Investment Commentary

HANOVER ADVISORS

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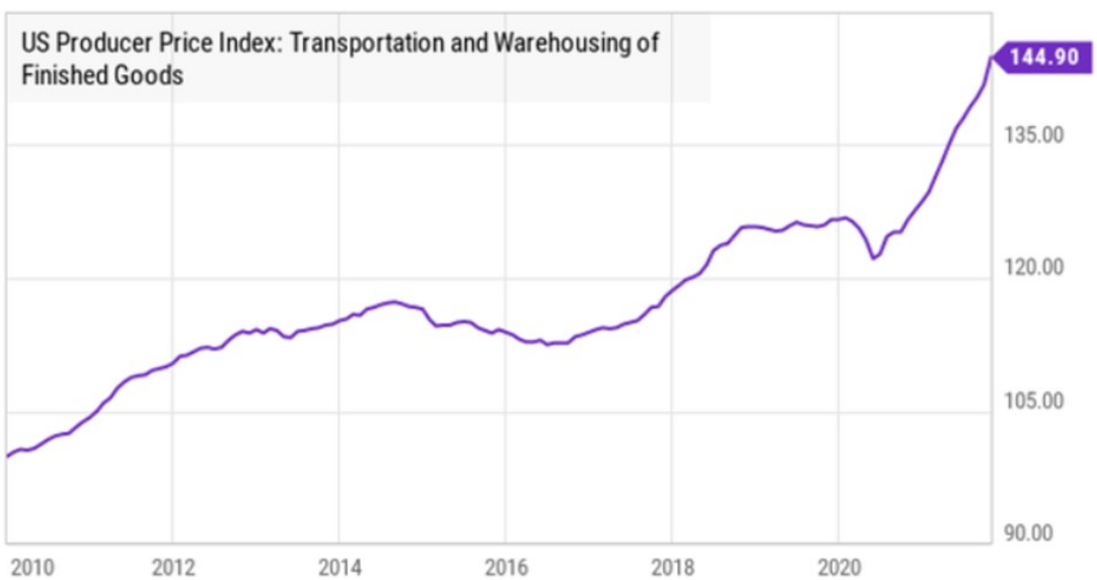
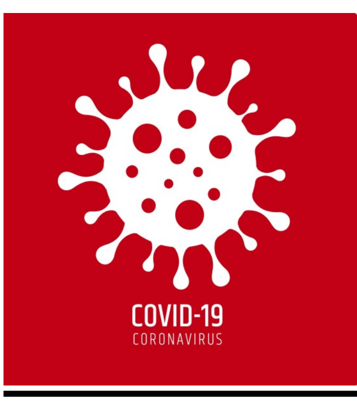
The Fed Looks for Calm Waters Amid Wave of Worry

After stumbling somewhat in the third quarter, the economic recovery appears to be stabilizing as the impact of the Covid-19 Delta variant passes. However, ongoing supply chain disruptions and labor shortages are likely to continue hindering growth and driving up prices.

In the short-term, inflation remains the biggest headwind for the economy. Companies around the world are not only facing supply disruptions, but surging commodity and energy prices. In the U.S., the producer price index (PPI), which measures inflation from the perspective of businesses, increased by 8.6% annually, matching an all-time record. PPI in China has increased even more, surging 13.5% annually last month, a 26-year high. It is not only production that has become more expensive but shipping too. Pent-up post-pandemic consumer demand has strained global logistics, and transportation and warehousing costs have skyrocketed more than 12% year-over-year. With costs climbing across the board, companies have had to raise prices for consumers.



The Consumer Price Index (CPI), which tracks the prices consumers pay for a basket of common goods, surged 6.2% year-over-year in October. This is the biggest jump in 30 years and marks the fifth consecutive month where CPI has increased by more than 5%. How quickly prices rise and for how long remains the million-dollar question for both consumers and investors. Rapidly rising prices have U.S. consumers feeling more pessimistic, as evidenced by consumer sentiment falling to the lowest level in more than a decade. Despite this



Omicron Update

In the days since this commentary was written, the emergence of the Omicron variant of the Coronavirus has panicked investors and roiled the markets. We will continue to monitor the situation as it develops, but at this time we believe the new variant is unlikely to have a pronounced impact on the economy.

