That 70's Show….Inflation.

Monthly Equity Monitor – Stéfane Marion NBF Economics - July/2023

NBF's Economics team has a muted outlook for the broad equity markets into the end of the year. They have reduced Cash 2%, reduced Equities 2% and increased Fixed Income 4% The table from Page 5 summarizes the changes. These changes take equities down to 40% of total. We think this is a low allocation.

NBF Asset Allocation

	Benchmark (%)	NBF Recommendation (%)	Change (pp)
Equities			
Canadian Equities	20	18	-2
U.S. Equities	20	16	
Foreign Equities (EAFE)	5	3	
Emerging markets	5	3	
Fixed Income	45	51	+4
Cash	5	9	-2
Total	100	100	

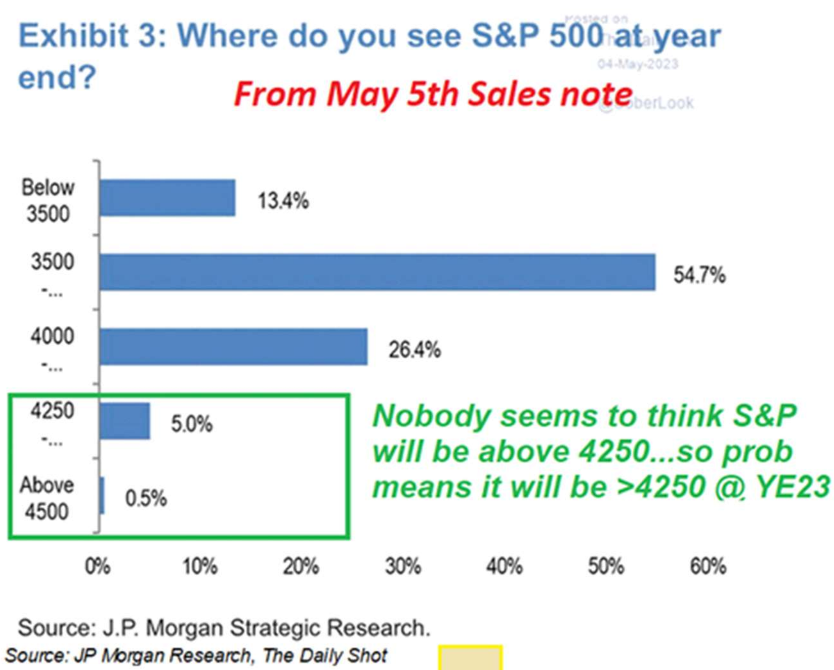
https://nbf.bluematrix.com/sellside/EmailDocViewer?encrypt=66f38419-c286-4ce1-8eb3-a2d46f5b503f&mime=pdf&co=nbf&id=steven.hilberry@nbc.ca&source=mail

We don't dispute the Economics Team's data or conclusions regards the near-term slowing of the economy. They think broad equity markets are not showing enough discount. Their job is to attempt precision. We differ on a market discount and the precision part. Get it generally right, and we can make money.

For the 'sacred money' we anchor portfolios with government-backed fixed income securities pared with smaller allocations to high grade corporate bonds. We add $CDN preferred shares for tax-advantaged yield.

For capital and income growth we're not Equity Indexers. We believe in value/dividend-based individual stock-picking. Our non-index approach means we may not own, sometimes to our chagrin, sectors of the market. Our returns often don't match index results. Our largest deviations have been during market meltdowns when previous excesses are blown out. Example Jan-Oct 2022: The S&P500 declined 26%. Our equity allocations were flat. We missed out on the way up…and the way down. It's tough not buying what's hot on the way up when everyone else is. It's harder to avoid selling quality on the way down just because everyone else is. It seems so easy after the fact.

At our May/2023 seminar we projected the latter scenario. We believed the market prices <u>for the stocks we own</u> appeared to have adequately priced in (discounted) a slowing economy and higher inflation/interest rates. With a nod to NBF we didn't know with precision if that discount was enough. We didn't think precision was critical. History says if we bought, or at least don't sell <u>what we owned</u> in those times, we'd be glad we did later. Note past tense. Lately and mysteriously for the punditry, stocks have been rising. We think this supports all of what we were saying in Q1 and 2 of 2023. JP Morgan agrees.

