GLOBE INVEST
CAPITAL MANAGEMENT INC.

INVESTMENT NOTES

SEPTEMBER 2021

UPCOMING 2021 BNN SHOWS

Christine: October 13 @ 12pm

Christine: November 16 @ 12pm

Christine: December 14 @12pm

Broad equity indices managed to eke out marginal gains in the quarter as the spectre of elevated inflation combined with the expectation of tapering of bond purchases by central banks kept a lid on markets. Sustainable upside is not likely until there is more clarity regarding the persistency of higher inflation and more importantly, the ability of corporations to maintain profit margins and meet earnings expectations for the balance of the year and next year.

The million-dollar question for financial markets is why the major central banks collectively opine that the current inflationary spike is transitory or not permanent. The latest dot plot released by U.S. Fed Chairman Powell projects core personal consumption expenditure (PCE) inflation will be 3.7% this year (revised up from 3.0% in June's report), fall to 2.3% next year (revised up from 2.1%) and then recede to 2.2% in 2023. GDP growth this year was revised down to 5.9% from 7.0%, due to the resurgence of the virus and supply constraints that is restraining economic activity, particularly acute in the motor vehicle industry. Nonetheless, growth remains significantly above trend and is projected to moderate to 3.8% in 2022 (up from 3.3%) and 2.5% in 2023.

The moderation in GDP growth to the pre-COVID 19 level is insightful – the "growth spike" this year is also viewed as transitory, reflecting base year effects and pent-up demand from consumers with significant excess savings accumulated since the crisis began. Accordingly, the U.S. central bank projects that inflation arising from the economic shutdown is also transitory and should eventually revert to its inflation target of averaging 2% over time. While the bottleneck effects have been larger and longer lasting than originally anticipated, inflation should abate as bottlenecks and shortages are resolved.

So, to summarize the U.S. Fed's 2023 projections: real GDP growth of 2.5%, core PCE inflation of 2.2% and the unemployment rate at 3.5%. Not too different from the economic conditions that prevailed pre-pandemic: Q4/19 real GDP of 2.1%, core PCE inflation of 1.9% and February 2020 unemployment rate of 3.5%. The view appears to be that the health crisis has not changed the longer-term trends that were in place prior to the pandemic. Financial markets are not accepting this at face value and are also questioning the impact of the massive amount of liquidity that has been injected into the financial system by central banks through quantitative easing since March 2020.

Focus on Inflation

Undeniably, inflation is a near-term concern and starting to influence future expectations. The core PCE inflation rate has consistently been below 2.0% over the past 20 years (chart 1) and only spiked up in the spring to above 3.0% with the most recent reading in August at 3.6%. Demographics, globalization, and technology are trends often cited as being disinflationary and the reasons behind muted inflationary pressures over the past couple of decades, particularly in developed economies.

Recently, some market pundits have argued that aging demographics are actually inflationary, a theory that David Rosenberg has firmly debunked. A key argument is that as the population ages and the dependency ratio, defined as the ratio of the very young and old (ages 0 to 14 years and over age 65) to those in prime working years (ages 15 to 64) worsens or rises, labour shortages will put upwards pressure on wages. However, the data does not support the inflationary argument but instead, shows a clear negative correlation between the elderly dependency ratio (percentage of ages 65+ to working population 15 to 64 years) and the core inflation rate (chart 2).

According to Mr. Rosenberg, the inverse relationship can be explained by a couple of key factors: (1) many people are working beyond what is traditionally characterized as "retirement years" and (2) the adoption of automation and technological change is inherently a disinflationary trend and could largely offset any upward pressures on wages. Coming out of the pandemic, the pace of automation adoption has quickened, with business spending on automation and software in the U.S. up over 7% in 2020.

Ed Yardeni is a vocal proponent of productivity growth in the "Roaring 2020s" through the adoption of technological innovations to offset higher wages. So long as productivity growth keeps up with wage increases, the latter should not be inflationary. He observes that the pandemic seems to have accelerated the pace of productivity growth, as companies have embraced technology as the best and fastest way to boost productivity. This is reflected in the S&P 500 profit margin, which rose to a record high of 13.5% during Q2/2021 (chart 3).

