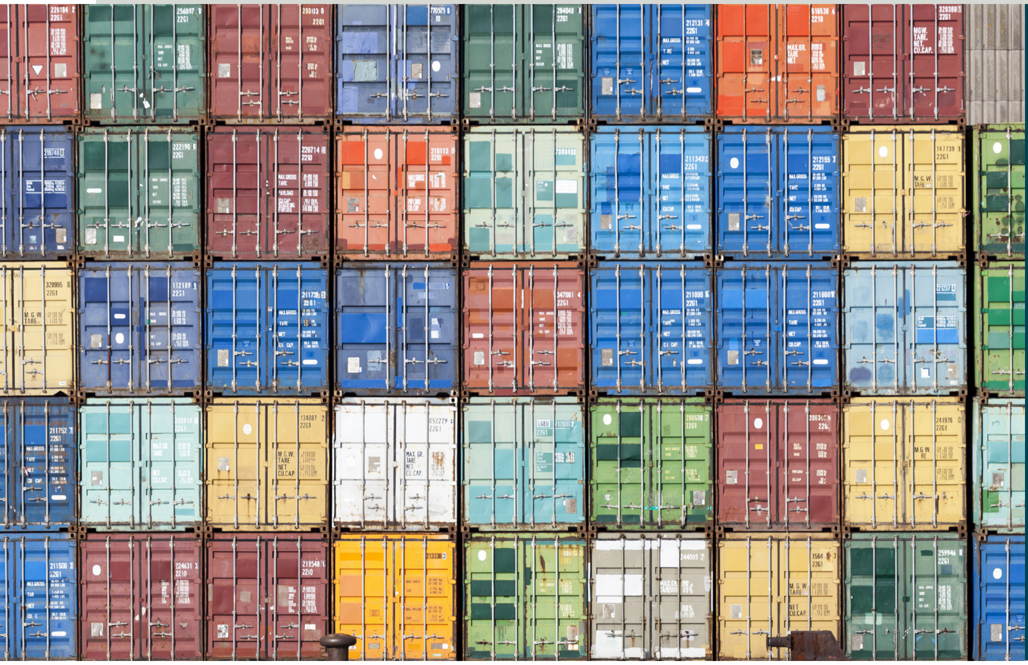
QuietCounsel

Fall 2021
Investment Outlook



Leith Wheeler
INVESTMENT COUNSEL LTD.

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"Transitory" Inflation and Looking Beyond the Headlines

Inflation has been everywhere in the headlines lately, prompting many conversations with clients about the causes of these cost-of-living increases, how permanent they might be, and what impact they might have on investment portfolios. We'll take each of these questions in turn, but start with a look under the hood.

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What's Causing the Current Inflation? In Three Words: Supply Chain Disruptions

The core reason for the current increase in prices for goods and services can be found in any Economics 101 textbook: a mismatch between supply and demand. The pandemic created broad-reaching consequences for supply chains as just-in-time manufacturing, the global efficiency standard which aligns material orders with production, has proven inflexible in dealing with a major disruption. Supply chains today are facing new challenges, including labour shortages and a lack of materials and component parts. The energy crisis in China has affected production, and the US, UK and Germany are all dealing with a shortage of truck drivers. Ports in L.A. and Long Beach have been overwhelmed with the backlog of cargo ships, and this bottleneck is expected to continue into next year. Rising demand for gasoline and natural gas, severe weather events, and constrained supplies are further contributing to higher energy prices.

When the virus spread in 2020, the result was mass industry shutdowns and millions of people sent home with stimulus cheques, which worked out to $2.7 trillion paid out to Americans households in COVID-related income. Central banks funded this fiscal spending, which boosted investors' asset prices. Americans then went on a shopping spree, purchasing almost 20% more in goods in Q2 2021 than they did in Q4 2019, prior to the pandemic.

While either the supply or demand shock would have driven prices higher, the fact that these two major shocks occurred at the same time was a catalyst for much higher prices. We do not know how long it will take for supply chains to normalize, and there are some longer-term structural risks, including the trend towards de-globalization and the shift from monetary to fiscal policy as governments' tool of choice, but our view is that these shocks will eventually pass.

