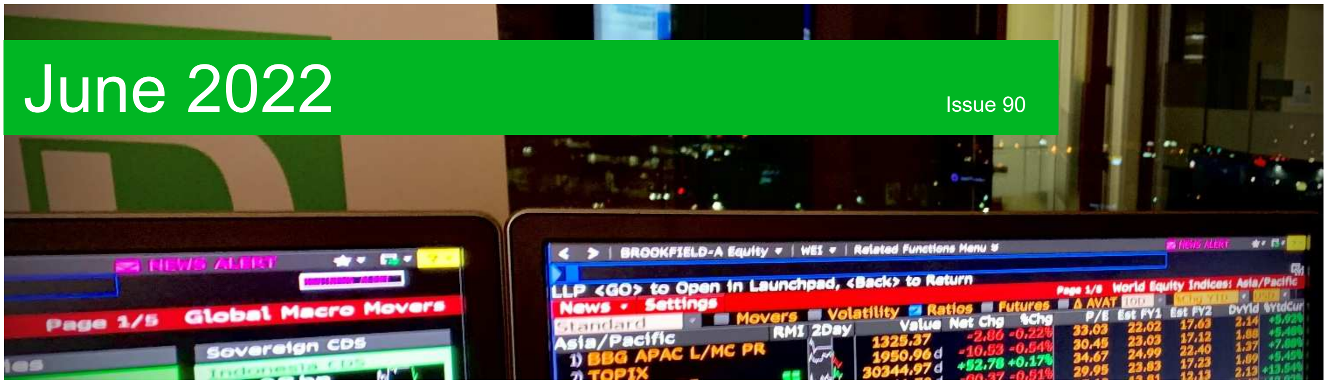
The Charter Group Monthly Letter



June 2022

Issue 90

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Economic & Market Update

Inflating Inflationary Ingredients

If the recipe for a return to lower inflation requires cutting back on the catalysts that drive inflation, then there is not much current evidence that we will see sustained lower inflation anytime soon.

There is some hope among economic analysts that inflation will wane as we progress towards the end of the year.

However, this view tends to overlook the persistent strength of many factors that can produce inflation with some time lag.

The high inflation rates that we are now seeing were impacted by factors that have been in place for a while. Economics is full of lagging effects, and inflation is no different. The problem is that many of those factors are still at elevated levels which could have an impact on inflation over the next three to twelve months. These factors include energy, labour, producer costs, food, and supply chain logistics.

Energy

This time last year oil was hovering around $65 USD per barrel.[1] Depending upon where the oil is extracted, it takes about one to three months on average for oil to travel from the

[1] Source: Bloomberg Finance L.P. as of 06/07/2022. Spot price for West Texas Intermediate.

wellhead, to a refinery, to a gas station, and into my car. The transportation and intermediate storage of the oil and the refined gasoline tend to take up most of this time. That same oil is now at over $120 USD per barrel (**Chart 1**), near a 14-year high. That would suggest that there won't be much relief at the pump until a mid- to late summer.

Energy is much more expensive than last year as oil is touching a 14-year high.

Chart 1:

Oil Prices (West Texas Intermediate - USD per barrel)

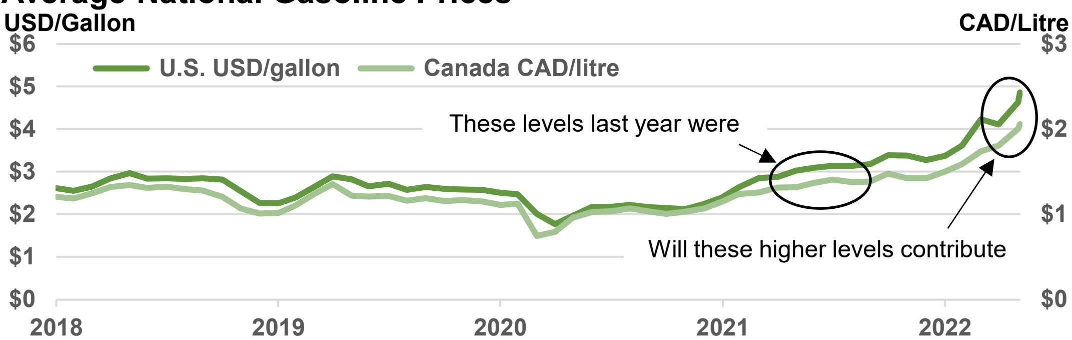
Source: Bloomberg Finance L.P. as of 6/7/2022

A factor that could aggravate gasoline prices specifically is refining capacity. Investment in refineries has fallen over the last number of years. Because of that, there are greater risks of a choke point developing at the refining stage as compared to the past (**Chart 2**).[2]

Constrained refining capacity could add to the price pressures impacting gasoline.

