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October 2021 - Excerpt # 66

"Transitory" Inflation or "Inflationary" Transition

BMO Private Wealth

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Pierre's comments

"Transitory" Inflation or "Inflationary" Transition

September 15, 2021. What a great feeling, looking at our financial position and net worth nowadays! Other than COVID-impacted businesses in the travel and leisure-related industries, it seems that real estate and equity valuations have been growing at a record pace. We have written about the "mirage" that usually accompanies the early stages of inflation in previous letters, and the comfort zone that comes with it. Asset inflation can be triggered by a variety of conditions or events. Supply and demand are at the center of any price adjustment, but both can be impacted by the economic context.

Globalization set us on the path to the disinflationary period of the last 40 years (1981 – 2019), a consequence of lower production costs (technology and labor), increasing supply capacity (commercial treaties and agreements), and the enhancement of transportation and logistics. All the pieces of the puzzle were there to increase supply at a relatively low cost. As well, the softening inflationary pressures allowed for a gradual reduction of interest rates; this, in turn, facilitated financing at a lower cost and positively impacting growth and profit margins. In the past, we've shown that equity and real estate markets tend to perform better through extended cycles in a disinflationary environment as opposed to an inflationary cycle (see letter # 57 The Balancing Act April 2017 p.7-8).

The last inflationary era lasted 36 years, from 1946 to 1981. While the S&P 500 performed very well during that time, economic cycles were shorter and more erratic, as this environment was accompanied by rising interest rates – an alternative for investors wishing to diversify and secure capital. Using such a conservative investment strategy could be favorable since bond prices rise when interest rates correct downward to boost the economy, from time to time. In other words, the transition period we find ourselves in today allows us to benefit from asset inflation without fully feeling its nasty impact on the cost of living – at least not yet for those who own assets. So, are we in what we call a Goldilocks period, or the eye of the hurricane?

Is the mirage, the illusion, becoming a reality or will it fade?

The supply chain was disrupted by COVID-19 and also by geopolitical tensions, trade embargos and sanctions, worldwide pressure on wages, rising commodity prices, etc. Meanwhile, demand for consumer products shot up following the economic shutdown, bruising the travel and entertainment industries, and fueled by extremely low interest rates, government support and consumer's additional borrowing power thanks to rising asset values. The obvious combination of lower supply and increasing demand is now becoming a new reality for consumers, and workers are pushing for higher wages to compensate. We see this self-feeding phenomenon as an "inflationary" transition rather than "transitory" inflation. So, unless we fix the supply chain or we raise interest and mortgage rates, allowing extra savings to be used to service the debt and lower demand, inflation will feed on itself.

Some of you (who are at least my age) will remember the "Hygrade" slogan: "Fresher because more people eat them. More people eat them because they're fresher."

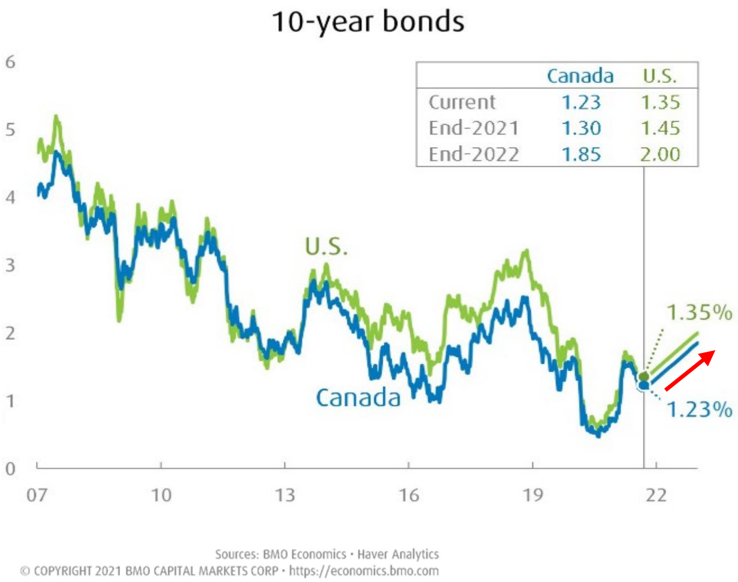
Well, the higher the wages, the higher the cost of production. The higher the cost of production, the higher the wages especially during an economic expansion fueled by government and Central Bank stimulus and low unemployment rate.

This phenomenon of "self-feeding" is validated by the length of these inflationary and disinflationary cycles over 36 and 40 years, respectively.

A lack of alternative investments

The shortfall in affordable housing and the high valuations on equity markets are proof that an unprecedented amount of capital was taken away from another asset class – the bond market. Chart 1 (10-yr. U.S. bond yields at 1.35%, 10-yr. CDN bond yields at 1.23% as of September 15th).

