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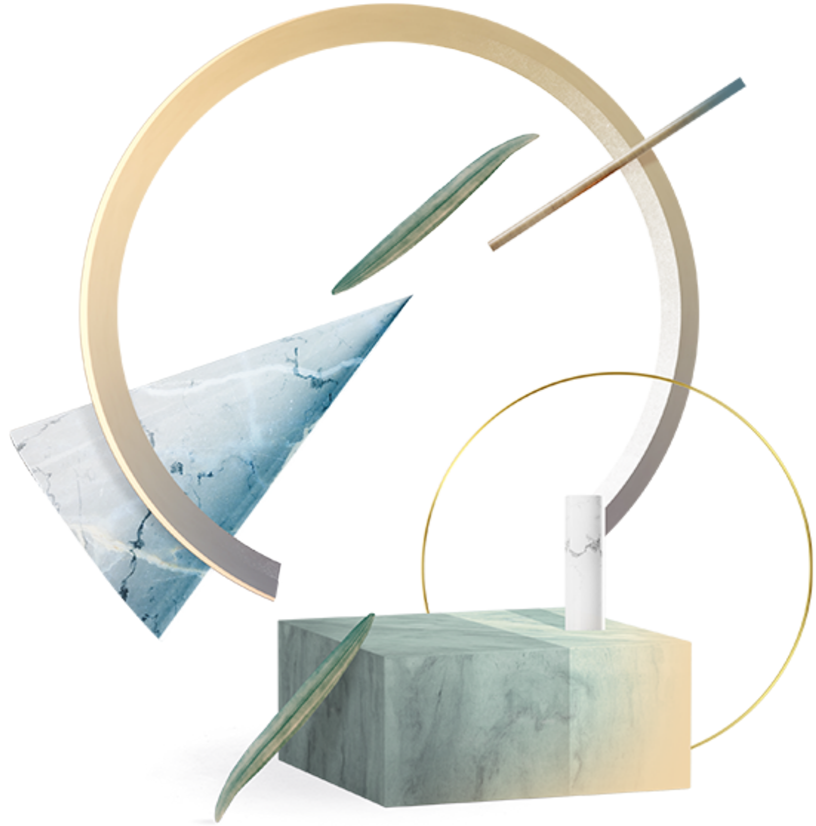


CIO Strategy Bulletin

Wise Investors Should Pay Close Attention to Falling Inflation

●Investors tell us that they will not allocate more to bond investments because rates will stay higher for longer. They also say they will not allocate more to equities because of an impending recession. The inconsistency of these two views is obvious.

●Inflation is a symptom of a sick world economy, one suffering from too much money chasing too few goods and services. That was true of the pandemic period, but it is ending. Inflation's drop from an 8.7% pace globally in 2022 is just one sign of the world economy healing. While supply shocks remain a risk, demand is moderating, and supply is recovering without a severe economic contraction. This is good news.

●In the US, we see data that shows considerable progress toward normal levels of inflation. Wage growth, for example, is decelerating even in the services sector.

●While not every CPI report will fall below expectations, this week's soft CPI figures were not a surprise to us. Shelter costs are now coming down in earnest. We expect a material and steady drop for the next 11 months before housing costs start to stabilize towards the end of 2024.

- Markets are responding quite positively to reported declines in inflation with the S&P 500 gaining 7.6% in the month to date. The 10-year treasury yield has fallen 44 basis points over the same period.
- Though bonds are strong competition for equities, the Global Investment Committee (GIC) added further to our equity allocation with an overweight to the S&P 400 and 600 Growth components on October 18th. This was the first time our asset allocation to equities went "overweight" from neutral or underweight since June 2020. If inflation falls while yields moderate even while corporate profits rise, we expect it to lead to substantial gain for US equities in the coming year. If yields decline in the coming year on slower employment growth while corporate profits rise, we will raise our equities weighting further.

Wise Investors Should Pay Close Attention to Falling Inflation

Investors tell us that they will not allocate more to bond investments because rates will stay higher for longer. They also say they will not allocate more to equities because of an impending recession. The inconsistency of these two views is obvious. Falling inflation and other economic developments are slowly improving the outlook for both asset classes.

Inflation is a symptom of a sick world economy, one suffering from too much money chasing too few goods and services. That was true of the pandemic period, but it is ending. Inflation's drop from an 8.7% pace globally in 2022 is just one sign of the world economy healing. While supply shocks remain a risk, demand is moderating, and supply is recovering without a severe economic contraction. This is good news.

