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Economic & Market Update

Just in Time

Five years ago, I was in the market for a new grate for my barbeque. I found one on Amazon.com that was exactly what I needed and ordered it while I was on a break at around 9:00am. At around 11:45am, a delivery person arrived the lobby with a package for me. I had assumed that it might have been something I ordered over the past few weeks. To my surprise, it was the grate for my grill.

This was likely the perfect scenario where the grate I wanted had been sourced from a place in Surrey and the vendor had time that morning to arrange for a courier to ship it to me. However, I have heard similar stories where buyers of online goods had been surprised by how quickly the merchandise arrived. Whether it is a few hours, or a few days for something from overseas, this would have been hard to imagine 30 years ago.

What contributed to this phenomenon over the last three decades? Perhaps the biggest factor was the end of the Cold War trade which freed up the global economy with respect to the flow of capital, goods, and labour. When I was a kid back in the 1970s, the world

The global supply chain had become so efficient over the last number of decades that many of the costly buffers were removed.

The pandemic now appears to be illustrating the risks of not having enough of a margin of safety built into supply chain logistics.

map was divided up between "free" and "authoritarian." While these terms still apply to various countries around the world, during the Cold War the division basically meant a line where there was virtually no trade in goods and services, and almost no movement of financial or human capital. By limiting trade to allied countries, the world back then was an economic shadow of what it eventually became. The end of the Cold War generated a number of "peace dividends." Less money spent on militaries meant less taxation, money that could then be used to increase consumer spending. Also, manufacturing could then be moved offshore to lower wage jurisdictions (countries that were harder to access logistically before, or counties that might have been considered enemies before).

Back in the 1970s, trade was more restricted which led to more disruptions.

Much of the world back then was off limits to the flow of goods, people, and money.

Another major contributor to the rise in international trade was technology and communications. Communicating internationally back in the 1970s was slow, expensive, and inconvenient. Businesses and banks had the budgets to manage this, but very few consumers did. Ordering something you really wanted could be an arduous task.

Communicating overseas was expensive.

Technology also increased computing power which facilitated the growth in precision logistics, where all the steps from manufacturing to delivery were so smooth that we forgot how complicated it really is. Nowadays, goods might make a quick visit to a warehouse or, in some cases, skip them all together if the supply chain is efficient enough.

Technology wasn't capable of building seamless supply chains.

Technology also helped to reduce how much energy went into manufacturing and shipping. Lower costs allowed for lower prices which economists tell us can increase demand and, thus, more trade. Plus, technology also aided in the exploration, extraction, and the delivery of oil and gas, reducing energy costs and final retail prices even further.

Costs of energy made shipping less viable.

The last major factor in creating the "just in time" world was the liberalization of trade through the reduction in tariffs and barriers. The advent of the World Trade Organization (WTO) in 1995 was a huge inflection point. Then, when the WTO voted to include the People's Republic of China, things really took off. There were still some tariffs and barriers, and prohibitions against unfair practices, but a lack of enforcement supercharged the velocity of trade, for better or worse.

Tariffs and trade barriers were a common feature after World War 2.

Since the Cold War, most of these challenges were overcome and seamless global trade was something we often took for granted …

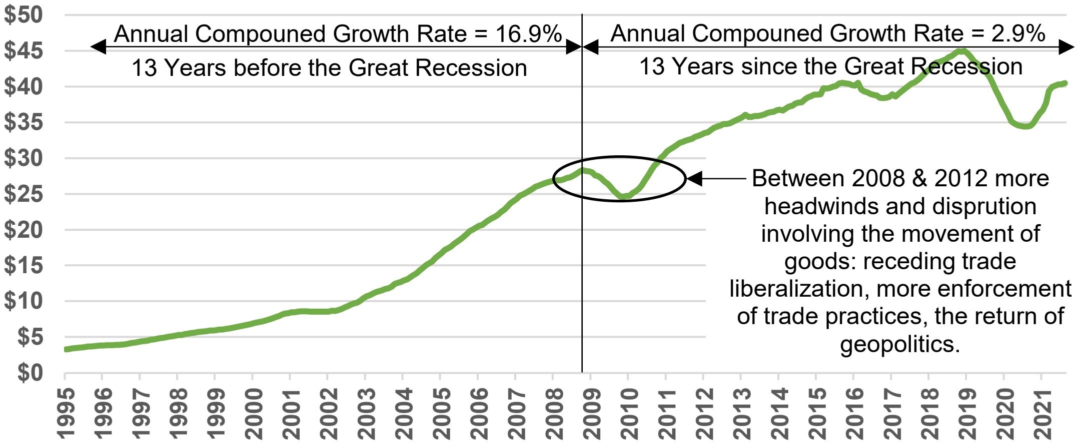
The first real shock to this "Goldilocks" scenario was the Sub-prime mortgage crisis and Great Recession of 2008-09. Demand for goods and services fell, causing some disruption. However, China heavily stimulated its economy and the resulting economic growth there helped to soften the impact on the global economy. Once the U.S. began to

… until the pandemic disrupted things.

stimulate but cutting interest rates and initiating massive purchases of government bonds, the global economy was able to get back on course in a relatively short period of time. However, things were never really the same in terms of the easy and unhindered velocity of international trade. My estimation was that things changed in terms of geopolitics, trade practice enforcement, and the efficiency of supply chain logistics sometime between 2008 and 2012 (**Chart 1**).