Chart 2:

Average National Gasoline Prices



Source: Bloomberg Finance L.P. as of 6/7/2022

<u>Labour</u>

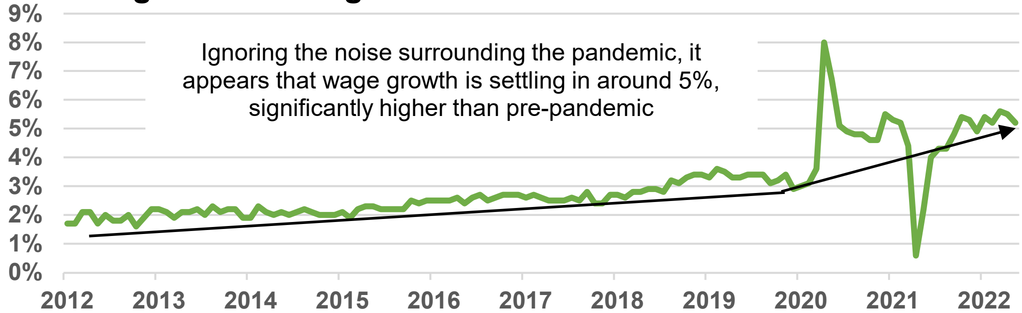
The cost of labour has grown rapidly since this time last year (**Chart 3**). Early retirement, people choosing not to work, or people not working unless they get a higher wage continue to limit supply (**Chart 4**). I suspect that higher wages would solve much of this (everyone has their price!). The lag effect would depend on how quickly businesses give in. Maybe three to six months?

Wages are higher than this time last year as limited labour supply is still a problem.

[2] Kevin Crowley & Alix Steel, June 3, 2022. "US May Never Build New Refinery Even With Surging Gas Prices, Chevron CEO Says", *Bloomberg News*. Not only has investment in new refining capacity waned over the last number of years, political opposition may reduce it to near zero creating an inflationary choke point for years to come.

Chart 3:

U.S. Wage Annual Wage Growth



Source: Bloomberg Finance L.P. as of 6/7/2022

Chart 4:

U.S. Labor Force Participation

Source: Bloomberg Finance L.P., U.S. Bureau of Labor Statistics as of 6/7/2022

Producer Costs

Material input prices are still at levels where they can contribute to inflation going forward. Until now manufacturers have been reluctant to pass along much of the increase in material costs for fear of losing sales. But, if they want to be profitable, they may not have a choice. It is plausible that the consumer price inflation that is currently wreaking havoc on family budgets and the ambitions of politicians, doesn't yet fully reflect the scale of the inflation that is plaguing producers (**Chart 5**).

The costs facing manufactures have risen faster than consumer price inflation. Consumer prices may need to catch up if producers are to maintain their profit margins.

Chart 5:

U.S. Inflation - Will Producers Have to Pass on Costs Soon?

Source: Bloomberg Finance L.P. as of 6/7/2022

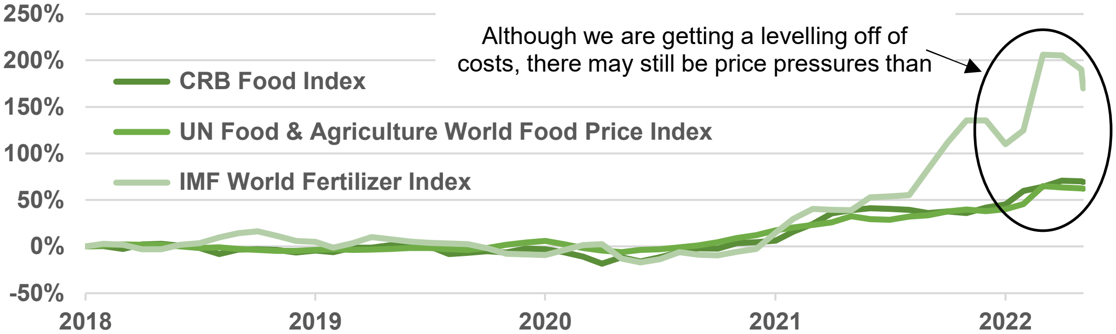
Food

Food prices and the prices of inputs for producing food are still very elevated (**Chart 6**). The Russian invasion of Ukraine has changed the calculus with respect to the availability of basic food commodities and fertilizers, and things do not look like they are going to change anytime soon.

Food prices have risen since last year and accelerated with the Russian invasion of Ukraine.

Chart 6:

Food & Fertilzer Prices



Source: Bloomberg Finance L.P., the Commodity Research Board, the Food & Agriculture Organization of the United Nations, and the International Monetary Fund as of 6/7/2022

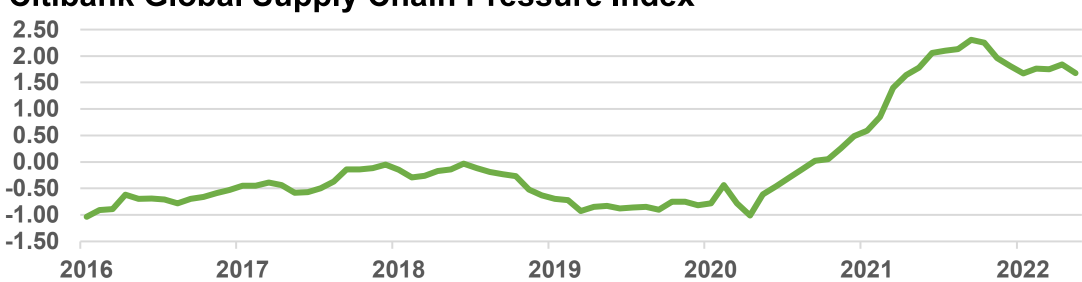
Supply Chains

Although this factor has eased off a little since this time last year, it is still a major problem compared to pre-pandemic levels (**Chart 7**). Businesses are still adapting and facing pressure to pass on costs related to less efficient supply chains.

