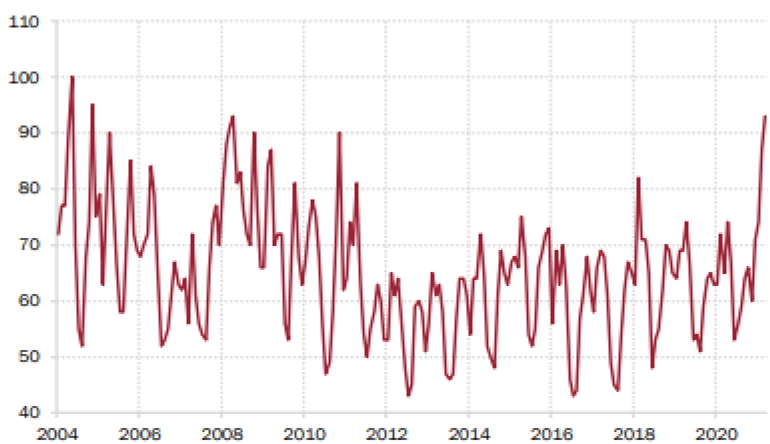
June 1, 2021

Is Inflation Here to Stay?

Investors can be fickle when it comes to topic obsession, but a persistent one over the last few months has been inflation. Inflation fears have picked up as a result of the jump in commodity prices and a recent CPI spike from economic reopening spending. Rising prices impact the cost of living and borrowing rates. This in turn affects asset prices and every other facet of the economy.

The debate is whether this inflation spike will be short term (transitory) or somewhat more longer lasting. Inflation, by definition, is not a one-off change in the price level by short term distortion, but more of a persistent acceleration in prices.

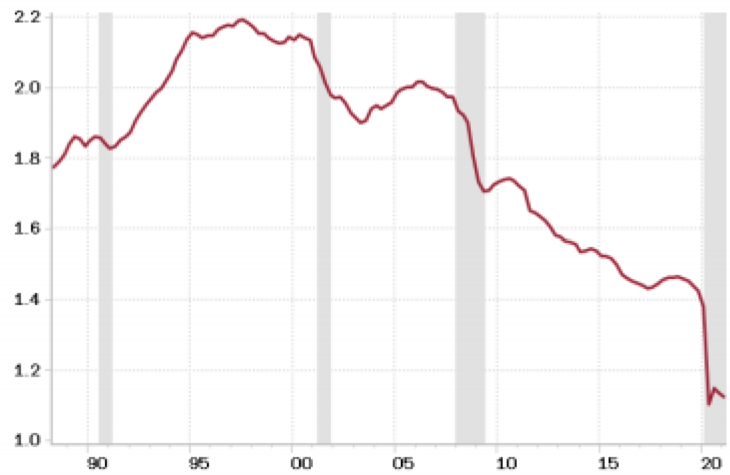
Google Searches for "Inflation"



Source: Google Trends

Historic levels of liquidity from monetary and fiscal stimulus have fueled concerns of a surge in money supply and, in turn, money velocity (M2). The velocity of money is the number of times one dollar is spent to buy goods and services per unit of time. If the velocity is increasing, then more transactions are occurring between individuals in the economy. Although stimulus has fueled the recent surge in money supply, money velocity(M2) remains very low, indicating a preference to saving vs spending.

M2 Money Velocity

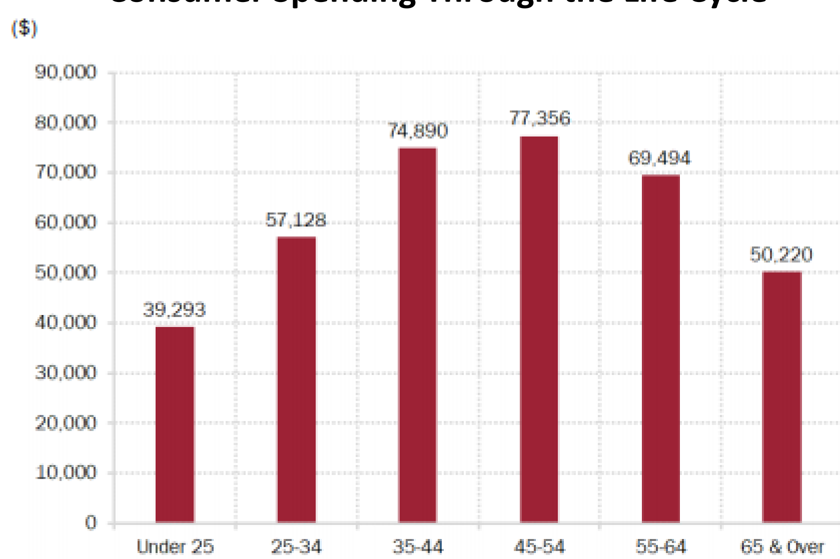


*Source: Haver Analytics *Shading Indicates Recession*

With each successive COVID19 recovery stimulus package, the portion actually spent by consumers has declined. The system appears to have broken down as money needs to find its way into the economy and turn over rapidly to generate inflation. From a long-term perspective, there has been little correlation in recent years between the level of debt in the economy and inflation. If velocity does not pick up it would lend credence to the view that the recent elevated inflation could indeed be "transitory"

A global natural disaster has the potential to profoundly impact supply and demand, causing huge disturbances. However, the impact is generally not permanent. The pandemic hasn't changed the secular disinflation fundamentals that have been around for decades. Much of the developed world's population is aging and the pace of technological change hasn't slowed. There is a well-documented correlation between age and level of consumer spending.

Consumer Spending Through the Life Cycle



Source: Haver Analytics

The consumer spending on durable goods is currently tracking over 20% of the pre-COVID19 levels, and it is hard to imagine that this hasn't added to the shortages of materials. We may see the so-called "pent down" demand as the economy reopens as nobody is building a second deck or a pool in their backyard, and this might provide a significant offset to the service sector boom. We expect some of this inflationary pressure to ease as fiscal stimulus wanes, pent up reopening demand subsides, and production in areas of shortage ramps up (eg semi-conductors, lumber etc.).

Another potent inflation killer is the excessive indebtedness. We will come out of the pandemic with a combined (government, business and household) debt of 350% of GDP (Source: IIF). Because the debt situation is so onerous, interest rates must stay extremely low to prevent the economic and financial system from collapsing.

There is truly nothing quite like a disruption caused by a pandemic. The initial shock hit demand more than supply, so we saw a temporary deflation shock to the economy. The same holds true for all the supply chain disruptions and the distortion we are seeing as a result of the economy reopening. We need to keep in mind that the economy only reopens once and many of the factors that are causing the inflationary jump could prove to be short-term in nature. With this we expect to see production expand and demand growth recede, and all the inflation chatter to die down.

Markets are likely to exhibit higher volatility as we move through this economic reopening phase. We will be assessing risk and position in order to proactively take advantage of opportunities that arise.

Sincerely,

Dwight Mann, CIM, B.Comm.
Senior Vice-President
Investment Advisor & Portfolio Manager
T: 604-643-7478 E: dmann@cgf.com

Jordan James, CIM, B.A.
Investment Advisor & Portfolio Manager
T: 604-643-7486 E:jjames@cgf.com

Ilia Nizker, CFA, B.Comm.
Associate Investment Advisor & Portfolio Manager
T: 604-643-7485 E: inizker@cgf.com