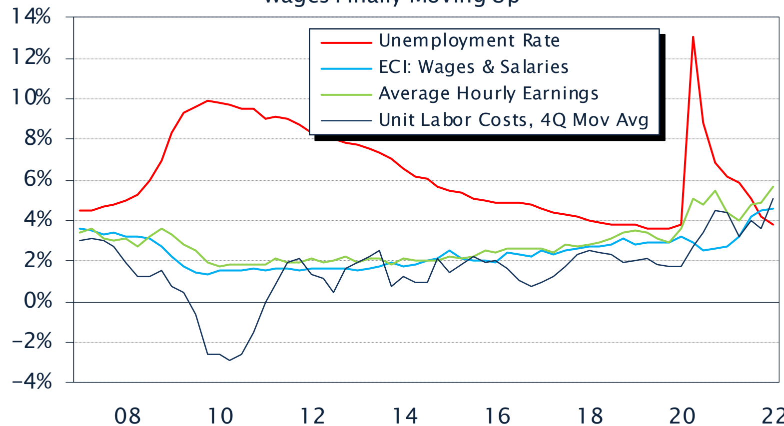
JUNE 2022

INVESTMENT UPDATE

Over the past four decades, our world has seen some seismic changes in demographics, economics, and politics, with each of these big "building blocks" impacting each other. The fall of the Berlin Wall, for instance, led to economic reforms in Eastern Europe, while political policies produced demographic changes in China that, in turn, slowed economic growth. In general, the globalization of world markets has generated significant benefits in the aggregate, and boosted returns on capital. The result is that the past forty years has been something of a Golden Age for investment returns for stock and bond investors, as returns have been well above historic averages.

The events of the past two years, however, have caused many of us to question whether this long period of easy returns and relative economic tranquility may be coming to an end. Are we witnessing a change in the fundamental building blocks that feed into what investment folks call their "macro outlook," or are we just dealing with big disruptions that will soon fade? We will take a look at some of the major factors impacting our outlook, starting with the labor market.



Prior to the worldwide COVID outbreak, the general consensus was that the US labor market would continue to steadily grow, although an aging US population would mean that the labor force participation rate would continue to fall, with an increased burden on taxpayers to supply post-retirement medical and social/economic support. Wages, it was believed, would continue to grow only at a modest pace, particularly in the manufacturing sector, as globalism broadened the potential workforce to include workers from less-developed economies with lower wages.

The post-financial crisis expansion from 2009-2020 saw a steady decline in the unemployment rate, but only a minor uptick in wages, as shown in the chart on this page. During this time, unit labor costs, historically the most closely-watched wage measure, barely broke above 2%, despite an unemployment rate that fell below 4% by 2018. As the chart shows, unemployment spiked as businesses shut down when COVID hit in 2020, but quickly fell, and today is back below 4%. But unlike the previous cycle, we have seen wage costs rising, including unit labor costs, which today are running at a 5.1% annual rate, the highest in more than 35 years.

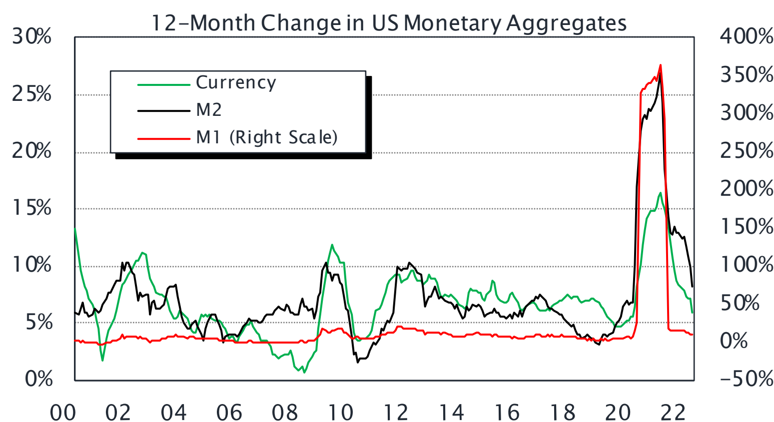
COVID changed the narrative for labor markets, as remote working arrangements and a re-thinking of global outsourcing of both manufacturing and service-related jobs has emboldened US workers and left employers struggling to fill openings. The Bureau of Labor Statistics' JOLTS survey shows more than 10 million job openings currently in the US, still near all-time highs, which is keeping upward pressure on wages. Even if the economy slows in the coming years, we expect that these changes in the US labor force are likely to fade only gradually, with a high probability that wages remain elevated compared to recent history.

