NEWSLETTER Q2

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What Drives Us

Spring 2022

Spring is a time of re-birth and change. However, should we be optimistic? We all understand the trepidation in the markets and people in general. Global conflicts persist, inflation levels are approaching a 40-year high, and Covid still lingers.

However, with high vaccination rates and improved treatment options, Covid is less likely to cause the massive disruptions witnessed over the past two years. And although inflation may not yet have peaked, central banks are laser-focused on reigning it in. In addition, the labour market is strong with low unemployment. As a result, there are increased opportunities to improve job satisfaction and earning potential.

Over the coming weeks, we can expect additional positive changes. As more employees return to the office, roadways, public transit, and your local lunch spots will be buzzing again. Furthermore, consumer spending should remain strong but with a shift to increased spending on services, like travel, and away from larger hard assets sought after during restrictions. Lastly, Covid exposed some weaknesses in many supply chains, and companies will be looking closely at ways to repatriate manufacturing to secure their inputs.

This newsletter edition not only discusses some of the intricacies of the 'economic stresses' mentioned above but also features a great company that is helping our world transition to a low-carbon future.

Stay Positive,

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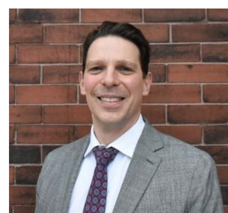
Brian Porter
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Inflation + Rate Hikes + Geopolitical Conflict = Stress

Aurav Ghai, Senior Fixed Income Analyst; Van Hoang, Global Macro Strategist | TD Wealth
Excerpt from TD Wealth Monthly Perspectives – March 2022

For much of the past 30 years, inflation has tended to affect us the way warming water in a pot affects a frog — as long as prices didn't rise too quickly, we barely noticed. Indeed, when it comes to inflation, it's been a rather sleepy period (Figure 1), with political leaders and central bankers more intent on stoking inflation than restraining it.

So, if before we were content to sit in warming water, today we're desperately trying to leap out of hot water. In Canada and the United States, inflation is at 30- to 40-year highs, with February data showing a 7.9% rise year-over-year, driven by an astonishing 6.6% month-over-month jump in gasoline prices. Keep in mind also, that figure does not include a full month of energy implications from the Ukrainian war, so inflation is likely to rise higher still over the short term. Indeed, the consensus is for CPI inflation to accelerate and reach above 8% on a y/y basis.

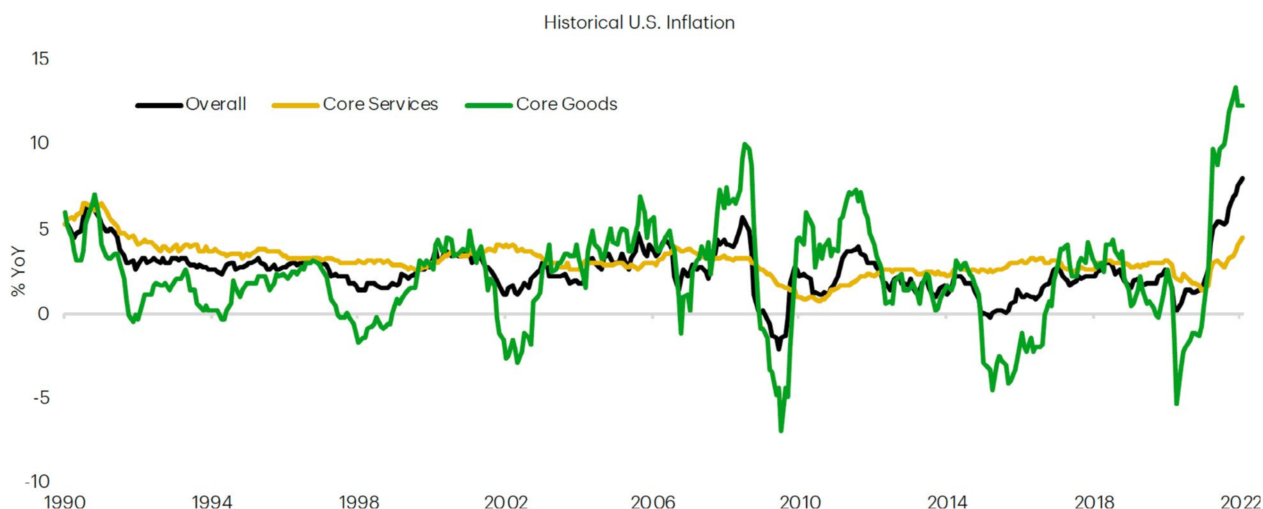
Of course, there are always a multitude of factors driving inflation, but at risk of oversimplification, here are the basics: At the outset of the pandemic, fear of a global recession led to enormous economic stimulus and high levels of household savings, which generated demand for the only spending outlet still available to consumers: manufactured goods. Supply, meanwhile, was compromised by staggered shutdowns around the world and choked-off supply points. So, in a nutshell, the pandemic boosted demand for goods while simultaneously reducing supply, resulting in an intense inflationary spike.

