Investor Insights

Inflation – And Where Are We

My first attempt in trying to formalize my thoughts into words to share with you, my clients. Over the past several weeks my days have been filled with a lot of reading, listening, discussions and analysis of where we currently sit in the business cycle, how markets are reacting to the continued barrage of variables that can effect market volatility and how our economic backdrop paints a picture of where we currently sit and how to position ourselves the best going forward. Strategizing using our longer-term views and the same time balancing tactical positioning in the short and medium terms of the cycles. Gathering from various sources that we most respect in the economic/financial world is where we've drawn our views from to get a firmer handle on where we might be headed on the inflation front, as a consequence, where long term interest rates might be headed.

A recap of how we've started this year, with several weeks into trading, the TSX is down about 5% from its late 2021 highs, S&P500 is down around 8% - 9% from its recent January highs and globally the MSCI AC World also down about 6% for its highs in January as well. All three indices YTD have had a drag on their performances due to the Info Tech sector as well as the Consumer Discretionary sector as in the case for the S&P500 and MSCI. On the upside all these three indices have seen strong performance in the Energy sectors YTD, as well as the Financials, particularly banks as seen in

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the TSX. The sharp rise in long term interest rates since the beginning of the year have benefited the Canadian banking sector. The firming of oil and gas prices have pushed the leading energy sector as of late. The strength in sectors which respond to rising inflation and interest rates and concomitant weakness in other sectors which benefit from declining inflation and interest rates is totally logical given the trend of both inflation and interest rates thus far in 2022. But where do we go from here?

Outlook for inflation

Inflation has been one of the most widely reported and discussed economic factors in the past year. Where is inflation headed is a question on everyone's mind. Recently both central banks in Canada and the US have retired the term of "transitory" inflation to inflation that is more persistent. Attributing to this persistent inflation; surging energy, rents, building materials, automotive, food and supply disruptions have boosted the year-over-year rise in the inflation rate to the fastest pace in decades. Many of these aspects have been accredited to the pandemic experience and resulting in economy re-opening frictions and supply-chain bottlenecks. There are no simple straight forward answers as to the above question but we can take views from whom we believe have a deeper understanding of cycles, markets and economic variables to help formulate the inflation outlook and long term interest rates.

Expressed views of our most revered economists and financial experts are briefly summarized or directly quoted. Starting with Simon Ward, who is a monetarist, said recently: Real money trends typically lead economic momentum by six to 12 months which hit is peak in 2020 and has been significantly trending down for the most part of 2021. With continued weakening in real money growth, PMI is expected to resume it's decline, with lows expected to be reached in mid-2022. This weakness is not expected to tip over into a full scale recession for a couple reasons; 1) global six-month real narrow money momentum usually turns negative before recessions, which has not, although weak it still remains positive and 2) longer-term business investment and housing cycles are scheduled to remain in upswings in 2022-23, recessions are usually associated with joint cycle downswings. Ward believes that yields are likely to remain capped in the near future and fall in 2022. The Fed's "hawkish pivot" not expected to be sustained and will shift back to the "transitory" narrative likely as economic/inflation data cool and mid-term elections approach. He suggests a decline in Treasury yields in 2022-23, consistent with the stock building cycle – yields usually reach a low within several months of a cycle trough, which is scheduled for mid-2023.

In a recent interview with CNN Business News and Lakshman Acuthan, co-founder of Economic Cycle Research Institute (ECRI) underlined how the ECRI's Weekly Indicators had been decelerating over multiple months. He explained there is narrative building that once Omicron/Covid fades that we're back off to the races and reaccelerating the economy but this is not substantiated by the forward leading indicators. Those indicators are still cycling to the downside, no signs of a recession but more slowing ahead. This

cyclical slowdown started in the Spring of 2021, prior to Delta and Omicron variants and reinforces the downturn is a cyclical one rather than a pandemic induced downturn. A potential risk factor going into 2022 is Fed getting it wrong and are moving behind the curve, but that is yet to be seen as how this will unfold.