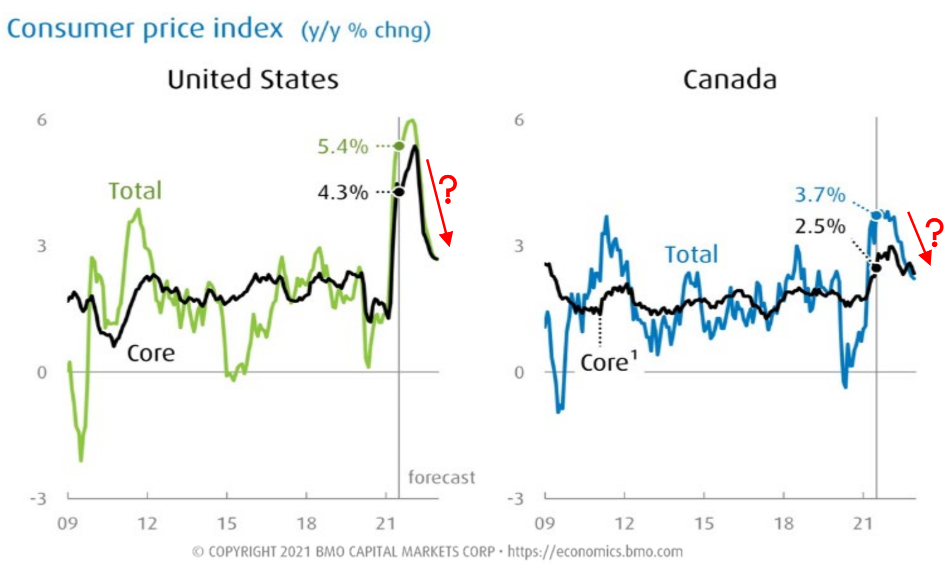
Chart 1



Negative interest rates in many G20 countries and the extremely low rates in North American, combined with central banks' bond purchase programs to maintain interest rates "artificially" low, basically pushed investors to concentrate their savings in two asset classes – equities and real estate. This man-made intervention was not supposed to last 13 years after, in other words, since the 2008 financial crisis. The pandemic, however, rekindled quantitative easing (QE) programs (money printing), and also caused the economy (or those who control it) to become addicted to them. Interfering with natural market forces can be like defying gravity, just like climate change and messing with Mother Nature!

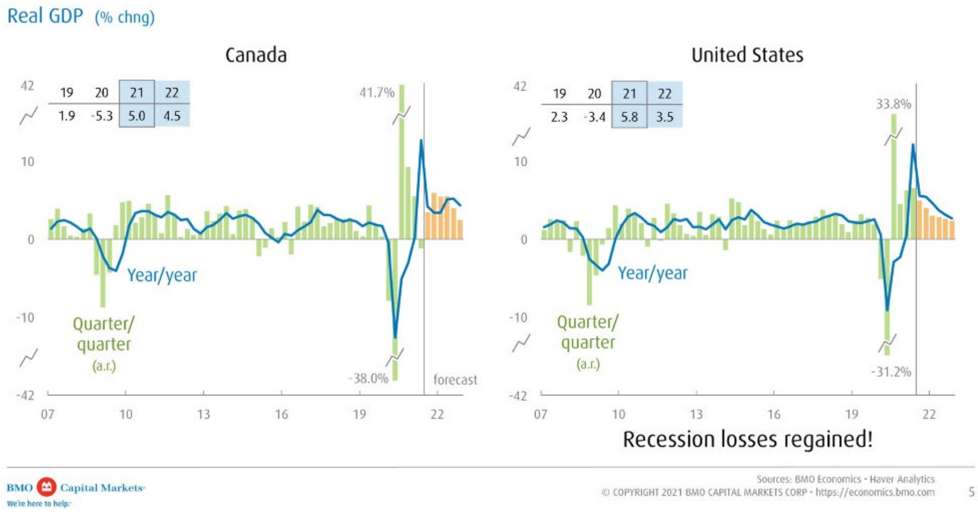
The Federal Reserve Board (Fed) does not have a mandate to directly or indirectly intervene in equity markets. It does, however, have the responsibility to ensure that inflation is kept in check and not flying out of control. Its current target inflation is an "average" of 2%. In the U.S., the Producer Price Index (PPI) for August reached 8.3%, year-over-year, and 6.3% excluding food and energy (core PPI) (which mean that food and energy grew even more). The PPI is a leading indicator of the Consumer Price Index (CPI), as manufacturers and producers tend to pass higher costs along to consumers. As of mid-September, the year-over-year CPI was up 5.3%, while core inflation was up 4%, thanks to weaker than expected August figures, which could be just a temporary dip given the strong PPI (y/y CPI was up 6.8% at the end of July). Chart 2

Chart 2



With this in mind, the Fed would normally intervene and move interest rates higher or at least start tapering off its bond purchasing program, which caps interest rates at an artificially low level. But the Fed is resilient and has maintained its QE program... at least for now. It is therefore continuing to fuel this economy with cash, when the Canadian and the U.S. economies are growing at above 5% this year, and inflation has way exceeded the average target of 2%... Chart 3

Chart 3 U.S. and CDN GDP growth rate



According to Leon Cooperman, a very well-respected American businessman and extremely successful portfolio manager, 10-year U.S. Treasury yields, "should be in line with the nominal GDP growth rate before and after pandemic adjustments (+/- 4%)." The question is where would the markets be without the Fed's intervention? If 10-year bond yields were at, say 3.6%, chances are that a significant amount of capital would flow back into bonds. Real estate foreclosures would increase sharply and stocks would plummet, deflating the bubble.

Although this outcome is by no means our prediction over the shorter term, it is important for investors to understand what they're up against when managing their lifetime savings. Mr. Cooperman currently describes himself as a "fully invested bear." He also states that the Fed's actions are "pulling demand forward," which is a major concern to him. The "subsidized" short-term demand boost may come back to haunt us when the time comes to pay back debts. However, he remains fully invested because he still doesn't see the catalyst that could trigger interest rates to move sharply higher, as the Fed seems to be caught between a rock and a hard place trying to ensure a strong economic recovery.