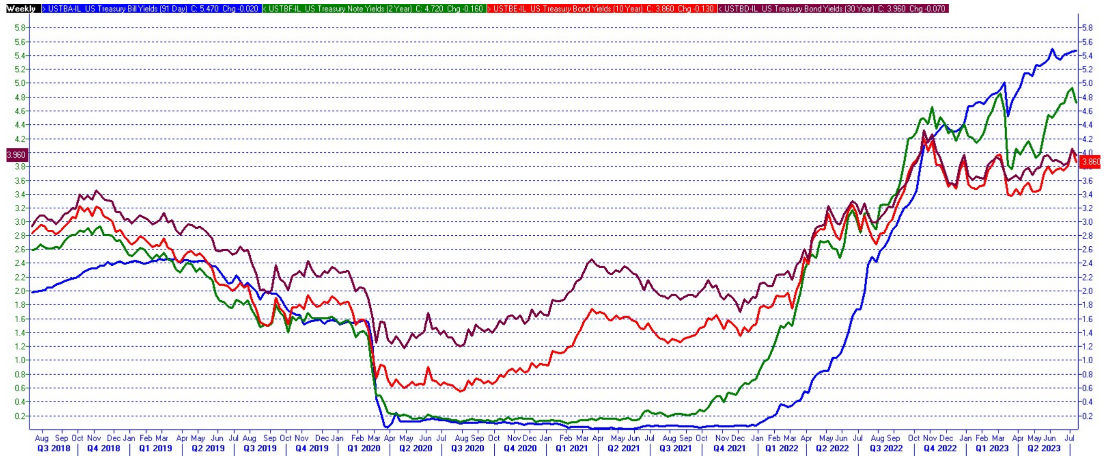


What are financial markets saying?

S&P500 (SPX-4511) weekly ranges – 2020-2023.

The S&P500 ‘broke out’ in April/2023 when prices crossed and remained above the 50-week moving average trend (blue bars above red dotted line top chart). Pundits have been selling advertising saying US stock prices are ‘separated from reality’. They say a recession is coming and stock investors are dancing in the streets when they should be hiding under the bed. We think that ship has sailed. We’ve been net buyers late 2022 onwards. The equity markets aren’t predicting a further recession. That was so last year.

US Bond Yields 90-day (blue), 2-yr (green) 10-yr (red) 30-yr (burgundy) – 2018-2023



The elevated Fed rate (blue line) combined with tight monetary policy has contracted the money supply. Inflation worries are down. If an economic crash was imminent, bond market rates would be falling sharply. US Bond yields are not predicting a recession.

Revisit Scott Grannis June 28 comments we noted two weeks ago here:

http://scottgrannis.blogspot.com/2023/06/m2-update-no-reason-to-worry.html

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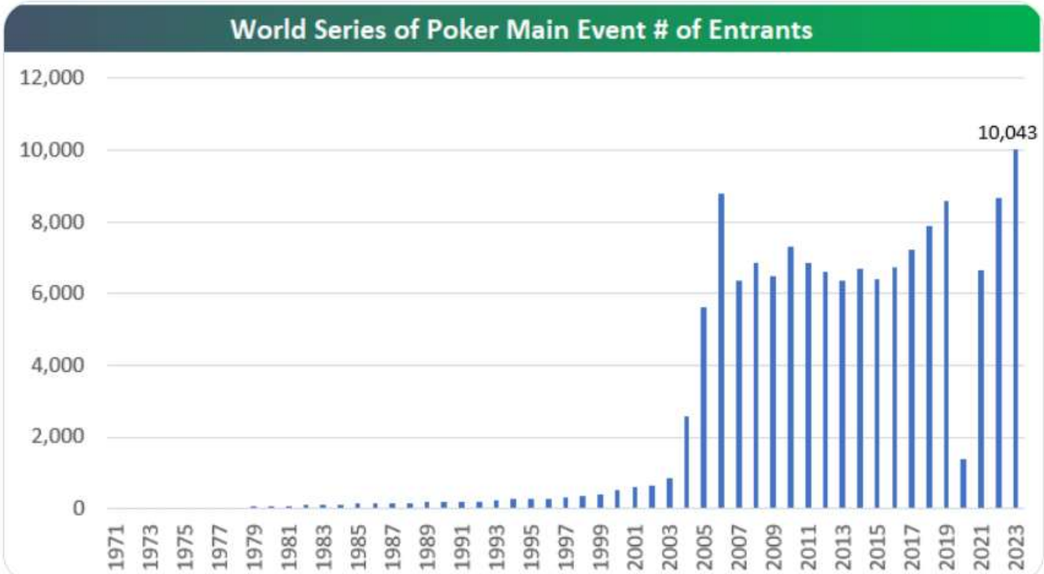
Now here is a different economic indicator

