



## On the Radar Screen

- 1. Inflation is public enemy number one.** We believe price hikes will abate as supply chains are repaired, inventories peak, and more workers return to job sites. Nevertheless, inflation will run hotter than pre-pandemic rates for the foreseeable future.
- 2. Whereas inflation provides the initial impulse, it is the Fed's reaction function that will have a greater impact on business activity and capital markets.** Anticipate tighter policy through both a reduction in asset purchases, and eventually, higher interest rates.
- 3. Labor imbalances are an important element to the inflation story.** If workforce participation rates don't improve significantly in the months ahead, wage pressure will remain elevated.
- 4. At least through the third quarter, companies have been quite successful in maintaining and growing profit margins despite rising costs.** Upcoming earnings reports will shed light on the degree to which that has been true in the fourth quarter as well.

## Asset Solutions' Portfolio Managers

*“Consensus thinking isn't always wrong, but when it is, it is often spectacularly so.”*

*– Chris Verrone, Strategas Research Partners*

**The persistence of “transitory.”** We have from the beginning been amongst those skeptical that inflationary pressures would prove fleeting. Price instability has been a central theme of these letters throughout the year. It comes as some small vindication that most others seem to be moving in our direction, the most notable being the Fed itself, first with Chairman Powell pronouncing that it is time to retire the word transitory and then with the Fed electing to accelerate the rate at which monthly bond purchases are to be reduced and pulling their estimates of rate hikes substantially forward. Consumers also seem to be coming to terms with the idea that price instability may be here to stay as household surveys show inflation expectations over three- to five-year periods have risen considerably.

Interestingly, though, market-based measures of inflation look quite tame. Market based inflation expectations are actually lower now than at points in the spring. Investors appear to embrace the idea that today's elevated readings will be quite fleeting, falling back near pre-pandemic levels relatively quickly. While deflationary impulses present prior to the pandemic certainly remain, we see things quite differently:

- The explosive growth in money supply deliberately engineered by monetary and fiscal authorities over the past two years tops the list. Simply put, there are now a lot more dollars in the system chasing a limited supply of goods and services.
- Competition among global super-powers and strategic demand for supply chain resiliency are ushering in era of deglobalization. Reshoring is replacing offshoring. Gone are the days of cheaper “made in China” products.

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## Insights from Multi-Asset Solutions' Portfolio Managers

- The vulnerability of just-in-time inventory management systems has been revealed and will likely be displaced by just-in-case overstocking, lifting the cost of goods sold.
- The need to significantly curb carbon emissions is now broadly accepted. The shift to the use of cleaner, more efficient fuels, materials, and processes will come at significant cost that will ultimately be passed to consumers.
- The pandemic has shocked the public imagination, causing many to reconsider their relationship with work. What people choose to do for a living, and where they choose to do so, is likely to change for many. Business must confront a chronic and persistent shortage of workers in some industries.

We have been resolute in our belief that higher inflation would bring higher bond yields, putting stress on long duration assets. Time has proven our concern regarding the former somewhat prescient, but our expectations for the response in capital markets has thus far not been validated. The yield on Treasury bonds has retreated from its springtime high, and long duration assets – US growth stocks, before all else – continue to hold their ground. Sooner or later, however, something has to give. Either the current inflationary tide must retreat sharply, or bond yields must rise to fit this new environment; deeply negative real yields cannot long endure. If/when that day of reckoning arrives, it is likely to be violent and swift as a lot of money will be put into motion getting back on side.

To be clear, while we anticipate lasting inflation this in and of itself is not worrisome to us. We believe risk assets can perform well against an inflationary backdrop, and we lean into both equities and credit accordingly. But there are those more richly priced corners of the market whose valuations have been lifted to improbable heights by an intoxicating mix of low rates and abundant liquidity that look to be in jeopardy of repricing sharply lower as the Fed gears up for a battle with inflation. Favoring shorter maturity bonds, lower P/E stocks, and a global exposure might prove to be an effective strategy as we move through 2022.

**“Business is all about solving people’s problems — at a profit.” – Charles Baudelaire.** COVID restrictions, supply chain bottlenecks, worker shortages, climate change... Companies today encounter all manner of unique challenges. Fortunately, mankind has consistently shown enormous ingenuity in confronting such obstacles and continues to do so today! The particular constellation of headwinds faced today may be new, but the need to overcome forces is anything but. Business has been remarkably adept at meeting customer demand throughout the pandemic and doing so while maintaining their margins (by raising prices to their customers – see inflation above). Both revenues and earnings have been robust and look poised to continue along that trajectory higher in the year ahead. The point we wish to make is that the economy is healthy; businesses are healthy; and capital markets are healthy. Our anxiety in regard to certain mispriced segments of the market that we expect will perform comparatively poorly does not extend to the market in total. We are in midst of a vigorous expansion in which we believe it is appropriate to maintain a “risk-on” posture overall.

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## **Insights from Multi-Asset Solutions' Portfolio Managers**

*There is no assurance that the investment objectives will be met.*

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