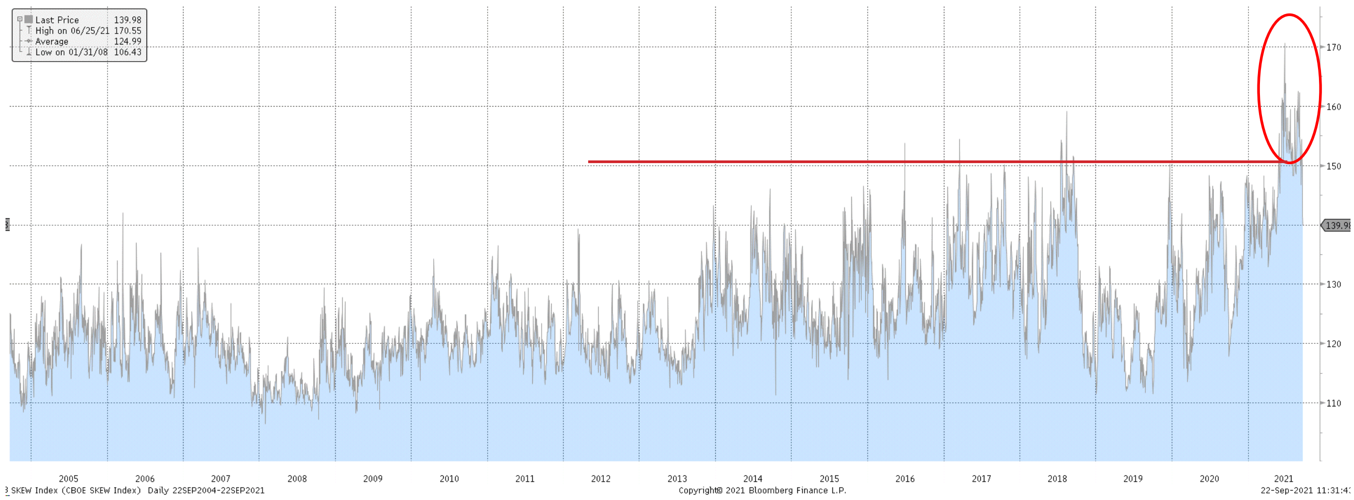
So, the bet is a post-COVID, globally synchronized recovery. With interest rates hovering around 0%, future earnings can grow indefinitely, and so could stock valuations, with unlimited P/E multiples. Mr. Cooperman's pessimism ('' Bear''), along with his fully invested strategy, must come with some form of occasional protection or hedge. When assessing current market conditions, investors should be concerned about the size of the hedges outstanding in the market. The two most common form of hedges are:

1) Selling short positions – making money on the downside by first selling a position at a high price then buying it back to cover your sell (short) position at a lower price.

2) Buying put options – buying a contract option that guarantees you will sell a stock at a fixed price should it drop unexpectedly. Like an insurance policy, the cost of the put option is partly a premium that may vary in value as a function of what the buyer is willing to pay. The more pessimistic the buyer is, the higher he is willing to pay for protection.

There is a measure that reflects the disproportionate premiums of put and call options. It is called the Put/Call Ratio. This ratio could well represent investor sentiment, given that it shows an investor's inclination to pay a larger premium for a put or call option. Thus, a larger premium for a put option implies a larger downside risk on the market. This can also be measured by the "SKEW" Index (Chart 4).

