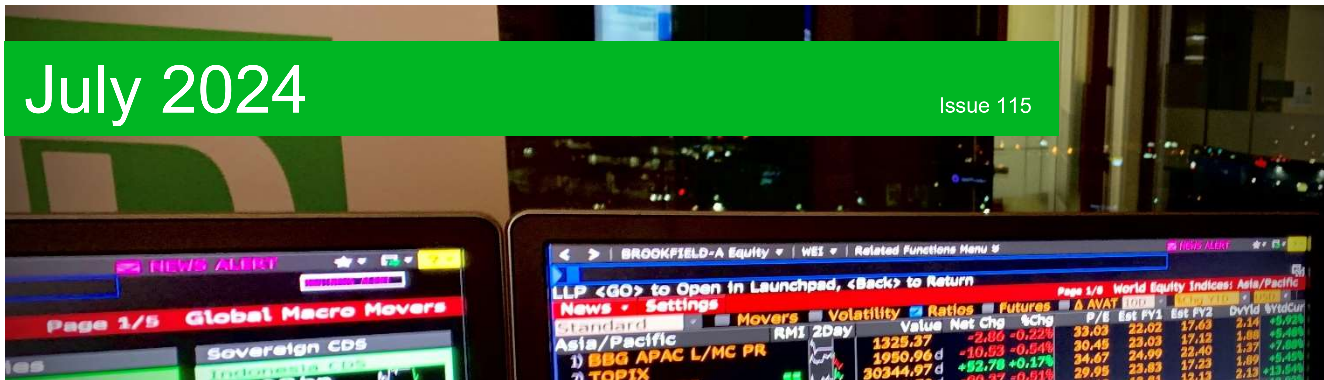
The Charter Group Monthly Letter



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Economic & Market Update

The People's Inflation

On July 11th, the U.S. Bureau of Labor Statistics reported that the annual U.S. inflation rate was 3.0% at the end of June. Following the release, a parade of economists and strategists appeared on TV proclaiming that central bankers have almost completed their battle against inflation and that interest rate cuts are now on the immediate horizon (despite the fact that cuts were supposed to be on the immediate horizon a year ago!).

There is the inflation that gets reported, and then there is the inflation that people feel.

Often, the two can appear to be quite different.

So, is it time to cue up U.S. Fed Chair Jerome Powell on the flightdeck of the U.S.S. Gerald Ford with a Mission Accomplished banner behind him?!? If so, it might seem strange that consumers and, more importantly, voters, don't seem to have gotten the message.

I was travelling through the U.K. and Europe for the past couple of weeks, and found myself in the midst of much discontent with respect to cost of living issues and how that translated into electoral outcomes in the U.K. and France. If inflation is on the verge of being conquered, one might expect better fortunes for the political encumbents as opposed to the results which ushered in sweeping electoral changes instead.

And, from travelling afar, it was a good distance to observe similar consumer/voter discontent in the U.S. and Canada. With a smartphone in hand, it was impossible to miss how cost-of-living issues were continuing to impact political developments back here in North America.

Economists tend to look for trends and justify arguments by looking at details that consumers don't pay attention to.

To explain this divide between what economists are saying and how people are reacting requires an explanation as to how the two groups perceive inflation.

Also, economists may be less than objective when working for an entity that has a specific policy goal or that would benefit from a particular outcome.

However, before that, it is worth pointing out that consumers are reacting to what they actually see and feel, whereas economists (at the Fed, in academia, and in the private sector) often mix hope and aspiration with their analysis of a situation. For instance, it has been my assessment that the Fed is itching to cut rates in order to keep unemployment at bay. Economists at the Fed have evolved from "inflation hawks" from four decades ago to socio-political economists who tend to view things from a perspective of helping people as well as maintaining the political status quo. That's not wrong. But, it's different than during the last big inflation battle of the 1970s and into the early 1980s.