The pandemic also created another major source of inflation: higher wages. In February, compensation in the U.S. rose 5.1% over the past year, with most gains in lower-skilled service sectors, where an exodus of waiters, cashiers and customer-service reps are trying to find more stable work arrangements. Multiple trends have converged to tighten the labour market. One of the issues has been the reluctance of parents to return to work amid the pandemic. For those with the ability to choose, juggling a job and daycare and home-schooling is simply not worth it.

There's no sugar-coating it — the inflation figures we're seeing are extreme, and the war in Ukraine could keep energy prices elevated for much longer than predicted, given Russia's status as the world's No. 2 oil producer. The war could also compromise the global supply chain. Russia is a major supplier of commodities such as potash (used in fertilizer), nickel (used in metallic end-products, including stainless steel) and palladium (used in a car's catalytic converter). The risks are particularly high for the European economy, given its exposure to Russia and Ukraine.

The big risks for inflation over the long term will be wages (which tend not to decline so easily) and energy, which could remain elevated for some time if the war in Ukraine becomes a protracted affair. In any event, the Fed has been clear that, as of writing on March 7, not even a European war will dissuade them from hiking rates (although there is some doubt as to whether the European Central Bank will follow suit).

Figure 1: A sleeping giant awakens



Source: Bloomberg Finance L.P., TD Wealth as of March 6, 2022

TD Economics estimates four to six rate hikes, at 25 bps apiece, in both Canada and the U.S., with a more hawkish tilt in Canada (Figure 2). So, if we assume five hikes in Canada, that would bring the policy rate here to 1.5% by the end of the year. Markets, meanwhile, had until recently predicted rates closer to 2% by the end of the year (more on that below). This, of course, has already had an impact on equity markets by limiting the capacity of corporations to borrow and grow their businesses. But it's also had an important impact on the fixed income market and household finances, particularly mortgage rates.

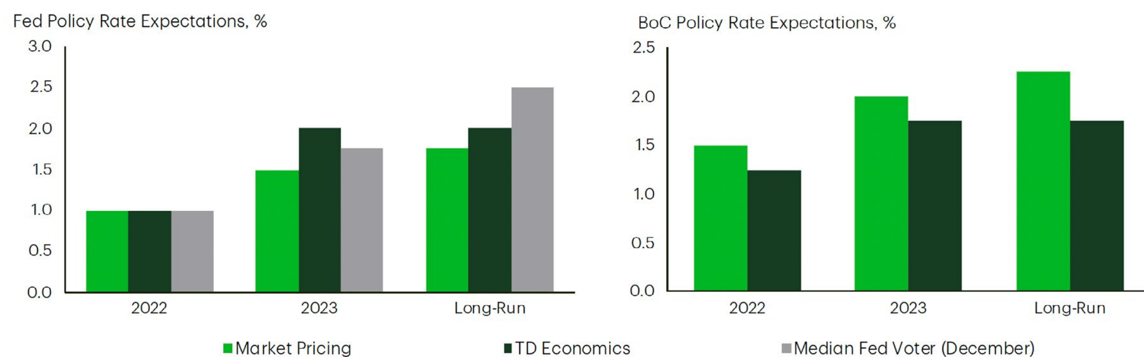
Liquidity in U.S. Treasury markets are under pressure, especially for shorter-maturity notes and older vintages. At the same time, expected volatilities have spiked to levels last seen in March 2020 (Figure 3). All this shows that there is not just a flight to quality but a flight to liquidity in financial markets as investors gravitate to the most liquid assets.

