The Navigator

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Welcome Back

It has been some time since we published our last newsletter about the economy and financial markets. Keeping up with events and responding for clients kept us busier than usual, though we wouldn't have it any other way. We often wish we could record our conversations at the office, and with clients, to share them more broadly. Today we take a step in this direction as we've had some great questions and have documented our answers for this newsletter.

We've been steadily working to conduct our own research and improve client outcomes with discussions covering a range of topics from macro-economic outlooks to housing markets, monthly income, and financial planning discussions. If you have questions after reading this newsletter, we encourage you to ask us as we're more than happy to clarify our views about the current situation as they relate to your personal situation.

The global economy and financial markets have been hit by an incredible number of simultaneous external shocks in the past few years. We encourage readers to keep the impact these shocks are having on interest rates in the back of their mind. In our view, interest rates are the most significant determinant of assets values and are important for other economic metrics as well.

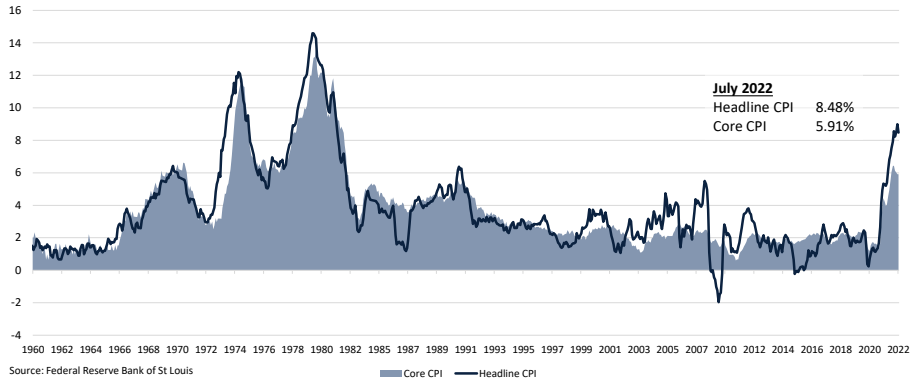
We begin with inflation because it is top-of-mind to most readers, and its trajectory will exert huge influence on the direction of interest rates and asset prices. We'll then discuss the implications of policy changes geared to fight inflation and how we anticipate these will impact the trajectory of the economy and asset prices.

To the Moon and Beyond!... Not so Fast

Those alive in 1964, when the above title was released, are old enough to have lived through an inflationary period like we are experiencing today; for many others, this is uncharted territory and something read about in textbooks. Since early 2021, after a long period of stable inflation around 2% per year and tending to the downside, inflation has risen to levels not seen since Pierre Trudeau was Prime Minister and Harrison Ford was Indiana Jones in the Raiders of the Lost Ark (see Chart 1 overleaf).

While we feel and sympathize with the pain of large prices increases across key items like food, housing (prices and rents), and energy, we do not believe inflation is running out of control and we will see a reprieve of rising prices, so no need to dust off the VHS machines just yet. This does not

US Core CPI and Headline CPI (1960 – Present)

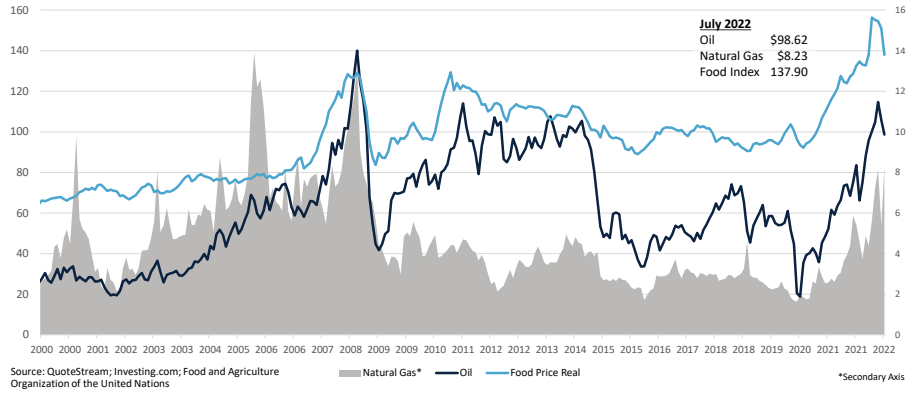


mean we're out of the woods with high prices for essential items because we believe relative price adjustments have occurred, and we may be at the beginning with higher food prices (see Chart 2 below). Inflation is a continuous process of rising prices; however, we do not believe the ingredients are there for a wage-price spiral to continue lifting prices.

