



Market Insights:

The Economics of Pandemics

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The Economics of Pandemics

Covid health risks, and, more importantly, the government response to the health risks, has dominated the direction of the economy and markets. The basic dynamics follow:

1. **Health policy dominates**; factories and services are forced to close; unemployment is severe; markets are worried
2. **Government compensates** through income supports to families and business; central banks lower interest rates directly and indirectly
3. **Many consumers conserve cash and build wealth** (i) unable to spend (ii) add to savings (iii) grow wealth from asset value gains (houses, equity portfolios, etc.) facilitated by low interest rates
4. **Suppliers cannot supply** (forced closures; recalcitrant staff; volatile supply chain)
5. **Giant rush of new demand when** services allowed to resume
6. **Manufacturers and transportation networks unable to keep up** (creating supply shortages and inflation)
7. **Central banks grow concerned about inflation** and prepare to remove stimulus and raise rates
8. **Equity markets question** whether the economy can moderately absorb higher rates (spoiler alert – they can)

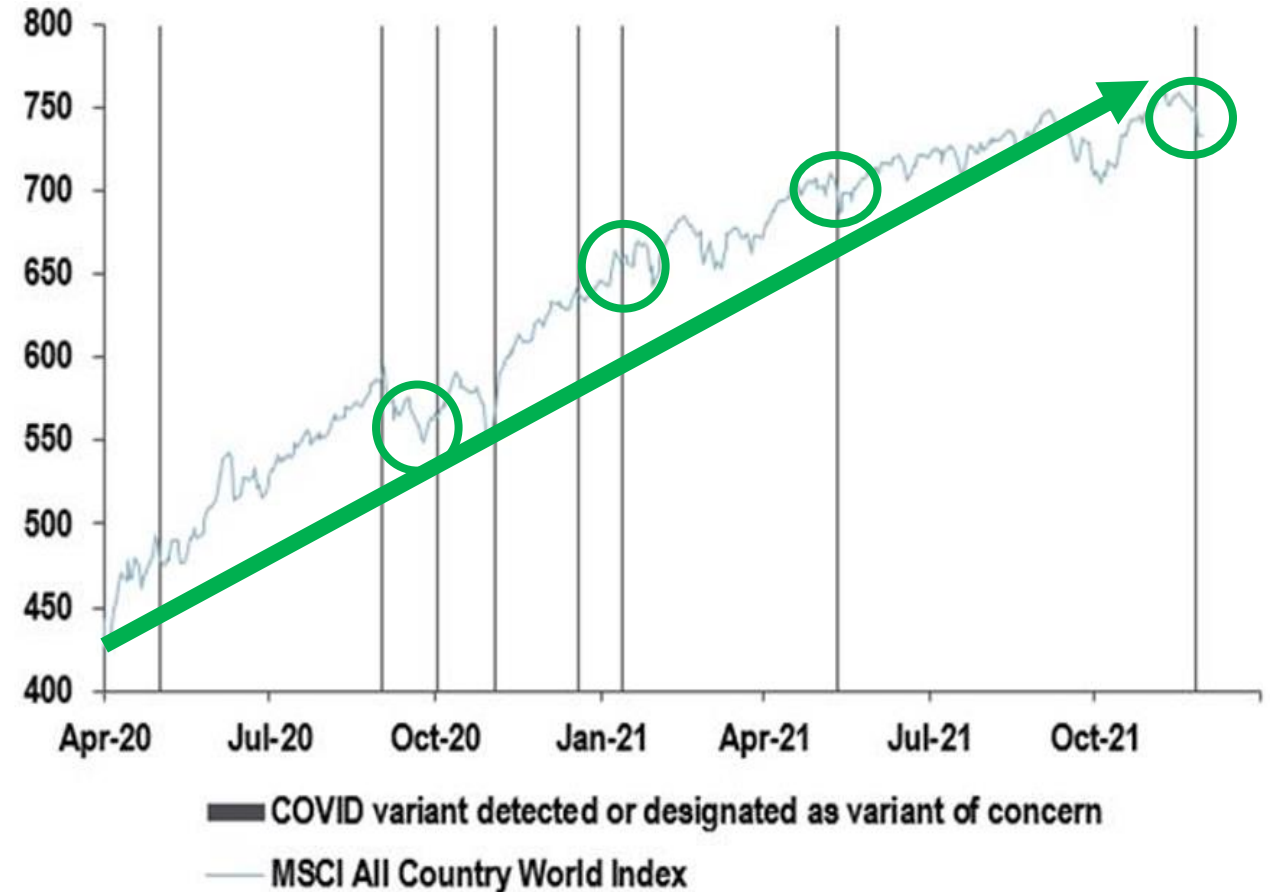
Each time new variant is discovered, there is concern that there is a return to Step 1.