Then, there are economists in the private sector who mostly work for institutions that have benefitted massively from the low to zero interest rates of the decade leading up to the Pandemic. It might be natural to hope for a return of the good ole days and highlight every possible silver lining that would bolster the case for declining inflation and, with that, a reduction in interest rates. Lower rates often push markets higher and increase new share issues and mergers which generate fees. A private sector economist who persists in looking at things in a purely objective light might be seen as a rogue, or as excessively contrarian and not very helpful in contributing to the investment industry hype-machine 😊.

When economists look at inflation, they will tend to highlight the annual growth rate. As mentioned, for the U.S., that's 3.0%. Wage growth in services has been close to that. So, those economists might conclude that there isn't much to complain about and that consumers are just being grumpy. And, compared to the recent peak of U.S. annual inflation growth of two years ago at 9.1%, people should be happy. Right? (**Chart 1**).

However, consumers have felt the cumulative brunt of rising prices for four and a half years now. This "3.0%" business is not going to resonate much when the prices for the things that we need for living have now risen over 22% in total since the beginning of the decade (**Chart 2**).

Often, big-ticket consumer purchases are infrequent. For instance, I bought my last car in 2019. My next car purchase will likely be a shock to the system. Economists chattering about inflation only being at 3% won't likely reduce my trauma by much!

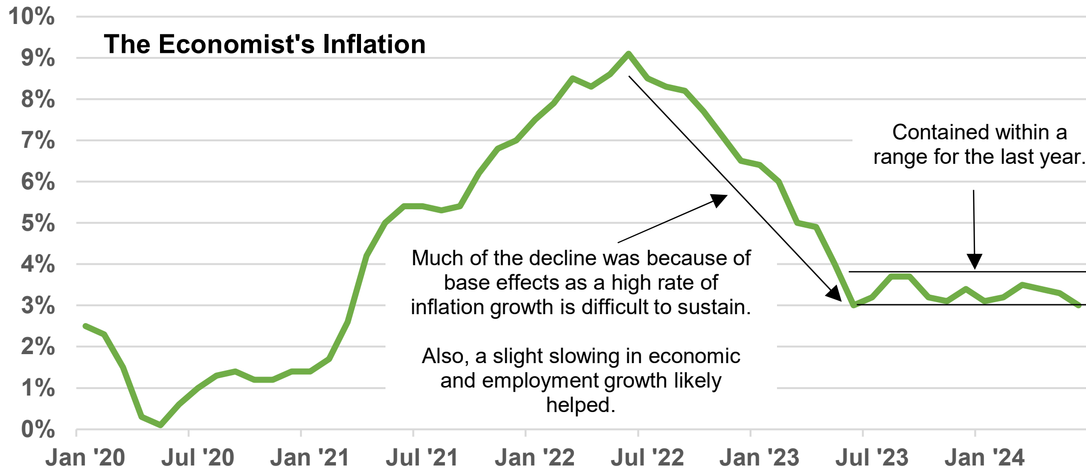
Consumers will often look at the increase in prices of things that they bought a few years in the past.

Consumer frustration can quickly materialize when rising prices impact the household budget.

Consumers don't tend to be sympathetic to economic arguments based on seemingly arcane statistics.

Chart 1:

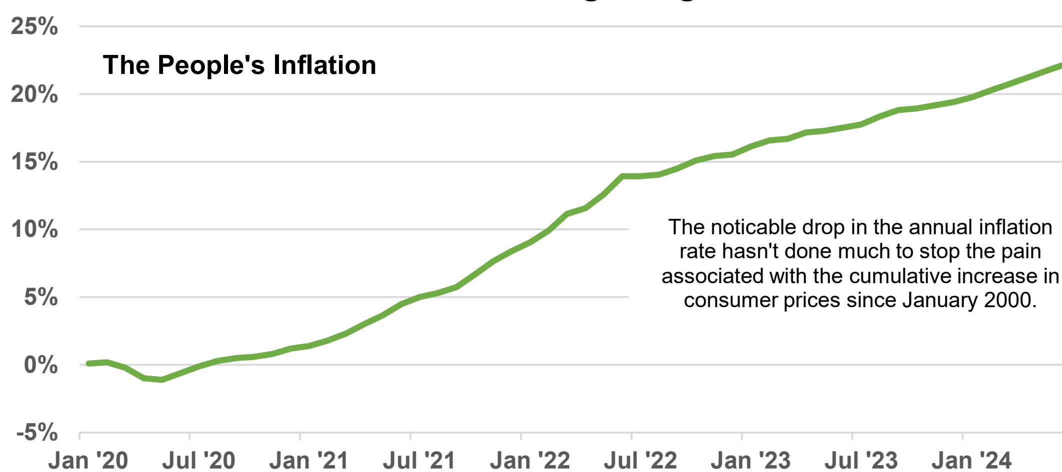
U.S. Annual Inflation Growth Since the Beginning of the Decade



