



THOUGHTS FROM HOME

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Inflation, Recession and the Federal Reserve

“Courage taught me no matter how bad a crisis gets, any sound investment will eventually pay off.”

- Carlos Slim Helu, Billionaire philanthropist

Carlos Slim Helu began building his diverse multi-billion dollar empire in the 1960's but many of his most successful acquisitions occurred in the inflationary 1980's when he was able to buy a

diverse portfolio of businesses as the global economy was at a low point. His courage to invest allowed him to build a net worth over \$60 billion. The current global inflationary situation, while not as severe as the 1980's, presents investors with both challenges and opportunities. This month, we will explore inflation, the market's fear of recession and the actions of the Federal Reserve to better inform us of what lies ahead.

August began on a positive note with equity values rising and fears of inflation easing. However, at the annual Jackson Hole economic summit, U.S. Federal Reserve Chairman Powell sent a firm message that the Fed will continue to raise interest rates until inflation is back down to their 2% target. This raised concern about future earnings growth and sent markets lower for the month. The market was looking for Chairman Powell to soften his position on rate increases but his remarks left the market worried that they will raise rates too high and cause a recession. His words were especially surprising as there is ample evidence that inflation is coming down. The U.S. driving season ended on Labour Day which will reduce gasoline demand and allow already declining prices to fall further, as supply also increases.

Another key inflationary factor is consumer demand. This has returned to steady pre-Covid levels thereby reducing supply concerns. Combined with the overstocked inventory levels many retailers have reported, it is reasonable to expect the price of consumer goods to trend lower. Food inflation should also begin improving as over four million tons of Ukrainian wheat has been shipped with more to come, despite the continuing war with Russia.

The common denominator to both food and goods inflation is shipping costs. At the height of demand in 2021, it cost over \$10,000 U.S. to ship a 40 ft container. In February 2022, it cost \$9,477 U.S. on average according to the Global Freight Rate Index. In August, the rate was down to \$5,986 U.S., a drop of over 35% or 5% per month for the last seven months. While the absolute cost of shipping remains high, the strong downward trend, combined with slowing goods demand, is an encouraging trend and we should see prices continue to fall over time as global supply and demand come back into balance. We expect these lower numbers to be reflected in the U.S. Consumer Price Index for August to be released on September 13th and the Personal Consumption Expenditures index on September 30th. As these numbers move lower, the expectations for fewer and smaller Fed rate increases will reduce, which should improve market conditions.

The bond market also took notice of the Fed's conviction, with the 2 year U.S. Treasury yield moving up to 3.44%, the 10 year to 3.21% and the 30 year to 3.35%. It is important to note the bond market still doesn't believe the Fed will exceed their 3.5% rate target, otherwise yields would be higher, but they are still pricing in a possible recession as shown by the inverted yield curve where the 2 year yield is higher than both the 10 and 30 year bonds. Earlier this week the Canadian government raised rates a further 75 basis to 3.25%, above their target rate of 3% and the highest level since April 2008. They also indicated they intend to keep raising rates until inflation is at 2%, just like the U.S. market. Despite the aggressive rate hike and tough talk, the Canadian bond market barely moved and our 10 year bond yield actually dropped 3 basis points to 3.16%. Our yield curve is also inverted and our bond market seems more concerned about a recession than further rate increases.

The U.S. push for higher rates has continued to send the U.S. dollar to fresh 20 year highs against most major currencies. The lone exception is the Canadian dollar, which has been boosted by our own rate increases as well as strong oil revenue. This will make imports cheaper and help tame inflation but may act as a drag on earnings for multi national companies.

Corporate profits will also remain a key driver of market prices. Forecasts for the coming quarters have come down but so far the main S&P 500 companies have exceeded expectations and we expect that trend to continue, as managers adjust to the current realities. In market conditions such as we have now, where short term emotional reactions are directing traffic, we can't lose sight of earnings just because share prices are down at the current moment.

As the sell off this year has been fuelled by the inflation/recession debate, let us now turn our attention to the possibility of a North American recession. Given the current evidence at hand, a recession seems unlikely in the near term. Since the Fed started raising U.S. rates, unemployment has actually fallen to 3.5% and the number of unfilled jobs has risen to over 11 million. It would take a massive negative swing in the economy for unemployment to rise in a meaningful way. Consumer spending is at 2019 levels and holding steady, with a notable shift from goods to services. The U.S. services industry Purchasing Managers Index, a key confidence measure for the sector, rose for the second straight month in August. Employment in the sector also rose and input costs, such as food and wages, dropped to their lowest level since January 2021. Hopefully, this is the initial evidence that the wage inflation we have experienced is more a one time upward adjustment than a persistent year over year increase. These are all positive signs of a world slowly but surely returning to normal.

The pandemic caused an unprecedented disruption to our personal, professional and investment lives. The effects are still being felt today but much like dropping a big rock in a lake, the ripples eventually fade away. Hopefully, the economic data will continue its rapid improvement so the Fed can stop dropping rocks in our investment lake.

As Carlos Slim Helu reminds us, it is a time of not only for courage but also conviction. We own sound companies with solid earnings, strong free cash flow and excellent management. Bad times do end and good investments will prevail. Remember that true recessions occur when there is a shortage of money, not with the excessive liquidity we see in the market today. Until next month, we wish you continued health and happiness.

As always, questions, comments, concerns, thoughts and feedback are always appreciated.

Yours truly,

Trevor, Walter and the Cooper Wealth Management team

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