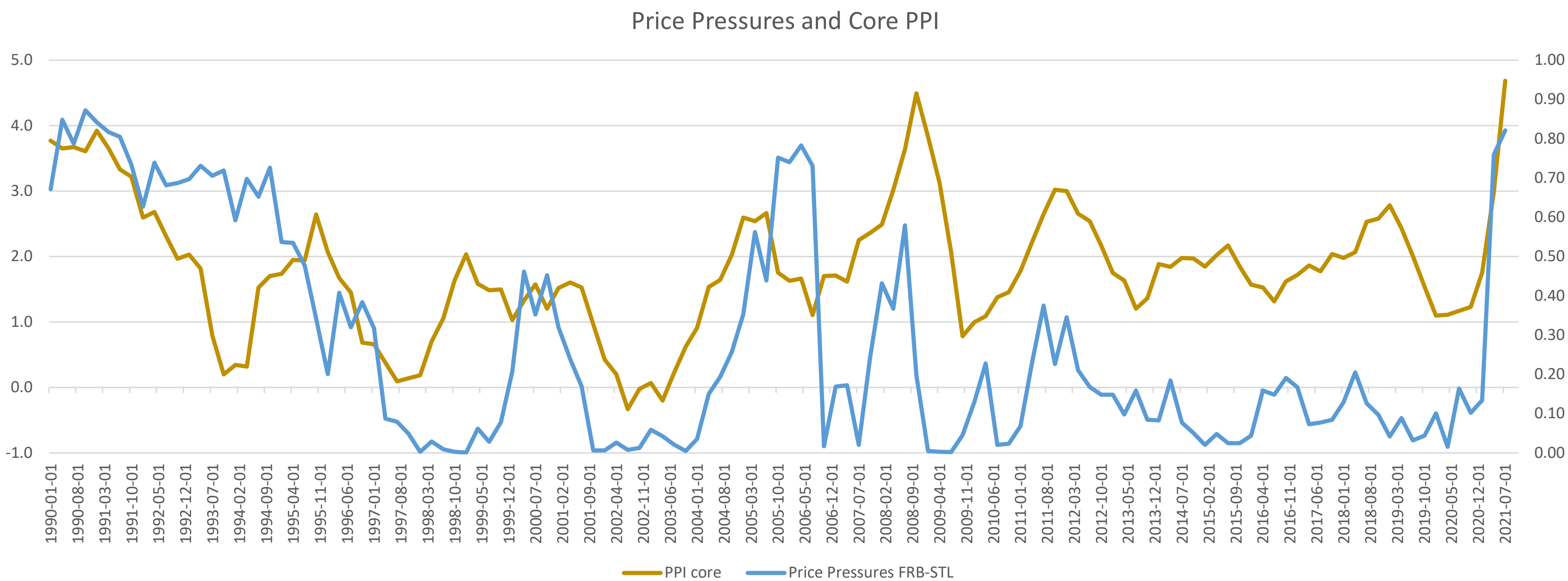
Inflation fears drift in

  - Commodity Prices---WTI—up, energy pricing issues
  - Rising Core PCE
  - St. Louis Fed Price Pressures Index up
  - ISM Prices Paid above 80

Unfilled Orders and Core PPI



Price Pressures and Core PPI



Credit Markets

- **Monetary Policy: suppress nominal market interest rates**

- **Benchmark UST 10-Y, 2-Y rates—moving up—but inflation exceeds nominal rates—real rates negative**
- "There is no easy escape from the global debt trap," FT 11/22/2021

