



On the Radar Screen

- 1. 3Q earnings reports will shed light on the degree to which rising input costs are squeezing profitability.**
Early indications are not promising.
- 2. Unemployment claims can be erratic from week to week, but the general trend (4-week moving average) speaks volumes about operating conditions for corporate America.**
We expect to see this series continue to rise as we move toward recession, lessening wage pressure.
- 3. We are following compensation metrics closely, with wages central to the Fed's effort to tame inflation.**
The Employment Cost Index, next released October 28th, is of particular importance.
- 4. The U.S. Dollar has strengthened dramatically this year,** to the point of impairing the competitiveness of U.S. multinationals and potentially destabilizing some foreign borrowers.

Insights from Multi-Asset Solutions' Portfolio Managers

"We understand better now how little we understand about inflation."

– Jerome Powell, Federal Reserve Chair

A never-ending story. You're tired of hearing about inflation. We're tired of talking about it. And yet, what choice do any of us have? Inflation and the reaction function of the Fed remain the dominant drivers of today's market activity. So here goes.

Headline inflation—the index that covers the broadest basket of commonly incurred household expenses—appears to have peaked this summer. With COVID-induced supply chain bottlenecks largely resolved, inventories swollen, pandemic stimulus depleted, money supply growth tepid, and the cost of newly acquired debt moving dramatically higher, it is reasonable to anticipate that goods pricing will mean-revert, as appears to be happening now. It should not take long to see inflation readings fall from the 8%-9% range back down toward 4%-5% (or temporarily through that level) but that's where the good news ends. Reestablishing the Fed's 2% target on a protracted basis will be a much taller order, requiring significant economic pain before it can be accomplished.

Inflation has been running hot enough and for long enough, that workers are demanding higher wages to compensate, allowing them to better maintain their standard of living—and those demands are being met. Look no further than the railway labor agreement recently negotiated to avoid a crushing transportation strike. Railroad engineers received a 24% pay hike over a five-year window retroactive to 2020 plus a one-time bonus! That was not an isolated incident, as many workers across many different industries have successfully argued for higher wages. Labor markets remain very tight with roughly two job openings available for every unemployed individual looking for work, leaving employers little

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choice but to offer higher compensation to attract and retain talent in this competitive market. Companies must in turn look to pass those additional labor costs on to their customers through higher prices, to the extent that they can do so (and suffer declining profit margins to the extent that they cannot), laying the groundwork for future pay increases. The wage/price spiral is upon us.

The Fed is fully aware of the need to break this malicious cycle, and they're doing their best to prepare the public for what that will require. The aggressive series of rate hikes already implemented, and those yet to come, are designed to curb business activity. Only by suppressing the demand for labor and driving up jobless rate can the Fed rein in rapid wage gains, and that almost certainly means a recession is on the horizon.

The market has come to grips with this idea, having sold off markedly since the summer highs observed in mid-August. Given probable earnings downgrades yet to come and price multiples that remain a bit elevated given inflation dynamics, we're probably not out of the woods just yet. Within our portfolios, we are trading tactically while trying to stay close to neutral in terms of our overall stock/bond blend. Likewise, our exposure to credit is very close to that of the benchmark. We sit on an unusually large cash position awaiting an opportunity to add risk if and when we see real distress in market pricing. We're holding out for a sale!

“Without labor nothing prospers” – Sophocles. Throughout its history, the United States has benefited from a fast-growing pool of available workers. That's no longer the case. With birth rates having declined in recent decades and the demographic bulge that is the baby boomer generation transitioning into retirement, the labor force is expected to be largely static in the decade ahead, barring a dramatic change in immigration policy. For an economy in which unemployment rates are flirting with historic lows and in which half of all businesses report difficulty finding qualified workers to fill job vacancies, this portends poorly for both growth and inflation. That's especially true given that it comes during a period of “quiet quitting,” “the great resignation,” and discussions of a four-day workweek.

We can think of economic output as being the product of 1) the total number of employed workers times 2) the number of hours they are on the job times 3) the amount they can produce in an hour, referred to as productivity. If the first of these factors is no longer growing, and the second shows some signs of contracting, we are asking a lot from productivity if we are to maintain the rates of growth observed in the past. Advances in labor-saving technology are truly mind-rending. Nevertheless, trend rates of growth—and so growth in corporate profits—are likely to be below what we have come to expect in the post-WWII era.

The scarcity of labor necessarily has implication for inflation also. We have already asserted that worker shortages are followed by higher wages, which in turn result in higher prices for consumer goods and services. Demographics suggest this pressure may be present for years to come. Sustained inflation pressure coupled with restrained trend growth doesn't bode well for real capital market returns.

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