

THE KWAMMENTARY

November 2021 Edition



ODLUM BROWN
Investing for Generations®

Kwame Boateng, CFA – Portfolio Manager, Investment Advisor

T 250 861 8173 | Toll Free 1 800 788 5677 | kboateng@odlumbrown.com

Odlum Brown Limited | Suite 1500 – 1631 Dickson Avenue | Kelowna, BC V1Y 0B5

Member-Canadian Investor Protection Fund

Stagflation – Santa’s least favourite reindeer

♪ You know Dasher, and Dancer, and Prancer, and Vixen
Comet, and Cupid, and Donner and Blitzen
But do you recall, the least favourite reindeer of all? ♪

If you were around during the 1970s, you likely met this one. Its name is Stagflation, and in recent months, concerns around it swinging by for the holidays (and beyond) have increased. While the prospect of this happening would be ho-ho-horrible, there is a case to be made that the concerns are not yet fully justified.

What is stagflation?

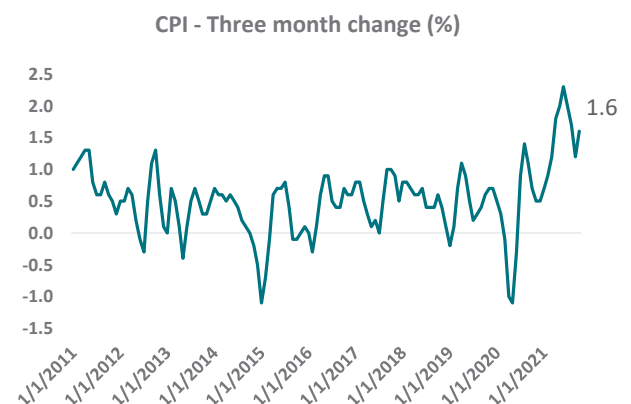
There are four types of price change environments that we can observe:

- **Inflation** – prices change in an upwards direction, either consistently accelerating or consistently decelerating. Typically indicative of a well- to hyper-functioning economy, easy monetary policy, or both.
- **Deflation** – prices change in a downwards direction, either consistently accelerating or consistently decelerating. This can be indicative of an underperforming economy, and/or tight monetary policy.
- **Disinflation** – prices change in an upwards direction, but at a slower pace. Think of an economy transitioning away from a highly expansionary phase toward a more mature growth profile.
- **Stagflation** – an environment where prices are increasing while economic activity is stagnant/decreasing.

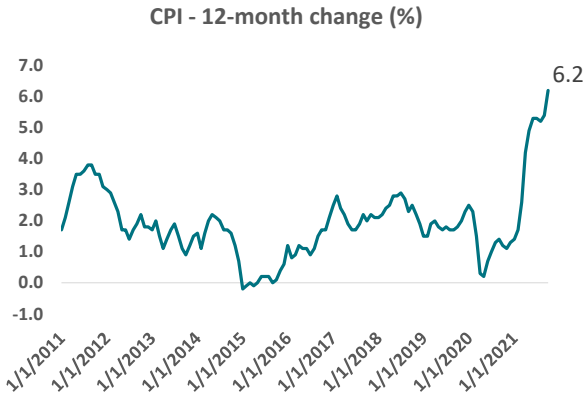
Each type of environment, on its own, is less than ideal when taken to the extreme, although I would argue that stagflation is the most difficult and painful to address. There are a range of tools that governments can use to combat inflation, both monetarily (e.g., money printing or increasing interest rates) or fiscally (e.g., higher taxes or decreasing direct payments), that can cool down demand. Doing any of those things while economic activity is stagnant, however, is a recipe for disaster.

The case for stagflation

Recently, there have been a few data points indicating a stagnant/inflationary environment that has given some investors pause. In the inflation camp, we have gotten a better sense of where things might be heading. The takeaway: inflation is here and will likely be around for a while.



Source: U.S. Bureau of Labour Statistics



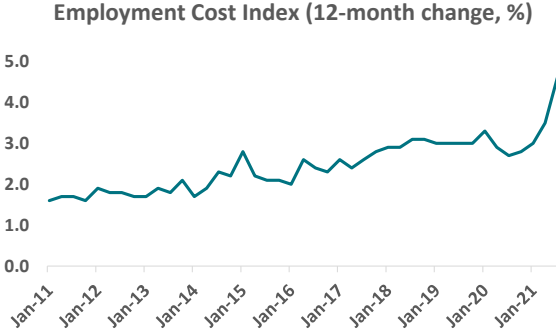
Source: U.S. Bureau of Labour Statistics

The Consumer Price Index (CPI) is a measurement commonly used by economists and investors to get a sense of how prices across multiple items are moving in aggregate. The graphs above and on the previous page are based on activity in the U.S., but the trend can be extrapolated to Canada and the rest of the developed world. When you look at anything from eggs and bread to natural gas and petrol, everything has gotten more expensive. I've spoken about inflation in previous notes, but it is worth providing some updated thoughts, especially given what we've recently seen happen. When I think about inflation, I tend to split it up into two components: the **scarcity component** and the **labour component**.