The most important reason for our belief that a wage-price spiral won't continue in the short-term is authorities in the US and Canada (and globally, ex-China & Japan) are rapidly tightening both monetary and fiscal policy to slow inflation. Because circumstances outside their control are hampering supply chains, they are forced to attack inflation by reducing the demand side of the economy. So far, this has taken the form of interest rate increases and liquidity reductions on the monetary policy side and terminating government transfers on the fiscal policy side (though tax increases may also be forthcoming).

We believe demand destruction is well underway as highly levered consumers are sensitive to higher interest costs, forcing them to reduce spending in other areas, while facing steep price increases for food and energy. The desire to borrow and pull consumption forward from future periods is reduced by rising interest rates. Debt may be used to afford staples, but the outlook for discretionary consumer spending does not look good in our view.

Crude Oil, Natural Gas & FAO Food Index (2000 – Present)



Second, from a longer-term perspective, the demographic dynamics that challenged growth prior to the pandemic and war in Europe have advanced, as have the consequences of this senseless war. Together, these suggest economic growth will be modest at best, absent continued shots of stimulus and debt accumulation. Today's high-debt levels will take years to work off in a stagnant

economy, restraining consumers until wages grow or asset values and risk appetite recover.

These factors taken together suggest to us prices will moderate and we will return to our previous concerns about sluggish economic growth and inflation, though not in certain key areas like food and energy. If there is a bright side to the economic pain of higher interest rates, it is that monetary authorities have bought themselves some room to stimulate later if they are successful at reducing inflation today. Tighter monetary policy and liquidity conditions may also restore some much-needed market discipline.

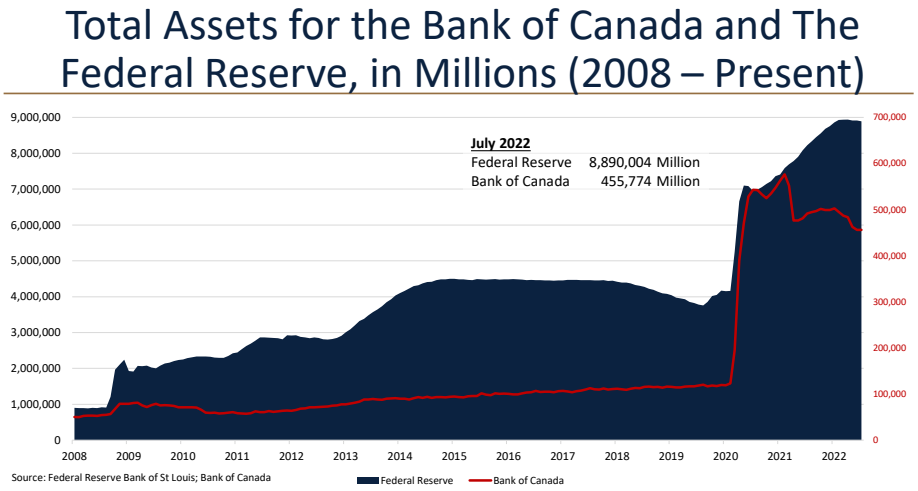
My Porridge is too Hot! Mine's Too Cold!

Being a central banker strikes us a challenging and stressful job! We believe inflation and unemployment are two main concerns of most political leaders -- letting either one run too hot or cold is a recipe for social unrest and losing power. And, unfortunately for central bankers, they take a lot of political flak for things they can't directly control, but if they get it right, they're canonized.

Many readers will recall coming out of the Financial Crisis in 2009, we had the opposite problem: persistently elevated unemployment, concerns about deflation (falling prices), and slow growth. The response was to cut the policy interest rate to zero. When this proved insufficient, the US Federal Reserve and the European Central bank initiated a quantitative easing (bond buying) program program to drive down longer-term interest rates (see chart below). As well explained by Ben Bernanke at the time, the objective was to drive up asset prices to stimulate the economy via the wealth effect – people spending more because they feel wealthier.

(We expect Ben Bernanke will be credited with saving the American economy from depression, much like Paul Volker was for slaying the inflation dragon in the early 1980s).

