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## Inflation - Transitory or Not?



The U.S. Federal Reserve has given the markets another buzzword – “transitory”. They assert that any increase in inflation will only be transitory, or temporary. Let us hope they are correct as the U.S. inflation rate for June came in at 5.4% annualized. This is the highest rate of inflation in over a decade. While many economists

are now of the opinion inflation will rise and become problematic, the opinions are far from unanimous. Many also believe inflation will indeed be temporary and agree with the Federal Reserve. The next several months will be pivotal in shedding some light on the inflation debate.

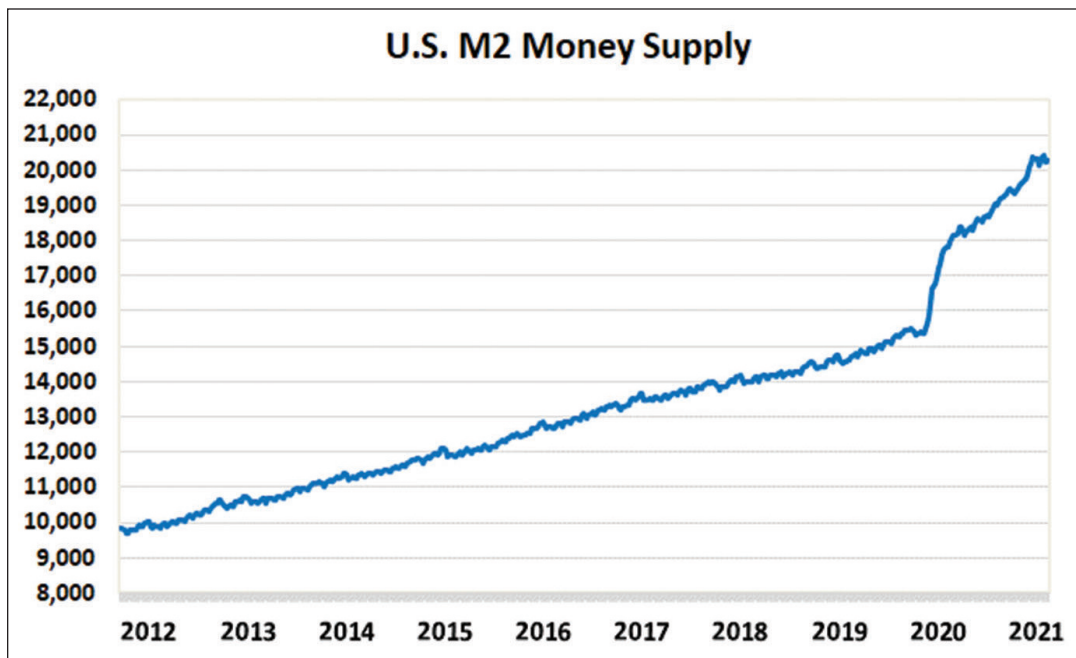
The argument for a benign and transitory inflation centers on supply side shocks and shortages, a direct and still lingering effect of the lockdowns during this pandemic. These will eventually clear and help to restore normal prices. Chairman Powell has commented on the challenges of ‘bottlenecks’. In a recent testimony before the U.S. Senate he said, “shutting down and then reopening the economy has had a substantial disruption on supply chains. These take time to adjust, and businesses are slowly getting back to operating efficiently again”. He insisted these are temporary blockages and will be resolved in due course.

Bottlenecks and shortages are also explained by the shift in consumption of goods and services. Consumer purchases of “goods” increased during the past year since many “services” were shut down - salons, restaurants, travel, etc. Higher spending on computers, appliances and furniture caused shortages in those goods and firmed up prices. A rebalancing will occur as the economy normalizes and this should put downward pressure on prices.

Mohammed El-Erian, chief economic advisor at Allianz, is well known and respected for his commentaries over the years. In his opinion inflation will not be transitory. He notes many international companies have already announced price increases and he expects further price increases to come.

Many others that claim inflation will become more problematic are looking at the supply of money. M2 money creation in the U.S., as per the chart below, has risen sharply - up over 25% since the start of the pandemic. Too many dollars chasing too few goods is the classic concern of monetarists. While an increase in money supply should in theory produce inflation, the historical record is sketchy.

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CPI. The year-over-year increase in median asking rents has jumped by over 15%. The CPI rent component however shows just 1.9% year-over-year growth.

Proponents of a transitory bout of inflation also cite the weak labour force. The output gap is large and will take at least two years before it is filled, and employment levels return to where they can command wage increases. Wage pressures were starting to build, however with the governments very generous employment benefits coming to an end, a larger labour

Inflation does not only establish itself in consumer goods and services but also in assets – namely financial assets and real estate. The price increases in stocks and bonds however are not measured in the CPI inflation numbers and the price increases in residential housing is inappropriately measured. Yet money flows have clearly found their way into both assets.

