Marble Harbor Investment Counsel, LLC
First Quarter, 2022 Letter

We are pleased to send an excerpt from our quarterly client letter that discusses our current thinking. We welcome your thoughts.

Sincerely,

Paul Davis, L.J. Harrington, Eric Robb, Daniel Rosenblatt and Howie Cowan

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Six months ago, we wrote to you about how inflation rose from a whisper to a roar. Today it is a howl. Inflation loomed large early in our professional lives, so we have been dusting off some classics to refresh our knowledge of the subject. To wit, we just finished reading Steve Leuthold's 1980 treatise *The Myths of Inflation and Investing.* Leuthold was a great favorite of one of our mentors, Bob Mastrovita. While we always started Steve's *Green Book* with the joke section at the back, this monthly tome was replete with thoughtful economic commentary.

Steve wrote the book after ten years of managing money through the inflation-plagued 1970s, which was mostly a lost decade for stocks. He had just lived through seven brutal years of inflation and was seeing some green shoots that suggested inflation was subsiding. Leuthold was prescient: Fed Chairman Paul Volcker started raising interest rates in 1979, which caused inflation to peak in 1980, beginning a great era of growth and prosperity.

Looking back over 100 years of market data from this perch in 1980, Leuthold found some interesting correlations. The best environment for stocks was when there was little to no inflation. If we consider the last 40 years of investing, we see that we have been in a Goldilocks, low-inflation environment, and stocks have a had great returns during this period, just as Leuthold predicted. Periods of sharp inflation and deflation weren't as encouraging for short term stock prices. However, we would point to more contemporary research that shows it's the combination of inflation *and* high interest rates that is most challenging for stocks. While inflation is currently higher than usual, interest rates are still historically low. We have our eyes on how this new period of rising interest rates proceeds and whether the current bout of inflation will be persistent or episodic.

Today, what's most relevant from Leuthold's work is that stocks did well in periods where inflation was declining. Further research has shown that these periods happened to coincide with generally declining interest rates. At this writing, CPI numbers for March show a slowing in core CPI. It would be nice if this trend persisted and inflation started falling, but predicting the economy is not central to how we invest. Time will tell.

The Federal Reserve has twin mandates of managing inflation and employment. While inflation has been climbing, unemployment is at its lowest point since World War II. Putting more people to work is a good thing; however, it has resulted in wage inflation, particularly for lower-income workers. These folks have the highest propensity to spend additional earnings.

The empirical data we have seen on labor market tightness shows that it is predominantly a result of three million baby boomers retiring during the pandemic coupled with a dearth of immigrants to replace them. Higher wages are starting to entice workers who have been staying home during the pandemic to re-enter the workforce. Women's employment was particularly hard hit during the pandemic as more women were forced to stay at home for childcare during Zoom school. We are pleased to see that women have recently rejoined the workforce in greater numbers. Stimulus checks are running out, and as they do, more people will be lured back into the labor force by higher wages, increasing the supply of workers and moderating wage inflation. More people working for higher wages is good for the economy.

While reading Leuthold's book with 40 years of hindsight, we were struck that he in part blamed labor inflation on "younger workers [who] have different work attitudes and are not content to wait until they are 65 to enjoy themselves." Of course, the younger workers he was talking about were baby boomers entering the work force. This echoes commentary that we've seen in the press about Gen Z's disinclination to work. Hey boomer, indeed. The realities of supporting a household eventually take hold in each generation.

If you watched Congressional hearings this month, you might think that gas prices are high because of greedy oil companies, and the way to bring them down is to enact a windfall profit tax. This gives too much credit for market power to U.S. oil companies. In the 1970s, the U.S. government tried something similar, enacting price controls and quotas on gasoline in a misguided effort to combat inflation. These price controls resulted in shortages and even higher prices. You may even remember waiting in line to fill up your gas tank on even or odd days. We hope the powers-that-be study the lessons from those who came before them.

After much jawboning, the Fed has finally started to get serious about fighting inflation, raising interest rates 25 basis points and committing to a series of rate increases over the coming years. In fact, Fed Governor Lael Brainerd began a recent speech by sharing a warning voiced by Volcker in 1973 about the dangers of inflation. Her speech was unusually fiery in the restrained world of Fed-speak, and it's clear that combatting inflation is now a top priority.

As a consequence of the Fed's hawkish words and actions, the more speculative corners of the equity market have fallen; however, the S&P 500 was off only 4.6% in the first quarter. The real action happened in the usually staid bond market. The first three months of the year have been one of the worst periods ever for bonds. The ten-year Treasury lost 7% of its value, and the thirty-year Treasury lost 10%. This is a difficult loss in an asset class where the best you can generally hope for is to simply get your original principal back.

We have avoided medium- and longer-term bonds for years since we haven't been paid enough to warrant lending money for long periods of time. Last summer, a ten-year bond yielded 1.3%, while inflation was chugging along at 4%. We saw no logic to owning something that *guaranteed* we would lose about one-third of our buying power by the time it matured. That ten-year bond has now also lost more than 10% of its value as rates have risen. This has wiped out six or seven years of future interest. Bonds are *not* risk-free.

With the rise in interest rates, we have started to dip our toes back into modestly longer-term bonds where appropriate, as we see more attractive yields that have a chance of staying close to long-term inflation. We are keeping maturities relatively short (two to three years in general) but may lengthen out maturities as the market evolves. With the Fed continuing to raise interest rates, we expect to find more attractive yields, so bonds may play a larger role in your portfolio in the future.

We hope the Fed succeeds in its mandate of keeping inflation tame and employment strong, so we can return to a lower inflation environment that supports the next economic expansion.

Please don't hesitate to contact us if you have any questions.

Sincerely,

Paul, Eric, LJ, Dan and Howie

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