Not recessionary: The World Series of Poker Main Event ($10k buy-in) drew a record number of entrants this year at 10,043, eclipsing the prior high from 2006.



taken from twitter feed @bespokeinvest July 14/23

‘The Greatest Reindustrialization Process in US History’ – Peter Zeihan, July 10, 2023

https://zeihan.com/the-greatest-reindustrialization-process-in-us-history/

The occasionally bombastic, always interesting, Peter Zeihan argues the US is embarking on a dramatic altering of its industrial future. We agree. That’s why we’re optimistic for Canada. If we play our cards right (we haven’t lately) we could be big beneficiaries of this trend. We should avoid attempting to outcompete the Americans in their own markets. Yes, Canada needs to update its industrial policy. That policy should augment what we’re good at, not try to steal market share from what the US is good at.

Canada is 7,560 KM long. 90% of us live within 250 KM’s of the US border, 80% within 160 KMs. We’re long, skinny, cold, and few with big empty space to cover. We have a lot of building to do. We’re good at construction, transportation, communications, and finance. With our ample resources we’re good at resource extraction and processing raw materials. Canada’s small, highly educated work force, doesn’t provide an underutilized low skill/low pay labor force available for low-value manufacturing and services. We don’t have the internal market demand for most of what we’re good at producing. We need to sell to others. 1/3rd of our economy is exports, mostly raw materials including energy. Recall energy includes electrical power exports.

NOTE TO OTTAWA: Trying to outbid the US industrial base is a fool's errand. A Chi-Hua-Hua should mind its bark around a Rottweiler. Play to our strengths.

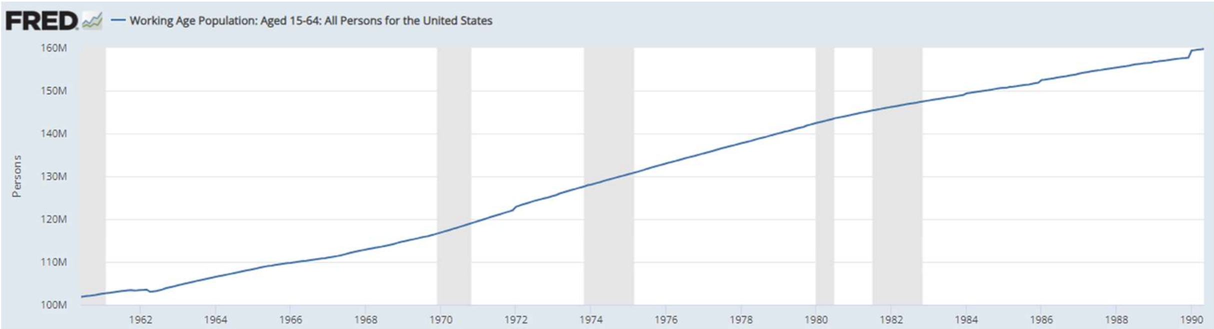
As Mr. Zeihan points out, President Joe Biden's *'Inflation Reduction Act'* (abbreviated as 'The IRA' – makes me think taxes) is misnamed. It's possible that the grand bargain improves productivity, producing more goods at a lower cost with the wage benefits (and tax revenues on those earnings) falling within US borders. Getting there, as Mr. Zeihan notes, will be inflationary. We agree getting there will be inflationary. We're also not disputing the need to 'friend-shore', return control over vital areas of the North American economy to North American. Where we differ is what happens afterwards. We foresee better wages in North America (see the following on the millennials) but…and this is a big departure…we foresee an embedded level of inflation. Recalling Milton Friedmans advice that inflation is the result of government fiscal and monetary policy, we're challenged with the notion pumping trillions of government-subsidized and targeted dollars into the US or Canadian economies will be anti-inflationary. It's possible but not likely. As Mr. Zeihan notes, a major element to productivity gains in North America, particularly the US, was the off-loading of lower value-add, heavy industry (with associated pollution) to countries with lower industry standards and underutilized labor forces. Beijing has worse air-quality than New York city for a reason. New Yorkers bought the T-shirts cheap and sold Beijing cell phones expensive. If that reverses, inflation is likely. That will be an unfamiliar problem requiring a huge relearning curve for some. That future isn't all bad, but we need care with interest rate sensitive holdings.