Chart 4 SKEW Index

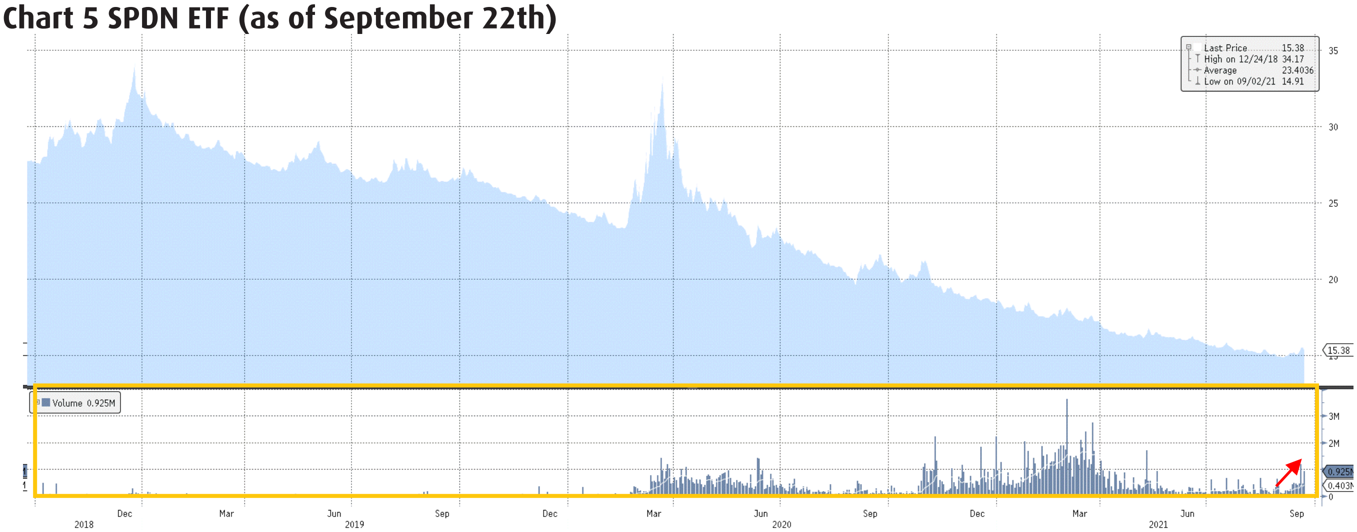


This chart shows that the level and the value of protection is at its highest range ever (150 to 170 range). This may well explain Mr. Cooperman's investment sentiment and definitively that of many other "fully invested bears." There is also a school of thought that believes the SKEW to be a contrarian indicator. In other words, when most investors become overly pessimistic, the markets tend to move higher and when they become overwhelmingly bullish, it may be a sign that the market is topping off. The historical pattern of the SKEW sometimes supports this argument on a shorter-term basis.

According to Mandy Xu, Chief Equity Derivative Specialist at Credit Suisse, investors are facing a wall of worry that is driving them to buy more protection in various forms against downside risk. We could agree that this protection build-up is a function of the increasing risk of higher bond yields as a result of the Fed's slowing its bond buying program. A video of a CNBC interview with Mandy Xu in mid-September is available on our website, under Selected publications.

Another protective measure can be seen in the volume of short positions, as mentioned in point 1, through the SPDN ETF. (Chart 5)

Chart 5 SPDN ETF (as of September 22th)



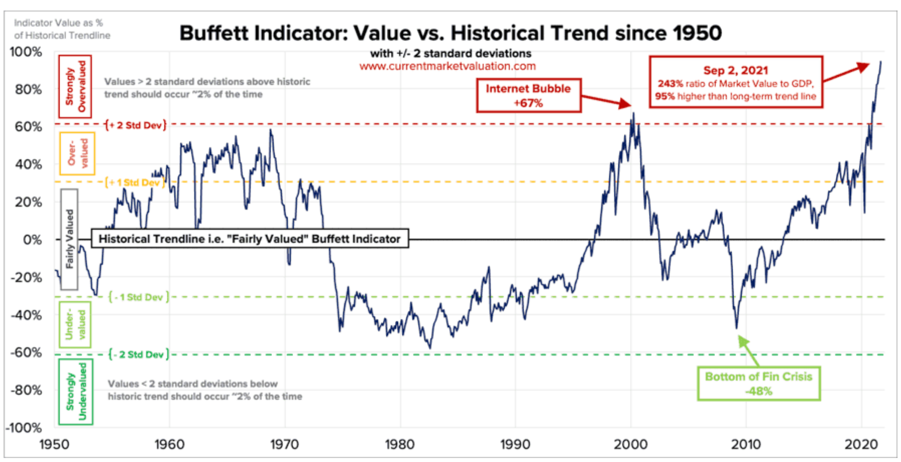
The price of the SPDN ETF (Exchange Trade Fund) is the reverse of the S&P 500. In other words, for every 1% increase in the S&P 500, you'll see a corresponding 1% drop in this ETF within the same day, and vice versa. The high volume (seen in the yellow boxed bar chart below graph 5) is a testimony of rising pessimism. However, it could also corroborate the ever-increasing equity exposure in portfolios, given the lack of alternative investments – namely bonds! So, the larger the equity exposure, the stronger the need for protection, which may not necessarily reflect such high pessimism...?!

These charts are a way of expressing investor sentiment, as both reflect defensive strategies. In other words, the actions taken by investors to better protect their investments correlate with their level of pessimism and/or the increasing weight of equity holdings as part of their lifetime savings. However, as investors are usually late to the party, short interest and put options tend to rise significantly as markets drop. Furthermore, these protective investment instruments are not applicable for the long term as they have carrying costs. They are designed for the short-term trader and not for the long-term investor.

<u>The Buffet Indicator (BI)</u>

Introduced in 1971 and named after Warren Buffett, who needs no introduction, this market valuation method was once claimed by its creator to be "the best single measure of where the valuations stand at any given moment." It is the ratio of total market valuation to gross domestic product (GDP). Although the concept is great, it is difficult to use over time, comparing valuations of today against those of the 1980s or 1990s, since other variables have changed. Inflation, money supply (M1, M2) and debt levels would create some distortion. Although some adjustments have been made to offset the drift, it is by no means perfect, but it can provide us a good clue as to where valuations stand today. Chart 6

Chart 6



<u>Buffett Indicator Valuation Model (currentmarketvaluation.com)</u>

It doesn't take rocket science to suggest that reducing equity exposure when you reach the doted red line and increasing equity exposure when you reach the doted green line looks like a good strategy! If only it was that easy! For those readers with a more mathematical background, to be within one standard deviation occurs 68% of the time. To be within two standard deviations of the mean occurs 95% of the time. It also means that above two standard deviations from the mean, the probability is less than 5% of the time and a mere 0.3% above three standard deviations. As of September 2, 2021, the BI value stands at 3.1 standard deviations above the trend line...!

Inflationary pressures, expanding money supply (money printing) and near-zero interest rates explain the overvaluation, but do they justify it? And if so, for how long? This is precisely why the Leon Cooperman's of this world are "fully invested bears."