Scarcity: Supply and demand dynamics influence price, as we know, and the intensity of either side will have an outsized effect on how far the price of the good/service will move. In recent months, we have seen the supply side (across multiple products/goods) get squeezed for various reasons, while the demand side has marched upwards. This scarcity, while intense right now, can usually work itself out over time as the various kinks that lead to constrained supply get worked out. How long that will take is anyone's guess, but price changes due to this dynamic generally moderate.

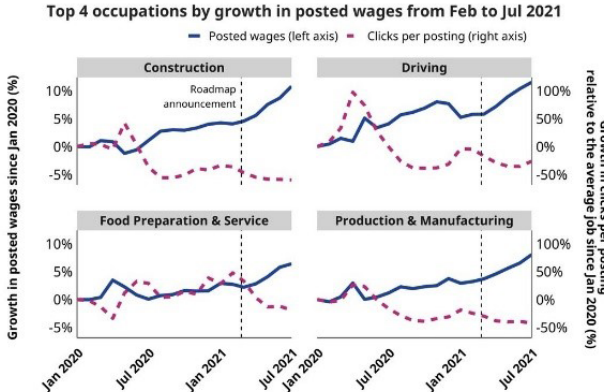
Labour: The cost of human capital to produce goods/provide services is also a key dynamic in pricing. There is a reason why your fast-fashion clothes or the average button-down shirt (which are often highly labour intensive to make) don't cost \$200 each. Taking advantage of lower-cost means of production has been a boon to developed economies for the better part of 20 years. However, this is increasingly not the case anymore, and the cost of goods adjusts accordingly.

More locally, the cost of labour for those in the agriculture space, front-line services and construction have increased as a consequence of labour shortages and a lack of interest at previously acceptable wage levels. Unlike the scarcity component described above, wage increases have a tendency to be sticky.



Source: U.S. Bureau of Labour Statistics

Posted wages have grown rapidly in some occupations

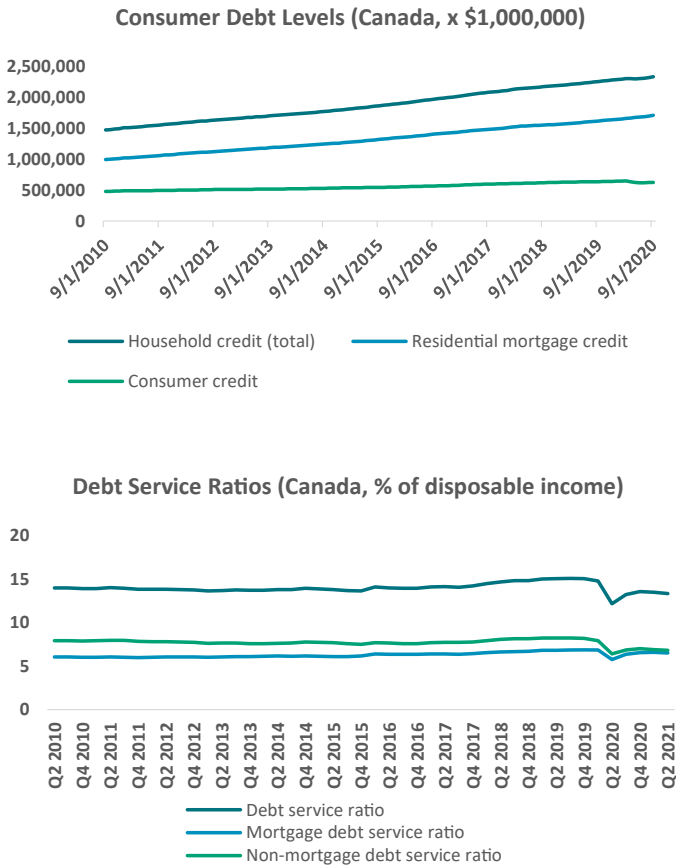


Source: Indeed. Growth in posted wages adjusted for shifts in the mix of job titles and locations within each occupation over time.