By some estimates, if housing costs (both house price increase and rent) were accurately reflected in the CPI, the June number would have been closer to 10% rather than the reported 5.4%. Rental costs have always been criticized for understating the shelter cost component of

pool will be looking to fill the job vacancies. A significant rise in wages is questionable in the immediate horizon and will unlikely be a catalyst for a sustained and higher level of inflation.

Recent market dynamics support this view – bond yields have reversed and are trending down. The price of many commodities has recently drifted lower. Perhaps inflation will be transitory. Perhaps the markets **agreeing with the Fed** will be transitory. Still, with inflation likely trending at its highest level in a decade, it is difficult to make sense of a 10-year government bond yield of just 1.25%.

## The Taper Tantrum Redux

Chairman Powell has acknowledged the Federal Reserve has been having discussions about “tapering” or reducing its purchases of bonds. It is currently purchasing \$120 Billion per month of which \$80 billion is in government treasury bonds and \$40 billion is in private mortgaged-backed securities.



They are not alone. According to an article on Bloomberg, since last March at the start of the pandemic, the three main central banks, the Federal Reserve, the European Central Bank (ECB) and the Bank of Japan (BOJ) have increased their balance sheets by \$9 Trillion. Their combined balance sheets are now equal to \$24 Trillion, a

60% increase in just over a year. This is monetary stimulus on steroids.

In 2013 when the Federal Reserve last considered tapering, the financial markets had a tantrum – bond and stock prices dropped as 10-year treasury yields rose by more than 1% to about 3%. Ben Bernanke was the Chairman at the time and the Fed’s

quantitative easing (QE) program was purchasing \$85 billion in bonds per month. Eight years later the amount of any tapering program will be considerably more challenging.

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## The Taper Tantrum Redux *(cont'd from page 2)*

At the moment, bond yields are easing. The U.S. 10-year treasury yield is down to 1.25% from a high of 1.75% at the end of March. Three months ago, inflation concerns were building, and market participants were positioning for interest rates to rise. These positions have since reversed, along with the more hawkish views on inflation. For now, the market is less concerned the Fed will “taper” and take away the punch bowl.

Markets also recognize the Fed has a dual mandate - to keep inflation in check and to seek full employment. With unemployment at roughly 8%, the labour markets are still fragile. The Fed is not anxious to raise interest rates to combat inflation, transitory or not. Barring any further outbreak of Covid-19 variants which puts the global economy in another lockdown, this market cycle should continue to grow and recovery.

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## Bonds Remain Unattractive



At this juncture, the bond market is betting inflation pressures will abate. Investors have driven down the U.S. 10-year

government bond yield to 1.25%. At its height early this year the yield was 1.75%. Canadian bond yields have likewise declined. Bond investors believe in the Federal Reserve’s narrative that inflation is transitory. At least for now. While the jury is still out, inflation is likely to be sticky as the global economy recovers. The consumption of oil, as per the International Energy Agency (IEA) is already back close to pre-pandemic levels and estimated to grow to over 100 million barrels per day. This is not a deflationary force. As well, monetary policy globally continues to be very loose. A definite recipe for more, not less inflation.

Interest rates are likely to be heading higher. Unless of course the economy proves less resilient when taken off government life support. Nonetheless, interest rates cannot remain permanently low, as this would suggest little or no economic growth. Inflation is becoming an issue as the global economy recovers.

It was not that long ago the Federal Reserve asserted that any sustained inflation above their target of 2% will not be tolerated, quote, “if, contrary to expectations inflation were to move persistently and materially above 2%, we would use our tools to bring inflation and expectations down...” Presumably this means raising interest rates.

The Federal Reserve is now preparing to exit from its massive stimulus program. The bond market may be able to absorb the extra supply as the Fed exits as the intention is to do so gradually. Still, given the enormous amount, efforts by the Fed to withdraw could drive interest rates much higher than expected.

Importantly, investors can and do react quickly when market conditions change or there is general uncertainty. Selling is a primary instinct for many active bond traders, especially those with leveraged portfolios. Hedge funds that operate with borrowed money can be caught offside when their bond positions reverse in price. As prices decline and bond yields move up, more fund managers get anxious and may also begin to sell. A quick decline of 10 or 15% can occur in bond prices without any real or obvious change in economic conditions.

The bond market remains unattractive due to the low yield it offers investors and importantly the likelihood of increased volatility as the inflation debate continues to make headlines.