This policy continued for years as the economy remained weak and too-low inflation (not too high) was the issue. And while these policies did little to lift the consumer price index or wages, it was wildly successful in (re)inflating asset values. As ownership of financial assets is concentrated amongst the weatlhy, the inequality gap widened further and ate away at what was already deteriorating social



cohesion. Rising social unrest and few concerns about inflation prompted authorities to find ways do more to lift all boats, to "do whatever it takes" to borrow a line from Mario Draghi, the European Union central bank chair who is widely credited with saving the Eurozone in 2012.

The desire to improve growth and tackle inequality gave rise to much debate about Modern Monetary Theory: the use of both fiscal and monetary policy combined to stimulate growth in the absence of inflation. An example often considered was to provide every citizen with a basic income, have the government borrow the money to fund the program, and the central bank would purchase the bonds with newly printed money. While this was never implemented beyond isolated test markets, it was quickly deployed to ease the financial burden of COVID lockdowns.

If ultra-loose monetary policy is well equipped to inflate asset prices, its effects are too narrowly focused inside the banking system to deliver broad consumer price inflation, and its efficacy reduces as debt levels in the economy increase. However, if consumer price inflation is the objective, it appears that giving people money directly is exactly what is needed, especially when supply chains are in shock or prices of key commodities are rising.

Assuming authorities are successful at destroying demand sufficiently to reduce inflation and then become concerned about stimulating a moribund economy, we expect the non-inflationary speed limit of the economy has been reduced relative to the pre-pandemic/war period for all the reasons discussed above. While we expect spurts of stimulus induced growth, we do not abandon our low-growth-for-longer scenario favouring long-duration assets when purchased at reasonable prices.

Shocks to the System

The field of economics likes to use models to draw inferences about what may occur if something changes: for example, a rise in the price of oil. Sometimes, this is paired with a rise in the demand for oil at the same time. In this simple case, a rise in demand paired with a reduction in supply, and it's not too hard to understand why oil prices rose. If only it was this simple.

When you start adding multiple, simultaneous, shocks to demand and supply across many goods and services, it becomes very difficult to estimate the relative magnitude of each shock, and to understand the interplay between these shocks as consumers and producers adapt their behavior to respond. There are no simple models for understanding how the economy and our world will be different from here. While the probability of being wrong is elevated we've had many questions about our outlook, so will advance a few ideas here.

Disease

COVID-19 was a massive shock to many systems perhaps felt most acutely in supply chains and health care systems where massive vulnerabilities were exposed, creating shortages of goods and

people, and driving up prices. Consumers, unable to spend on services during a lockdown and having received stimulus cheques (needed or not), feasted on record low interest rates, expanded consumption, and bid up prices.

As work-from-home became common and human nesting instincts took over, demand for housing and related durable goods rose sharply, precisely when the ability of supply chains to respond was restricted, naturally leading to long delays, followed by rising prices as businesses competed for scarce labour, and responded to their own rising input costs. Small-town real estate markets were turned upside-down with locals priced out as big-city willingness-to-pay and incomes were brought to small towns (though this is rapidly reverting to trend). Intuitively, it made little sense to see soaring asset values while the outlook for the real economy was so dour.

COVID-19 served as a reality check for labour markets; workers in the service industry quickly realized when they were laid off that 1) they were not valued by their employers; and 2) wages they were receiving did not compensate adequately for the risks they were taking, especially when increased government benefits and other options became available. Upon the termination of government benefits, many had found other work, or started their own business, choosing not to return to their previous employment.

The result has been a significant shift in the available labour pool away from food and beverage, hotel, and other service-related businesses. As well, a general decline in the amount of labour available occurred as people took a hard look at whether they needed to work, and if so, what they were willing to do. Restaurants reduced their hours or shut all together due to staff shortages – we joke this is silent inflation, but it's apparent to us the supply of services falls well short of the demand, especially for health care.

A reduced labour pool in key services had less impact when COVID restrictions were in place and demand for services was reduced. When society opened back up with the introduction of relatively effective vaccines and a general sense that COVID is a cost of doing business, the supply of services, absent a large portion of its previous labour pool, has struggled to keep up with demand, resulting in rising wages and less product availability. This could of course change with another variant, though we expect broad lockdowns would be very difficult to achieve at this point.