Here We Go Again: Markets Always Decline at the Arrival of Each New Variant

Each new variant creates a round of worry about its health risks as well as the risks of new economic restrictions.

The June mini-decline was based on concern about the Delta variant.

Overall, these market dips have proven as excellent buying opportunities.

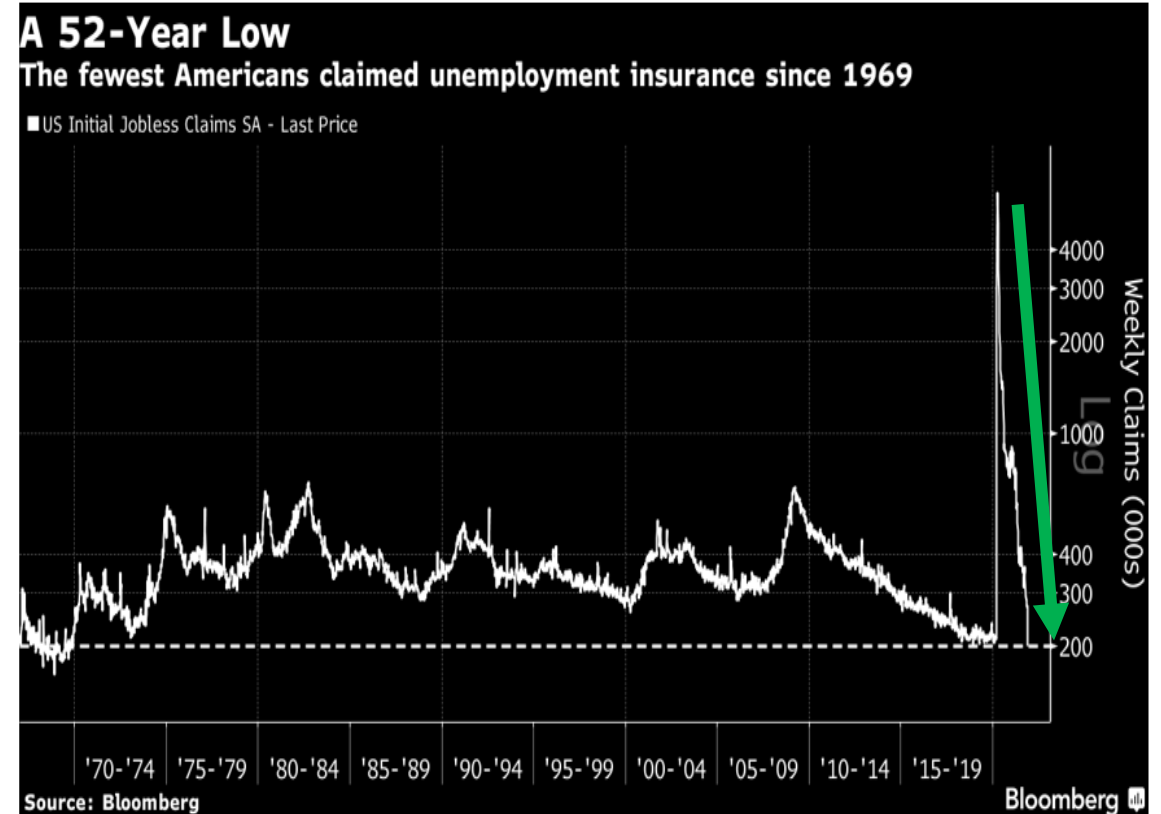


Full Economic Recovery: Labour Market Is on Fire

This economy now features the lowest new claims for unemployment coverage since 1969.

Workers are now increasingly a scarce and valued commodity.