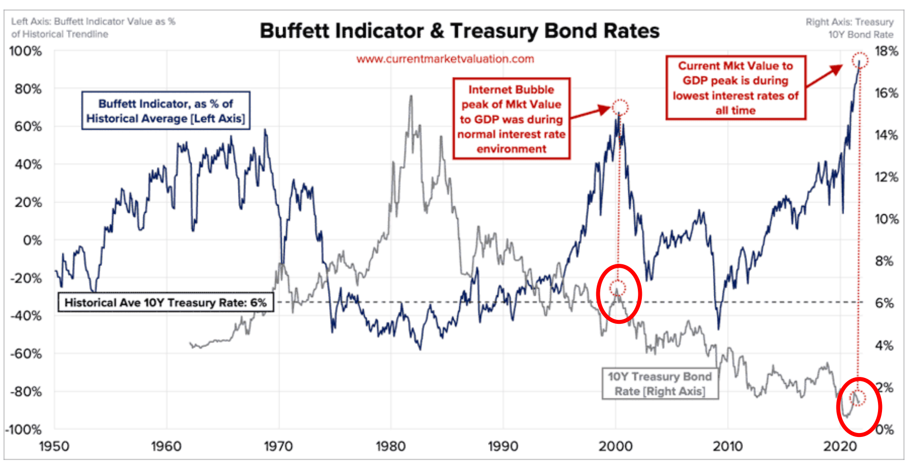
Looking at this BI chart a little closer, note that both times since the 1950s when we brushed against or edged past two standard deviations above the trend line, the bear markets that followed lasted more than 10 years. In fact, we covered the 2000-2010 bear market quite extensively in our last newsletter. What we would like to emphasize this time around is the difference between the 2000 cycle peak and the current overvalued levels.

First, on average, today's market is not trading at unprecedented price to earnings multiples as it was in 2000. In fact, the S&P 500 is trading at slightly above the 18 times average P/E, currently standing at 22 times, at the time of writing, down from 30 times last spring. Q1 and especially Q2 earnings were extremely strong, and caught up with higher valuations earlier this year.
Second, there is ample liquidity, as investors do not want to lock in a very low rate, and central banks are continuing to print money. As demand outstrips supply, companies and governments are playing catch-up building capacity, creating jobs and stimulating the economy.

Third, near zero interest rates offer few alternative investments to investors. Given that valuations represent the discounted value of future earnings, if the discounted rate is 0, then the valuation is infinite!

Fourth, when the dotcom bubble burst in 2000, there existed an alternative investment option, as 10-year U.S. Treasuries were yielding over 6% compare to 1.35% today. Chart 7

Chart 7



Buffett Indicator Valuation Model (currentmarketvaluation.com)

Although this doesn't justify the high BI on a fundamental basis, it does explain investor behavior. It also suggests a risk of a downward correction but not so much the risk of a collapse.

Fifth, fiscal policy and government spending are going through the roof. For the U.S. government, we're talking trillions of dollars in the low single digits! How many zeros is that? If $1 billion is one thousand million, it takes one million million to make 1 trillion! The U.S. is budgeting $3.5 T to $5 T for what it calls "human infrastructure" spending. That's quite a chunk of change! Perhaps paying back this debt will be transitory as well...? Maybe we should redefine the word "transitory..."

Investment Strategy

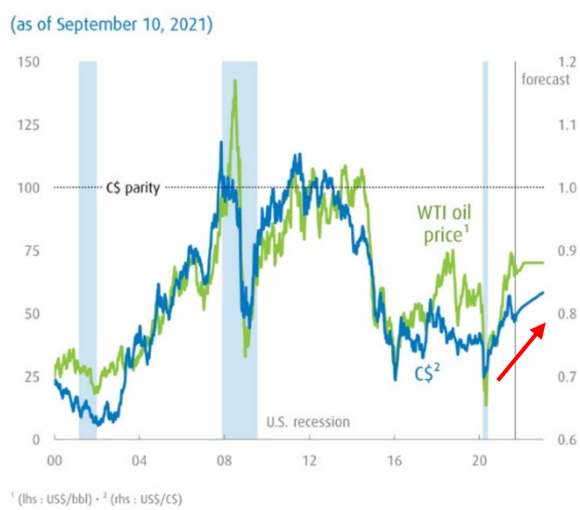
Given the expected post-pandemic, synchronized world growth fueled by accommodative monetary policies and huge government spending commitments, we should manage our expectations and take into account pressures on corporate profit margins caused by rising taxes, wages and commodity prices. According to David Kostin, Goldman Sachs Chief U.S. Equity Strategist, the net impact on earnings growth could well be in the -5% EPS growth average. If we apply new tax policies both in Canada and the U.S. in the upcoming year, we could potentially see a market slowdown late this year or early next year as investors decide to take advantage of a lower capital gains tax rate this year, or possibly split it over two years if a new capital gains rate isn't announced soon.

According to a September 11, 2021, Financial Post article, the cumulative debt of all of Canada's Prime Ministers since Confederation in 1867 is lower than the debt racked up by Liberals over the last six years! So, a capital gains tax increase is surely being considered in Canada as well. There is a favorable argument suggesting that consumers who own assets are close to their highest purchasing power ever, while others cannot afford to buy a home... even at the lowest interest rates ever! Extremes are far from the point of equilibrium. The best way to protect yourself is therefore by trying to maintain a certain balance in order to reduce the shock of a "market-imposed" rebalancing. Investors should respect their own pre-established investment policy statement and asset mix, as they reflect your own tolerance to risk and volatility. We also continue to emphasize the importance of strong, predictable and stable dividends to further reduce volatility and generate a steady cash flow. In other words, if, as and when the market corrects, you will at least get paid while you wait for the recovery.