Conflict

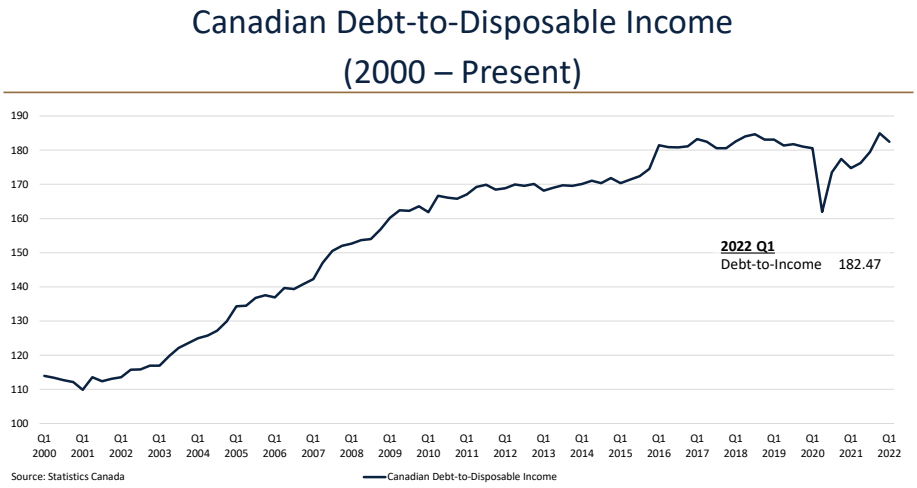
War is tragic and it pains us to see the needless loss of life as Ukraine defends itself from Russia's invasion. We expect the social and humanitarian implications of this conflict will be with us for years, as will the economic impacts. We continue to hope for a quick resolution to this conflict, but fear this will not be the case, and even if the immediate conflict ends, we expect geopolitical relations with Russia are altered for the foreseeable future, taking us to what we can only describe as a second edition of the Cold War. And this says nothing of Russia's potential alignment with China and the prospect of conflict over Taiwan.

From an economic perspective, war is inherently inflationary as resources, capital and labour are diverted from producing goods and services that can be usefully consumed, invested, or exported to other markets, and used to create destruction. Resources and productive goods and services are destroyed in battle, and the targets of military strikes (people and capital) are the very inputs required to produce goods in the future, thus impairing the future productive capacity of the economy. Ultimately, when resources are wasted, prices for key goods and services tend to rise and the overall standard of living declines.

Needs Vs. Wants

In an unpublished newsletter written in May 2021, before Russia invaded Ukraine, we discussed why some are apt to spend a lot more of their budget on their needs, instead of their wants, and that expectations overall will need to be reduced. At the time, our thinking revolved around the supply chain impacts of COVID-19 and the impacts of climate change on our economic well-being. Considering now the tragic events in Ukraine and prospect of a protracted conflict, we wish we had published the newsletter, and feel it's important to bring these points forward here.

To be sure, when supply chains are functioning properly and interest rates are zero (making money free), many can afford to satisfy their wants because their needs are well looked after. This was the case for many years coming out of the financial crisis as authorities seemed able to inject ever-larger doses of stimulus to maintain growth momentum in their economies. With rising house prices, those who couldn't keep up on wage growth alone, could rely on rising house values and equity withdrawals to support their consumption, as well as other forms of debt.



The debt-fueled growth model (see chart above) we've experienced for much of the last three decades relied on lower interest rates and relaxation of borrowing standards to facilitate continued debt accumulation and consumption growth. While this model had its shortcomings, rising inequality and wasteful consumption being the two that stand out to us, it did yield a long period of steady growth, stable inflation, and rising asset values. This was made possible as inflation remained at or near the Federal Reserve's target, largely due to the disinflationary effects of globalization.

As noted above, COVID-19 combined with conflict in Ukraine have shredded supply chains and significantly reduce the capacity of the global economy to seamlessly produce and move goods around the world. As recovering demand met hampered supply chains, the natural result was shortages of goods and services, followed by rising prices as businesses competed for labour and faced rising input costs for key productive inputs. Combined with soaring asset values, inflation expectations started drifting up after years of being well-anchored near the 2% target, prompting action from central bankers concerned with losing control of inflation after working so hard in the early 1980s to corral it.