One reason is that Government officials are acting quickly. President Biden has asked California's ports to move to 24/7 operations, while California's governor issued an order to alleviate congestion at shipping ports and tackle the shortage of truck drivers. The Chinese government has also taken a "slew of measures" to ensure adequate power supply to keep factories running. Another positive development has been an easing of the global chip shortage, as lead times are beginning to slow. We are finding that companies are investing in fixing their supply chains, and they could likely recover even more productive and resilient.

All of these give us hope that the supply-side disruptions will resolve themselves in time.

On the demand side, the data shows us a relatively normal profile. Consumers are not panic buying due to concern of future price hikes, so the sales we see are not inflated due to a pull-forward of demand.

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Figure 1 shows how US personal consumption expenditures returned to trend in Q3 2021 and are in fact now back in line with the historical average.

Figure 1: US Personal Consumption Expenditures, November 30, 2007 – September 30, 2021

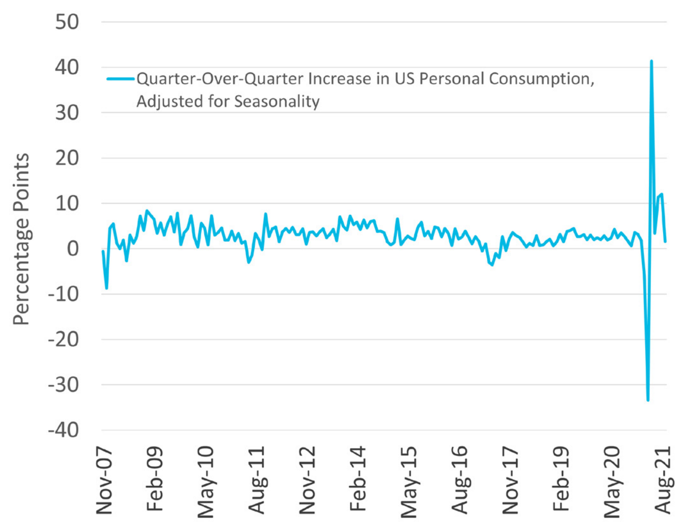


Chart shows the quarter-over-quarter percentage change in annualized US personal consumption, adjusted for seasonality.

Source: Bloomberg, Leith Wheeler.

Translating Economist-Speak When it Comes to Inflation

The term used to describe a "return to normal" in regard to inflation is "transitory," but transitory relative to what? In simple terms, transitory inflation in *absolute* terms would see prices coming back down after a temporary increase. Transitory inflation in *rate-of-change* terms would mean that prices increased quickly and stopped going up quickly but would remain high.

The example in Figure 2 illustrates an extreme hypothetical situation in which prices fall precipitously, rebound even harder, and then moderate at a higher level.

Figure 2: Illustrating Inflation in Absolute and Rate-of-Change Terms (Illustrative Example)

	Cost to fill the shopping cart	Change $	Change %
Day 1	$100		
		-$20	-20%
Day 100	$80		
		+$40	+50%
Day 200	$120		
		+$4	+3.3%
Day 300	$124		
		+$2.5	+2%
Day 400	$126.50		

In this case, the rate of change of price increases settles into the low single digits (2%) – in line with central banks' target rates – but at an absolute level that is higher ($126.50) than where we started ($100). Unfortunately, this is what most economists are referring to when they talk about transitory inflation: the high rate of change proves transitory but consumers are left with a persistently (though more stably) higher shopping bill. **For the rate of change of inflation to stay high, we would need to see *a sustained supply shock or demand continuously rising*, or both.**