Is Inflation Here to Stay? No.

Ever since the Fed began its campaign of higher rates to control inflation, there has been a raging debate about the nature of that inflation. Did the large fiscal and monetary responses to Covid create inflation that was self-reinforcing or transitory? And, if "Covid inflation" was embedded, would an upward wage-price spiral force policymakers to engineer a recession to drive up unemployment to push down prices?

We are now beginning to see the answer. The spike in inflation is coming down as fast as any supply-driven spike of the past.

Shelter Inflation in the Rear View Mirror

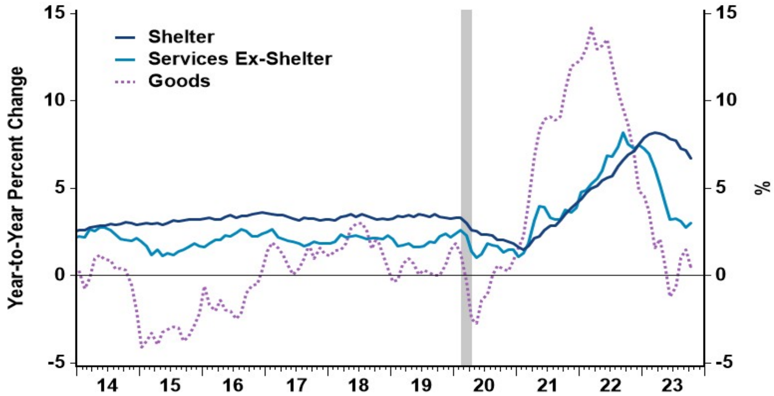
Inflation peaked in the US at 9.1% in June 2022 and in the Eurozone at 10.7% in October 2022. These amounts were several multiples of the respective central bank's 2% inflation target. One of the largest elements of the CPI calculation is shelter. The way it is measured in the US, it does not capture housing inflation developments in real time. This means that if the cost of shelter rose substantially, it would only fall slowly. This is one of the reasons that the larger "services" component of the CPI is a member of the US Index of Lagging Economic Indicators.

The very nature of this large portion of measured inflation - how the headline Consumer Price Index (CPI) is formulated - ensures that inflation would ***appear*** to stay high even when meaningful parts of the economy were slowing enough to see prices fall (**Figure 1**).

The rapid rate rises by the Fed, plus pandemic-induced "work from home" and" work from anywhere" decisions created several unintended, but reinforcing upward impacts on housing prices. Many US homeowners refinanced during the early stage of the pandemic, capturing low 10 to 30-year interest rates. Then, as mortgage rates climbed rapidly, home sales collapsed. At the same time, some people living in cities chose to move elsewhere, in many cases renting apartments. This caused rents to rise. And then, as mortgage rates climbed even higher, rents rose further. Oddly, housing prices rose, too. This was due to a profound lack of housing supply as homeowners could no longer afford to sell and move elsewhere.

All these unexpected, inflationary events combined to create a "shelter cost spiral", but that is ending now. US shelter prices (45% of the core CPI) have slowed from a cycle peak of 8.2% to 6.7% and are poised to slow much further in the coming year (**Figure 2**).

Figure 1: Shelter, Other Services and Goods CPI in the US



Source: Haver Analytics as of November 18, 2024 . Shaded region is recession. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 2: Home Prices in the US leads Shelter in inflation by a year and a half on average.

Source: Haver Analytics as of November 18, 2024 . All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Falling Inflation