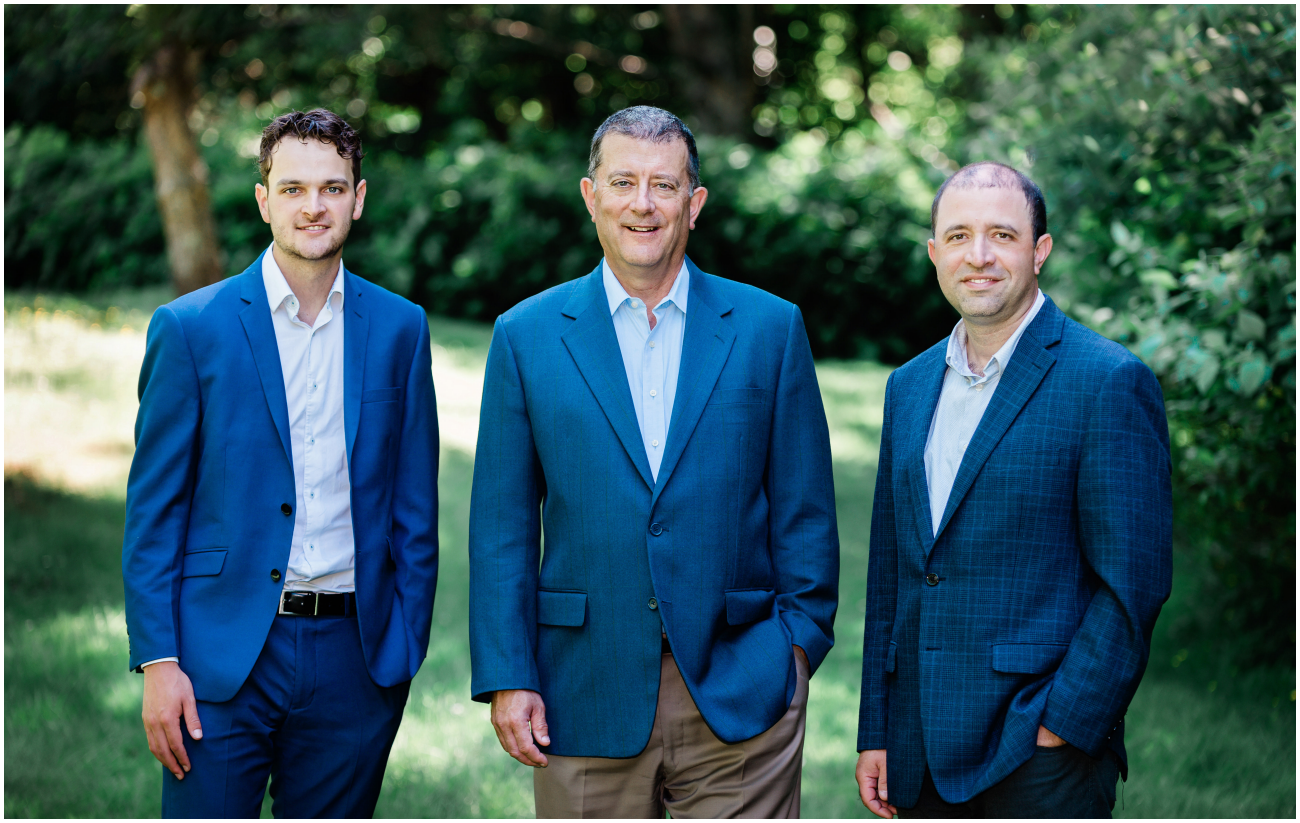
Concluding Thoughts

The outlook for the global economy remains fraught with risks – we remain concerned about a resurgence in COVID-19 and are obviously concerned about the continued conflict in Ukraine and the potential for it to spread. The impacts of climate change and the scope of the human response required to mitigate and adapt to its effects will be a massive undertaking, requiring many resources that could be used elsewhere. Lastly, when looking at aggregate debt levels, we are not overly well prepared to deal with these challenges and maintain the standard of living we've become accustomed to, absent a significant increase in global growth prospects.

Given our current starting point, we are sad to say our base case forecast is for a period of low growth, where people spend a larger portion of their resources meeting their needs, leaving less to meet their wants. In our current environment of rising interest rates and declining liquidity and asset prices, it would be no surprise to us to see a significant consumer led recession as households repair severely stretched balance sheets.

We accordingly maintain our defensive positioning which is characterized by elevated cash levels, defensive positioning in both fixed income and equity holdings, and a focus in areas we believe are in secular up-trends and well positioned to benefit from this outlook. We have been expecting a recession for the last few months, and evidence continues to suggest this to be the case, although nothing has been officially declared at this point. Readers should note that recessionary indicators are lagging; the worst is often over when the beginning is finally declared.

After six months of volatile and generally declining markets, we're unable to say with sufficient certainty if the worst is behind us, though we can say that asset prices in general have declined significantly from their peaks, offering better risk-adjusted returns and entry points. However, not all sectors have priced in a recession the same way, and caution continues to be warranted at this time.



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