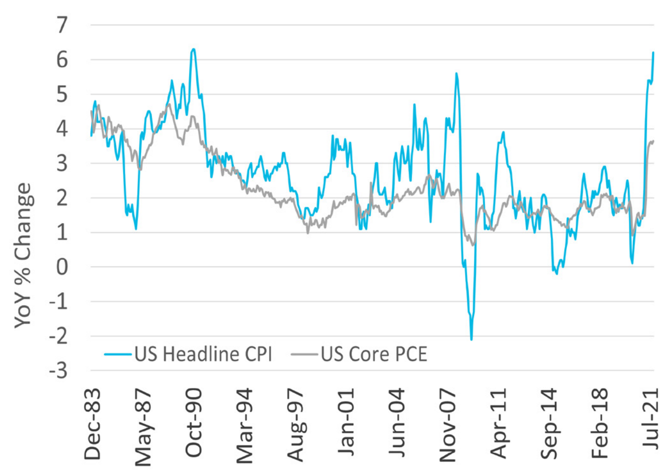
Why Do We Care About Inflation?

We are keeping a close eye on the measures that the US Federal Reserve ("Fed") and Bank of Canada are watching, because it's long-term inflation expectations and wages, along with broadening and deepening of supply shock inflation, that ultimately drives policy. If the Fed or Bank of Canada believe that inflation will continue to run above certain thresholds, it could move up the timeline for rate increases. Rate increases are intended to put a break on the economy and tend to trigger short-term sell-offs in equity markets, especially if they are unexpected. Bond markets similarly tend to fall as rates rise, at least in the short term. As discussed in our recent article, Value is Back, however, periods of central bank hikes have in fact tended to correspond to periods of market and economic expansion.

How Do the Current Numbers Look in Context?

The Fed's preferred headline measure of inflation is the Core PCE Index, which attempts to smooth out the short-term impact of gyrations in food and energy costs. Figure 3 shows Core PCE is running at 3.6% year-over-year and is more anchored as compared to the headline rate of 6.2%.

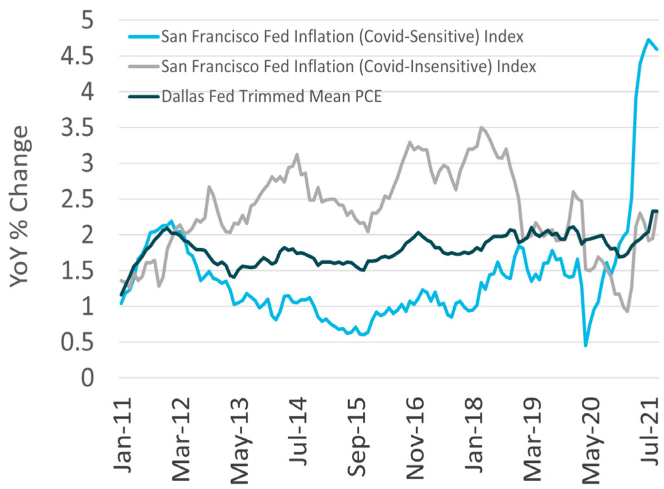
Figure 3: US Headline CPI and US Core PCE, December 31, 1983 – October 31, 2021



Source: Leith Wheeler, Bloomberg

The San Francisco Fed breaks it down further, distinguishing between COVID-sensitive and COVID-insensitive components of inflation. As seen in Figure 4, the COVID-insensitive components are trading in line with the rates seen in the last decade. The Dallas Fed's Trimmed Mean PCE Index, shown in dark green, shows a similarly sanguine picture.

Figure 4: San Francisco and Dallas Fed Inflation Measures Remove Short-Term Noise, Jan 31, 2011 – September 30, 2021