The labour shortages and supply chain constraints coincided with a spike in demand as the U.S. economy reopened driven by consumers who were flush with cash from savings accumulated during the pandemic as well as from fiscal stimulus programs. Fiscal stimulus is now shifting to fiscal withdrawal and demand growth should eventually slow, allowing supply to catch up when the pandemic ends.

The Delta Impact

The cog in the wheel has been the Delta variant, causing significant hiccups in resolving the pandemic-induced supply issues. For example, the typical number of inbound container ships at anchor outside of the port of Los Angeles is one compared to a recent high of 73 vessels. Passenger planes carry about half of all air freight (as belly cargo), so a sluggish recovery in transatlantic air travel has added to shipping burdens. Major U.S. retailers including Home Depot, Walmart and Costco are chartering dedicated container ships and looking for different ports of entry. The shortage of 40-foot shipping containers has pushed up the cost to send one from Shanghai to Los Angeles to over US$20,000 from a "normal" historical rate of US$2,000. The congestion at the major U.S. ports should eventually be cleared as operating hours have been extended but with the holiday season approaching and a need to subsequently replenish inventories, most industry experts expect it will last into 2022.

The resurgence of the Delta variant is delaying the recovery in many service sectors, international air travel and return to office work. Vaccination passports and full vaccination work policy from the public and private sectors should help overcome vaccine hesitancy. While the vaccination rate is rising, it remains very low in developing countries (chart 4). International health organizations have set a target for 70% of the global population to be vaccinated by September 2022. The growing acceptance of booster shots amongst the medical community suggests COVID-19 will become a disease that is managed and contained, much like influenza albeit the former virus is more contagious and potentially causes more serious illnesses.

Not a Global Energy Crisis

Gasoline shortages in the U.K., escalating natural gas prices in the European Union (EU), and forced restrictions on energy use in China are not signs of a global energy shortage but rather, a coincidence of regional crises. Energy prices have risen significantly over the past year due to a rebound in global demand combined with ongoing supply restrictions by OPEC and production restraint by U.S. producers. The global transition to a net carbon zero footprint and renewable power generation sources has discouraged many energy producers to embark on production growth plans.

In the U.K., the lack of fuel at filling stations is not due to a lack of gasoline, but a shortage of truckers to get the gasoline from refineries to retailers. The lack of truckers is a side-effect of Britain's exit from the EU, which also resulted in the exit of many immigrants that were employed as truck drivers, compounded by postponed trucker certification and training during the pandemic. As an aside, the exodus of immigrants is also impacting staffing within the nursing profession, seniors' homes, food processing, and construction industries.

Rising natural gas prices in the EU is due to a few factors that have been building up over time. Demand has rebounded as countries reopen from lockdown restrictions coinciding with a decline of natural gas in storage to 74% of capacity coming out of a colder winter and spring compared to 94% at the same time last year. Lower storage levels coupled with a phasing out of coal and a bad year for wind production has driven up the need for natural gas. Domestic production has been declining exacerbated by less maintenance on oil & gas fields during the pandemic, leading to an increasing reliance on imported natural gas. Russia was the largest exporter of natural gas to the EU in 2019 and 2020, representing more than 40% of EU imports. There is some speculation that Gazprom is withholding natural gas to the EU to push approval of the Nord Stream 2 pipeline, an offshore natural gas pipeline running through the Baltic Sea from Russia to Germany. Concerns of securing sufficient supply through the winter season is driving prices up. The situation in the EU also highlights the challenges of transitioning to renewable energy sources.

In China, the rationing of electricity is due to a crunch in coal supply triggered by stepped-up safety checks at Chinese mines which reduced output below year-ago levels for much of the first half of the year. The government's policy goals to limit carbon emissions has also discouraged growth in coal production even as the country still relies on coal for more than half of its power. Reduced coal production fueled a steep climb in local thermal coal prices and are up over 80% year-to-date. Because Beijing controls and sets power prices, coal-fired plants have been losing money with such high coal costs and have been shutting down. Goldman Sachs estimated that as much as 44% of China's industrial activity has been hit by the power shortages and has reduced China's GDP growth rate this year to 7.8% from its previous forecast of 8.2%. Government agencies have recently directed the state-owned power companies to "expand their procurement channels at any cost" to ensure winter heat and electricity supplies. These actions should be supportive for thermal coal and liquefied natural gas prices over the near-term and result in less disruption of industrial activity.