Supply chain problems are persisting. There has been some relief lately, but the challenges are still far greater than pre-pandemic.

Chart 7:

Citibank Global Supply Chain Pressure Index



Source: Bloomberg Finance L.P. as of 6/7/2022

Many of these cost pressures are still entering into the economic system. And those that are levelling off or declining marginally are still at elevated levels. Businesses and consumers can take a few years to go through a complete spending cycle and many of the required needs have not yet been purchased at higher prices. As businesses and consumers struggle to make those purchases, many of those adjustments (raising prices further for more revenue or seeking raises to afford things) will further feed into the machinery driving inflation higher. If this results in inflation holding at 4% to 5%, or higher, there may be significant economic, political, social, and investment implications.

Central banks are still forecasting that inflation will recede to close to pre-pandemic levels of near 2%. That might be wishful thinking with all the elevated inflation factors still present.

Model Portfolio Update[3]

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 May. We are continuing to hold the proceeds a March bond maturity in cash until an opportunity presents itself. The markets may have to pass through this current stretch of uncertainty with respect to inflation, interest rates, and economic growth before that happens.

No changes in the model portfolios during May.

Despite the volatility across stock markets in North America and globally, a recovery towards the end of the month left stocks relatively near to where they started the month of May. The main resistance to positive performance in our model portfolios was the strength in the Canadian dollar (rising 1.83%)[4] which reduced the returns from U.S. equities, international equities, U.S. bonds, and gold.

A volatile stretch was followed by a recovery towards the end of the month.

Canadian dollar strength impacted results negatively.

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 6/7/2022. 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.
[4] Source: Bloomberg Finance L.P. as of 6/7/2022.

Was the recovery a sign that markets and investors are beginning to see sunnier skies ahead? Unfortunately, that does not seem likely. What investors may be doing is starting to wager that central bankers will lack the resolve to fight inflation if recent interest rate hikes begin to hurt economic growth. A pause in interest rate hikes may be cause for some short-term celebration, but it would hardly help in solving the inflation problem considering that contributing inflationary factors still appear to have strength (discussed in the above section).

Does the month-end recovery signal a return to good times for investors? That doesn't appear very likely.

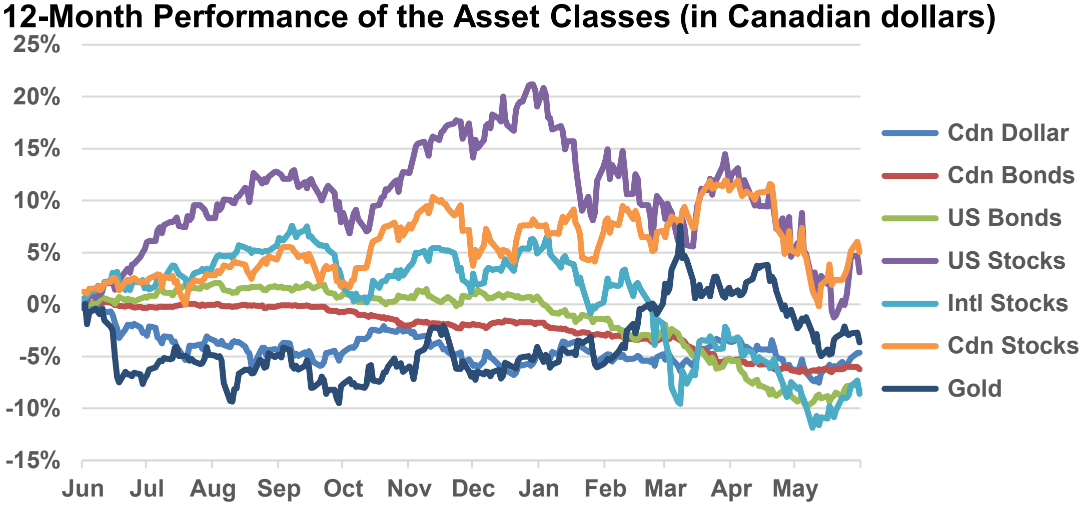
If there is a short-term recovery, we have enough exposure to equities that there should be some upside participation. However, my sense is that most of the euphoria might be in the more growth-orientated stocks that have been hit the hardest. I am not inclined to chase these if that does happen. If the rally is relatively short, there is a good chance that investor focus will begin to shift back to the defensive and inflation-hedged positions that reinforce our model portfolios.

There is some consensus that inflation will evaporate towards year-end. However, it is tough to find much convincing evidence of this.

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 8**).[5]

Chart 8:

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



Source: Bloomberg Finance L.P. for the interval from 6/1/2021 to 5/31/2022

[5] 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[6]

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

[6] 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.