Executive Summary:

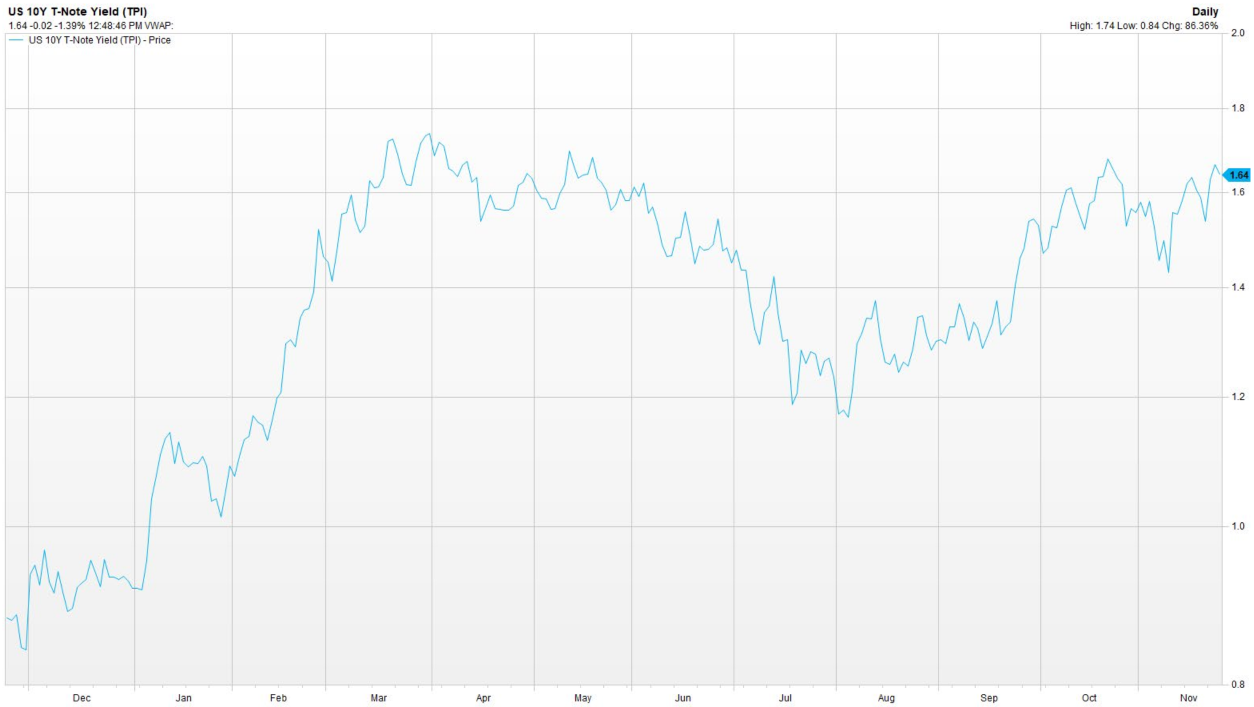
- We had a high inflation point. This is something to be watched and monitored. This is not something we believe requires a drastic portfolio shift.
- The labor market is strong. Companies are having trouble attracting and retaining the talent required to continue growing at current rates. Wages increases should help attract more talent and fill job positions.
- While wages have increased, companies have been able to increase prices to offset these increased costs.
- The US bond market is expecting around 2.5% inflation over the next 10 years. This echo's what the Fed has been saying from the beginning of the year. Inflation will be transitory (temporary).
- Rates are expected to increase gradually. This is a sign of good economic growth, not hyperinflation.
- Companies can increase their prices to offset higher costs. If inflation does become an issue, equities represent a good long-term hedge against it.

This week the markets received important news; Jerome Powell is to be nominated for a second term as the Federal Reserve chairman. Many were expecting President Biden to nominate Lael Brainard, who is a registered Democrat, an economist and member of the Federal Reserve Board of Governors since June 2014. Let us ask why would President Biden, a Democrat, nominate Powell, a Republican, to head the Federal Reserve? The answer is two-fold, but surprisingly simple.

First, Jerome Powell has proved he can be independent. This means he can remain focused on maintaining a healthy U.S. economy regardless of which party may be in office. Having a Federal Reserve that is independent is key to maintaining a strong banking sector and financial markets. That means if the Fed believes a hike in interest rates is necessary, they will be able to do so without political intervention. No one likes when borrowing costs increase, just like children do not like taking medicine. Nonetheless, sometimes these things are necessary to maintain good health.

Second, keeping the current Fed chairman means markets don't need to recalibrate, to a potentially different chairman's view on the economy. This should provide for a level of stability when it comes to interest rate policy. To be clear, a stable interest rate policy (monetary policy) does not mean interest rates are expected to remain at current levels. The markets know the Fed plan as Powell is very open about them. The one thing markets dislike is uncertainty. Nominating Powell as Fed Chairman eliminates an element of uncertainty regarding rate policy. Now let's discuss the interest rate expectations.