When you combine both of those dynamics, I think it's reasonable to expect inflation, in general, to increase persistently in the short to medium term. Longer term, as the scarcity component moderates, price increases should also settle, albeit, at a higher level than they have been historically due to the sticky labour cost component.

What about the prospects of a stagnant economy? So far, the numbers aren't showing it. Gross Domestic Product (GDP) growth in most developed countries has been robust coming out of the most restrictive periods of COVID-19, and that trend is likely to persist (with the occasional hiccup) as seasonality impacts COVID-19 case counts. What has made some nervous is the

potential impact that an interest rate increase would have on economic activity. Let's consider the average Canadian and their debt loads.



Source: Statistics Canada

What you can see in the charts above is that debt levels have continued upwards (specifically the top chart), but in terms of the impact on disposable income (bottom chart), the effect has been minimal. This is exclusively a consequence of the ultra-low interest rate environment we have been in since the Great Financial Crisis in 2007/08. Should we enter a period where interest rates need to rise significantly (i.e., to combat inflation), this could prove to be a significant headwind to economic activity. I am picking on Canada at the consumer level, but we are seeing similar trends in multiple developed countries, both at the consumer and government levels.

The case against stagflation: to be continued

At this point, you might be thinking, "Well, Kwame, where's the holiday cheer?" I know the points above are a little gloomy, but I assure you there are more positives to the environment that we're currently in than meet the eye. In the next *Kwammentary*, I will elaborate on why I am not as concerned about stagflation as some may be, as well as what I will be looking for throughout 2022.

As always, very happy to chat.

Sincerely,

KWAME BOATENG, CFA

Portfolio Manager, Investment Advisor

Tel 250-861-8173

Toll Free 1-800-788-5677

kboateng@odlumbrown.com

**PLEASE READ OUR ODLUM BROWN LIMITED
DISCLAIMER AND DISCLOSURE - IT IS IMPORTANT!**

Odlum Brown Limited is an independent, full-service investment firm focused on providing professional investment advice and objective research. We respect your right to be informed of relationships with the issuers or strategies referred to in this report which might reasonably be expected to indicate potential conflicts of interest with respect to the securities or any investment strategies discussed or recommended in this report. We do not act as a market maker in any securities and do not provide investment banking or advisory services to, or hold positions in, the issuers covered by our research. Analysts and their associates may, from time to time, hold securities of issuers discussed or recommended in this report because they personally have the conviction to follow their own research, but we have implemented internal policies that impose restrictions on when and how an Analyst may buy or sell securities they cover and any such interest will be disclosed in our report in accordance with regulatory policy. Our Analysts receive no direct compensation based on revenue from investment banking services. We describe our research policies in greater detail, including a description of our rating system and how we disseminate our research, on the Odlum Brown Limited website at www.odlumbrown.com.

This report has been prepared by Odlum Brown Limited and is intended only for persons resident and located in all the provinces and territories of Canada, where Odlum Brown Limited's services and products may lawfully be offered for sale, and therein only to clients of Odlum Brown Limited. This report is not intended for distribution to, or use by, any person or entity in any jurisdiction or country including the United States, where such distribution or use would be contrary to law or regulation or which would subject Odlum Brown Limited to any registration requirement within such jurisdiction or country. As no regard has been made as to the specific investment objectives, financial situation, and other particular circumstances of any person who may receive this report, clients should seek the advice of a registered investment advisor and other professional advisors, as applicable, regarding the appropriateness of investing in any securities or any investment strategies discussed or recommended in this report.

This report is for information purposes only and is neither a solicitation for the purchase of securities nor an offer of securities. The information contained in this report has been compiled from sources we believe to be reliable, however, we make no guarantee, representation or warranty, expressed or implied, as to such information's accuracy or completeness. All opinions and estimates contained in this report, whether or not our own, are based on assumptions we believe to be reasonable as of the date of the report and are subject to change without notice. Please note that, as at the date of this report, the Research Analyst responsible for the recommendations herein, associates of such Analyst and/or other individuals directly involved in the preparation of this report hold securities of some of the issuer(s) referred to directly or through derivatives. No part of this publication may be reproduced without the express written consent of Odlum Brown Limited.

Odlum Brown respects your time and your privacy. If you no longer wish us to retain and use your personal information preferring to have your name removed from our mailing list, please contact Kwame Boateng at 250-861-8173 or kboateng@odlumbrown.com. If you are currently a client of another Odlum Brown Investment Advisor, accept my apology as it is not my intent to contact existing clients. For more information on our Privacy Policy, please visit our website at odlumbrown.com.