Economist Gary Shilling gives his monthly "Insights", below is summary of his 10 likely implications from the economy, inflation and security markets in 2022: 1) Excess inventories leading to economic weakness 2) Continuing supply chain problems that will depress global economic activity 3) A softening U.S. economy as consumers remain cautious and there are no further big rounds of monetary and fiscal stimuli 4) A spreading Omicron virus resulting in renewed office and factory shutdowns 5) A lack of big increases in equity and house prices to push up incomes and net worths 6) Slowing growth in China 7) Easing inflation as inflationary expectations continue to be absent 8) Central banks behind the curve 9) Vulnerable stocks and financial speculation with a major bear market possible 10) A further rally in Treasury bond prices.

In a recent article, David Rosenberg, economist, quoted Bob Farrell's rule: "When all the experts and forecasts agree, something else is going to happen." He suggests that everybody is talking inflation and that it is axiomatic that the news has been built into the pricing of financial markets. He suggests that inflation tied to the pandemic is rising at an annual rate of 5% but that inflation that has nothing to do with the pandemic at all is barely running at 2% and is lower than when Covid began.

Lacy Hunt economist and Vice President of Hoisington Investment Management, who has consistently been bullish on long term treasury bonds and has been right for 40 years. In his most recent quarterly review and outlook says, "With money growth likely to slow even more sharply in response to tapering by the FOMC, the velocity of money in a major downtrend, coupled with increased over-indebtedness, poor demographics and other headwinds at work, the faster observed inflation of last year should unwind noticeably in 2022. Due to poor economic conditions in major overseas economies, 10- and 30-year government bond yields in Japan, Germany, France, and many other European countries are much lower than in the United States. Foreign investors will continue to be attracted to long-term U.S. Treasury bond yields. Investment in Treasury bonds should also have further appeal to domestic investors, as economic growth disappoints and inflation recedes in 2022."

How do we interpret these views

Our respected sources have similar views in the general trend of where inflation is headed for 2022, which indicates a gradual decline this year. Note that there are many notable pundits that view it differently, inflation may stay higher and for longer than most believe. While we are not definitive on timing, there is a belief that inflation will become less of a threat as this year unravels. But what transpires afterwards is uncertain and the actions of the Fed could steer the course of what unfolds. The Fed has signaled the end of its taper, clearing its path to include three rate hikes this year. How will markets react if numbers for GDP growth in North America disappoints, we're in an environment of weaker earnings and liquidity

reduced? How will the Fed react, will a pivot occur? It's clear we don't have the answers to those questions at this point but what is evident is that there is mounting market risk.

Thus, the relatively reduced risk that we have been advocating in the portfolio mix for most clients over the past year seems to continue to make sense. We believe it is sensible to maintain a level of risk protection in the event of a potential 10%-20% pullback in the markets in the first half of this year. With much optimism and speculation built into investor expectations currently, if that is dampened by a sharp correction in the short term and the Fed does indeed step in, we would want to be in a position to become less defensive and more constructive on equities in the second half of the year. What is our strategy to become more defensive in the short term? Looking to possibly reduce equity exposure and build up on defensive equity positions and build a position in the precious metals sector, reposition our fixed income segment by reducing the preferred rate reset holdings and increasing duration as lower GDP growth and decelerating inflation would result in a more favourable environment for the pricing of longer-term bonds.

Within the overall equity mix in the past year, we have sought to have a diversified balance of stocks, diversified in sectors that favour rising inflationary environments and rates, combined with sectors that maintain a defensive nature with predictable and growing dividends and exposure to those growth style names and US dollar denominated securities that provided diversification in terms of currency. We still continue to maintain this position of diversification for our clients, although we've seen a shift in sentiment away from tech sector and defensive stocks in the more recent while and will perhaps continue to see this trend for the first half of this year. We suspect that the pattern will reverse itself, if we see the expectations of economic growth and inflation start to subside and central banks step in again. We don't know for certain how this all plays out but maintaining a diversified position will indeed help protect us in these uncertain times. We continue to monitor our views and have our eyes set out to confirm if the superbubble burst as defined by Jeremy Grantham is on the loom and in the horizon. We remain cautious in the short term with a potential upswing in the second half of this year. Noting that no imminent indicators that show significant recession at the moment but will revisit those views constantly. In the meantime, we feel it's prudent to posture more defensively.

Sincerely,

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