"a large grain of salt"

The minutes from the most recent Fed meeting suggests a significant change in the board's strategy to carry out its dual mandate of maximum employment and price stability. For the first time, certainly during the tenure of the current Jerome Powell led board, there is a recognition that the U.S. economy can grow without needing the massive injections of liquidity we have witnessed over the last decade. In addition, the minutes reveal a new sense that inflation, while not permanent, is less transitory than the Fed has been maintaining lately. To quote Mr. Powell, "Inflation is larger than we expected and may turn out to be more persistent". There is no immediate change in policy as regulated rates are still forecast to remain at current levels until 2023. However, as the Chairman correctly pointed out, forecasts that far into the future should be taken with "a large grain of salt". As proof of how quickly the outlook can change, at the March meeting of the board 13 members predicted core inflation would be below 2% in 2022 and only 5 said higher. As of this week there has been a complete reversal and 13 members now say higher than 2%. The tapering of the Fed bond purchasing program is also on the table with expectations that implementation will begin early next year. Perhaps we will get a better sense of the timing at the Jackson Hole conference of central bankers in August. While the change in attitude by the board appears subtle, I would suggest we have seen the peak in its efforts to use monetary policy to drive growth in the economy. It is only a peak and policy remains very accommodating, but as we go forward fundamentals such as sector and security selection will become more important.

Inflation rates are rising rapidly as expected and the debate about its permanence rages on. The PCE index (Personal Consumption Expenditures), which the Fed prefers as a broader measure of inflation than the CPI, rose 3.4% in May. That's the highest rate of increase since the 1990's but had little impact as that met expectations. Which is to say there is no panic about inflation as of yet and investors are accepting of the argument that these price increases will be temporary. For the most part large boosts in prices have been confined to areas most impacted by reopenings: travel, restaurants, cars, home building and of course gasoline. Less expected are the supply chain problems and bottlenecks which have led to higher costs, and consequently prices. There are some empirical examples that market forces may actually be working. Home builders have balked at the high price of lumber and cut back on speculative building which has caused lumber prices to fall. As well, transportation of goods has been a major contributor to the bottlenecks, but in just over a month 11,000 new trucking firms havebeen formed which should relieve some of the pressure. I am of the belief that over the next 3-6 months much of the current stress on prices will dissipate.

As reopenings increase, U.S. economic growth is in a period of peak expansion much like inflation. This is bound to normalize by the 4th quarter but growth should remain a positive factor for both earnings and markets. The world's second largest economy, China, is tightening monetary policy and already reached peak GDP growth in February. We will watch for the effect this has on other global economies. The U.S. jobs report due later this week will be important. Firstly, to gauge the improvement in the labour market, and secondly as an indicator of possible wage inflation, a negative for markets.

The S&P 500 only briefly felt the impact of the Fed press release despite the negative possibilities if higher rates are on the horizon. In fact, we have now seen new all-time highs in the Index, but more broadly based measures such as advances versus declines and the Russell 2000 have not confirmed those highs, so we remain sceptical. Potential for a consolidation or correction over the summer months remains in play before we see a resumption of stronger markets. My 4 main concerns for the stock market are: 1. Valuations are high; 2. The Fed makes a policy mistake; 3. Economic growth is overestimated; 4. The pandemic worsens. The bond market also acted strangely given the Fed's subtle threat that rates would rise. Nevertheless the yield on 10-year Treasuries is lower today than levels seen in April and May. I've read two possible explanations: fixed income

investors see a rapid slowdown in growth once the reopening frenzy passes; or the demand for high grade debt is just very strong. One theory suggests that the rise in equity and bond markets has helped many pension funds to a near fully funded status and they are rotating to high grade issues to lock in the gains.

US foreign relations continue to be cause for concern. New governments in Israel and Iraq add to the uneasiness and tensions with Russia and China persist. I was surprised to be reminded that Russia, despite being a military and energy power, is a lesser economic entity. Total GDP is smaller than Canada's, and per capita GDP is about a quarter the size of Canada's. Internally, nothing changes in the U.S. as no compromise is the mantra of both political parties. The objective is to win a majority and ram through legislation despite the fact the opposition will reverse it at the first opportunity. President Biden announced a bipartisan infrastructure bill which is a quarter the size of his original $2.25 trillion proposal. However he is counting on Congress to make up the difference through budget reconciliation legislation that requires no Republican votes and only a simple majority in the Senate.

Even though pitfalls are prevalent, I remain positive on markets given an outlook for renewed growth, dwindling inflation, and a market that despite periods of decline has had the ability to contain weakness at levels of support.

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