Five Questions

Episode Six | Inflated Expectations?

Pete: Hi, my name is Pete Mann, and I'm the President and Co-CEO of Grayhawk Wealth. Welcome to the second season of our podcast, Five Questions, which will see one partner at Grayhawk, paired up with another to touch upon relevant topics as they relate to the economy, investments and generally what's happening in the world as we see it. Sometimes we'll invite special guests to join us so you can also hear their views. With me today is Greg Gipson, Grayhawk's Chief Investment Officer, who is responsible for shaping our investment philosophy and portfolio strategy. Welcome, Greg.

Greg: Morning, Pete. I hear you are out west in Calgary. And, you know, fortunately, we've gotten through, I guess the first of many 50 basis point hikes from the U.S. Fed.

Pete: Well, it's interesting you bring that up as our topic today is none other than inflation. It is this very confusing term for many people. It has been a long time since people have seen it in any economy, anywhere in the world, outside of some of the very small emerging debt-ridden nations. So maybe we can dive right in there and have a little conversation about inflation. Why don't you start by defining it? What is inflation, Greg?

Greg: Well, there's many ways that many people have described inflation, but perhaps the simplest way of thinking about it is an increase in the prices of goods and services that people purchase. Perhaps the more fancy or fanciful way of describing inflation is a decrease in the purchasing power of money. Well, what does that mean? That means that what you could buy in the past, currently for the same amount of money, you can purchase less. When you think about inflation, I always go back to, you know, basic economics of supply and demand. So again, the fanciful ways of describing inflation will be words like cost, push or demand push, changes in money supply. But think of it very simply, in the realm of supply and demand. So, in an environment where demand increases and supply does not, prices will rise. In an environment where supply decreases and demand stay the same, prices will increase. The environment that we're in right now, there's really three main effects of why we're seeing this inflation and why we're seeing a tremendous increase or strength of inflation. So, if we think in supply terms, certainly COVID lockdowns have created bottlenecks. They've reduced the amount of supply. Cheap and easy money has made demand increase and so what we've seen is really a twofold effect of a decrease in supply, an increase in demand, and both of those impacts have served to materially increase the level of inflation or the price at which people may purchase a good or a service.

Pete: Thank you for that, Greg. That's really helpful. Maybe we can talk a little bit about some of the structural forces at play in the world today as it relates to inflation.

Greg: So, when you look over the last 40-50 years, whatever time frame, you see that the environment, the economic environment has been very deflationary. This is very clearly driven by a number of long-term megatrends. Increase in level of debt, aging demographics, increased innovation, or technological advancement, increases in productivity and globalization. All of those forces have combined to really create a long-term deflationary environment. What have we seen in the past year that perhaps has changed that? Well, debt demographics, innovation and productivity all continue on the same trend that they have been. Globalization is the one aspect that has changed. So certainly, the invasion of Ukraine by Russia, certainly the longer term impacts of COVID have actually served to reduce the level of globalization. And in doing so, that has an increase or a positive effect on rising inflation. Now, you combine those macro or global megatrends with the short term impacts we've seen coming through COVID, the invasion of Ukraine, and you've had this imbalance in supply and demand. And there's only two ways to fix that imbalance. One, impact the level of supply, right, increasing supply will bring prices down. And two, decreasing demand. And I think the second impact of decreasing demand really will serve to reduce the consumption of individuals and lower the prices in the market.

Pete: So effectively, if I can jump in, what you're really saying is, is that the forces that push prices up are also the very same forces that prevent people from being able to buy more, thus limiting the actual demand mechanism, thus reducing it, obviously bringing prices back down.

Greg: Correct. It's almost back to the days of economics 101, simple supply and demand. If you just think in those terms, the environment that we're in is really a perfect storm of constrained supply, somewhat unconstrained demand given the amount of easy money in the system. Those two forces together really explain the type, the level, the magnitude of inflation that we've seen certainly over the last six months, if not over the last 12 months.

Pete: So maybe we can talk a little bit about what the impact has been of inflation on various commodities. Everyone sees it, obviously, at the gas tank. There is this old adage, which I know you've expressed on many occasions, the cure for high prices is high prices. And effectively it goes back to what we were just talking about a moment ago. But maybe you could touch a little bit about energy, oil, food, some of these primary inputs for a family and the challenges that inflation is bringing towards that.

Greg: Now, it's an interesting, interesting question. And, you know, it's the chicken and the egg question. So, does commodity strength lead inflation or is it led by inflation? And I would argue that it is a leading indicator of inflation. When you look at commodities in general, it's oil or metals or food. They suffer from that same conundrum that we just spoke about of constrained or reduced supply and increased or consistent levels of demand. So, what we're seeing in those markets is understandable and really a result of that perfect storm that permeates throughout all goods and services, whether it's oil or food or metals, or semiconductor chips, whatever the case may be, it's really the confluence of these two forces that are working in unison to increase the level in freight inflation, increase pricing for the average consumer. When I think about commodities and in general and you think about oil, certainly in the current environment, in the macro environment and the geopolitical environment, there's been a move to alternative energy sources or a focus on green energy. This has had an impact of decreasing supply. I think it's always important to remember that OPEC can control supply, if not at the margin, materially so. So our focus and our interest is in those commodities where there is not that price control mechanism. And in that space, that's where we see certainly metals being in that case, food in particular. And of all the different commodities, I think food is actually one of the biggest challenges that we as a global society are going to face because you can't simply plant a new crop if you miss the season. And that I think in the short term, if not the medium term, is going to be the biggest challenge for the average family because while you may choose to walk rather than drive your car, it's a very difficult choice when it comes to feeding your family.

