April 2021

Dear Clients and Friends,

In the first quarter of 2021 vaccines took hold; Congress passed another $1.9 trillion in financial rescue funding; stocks cheered. While there have been hiccups – not all vaccines seem to be working out, there's a shortage of some semiconductor chips effecting everything from cars to home appliances, and the Panama Canal was closed for several days because a freighter got stuck -- overall, investors remain super bullish on the expectation that corporate earnings can only go up from here and may potentially go up a lot.

Looking ahead, we expect investors will pay significant attention to two metrics: inflation and interest rates. For the first time in over a year the word on most investors' minds (at least in the U.S.) is no longer COVID-19. With vaccines now reaching 3-4 million Americans per day, there is a clear path to a post-COVID social and economic recovery, an enormous achievement that is happening faster than even the most optimistic experts imagined. Now the word on many investors' minds is clearly inflation. Fed Chair Jerome Powell, more often than he says "inflation" is saying "transitory," a clear admission that the Fed is anticipating rising inflation, but also expecting elevated inflation to be temporary. The extent and duration of this inflationary bump may have significant consequences though. Inflation that comes on too strong will restrict economic growth that is badly needed both fiscally and psychologically.

In many pockets of the economy, inflation is already red hot and causing significant challenges. A prime example is lumber, where futures prices have surged more than 60% to record highs since the start of the year. The National Association of Home Builders reports that soaring wood costs have already added more than $24,000 to the price of the average new U.S. house. Huge price increases have not been limited to lumber, below are several commonly traded commodities and their 12-month price increases.

- Lumber: +115%
- Soybeans: +59%
- Silver: +55%
- Copper: +46%
- Corn: +45%
- Cotton: +30%
- Coffee: +25%
- Gold: +17%
- Crude Oil: +16%
- Wheat: +16%

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Already, inflation as measured by the Consumer Price Index (CPI) is running hotter than at any time in the last 10 years, even though CPI tends to underweight healthcare and housing expense (single family home prices increased a whopping 13% in the last 12 months!). Particularly notable is the recent jump in gasoline prices which contributed half of the 9.1% jump in the monthly March CPI.

Now, a potentially more influential inflation spike is just getting started: wages. The overall U.S. labor force shrank by over 8 million workers since February 2020 and millions of those workers when surveyed say they intend to stay out of the labor force. Still, job openings are rising dramatically and the service industry is already strained to find workers as the economy restarts, putting pressure on employers and pushing wages higher. A recent Bloomberg article clearly laid out the challenge: wages in the leisure and hospitality industry for non-managerial workers grew by more than 1.5% <u>per month</u> for two straight months, a rate of increase not seen since at least 1981 (chart below).

Why worry about inflation? Inflation saps purchasing power, thereby reducing potential economic growth. Any signs of inflation crimping growth eventually results in reduced expectations for corporate earnings and a reassessment in stock valuations.

