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INVESTMENT PERSPECTIVES

>>FOURTH QUARTER 2021

I can't get it for you wholesale: Supply chains are still broken

By Michael A. Tyler, CFA
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In recent months, companies across a wide spectrum of American commerce — meatpackers, automobile manufacturers, retailers, technology firms, and more — have reported that their profits were adversely affected because of problems with their supply chains. Demand for their products and services is healthy, these companies say, but they can't meet that demand because their supply chains are causing production delays.

Investors don't like to hear about broken supply chains. Wall Street sees the impact all over a company's financial statements: Lower revenues because of unfilled orders; lower profit margins because fixed costs are spread over smaller sales volumes, because unit costs for raw materials are higher, and because inventory can't be managed efficiently. Lower revenues and thinner margins invariably lead to lower earnings and falling stock prices.

Ideally, a company wants more than one source for all critical inputs, to build in resiliency. The alternative — sole-sourcing key items — may be slightly more cost-effective, but it is also far more brittle; an interruption in the availability of just one part from just one vendor can sideline an entire factory.

The "broken supply chain" meme has been hovering over the stock market for several years. Even before the pandemic, the trade war caused many firms to seek alternative sources for materials they had previously been getting only from China; that was a political issue between sovereign governments that nonetheless affected — and still affects — the profits of American companies.

During the pandemic, companies blamed Covid for interrupting the smooth flow of inputs and outputs. That's what happened with building supplies, for example: Foresters could get the trees to the mills, but the mills were unable to process raw timber into lumber products. Homebuilders suffered as lumber prices soared even though timber prices stayed relatively flat.

By early this year, the problem morphed again. Millions of workers retired rather than return to their physical work locations. That left the ports without longshoremen, the truckers without drivers, and the warehouses without stockers. Dozens of ships laden with merchandise sat idle outside our ports, unable to unload their goods.

Sooner or later, American companies will fix their supply chains. But that hasn't happened yet, as companies blame one issue after another. As the business news reporter Roseanne Roseannadanna used to say, it's always something.

>> PERSPECTIVES ON THE ECONOMY

The U.S. economy is still growing, just slower

By Timothy Garvey, CFA
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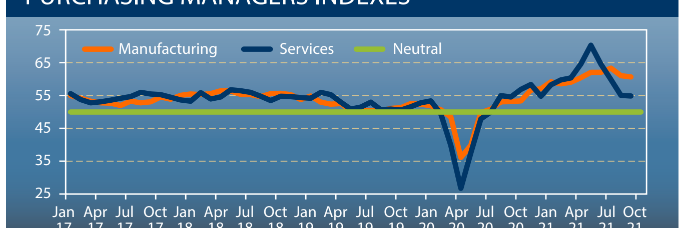
Coming out of the depths of the pandemic, the U.S. economy has experienced well above average growth. In fact, GDP growth has surpassed 6% through the first half of this year. The early spurt wasn't entirely surprising, as businesses reopened, people returned to their workplaces, vaccination rates increased, and people resumed many of their pre-pandemic spending habits. However, these elevated economic growth rates are unsustainable. The U.S. economy is still growing, just slower.

Slower growth comes with some risks. The most prominent is the striking dichotomy between supply and demand. Both consumer and business spending have increased considerably since the economy began reopening, so demand is evidently healthy. Purchasing managers are still bullish, although they have tempered their optimism in recent months.

However, companies across many industries are struggling to meet the elevated demand levels. Production inputs like workers, commodities, and semiconductors are becoming increasingly scarce and costly. Suppliers' delivery times are lengthening, and backlogs continue to grow. High demand, together with supply shortages, are putting upward pressure on prices. Both consumer and producer price inflation are running hot, which could prompt the Federal Reserve to become less accommodative by tapering its asset purchases and eventually raising interest rates.

Despite these risks, we believe the economy is resilient. As the labor market continues to recover, supply constraints and inflation should abate. Meanwhile, consumer spending should continue to be very strong, as wages are accelerating. We may not see GDP growth exceed 6% for quite some time, but the economy remains in solid shape.

PURCHASING MANAGERS INDEXES



Purchasing managers still expect a growing economy, but the pace of growth has slowed. (Index: Over 50 = expansion)

Source: IHS Markit

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>> FOCUS ON EQUITIES

Equity portfolios capture advances in health care therapies

By Jia Min, CFA
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When we build stock portfolios for clients, we select companies that benefit from key trends affecting the world today. We find companies tied to the digitalization of the economy, clean energy transition, flexible work, and housing, among other themes. One of the most important is health care innovation.

We are seeing a renewed wave of innovation in life science research. This emphasis has been facilitated by a better understanding of disease biology, development of gene and cell therapy, and Covid's powerful reminder of the critical role health plays in both the economy and our everyday lives. Both the biopharmaceutical industry and government agencies, such as the National Institutes of Health have substantially ramped up funding for therapeutics development. We think this will result in robust clinical trial activities going forward.

High-profile successes of the mRNA platform in Covid vaccines boosted Moderna's and Pfizer's stock prices, but many other firms have lost half their market value when key drug trials failed. And then there's Biogen, whose stock price has been extremely volatile during decades of investment in a disease-modifying Alzheimer's treatment; even after Aduhelm was approved, controversies about pricing and the approval process still buffet the stock.

We believe the best way to capitalize on health care innovation is through our investments in the tools and diagnostics companies that provide the equipment and biomanufacturing capabilities essential to the clinical research process; they can succeed regardless of whether any specific treatment ultimately is approved. These stocks are protected against the risk of binary outcomes, in which a drug's ultimate approval could make or break its developer.

It's an exciting and important time to be invested in health care and the broader economy, but stock selection is critical. We continue to position our client portfolios to thrive in a range of macroeconomic scenarios. As market concerns have shifted throughout the past year between high inflation, the timing and pace of Fed tapering, a surge in the Delta variant, supply chain disruptions, and then back to inflation risk, markets experienced a push and pull among cyclicals, growth, and more recently, defensive stocks. Throughout, our balanced and focused approach on quality has continued to serve our clients well.

>> FOCUS ON FIXED INCOME

Investors brace for an environment with higher yields

By Tom Bussone
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When the economic history of 2021 is written, the Federal Reserve's late September reversal may be seen as an important turning point. The Fed acknowledged that the time was approaching when it would be necessary to taper its asset purchases. More than half of the Fed officials also suggested that the Fed should raise interest rates next year, sooner than many investors had expected.

The Federal Reserve has been consistently calling elevated inflation rates transitory, but the Consumer Price Index remains stubbornly high. Persistent inflation largely reflects disrupted supply chains and shortages associated with the reopening of the economy. Also, OPEC has stuck to its current output policy despite pressure from some countries for a bigger boost to production. American drillers, despite flush balance sheets, have also acted with restraint. This has sent oil prices significantly higher, which has in turn pushed gasoline over $3.00 per gallon in most states.

We expect U.S. Treasury yields to continue moving higher as inflation abates more slowly than the Fed anticipates. We have positioned our client portfolios to be protected from interest-rate risk. We added to our position in the SPDR Blackstone Senior Loan ETF and initiated a new position in the Shenkman Capital Short Duration High Income Fund. Both of these funds have a duration of below one year; they are more likely to benefit from higher interest rates than to suffer, unlike most bond funds. We aren't sacrificing yield, as both funds invest in lower-quality securities that carry higher yields. As the economy continues to improve and corporate balance sheets bulge with cash after record bond issuance, these short-duration, low-quality credits should continue to perform very well.

10-YEAR TREASURY NOTE YIELD

Bond yields have been rising as the Fed has turned more hawkish.

Source: FactSet