Rising wages aren't the only input cost that organizations are having to deal with. The disruptions in global trade from COVID over the past couple of years is well-documented, and while those pressures are now easing, that doesn't mean that multinational companies are going back to their 2019 business models. COVID exposed vulnerabilities in the "just in time" inventory models that many organizations have been using for years, models that are now being reconsidered and modified. Just as the assumption that labor could be easily supplied from any region of the world has been thrown in doubt, companies will be keen to bring the manufacturing of critical parts and components closer to home. This is a complex, expensive undertaking that will take many years.

Another complicating factor for future inflation is global political uncertainty, irrespective of COVID. Russia's invasion of Ukraine and (to a lesser extent) China's saber-rattling regarding Taiwan have both short- and longer-term effects. In the short term, both energy and agricultural commodity prices have spiked as Western nations have moved quickly to shut

down their imports of Russian energy and agricultural products, while there are dire predictions of grain shortages due to huge disruptions in Ukraine's planting season. Perhaps even more critical to our analysis is the amount of resources countries will likely spend to defend their borders from foreign aggression. Western European countries in particular (but not exclusively) will have to allocate a much bigger slice of their budgets to project security and strength to keep their borders secure. Munitions, weapons, vehicles, aircraft—all are commodity-heavy, and in some cases involve strategic metals and other components which are already in short supply.

Taken together, these factors point to a period of heightened inflation pressures. Perhaps more concerning is that changes in the labor market, global trade, and defense spending are likely to persist well beyond the next few quarters. This is not what policymakers had in mind only a few months ago. You'll recall that the Federal Reserve was convinced that the run-up in inflation post-COVID was thought to be "transitory," due to temporary factors that would subside relatively quickly once the pandemic was under control. Now it's crystal clear that those predictions were wrong, and policymakers—both here and abroad—are scrambling to get inflation under control.



If there's any good news (and there is), it's that a lot of these negatives have already been "priced in." Short-term yields in the bond market now reflect the reality that the Fed will be pushing up its overnight lending rate more aggressively than it has in almost 30 years, with the Fed funds rate priced to rise to at least 4% over the next year. Further out the yield curve, longer rates have shot up with inflation fears building, along with the end of the Fed's bond purchase program. Mortgage and Treasury rates stand at multi-year highs, while the average yield for a high-grade corporate bond is almost 5%, the highest level that's been available in more than a decade.

Perhaps the best news for bond investors is that the increases in rates we've seen in recent weeks are sure to slow the economy and turn the heat down on inflation from a rapid boil to a simmer. We're already seeing evidence that high consumer prices are causing households to shift their buying habits, moving to lower-priced items and substituting or delaying other purchases. This pattern has emerged over practically every past economic cycle, as higher rates and higher inflation act to self-correct an overheating economy; we expect the same sequence of events this time.

In addition, the historic flood of COVID-era relief funds that was injected into the economy is running low, with savings rates falling back to pre-COVID levels. Those who side with classic monetarism, will recall Milton Friedman's adage that "Inflation is always and everywhere a monetary phenomenon…" but may not recall the second part of that quote, which applies today: "…in the sense that it is and can be produced only by a more rapid increase in the quantity of money than in output." When the quantity of money (M1) grows by 350% in one year (as shown on the chart on this page), you should expect inflation. Lots of inflation!

We may be witnessing the end of the 40-year bull market for bonds, and we're OK with that. Bond yields, after flirting with the dreaded "zero lower bound" over the past few years (and even below zero in some overseas markets), had become untenable, and offered little upside for investors. The reset to higher rates has been dramatic and painful; it could have been handled better, and managed in a way that wouldn't have forced bondholders to accept the brutal losses we've seen, but a unique conspiracy of factors, along with some pretty big policy errors, led us to this place. The tradeoff is that now we can build portfolios with a reasonable amount of coupon income and yield, which will help offset any further price declines, something we've been missing for the better part of the past fifteen years. For the first time in a long while, the high grade bond market is offering investors more than just a "safe haven" from riskier assets, with returns that can compete with other asset classes.

Yes, inflation has a corrosive effect on bond valuations, simply from a present value calculation. But an economy with no inflation creates a bond market that offers scant value for investors; just look at Japan, where bond returns have averaged 1.3% annually for the past two decades. We've been trained to believe that any inflation is bad, but US bond returns were better in modest inflationary periods, such as the 1990s, than in the ultra low inflation environment we've been in for the past 15-20 years.