Note: Workers, and their families, are also key consumers.



Demand for Goods Continues to Rise

Consumers have high savings, plentiful employment with rising wages, rising investment accounts and rising home values.

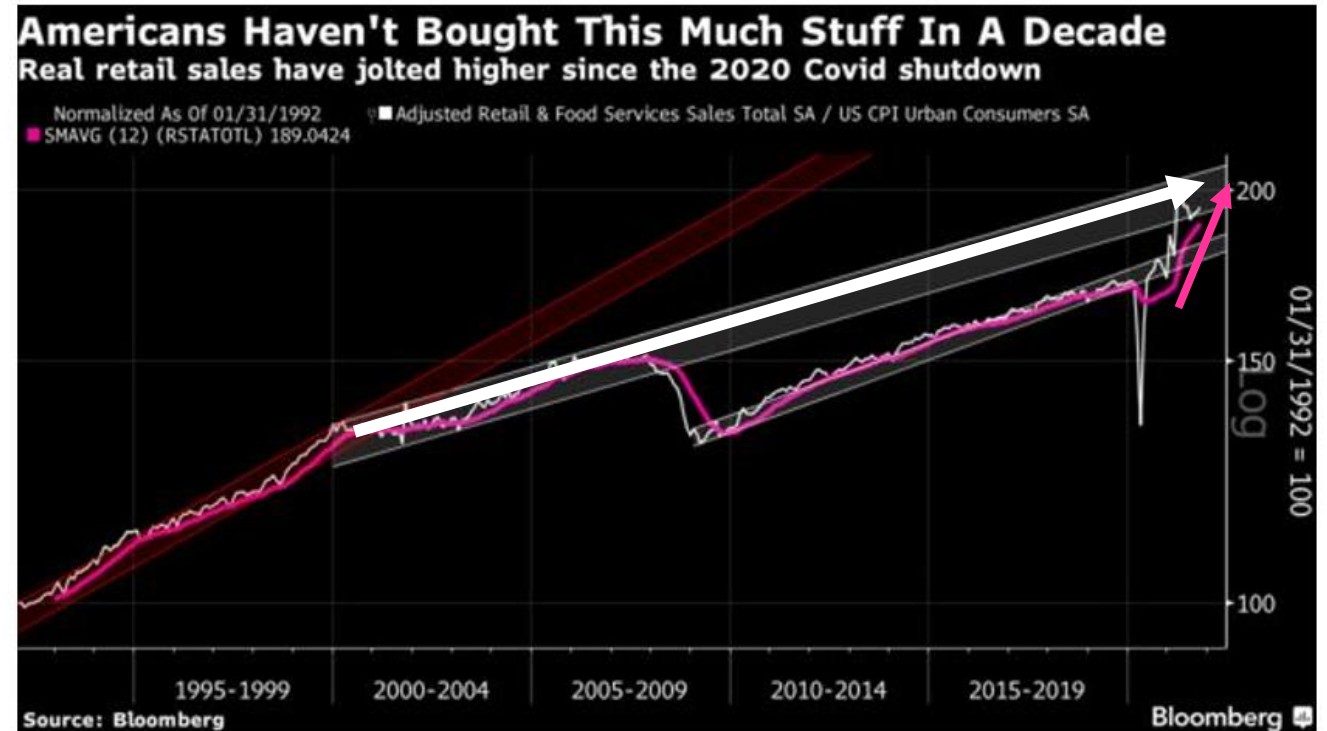
They are eager to spend – especially to support their increasingly “at home” lifestyle.



Demand Is Very Strong – Just like before the GFC

It seems to have taken both the current strong economy, and, a decade plus of healing, for consumers to regain the confidence lost during the Great Financial Crisis (2008-09).

If so, the upwards demand trends will be enduring.

