THOUGHTS FROM HOME

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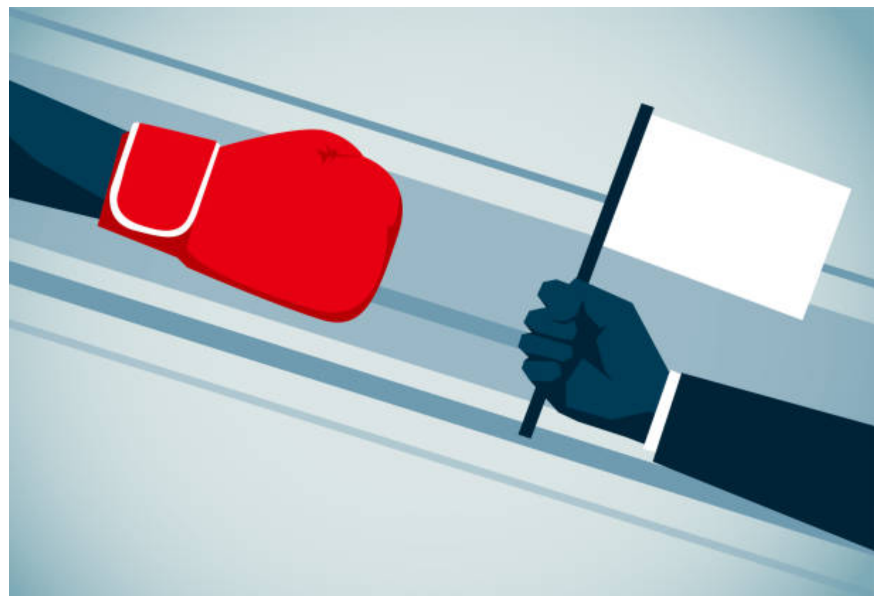

War, Patience and Time

"The two most powerful warriors are patience and time."
-Leo Tolstoy

Tolstoy's epic novel "War and Peace" is a profound exploration of humanity in conflict, both in war and at home. One of the philosophical centre points of the novel is that great historical events are the result of many smaller events driven by the thousands of individuals involved, rather than any

individual leader. This wisdom is as true today as when Tolstoy first proposed it in 1865. This month, we will consider two wars: the Ukrainian crisis and the global battle with inflation, as they relate to our investment outlook and how patience and time can help inform our perspective.

The Ukraine remains the focus of global attention. As the conflict continues into its second month, it seems there will not be an early resolution, either through combat or sanctions. In the very short term, stock markets have begun to recover as conviction mounts that UN forces will not directly intervene. Patience and time will be essential for successful investing with this market backdrop. The longer the conflict continues, the longer we will have elevated commodity inflation, as Russia is a major exporter of several key commodities such as oil, gas, fertilizer and wheat. Their exports have already been severely reduced by either sanctions or simply reluctance to deal with the current Russian regime. Given the level of damage already sustained by the Ukraine, it seems more likely that sanctions against Russia will remain in place even after the war has ended. The great investment temptation here is to significantly add to commodity based investments to hedge the portfolio's investment risk. The problem with taking that action now is that commodity prices have already shot higher and chasing them before the Ukraine is solved will result in overpaying. Nor is the solution selling at this time as we believe the inflationary commodity cycle has a couple of years to run, all be it at somewhat lower, post war prices. Fortunately, the portfolio already has exposure to pipelines, oil, gas and iron ore which we believe will serve us well. We will look to opportunistically add to these positions as post war market conditions dictate. One potential fly in the ointment is the Covid outbreak in China. China has a zero Covid policy and does not hesitate to shut down major cities to control outbreaks. This most recently happened in Shanghai, which immediately caused oil prices to drop 4%. Any significant reduction in Chinese demand would lead to commodity price reductions but we would view this as temporary. Commodity prices are expected to remain elevated until either demand is reduced or supply increased. However, the China Covid situation could add further short term volatility.

The fight against inflation is also a problematic battle which has been further complicated by the Ukrainian conflict. After years of underinvestment due to the global push for greener energy alternatives, oil and gas prices have risen to their highest levels in the past 10 years from their peak Covid lows and have helped push inflation to levels unseen since the 1990s at 5.7% in Canada. In the U.S., inflation is running at 7.9%, the highest since 1982.

The U.S. Federal Reserve is trying to lead the fight by raising interest rates like former Fed chairman Paul Volcker did in the 1980s when he was fighting monetary inflation. This is designed to raise the cost of borrowing so that economic growth will ease, reducing the demand for goods and therefore inflation. This theory worked for Volcker when the entire Baby Boom generation was borrowing at the same time. In 2022, we believe this approach is likely to fail. Interest rates have been in the 0-2% range since 2008. Interest rates remained low because the money supply was much higher than demand and nothing has changed globally in that regard. As a result of Covid, many households saved record amounts simply due to travel restrictions. A good portion of those savings was redirected to home renovations and consumer purchases which helped to push commodity prices quickly higher. Many people are making these purchases through either savings or investment gains and no amount of interest rate increases will stop them. The terrible

irony here is that by raising interest rates, the Federal Reserve will be disproportionately hurting lower income households and actually raising inflation for those with mortgages, as housing costs are a key component of the Consumer Price Index. The good news is that this excess demand will eventually peter out as either costs become too high or demand is satisfied. This situation has a similar feel to the last bout of inflation in 1999 when the fear of Y2K sent computer equipment prices soaring as everyone replaced all their hardware. By December 31st, all the demand had been met and we went into recession in 2000 until demand normalized again. This time the situation is different as unemployment remains low and consumer demand is still robust. We expect more demand to shift to travel and leisure in the coming months which will help but this round of inflation will only come down once consumer demand is satisfied and/or supply rises to meet demand.

The U.S. bond market is already showing us the signs of how the interest rate strategy is failing. As of today, the spread between the 2 year and 10 year U.S. Treasury bond was down to 2 basis points versus 25 basis points last month, with the 2 year bond yield shooting higher while the rest of the yield curve stayed relatively flat. Even more telling is the 2-30 year spread which is only 12 basis points and the 5 year bond yield is 0.11% higher than the 10 year, showing us that the yield curve is not only flattening but beginning to invert. An inverted yield curve, where short term bond yields are higher than longer term rates, typically indicates a pending recession but this still looks to be a couple of years off, given the current global economic momentum. The European Union is largely handcuffed from raising rates for now as they scramble to rearrange their trade deals away from Russia and manage with the massive influx of Ukrainian refugees. The good news for stocks is that as expectations for the number of future U.S. interest rate increases declines, the rally in growth investments should continue and we expect our technology holdings to do well.

All this global uncertainty is actually good news for the Canadian economy. As Canada produces many of the same commodities as Russia and we have already begun to experience increased global demand.

Neither the Ukrainian conflict nor global inflation will resolve quickly. Patience and time will see these situations come to an end and there will be investable opportunities along the way. We can live with some inflation but let's hope the actions of millions of Ukrainians will bring us to a swift and peaceful conclusion soon. Until next month, keep your guard up against Covid and stay healthy.

As always, questions, comments, concerns and feedback are always welcome.

Yours truly,

Trevor, Walter and the Cooper Wealth Management team

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