A Important Note: Inflation and Rising Interest Rates

Inflation reflects a general increase in prices which equates to a fall in the purchasing power of money. While inflation has declined from 13.3% in 1979 to 1.4% in 2020, in 2021 it has increased to 2.5% and has become a topic of many conversation.

But how does this affect you? Does this call for a change in strategy?

It is important to produce a return above the rate of inflation. If I could by to buy an item for $100 in 2011, after ten years of 2% inflation the same item would cost $122 today, and after ten years of 5% inflation that same item would cost $163 today. Therefore, if we do not earn more than inflation, the dollar amount in an account may increase, but the value (purchasing power) of the account actually falls. For example, if we did not buy the above item in 2011 but instead invested the $100, then our investment must at least grow to $122 (after-tax, importantly) in order to be able to buy the same item in 2021. In fact, if the investment did not grow to more than $122, we would be no better off, no richer. And if one earns only 2% when inflation is 4%, then the value of the portfolio will steadily decline.

Higher inflation therefore requires higher returns. Fortunately, two forces assist us in protecting the value of our portfolios.

First, with an increase in inflation one usually sees an increase in interest rates. The government fights inflation by rising interest rates in an attempt to cool the economy. As such an increase in inflation may be offset by the accompanying increase in the rate of interest earned on a bond portfolio. While

helpful, understand that there is a lag between when inflation rises, to when interest rates rise, to when one benefits from an increase in rates. If one purchases a bond for say 10 years, then the interest rate is fixed for that period of time and one cannot benefit from an increase in rates until that bond matures in 10 years.

In anticipation of the possibility of higher interest rates our bond managers predominantly own short term and floating rate (reset periodically to capture any increase in rates) bonds.

Second, stocks, real estate and other assets usually increase in value with inflation. There are of a number of good reasons for this, most tied to the dynamic nature of corporations where they can adjust prices, operations and strategy. This is best shown through some historical examples.

- From 1954-1960 inflation rose from 0% to 1.4%, interest rates rose from 2.3% to 4.7% while the stock market (S&P500) rose 207% or 17.4% annualized
- From 1971-1981 inflation rose from 3.3% to 12.5%, interest rates rose from 6.2% to 13.7% while the stock market (S&P500) rose 113% or 7.1% annualized
- From 1993-1994 inflation was steady, interest rates rose from 6.6% to 8.8% while the stock market (S&P500) rose 12%
- From 2003-2007 inflation rose from 1.9% to 4.1%, interest rates rose from 3.3% to 5.1% while the stock market (S&P500) rose 83% or 12.8% annualized
- From 2012-2018 inflation rose from 1.8% to 1.9%, interest rates rose from 1.5% to 3.0% while the stock market (S&P500) rose 131% or 3.9% annualized

(Macrotrends.net May 2021)

Inflation therefore should not be a fear of a stock owner over the long term.

Conclusion

It is very possible that the upswing in inflation will be short lived as the recent increase may only be a result of the post-pandemic pent up demand. Once the demand wanes over the coming year inflation will return lower.

However, even if inflation is here to stay, I am comfortable that our investments (stocks and bonds) are well positioned, and that there is no need to change our strategy.

Market Update – May 2021

May was a mixed month with most asset classes only rising a little.

In general, the markets posted positive news and results. The current market and economic environment are excellent. Earnings and sales momentum are accelerating, not decelerating. The economic recovery is robust (the Atlanta Fed now anticipating 11% average annual GDP growth in the second quarter). Governments appear committed to keeping key interest rates low through 2023. Consumers appear to be increasing their spending, and job growth is strong.

At this moment most statistics are strong and things look great.

But always remember that the stock market is a forward-looking mechanism. As such, this current wonderful time is the reason the markets rose so much over the past 6 months. Conditions may remain wonderful for a period of time but the market will move depending on how it believes the next 6 months to a year will look.

My conclusion remains that same as always: focus on the longer-term. Strong environments come and go and there is no telling how long this one lasts. Instead, remember that your portfolio is positioned to return what you need to meet your long-term goals. That is the only objective that truly matters.

We are cautiously positive in the short term, and positive in the medium and long term. We continue to hold our positions and invest cautiously.

For the Month, the bond market was up 0.6%, the Canadian market up 3.3%, the US market was down 1.6%, International markets were up 0.1%, the Emerging markets were up 0.7%, the Real Estate market was up 0.36% and the preferred market was up 2.9%. (Reuters 5/31/21) (1)

Year-to-date, the bond market was down 4.5%, the Canadian market up 15.3%, the US market was up 7.2%, International markets were up 11.3%, the Emerging markets were up 3.3%, the Real Estate market was up 16.9% and the preferred market was up 14.2%. (Reuters 5/31/21) (1)

Have a great month and let us know if there is anything we can do for you,

- Meir

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1. Indexes shown

Bonds FTSE Canada Universe Bond Index

Canadian Equity - S&P/TSX 60 Index

US Equity – S&P 500

International – MSCI EAFE Index.

Emerging Markets - MSCI Emerging Markets Index

Real Estate - Dow Jones® Global Real Estate Index

S&P/TSX Preferred Share Index

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