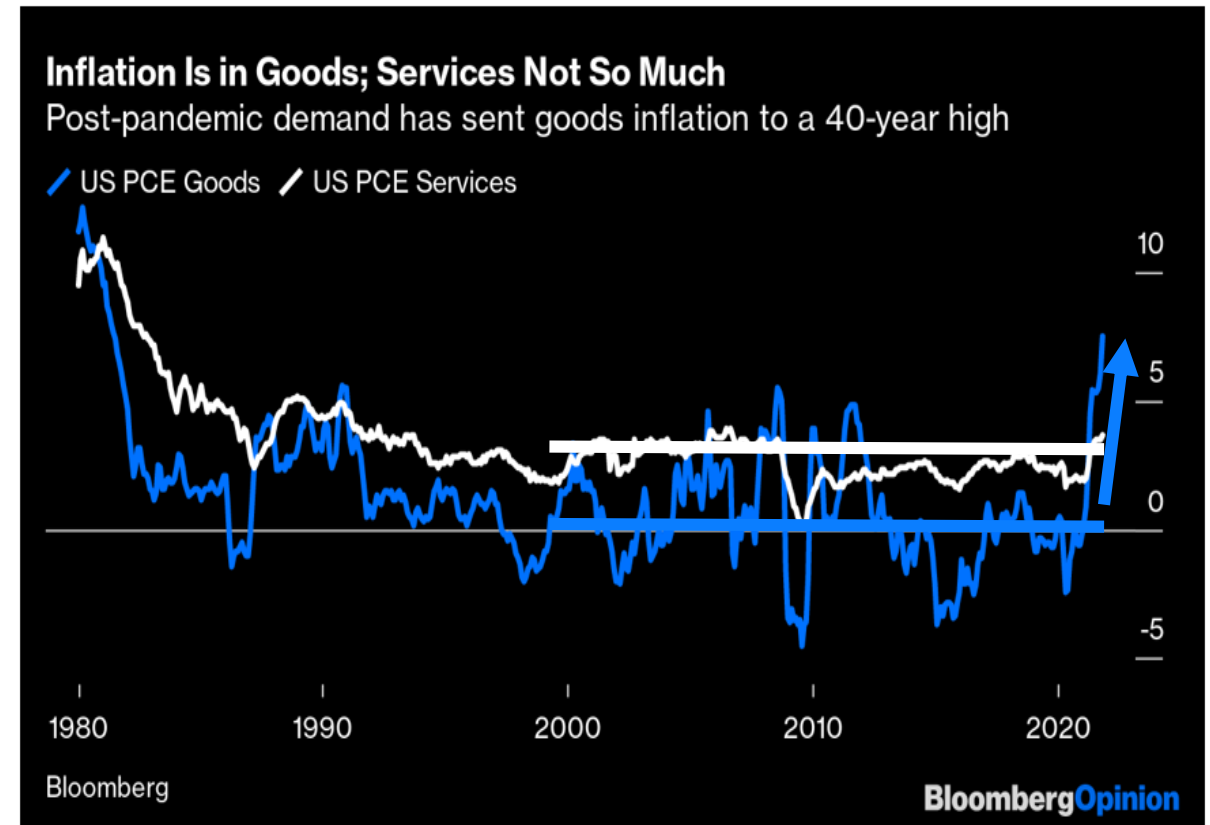


Creating Inflation in Goods

Note the much higher recent inflation in goods (blue line) compared to services (white).

Manufactured goods often require necessary raw materials, a well-functioning supply chain, well-staffed production facilities and global distribution networks.