China in the News

China has also been garnering headlines with its "common prosperity" campaign and the potential demise of a major Chinese property developer, Evergrande. Both are creating havoc for Chinese-listed companies with the Hang Seng Price Index down 13% this quarter. The goal of common prosperity is to narrow the significant wealth gap that exists in China with China's richest 20% earning more than 10 times the poorest 20%. President Xi Jinping, poised to begin a third term in 2022, has pledged to make "solid progress" towards common prosperity by 2035 and "basically achieve" the goal by 2050. Recent actions include a sweeping overhaul of the $100 billion for-profit education system, banning tutoring companies from making a profit, a clamp down on its major technology companies to limit monopolistic practices and increase data protection and decreasing speculation in the housing market. The "event risk" in Chinese financial markets is rising and becoming increasing more difficult to assess with the slogan *caveat emptor* ever more applicable to foreign investors.

Evergrande, China's second-largest property developer, has rattled financial markets given the importance of the real estate industry in the Chinese economy which is estimated to account for close to 29% of China's GDP. The Chinese government has been trying to cool the real estate market and reduce speculative activity by raising mortgage rates, temporarily halting land auctions, and banning private equity funds from raising money to invest in residential developments. Possibly a victim of the crackdown is Evergrande who is facing a liquidity crisis and unable to meet its interest payments. U.S. Fed Chairman Powell sees low contagion risk to the global financial sector from Evergrande debt as most of its debt is owned domestically. While the Chinese government has already indicated that a bailout is not coming, the central bank has been injecting liquidity into the banking system. Evergrande has managed to divest some assets and most observers expect that in a worst-case scenario, the government will ensure an orderly default. However, any spill-over impact to other domestic real estate developers may slow GDP growth and since China consumes nearly 60% of the world's resources, may also lead to weaker demand for certain commodities such as iron ore (used to make steel).

OUTLOOK

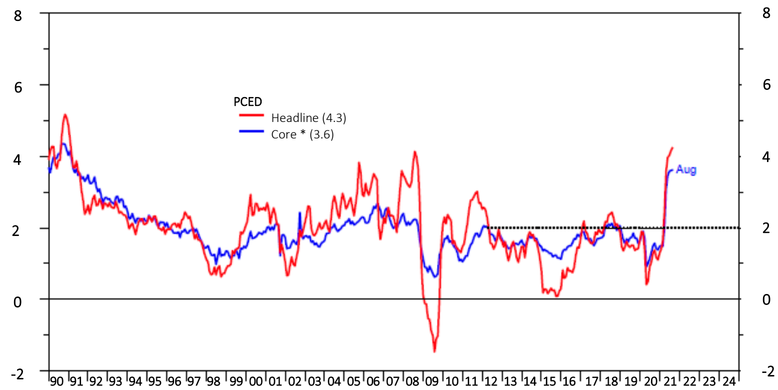
Central bank policy around the world remains very accommodative and interest rates near zero. Notwithstanding inflationary concerns, the U.S. 10 Year Treasury Bond yield at 1.53% remains below the peak of 1.73% in March when inflation fears were first stoked. The 10 Year Breakeven Inflation Rate is 2.38% (Chart 5 - the latest value implies what market participants expect inflation to be in the next 10 years, on average) and has risen this year but is still at a manageable level.

Once again, we highlight corporate profit growth as the primary driver of price appreciation for stocks. The price gains so far this year has been due to earnings growth as the current price to earnings multiple for the S&P/TSX Index and S&P500 Index on 2021 consensus earnings is lower than it was at the beginning of the year. 2021 consensus earnings for the S&P/TSX companies have been revised up 24% and up 20% for the S&P500 since the start of the year and has propelled double-digit returns year-to-date. Earnings growth in 2022 and 2023 is expected to continue albeit slow to a single-digit rate. Dividend growth and share buybacks have not kept pace with profit growth so there should be some catch-up which is also supportive for stock prices.