Pete: Yeah, it's so interesting you know, what many people may not know or be aware of is that the Ukraine is one of the largest wheat producers in the world. And of course, as you rightly point out, in a couple of months, it's crop time and how to supply get out. What are the mechanisms that enable that? And people can already start to feel some of that pressure. You know, if I can go back for a minute just to sort of put something in terms, I think for our audience that's so helpful if you think about it. About 18 months ago, you started to see minimum wages start to rise. So, at the very low level of lowest level of income in developed nations, primarily, you started to see some of this inflationary pressure on costs that was coming in the form of labor. That, as you point out, has since hit almost everything else. But an example that so many of our audience will understand is really this perspective around real estate and the migration patterns of people during COVID. They have gone to some economies and some geographies where there was much less supply with no anticipation of the growth that has materialized. And what that has done to the prices of homes that underlie that on that supply demand equation, this is yet another inflationary pressure that people can't seem to escape.

Greg: Absolutely. If you look at the U.S. data, I think what you'll see is that the average job hopper, so the person who changes jobs has been able to secure on average, upwards of a 10% increase in their nominal wage. For workers who have chosen to stay at their firm, again on average have been able to increase their nominal wages by approximately 5%. So, in some ways, that wage increase is helping to offset some of the inflationary pressure as far as a consumption perspective, but what it does is it maintains or increases the level of demand. So, if you don't fix the supply side and you're adding to the demand side, it should not come as a surprise that inflation is moving in the direction that it is.

Pete: That's so helpful, Greg thank you. So, if we start to put this in the form of a portfolio or people's expected rate of return, almost the entirety of both, our careers, inflation has sat somewhere in the neighborhood of 2%. And so, when people would look for a rate of return over and above inflation, it required a fairly nominal return to be able to capture that. Today, we know parts of the world where inflation is running at high single digit. And of course, the question that we often are posed is how clients earn a real rate of return over and above that. And maybe you could touch a little bit firstly by defining what the real rate of return actually is. And then maybe more specifically, talking about some of the, the ways in which we're trying to think about that.

Greg: Well, this is maybe some of the, you know, financial services jargon that we like to use, real versus nominal. So, think of it simply as nominal is the actual number. The actual return, the actual interest rate, the real yield, or the real interest rate is the nominal less inflation. So, it's always going to be a smaller number. And so that's where you see stories in the news about nominal interest rates being some level, real interest rates still being negative. So, if you look across fixed income bonds around the world, you still see that many real yields are still negative. And from that perspective, perhaps public market bonds or fixed income have been not very attractive, certainly over the last year and a half and in the short to medium term are likely to continue to be unattractive. When you look at different asset classes globally over the long term and again, we don't like hyperbole or absolutes, but public market equities have typically been the best hedge against inflation over the long term. However, in the short term, where we're in this type of market and really what has happened in 2022 has been a very high level of uncertainty. Markets do not like uncertainty and that's why we've seen weakness across public market equities, certainly over the last four to six months. With the Fed speech yesterday, we saw the market rally quite strongly because in some ways that level of uncertainty was reduced. But the power of inflation, you know, this is a long, a long tail to the problem. So, as you may recall, when we spoke about COVID two years ago, we were generally positive that economies would come out of it. But we always professed that the impact or the tail of the impact of COVID would be quite long. When it comes to inflation we've been in the in the transitory camp. I think that we're still in the transitory camp. It's just we think in terms of quarters and years and not weeks and months. So again, I hearken back to these megatrends that are deflation area in nature, maybe some offset with de-globalization. So, what does that mean? It just means that inflation structurally may be slightly higher than where it is. But in the long term, we would expect it to be lower than what we're seeing in the current environment. So, the question then is how do you position in this type of environment? Well, certainly within public market equities, there's a benefit to favor markets or favor geographies that have a larger exposure to commodities. So, think of Canadian equities Australian equities. You know, there was a recent report out yesterday looking at dividends and our dividends, a way of fighting inflation and their research said, no, it's not. But in our opinion, really within equities, when you look at COVID, you know, coming out of the initial market sell off, it was really that, you know, work from home trade. Then we saw kind of throughout last year, you know, the reopening trade in equities. I think what we've seen in 2022 is the stuff people need trade.

