Eagle Strategies LLC

The Eagle Edge

Quarterly

MARKET & ECONOMIC OUTLOOK

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On the Radar Screen

1. **With schools reopening and enhanced unemployment insurance benefits expiring,** there are expectations that workers will reenter the labor force in larger numbers and fill some of the many vacant positions in larger numbers than has been the case in recent months. That remains to be seen.
2. **Inflationary pressures showed some signs** of moderating over the summer but remain elevated.
3. **With costs surging even as top-line growth has been restrained by a wave of delta-variant COVID infections,** corporate profit margins may get pinched. Earnings announcements will be telling.
4. **Congress continues to hammer out a reconciliation bill alongside pending infrastructure legislation.** The outcome will have a profound effect on the role of the government in terms of both taxes and spending.
5. **Amidst rising tensions with the West, China continues to exert** greater state control over a range of businesses with significant implications for the global economy.

Asset Solutions' Portfolio Managers

"Blessed are the young, for they shall inherit the national debt." – Herbert Hoover

The hole gets deeper. It's been an especially busy couple of weeks for legislators in Washington, D.C. In addition to the usual wrangling over the federal budget that occurs this time of year, supplemental spending bills related to the Afghan withdrawal and cleanup from Hurricane Ida hang in the balance as Democrats negotiate feverishly amongst themselves to draft an enormous social infrastructure bill designed to sit alongside the physical infrastructure package that emerged from the Senate over the summer.

In our view, total new spending, only partly offset by a battery of corporate and individual tax changes aimed at wealthier households, may have a considerable impact on the economy and capital markets over time.

Elements spending may portend to more productive workforce and the facilitation of commerce potentially boosting growth. For example, more accessible post-secondary education can help expand the pool of skilled labor while universal pre-kindergarten schooling may allow young parents, particularly women, to enter the workforce during early child-care years. At the same time, improved transportation systems and upgraded communications networks can facilitate commerce and the sharing of information.

Redistributive taxation may also serve to fuel faster growth: economic theory tells us an incremental dollar in the pocket of higher-income individuals is less likely to be spent than would be the case were it in the pocket of a lower-wage worker; and it is the recycling of money through consumption that drives growth.

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Insights from Multi-Asset Solutions' Portfolio Managers

But as deficit spending pulls growth forward in time, the same boost to consumption that drives faster economic growth today may also threaten to propel prices higher across a wide range of goods and services. A post-pandemic surge in household spending has already run headlong into constrained supply as labor, materials, and logistics bottlenecks have emerged. Inflationary spikes have developed in any number of industries from cars and energy to housing and food. Additional fiscal largesse adds to the risk that these price pressures morph into entrenched expectations for higher inflation in the future.

"Faced with the choice between changing one's mind and proving that there is no need to do so, almost everyone gets busy on the proof." – John Kenneth Galbraith. The popular narrative within financial circles still seems to be that inflationary spikes currently on display will prove transitory. Technology-driven productivity gains, globalization, aging demographics, and effective monetary policy have reinforced the idea that inflation was a problem of yesteryear. Gradually, however, as materials costs continue to rise, backlogs persist, job openings remain vacant, and home rental rates surge higher, the burden of proof is shifting. Price stability may be eroding. Capital markets have become geared toward perpetually low rates and mild inflation. A regime change, if at hand, comes with very consequential implications. Flexible thinkers that successfully adapt to this changing environment may stand to reap considerable rewards.

Duration is everywhere. In finance, duration is a concept with a very specific meaning—the sensitivity of a price of a bond to a change in interest rates—but it loosely corresponds to the timing of cash flows. An asset that is expected to generate distributable cash flows in the near term can be thought of as having a shorter duration than one whose cash flows will arrive in the more distant future. A long duration asset is therefore more vulnerable to inflation than is a short duration asset because its cash flows are subject to greater erosion when measured in present value terms—an amount of money today is worth more than that same amount of money in the future as it must be discounted.

Think of a bond which returns the original principal at maturity on a specific date in the future. That principal repayment will be more valuable—will have greater purchasing power—if inflation in the intervening years is low and the dollar retains its value than if inflation is high and the purchasing power of the dollar has been badly eroded. The value of assets today is therefore heavily influenced by changes in expectations for future rates of inflation.

Within a bond portfolio, a prudent course of action for an investor who anticipates rising inflation might be to shift a portion of their assets from long maturity debt to shorter maturity instruments, as we have done in our own portfolios.

A similar logic applies within equities. Stocks that trade with high price-to-earnings multiples represent investments into a business with usually long-dated cash flows relative to stocks trading at a discount. Investors these highly valued stocks expect those earnings to grow at a faster rate in the future. As such, higher multiple

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growth stocks like those often found in the technology and communications sectors are effectively long duration assets. These longer dated cash flows make them more sensitive to changes in the discount rate. We believe that these growth style investments will be relatively sensitive to a rise in inflation than value stocks.

Anticipating higher rates of inflation in the years relative to the last two decades, we favor shorter duration cyclical value equities. These businesses trade at a lower multiple of earnings and often offer a higher dividend yield. In our own portfolios, we express this through a tilt toward smaller sized stocks found in cyclical sectors and global markets.

There is no assurance that the investment objectives will be met.

Past performance is no guarantee of future results, which will vary. All investments are subject to market risk and will fluctuate in value.

The opinions expressed are those of Multi Asset Solutions Portfolio Managers as of the date of this report and are subject to change. There is no guarantee that any forecast made will come to pass. This material does not constitute investment advice and is not intended as an endorsement of any specific investment

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About Risk

All investments are subject to market risk, including possible loss of principal.
Stocks and bonds can decline due to adverse issuer, market, regulatory, or economic developments. Bonds are also subject to credit risk, in which the bond issuer may fail to pay interest and principal in a timely manner, or that negative perception of the issuer's ability to make such payments may cause the price of that bond to decline. A bond's prices are inversely affected by interest rates. The price will go up when interest rates fall and go down as interest rates rise.

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