



INVESTMENT UPDATE

This month, we'll provide an update on the Fed and the challenges it faces in bringing down inflation, as well as a quick look at the high grade credit markets.

After the recent release of August's US inflation data, it's becoming clear that the Fed has plenty of work left to do to reduce the persistently high rates of consumer price inflation. Demand for consumer goods continues to outpace the available supply of those goods, which in turn places pressure on producers of those goods to expand, putting further upward pressure on raw materials and the wages paid to workers who produce, distribute, and sell those products. Central bankers cannot do much to help ramp up the supply side of the equation, which means that they have no choice but to use their tools to tamp down demand to move towards economic equilibrium.

The two main tools that the Fed has available—adjusting the overnight Fed funds lending rate, and expanding/contracting its holdings of government bonds—work indirectly and with considerable uncertainties, lags, and side effects. When the Fed hikes the overnight funds rate, it results in a domino effect, as banks are forced to raise the lending rates on short- and floating-rate loans. This raises the costs for businesses looking to borrow, which, in turn, discourages expansion and business formation. The dominos fall one by one, with interest-rate sensitive sectors (real estate, finance) generally the first to slow. Eventually, rates will rise to the point they become a drag on the larger economy, particularly if the Fed is simultaneously shrinking its portfolio of bonds (current size: \$8.4 trillion), which, unlike the Fed funds rate, tends to raise rates for longer maturities, like those for mortgage loans.

The big domino in this chain of events is the labor market, which comes relatively late in the process, as most employers are reluctant to lay off workers, particularly those in skilled positions. But unfortunately, for restrictive monetary policy to have any clout, the Fed must put people out of work. When Fed Chair Jay Powell warned last month that its policies will cause "some pain" in the coming months, he's alluding to increased layoffs

and a higher unemployment rate for the US economy. Policy-makers know that the only sure way to slow demand is to threaten consumers with the loss of income.

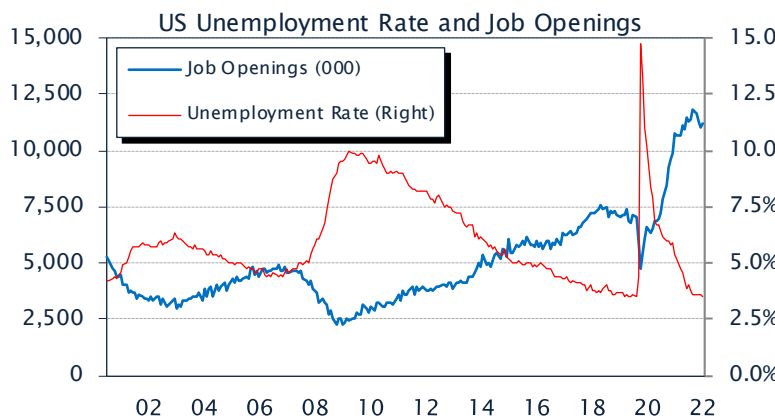
Likewise, when members of the Fed's policy-setting Open Market Committee talk about "remaining committed" and being "in this for as long as it takes to get inflation down," they're acknowledging the fact that reducing inflation may not happen for a period of months, if not years. One big reason for that is due to just how strong the US labor market is right now. As the chart on this page shows, the unemployment rate is only 0.2% above the lowest level of the past couple of decades,

while there are approximately 11 million unfilled job openings—also a near-record. Workers aren't particularly afraid of losing their jobs, knowing that there's a real labor shortage right now, and plenty of jobs available.

That doesn't mean that consumers aren't beginning to shift their spending patterns. Tighter monetary policies have begun to put

off some potential homebuyers (as well as those looking to upsize), as mortgage rates have moved up by 300 basis points over the last year. While we've yet to see home price indexes fall in the US, it's already happening in Canada and other western countries, as higher rates and dwindling pandemic relief funds take their toll. Rents are rising in sympathy, and one of the main components of core CPI—homeowners' equivalent rent—is beginning to accelerate. Rising rental costs will continue to put pressure on lower income households, with knock-on effects for the broader economy.

