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A Singular Focus: Inflation

The U.S. inflation rate remains stubbornly high. In August of 2022, the annual core inflation rate in the U.S., which excludes volatile food and fuel costs, accelerated to 6.3%, the highest rate since March. The Federal Reserve deems a 2% inflation rate as the optimum rate for a healthy economy, the current higher rate is unacceptable. Investors are singularly focused on the rate of inflation and the ability of our country's economic policy leaders to reduce it.

The dynamics that spurred the higher inflation rate have continued without resolution. Supply chain constraints and the port congestion that arose during the pandemic are not fully resolved. The Ukraine war continues to dislocate energy and grain markets, creating upward pressure on commodity prices. The low level of unemployment has created a tighter labor market leading to an increase in wages. Finally, an increase in remote work created higher demand for housing, a key component of the higher inflation rate.

When inflation increased, the Federal Reserve labeled it "transitory," rationalizing its monetary easing stance. Congress fueled inflation by continuing to pass trillions of dollars of additional stimulus, including the American Rescue Plan and the Inflation Reduction Act. Ultimately, the stimulus increased consumer demand for goods and services and, in turn, propelled inflation. The Fed's reaction coupled with the massive stimulus programs further increased demand, creating upward pricing pressures.

To quell inflation, the Federal Reserve increased interest rates five times this year for a total increase of 3%. During the quarter, yields on one-year and ten-year treasury bonds rose to above 4%, their highest rates in almost 15 years. Additionally, to slow the economy, the Fed has started to decrease the size of its balance sheet by allowing bonds to mature. The Fed's actions were too late to ward off the acceleration in the inflation rate. Higher interest rates have not yet been effective at reducing inflation. Historically there is a lag time before the economy will feel the effects of the Fed's actions.

In response to the uncertainty about the economic outlook, both stock and bond prices have declined significantly. Currently, stocks are undergoing a "re-valuation" to reflect the potential slowdown of the economy and earnings growth. Equity investors are no longer willing to pay high valuations for companies without commensurate earnings growth. As discussed in prior letters, higher interest rates provide bond investors with a higher rate of return that is a competitive alternative to owning stocks. For those investors who own individual bonds, such as

AHB clients, the decline in bond prices is temporary as the bonds, when held to maturity, will return the initial investment to the investor. Investing in individual bond issues provides a significant advantage compared to bond mutual funds. Bond funds have no maturity date and investors must sell the fund to receive a return of their principal. As bond prices have declined, the bond mutual fund investors may

have to recognize a significant loss of principal to reduce their exposure to the risk of higher interest rates. It has been a difficult period to own bond funds, especially for those investors who believed them to be a vehicle to preserve capital. The significant benefits of investing in individual bonds in a laddered bond portfolio could not be more apparent than it is today.

Today, the bond market is predicting a U.S. recession, evidenced by shorter maturities providing a higher return than longer maturities. As a result, the shorter maturity bonds have become attractive investments. For example, the 1–2-year U.S. Government bonds provide equal to or greater rate of return than many investment-grade corporate bonds of the same maturity. AHB has diversified client taxable bond portfolios to include this opportunity in "risk-free" government bonds where appropriate. Similarly, we are finding unique opportunities in municipal bonds with 2–5-year maturities for client portfolios, with emphasis on callable bonds with higher coupon rates to minimize downside risk in the current rising interest rate environment.

AHB equity portfolios are overweight in sectors and companies that we expect strong earnings growth despite the possibility of an economic slowdown. Sectors such as Healthcare, Consumer Staples, and Insurance are attractive. AHB is emphasizing protecting our client's principal during these uncertain times which buffers the client portfolios from the deep declines in the broader stock and bond markets.

We are living through a period of dramatic and rapid change. This challenging and uncertain period has already brought formative changes to our everyday lives and global landscape. Our charge is to protect our client's principal and be prepared to act after the dust has settled and stabilization of the longer-term outlook becomes more apparent.

We thank you for the confidence that you have placed in our firm.

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