How far is the Fed likely to go?

As already mentioned, the Fed and the Bank of Canada will likely be less reticent than their European counterpart when it comes to hiking rates, given the fact that the North American economy is better insulated from Russian/Ukrainian exposure.

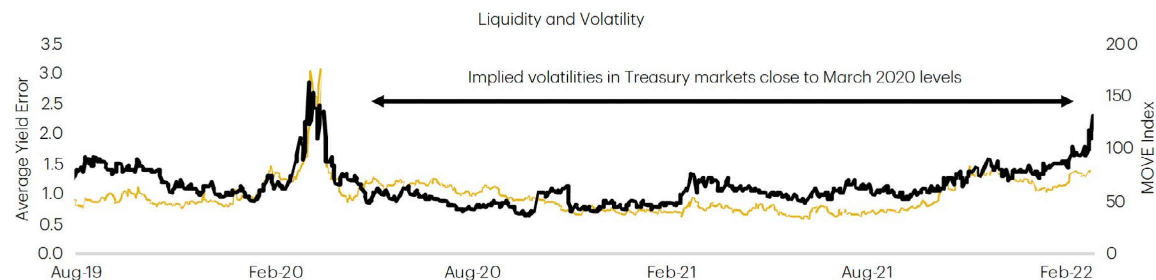
Historically, the U.S. Federal Reserve policy rate and U.S. government bond yield curve have had a unique relationship. In past hiking periods, the curve has flattened (i.e., the difference between shorter- and longer-maturity yields compressed) with two-year yields often rising above 10-year yields (in what is often called an "inversion"). This time around, the curve has already flattened, with the spread between two- and 10-year maturities approaching zero even before the start of the hike cycle. This flatter yield curve might make the Fed uncomfortable in delivering too many hikes. As it stands, the U.S. government yield curve one year from now is quite flat, which may be the harbinger of a recession — but let's not get ahead of ourselves; central banks have it within their power to tweak their hiking strategy as they see fit and, importantly, as the economy reacts to initial hikes. Additionally, we need to remember that the Fed will commence the unwinding of its bond portfolio sometime this year and that can theoretically offset the flattening.

Figure 2: Central banks prepare to hike



Source: FOMC, Bloomberg Finance L.P., TD Economics as of January 2022

Figure 3: Flight to liquid quality



Source: Bloomberg Finance L.P., as of March 7, 2022

For access to the full version of this Monthly Perspective, please visit TD Knowledge Centre: https://bit.ly/36RKvqB

GREEN ECONOMY

Climate change is increasingly becoming a higher priority for governments, corporate leaders and investors. As we've done in previous issues, we'd like to take a moment to highlight companies who are developing innovative solutions to this complex problem while taking advantage of this growing global market.

Green Highlight

From left to right COO Mike Munro, Brian Porter, CEO Jim Vounassis, P.J. Dupuis, CFO Stéphane Archambault; in front of a BGX Biostream

We recently had the opportunity to visit Xebec Absorption at their first-ever investor day, at their newly acquired manufacturing facility in Denver, Colorado. The focus of the investor event was to unveil the company's 3-year strategic growth plan and interact directly with the senior executives and staff responsible for their innovative products.

"Xebec is dedicated to helping our world transition to a low-carbon future by accelerating the production of renewable gases. The company specializes in deploying a portfolio of proprietary technologies for the distributed production of hydrogen, renewable natural gas, carbon capture, oxygen and nitrogen. By focusing on environmentally responsible gas generation, Xebec has helped thousands of customers around the world reduce their carbon footprints and operating costs. The company is headquartered in Québec, Canada and has a global footprint with nine manufacturing facilities, seventeen Cleantech Service Centers and four sales offices spanning over four continents. We look forward to playing our part in making the world a better place over the long-term and doing so profitably."

– Jim Vounassis, CEO Xebec Adsorption Inc.

Save the Date

Client Appreciation Event
Thursday, June 23rd
Willistead Manor
5-8pm
Details to follow!

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