Fahnestock Asset Management
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Dear Client,

Split pea soup day is Thursday at the diner across the street from our office and it is delicious. We have been in our office for a very long time and we eat it often so we can remember 15 years ago when a bowl cost just $3.35. Today that same bowl costs $5, an increase of almost 50%. Over time inflation gradually erodes the buying power of a dollar.

Lately inflation has been flaring up. As measured by the Consumer Price Index (CPI), inflation has risen from 1.4% at the end of 2020 to 5.4% in June and 5.4% in July, the fastest year over year increases since 2008. A subject of much debate is whether this pace is temporary or if sustained higher inflation is here to stay.

You are likely experiencing higher prices first hand. Companies are seeing higher costs for rent, energy, labor, logistics, commodities, etc. and are passing those costs on by raising prices. **Half of June's inflation can be attributed to six factors that we believe are temporary covid aftershocks**: used car prices, rental car rates, vehicle insurance, lodging away from home, airfares, and food away from home. The driving forces behind these factors are elevated demand, labor shortages, and supply chain bottlenecks.

Elevated Demand - Many people are again comfortable in crowded places and are making up for 18 months of cancelled experiences at the same exact time. 70% of the US adult population is at least partially vaccinated, and a jab is available to anyone who wants one. Most businesses are fully open and are making up for 18 months of lost revenue by capitalizing on high demand and charging what the market will bear. Flights and hotels are packed and rental cars are next to impossible to find in tourist destinations. **We believe this surge is temporary and demand should return to a more even cadence over time.**

Labor Shortages - Many laid off workers, especially in manufacturing and hospitality, have moved on to new jobs in new industries. We are in the midst of "the great resignation", where some people, confronted by the fragility of life, have left their jobs to pursue something more meaningful. As employers rehire, they are facing labor shortages and the applicants they do get are untrained and have higher wage expectations. On the lower end of the pay scale, employers are still competing with expanded federal unemployment benefits. Lastly, uncertainty on school openings is preventing primary caretakers from reentering the workforce. **Wages should stabilize as expanded benefits expire in September and there is more clarity on school reopenings.**

Supply Chain Disruptions – Covid disrupted global manufacturing supply chains and they have yet to recover their former efficiency. A steep drop in consumer demand had manufacturers cautiously under order from their suppliers, who did the same thing with their suppliers and so on down the value chain. This has led to a scarcity in certain ubiquitous critical components such as semiconductors, just as demand is going through the roof. Less developed countries with limited access to vaccines are also still struggling with outbreaks and lockdowns slowing production times. **Bottlenecks should eventually catch up with demand as the world gets back to normal.**

While recent inflation numbers make for daunting headlines, we think it is important to consider them in the context of how inflation is measured. The CPI compares the cost of a basket of goods in a given period to that same basket in a previous period, typically the year before. We are comparing today's prices to a time when we were crippled by lockdowns, layoffs and fear of an unknown virus. **Inflation may be higher year over year, but it is still in line with long term price trends.**

Near term, as the world adapts to life with covid, the above after-shocks should gradually abate, slowing the rate of inflation to a historically normal cadence. Longer term, inflation will be heavily influenced by monetary policy and government spending. Compared to the numbers described in our previous letter (posted on our website), these pressures are already declining; the Federal Reserve has outlined a roadmap for withdrawing monetary stimulus and proposed government spending packages have been greatly reduced in size during legislative negotiations.

Back to the tastier topic of split pea soup. A price increase of 50% over fifteen years is only 2.7% per year on average, close to CPI's 2% over the same timeframe. This inflation rate is reasonable, and yet over time it clearly still adds up, demonstrating the need to invest in a way that keeps up with inflation. We believe your portfolio is appropriately postured and we will continue to opportunistically identify investments that protect your spending power.

Our offices are open and we are all fully vaccinated. If your comfort level permits, please stop on by and join us for a bowl of soup. We would love to see you!

Sincerely,

Craig W. Hutchison
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