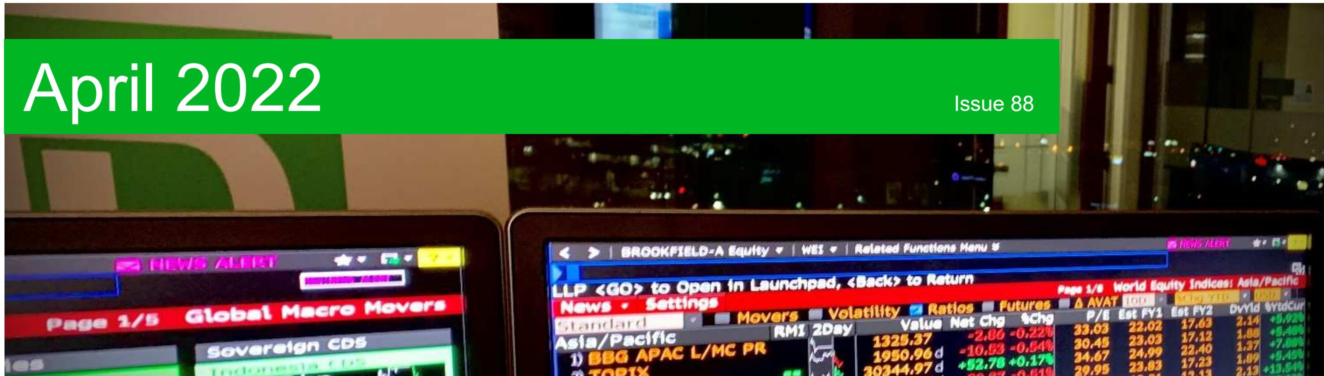
The Charter Group Monthly Letter



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Economic & Market Update

Warflation

During our Winter Economic & Market Update WebEx presentation on February 17, 2022, I went through a list of almost three dozen factors that can potentially contribute to inflation to help counter the notion that it was only the supply chain disruptions extending from the pandemic that was causing price spikes. The press and political leaders where seizing upon the supply chain narrative; its relatively easy to understand and it is not something one can do much about, helping to deflect blame for the resulting inflation.

Now, it is Russia's invasion of Ukraine, which started a week after our Winter presentation, that is providing the alibi for inflation that is beyond control of the policymakers. They are correct in that assessment. Higher gasoline prices are almost certainly a direct result. However, as before with the focus on the supply chain, it ignores all the other significant contributing factors.

In March, the U.S. reported an inflation rate of 7.9%, the highest rate since January 1982. What were the most significant of many factors and how might they evolve in the future?

The inflation that we are now seeing is often attributed to a single factor at a time.

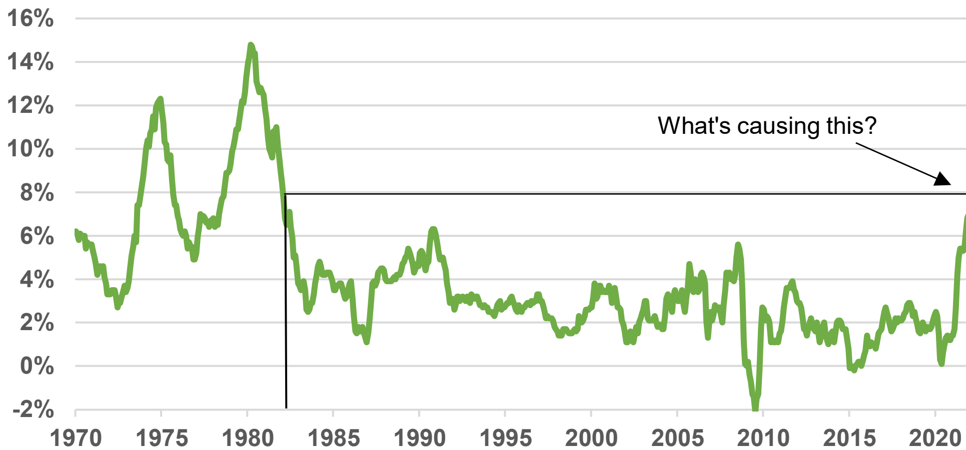
First it was supply chain disruption. Now it's all about the Russian invasion of Ukraine.