Given the current environment, we would favor the communication services, financial, industrial and materials/energy sectors, as they provide security, income and sensitivity to inflation when combined. The unpopular energy sector that has been put in the penalty box by many investors, has cleaned up its balance sheet with one of the lowest debt to equity ratios, and is now considering investing its huge cash flows in renewable energy. I anticipate a fair amount of merger and acquisition activity, which may involve some utilities sector companies. Their ESG (Environmental, Social, Governance) score is quickly becoming a top priority if they want to attract investors in the future. An early vote of confidence supporting their good intentions may wind up to be helpful to the environment and very lucrative for those who support their change in behavior and future direction.

While we are maintaining our weighting in consumer staples and health care, we are shuffling our positions in consumer discretionary to include Canadian Depositary Receipts (CDR), a way for investors who want to own U.S. stocks while hedging their currency risk. Amazon (AMZN.NE), as well as Google (GOOG.NE), Microsoft (MSFT.NE) and Apple (AAPL.NE) are now available CDR's. Since we believe the Canadian dollar will firm up versus the U.S. dollar over the next year, we would recommend the use of CDR's going forward. (Chart 8)

Chart 8 CDN Dollar VS Oil price



Sources: BMO Economics - Haver Analytics
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https://economics.bmo.com

Our take on the Canadian dollar is based on our solid trade relationship with the U.S., and on Canada's ability to fully participate in the synchronized world growth projections as a world-leading exporter. This positioning proved to be beneficial to Canada during the post-dotcom bubble through to the 2008 financial crisis. During that time, Canada TSX outperformed the U.S. market five years out of seven, and the looney shot up to US$1.08. We also know that banks and financial institutions tend to react better when interest rates move up slightly, and energy and material sectors tend to outperform when inflationary pressures build up. The table 1 below shows the weighting of those three sectors as part of their indices, namely the TSX and S&P 500.

Table 1

	TSX	S&P 500
Financials	28.60%	11.20%
Energy	14.10%	2.60%
Materials	13.50%	2.60%

S&P 500 Stocks & Sector Weight Analysis| Top Companies by Weight 2021 (finasko.com)

This partly explains why the TSX is bound to outperform in the post-pandemic world economic recovery environment. Thus, a combination of investing in CDRs to own U.S. companies and an increased weighting of inflation-sensitive sectors may help optimize returns going forward.

At the time of completing of my final draft, dark clouds were gathering over China and its real estate giant Evergrande. The company's US$300 billion debt had reached a critical level and the risk of default was growing. This evolving situation reminds me of the Lehman Brothers bankruptcy in 2008. While these events always seem to be containable early on, sooner or later we may discover unexpected consequences and their spillover effects. A worsening scenario could initiate a run on Asian currencies in favor of the U.S. dollar like in 1997-98, derailing the global economic recovery. This could have negative implications on the Canadian currency as well. China's real estate sector represents 25% of the country's GDP.

The American real estate sector might be facing headwinds as well, with all the affordability issues and the risk of rising interest rates leading to defaults. In the U.S., no less than 1.8 million homes will be coming off the "forbearance" list in the coming months (this is a list of owners unable of paying their mortgages during the pandemic – their mortgage payments were temporarily put on hold). This applies to U.S. residential real estate and could increase inventories as many continue to be unable to pay. Rising inventories could slow the price per unit growth.

In Canada, affordability and the tightening of mortgage qualification measures should negatively impact pricing as well. As for commercial real estate, office or industrial properties, we feel current valuations offer limited upside.

Lastly, we are maintaining our weighing in the information technology sector and we should take advantage of some of the new CDR's offered in order to reduce currency risk.

Conclusion

A possible scenario could be the following:

The unwillingness of central bankers to raise rates will continue to feed buyers for stocks, real estate and hard assets, pushing values to new highs. Economies will continue to expand, job supply will exceed demand, pushing wages up. Baby boomers will retire in droves, further tightening the work force, adding more pressure on wages. Profit margins will come under pressure as inflation will spill over to commodity prices as well. The Fed will eventually intervene to reduce inflationary pressures by raising rates and or to slow an overheated economic expansion... which will work for a while. At one point, they will cut rates again to get the economy going again, but companies will soon try to pass on their higher cost of borrowing, edging inflation even higher. And so, the vicious circle repeats itself. Economic and monetary policies are sciences that are as far from "exact" as can be. Rather, it seems that we make the "exact" same mistakes time after time... and we get into deeper trouble with every cycle! A rising interest rate environment is no longer a question of "if" or "when" but rather a "how soon".

I will let you figure out the "exactitude" of the Fed's call of transitory inflation!