Source: Bloomberg Finance L.P. & the U.S. Bureau of Labor Stastistics of July 16, 2024

Chart 2:

Cumulative U.S. Inflation Since the Beginning of the Decade



Source: Bloomberg Finance L.P. as of July 16, 2024

Looking at the annual inflation growth rate, one could make an argument that we are nearing the end of this inflationary cycle. The current rate is well below peak and some of the components underlying the topline inflation number appear to be moderating. Perhaps we can give it a year and consumers will be in a better mood.

That is an unlikely scenario for a number of reasons.

Unless wages rise appreciably, or we get actual deflation, it could be a while before consumers feel that they are not being swamped by increases in the cost of living.

First, for consumers to feel better, one of two things may be needed. One would be continuing wage gains in order to keep up with the cumulative inflation since the beginning of the decade. Wage earners generally have more negotiating power than they had in the previous decade, but corporate profit margins are beginning to narrow. Even if companies wanted to give raises, they just may not be able to. After all, companies are impacted by inflation as well and their non-labour costs of doing business have risen about as much as consumer prices have. Plus, in Canada, taxes are generally higher than they were compared to the beginning of the decade. Finally, wage gains themselves tend to be inflationary as we learned from the 1970s. Wage-Push Inflation is a feedback loop where higher wage costs need to be factored into retail pricing for goods and services. As a result, one might get a wage gain, but the cost of it is eventually leads to higher prices which cancels off that gain. That may not be enough to reduce the prevailing consumer grumpiness.

The second thing that would help to quell discontent would be a reduction in prices across the board. There are always niche areas where prices move down because of excess inventory (supply), obsolescence, changing trends, or lack of demand. But, overall reductions in the Consumer Price Index are very rare. This is called deflation. If that is what people are hoping for, they are unlikely to get it.

Thirdly, in the background, the significant factors that contribute to inflation are still lurking. Restaurants, shopping malls, sports & entertainment events are still jammed relative to a decade ago when things were already busy. Perpetual "road-cone zones" and contruction activity is running full-tilt. Infrasctruture costs are skyrockting (see water treatment plants in B.C.!). Airports are full, traffic is continually heavy (regardless of time of day or season), real estate and rents in North America are slowly trending up again (although B.C. has levelled out a little). And government spending spigots are still wide open relatively to the past (witness the growth in the public sector over the last decade).

Finally, when the annual inflation rate falls to lower levels, the statistic becomes vulnerable to a base effect shock. Global oil prices are within toughing distance of two-year highs. When every thing is just right, it doesn't take much of a bump in the night to throw a wrench into that annual inflation growth number that economists like to quote.

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 in the model portfolios during June.

The asset allocations and the securities in the model portfolios remained unchanged in June.

June's results were enhanced by gains in U.S. stocks driven primarily by hopes of interest rate cuts.

Most of the octane for the model portfolios came from the exposure to U.S. stocks. With a belief that earnings will hold up for the stocks that have done the best, and that the U.S. Federal Reserve (the Fed) will cut interest rates, investors were encouraged to run ahead of things and buy shares.

The prospect of interest rate cuts also helped gold.

Gold was also a notable contributor to portfolio results. However, again, this was in anticipation of Fed rate cuts which would potentially hurt the U.S. dollar and make gold look a little more attractive when compared to yield-generating investments. That said, if rate cuts come later than anticipated, gold may give back some of those short-term gains. I have gold in the portfolio primarily as a hedge against the loss in purchasing power over the longer-term, so the shorter-term fluctuations don't tend to get much of my attention.