From personal 1970's hard experience, periods of inflation mean rising unemployment. After initial success by organized labor's bargaining power, private and government employers must protect budgets by cutting costs. The largest cost line item is the employee base. If governments add initial fuel to the demographic fire with loose fiscal and monetary policy, the final bill is larger for longer. The resulting taxes to pay for it all add to pocket-book misery. And then if energy costs rise…you get the idea. Are governments adding inflation to a coming demographic pulse?

The Millennials are coming

While not as big a bulge relative to the population, in absolute numbers the Millennials are a larger demographic group than the Boomers. They are entering the work force, pairing up and establishing households. For a future hint we revisit the 1970's. After messing around with Hippie Peace & Love in the late 1960's, the Baby Boomers hit the workforce hard in the 70's and 80's. The following charts plot millions (mm) US working age population age 15-64.

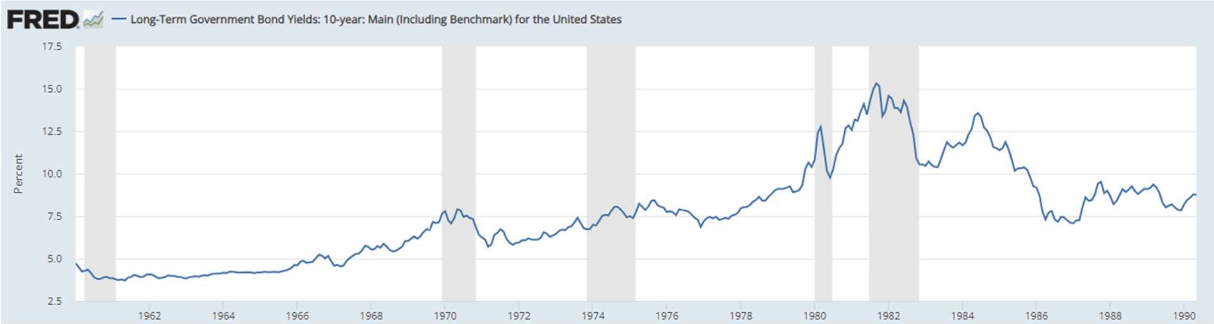
US working age population 1960 (101.9 mm) - 1990 (159.7 mm)



From 1960-1990 the US working age population grew over 56%. The Boomers had arrived.

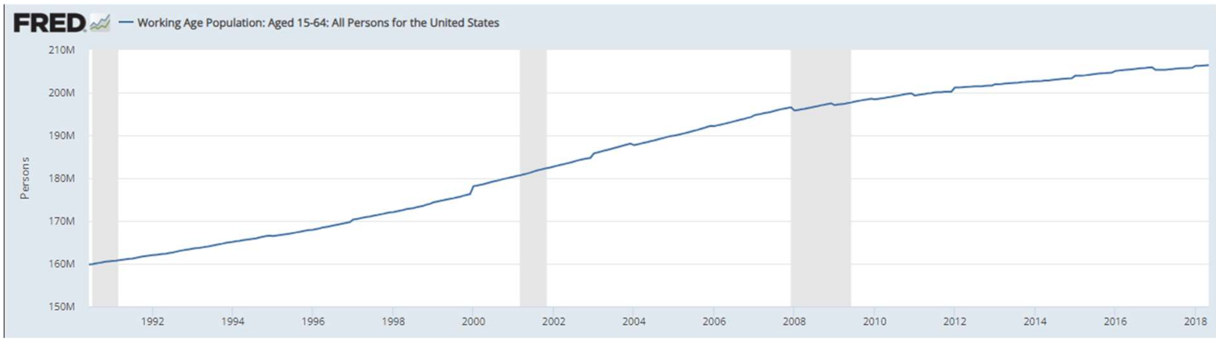
Here is what they did to interest rates.