The August CPI numbers also showed a continuation of the long-expected rotation by consumers from goods to services. For most of the past couple of years, the biggest price increases have been attributable to shortages of supply due to bottlenecks in global shipping and closures of factories and transportation facilities. Along with commodity price pressures, this resulted in big increases in both nominal and core CPI (which excludes food and energy products) due mostly to increases in "goods" components, which had shown very little price appreciation over the last decade or two.



As the chart on this page shows, after a multi-year period of extremely stable prices, goods prices soared in 2021, and became the big factor propelling inflation higher over the past couple of years. But those price increases are now abating due to some cooling of demand as well as the easing of global supply chain issues. Likewise, energy price increases are decelerating year-over-year as global commodity demand has slowed, bringing top-line inflation down from its peak in June.

While that's good news, service-oriented prices, including housing, medical, transportation, and education, are now accelerating. This will be of great concern for the Fed, as service-oriented spending is far "stickier" than those of goods and commodities. Most service businesses aren't particularly interest rate sensitive, so higher rates won't have much of an impact on their operations. But more than that, these businesses' expenses are tied to the cost of human capital, and with the labor markets expected to remain tight for at least the next few months, there will be continued pressure on wages for these companies as long as demand remains strong. The other big factor is that home rental inflation (which accounts for approximately 1/3 of core CPI) is accelerating—from an annual rate of 2.6% to 6.3% over the past twelve months. Along with medical and education expenses, these CPI components tend to be far more stable and trend in the same direction than non-core items. In short, the service-related components of CPI are likely to be far more resistant to the Fed's policies than goods-related components.

Again, the Fed's tools are limited, and their effectiveness and timing are difficult to predict with any real precision. Our base-case scenario has been—and continues to be—that the Fed will have to do more to slow the economy and bring down inflation this cycle than it has had to do in at least two decades of monetary policy. And even then, we're not convinced the Fed will be able to hit its 2% inflation target before the political pressures become so pressing that it's forced to back off.

On a semi-related topic, one area of the bond market that looks well positioned for an economic slowdown is the corporate bond sector. This isn't always the case when we reach the "Fed taking away the punchbowl" part of the business cycle, as companies typically see their credit quality deteriorate late in the cycle. A review of credit metrics published last week by JP Morgan highlighted the fact that the high grade US corporate sector is, by almost any measure, strong.

First, the bad news—profit margins are slipping due to higher energy and labor costs over recent months, while revenues have tailed off due to slowing economic growth. Yet profit margins are averaging 31% this year, only 1% or so below the highest levels of the past dozen years. That's about it for bad news.

Corporate treasurers have been managing their companies' balance sheets with considerable restraint: Long-term debt growth has barely budged over the past five quarters, a period that showed top-line revenue growth of more than 20%. The net result is that EBITDA—essentially, pre-tax, pre-interest earnings—has been growing strongly. The numbers have been boosted somewhat by very strong revenues for commodity-

related companies, but even if we exclude the energy, metals, and mining companies, the numbers remain strong. This conservative balance sheet management is music to bondholders' ears, and should help support valuations and credit ratings as we move into a period of slower growth and tougher credit conditions.

From a bondholders' standpoint, the most important measure is interest coverage—the company's ability to meet its debt payments from EBITDA. Despite big increases in rates over the past year, interest expenses have fallen, by 7% year-over-year, and interest coverage ratios are at their highest levels in more than a decade. Much of this strength is attributable to treasurers taking advantage of ultra-low rates during COVID to retire older, high-coupon debt while locking in new, low-cost, fixed-rate debt.

Corporate profitability will take a hit if the US slips into recession; the degree to which an issuer will suffer will depend on the unique characteristics of the company and the industry in which it operates. Careful security selection, as always, will become increasingly important, especially if inflation proves difficult to extinguish and the Fed is forced to use its tools aggressively and for an extended period. We are currently able to buy excellent quality corporate bonds with above-average incremental yields compared to benchmark Treasuries, with all-in yields in the 5.0%–5.5% area for intermediate maturities. Given the strong fundamentals in the credit markets, and with yields at decade-plus highs, we're pretty bullish on the high grade corporate bond sector.

Finally, we offer our congratulations and gratitude to Brad Coats, a founding Partner at Agincourt, who is retiring this month after more than 35 years as our trusted colleague. We are deeply appreciative to Brad for his leadership.