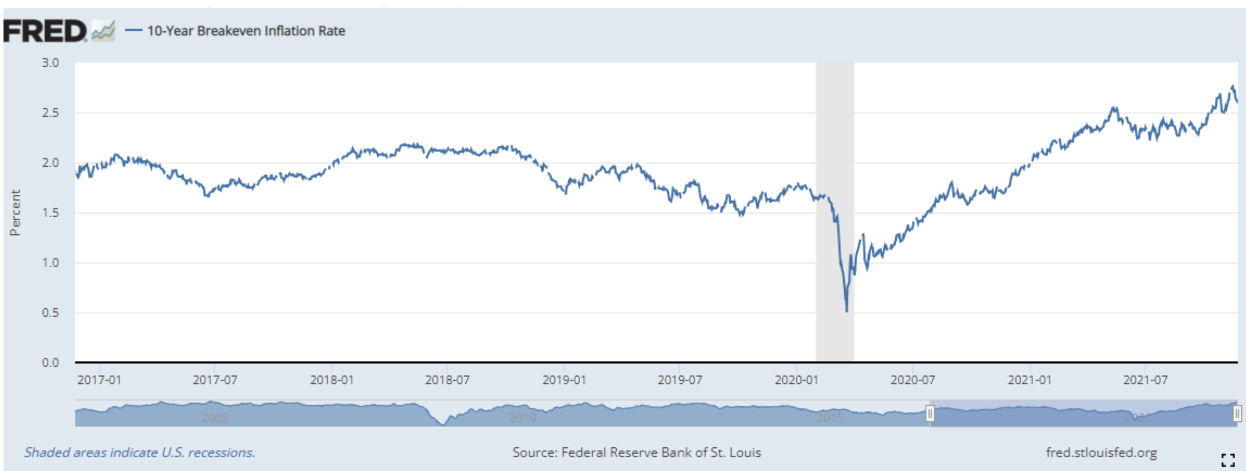
After the news of Powell's re-nomination, interest rates actually increased on the 10-year U.S. government bonds. The yields went from 1.54% to 1.66% and have since settled at 1.65%. This is within the normal daily volatility of interest rates we have seen throughout this year and below the high of 1.74% in March. According to FactSet, economists are only forecasting rates of 2% by the end of 2022 and 2.25% by the end of 2023. This would generally be a good thing as rates are not expected to sharply increase and they are moving in line with the long-run inflation expectation of 2.25%. This leads us to the topic of inflation and the effect it may have on interest rates and growth.



Earlier this month the October inflation numbers, measured by CPI, hit a 31-year high of 6.2% year-over-year growth. This is certainly worth taking note of; however, you must be careful not to have knee-jerk reactions to these numbers. Popping the hood and looking at some of this week's economic data we can see why. The weekly jobless claims hit a 52-year low, overshadowing the 31-year high in the CPI index. This is widely seen as a measure of how strong the labor market is, because if fewer people are filing for unemployment benefits, companies are not laying off workers. Listening to earning calls the latter half of this year, wage inflation has been a topic of note. Employers are having to increase worker pay to attract and retain talent. When you combine this with the supply chain issues, it becomes easy to understand why we had a 6.2% CPI increase. However, the supply chain issues are expected to subside mid to late next year. This is something the Fed has echoed and acknowledged as transitory (meaning temporary).

The Fed has also stated that if inflation does become a threat to economic growth, they will take appropriate action. Reading the meeting notes released this month, we can see this is already happening. Earlier this month they announced a $15B a month tapering. This is a reduction in the amount of net-new bonds they are buying. There were also talks of rate increases happening next year. However, even with these actions, the Fed is still targeting a 2.0% inflation rate by the end of next year. This means the largest price increases from increasing wages and supply chain issues has already happened.

What we find so interesting about this inflation debate is, the Fed has been trying to stimulate inflation since the Great Recession. Now that we are starting to see some inflation, we should be happy as it is usually indicative of economic growth. As an economy grows wealth is usually distributed to workers via wage increase or wage inflation. What does this mean in the short-term? It means this is something we are going to watch and see how it evolves. In the short-term, companies have been able to increase their prices covering increases in wages and supply chain costs. While this can make for some scary headlines, it does not necessarily make sound investment advice. When we turn to the bond market as an indication of what inflation is likely to be over the next 10 years, it is much more muted than the 6.2% headline number.



With this information, we see that rates are likely to gradually increase in the coming years, but not to a level that should induce panic selling of your equity portfolio. We still believe a growth portfolio of best-in-class companies will continue to perform well over the coming years. Think about the work from anywhere environment and the Metaverse. These are going to allow companies to shift costs away from office space, change how advertisers spend their ad budget, change consumer spending habits, etc. Using the office space example; a common statistic is that companies will be able to reduce in office space by 60% for current staffing levels[1]. However, this also means with current office space levels, companies will be able to grow their workforce without having to lease additional space. Because with a hybrid work model, fewer in office desks will be required. The current office space company will have to grow their workforce to around 67%, before they need to acquire more space. This is one example of how technology can reduce the cost of growth.

1: https://www.forbes.com/sites/joemckendrick/2021/05/30/remote-work-evolves-into-hybrid-work-and-productivity-rises-the-data-shows/?sh=27173d934825