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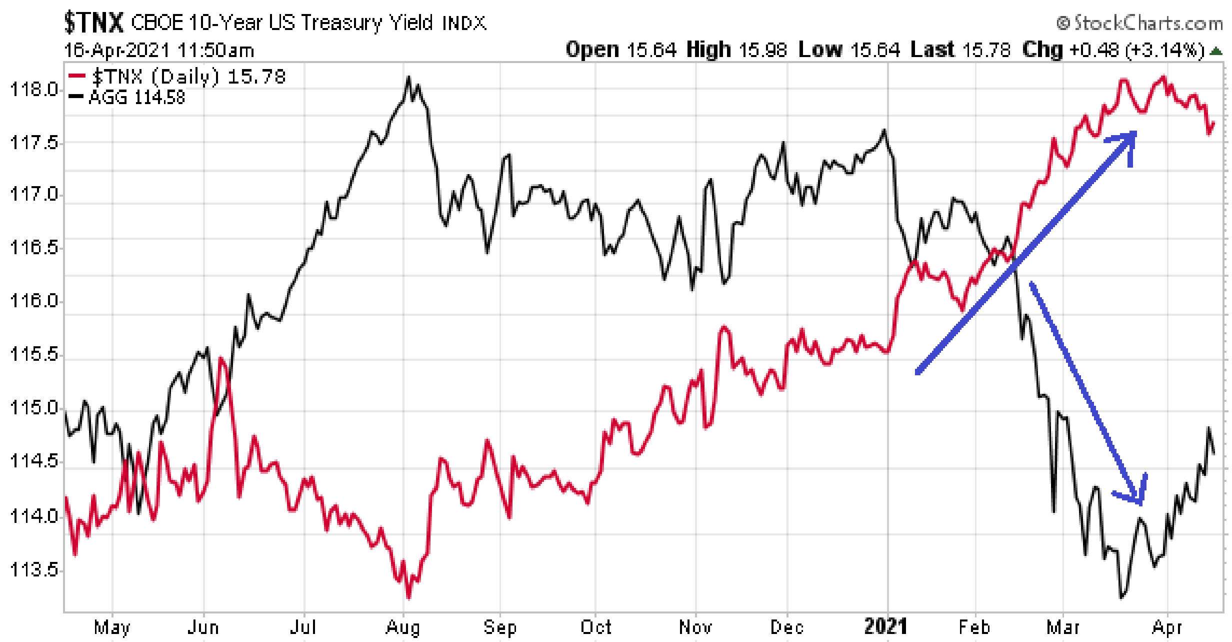
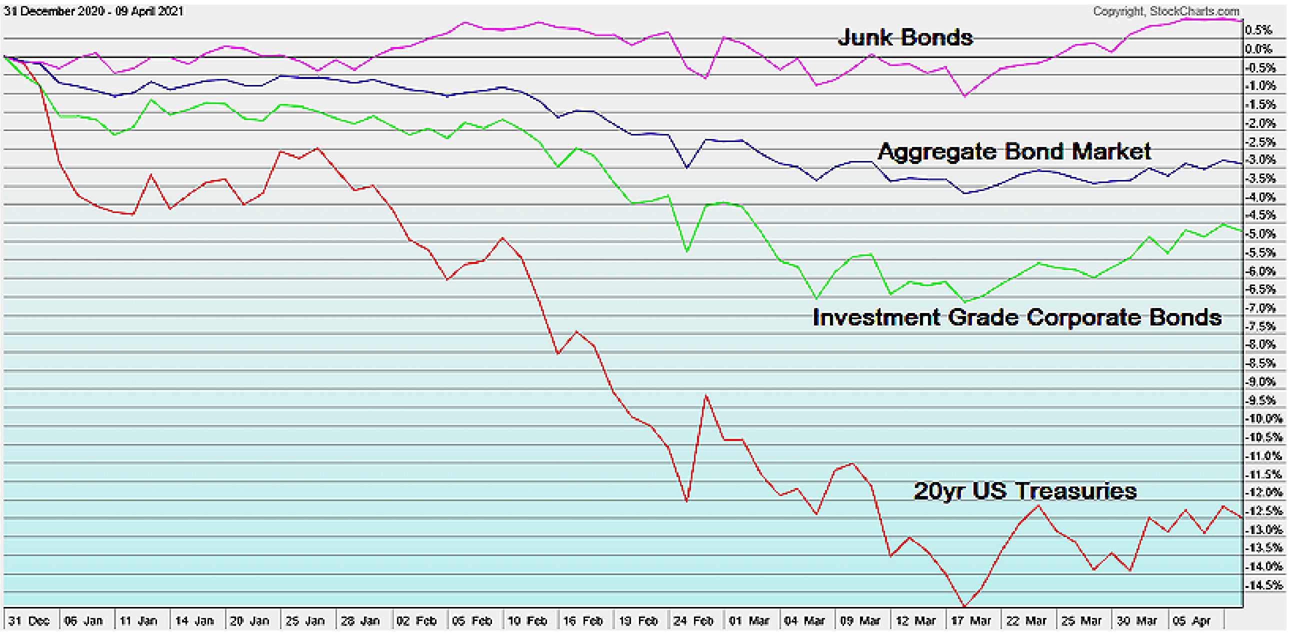
Both businesses and consumers have been able to borrow at historically low interest rates for over a year now. The U.S. central bank has held short term rates at or near zero to encourage borrowing, spending, and investment. While the Fed can influence market interest rates, they do not control them. Governments and institutional investors that trade in U.S. government bonds have demanded higher rates.



Recently, as 10-year treasury rates leaped higher (as shown in **RED** on the above chart), the aggregate bond index took a sudden and dramatic hit (shown in **BLACK** above – ticker AGG). Since the start of the year, 20-year U.S. bonds have tumbled over 12% (as shown below in RED) and investment grade corporate bonds over 5% (as shown below in BLUE). The effect of higher interest rates was inescapable: prices in almost all classes of bonds declined sharply.



Looking ahead to the summer and fall, if inflation and interest rates keep rising, there is no question it will sap investors' zeal for stocks. But also possible is that sharply recovering corporate profits will outrun inflation concerns, with those concerns easing as the economy returns to a more normal trajectory. Speed bumps are expected. It is the unexpected shock that usually triggers a broader reassessment of company valuations, which remain stretched and approaching historic levels.

To future profits,

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