Our base case is that current inflationary pressures are not permanent. The pace at which it subsides will largely be dependent on when the health crisis is under control and economies and borders can fully reopen. Forecasting with precision is difficult at the best of times and becomes even more difficult when the world has experienced a global health pandemic and a very uneven recovery amongst countries and socioeconomic status. The economic recovery will also be uneven due to the unique challenges that has resulted from the pandemic. As such, financial markets will continue to be sensitive to economic data and indicators using them as gauges to assess future growth and inflation rates. Our investment philosophy remains focused on buying financially sound income and growth stocks at reasonable prices to generate capital appreciation over the long term.

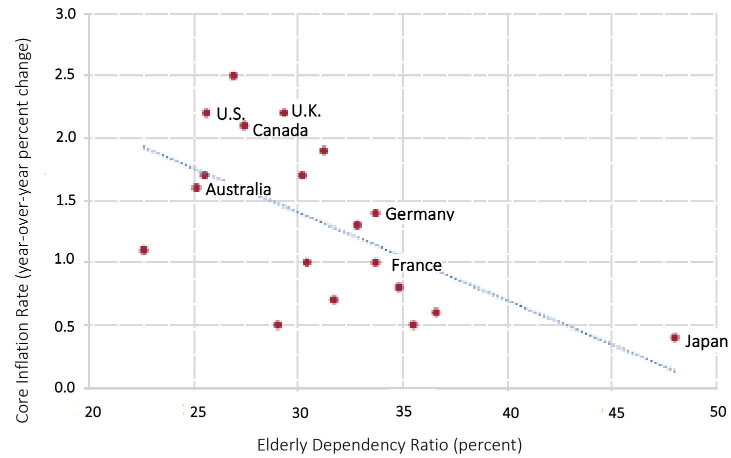
Christine Poole, MBA, CFA

CHART 1: Personal Consumption Expenditures Deflator (yearly percent change)
-Bureau of Economic Analysis, Yardeni



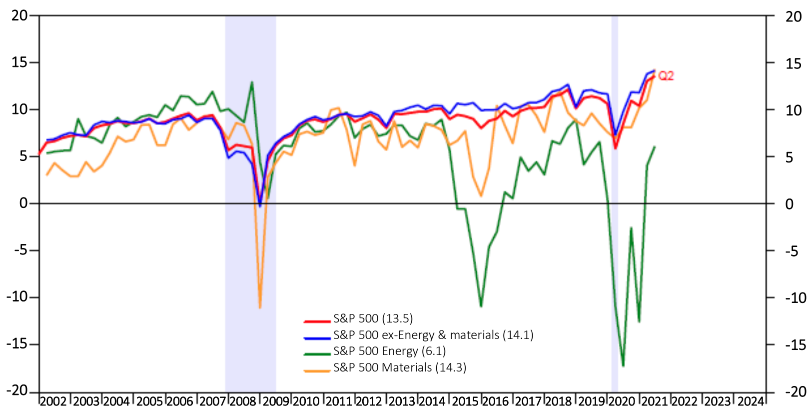
*Excluding food and energy prices
Note: Dotted line is the Fed's official target set during January 2012.

CHART 2: Elderly Dependency Ratio and Core Inflation Rate
- Haver Analytics, CIA World Factbook, Rosenberg Research



Note: Annual 2019 core inflation rates were used to avoid pandemic-related distortion in price data

CHART 3: S&P 500 Profit Margins (percent, quarterly)
-Standard & Poor's Corporation



Note: Shaded areas are recessions according to the National Bureau od Economic Research

CHART 4: Canada Vaccine Update (Doses Administered/ 1000 People)
-Bloomberg Professional service, Credit Suisse