[1] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of July 16, 2024. 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.

Going forward, I would expect most of the market's focus to be on the probability of those expected Fed rate cuts. Current implied probability using interest rate futures contracts pegs a 100% chance of a 0.25% cut on September 18th, and then potentially two more 0.25% rate cuts before the end of the year.[2] If it turns out that not *all* of those cuts are eminent, then the markets might need to manage some disappointment.

Those cuts are likely going to need to occur in order to keep the markets satisfied.

As far as vulnerability, it might be the AI-related stocks that have led the charge that could face most of the adversity in a correction induced by a lack of rate cuts. The rest of the stock market has not participated much in recent rallies and their valuations are not too stretched relative to history.

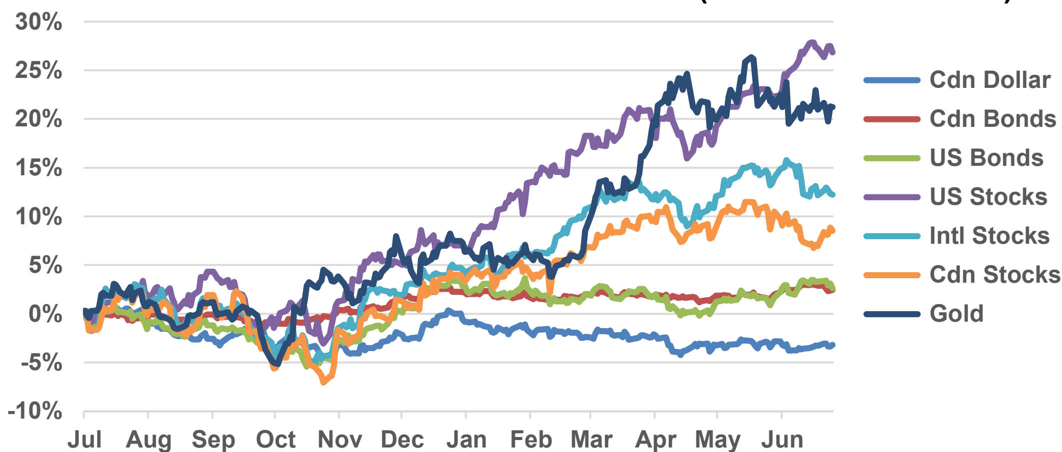
However, if we get a correction because of a delay in rate cuts, stocks that have done the best may be the most vulnerable. Many sectors have not participated much in the upswing and may not be that exposed to a selloff.

There is an expectation that the Bank of Canada will cut a number of times before the end of the year. They may be a little more latitude for Canada to do so given a more sluggish economy relative the U.S., less inflationary pressure, and a lack of productivity. However, if they do cut and the U.S. Fed feels that it needs to stay put, there could be downward pressure on the Canadian dollar when investors consider the higher relative yields they could earn on U.S. government securities.

The Bank of Canada is also expected to cut rates which could stress the Canadian dollar.

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 July 1, 2023 to June 30, 2024

[2] Source: Bloomberg Finance L.P. as of July 16, 2024
[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. Global Geopolitics	Significant	Negative
2. Canadian Federal Industrial Policy	Moderate	Negative
5. Inflation (Portfolio Impact)	Moderate	Positive
3. China's Economic Growth	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
7. Short-term U.S. Interest Rates	Medium	Negative
6. U.S. Fiscal Spending Stimulus	Medium	Positive
8. Long-term U.S. Interest Rates	Medium	Negative
9. Global Trade Wars	Medium	Negative
10. Canada's Economic Growth	Light	Positive

[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 July 16, 2024.

The information contained herein has been provided by Mark Jasayko, Senior Portfolio Manager and Senior Investment Advisor, TD Wealth Private Investment Advice, and is for information purposes only. The information has been drawn from sources believed to be reliable. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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TD Wealth Private Investment Advice

Thank you from The Charter Group at TD Wealth

Thank you to our clients and community for voting The Charter Group, your favorite for Investment Management and Financial Planning in Langley for the fourth year in a row.

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