DM PORTFOLIO COMMENTARY
1st Quarter 2021

Cold & hot

No sooner had we adapted to investing in an economic winter, than markets started fretting that the temperature is about to get uncomfortably warm. More specifically, worries now abound that inflation will soon surge, the result of overstuffed household balance sheets colliding with our ability to move about freely once again and a supply chain that's strained in several areas. Unfortunately, the natural corollary of higher inflation is higher interest rates, and the fear is that a jump in yields could undermine an important part of the valuation calculus that has helped to propel stocks up from their pandemic lows.

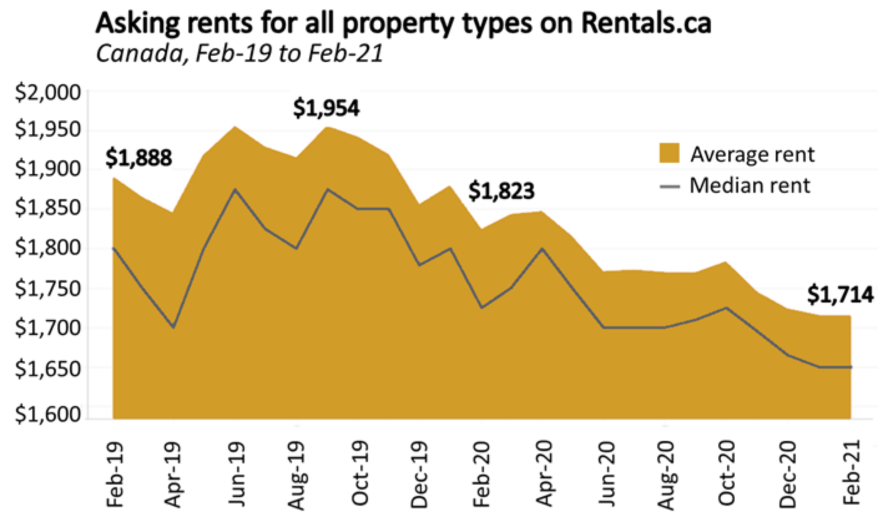
On the surface, the conditions for a bump in consumer prices would certainly seem to be in place: alongside the record liquidity and pent-up demand referenced above, input prices for manufacturers are rising and major ports and distribution networks are bottlenecked, a condition that wasn't helped by the scrape in the Suez! As we consider this evolving backdrop and its implications for equity investment, two questions are prominent. First, if the rate of growth in consumer prices does increase, will it be a temporary acceleration or something more enduring? And second, if an economic rebound pushes inflation and interest rates higher, will the accompanying rise in corporate earnings be great enough to overcome this drag?

In one of our recent investment committee meetings, we concluded that much of the inflation that will appear in the months ahead will probably be better characterized as *reflation*. By this we mean that prices will not so much set new highs as they will simply return to the path that they would have trod had such an extraordinary interruption not been inserted at the beginning of last year (*this behaviour is probable in things like airfares and apparel, and has already been witnessed in gasoline*). At the same time, goods which found themselves in extreme demand during the pandemic (*cleaning products, home office supplies, certain grocery items*) should be under less pressure once we make our way back to a more 'normal' economic existence, potentially providing a counterweight within the aggregate Consumer Price Index (CPI).

The unusual inflation backdrop that we're likely to face in the months ahead has been aptly illustrated by the used car market. Last spring, as lockdowns took effect, not only did wary consumers initially sit on their hands when it came to big ticket purchases, but new car production plunged as automakers were forced to shutter factories until mid-May. Soon, though, stimulus checks started arriving and sidelined commuters began to contemplate the idea of returning to crowded buses and trains in a post-pandemic world. As resultant demand for vehicles jumped, dealers had limited means to replace inventory and the perfect storm quickly made its way to the used car market, where prices leapt by 14% from February to October. Since then, however, demand pressure has tapered and factory output has resumed, allowing prices to retreat by 4%.

It often feels like CPI figures don't represent the 'real world' and that the price increases we experience in our daily lives occur at a rate well in excess of what the government tells us about inflation. Last summer, the Bank of Canada produced a study that looked at how psychology and bias can play a role in our perceptions about inflation and they found that (a) consumers assign significant weight to price increases but often disregard reductions, and (b) we are prone to focusing on one part of the economy or shopping basket, while overlooking others.

For those of us living in southern British Columbia, for example, much of our economic experience over the past two decades has been coloured by real estate and construction. Watching bidding wars now erupt for tear-down condition houses or hearing that lumber prices have doubled in less than a year can seem wildly inflationary to many of us. For much of the population, however, the cost of buying or building a home is of only fleeting interest, with the far greater concern being what it costs to rent accommodation. On this front, the past year has been uncommonly deflationary. In major US centres like Boston (-8.9%), New York (-15.5%), and San Francisco (-21.5%), rent declines have been even steeper and are probably more than offsetting increases in other parts of many household budgets.



With these examples and others considered, it seems unlikely that the inflation story will be as straightforward as many are suggesting or what our instincts might be telling us (and we shouldn't forget that the past year has seen a steep acceleration in technology and virtual commerce adoption, both of which tend to be deflationary in nature). To be sure, there will be several dramatic price jumps from year-ago levels, but many of these gains will be coming off spectacularly depressed levels and others will last only until supply chains and distribution networks are able to adjust to a reinvigorated economy. This pattern is also evident in interest rates, which have climbed sharply over the past three months, but still sit below where they were at the beginning of 2020.

While the effect and timing of rising rates on equity markets has been nuanced throughout history, the impact on bonds is always more direct and immediate, a fact of which we were emphatically reminded in Q1 when fixed income prices turned sharply downward and the Bloomberg Barclays Treasuries Index suffered its biggest quarterly decline since 1980. Though we don't expect bonds to be under similar pressure for the balance of the year, the tailwind of falling rates won't likely be with us for some time, given the strong rebounds expected in consumption, business activity, and global trade. Because of this, fixed income allocations will continue to serve their dual purposes of risk mitigation and capital availability but are unlikely to make a significant contribution to aggregate portfolio return in the near term.

As mentioned, the upside to this expansionary backdrop is that corporate profitability should be equally buoyant, a market-positive outcome which has recently been supported by both reported earnings and upbeat management comments. Of course, the attractiveness of a stock is influenced not only by its expected income, but also by its current price level and the return offered by alternatives, especially interest-bearing vehicles. In a setting that is likely to include an economic boom countered by meaningful shifts in consumer prices and interest rates, weighing these variables will present a new set of challenges as the economy catapults from frozen to superheated. And, just as pandemic conditions were a boon to some industries and a nearly insurmountable obstacle to others, this unique economic tide is also unlikely to lift all boats equally, a consideration which will inform much of our analytical work in the months to come.