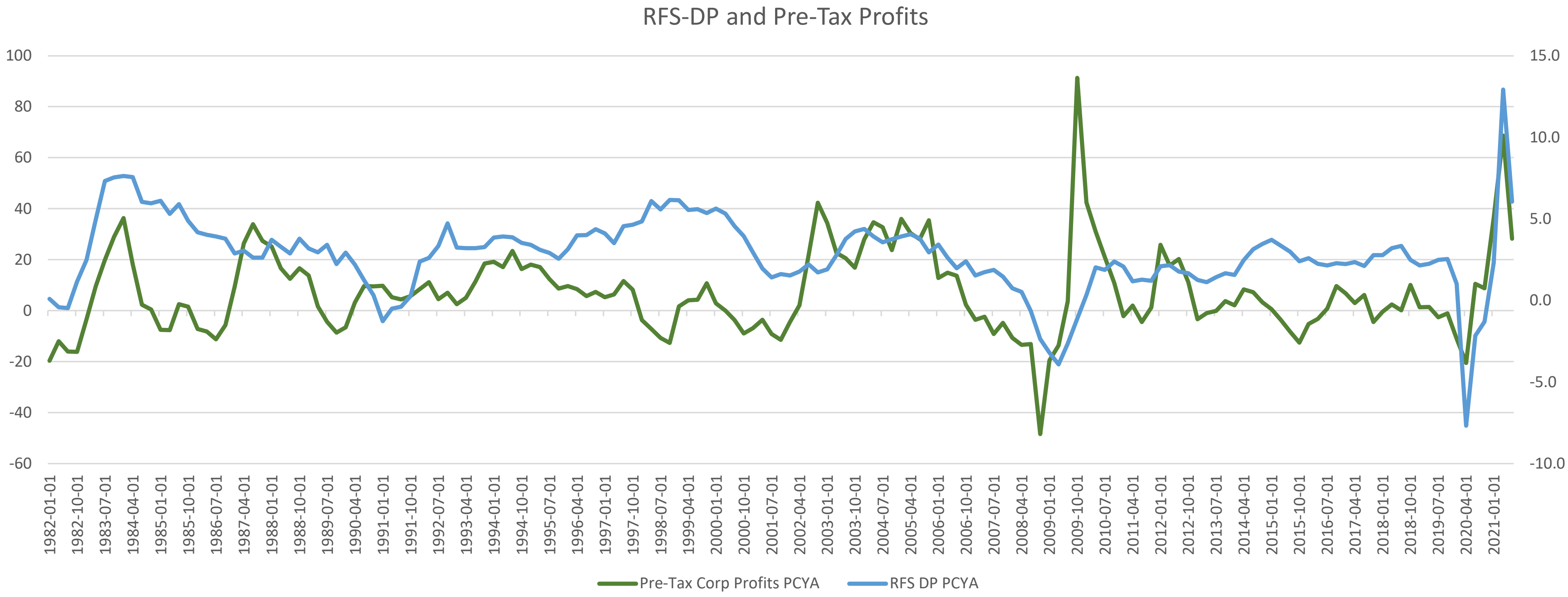
- Core PCE Deflator is linked to 10-Y rates—with the Fed suppressing the nominal ten-year rate, rising PCE deflation delivers negative returns to government bond portfolios

- **Credit Spreads: HY spread creeping up, AA spreads down versus a month ago.**
  - **Corporate spreads below equilibrium given Fed buying.**
  - "Junk-Bond Rally Pulls Yields Below Inflation," WSJ 7/9/2021
  - Five-year Treasury rate is linked to AA corporate rate—with the Fed suppressing the nominal five-year rate, nominal corporate AA rates are too low and an inefficient allocator of capital.
  - "High-Yield Bond Sales Soar to Record as Investors Have Few Other Places to Go," WSJ 11/26/2021
  - "Low yields have left investors numb to risk" FT 11/19/2021

Profits: Future Expected Earnings Discounted by Interest Rates

- Real Final Sales are linked to profit growth and profit margins
- Meanwhile, nominal interest rates are being suppressed
- Net Result, Equity price appreciation. Real Final Sales have a direct linkage to NYSE index.
- “Investors lulled into ‘dreamland’ by central banks, warns Bill Gross,” FT 11/16/2021
- “The Market Is Right to Be Spooked by Rising Bond Yields, “ WSJ 10/4/2021

