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As the third quarter came to an end, investors began to recognize that economic growth was somewhat slower than expected and inflation somewhat higher. Payrolls were a little weaker while wages had increased more than expected. Some on Wall Street were going as far to say we have now entered a stagflationary environment (long term slow growth and high inflation). We feel that continued increases in vaccination rates around the world will help economies recover even as infection trends ebb and flow.

The current volatility in the markets is due to the uncertainty of what slower growth and increased tax rates may mean for corporate earnings; and what higher inflation may mean for interest rates and valuation multiples. It is no wonder that the markets are reacting as assumptions on these key variables change. Not surprising that September's weakness offset a positive summer leaving Q3 performance basically flat. The magnitude of a continued pullback will be determined as Q3 earnings reports are delivered and investors adjust their views on the transitory nature of inflation.

However, consumer demand remains strong. It is supply that is constrained. Perfect conditions to raise prices—in the short term. This pricing strength won't last as new capacity and supply become available, and constraints are moderated. We say this with some confidence because interest rates are still historically low. With the 10-year US Treasury near 1.5%, bond investors are seemingly not concerned about an extended inflationary period. (In Germany, rates remain negative.)

There is also worry about wage inflation and the difficulty in filling jobs especially in the consumer-facing services industries. This has been true in a subsidized environment that included enhanced unemployment benefits and rent moratoriums. Now that vaccines are widely available, enhanced subsidies related to the virus appear counterproductive. Most subsidies are ending and it will become clear over time whether these had any role in this year's wage inflation.

The paragraphs above describe the latest Wall of Worry concerns for the markets. For the next few years, we remain confident that the US economy can continue to expand at levels higher (3%-4%) than what was experienced in the decade pre-pandemic. We believe that inflation will rise some in the near term but will eventually be subject to the same disinflationary secular trends that the economy faced in the past decade.

In addition to the fundamentals we discuss, investor sentiment is also influenced by fiscal policy out of Washington. Right now there are three major issues being negotiated. First, the (bridges & roads) infrastructure bill for $1.2T; second, the social infrastructure bill for $1.5T-$3T; and finally, the tax provisions to pay for it all. Our belief is that compromise will prevail (as it historically does). We anticipate a result that will allow us to remain positive on domestic equities over time.

In the near term, volatility may be higher than normal so we are sharply focused on valuation risk. We mitigate that risk by investing in "shorter duration" equities. This means companies that currently generate enough cash flow to support their valuations and have prospects to increase that cash flow going forward. We also describe this as our preference for companies that provide dividend growth over time.

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