SV Wealth - Newsletter

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Historically, September is not a kind month for equity markets, as people return from vacation and start readjusting their portfolios. The month that just ended was no exception, unfortunately.

Equity markets broke their months-long winning streak in September, with the Canadian TSX 60 losing 2.27% and the American S&P 500 shedding 4.8%. It was the worst month for equities since March 2020, when the markets first realized that Covid-19 was going to be a big problem.

The news was not all dire, however. For the quarter, markets essentially ended where they started: the TSX 60 was down 0.5% while the S&P managed to eke out a 0.2% gain.

With October generally being the most volatile month for equities, we remain bullish but are turning cautious and slowly raising cash.

Inflationary Clouds on the Horizon

While the bull market appears intact on account of easy money by central banks (i.e. low interest rates), inflation continues to be a menace, despite the insistence of central bankers that it remains "transitory". The consumer price index, the gauge used for inflation, showed prices were 5.3% higher in August relative to the previous year, far above the bank's 2% target.

Inflation was initially thought to be "transitory" in March based on pent up demand as economies reopened and "base effects" (i.e. an easy comparison period from a year prior). However, supply chain issues, spiking energy prices and events in China are making inflation more stubborn than anticipated.

Shipping & Supply Chain Constraints

Supply chain issues that began after closures at shipping ports during the start of the pandemic continue to persist, causing spikes in logistical costs. For example, several large ports in China shut down operations after a cluster of coronavirus infections were found. Many other Chinese ports were also impacted by a recent typhoon that resulted in several days of closures.

With shipping ports clogged, retailers are resorting to moving their inventory by air instead, a much costlier proposition as air freight costs four times more than sea. As demand remains strong and retailers protect their margins, prices will continue to move upwards. Couple that with the microchip shortage that refuses to abate, and it's not hard to see the inflationary pressures continuing.

Insert Fiscal Stimulus?

Despite inflation, the Democrats in the US are insisting on passing $3.5 trillion of new government spending, along with another trillion for infrastructure spending. While the final total for the spending bills is likely to be lower on account of opposition from centrist Senators, it is still a massive amount of stimulus to inject into an economy that's experiencing its sixth month of inflation above the Fed's mandated 2% level.

Energy Prices

When the wind stopped blowing in Europe, it left windmills idled and towns without electricity. As a result, Europe ramped up imports of natural gas, pushing prices to levels typically seen in the depths of winter.

In China, a different energy crisis is happening. With coal prices surging due to a safety crackdown by Chinese authorities, factories have been ordered to reduce the number of days they operate, and on those days they're operating, to decrease the amount of energy they use. While coal prices won't directly affect us, the slowdown in the supply chain will irritate inflation further by reducing the amount of goods available.

China Risks

Adding to the destabilizing environment, China's crackdown on its tech companies continues to create havoc in some corners of the market. After the Communist Party crushed Didi Rideshare merely four days after their US IPO, authorities have gone on a wide-ranging crackdown on for profit education companies, video game companies and even entertainment companies promoting effeminate male stars. With many of these companies listed in the US, a further Chinese crackdown could add volatility to North American markets. This is to say nothing of the default by Evergrande, China's biggest property developer with some $300b in debts.

What Does Inflation Mean for the Markets?

As inflation persists, the central bank may be spooked into raising rates even sooner than mid-2022, the date they recently mentioned. Increasing rates is bad for most companies as it leads to higher costs. As costs increase, profit margins get squeezed, which typically results in a negative impact on equity markets.

The key thing to watch will be how high inflation goes, and how fast the central banks raise interest rates in response.

How We're Repositioning

We are rotating into more defensive sectors and since we continue to hold our exposure to the Canadian market, we are benefiting from exposure to energy and financials, two sectors typically well-positioned to take advantage of inflationary settings. Overall, while dark clouds may be closer than we'd like them to be, we remain bullish that in inflationary environments, stocks remain the best place to earn returns; it's just a matter of which sectors to be positioned in.

At SV Wealth, you can count on us to be agile in protecting your wealth. We will remain disciplined even in the face of uncertainty. We are your trusted partners on this journey.

We wish you a happy Thanksgiving!