Money Never Sleeps

The newsletter for the informed investor

Wealth Management
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Vito Finucci, B.Comm., CIM, FCSI
Senior Portfolio Manager
& Investment Advisor
519-675-2011
vito.finucci@rbc.com

Eric Janitis, CIM
Senior Portfolio Manager
& Investment Advisor

Jodie Fuller
Associate Advisor

Sarah Smith, CIM, PFP
Associate Advisor

Jessica Basacco
Administrative Assistant

Gary Weatherup, CFP
Associate Advisor
& Financial Planner

Lindsey Rideout
Administrative Assistant

Sherry Di Loreto
Associate Advisor

Fax: 519-675-2020
www.fjwealthgroup.com

RBC Dominion Securities
148 Fullarton St., Suite 1900
London, ON N6A 5P3

Inflation Bifurcation?

What type of "flation" now?

Source: Hedgeye

> "Central bankers always try to avoid their last big mistake. So every time there's the threat of a contraction in the economy, they'll overstimulate the economy by printing too much money. The result will be a rising roller coaster of inflation, with each high and low being higher than the preceding one." – Economist Milton Friedman

In the April 2020 edition of this post, we asked the question: What kind of "flation" would we see post-lockdowns? We thought we'd see inflation spike sharply due to the massive stimulus delivered combined with the effect of the lockdowns and supply chains being destroyed (which it did), and then explored the possibility of "stagflation" kicking in thereafter (i.e. higher inflation with no or slow economic growth, job losses, etc). That looks like it's still in play.

Now two years later, with rampant inflation the prominent topic on every business broadcast, we thought it would be a good idea to revisit the topic since much of future Central Bank policy revolves around that question.

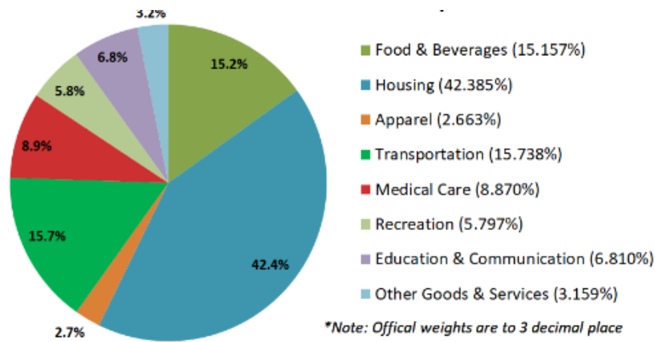
A couple of weeks ago, the U.S. government released the latest inflation report for November, and it confirmed that the U.S. is now experiencing its worst bout of inflation in over 40 years. Readers will recall how ad infinitum Federal Reserve Chair Jerome Powell repeated that inflation was "transitory"? Well, that is now out the window and Powell has publicly conceded that the word "transitory" should be retired. Now it looks like the Fed may ramp up its tapering of asset purchases (i.e. the Fed will still be buying assets, just simply reducing their bond purchases at a faster pace than before).

(Continued on page 2)

Looking at the numbers, November's headline inflation increased by +0.78%. That is actually a slight decrease from October's rate of +0.94%. For its part, the Federal Reserve put a lot of the blame on the supply chain crisis. In other words, the Fed says it's not the fault of the Fed.

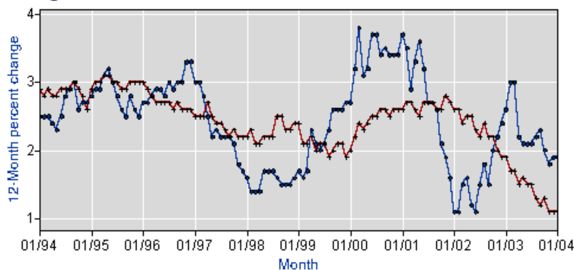
Over the past year, consumer prices in the U.S. have increased by 6.88%. Anyone who has left their home at all knows that the actual number is much higher in reality, but given how the consumer price index (CPI) is calculated, a lot of the day-to-day items are excluded in the measurement. So yes, gas prices are up, lumber is up, food costs are up, services are up – you name it – and by more than 7%.

Consumer Price Index Components*



(Source: Yahoo Finance https://finance.yahoo.com/news/foolish-why-inflation-rate-won-160000493.html)

Consumer Price Index for all Urban Consumers: U.S. City Average, All Items and All Items Less Food and Energy



(Source: Bureau of Labor Statistics (BLS) http://igmlnet.uohyd.ac.in:8000/InfoUSA/trade/whstats/price2.htm)

More importantly, in relation to our daily lives: this means that if you have a $1 million portfolio, inflation is eating up $68,800 every year. That's the highest year-over-year figure since June 1982 (which is also exactly around when I started working for RBC in finance).

Inflation has an unusual impact on day-to-day business, and further, corporate earnings, which in turn has an impact on stocks. Not all earnings are the same, and inflation exacts a heavy toll on asset-heavy businesses. Companies with high assets relative to their profits tend to report more scattered earnings. Inflation has an impact similar to putting a magnet near a compass – everything gets thrown off. Historically, stocks have not performed well during periods of high inflation. Investors who lived through the 1970s can certainly attest to that. During the entire decade of the 1970s, the Dow Jones gained a grand total of – get this – 38 points (no, it's not a typo).

While inflation has been tough on stocks, there's only one thing worse for stocks, and that's deflation. What the market truly loves is low, consistent inflation. In other words, pretty much what we've had over the past 30 years, less about 12 months in that entire period. However, the problem isn't inflation per se. The main threat to stocks is really the threat from bonds, for as rates rise during inflationary periods, bonds become more attractive. Inflation doesn't impact the stock market directly. Instead, inflation hammers the bond market and that throws a wrench into the gears of the stock market. Higher bond yields are higher competition for stocks.

