FAHNESTOCK ASSET MANAGEMENT

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Dear Client,

The Spanish Flu of 1918 surged in three distinct waves and then disappeared after two years. Two years into Covid we are all wondering the same thing: when will things get back to normal? With continued disruption from new variants, we think the better question in the face of such uncertainty is: what does "normal" look like? The spike in inflation continues with another 7% increase in December and there are mounting concerns that high inflation is the new "normal". While many side effects of the pandemic are here to stay, **we continue to believe that inflation will gradually revert to historical norms**.

In our last letter (posted on our website) we discussed the short term, pandemic driven causes of the spike in inflation: excess demand, government stimulus, labor shortages, and supply chain disruptions. Inflation might be grabbing the headlines today, but for the last three decades it was stubbornly low, averaging just 1.5% to 3%. **In fact, many economists were more concerned by deflation than by inflation thanks in part to two long term secular trends that exert downward pressure on prices: globalization and technology.**

**Globalization** – Low labor costs in emerging markets, low global shipping costs, and low tariffs incentivize companies to outsource to places like Mexico, China, and Southeast Asia. This results in greater profitability for companies and **cheaper goods for American consumers**. It is telling that a large portion of inflation over the last three decades has been in sectors that are not easily outsourced such as healthcare, education and real estate.

The pandemic has complicated global trade. In a predictable world, manufacturers produce just enough to meet consumer demand. But demand is hard to forecast with regions continuously opening up and locking down. Manufacturers also rely on complex supply chains that span the globe. China, a key industrial hub, has a zero Covid policy. Any supply chain dependent on China is operating in fits and starts which impacts production. **This uncertainty translates into higher costs for manufacturers and higher prices for consumers**.

**Technology** – In 1965 Intel's Gordon Moore predicted that the power of semiconductors would double every two years. This prediction – Moore's Law – has held true and exponential growth in computing power has been profoundly impactful. We are increasingly virtual, digital and information oriented and semiconductors are the backbone of this ecosystem. **Technology helps us solve problems, improve inefficiencies, and do things faster, safer, and <u>cheaper</u>. And it is growing exponentially**.

While globalization has hit a speed bump, **the pandemic has actually accelerated technological innovation**. The CEO of Twilio, a cloud communication software platform that we purchased at the depths of the pandemic panic, put it best on the August 8th 2020 earnings call:

*"Companies are adapting quickly to this changing environment. <u>Over the last few months, we've seen years-long digital transformation roadmaps compressed into days and weeks in order to adapt to the new normal as a result of Covid-19</u>. Our customers in nearly every industry have had to identify new ways to communicate with their customers and stakeholders, from patients to students to shoppers and even employees essentially overnight…"*

Inflation's long term trajectory will have a material impact on financial markets. The Federal Reserve has a long term inflation target of 2%, so if it continues unabated they might be forced to fight inflation by increasing interest rates faster. This could have a negative short term impact on economic activity and asset prices. **But long term we are happy to see the Fed withdraw stimulus as we think the economy is healthy enough to stand on its own. This is a step towards normalcy**.

The prospect of rate increases has been a catalyst for recent volatility, especially in some riskier more speculative investments. The Nasdaq Index, home to many of these companies, fell almost 20% peak to trough over the last ten weeks. While your portfolio is not immune to higher rates or volatility, the decline has been much more tempered. We continue to keep a long term perspective and so far consider this pullback as healthy and an inherent part of long term investing, especially in the context of the gains the market has experienced since the pandemic low. We are optimistic for what the future holds and intend to take advantage of the pullback as a buying opportunity.

The Spanish Flu did not disappear into thin air after two years, it continuously mutated and direct descendants still circulate in today's seasonal flu. Survivors developed partial immunity and were not hit as hard by subsequent infections. We expect to cut a similar path to stability as everyone vaccinates, gets Covid, or, as in Drew's case, both. We do not see a return to a "normal" where the virus is eradicated, but rather one adapted to life with Covid as an endemic. As that happens, we expect the long term pressures to gradually outweigh the short term pressures bringing inflation down to more manageable levels.

We had hoped to write a letter that did not have a mention of Covid but here we are…that must be our new "normal". May you live in interesting times!

Sincerely,

Craig

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