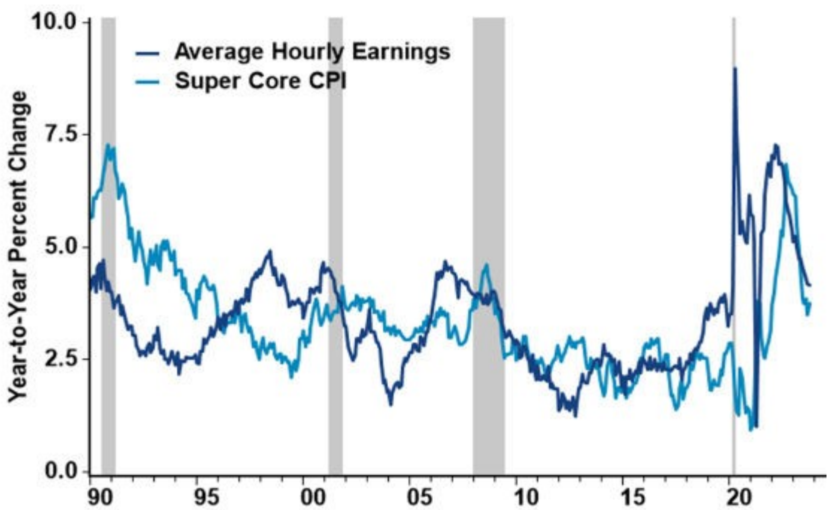
In the US, we see data that shows significant progress toward normal levels of inflation. Wage growth, for example, is decelerating even in the services sector (**Figure 3**). However, due to the long lags in the changes for shelter, the CPI will remain somewhat above target, likely for the coming six- to nine-months.

Ignore the European vs US View of Inflation

There is a story making the rounds in markets and central banks across the globe. They say that inflation in the US and Europe are fundamentally different. US inflation is more demand driven and will be more stubborn to stamp out. Euro Area inflation was all due to energy supply shocks and was transient. This drove inflation to peak higher in Europe than in the US, but inflation is now falling faster in Europe than in the US. In turn, the ECB will ease more and faster than the US central bank. But this assertion is not supported by facts. Using the same measure of CPI in the US and Europe we can see disinflation in both areas at very much the same time (**Figure 4**).

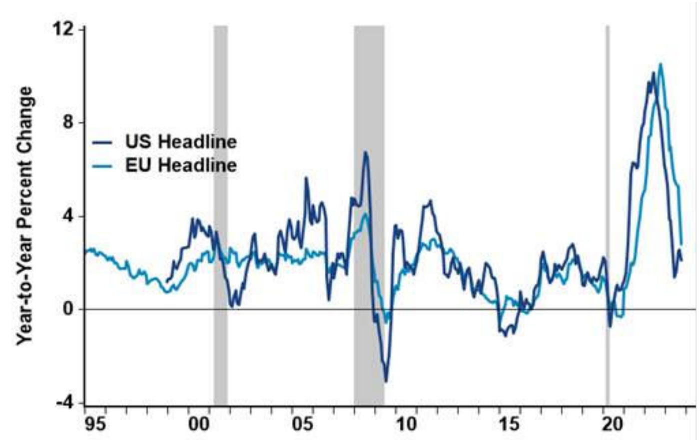
We see the Fed effectively reaching its inflation target by end 2024 and likely easing before the ECB does (please see our last bulletin). Of course, there remains a risk that shocks emerge separately in the two regions. There is a possibility that higher lagging shelter inflation measures will cause the Fed to wait too long before easing monetary policy. But there are numerous signs in markets and Fed commentary that the narrative is shifting.

Figure 3: Services CPI ex shelter and energy "Super Core CPI" is cooling rapidly along with wages.



Source: Haver Analytics as of November 18, 2024 . Shaded regions are recessions. "Super core" CPI is the CPI for Services Less Shelter and Energy. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary.

Figure 4: Harmonized CPI methodology for the US and Euro Area



Source: Haver Analytics as of November 18, 2024 . Shaded regions are recessions. Note: Harmonized CPI in Europe excludes owner occupied real estate. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. Past performance is no guarantee of future results. Real results may vary. When Will the Fed Shift from Fighting Inflation to Supporting Employment?

When Will the Fed Shift from Fighting Inflation to Supporting Employment?

Many investors mistakenly believe that an economic collapse is a prerequisite for Fed easing. But that is not true. Since 1980, the Fed has begun cutting rates while US employment was rising, at times when average employment growth of 146K jobs per month were being added in the prior six months.

We believe the Fed will see materially slower job growth during the year ahead. Job gains in 2022-23 exceeded GDP growth by the most since 1974. This is unsustainable and likely to reverse. As US employment gains fade in the face of restrictive monetary policy and slowing inflation, we also believe the Fed will change course and seek to protect the labor market from an unwanted contraction.

Some call this a “soft landing” scenario, but we do not think in terms of a hard or soft landing. Recessions have **already** “rolled across” cyclical industries in 2024 (see our latest Quadrant). Demand for goods, trade and housing contracted in the past year and will begin 2024 at weak levels. Discretionary services spending will then slow in 2024, keeping economic growth constrained. And if the Fed acts to protect jobs, as we expect, there is no reason newly lean industries will contract again. This is why we expect S&P 500 EPS to grow more than 12% over the next two years, and our estimates are purposely conservative.