Recommended Asset Mix				
Income Portfolio			Balanced Portfolio	
Apr 2021	Oct 2021		Apr 2021	Oct 2021
10%	10%	CASH (maturities ≤ 12 months)	5%	5%
42.5%	40%	Fixed income (Bonds & GICs)	30%	30%
15%	15%	Convertible Debs. And, Income, Generating, Securities	15%	10%
25%	27.5%	Equities	40%	45%
7.5%	7.5%	Foreign	10%	10%
Disclaimer: Subject to an evaluation of the risk profile of individual clients				

Recommended sector weighting October 2021			
Sectors	Rec'd weighting	Trend	Rational
Communication Services	4,50%	⬆	Remains our favourite yield play, despite challenges of yield strategies, given secular dividend growth, recent underperformance provides timely longer-term opportunity
Consumer Discretionary	2,25%		Cyclical with long outperformance tail suggest persistent outperformance, overweight names with strong US growth exposure.
Consumer Staples	5,00%		Expensive sector but earnings growth remains stable. Be increasingly selective within US focused names
Energy	3,00%	⬆	Structural challenges persist, but contrarian rebounds are often sharp and difficult to anticipate. Continue to favour higher quality large cap Energy stocks that have shown operational resilience in a range bound oil price environment.
Financials	14,00%		Steadfastly maintaining holdings in the broader sector, however we prefer those companies with strong US platforms – especially within in banks (commercial banking + wealth management).
Healthcare	4,50%		Significant price correction and Regulatory tailwinds within Cannabis suggest neutralized position. Prefer U.S for diversity
Industrials	7,00%		Well positioned for cyclical recovery, Focus on the rails, select manufacturers and waste companies – especially those leveraged to the US.
Information Technology	7,00%		Prefer the US; very select positions in Canada that are levered to secular trends.
Materials	4,25%		Epic stimulus = continued upward commodity price pressure. Fundamentals remain well positioned to benefit from strong commodity prices.
Real Estate	4,00%	⬇	Structural issue to persist 2021 and yield strategies likely to remain challenged as yield grind higher.
Utilities	7,50%		Rising yields, low organic growth and high payout ratios are a tough combination. However, electricity producers offering growth with a strong balance sheet remain attractive.
International Equities	2,00%		Be aware of exchange rates. We like Canadian Depository Receipts for US stocks.
Total actions	**65,00%**		Average equity weighting.

- The suggested weightings are appropriate for a 65/35 equity/fixed income portfolio and should be adjusted based on your investor profile.

Sources:

- Alpine Macro
- Bloomberg
- BMO Capital Markets Equity Research Reports
- BMO Capital Markets North American outlook
- BMO Financial Group Economic Outlook
- BMO Nesbit Burns
- BMO Nesbit Burns Part Team, portfolio advisory team
- BMO NB Canadian Equities Guided Portfolio – September 2021
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- BNN
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- Current market valuation
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- Globe and Mail
- Goldman Sachs
- Standard & Poor's Capital IQ Equity Research
- The Barons
- The Economist
- The high-tech Strategist
- The Wall Street Journal

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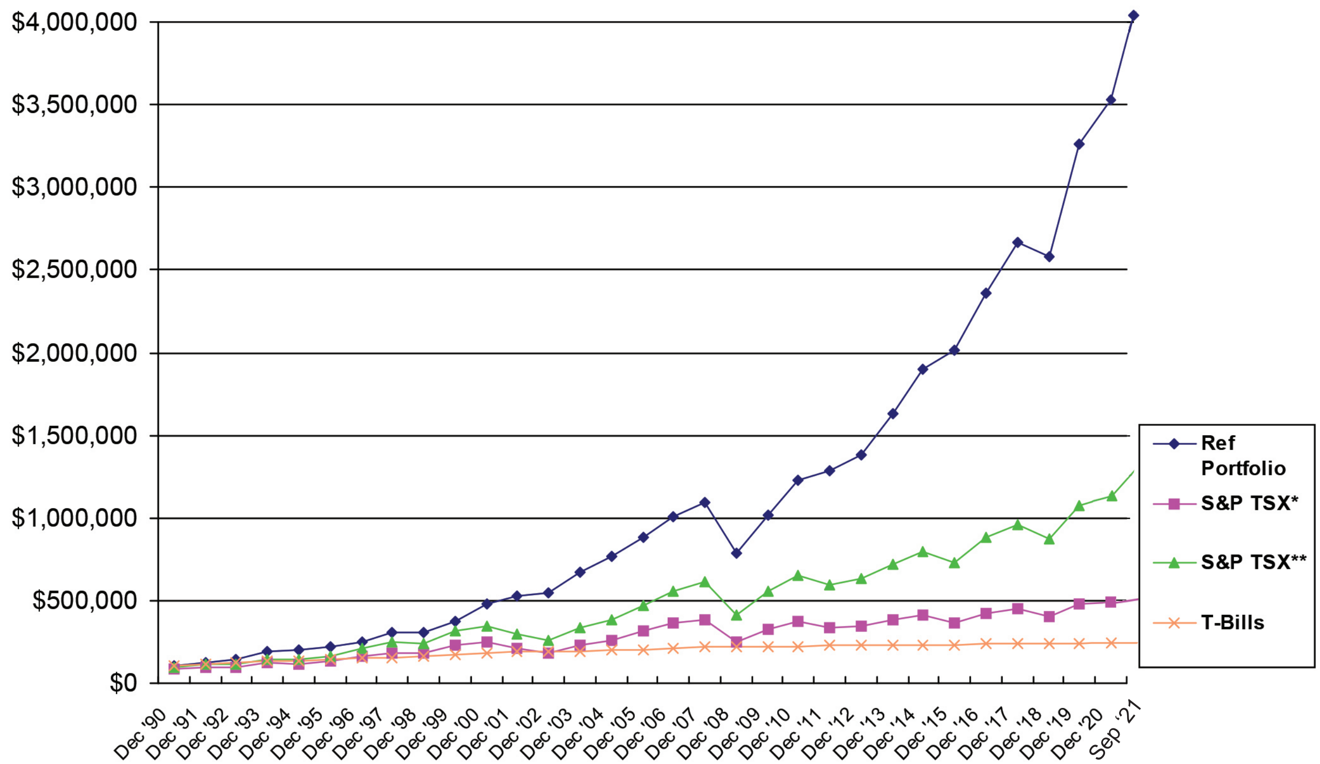
Reference Portfolio Return



Value as of September 30,
$ 4,117,881

Average Return
12.56 %

$100,000 invested on June 1st 1990

**Does not include income or div*

***Includes income and div*

The returns are compounded monthly and revenues are reinvested.