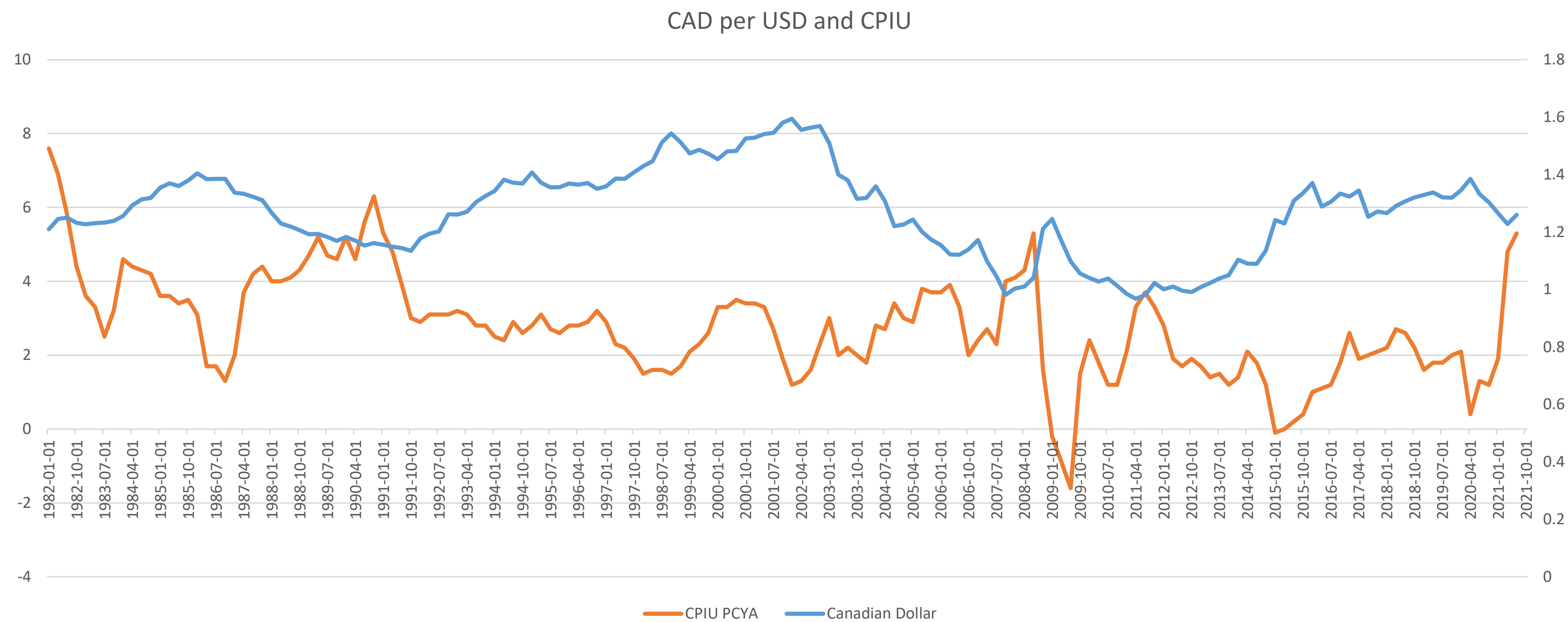
Real Final Sales and Pre-Tax Profits



Canadian Dollar and U.S. Inflation

- Domestic U.S. Inflation has a causal linkage to the Canadian Dollar/ U.S. Dollar exchange rate.
- Equity values in the U.S. also have a negative correlation and a causal link to the Canadian dollar value.
- To complete the feedback loop, the CAD, and the British pound, have a causal link to U.S. inflation.
- In a Four Sector model of the economy, the linkages are critical to understanding how market prices move.

Canadian Dollar and U.S. Inflation



Not a Return to Normal for Many—Still a Theme

- Job Losses by Education- Shutdowns Impact Significant
- Commercial Real Estate—trends in place now accelerated
  - Retail—consumer on-line shopping
  - Work from home
  - Suburban Office space more—central city less
- Technology assisted-security/communication/shopping
- Sustained lower inflation—NO! low inflation pre-2020 out now
- Lower Credit Spreads, Central Bank buying favors debt finance

The Importance of the Non-Recursive Model

- A non-recursive model contains one or more ‘feedback loops’ or ‘reciprocal’ effects
- Shifts in fiscal and monetary policy increase aggregate demand and, given the limited ability of aggregate supply, goods prices increase.
- Increases in goods prices, given the suppression of interest rates by the central bank, reduce real interest rates, and in the case of the U.S. real interest rates are negative.
- Negative real rates and the rise in goods prices, especially housing, lead to a boom in housing as well as a boom in commodity prices and land/timber prices.
- Negative real rates, along with gains in economic growth and thereby corporate profits, lead to gains in equity valuations.

Two Final Points

- **Market Prices/Indices are in Nominal Units**
  - S&P500, NYSE
  - Interest Rates
  - Profits
  - Exchange Rates
- **Markets Can Change Very Quickly**
  - “High-Yield Bond Sales Soar to Record as Investors Have Few Other Places to Go,” WSJ 11/26/2021
  - “Low yields have left investors numb to risk” FT 11/19/2021
  - “US junk bonds hit by sharpest sell-off in more than a year,” FT 12/01/2021