We hope that this update finds you well and enjoying the summer.

We have seen the return of volatility and markets will likely remain in this pattern for the foreseeable future. The stimulus provided by central banks to stem the economic impact of COVID is being withdrawn and this is causing markets to be revalued as inflation is now the primary focus of global central banks. We have seen rate rises in the United States of 75 basis points and the Bank of Canada recently raised rates by a full percentage point. The 1% hike in Canada was a surprise, but it indicates the resolve of the Bank of Canada to reduce the current inflation levels. It is likely that the United States will remain aggressive and may follow the Canadian example. In Europe, weakened economies are not allowing as rapid a response. As a result, the Euro and Pound have weakened with the Euro reaching parity with the $USD.

There are many causes of global inflation. The impact on energy prices caused by the boycott of Russian oil and gas resulting from the Russia/Ukraine war is a major factor. A lack of investment, due in part to policy shifts favoring renewable energy in North America and Europe, has created inelasticity in the supply response to increased demand. As Europe is dependent upon Russian gas and as there are few sources of gas that can replace this dependence in the short term, it could be a very difficult winter, especially in Germany. The Chinese zero COVID policy has also exacerbated inflationary pricing as entire cities and regions are shut down. Factories are closed, ports stop functioning and supply chains slow.

Despite the high Consumer Price Index (CPI) readings, there are indications that high prices combined with elevated interest rates are beginning to have the desired impact. Oil prices are down sharply from the peak. Copper which is considered an economic bellwether is down over 25% from the March high. Housing prices are declining. Despite this, employment levels remain elevated. Although wage growth is starting to pick up, it is running well below the rate of inflation. As spending power has decreased, consumer confidence has reached the lowest level on record. All of these factors signal that inflation may be near peak level.

Equity markets are factoring in higher interest rates and slower growth prospects. In the U.S., the S&P 500 is down over 20% year to date and NASDAQ is down close to 30%. In Canada the S&P/TSX declined approximately half of the U.S. markets due to elevated commodity prices. We have recently seen commodities roll over as the focus shifted from inflation to recessionary fears. This has caused increased volatility especially on the TSX.

Interest rates will likely continue to rise. We remain of the belief that these rate increases may slow toward the end of the year if Central Banks become more aggressive short term. Although there are initial signs that inflation may be moderating, the data remains elevated. It is important to note that CPI is backward looking and we have seen pricing pressure over a wide range of inputs, from lumber to base metals to energy, easing. Supply chain bottlenecks are slowly opening as shipping time and costs are on the decline. China remains a wild card, however with the upcoming Chinese elections and recent stimulative measures we may see more clarity.

Declining housing prices and record low consumer confidence may lead to delaying or cancelling major purchases. Although a recession in Canada is a possibility, we do not believe that there will be a prolonged retraction of economic activity in North America.

We remain focused on a dividend growth strategy as a growing stream of dividends should help offset the impact of inflation. We believe that companies that are highly leveraged and cannot flow borrowing costs through to consumers may have difficulties in this environment.

Earnings will likely be downgraded, however this will lead to better valuations that the markets can build upon. Risk/Reward is now better for equities than at the beginning of the year. We are uncertain about what the next quarter will bring, however, we remain constructive longer term. Corporations have strong balance sheets and we have seen dividends increasing which bodes well for future cash flow.

As always, if you have any questions or just want to catch up, give us a call or send an e-mail.

Have a great summer!

The Andras Group

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