It is likely much more complicated than that.

TD Wealth

Chart 1:

U.S. Annual Inflation Rate (The Consumer Price Index)



Source: Bloomberg Finance L.P. as of 4/8/2022

U.S. inflation has hit 7.9%, the highest in 40 years.

Canadian inflation has hit 5.7%, the highest in 31 years.

1. Government Spending

Historical levels of deficit spending over the last two decades have provided the latent "gasoline" to fuel inflation. All we needed were a few catalyst factors to ignite it. Eventually, excessive spending itself could be an inflation catalyst if it ends with a debt crisis necessitating the printing of money to pay for what is owed. But, as we have seen, and as I will discuss below, a few other catalysts have emerged before the debt, on its own, became the problem.

High government spending built up the fuel that only needed a spark.

Now that we have a few sparks, it has ignited into an inflationary spike.

Government spending has enormous inertia. The recent Canadian federal budget is full of enormous spending initiatives that will need to be financed with more debt. Most of us are aware that inflation has become an economic issue, and enough government leaders also know this. However, it can be human nature for policymakers to whistle past the graveyard until it becomes a *political* issue. So, I expect a continuation of "gasoline" in the form of deficit spending to be showered onto the current inflation fire for a while.

Continued high government spending might add more fuel to the fire.

Might be a couple of years before spending is trimmed.

2. Supply Disruption

This rather esoteric economics topic has become a hard-hitting reality that we can now grasp. Many of us experienced delays to get things we needed. This started quietly over the last decade as trade wars and brewing geopolitical tensions pulled us away from peak globalization and its maximized trading efficiency. The Pandemic dramatically accelerated these forces. The Russian invasion of Ukraine will likely worsen and prolong this problem.

Eroding globalization, the Pandemic, and the Russian invasion are making it hard to get stuff on time.

This is likely a challenge that we will face for the remainder of this decade. It is difficult to imagine the global political and trade landscape going back to where it was circa 2008-2012. It's a new era that will take time iron out supply and demand imbalances. Until that happens, disruptions will likely be a net contributor to inflation.

With no end to the geopolitical strife in sight, supply disruptions may be here for the rest of the decade.

3. Labour Shortages

Prior to the Pandemic, the Baby Boomer Generation was already a few years into retirement mode. More of them were retiring than there were young people entering the workforce. As a result, workforce participation began falling. Then the Pandemic hit which led to a surge in retirements. The Pandemic also led many people to question how much time there were spending on work and prompted a shift to more balanced lifestyles. Balanced lifestyles usually entail fewer working hours. The labour supply shrunk considerably over the last two years. When there is less supply of something, the price goes up. In this case the "price" is expressed as wages. Those wages need to be passed on to the consumer to maintain profit margins. That's inflation.

Well-documented labour shortages have increased wages.

How long will this phenomenon exist? There are signs that the shortage has alleviated somewhat. Many of the more ambitious early retirees are realizing that the increased cost of living might require earning a paycheque after all and are re-entering the workforce. Plus, office culture and competitive realities are slowly challenging the feasibility of a balanced lifestyle. Companies have gained a little more power in recent months in requiring full-time commitments.

However, there has been some easing of the shortage recently.

Compared to prior to the Pandemic, it is reasonable to expect there will be a greater acceptance of work schedule flexibility, but it is not likely that it will resemble what we saw during the height of the Coronavirus. So, I am expecting that this particular inflation contributor to ease back, but not all the way back to where it was five years ago.

4. Energy

Energy prices plummeted at the onset of the Pandemic, but that was not a sign of things to come. Instead, prices started ramping up with reopening from the lockdowns. Energy supply is relative fixed in the short-term. So, reopening-related demand spikes would send prices higher. Then, the Russian invasion drastically altered the calculus and made things much worse.

No Russian energy means less supply and higher prices.

With growing embargoes on Russian energy, all the risks of the policies geared at slowing down the exploration and production of fossil fuels have burst to the fore. There's a big reason as to why our model portfolio investment in Suncor doubled its dividend recently. Money saved from not drilling wasn't able to be invested profitably elsewhere, so it was given back to shareholders. Less supply upstream almost results in potentially less supply downstream at the gas pump. Less supply means higher prices.

