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October 26, 2020

Stagflation

Governments around the world are pumping funds into their economies trying to create inflation (stimulate growth) while their central banks are vowing to keep interest rates on the low for years to come. Concerns are rising that we appear to be entering a period of stagflation.

The winds of stagflation have begun to blow. Stagflation is characterized by higher inflation, higher unemployment, and lower growth.

Developed nations had already amassed significant amounts of government, corporate and personal indebtedness (with Canada being one of the biggest bingers) prior to the pandemic. Developing nations aren't too far behind. Current levels of indebtedness are extraordinary by historical standards.

One of the ways to relieve this kind of pressure is to allow inflation to take full effect. US Federal Reserve Chairman Jerome Powell is intent on keeping interest rates on the floor until at least 2024. The same will be true for most nations as they too struggle with low growth, increased debt loads & higher unemployment.

The net effect will be that inflation erodes the value of the debt being carried, but of course there are also less desirable consequences. Retirees looking to generate sufficient income with a conservative mix of bonds are struggling and often have to chase returns in the more volatile stock market, consume their capital or both, to make ends meet. Already unaffordable in many parts of Canada, lower rates for longer may further inflate real estate prices.

Hampering the growth picture still further will be the need for increased government revenue through taxation. Yup, taxes are going up. Which ones you ask? Why all of them of course!

The massive pile of borrowing has to be funded somehow. The current system of taxation and law in the US has allowed for a situation whereby 59 individuals own the same wealth as the poorest 50% of the population ~165M people.

With all of the power, influence and reach that accompanies this kind of wealth, these are modern day kings and queens atop vast empires. Many pay little to no corporate tax. Credit where it's due, Warren Buffett of Berkshire Hathaway fame has openly asked that the tax code be changed to levy higher taxes on super-wealthy people like himself given his secretary pays income tax at a higher rate than he.

A change to the tax code in the US, Canada and elsewhere that deals with the super-rich and their corporations undersized contributions to government coffers would be a populist vote getter. But there'll be more. It's likely that income taxes will rise at various thresholds and I suspect that capital gains, dividend & payroll taxes may also be under the microscope. In turn this will act as an anchor on growth and higher unemployment.

Looking at the economic future through the fog of a pandemic makes its analysis even less penetrable than usual. That uncertainty will likely keep market volatility high as will what polling suggests will be a transfer of power in the US.

Trump and the pandemic may have a number of things in common. It looks as though they will be short term phenomena that will long linger in the mind as a warning that things can change very quickly indeed, and that time can alter our perspective. Four years of Trump has made George W Bush look like a moderate intellectual, but I digress.

Stagflation & Portfolios

How do we go about creating a portfolio that leans toward higher than average inflation and lower growth?

Stagflation was already on the horizon before the pandemic in the same way that paper currency was being faded out. The pandemic just accelerated some of these things down a path they were already on.

There's no blanket, one-size-fits-all portfolio for clients however when building portfolios during stagflation we would hold best of class investments in the following categories;

- Commodities – Industrial metals, precious metals, energy
- Infrastructure
- Utilities
- Real Return bonds
- Treasury Inflation Protected Securities (TIPS)
- Technology
- Consumer staples
- Cash

These are additional areas of focus to our usual investment screens. Asset allocation (the percentage in equities, bonds, precious metals etc.) remains an important facet of portfolio construction.

There'll be no starting pistol for stagflation, but for the reasons outlined above we have begun the process of positioning our client portfolios to catch the approaching stagflationary winds. There may be some rough seas ahead but we're pointing in the right direction.

As usual we're continuing our research and will update our findings as things change.

Until then stay healthy.