Initial data suggests that the variant, while highly contagious, results in relatively mild symptoms. As the vaccination rate continues to climb globally and more treatments are developed, the economic risk posed by the virus continues to decline, despite this new variant.

Moreover, business and consumers have nearly two years' experience in adapting to the pandemic's changing conditions. There is little political appetite for further business restrictions, and we do not anticipate any limitations or lockdowns in response to the Omicron variant.

Moving Beyond 'Transitory'

For months the Federal Reserve has maintained that inflation would be short-lived and that upward price pressure would ease as the economic recovery progressed.

In a recent Congressional hearing, Fed Chairman Jerome Powell acknowledged that "transitory" was no longer an apt descriptor, noting "I think it's probably a good time to retire that word and try to explain more clearly what we mean."

Faced with inflation that is proving to be more severe and more persistent than expected, and an unemployment rate that is falling faster than projected, the Fed appears to be laying the groundwork to more quickly end its pandemic-era stimulus program.

The Fed is expected to announce an acceleration of in the tapering of monthly asset purchases. At the current pace, the purchases will wind down by June. The broad consensus is that the taper will be accelerated, ending in March, with an interest rate hike likely to come soon after.

more pessimistic outlook, consumers have thus far been willing to tolerate higher prices. Retail sales rose faster than expected in October, raising hopes for a robust holiday shopping season. U.S. consumers are well-positioned to weather a period of higher prices. Households have accumulated roughly $2.6 trillion in excess savings over the course of the pandemic, which bodes well for the economy.

Investors have largely shrugged off the recent bout of inflationary pressure. There have been some concerns that increased costs would begin to diminish corporate profit margins, but most U.S. and international corporations exceeded earnings projections in the third quarter, and stocks have continued to move higher. Still, the bond market is signaling much higher inflation expectations in the coming years. The five-year break-even rate, which tracks the difference between yields on Treasury inflation-protected securities (TIPS) and standard Treasuries, has surged recently, jumping to a record high. This suggests that traders are worried that inflation will prove to be sticker than the Federal Reserve currently expects and that the timetable for interest rate increases may accelerate.

The Fed seems to have finally realized that the recent bout of inflation is more than "transitory" and has begun the process of normalizing monetary policy. The first step is the tapering off of monthly asset purchases, which has already begun and is on track to be finished by the middle of next year, at which point they will consider interest rate increases. The consensus expectation is that we will see at least one rate hike in the second half of next year. Thus far, the Fed's moves have been telegraphed well enough to avoid a repeat of the "taper tantrums" that roiled the markets when the Fed began normalizing policy after the Great Recession. Though if inflation proves to be more severe or persistent than the Fed currently expects, an acceleration of their timeline could spark a correction in the stock market and upend the bond market. Even if the Fed is able to stick to their current timeline, yields in the bond market are likely to increase, as is volatility, particularly in the riskier segments like high-yield or "junk" bonds. As yields of risk-free Treasuries rise, investors may demand higher yields from bonds with risker credit ratings, and less Fed purchasing means there will be less liquidity, both of which could lead to more defaults.

The unfortunate reality is that the Fed is likely already behind the curve with regard to inflation and may be forced to hike rates sooner than anticipated. The Fed uses two criteria to determine when to move interest rates. The first is inflation. The Fed announced last year that it would allow inflation to exceed the standard 2% target for some time, aiming instead for an "average" inflation rate of 2%. Though the Fed's preferred inflation gauge, the personal consumption expenditure (PCE), tends to run cooler than the CPI, it too has exceeded 2% for several months, leaving many wondering how hot and for how long the Fed is willing to let inflation run.

The Fed's second criteria is unemployment. The Fed has suggested that it will not move on interest rates until the economy sees "full employment," but it remains to be seen what this means in the post-pandemic labor market. Though it stumbled in the third quarter, job creation has been robust by historic standards and the unemployment rate has continued to steadily decline since the pandemic began. However, just focusing on the headline figures overlooks the lasting damage that Covid has done to the workforce. An estimated 8 million workers have left the workforce since the pandemic began, and the labor participation rate is 1.7% below its pre-pandemic level. It remains to be seen how the Fed would react if unemployment falls to around 3% next year but the labor force participation rate remains low.