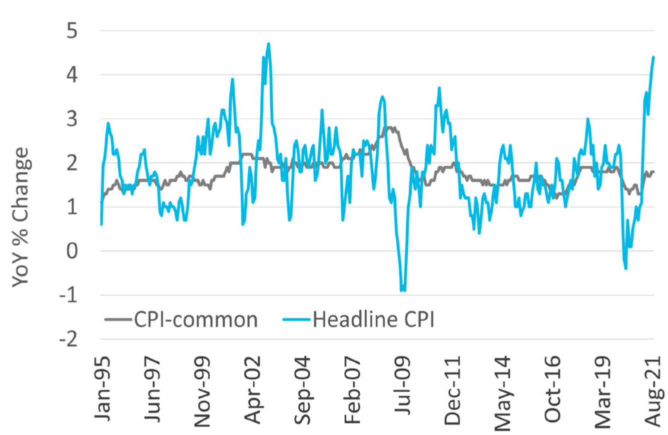


Source: Leith Wheeler, Bloomberg

We are also not seeing higher wages driving price increases, with wage growth clocking in at 4.2% in September, which is in-line with the past 25 years. Now that government benefits have expired, it remains to be seen what the impact on labour supply and wages will be as those who are unemployed return to the workforce.

The Bank of Canada is watching the "CPI-common" rather than Headline CPI, which similarly filters out volatile short-term price movements. Figure 5 shows it is trading at 1.8%, in line with its historical average, and well below the headline CPI at 4.4%.

Figure 5: Canadian Inflation Measures: Bank of Canada Headline CPI and CPI-common, January 1, 1995 – September 30, 2021



Source: Bank of Canada, Leith Wheeler

The Bank of Canada has identified some of the key risks they are watching, including stronger household spending and more persistent supply bottlenecks and cost pressures. They expect inflation to pick up more in 2021 before coming back down to around the 2% inflation target by the end of 2022.

Inflation expectations will also influence how long price increases remain an issue. Usually, the more price hikes are anticipated, the more likely they are to materialize. The data here is also encouraging. The University of Michigan tracks expected changes in prices 5-10 years into the future, and these figures are in line with long-term average of 2.5%. And long-term bond market data implies levels slightly lower than that.

How Does Inflation Impact Stocks?

As discussed above, if the supply constraints, wage growth, and inflation expectations all signaled that we were in for a prolonged period of high inflation, central banks could raise interest rates, which would have an impact on all asset classes.

Equities represent ownership of real companies with underlying cash flows that are generally expected to keep pace with inflation. However, high inflation can shrink those profit margins and cash flows and compress valuations, and so is an important factor in forecasting stock prices. So what stocks provide the best protection?

In inflationary times, companies with: a high level of innovation, with robust pricing power, and which are trading at less-expensive valuations have the greatest likelihood of generating value for shareholders. Stocks that pay dividends can also help supplement returns through income.

Below are two examples of companies in our equity portfolios, highlighting the successes and headwinds they are facing in this environment:

Waste Connections ("WCN") is the third-largest North American waste management company and the culture since inception has been very focused on market selection and safety. WCN's deliberate efforts to choose its markets has translated into industry-leading pricing growth and metrics above inflation over the long term. Any cost increases are generally passed on to customers through annual price increases as well as surcharges. In the first half of this year, WCN's pricing growth has been nearly 5% despite the environment. We believe the company's upside potential will come from their robust free cash flow generation being deployed on acquisitions, dividends, or buybacks.

Axalta Coating Systems is a producer of industrial and automotive coatings sold globally. Coatings companies generally have strong pricing power due to low cost but high value-in-use. The industry has low capital intensity, resulting in high returns on capital and strong free cash flow. Coating companies have introduced innovations such as reduced drying times and applications, enabling customers to be more productive. We initiated a position in Axalta following underperformance driven by factors that should prove temporary. With new car dealers at historically low inventories and chip companies increasing capital expenditures, we believe there will be strong growth in production over the next few years. Rapidly rising costs for petroleum-based raw materials has created near term margin pressure that should abate as the industry raises prices. At less than 10x our estimate of normalized earnings, Axalta trades at a compelling valuation.

The balance of probabilities suggests sustained levels of elevated inflation are not in the cards but irrespective of what comes, our investment process positions Leith Wheeler clients well. We focus on investing in high-quality companies trading at lower valuations than their intrinsic value, based on our disciplined research process. We buy businesses that have a competitive advantage that can create value either through thoughtful reinvestment in the business or by returning capital to shareholders. And by purchasing these businesses at more attractive prices, we believe it provides our clients with an additional margin of safety to navigate different economic cycles – including periods of higher "transitory" inflation.

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