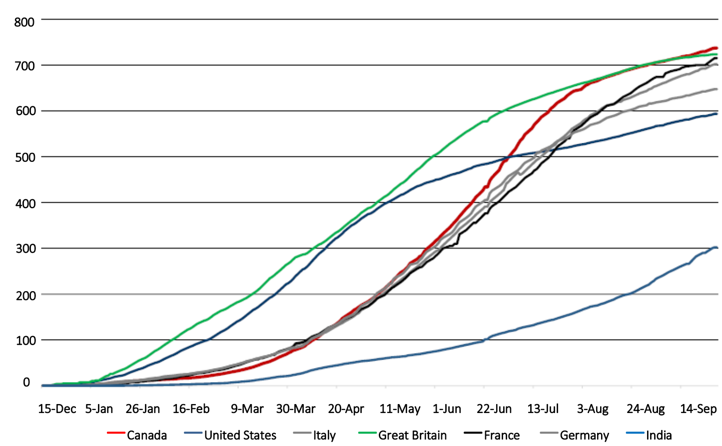
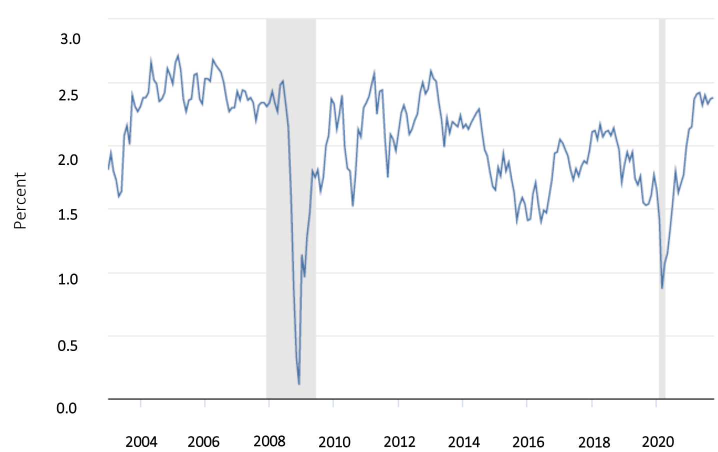


CHART 5: 10 Year Breakeven inflation Rate
– Federal Reserve Economic Data



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RECENT BNN SHOWS

Christine: September 14, 2021

Christine: August 12,2021

Christine: July 13, 2021

Christine: June 16, 2021

Christine: May 18, 2021

Christine: April 15, 2021

20 Queen St. West, Suite 3308 Toronto, ON M5H 3R3

www.globe-invest.com

416-591-7100
1-800-387-0784

416-591-7133

info@globe-invest.com

SEPTEMBER 30, 2021 STATISTICAL SUMMARY

STOCK MARKETS	QTD	YTD	1 YEAR
S&P TSX COMPOSITE TOTAL RETURN (CAD)	0.2 %	17.5 %	28.0 %
S&P 500 TOTAL RETURN (CAD)	2.9 %	15.4 %	23.7 %
S&P 500 TOTAL RETURN (USD)	0.6 %	15.9 %	30.0 %
DJIA TOTAL RETURN (USD)	-1.5 %	12.1 %	24.2 %
NASDAQ COMPOSITE PRICE RETURN (USD)	-0.4 %	12.1 %	29.4 %
MSCI WORLD INDEX PRICE RETURN (CAD)	1.9 %	11.3 %	20.9 %
CANADIAN UNIVERSE BOND INDEX	-0.5 %	-3.9 %	-3.3 %

COMMODITIES	QTD	YTD	1 YEAR
GOLD	-1.5 %	-8.5 %	-8.1 %
SILVER	-15.1 %	-16.3 %	-7.3 %
COPPER	-4.4 %	15.4 %	34.1 %
NATURAL GAS (NYMEX)	47.2 %	136.4 %	236.1 %
WTI	2.1 %	54.6 %	86.6 %
BRENT	4.4 %	49.8 %	87.8 %

TREASURY BONDS	09/30/21	12/31/20	09/30/20
2 YEAR (CAD)	0.53 %	0.20 %	0.25 %
2 YEAR (US)	0.28 %	0.13 %	0.13 %
5 YEAR (CAD)	1.11 %	0.41 %	0.37 %
5 YEAR (US)	0.98 %	0.36 %	0.28 %
10 YEAR (CAD)	1.51 %	0.70 %	0.56 %
10 YEAR (US)	1.52 %	0.93 %	0.69 %
30 YEAR (CAD)	1.98 %	1.24 %	1.13 %
30 YEAR (US)	2.08 %	1.65 %	1.46 %
CPI (CAD) CORE	3.50 %	1.30 %	1.00 %
CPI (US) CORE	4.00 %	1.60 %	1.70 %

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