Policies aimed at reducing energy exploration and production are now aggravating the situation caused by bans on Russian energy.

It might take a few years to reestablish previous rates of exploration and production. Plus, the infrastructure to transport natural gas around the world will also require a few years to be built to meet the needs of Western Europe which had a critical dependence on Russian gas. Energy as an inflation catalyst may be around for the better part of this decade. There might be some relief if we go into economic recession, but that might only be a temporary reprieve from the trend.

Replacing Russian sources on energy may take two or three years.

5. Food Security

I have written at length about this subject before. It has been a big issue in emerging market countries because consumers there spend a greater portion of the household budget on food. Pandemic-related supply disruptions have brought the pain to us. However, the Russian invasion-related supply disruptions take this to a whole new level. Russia and Ukraine accounted for about a quarter of global wheat exports. More importantly, Russia and Belarus accounted for 40% of global potash exports (a vital fertilizer component). Emerging markets and third world countries are going to feel the chain reaction of this. Less food to buy plus less crop yield because of a lack of fertilizer. And, since food is a global commodity, prices elsewhere affect prices in North America.

Embargoes on Russia are also causing concerns for the supply of food and fertilizer.

Canada is a major producer of both, but it will take a couple of years to build up capacity to meet demand.

We have various investments in the model portfolios that address food security. I thought it might have taken most of this decade to realize the full gains on these positions. Now, that time has probably been cut in half, or more. May take up to five years to access enough alternative sources of food supplies in order to quell the inflationary impact.

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A sundry list of other inflation catalysts and contributors: Transportation costs; higher inventories; slowing technological gains and labour productivity; tariffs & duties; continued lockdowns in China; emerging market debt crises; governments subsidizing rising costs; business regulations; consumer spending & debt; increasing mortgage debt; taxation; hoarding goods because of fear of rising prices; relatively dovish policymakers.

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

There were no changes to the asset allocations or the individual securities in the model portfolios during March other than a bond maturity, the proceeds from which are residing in the cash balance until we get some more clarity on the bond market selloff.

No changes in the model portfolios during March except for a bond maturity.

During the month, the asset class with the most significant positive contribution to the results was Canadian Equities. Canada was in the right place at the right time. With Russia being shut off as a source of basic materials and fertilizer, a number of countries went directly to the managements of Canadian resource firms to negotiate contracts. If they are coming right to us, we know who has the bargaining power. This happened with such surprising speed and frequency during March that the effect appeared to outweigh concerns over Canada's fiscal finances. This was also reflected by a gain in the Canadian dollar versus the U.S. dollar over the month.

Canadian equities, (resource companies in particular) did well during the month as global resource buyers looked for alternative sources of supply. This also lifted the Canadian dollar a little.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 4/8/2022. 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.

That said, the Canadian dollar did get a bit of a punch in the nose when the federal government released its budget on April 7. Standing back a little, it is remarkable that the Canadian dollar hasn't thrived during this phase of rapidly rising energy and commodity prices. However, the historical potential of the Canadian dollar, especially during the commodity super-cycle from 2000-2012, may not be a useful precedent if there isn't more government spending control.

It is notable that the Canadian dollar got hit during the federal budget release despite soaring commodity prices.

The other notable development in markets has been the rise in interest rates (and corresponding bond market selloff). Long warned about in this column, inflation has become too much to ignore and needs to be factored into lending rates if lenders don't want to see erosion of the purchasing power on the dollars that are eventually paid back on loans. Some fear that this alone might push us into recession. There is a chance of that. However, employment growth is still strong, indicating some momentum in areas of the economy. That could put a floor under stock prices. If employment erodes, then we could have another leg down. Much will also depend on how much fortitude central bankers really have in their inflation fight. Tough rhetoric and actual tough medicine can be two very different things.

Interest rates have risen to levels not seen since 2018, driven by inflation concerns.