US Federal Govt 10-year yields 1960 (4.7%) to 1990 (8.7%)



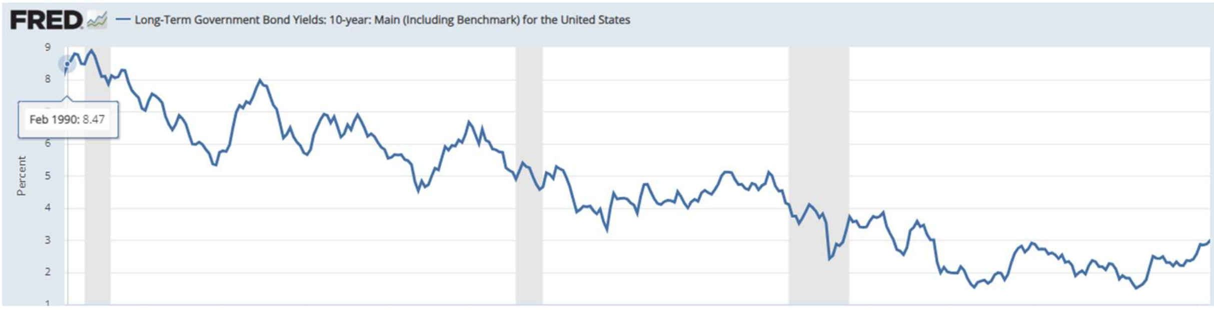
Note the Sept/1981 peak of 15.3%. While there were other things going on in the 1970's (Vietnam War, Arab Oil Embargo, civil strife. strikes) the Boomers starting to acquire everything, increased demand for everything, including money. Then things started to slow.

US working age population 1990 (159.8 mm) - 2018 (206.4 mm)

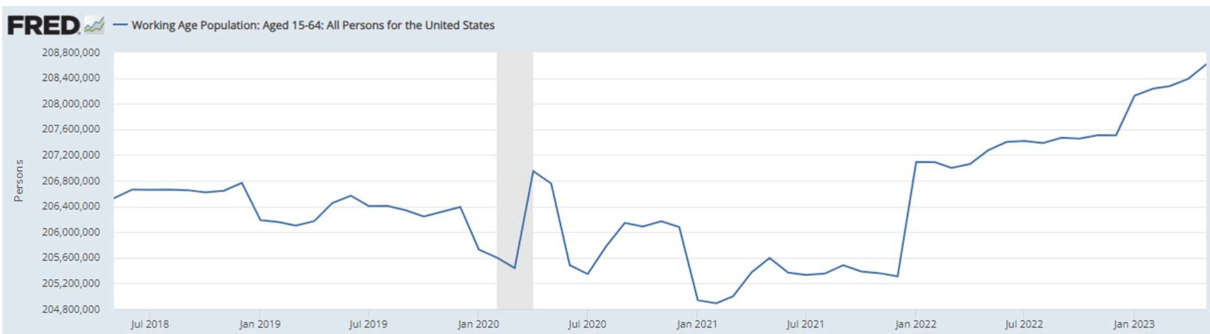


1990-2018 the US work growth rate steadily declined peaking in Dec/2018 28% above 1990's count. The working population grew, but at a slower pace. While many salute Paul Volker's strangulation of inflation in 1981, the Boomers affected inflation and interest rates. As the workforce growth rate tapered, inflation and interest rates fell sharply.

