April 2022

Well, let's count the things people are worrying about: we're over two years into a global pandemic, commodity prices are spiking upward, consumer price inflation has risen dramatically, the Fed is raising interest rates, recession worries are spreading, and there's a war in Europe. I am asked almost every day, "Why aren't stock prices collapsing?" It's at times like these that we need to remember that stock prices don't measure how you feel, but rather they are an estimation of the value of businesses. Business valuations don't necessarily go down just because you feel bad. Some businesses are actually *worth more* when you feel bad, such as the businesses that produce the commodities whose prices are rising.

Nevertheless, there does seem to be a lot to worry about today, and many of these worries are closely related. So, let's talk about them. As we've often said before, it's important that we worry about the right things. Among the worries listed above, one that we're worrying less about as each month passes is the pandemic. In the U.S. and the Western world (where most of our companies do business), immunities are building thanks to high vaccination rates and natural immunity from prior infections. COVID-19 is certainly not gone, but hospitalizations in the U.S. are down significantly, even as new variants keep coming along. This is encouraging.

Inflation is a more complicated matter. Consumer price inflation is always the result of high demand combined with a constraint in supply. "Too much money chasing too few goods" is a good working definition. Whether rising inflation is a temporary or long-term problem depends on the factors increasing demand or restraining supply. Despite all the money-printing by the Fed, inflation had stayed very low for over a decade. The reason for that was on the supply side: globalized production, technology, and deregulation kept the supply of goods large and growing. All was well on the inflation front until the supply situation changed, and it changed dramatically.

The pandemic first and now the Ukraine war have delivered many shocks to the supply side, resulting in rapidly rising costs for a host of products. Some of these rising costs will likely recede when the pandemic and war end, but some probably will not. This uncertainty is the reason many are pessimistic about inflation. Production, transportation, and logistics disruptions caused by the pandemic have created product shortages and rising prices, as have labor shortages triggered by the decisions of many older workers to retire or delay going back to work. Thus, inflation did rise.

The war has worsened inflation in two ways. First, the costs of many commodities produced in Russia and Ukraine have risen dramatically due to the direct effects of war-related supply reductions. Such commodities are oil, natural gas, nickel, palladium, neon, titanium, potash, uranium, and wheat. These are basic commodity inputs for many goods, and their rising costs have rippled through the economy. The second impact is an indirect link: the decisions by the Western powers, led by the U.S., to deny Russia access to global trade and the global financial system is accelerating the deglobalization of the world economy. Confluence's macro team has been writing about this trend toward deglobalization for many years. These trends have been exacerbated by the Ukraine war in many ways. A deglobalized world is a higher cost world since goods might not be produced at their *lowest cost* location but at their *most secure* location for movement to market. Undoing the disinflationary benefits of globalization will result, therefore, in higher rates of inflation than would have been expected otherwise.

And then we have the Fed. After many years of stimulating the economy with ultra-low interest rates and actually trying to create inflation, the Fed seems to be in panic mode now that inflation is actually here. Thus, they have begun raising the fed funds interest rate and selling bonds. Unfortunately for investors, the only tool the Fed has is a hammer to reduce demand. That is, they can slow down the economy to match demand with the lower supply. It's a bit like trying to lose weight by getting sick. You might lose weight, but at what cost? The Fed always thinks they can raise rates just enough to tame inflation, but not so much as to cause a recession. In practice, they have rarely "threaded the needle." We will watch this closely. It is potentially more of a problem for 2023 than this year.

So, what's an investor to do? We have seen this drama before; it played throughout the 1960s and 70s. In fact, what we learned from that time period is that equities give investors a better opportunity to battle inflation than most other asset classes. Stocks of two classes of businesses can do well. The obvious class are those companies that produce the commodities and other products that are in shortage during an inflationary cycle. But less noticed are the class of companies that have substantial pricing power in whatever industries they operate as they are better able to pass along costs and maintain profit margins. These companies have always been a focus for Confluence and will remain so going forward.

In summary, inflation is indeed an important obstacle to be overcome by investors. We at Confluence have seen it before and are prepared to battle it on your behalf.

We appreciate your confidence in us.

Gratefully,

Mark A. Keller, CFA
CEO and Chief Investment Officer

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