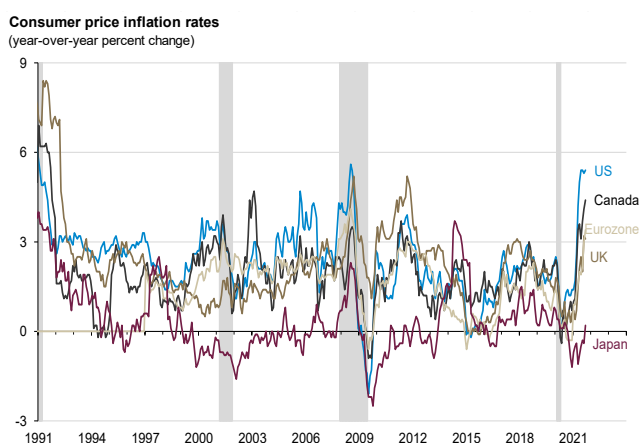


November 2021

Inflated sense of self-worth

Just over a year ago in this space, in our article [‘Inflation: Forgotten but not gone’](#), it was noted that inflation could soon return to the top of the list of investor considerations.

Cut to today and the topic of rising price pressures is prevalent in media and market discussions as inflation rates have rebounded from last year’s lows to touch multi-decade highs globally.



Data to September 2021; shaded regions represent periods of US recession
Source: Bloomberg, Guardian Capital

These conversations carry a somewhat dark tone, with allusions to a potential, and frequently increasing, return to a “stagflation” (low-to-no economic growth with high inflation) environment like that seen through the 1970s. However, it is important to emphasize that inflation (the generalized increase in prices of goods and services within an economy) is not inherently a bad thing.

Modest incremental increases in prices mean that companies are charging more for what they produce, which in turn means that they can pay their employees more, increasing their purchasing power and supporting growth in demand.

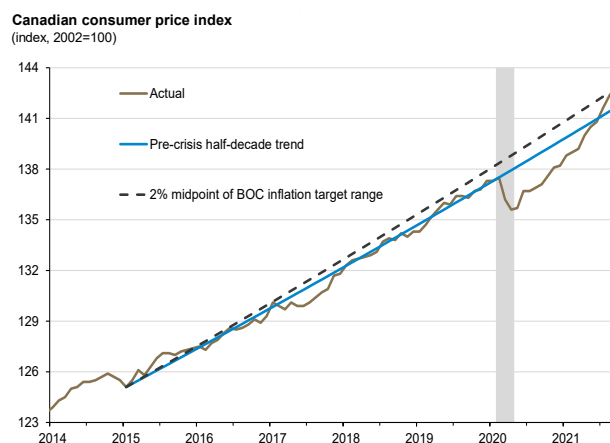
Anything in excess is not good and that is especially the case for inflation – large and rapid increases in prices can significantly erode purchasing power (especially if wages do not see commensurate gains), effectively acting as an escalating tax that constrains spending and investment.

The question right now is whether the inflation prints being recorded represent a sustained shift in the trajectory for prices, or if other factors are at play that make the figures less concerning – and on this score, it still appears that it is the latter.

Inflation data have been firm of late, but this follows a year in which the collapse in demand driven by the severe lockdown conditions of the early stages of the pandemic saw prices fall. In this sense, prices have largely just been retracing that earlier weakness.

For example, projecting the average consumer price inflation rate in Canada, from the five years following the oil price collapse in 2014 over the last two years, shows that prices have effectively just reverted to trend, albeit they now stand just above it. Aggregate prices are, however, at a level consistent with the 2% midpoint of the Bank of Canada’s inflation target range.

Much of the “strength” in year-over-year inflation data this year has been due to the “softness” last year – these “reopening” and “base” effects are the main culprits behind the sticker shock of recent inflation readings and will drop out of the calculation in the year ahead.

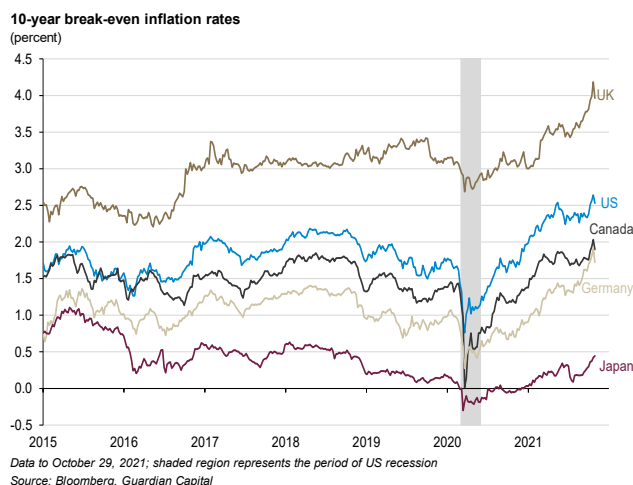


Data to September 2021; shaded region represents the period of US recession
Source: Bloomberg, Guardian Capital

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It has also been the case that prices for a range of goods and services have been rising sharply due to more fundamental factors, namely the sustained increase in costs of raw materials and lingering pandemic-driven supply chain issues amid robust demand.

The latter issue appears to be more persistent than assumed. While the expectation is for these pressures to moderate going forward as the supply side plays catch-up, it still has factored into the recent increase in market-based inflation expectations. The shift in the anticipated path of future inflation matters because these views can become a self-fulfilling prophecy.



Even here, context is important. Expectations are for inflation rates of around 2% and not the recent levels of over 4%, let alone a return to the double-digit rates of the 1970s. These are higher than the pre-crisis trends but in line with inflation targets set by central banks that are viewed as consistent with price stability (i.e. not detrimental to economic growth).

Inflation is not necessarily a bug in the system, but a feature of it.

The good news is that with most major central banks' policy rates at or near their effective lower bounds, there is more than enough scope to tap the brakes on demand to ease inflationary forces without necessarily stalling the nascent recovery.

The bad news is that expectations for underlying trend price pressures might persist with the response from policymakers to keep prices under control. This can potentially have negative implications for investors given that the prevailing level of market interest rates offers effectively no protection from inflation and limited insulation from a rise in yields. The impact of inflation needs to be a key consideration for investors in developing a plan to ensure that there is limited loss in the purchasing power of their invested capital down the road.

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