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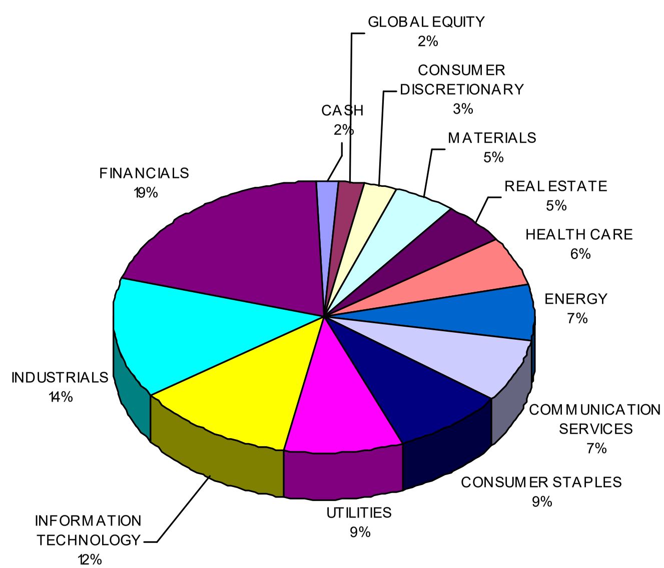
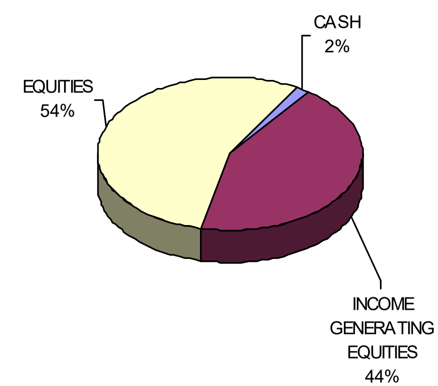
September 2021

REFERENCE PORTFOLIO HOLDINGS AND ASSET MIX



By Sub-Index %



By Category %

Performance - T-Bills vs SP TSX vs Reference Portfolio				
Year	T-Bills (return)	SP TSX[1]	SP TSX[2]	Portfolio(return)
1990	13,20%	-17,96%	-14,80%	**5,94%**
1991	9,35%	7,85%	12,02%	**22,14%**
1992	6,67%	-4,61%	-1,43%	**10,50%**
1993	4,68%	28,98%	32,55%	**34,91%**
1994	5,19%	-2,50%	-0,18%	**6,09%**
1995	6,42%	11,86%	14,53%	**8,09%**
1996	3,93%	25,74%	28,35%	**16,21%**
1997	2,85%	13,03%	14,98%	**21,05%**
1998	4,56%	-3,19%	-1,58%	**1,87%**
1999	4,67%	29,72%	31,71%	**19,96%**
2000	5,23%	6,18%	7,41%	**30,40%**
2001	3,73%	-13,94%	-12,57%	**9,54%**
2002	1,75%	-13,97%	-12,44%	**3,61%**
2003	2,22%	24,29%	26,72%	**22,23%**
2004	1,84%	12,48%	14,48%	**13,87%**
2005	2,53%	21,91%	24,13%	**15,73%**
2006	3,52%	14,51%	17,26%	**14,30%**
2007	3,59%	7,16%	9,83%	**8,06%**
2008	1,50%	-35,03%	-33,00%	**-28,07%**
2009	0,29%	30,69%	35,05%	**29,37%**
2010	0,60%	14,45%	17,61%	**21,05%**
2011	0,92%	-11,07%	-8,71%	**4,18%**
2012	0,97%	4,00%	7,19%	**7,38%**
2013	0,97%	9,55%	12,99%	**18,14%**
2014	0,92%	7,42%	10,55%	**16,43%**
2015	0,50%	-11,09%	-8,32%	**6,36%**
2016	0,50%	17,51%	21,08%	**16,75%**
2017	0,71%	6,03%	9,10%	**13,26%**
2018	1,40%	-11,64%	-8,89%	**-3,26%**
2019	1,67%	19,13%	22,88%	**26,19%**
2020	0,39%	2,17%	5,60%	**7,13%**
*2021	0,29%	15,13%	17,48%	**16,62%**
Return Compounded as of December 31, 2020				
3 years	1,15%	2,46%	5,74%	9,36%
5 years	0,93%	6,03%	9,33%	11,58%
10 years	0,90%	2,63%	5,76%	10,97%
Average return since inception (YTD)*..				**12.56%**

* (YTD): Year To Date (September 30th 2021)

$100,00 invested on June 1st 1990

The returns are compounded monthly and revenues are reinvested.

1: Does not include income or dividend

2: Includes income and dividend

The Team

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