While "Covid" may be the word most used (and hated) in the world today, "inflation" might be the most used word in the financial world. Inflation is simply the increase in the cost of goods and services that we all consume. Some positive level of inflation is a sign of a healthy economy as companies can earn profits and invest in future growth, in turn employing more people and paying higher wages that, again in turn, allow for more consumption. The Federal Reserve (the Fed) would like for inflation to rise at a rate of 2%. Last year the Fed stated that since inflation has been below that 2% target for some time, it would not be bothered if prices rose at a rate higher than 2% for some period of time, the belief being that the long-term average would stabilize around 2%.

When inflation (as measured by the Consumer Price Index) was reported at the end of November, it reached its highest year-over-year reading since the early 1980's. Prices increased 6.8% over the prior November. This is certainly a high inflationary reading, is significantly above the Fed's 2% target, and made headlines around the investment world. The problem with this year-over-year reading of inflation is that it begins with a period in 2020 when the economy was just beginning to recover from the Covid-induced economic shutdown when prices of everything had fallen significantly. At one point in 2020, the price of oil was negative (a concept difficult to understand). Because of the Covid lockdowns, the prices of many things, most importantly energy, collapsed. When the economy began to recover and reopen, it would be expected that prices would rise (i.e., inflation would return) and that is indeed what is happening.

What is missing from the year-over-year comparison of prices is a longer-term perspective. As noted above, inflation has been below 2% for some time and the Fed is okay if inflation is above 2% for some period so that the averages work out over time. If we compare today's prices to those in January 2019, we see that the annualized inflation rate is 3.5%. Yes, this rate is higher than the Fed's target, but it is also half of the most recent reading in November. Take a longer view back to January 2011 (nearly 11 years) and we see that, despite recent high inflation, prices have only increased 2.2% per year. [Note: these calculations are based on Federal Reserve data using the CPI-U price index, base period 1984].

So where does inflation go from here and what are the implications for the investment markets? These are tough questions to answer as Covid continues to impact the world around us, including global manufacturing and supply chains. Problems in these areas have certainly contributed to inflation as more dollars have been chasing fewer available goods because those goods are either in short supply (manufacturing has been hampered) or they are stuck on ships outside of major ports (supply chain bottlenecks). These sources of inflation may have an impact on the economy for longer than many originally expected, but they should be self-correcting over time. If demand for goods remains high, supply will eventually figure out a way to rise to meet that demand.

The Fed has also taken note of recent high inflation and is taking action to end their bond-buying program that was meant to stimulate the economy. That program should wind down in the spring and then they plan to raise interest rates, making it more expensive to borrow money for all sorts of projects, both consumer and commercial. The Fed's intent is to slow the growth in the economy and inflation. The Fed's mandate in the Federal Reserve Act is to "promote

effectively the goals of maximum employment, stable prices, and moderate long-term interest rates." Unemployment is down to 3.9% meaning that we are at or very near mandate number one, maximum employment. Interest rates are and have been low for a long time, so the Fed can afford to raise interest rates in order to fight inflation and achieve both stable prices and moderate long-term interest rates.

We are optimistic about equity markets in the year ahead. Equities tend to do well in an environment of moderate inflation. The country and the world continue to adjust to Covid and the economy is strong. James Liu from Clearnomics summed it up well in a recent commentary:

> In times like these, it can help to focus on the big picture. Although every market cycle is different, we are still quite early in this expansion. The underlying economic trends are strong with businesses growing, earnings rising and employees finding better jobs and higher wages. Inflation is elevated but much of this is due to year-over-year comparisons and supply chain disruptions. High inflation could become "sticky" and sour the mood among businesses and consumers, but it could also begin to subside later this year. Even without rising inflation, the Fed would reasonably be expected to raise rates at this stage in the cycle. After all, their job is now to make sure the economy doesn't overheat. And although we are still in the middle of another delta/omicron surge, this is having a smaller impact on economic growth and will likely subside as well - until the next variant is discovered.
>
> Controversy over these topics is what fuels the day-to-day market debate. Rather than trying to accurately predict every outcome and incur trading costs, the better approach that has worked for decades is to hold an appropriately diversified portfolio that can withstand these uncertainties, while benefiting from the long-term growth of markets and the economy. Doing so in a way that is aligned with broader financial goals, especially with the guidance of a trusted advisor, has stood the test of time.

If we can answer any questions or help you review your broader financial goals, please do not hesitate to call your Relationship Manager. We thank you for your trust, confidence, and patience through 2020 and 2021 and look forward to a great 2022. Happy New Year!

The views of this commentary are not intended to be a forecast of future events, a guarantee of future results, or investment advice. We do not undertake to advise you of any changes in the views expressed herein. Investors should not use this information as the sole basis for investment decisions. The performance of an index is not an exact representation of any particular investment, as you cannot invest directly in an index. Past performance is no guarantee of future results. Any statistics have been obtained from sources believed to be reliable, but the accuracy and completeness of the information cannot be guaranteed.