So, what do people need? You know, they need consumer staples, right? They need food, they need energy consumption, and it's really gone back to basic needs. And that's where I think public market equities sit. Within fixed income, our preference would be in the private side: private credit, private debt. So, areas of the market where you can capture a higher level of yield or income with a lower level of volatility. And we're seeing in public markets and certainly even in public market space, reducing the level of interest rate sensitivity because we expect certainly today and it changes every day so who knows but the U.S. ten year at 3% that, you know, is likely to continue to creep higher. When we think about consumer spending, so in this environment where we are seeing wage growth, where we've seen healthy household balance sheets, healthy level of savings, coupled with that higher nominal wages, consumer spending is actually in a pretty good space.

The corporate side, the corporate balance sheet is a little bit different. So, while profits have been strong, earnings have been strong, the number one concern that companies are coming out with is concerns over supply chain disruptions. So, when you couple that, so supply chain disruptions increase the cost of acquiring inputs when you have increasing wages, again, an increase in the cost of inputs, that only serves to reduce corporate profitability if the companies are not able to then charge a higher price for their goods in the market. So, we're just in this virtuous cycle right now. And some of it is self-compounding and it really leads back to the causes of inflation and how can you fix them. And if you think of the supply and demand, again, very simple, so what can the Fed control or any central bank control? They can control demand, so raising interest rates will make it more expensive to borrow. They can decrease the supply of money in the economic system. So again, reducing the supply, making it harder for people to have cash to acquire goods. What the Fed cannot do is impact the supply of goods. And if you look at recent data that has come out, certainly there's been some improvement in shipping rates, tanker rates, cost of freight, whatever metric you look at, we've seen a bit of curtailment from the prior excessive levels. So, we do see modest, albeit small improvement in the supply side. But that's really from a long-term perspective. That's the structural issue that needs to be solved is the supply side and not the demand side.

Pete: So, Greg, maybe for our final question, could you share with us some of the learnings that we could garner from the past that would give us some insight as to how we're thinking about today and going forward?

Greg: Well, I think that you know, markets, economies, always move in cycles, right? There's ebbs and flows to positive news, negative news. You know, there's been countless number of articles written about, you know, what happened in the 70s or what happened in the late 90s or 2006 to

2008. There are all these different extrapolations. I think that the environment that we're coming out of, you know, is just a confluence of corrections or adjustments that were made in the past to solve past problems and that's kind of coming home to roost a little bit. And a lot of that has to do with cheap and easy money. Right. It's with low interest rates, consumption will always be high because you're not being paid to hold cash. If you put money in your bank account you're earning, what, 1/10 of 1%. Why would you not go out and buy Bitcoin or your favorite meme stock? And so, in some ways, what the Fed is doing is really just a normalization. So, this is really getting back to a state of long-term consistent growth in markets. And by increasing interest rates, it does increase interest of savers to keep cash in their account. So, they're being paid to hold cash as opposed to consuming. So, in some ways, we're just moving back to a place where we were before, certainly the last two years in many ways have been unique. And I don't like using unique as everyone points to some historical case. But certainly, the last two years coming out of COVID have been a unique situation where money has been easy and cheap. And you hear acronyms like Tina: There Is No Alternative, and so in many ways, from a classical perspective, we've been in what many would call a momentum market. So, returns beget returns, demand begets demand. And in many ways, where we are now is just a rebalancing of sorts. And so, these periods can often be painful in the short term, perhaps the medium term, however you define them. But over the long term, certainly for long term investors, you know, investing in capital markets, gaining exposure to the world of tomorrow is certainly beneficial in the long term with the understanding that the short term, however you define it, can often feel much more painful than it actually is.

Pete: It's such a good point. You know, I think one of the things that gets lost in the discussion of sort of short-term nature of all of these issues that you've brought up. It really stems from the fact that the people that oversee capital globally today, many of them have never seen a scenario of a rising interest rate environment. They've never lived through an environment where this transitory period begins, and that is heightening the level of uncertainty and volatility that you were pointing out. And it also, from a perspective of a capital allocator like us or others, creates opportunity. And it allows for you to reform how it is that you want to make sure that the long-term positioning of a portfolio is properly aligned. And I think that that is one of the things that has really been lost in this last decade. Everything has always come back so quickly. We've gone down quickly. We've come back even faster. And typically, that expression of escalator up and elevator down has been what markets have been. And today, or the last 10 or 15 years have really just been, you know, escalator down, escalator up. And those two things, I think, have really fundamentally changed people's level of patience.

Greg: And I would even posit at certain times it was escalator down, elevator up.

Pete: Yeah. Fair enough. Okay. Thanks very much, Greg. Well, that's it for this episode of season two of Five Questions. I'm Pete Mann, President and Co-Chief Executive Officer of Grayhawk. On behalf of my partner, Greg Gipson, our Chief Investment Officer, we want to thank you very much for listening. We'll be back in two weeks with a new episode. This podcast is for informational purposes only. It is not meant to be relied upon for investment or tax advice. It is the opinions of those on the podcast and does not necessarily reflect the opinions of Grayhawk Wealth. If you'd like to offer any feedback or pose a question for inclusion on the podcast, please reach out to our Chief Experience Officer, Allison Comeau at acomeau@grayhawkwealth.com. Look forward to chatting again in a couple of weeks.