Chart 1:

Monthly US Imports From China (Trailing 12-mth Average in Billions)



Source: Bloomberg Finance L.P. as of 11/5/2021

Many of these changes were subtle. Plus, they were often obscured by the continuing gains in productivity as well as technology available to the consumer when looking to make purchases. Online retailers continued to improve customer experience and helped to keep a lid on the price of merchandise. As a result, what was happening at the structural level with global trade wasn't evident to many observers.

Geopolitical tensions have returned after decades.

Greater enforcement of trade practices.

Increased tariffs and barriers.

Then the pandemic hit. Supply chains were so severely affected that we began to see the vulnerabilities that were lurking beneath the surface for the last decade.

The need for a buffer in the form of costly inventories is making a comeback.

In the 1980s, my accounting classes spent much time on dealing with inventories. The timing of goods moving through inventory and how this impacted the cost of goods eventually sold could have a big impact on the earnings of a company. Despite the complexities and the financial risks, inventories were maintained because of the margin of safety they provided in the case of unforeseen disruptions. Global supply chains weren't very efficient and not maintaining a sufficient buffer was tantamount to playing roulette.

The consumer will need to pay those higher costs if companies want to maintain profit margins.

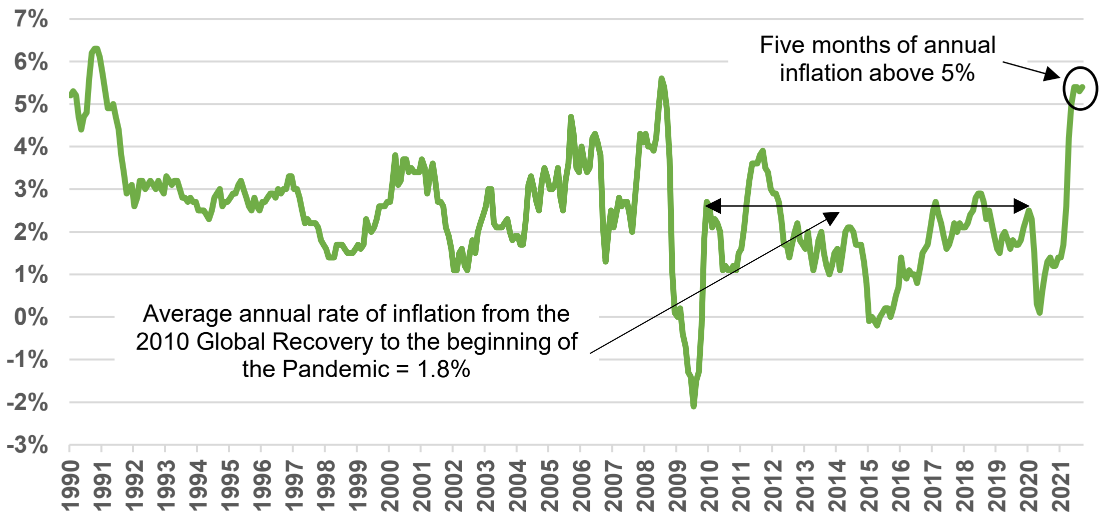
The pandemic has illuminated the problems associated with not having enough of a margin of safety. It was easy to stop everything en masse. However, coordinating a restart is proving to be more complicated than rocket science. Suddenly, maintaining inventories (and incurring the related costs) looks prudent instead of wasteful.

Disruptions in global trade is one of the factors contributing to a rate of annual U.S. inflation that has remained above 5% for five months now.

The collision between the pandemic-related disruptions and the slow rise of general disruptions since at least 2012 has added to the upward pricing pressure for merchandise and food recently. Aside from the base effects (rising from a very low base can excessively amplify statistics) during the quick recovery from the Great Recession, we would have to go back to the home-buying and economic frenzy before the Sub-prime mortgage crisis to find an increase in inflation similar to what we have seen recently (**Chart 2**).

Chart 2:

US Consumer Price Index (The Annual Rate of Inflation)



Source: Bloomberg Finance L.P. as of 11/5/2021

If the disruptions aren't resolved, high inventories and the associated costs may be something that we will have to get used to.

We may have to expect longer wait times and higher prices for goods that we badly want. Considering that, it might be a good idea to reduce investment exposure to companies and sectors that are the most vulnerable. If companies can't pass on the increased costs resulting from inventories and transportation, or can't deliver a product quickly enough, lost sales and declining revenue could be the result.

Model Portfolio Update[1]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	12.0	None
U.S. Equities	38.0	None
International Equities	8.0	None
Fixed Income:		
Canadian Bonds	22.0	None
U.S. Bonds	6.0	None
Alternative Investments:		
Gold	8.0	None
Silver	1.0	None
Commodities & Agriculture	3.0	None
Cash	2.0	None

No changes to the model portfolios in October.

