April 4, 2022

Dear Clients and Friends:

As long-time readers may know, I find etymology and the origin of idioms to be an endlessly fascinating subject. As I watched the inflation conflagration reach a crescendo this quarter, the phrase "the chickens have come home to roost" immediately came to mind. Hackneyed though it might be, it is apropos nonetheless. The modern version of this phrase is typically attributed to Robert Southey's 1810 poem, *The Curse of Kehama*: "Curses are like young chicken, they always come home to roost." Reaching even further back to c. 1400, we can find Geoffrey Chaucer riffing on this topic in *The Canterbury Tales*: "And oftentimes such cursing wrongfully returns again to him that curses, as a bird that returns again to his own nest."

Chaucer is impenetrable in its original Middle English and only slightly less so when translated into modern English – there is a very good reason that Brad Pitt's character in the movie *Seven* needed Cliff's Notes to make any sense of it – but the connection of this idiom to Chaucer was unexpected and intriguing. The quote comes from "The Parson's Tale," one of the lesser known of 24 tales that constitute Chaucer's magnum opus. In contrast to the others, "The Parson's Tale" is not written in verse and is essentially a (very long) sermon about the seven mortal sins and penance. Without delving into any religiosity, and more importantly to bring things back on topic, the original sin of "Pride" features prominently.

And it is pride that afflicts the economic shamans sitting atop the Federal Reserve, pride and its first cousin hubris. Unfounded belief in their ability to see years into the future and turn the knobs of the U.S. economic machine *just so* to achieve the desired results. That the farce of the Fed's "dot plot" is still treated with any degree of seriousness continues to amaze me. The Federal Reserve governors have little ability to predict accurately what will happen in Q2 or Q3 of this year, much less what the economy will look like in the impossibly distant 2024. For what it's worth, neither do we, but at least we can admit as much.

The inflation chickens, then, have come home to roost. More than a decade of profligate monetary policy has combined with a reckless amount of fiscal stimulus to create a perfect storm of inflationary pressures. There are also exogenous factors at play here, supply chain disruptions, pent-up post-COVID demand, and the nitroglycerine cherry on top that is the conflict in Ukraine, but years of misguided monetary policy and, more recently, fiscal policy have laid the bedrock foundation for what we are now confronting. But don't take my word for it; the San Francisco Fed just released research concluding that excess U.S. fiscal stimulus has caused inflation to run hotter here than in other OECD countries. Who woulda thunk it?

Thus the Fed finds itself in a conundrum, albeit different from the one the maestro himself, Alan Greenspan, lamented in 2005. How to rein in inflation without simultaneously crashing the economy, or at least without crashing risk assets? The Fed has shown little ability to stick the landing on these kinds of policy shifts and their margin of error appears razor thin in the current environment. The Fed is of course "independent" and "data-dependent," but it is also difficult to ignore the political backdrop and the looming mid-term elections in November. If forced to choose between getting inflation under control (or at least appearing to) and stepping in to rescue risk markets yet again, we believe they will opt for the former.

None of this is a foregone conclusion, however. The most plausible outcome, as far as we see it, is that the inflation wave will crest soon and recent rate increases will prove to have gotten too far ahead of themselves, too quickly. Although the magnitude of the Q1 2022 backup in rates was roughly equivalent to Q1 2021, the economic situation is wholly different and the tone in the Treasury market has become more feverish, hinting of a blow-off top. Growth and inflation may in fact decline more sharply than most are predicting during the second half of the year, obviating the need for and ability of the Fed to pursue an aggressively hawkish policy response.

On the other hand, we can also conjure up a scenario where inflation is stickier than expected. Fed rate hikes do not control global supply chains after all, and some of the underlying factors appear to have staying power, so perhaps the Fed will not be able to destroy enough aggregate demand via tightening financial conditions to move the needle. This scenario is not, however, being priced into the rates market whatsoever, as evidenced by the smashed-flat yield curve from the 2-year point outward, or long-term inflation expectations that remain in check despite the recent string of eye-popping monthly CPI prints.

In terms of portfolio strategy, we have added moderately to credit risk in response to wider spreads and valuations that are more attractive than they have been since late 2020, although there is still ample room to increase exposure on continued weakness. We have also moved towards a more neutral duration stance across most portfolios and implemented curve positioning that seeks to take advantage of recent distortions. In conjunction with these shifts, we have been busy putting the portfolios we oversee on your behalf in better fighting shape, chopping the dead wood, as we like to call it on the trading desk, in preparation for what we expect to be an eventful remainder of the year.

The Fed's roost is full to the rafters. The problems they now face are without question daunting, but they are also largely of their own making. Given the extreme uncertainty and wide range of potential outcomes, we must remain humble in our own prognostications, flexible in our positioning, and prepared as ever to react opportunistically to the unexpected.

Sincerely,

Mark M. Egan, CFA
Managing Director