Source: Vito's currency note collection

The bond market is already pricing in the rate increase. Fed futures markets now see three rate hikes in the coming year, which is a sudden change from only a few months ago. On June 3, 2021, the two-year U.S. treasury was yielding just 0.09%. As I type this, it's .80%. Yes, that's still very low historically, but it's a full point over where it was just six months ago. Over the same time frame, the three-year yield has gone from 0.16% to 1.03%.

At the same time that all this is going on, the government in the United States has never been larger or more intrusive. This makes economic forecasting and investing a balancing act between the "supply side" of new technology and the "demand side" of government intervention. Case in point is the Federal Reserve. The markets are concerned about a Fed "policy error," which has typically ended most cycles. The Fed has been far less concerned than it should have been about falling behind the curve on inflation. That may have been the first policy error, when last year, the Fed

didn't begin to reduce quantitative easing (QE) and prepare markets for gradual rate increases. In addition, if the "Build Back Better" eventually gets passed by the U.S. Congress, it will add another $2 trillion or so in stimulus, which is once again inflationary.

The latest COVID-19 virus strain, Omicron (and perhaps those that will follow), is just the latest potential risk that could extend the pandemic and further add to disruptions we have already witnessed in global supply chains. This could lead to even higher prices and inflation.

Source: Vito's currency note collection

Governments around the world responded to COVID-19 in many different ways. Many provided financial support to workers who lost pay due to the pandemic. The U.S. created three peaks that correspond to stimulus payments to each American (except for certain high-income earners): in April 2020 ($1,200 per person), January 2021 ($600) and March 2021 ($1,400). Those injections had giant effects on U.S. inflation, as it increased the demand side of the equation. The lockdowns caused manufacturers around the globe to shut down facilities and / or drastically reduce output, or the supply side. At the same time, the government payments provided enormous amounts of money to people with a high propensity to spend it on consumer goods. That was not an unintended consequence, it was the intent.

That combo created huge distortions, and for a while, we had demand normalizing with producers trying to catch up. One way they've done it is by increasing prices and passing on any price increases. And guess what? It's become a vicious spiral that continues into 2022.

Here's the rub though. Central bank policies don't help supply chain issues. A semiconductor company making mid-level chips is not going to spend billions right now investing in a new plan for old technology. The same applies for many other industries.

As a result, I think it is going to take a long time to work through the supply chain issues. For some sectors, it will be later in 2022, for others, I think it could be 2023 or beyond.

In any case, it adds to the inflation problem. Now layer on top of that a tightening labour market because fewer workers are available or wanting to work. Each and every day, the biggest complaint I hear from job creators is this: "I can't find people who want to work." If you get a wage-spiral as result, that will only exacerbate inflation even more.

Source: Vito's currency note collection

So where is all this going?

I think the year 2022 could be a year of inflation bifurcation, where some products and services will continue to rise at a rapid pace while some even decline. But for the most part, it will be the former. Some businesses are trying to make up for two tough years under lockdowns.

Will high inflation last into 2022? Unfortunately, I think so. If you look at the early 1980s, even with a determined Fed under Paul Volcker raising rates to 20%, it still took quite a bit of time to get inflation under control. If this Fed is behind the curve, then what? Add into the mix that there is a mid-term Congressional election in November. I don't think that the recently reappointed Fed Chair Powell will want to push the U.S. economy into recession as they head into an election, so my guess is that he will err on the side of caution and won't increase interest rates as much as the market is building in at the moment.

Loose monetary policies and continued government stimulus, combined with the supply chain breakdowns, pushed prices much higher in 2021. Most of those conditions are still in place.

Note as well, that starting this April, the year-over-year comparisons will start to look better and politicians will likely spin those. It won't mean actual inflation is any lower, of course, just that it is not growing as fast. Moreover, quite a bit of the stimulus will disappear in the next few months, as tapering picks up. I would suspect private industry (like credit cards and other lenders) will raise rates long before the Fed actually raises rates. That will have an impact on some consumers.

I can't see inflation heading back to the 2% range anytime soon, and if it does, I would guess it's because we are in a severe recession, which is not optimal. I would guess at some point in 2022 that Fed Chair Powell will face a dilemma, to choose between either continuing to fight the soaring inflation that affects the majority of Americans, or choosing to worry more about what stock prices are doing. The correct longer-term answer should be the former, but if you look at Powell's track record, every time the market has had a hiccup under his watch, he's gone dovish pretty quickly.

We will continue to do our best to stay on top of this rapidly changing and challenging environment. In addition, we would also like to use this opportunity to wish everyone the best for 2022 – let's hope it gets its act together sooner than later.

Be well, V

Source: Vito's currency note collection

P.S. The photos inserted in this edition are one of my latest auction purchases: bank notes from the 1920–1921 hyperinflation period in Germany. These were some of the notes that a working-class person would have carried in order to purchase basic goods like bread, meat, and coal to heat their homes – the prices of all of which were soaring. In retrospect, the chaotic hyperinflationary period was the natural result of years of war, revolution, debt and instability. The German economy began to buckle under the weight of these external and internal pressures. As the first repayments were made to the Allies in the early 1920s, the value of the German mark sank drastically, and a period of hyperinflation began. In early 1922, 160 German marks was equivalent to one U.S. dollar. By November of 1923, the currency would depreciate to 4,200,000,000,000 marks to one U.S. dollar. Not a typo.

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