NEWSLETTER Q3

What Drives Us

Summer 2022

The most recent Canadian inflation number confirms what many of us already know. With gas at $2 per litre, a head of lettuce at almost $4 and skyrocketing home prices, we've officially reached a 40-year high for annual inflation. This has been one of the primary drivers of the market volatility that we've seen so far in 2022, a story still unfolding.

Inflation alone is not necessarily a bad thing. In fact, the central bank of Canada has a stated policy to keep inflation at around 2%. Still, the uncertainty around this inflation rate is undeniably challenging for businesses and families.

So, what's the good news?

The primary factor contributing to our elevated inflation continues to be supply chain issues. These have been stretched to the limit through the pandemic (rising energy costs are the second factor), but there are some early indications that these are easing and that companies are adapting to the new reality. Great businesses can pass along increases and often have the scale to negotiate lower costs allowing them to continue to operate profitably. Owning them is the ultimate protection against inflation and the best way to grow long-term wealth.

In this newsletter, we've included a primer on inflation to help you better understand the current environment and a recap of our client appreciation event.

Stay Well,

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IN THIS ISSUE

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"I remember the $0.05 hamburger and a $0.40-per-hour minimum wage, so I've seen a tremendous amount of inflation in my lifetime. Did it ruin the investment climate? I think not." - Charlie Munger

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Inflation 101

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It's been over 30 years since inflation was dinner-table conversation. Most of us have heard about the dreaded stagflation of the 1970s and 20% interest rates, but many investors have never actually experienced a prolonged period of inflation. Food prices are now up nearly 10%, gasoline is up around 50%, and mortgage costs are set to rise as central banks aggressively hike interest rates.

Faced with the unknown, many investors are running scared. In fact, last quarter was the first time in 35 years that stocks and bonds both lost money simultaneously. But before we do anything rash, it's important to get some context. In this primer on inflation, we try to answer the basic questions that have preoccupied many investors for whom inflation is a new and scary concept. Think of it as a first step to understanding this strange new environment.

1. Why are prices going up?

As is often the case, there isn't just one reason — there are multiple causes that contribute to rising prices. The big picture is that prices go up when demand (or perceived future demand) exceeds supply, and ultimately that happens when demand rises much faster than supply, or when supply falls much faster than demand.

Sometimes, it's very easy to see a link between world events and rising prices. The pandemic closed many businesses and disrupted supply chains, stopping the production and transportation of many items, but because of generous government benefits and low interest rates (fiscal and monetary stimulus), demand for goods actually increased. So, with increased demand and reduced supply, it was only natural for prices to rise. Memorable price spikes in the auto and lumber industries are a good example of this. More recently, the Russian invasion of Ukraine has caused oil prices to rise because Russia is one of the largest oil producers in the world, and people feared there would be a disruption of supply — something that has partly come true.

Another way to look at it is from a monetary perspective. When the supply of a particular currency rises, the value of that currency falls relative to other currencies. When the economy stalled at the start of the pandemic, central banks dramatically boosted the monetary supply by creating dollars to purchase bonds from the government, which in turn allowed the government to distribute benefits. They did this to enable people to survive income losses and to encourage spending to bolster the weakened economy.

Now, with inflation at 40-year highs, the exercise is playing out in reverse. Central banks have vowed to raise rates and sell the bonds they purchased (in the process destroying dollars and reducing monetary supply). More importantly, raising interest rates increases the cost of borrowing and decreases people's ability to spend, so this is an effort to cool off all of that demand — to bring it more in line with supply.

2. How long will it last?

No one knows for certain, but it tends to behave somewhat like a pendulum — moving too far one way, too far the other way, then eventually settling in a more balanced middle. We must keep in mind that inflation has been extremely low for a long time now, for reasons both natural (globalization, technology) and manufactured, given the central bank's mandate to maintain inflation near 2%. For decades, the Federal Reserve has been trying to spur inflation by lowering rates. Now, by ending the bond-purchase programs (a practice known as "quantitative easing") and beginning to sell those bonds ("quantitative tightening"), central banks are trying to bring inflation back down to target. Since the early 1980s, interest rates have gone from around 20% to effectively zero; now they are bouncing back (Figure 1).

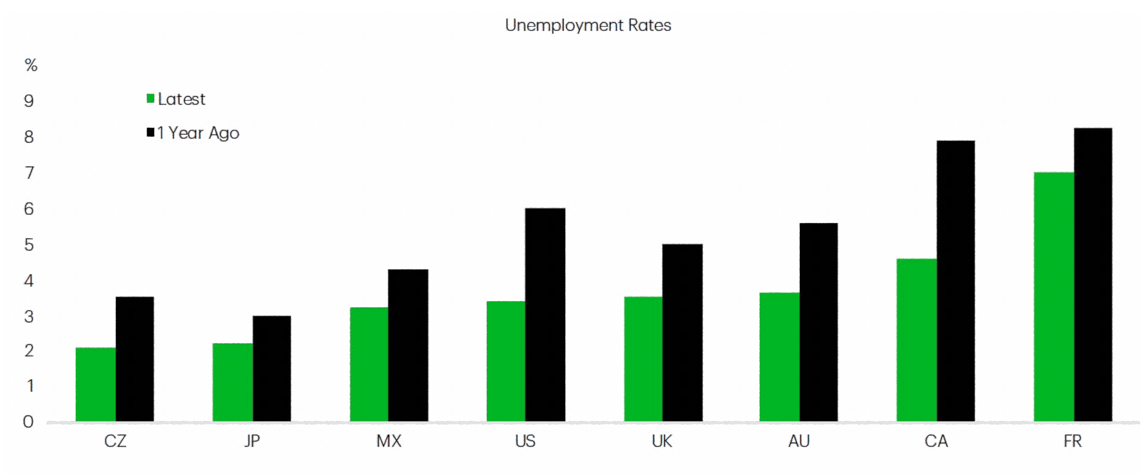
3. Does this mean we're on the way to a market crash or recession?

Not necessarily. Rising rates are more associated with a strong economy than a weak one, and the labour market is extremely strong right now, with unemployment close to historic lows (Figure 2). The real risk is that central banks raise rates too quickly.

Figure 1: Rates follow inflation

Source: Bureau of Labour and Statistics, Federal Reserve Board, TD Economics as of April 2022.

Figure 2: Labour market is 'drum tight'



Source: TD Wealth as of April 2022

For the unabridged version of this report, please visit TD Knowledge Centre: https://bit.ly/3nqytJh

BDWM IN THE COMMUNITY

Client Appreciation Gathering

The pandemic brought about many changes in our lives, but one of the things that we have missed the most is seeing our clients in person. After a 2-year hiatus, we finally gathered at the historic Willistead Manor on June 23rd, 2022, for an evening of conviviality and exchange over lovely food and vibrant music, courtesy of Thyme Kitchen and Coffee House Combo. In addition to enjoying the opportunity to reconnect, we also wanted to show gratitude to our healthcare workers, so we invited students and staff from the Faculty of Nursing at the University of Windsor to join us and share their stories from the front-line. In recognition of their tireless work, we are proud to donate $6000, with the help of our partners, which will go to the Faculty of Nursing to help train and equip the next generation of front-line workers.

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