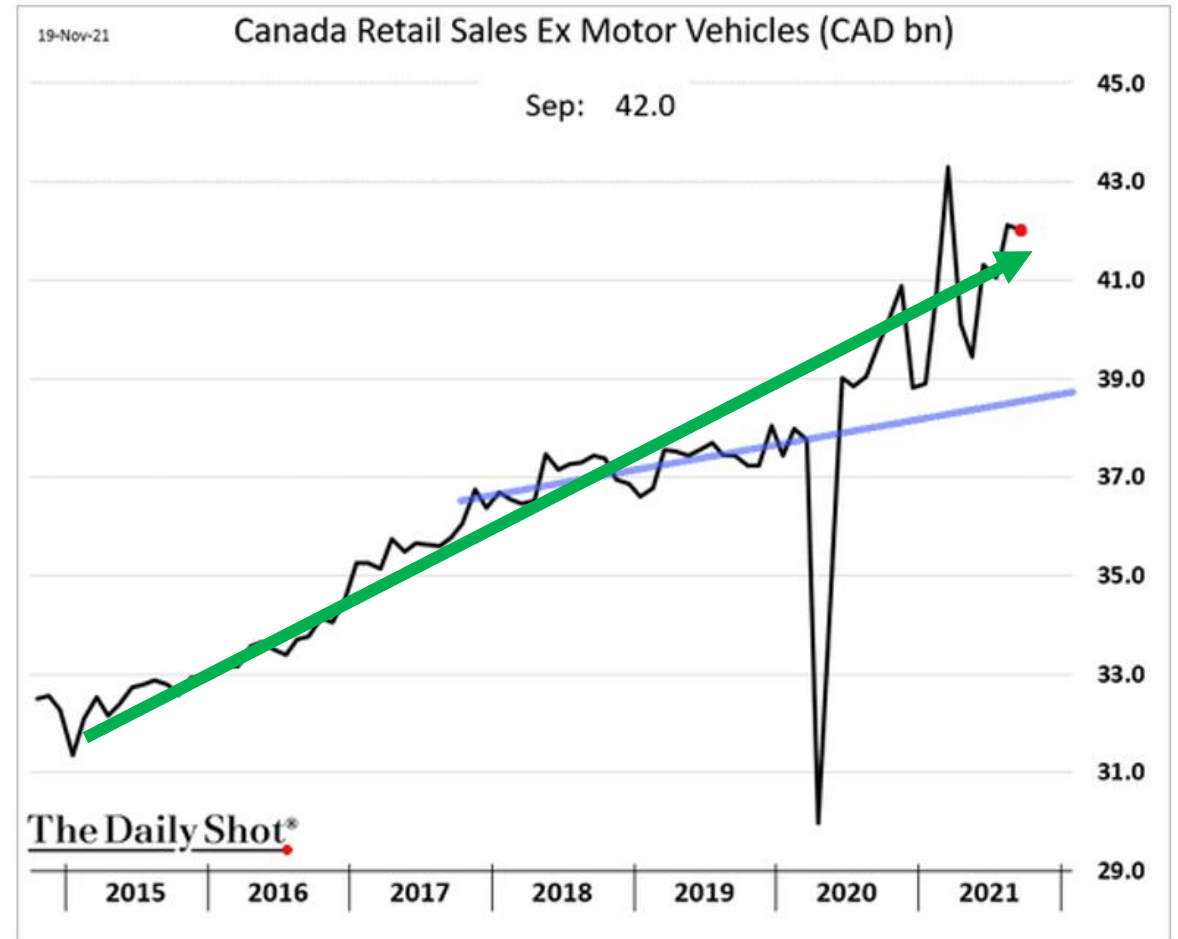
It is taking a long time to get this operational at the level necessary to serve booming demand.



Same Pattern in Canada

Canada shows a similar pattern of booming consumer demand and supply shortages.

The CDN labour market is also tight with over 1 million jobs unfilled.