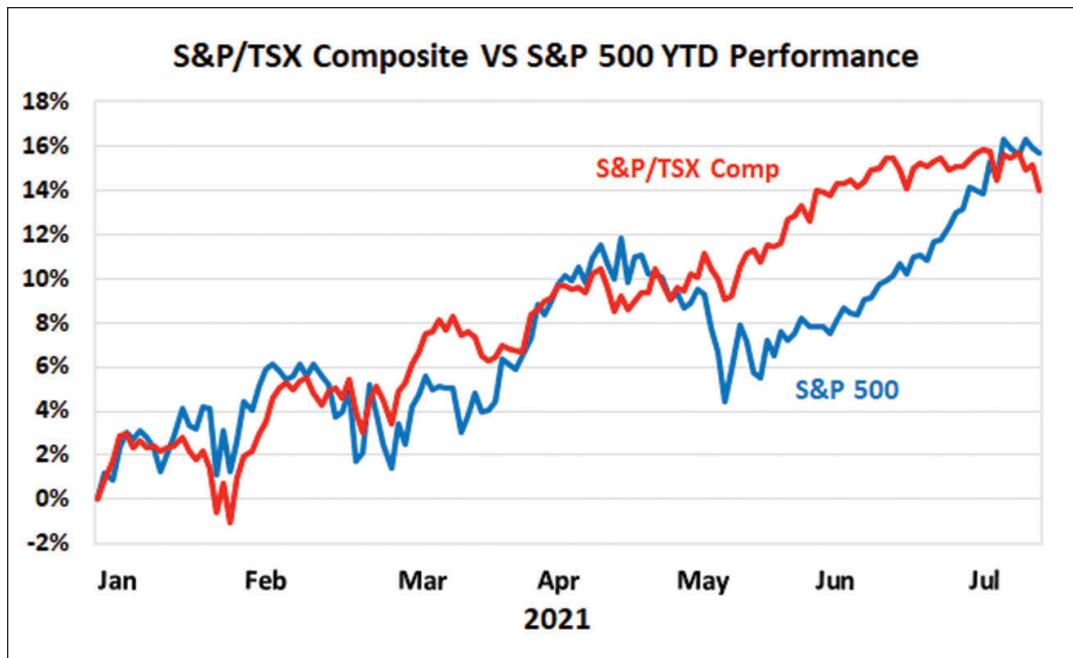
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## Portfolio Strategy

It may be time to start positioning for a more defensive strategy. Accordingly, in the weeks and months ahead we will be considering reducing the exposure to equity markets and/or emphasizing the consumer staples and utilities sectors. Also, bond weightings may need to be increased, and/or maturities extended towards the longer end of the yield curve.

For investments in both stocks and bonds, this also means moving to higher quality credits. In the equity component the focus should be on larger-cap Canadian and U.S. equities, and an increased weighting in higher dividend yielding securities or exchange traded funds.

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So far in 2021, market corrections have been modest and short-lived events. Stock prices continue to rally and are near their all-time highs. As per the chart below of the major U.S. and Canadian stock indices, stock prices are up about 15% year-to-date. We expect the immediate period ahead will be more volatile as financial markets adjust to an eventual end in quantitative easing and higher short-term interest rates, the result of rising inflationary expectations.

It is important to differentiate short term volatility in financial markets from the potentially more damaging longer-term downturn which characterizes the end of a business cycle. We don't believe a serious recession is around the corner having just experienced one in 2020. The next few years should show positive economic growth as the world is in recovery mode from the terrible pandemic. Therefore, if we shift a portion of the portfolio to a more defensive posture, we do not anticipate remaining with this strategy much beyond the next several months.

In an unanticipated development, the U.S. dollar has begun to appreciate again. Since May it has rallied by over 4% on a trade-weighted basis. Vis-a-vis the Euro, the dollar is now trading at about 1.18 to 1. The tensions in Europe have certainly helped the U.S. dollar as flight capital out of the Euro seeks a safer haven. Against the Canadian dollar, it has appreciated about 4 cents, trading at around the .79 level. Just when everyone was ready to give up on the U.S. dollar and citing an imminent end to its reserve currency status, it has been given a new lease on life.

Notwithstanding the rise in the U.S. dollar, we still believe the Canadian dollar is attractive and has the wherewithal to trade back up the in mid .80 cent range.

Increasingly, investors around the world are looking for protection from the inevitable devaluation of all fiat currencies. The Bitcoin phenomenon and the adoption of cryptocurrencies generally is partly a manifestation of this thinking. With the volatility witnessed in cryptocurrencies this past quarter, it may encourage investors to consider gold bullion once again as an

alternative. It could possibly be the next big theme – especially if the Federal Reserve is seen to be failing at withdrawing quantitative easing.

The global monetary system remains challenged. The pandemic has devastated economies and there is now more pressure for countries to devalue their currencies in order to boost export markets - and ultimately to pay down large government deficits and service debts. This has usually been a positive environment for gold, and we could finally see much higher prices for gold in the year ahead.

Inflation is likely to be a longer-term threat, which is a good environment for gold. A month or so ago inflation expectations were steadily ratcheting up higher. Many commodity prices were at all-time highs. Shipping and transportation costs, housing prices, were fueling an inflationary mindset. We have since had a reprieve. The CPI is destined to move higher in the next twelve months as the economy normalizes and as employment recovers.

Investing based strictly on fundamentals can often be a frustrating exercise. In many cases a company's valuation appears compelling enough and it reports decent earnings, yet the stock price performs poorly. Many companies considered "value stocks" are prime examples of this. For these companies, stock prices today are relatively cheap with reasonable price/earnings ratios. We continue to look for companies which we consider represent good value. Unfortunately, markets have a habit of going to extremes on either side of the pricing spectrum. It is a constant irritant.