US Federal Govt 10-year yields 1990 (8.7%) to 2018 (2.9%)



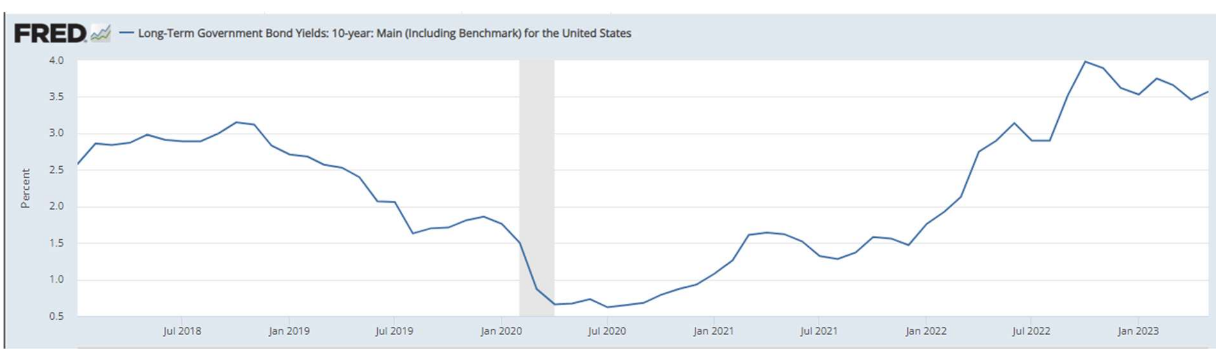
US working age population 2018 (206.4 mm) - 2023 (208.6 mm)



Over the past 5 years the US workforce showed a rare contraction. Some blame goes to the 2020 COVID Pandemic. We think early Boomers, who were of retirement age, got a wake-up call. *'Take this job and shove it'.* They would have retired anyway. Note the sharp spike upwards from Jan/2022 onwards. Yes, some of that is post-COVID return to work. The millennials are starting to show up. None of this should be surprising to leaders.

How about interest rates? Yup, tracking along nicely.

US Federal Govt 10-year yields 2018 -2023

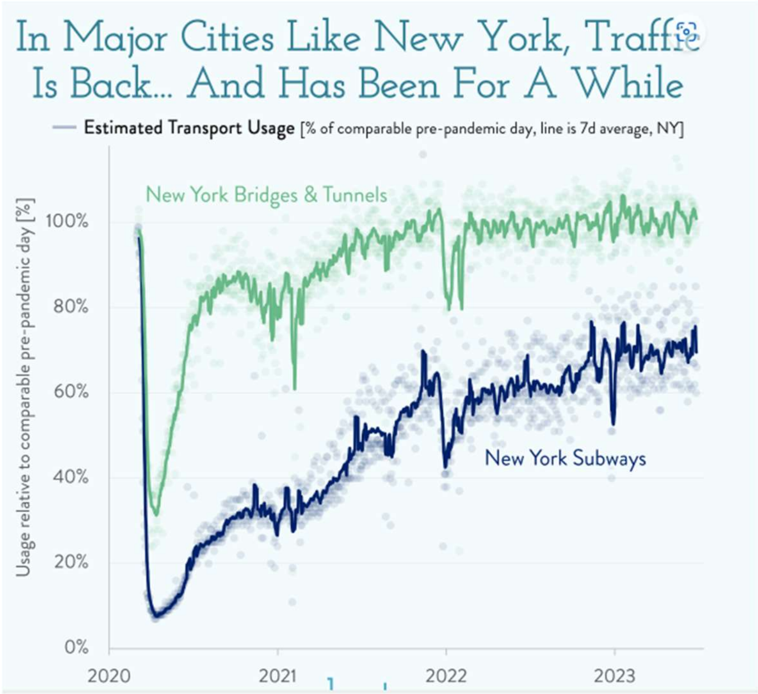


Combining extremely loose fiscal policies with a surge in work force implies higher demand. This tells us inflation is likely headed higher for longer. If inflation really takes off unemployment will rise. At this writing we're not seeing that potential. Yet.

Actions? We advise holding investments that pass through/profit from inflation. Businesses that can raise prices, keep profits growing and passing those rising profits to shareholders. We will avoid long-dated fixed income, low-growth investments. Avoid high leverage or low cash flow stories. Growth stocks suffer during such times. The 1970's lesson was hold shorter-term high-quality debt. Include energy in the mix. That's our long-term Big Picture.