Though the Fed has acknowledged that inflationary pressure is more than "transitory," it has maintained the stance that the primary cause of price increases is a mismatch between supply and demand and that inflation will ease once supply-chain disruptions are worked through. To some degree this is true. We have already seen prices for commodities like lumber retreat significantly, and there appear to be signs that shipping rates are coming back to earth after a meteoric rise. The Baltic Dry Index, which tracks shipping prices and is seen by many economists as a leading indicator for inflation, is down 50% from its recent peak. However, there are larger economic and demographic changes that are likely to keep inflation above its historic norm for some time.

The first is the role that the internet has played in keeping prices down. With the advent of online shopping, consumers have had access to countless sellers, making comparison shopping easier and driving down prices, especially in comparison to brick-and-mortar retailers. Average online prices dropped every year between 2015 and 2019, according to data from Adobe Digital Insights, but in August 2021, nearly every category of product that Adobe tracks saw an increase over its historic price. Some of this is due to pandemic-related disruptions, but much of it is driven by the ubiquity of online shopping, which now accounts for roughly $1 of every $5 spent by consumers. What was once a cost-saving convenience has become a standard way of life, limiting its ability to keep prices down.

The other trend is steadily increasing wages as workers become scarcer. Much has been made of the "Great Resignation" which has seen millions of workers quit their current job in hopes of securing better pay elsewhere. Employers are struggling to fill millions of vacant positions, and many have increased wages and offered hiring bonuses. These increased labor costs will likely be passed on to consumers in the form of higher prices. While the pandemic has certainly accelerated this trend, the U.S. workforce has been declining for years. The labor participation rate never recovered to pre-recession levels in either the 2001 or 2008 recession, meaning that even the pre-pandemic workforce had been diminished. The baby boomers represent 21% of the U.S. population, and their phased retirement over the next few years is poised to create a massive void in the workforce. Birth rates for Americans have been "below replacement" level for decades according to the CDC, suggesting that this void is unlikely to be filled any time soon. This means that workers will have additional leverage for some time, potentially setting up an inflationary cycle where wages and prices increase in lockstep.

Some economists worry that we may see the return of hyperinflation or stagflation like we saw in the 1970s. With the level of economic growth, we are anticipating, this is unlikely to be the case, but even "moderate" inflation over a long enough period of time could be detrimental for consumers and investors. If inflation eases somewhat from recent highs, to say 3% by the end of 2022, and remains there for several years, this will still mean cumulative price increases of more than 20%.

With so much uncertainty on the horizon, volatility is likely to increase. Nervous investors will see every piece of economic data as a potential clue to the Fed's thinking, setting up some potentially large swings. Despite uncertainty and headwinds in the coming months, we are cautiously optimistic about the equity markets over a longer time horizon. Corporate earnings have been stellar, and while they have likely peaked, the pandemic has highlighted the dynamism and resiliency of American corporations. Inflation has driven up input prices for producers, but they have been able to raise prices and push these higher costs onto consumers, who thus far have been willing and able to pay. With interest rate increases on the horizon, the bond market looks to be a risker proposition. In this environment, we are diversifying away from U.S. corporate and government bonds and toward stocks. One of the few attractive opportunities in the bond market is Treasury Inflation-Protected Securities (TIPS) and other inflation-protected bonds. These are not only a good hedge against already-elevated inflation, but if inflation proves to be more persistent and severe than current estimations, which we feel is likely, they will generate higher returns.

Hanover Advisor Bulletins

Special Reminders to all Hanover Clients

- The Hanover Advisors website can be accessed at hanoveradvisorsinc.com. There you will find our latest newsletter and investment commentary, articles, our blog, and videos. You can also learn more about our services, access both the Black Diamond performance reporting system and your Pershing brokerage account(s).

- **New enhancements to our portfolio reporting system**. All Hanover clients have free access to our internet-based reporting system known as Black Diamond. This robust system provides comprehensive performance reporting, asset allocation and risk assessment on clients' portfolios. The system will have a new look and major enhancements starting this fall. Our office is available to assist in accessing and utilizing the Black Diamond system.

- As a reminder to our clients that Hanover Advisors, Inc. now has an office in Greenville, SC. Meetings can be scheduled at either the Greenville office or our conference facilities at Concourse Parkway in Atlanta. Please see our website, HanoverAdvisorsInc.com, for detailed contact information.

- We want to invite all clients to contact our office to schedule a portfolio review. We would be happy to coordinate a sit down meeting, a conference call, or an online meeting at your convenience. Please call our office to schedule an appointment.