The Fed Is Getting Tough

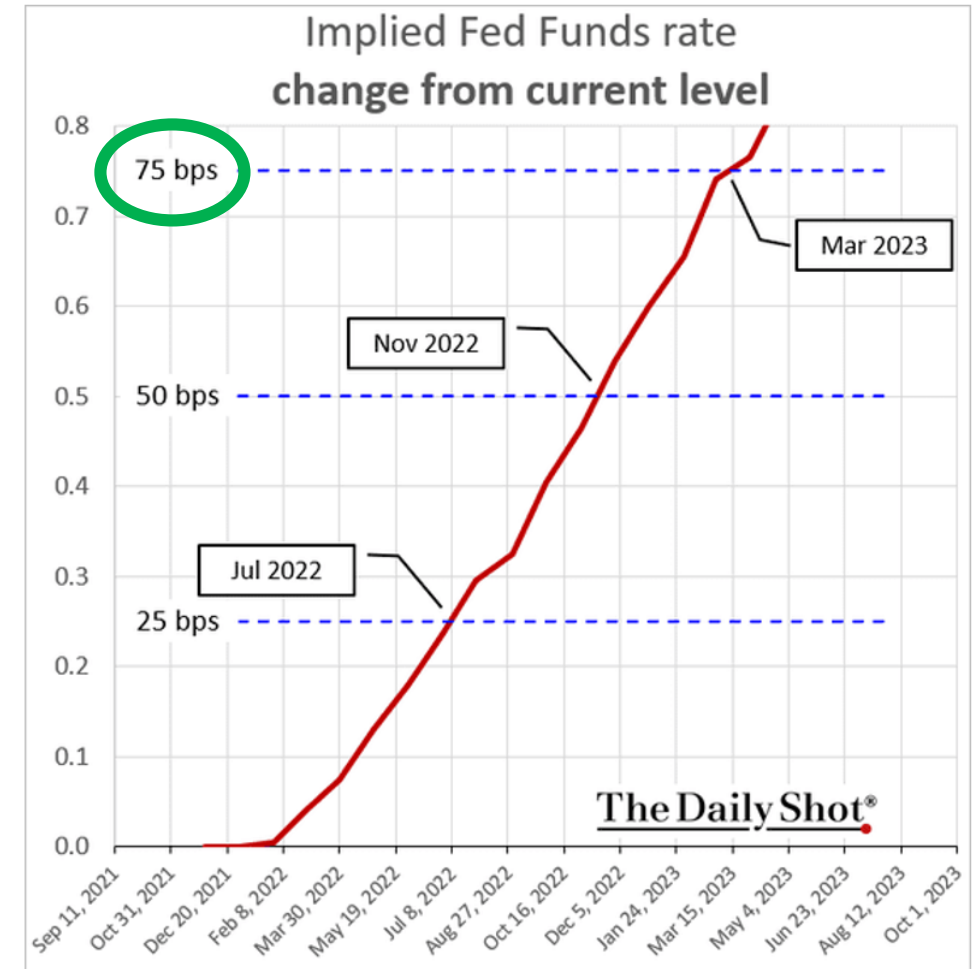
This week, Chair Powell of the US Federal Reserve was clear in his pivot to an inflation-fighting focus.

Previous discussion of allowing the economy to “run hot” has disappeared as has the description of inflation as “transitory”.

The Federal Reserve will be rapidly decreasing its bond buying; this will allow for the US to start raising rates by the Spring.

US Futures markets assume 2-3 rate increases (up 0.75%) over the next 12-months.

RBC GAM also forecasts 3 increases for Canada although some other estimates are higher.



Bond Markets Now Confident in the Central Banks

This week, a Hydro Quebec bond paying 2.7% until 2060 (almost 40 years away) sold out in a record breaking 8 minutes.

This new issue looks attractive relative to government bonds at the same duration (1.46% in Canada and 1.76% in the US).

Clearly, there is a lot of long term buyer confidence that inflation will be under control.



Concluding Thoughts: Investing During (Moderately) Higher Inflation

The OECD estimates 2022 US inflation at 4.4% and 2023 at 2.5%. RBC GAM estimates CDN inflation next year at 3.0%.

All professional forecasts indicate inflation will remain above the 2.0% target for quite a while.

From an equity perspective, companies have to grow profits, and dividends, faster than inflation to see future market value increases. This seems doable for many companies.

Favoured industries when interest rates are low and inflation is high include: **infrastructure, real estate, financials and commodities.**

Payers of growing dividends are especially favoured.

Long term rates, which are well anchored at very low levels, support: **technology (including innovative growth companies), consumer discretionary and communication sectors.**

How Long Will Inflation Persist? A Historical Precedent

“History does not repeat , but it rhymes”

In uncertain times, we look to learn from history for clues. The post World War II era provides the closest analogy.

During the war, supplies of consumer goods essentially disappeared to support the production of war materials.

Consumer demand was crushed by mandated rationing. Desired products (washing machines) were not produced.

After the War, accumulated consumer demand exploded.

Goods producers could not initially meet the demand. It takes time to convert a tank factory.

Further, about one-third of the workforce (i.e. the military and support workers) were “laid off” and had to find work.

The expert economists of the day forecasted certain disaster.

However, the business ecosystem took only about two years (featuring high inflation) to reabsorb the soldiers into domestic jobs and to retool their factories to meet domestic consumer needs.

After the (business-led) transition period, inflation settled, the economy strengthened and markets confidently settled into an extended multi-year boom.

Questions?

If you have any questions or comments, please email them to:

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