What about the short-term?

The New Abnormal – Chart R July 9, 2023



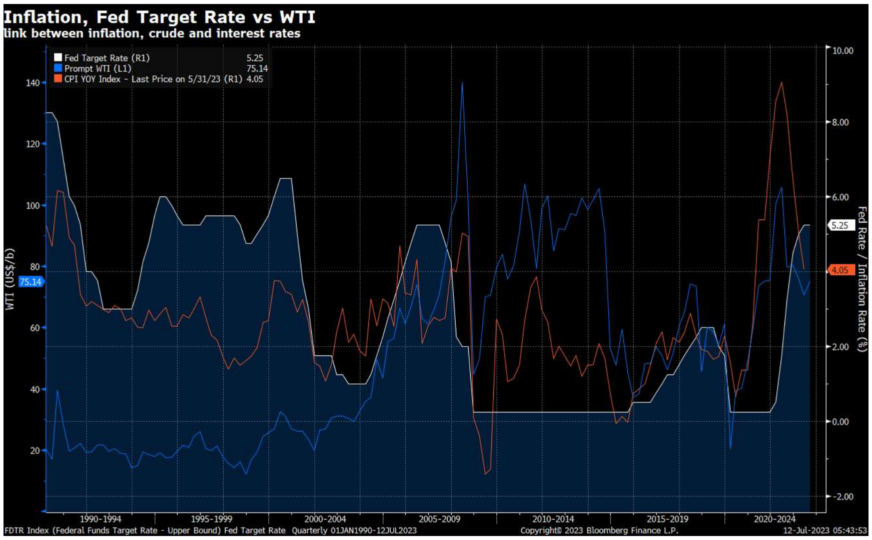
Car use is back to normal in New York. Subway use remains at 70% of pre-pandemic levels. Chart-R explains how 'work from home' continues to drag on office attendance. For some applications work-from home, works. For most it doesn't. Remote work has reduced productivity. Increased demand without increased productivity equals inflation. Meanwhile demand for labor means union pricing power, see West Coast Port Strike. Export more.

https://read.chartr.co/newsletters/2023/7/9/the-new-abnormal

From National Bank's daily Energy and FOREX notes for July 12, 2023

"...history suggests that there's a directional link between crude and inflation as the two tend to move together. It makes sense given that almost everything globally has either been transported by or made with refined crude oil – even solar panels and wind turbines. This relationship between crude and inflation dates back to the advent of the WTI contract in the early 90's (and probably before), remaining very consistent for more than 30 years."