Our View of Inflation Was Correct

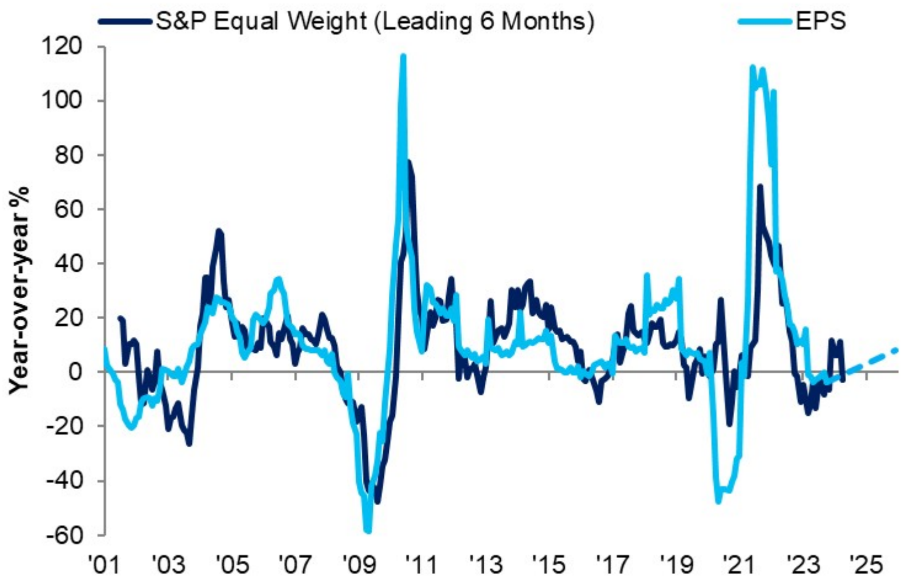
While not every CPI report will fall below expectations, this week’s soft CPI figures were not a surprise to us. Shelter costs are now coming down in earnest (**Figure 2** above). We expect a material and steady drop for the next 11 months before housing costs start to stabilize towards the end of 2024.

That is Why the GIC Increased Equity Exposure on October 18

Markets are responding quite positively to reported declines in inflation with the S&P 500 gaining 7.6% in the month to date. The 10-year treasury yield has fallen 44 basis points over the same period. Investment grade US corporate yields with a 5-year maturity – near our weighted average duration – still yield about 5.85%. This is nearly double the Fed’s expectation for its policy rate over the same period, making them an effective way to sustain yield and likely price appreciation when the Fed again swerves.

Though bonds are strong competition for equities, we added further to our equity allocation with an overweight to the S&P 400 and 600 Growth components on October 18th. This was the first time our asset allocation to equities went “overweight” from neutral or underweight since June 2020. If inflation falls while yields moderate even while corporate profits rise, we expect it to lead to substantial gain for US equities in the coming year (**Figure 5**). Therefore, if yields decline in the coming year on slower employment growth while corporate profits rise, we will likely raise our equities weighting further. Equity allocations would broaden globally if lower interest rates also led to declines for the US dollar.

Figure 5: S&P 500 Equal Weight Index (Leading 6-Months) vs EPS Y/Y% and Consensus EPS Estimates



Source: Bloomberg through November 16, 2024 . Consensus EPS is a forecast of a public company's future earnings based on the combined estimates of professional equity analysts. All forecasts are expressions of opinion and are subject to change without notice and are not intended to be a guarantee of future events. Indices are unmanaged. An investor cannot invest directly in an index. They are shown for illustrative purposes only and do not represent the performance of any specific investment. Index returns do not include any expenses, fees or sales charges, which would lower performance. **Past performance is no guarantee of future results. Real results may vary**.

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High quality (very strong)	Aa	AA	AA
Upper medium grade (Strong)	A	A	A
Medium grade	Baa	BBB	BBB
Not Investment Grade			
Lower medium grade (somewhat speculative)	Ba	BB	BB
Low grade (speculative)	B	B	B
Poor quality (may default)	Caa	CCC	CCC
Most speculative	Ca	CC	CC
No interest being paid or bankruptcy petition filed	C	D	C
In default	C	D	D

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