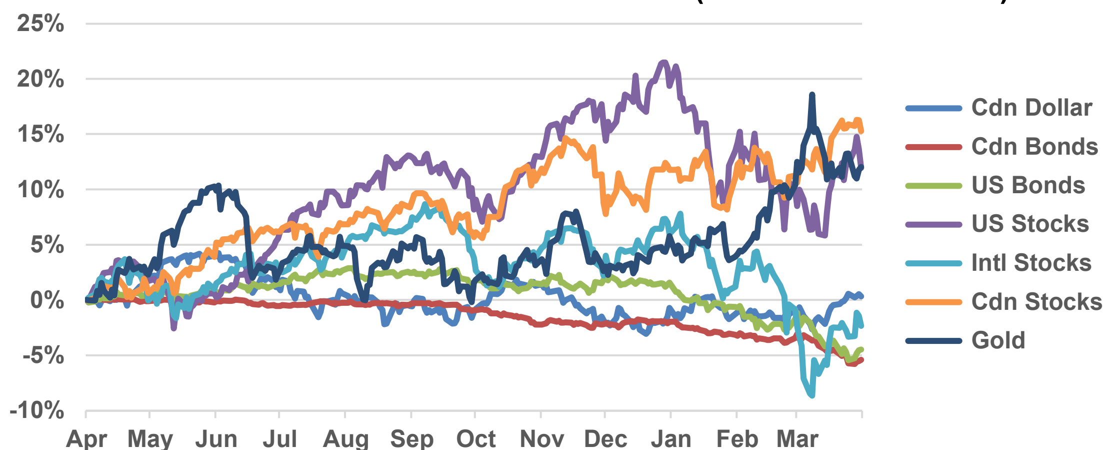
They may have to be increased more.

This creates some recession concerns.

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 2**).[2]

Chart 2:

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



Source: Bloomberg Finance L.P. for the interval from 4/1/2021 to 3/31/2022

[2] 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[3]

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

[3] 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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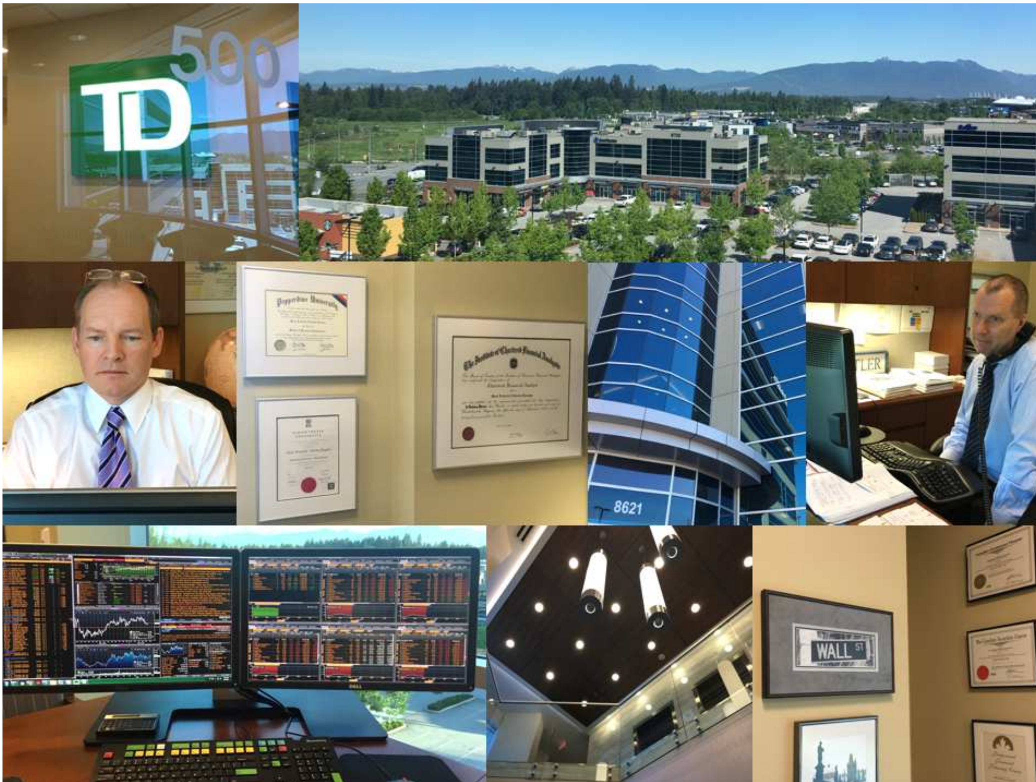
The Charter Group is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, B.C. office. We do 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 April 8, 2022.

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