There were no changes to the asset allocations or the investment holdings in our model portfolios during October.

Stocks were generally higher on good earnings.

Bonds were generally lower on inflation concerns.

October was generally good for stocks (in North American and internationally), and bad for bonds.

Stocks benefitted from good earnings. The importance was the magnitude of the earnings surprises which were sufficient to raise share prices (the level of surprise might have been a function of a lowering of expectations during the run up to earnings reporting season).

Bonds were mostly hurt by a growing lack of confidence among bondholders toward central bankers in managing the growing inflation numbers. An investor would naturally not be as keen to hold a long-term bond while inflation is eroding the real value of what

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 11/5/2021. The asset allocations of individual clients invested in this Portfolio may differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

they receive in periodic coupon payments, or the return of principle at the end of the life of the bond.

Inflation headlines appeared to confound the U.S. Federal Reserve Board (the Fed) which had initially speculated a year ago that any pandemic-related inflation would be "transitory." Investors might be looking for clues that would indicate a walk-back by the Fed and some tougher monetary medicine if inflation become a bigger political problem. On Wednesday November 3rd, the Fed announced a tapering of the rate at which they were buying securities. However, that was somewhat expected as well. What investors really seemed to want to know is when the Fed will start raising short-term interest rates. Fed Chair Jerome Powell didn't say, but interest rate futures markets are now expecting an initial rate hike by September of next year.[2]

Investors are looking to central banks for a response to growing inflation concerns.

The Bank of Canada appeared be taking initiative in this regard.

The U.S. Federal Reserve is a little more secretive.

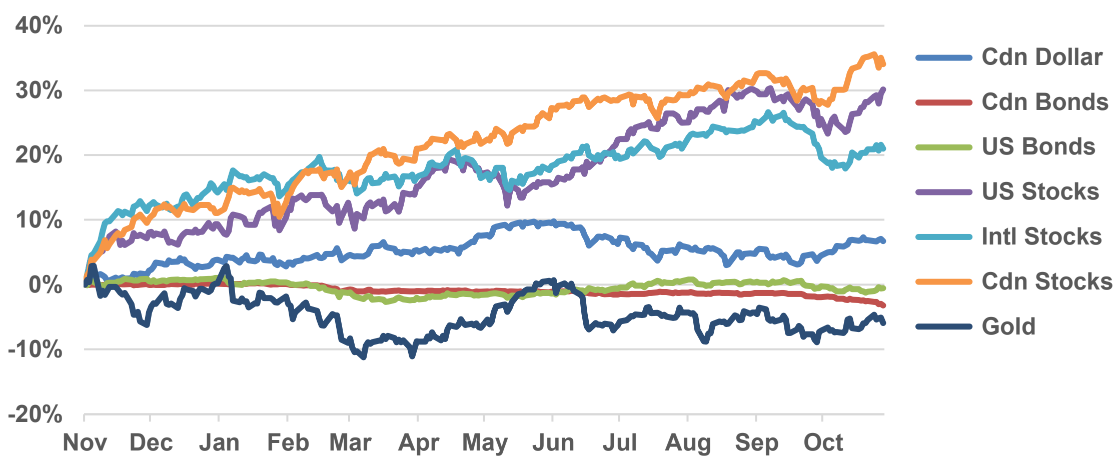
Inflation-fighting and any resulting increase in rates could be expected to increase stock market volatility.

The Bank of Canada took some initiative the week before in getting out ahead of potential inflation by announcing an end to buying bonds. Normally this would be bullish for the Canadian dollar. However, it may have already been priced in as there was not much reaction.

Below is the 12-month performance of the asset classes that we have used in the construction of The Charter Group's model portfolios. (**Chart 3**).[3]

Chart 3:

12-Month Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. for the interval from 11/1/2020 to 10/31/2021

[2] Source: Bloomberg Finance L.P. as of 11/5/2021

[3] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Canadian bonds are represented by the current 3-year Government of Canada Bond; US bonds are represented by Barclays US Aggregate Bond Index; U.S. stocks are represented by the S&P 500 Index; International stocks are represented by the MSCI EAFE Index; Canadian stocks are represented by the S&P/TSX 60 Composite Index; Gold is represented by the Gold to US Dollar spot price.

Top Investment Issues[4]

Issue	Importance	Potential Impact
1. U.S. Fiscal Spending Stimulus	Significant	Positive
2. Coronavirus Geopolitics	Moderate	Negative
3. Canadian Dollar Decline	Moderate	Positive
4. Short-term U.S. Interest Rates	Moderate	Positive
5. Canadian Federal Economic Policy	Moderate	Negative
6. China's Economic Growth	Moderate	Negative
7. Deglobalization	Medium	Negative
8. Global Trade Wars	Medium	Negative
9. Canada's Economic Growth (Oil)	Light	Positive
10. Long-term U.S. Interest Rates	Light	Negative

[4] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, I encourage you to email me at mark.jasayko@td.com or call me directly on my mobile at 778-995-8872.

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The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of November 5, 2021.

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