West Texas Intermediate Crude (WTI), US Inflation and Interest rates, 1990-2023

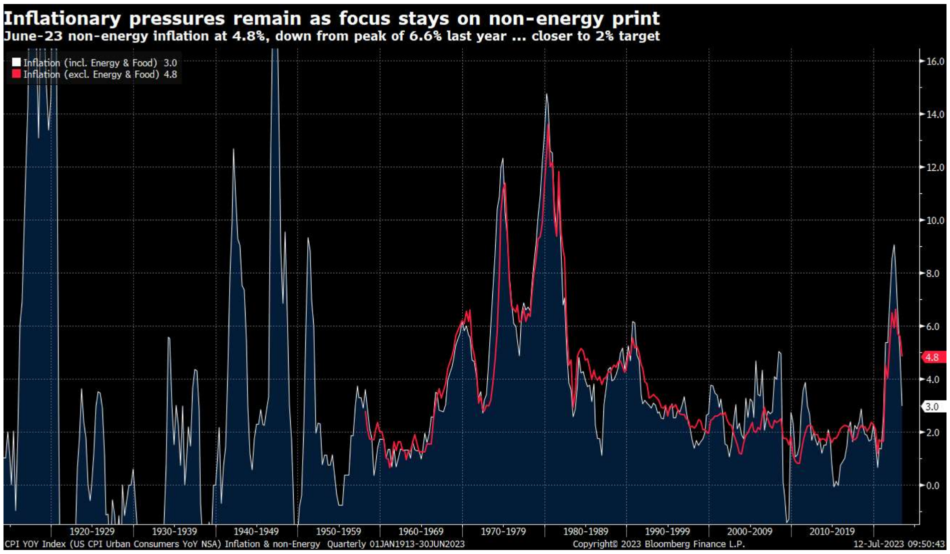


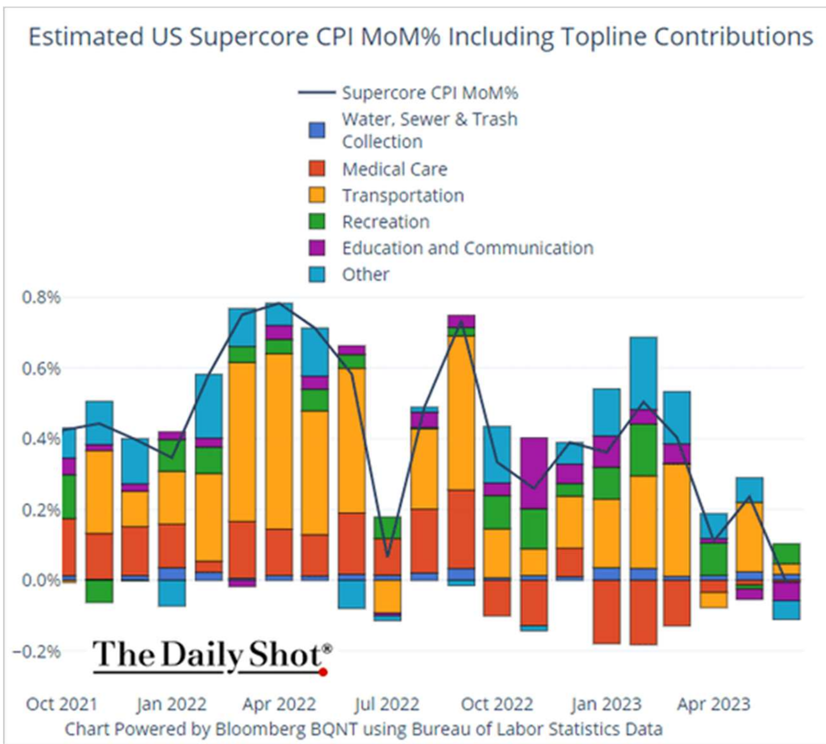
The US Federal Reserve target lending rate (white line), is 5.25% up from 0% in 2020. Following WTI (blue line) could be useful when thinking about inflation (orange). Recently WTI is down more than up. Short-term rates should follow (see US CPI comments below).

Over the longer term we expect energy costs to be higher than the past few years, meaning we don't expect inflation to fall back permanently under 2%. Interest rates aren't heading back permanently to 2% either. We expect borrowing costs to be higher over the next few years than that last few. That isn't necessarily a disaster (see Peter Zeihan's comments below). At this writing we don't see a return to 1980's double digit borrowing costs. At this writing…

US inflation (Consumer Price Index – CPI) All Items (white) show 3% annual. Ex-Energy (red) higher at 4.3%. Both are trending down (right hand below downward slide).

US CPI 100 years





The US core inflation elements are cooling, but still above the past 20-year ranges.

Consumer Price Index for All Urban Consumers (CPI-U): U.S. city average, by expenditure category, 12-month analysis table June 2023

We recommend a visit to the US Bureau of Labor Statistics (BLS) site.
https://www.bls.gov/news.release/cpi.t07.htm

The biggest sector increase is Transportation Services +8.2%. The largest decline was in Fuel Oil -36%. If fuel costs are down, why are transport costs up? Did regulatory policies have a role? We think US CPI slows. US and Canadian short-term interest rates should track lower.

CONCLUSIONS: We think stocks are pricing in expansion, that inflation will be higher than in the recent past and that the future isn't bad. We think there are profits to be made. With its commodity strengths, Canada could benefit, if our politicians will permit. We suspect voters will demand it.

Have a Great Weekend

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FOR THE RECORD July 14, 2023

DOW INDUSTRIALS:	34,523
S&P 500:	4,520
S&P/TSX COMP:	20280
WTI:	$75.74
LOONIE IN $USD:	$0.7583 $US

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