We are living in strange times. If you turn on the news, or load up a financial news website, you would think the world was coming to an end. Accelerating inflation, rising interest rates, equity and bond market declines, a rout in technology stocks, war in Europe and a never ending stream of metaphors to explain it all. However, if you look at the macroeconomic data, it's quite strong. Unemployment is below 4%, near historic lows, retail sales continue to grow at a brisk pace, business investment and corporate profits are holding up, and credit card and other loan delinquencies are still at historically low levels. So, what gives?

The answer is the same it's been to many questions over the past three years: it's complicated. The main cause of economic anxiety is inflation and inflation by itself is easy to understand. In economic terms inflation is the increase in the prices of goods and services in an economy over time. There are generally two types of inflation: the first is demand-pull inflation, where aggregate demand in an economy is greater than aggregate supply; the second type of inflation is cost-push inflation, this occurs when input costs increases result in increased costs of production which are then passed on to consumers. We are currently experiencing both.

In the early stages of the pandemic, as governments took action to stop the spread of COVID-19 by closing down parts of their respective economies, consumer demand shifted sharply from services to goods. The sharp increase in demand for goods combined with a fragmented global response to the virus, along with sharp increases in government spending, lead to an increase in prices for those goods. This is the demand side of inflation.

At the same time that the demand for goods was sky rocketing, the availability of the components that make up those goods was dropping. The increasing scarcity of inputs was made worse by congestion in shipping routes caused by a lack of labor and uneven regulations in different countries. The global supply chain that allowed for the free flow of goods from cheap manufacturing countries to wealthier countries whose consumers were buying those goods had broken down. Progress made by over two decades of globalization had come to a screeching halt. Suddenly, super-efficient supply chains that delivered components and finished goods "just in time" to where they needed to go, whose main purpose was to drive down the price of those goods, now were doing the exact opposite. In addition to supply chain issues, the war in Ukraine has caused a sharp increase in food and energy prices. This is the supply side of inflation.

There is a third driver of inflation and that is consumer expectations of inflation. Worker's expectations of inflation are almost as important as the actual economic mechanisms behind price increases. If a worker believes that inflation will be greater in the future, that worker is likely to ask for a wage increase right now. The company that employs the worker is likely to grant the wage increase but, in the face of higher input costs, will likely pass on the increase in their production cost to the end consumer. The increase cost to the consumer will increase consumer prices and the expectation of inflation in the future, for that same worker, will be higher. This cycle of price increases due to perceptions of higher inflation is what economists are referring to when they say inflation can become imbedded in an economy.

So, what can we do about inflation? The only real solution to drive down costs is to decrease aggregate demand. This is the Federal Reserve's dilemma: decrease aggregate demand just enough to bring down inflation but not enough to put the economy in a recession. And this is precisely where things get complicated.

The likelihood of the Fed getting this right is very slim. On the one hand the Fed could act too cautiously, hiking rates too slowly, and letting inflation become imbedded but even worse, inflation becomes imbedded while economic growth slows. On the other hand the Fed could raise rates too quickly and tip the economy into a deep recession. Oddly enough the latter scenario would be preferable as it would be akin to taking the pain upfront and then starting a proper recovery.

Towards the end of last year and throughout this year I have been focused on de-risking your portfolios, taking profits from positions that contained a higher level of risk and reinvesting those profits in to businesses that have much more durable, and predicable, business models and cash flows. Portfolios, regardless of overall strategy, have been repositioned to be more defensive with a primary goal of income generation (from dividends) and capital preservation. There is also excessive cash as market downturns create opportunities that I hope to take advantage of.

There are a serious set of economic factors acting against our economy. In light of such heightened uncertainty it is prudent to maintain a defensive position in our portfolios until there is a positive trend in inflation readings (there will be months where inflation eases but we really need to see a few months of cooling prices for the trend to be clear and convincing) and a healthier picture of economic growth. With the repositioning of your portfolios, I am happy to report that we are doing better than the market and, overall, I am pleased with the performance of Trillium's portfolios. We are setup well to weather this storm and, hopefully, come out of it stronger. We just have to remain patient and focus on the big picture.

If you would like to discuss your portfolio in greater detail or make any changes to your investments, please reach out to me. I hope you all are doing well.

Nik Bhardwaj
Principal
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