QUARTERLY COMMENTARY

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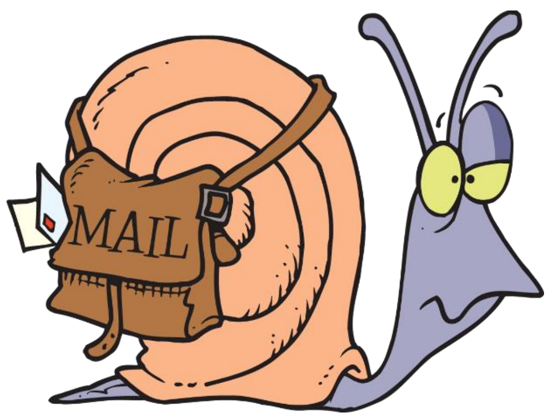
Nothing's Cheap Anymore

I hadn't sent anything by "snail mail" in a long time. When I recently trekked over to my local Shoppers Drug Mart postal office to mail out a few letters and the lady behind the counter asked me for $2.44 for two domestic stamps, it almost floored me. If that's not a sign of underlying, creeping inflation I don't know what is. Or perhaps it's just an indication of the burgeoning costs of our federal government's spending. In any case, in the real economy inflation has continued to run "hot" and has even picked up momentum around the world. While some of the recent factors pushing inflation higher (e.g., supply chain disruptions) are likely to moderate as we move further into this economic cycle, I believe that inflation is not going to go away so soon. Other than for high tech goods such as computers and televisions over the last few decades, when was the last time you noted that prices for goods were dropping? Certainly after prices move up they aren't so quick to move back down. Are car prices going to decrease after the supply constraints for computer chips are alleviated? I doubt it.

Inflation has, therefore, once again become the buzzword to promote fear in the market (like we really need more concerns!). To be sure, runaway inflation does have the potential to stifle growth and cut heavily into earnings. The Fed and other world leaders continue to downplay it as transitory, but if there is one thing I worry about for the big picture it's that their lack of concern could end up being a concern if they are incorrect.

Right now CPI inflation is running at 5% in the U.S. and 4% in Canada – that's the highest we've seen in 30 years. Why? Supply is constrained because of logistical bottlenecks partly due to the effects of the pandemic while demand is quite robust. For decades now, the cure for basically any problem the market/economy runs into is for central banks to ease and governments to provide stimulus. Yet, when it comes to inflation, such measures could actually make the situation worse, and the question then becomes what would the powers that be do? Taking action to cool down the economy isn't exactly politically popular and if it has to happen before a still recovering economy is ready, it could dump a whole bucket of cold water onto the fire.



September maintained its dubious distinction of being a lousy month for returns in the equity markets – the TSX was down 2.5% and the S&P500 was off 4.8%. Aside from the fact that it is traditionally one of the worst months of the year, this time around the debt ceiling showdown (a self-imposed federal borrowing limit in the U.S.) has been keeping investors on their toes. The debt ceiling has become a subject of intense partisan wrangling over recent decades, with negotiations going down to the wire in 2011 and 2013. Evidence of investors' concern is demonstrated by the number of Google searches of the key phrase "debt ceiling" which have surged to the highest level since the 2013. The impasse was partially to blame for all the market jitters the last few months, especially after equities have had an extended run higher. And although the U.S. Senate struck a deal to temporarily raise the debt ceiling recently there is more political squabble to come toward the end of the year. Kicking the debt ceiling can down the road again has helped take some of the near-term pressure off but the U.S.

QUARTERLY COMMENTARY

government could once again near a technical default around the time when the temporary government funding is set to lapse if Congress fails to approve new spending legislation and increase it again. As LPL Chief Market Strategist, Ryan Detrick noted, the debt ceiling has been increased 79 times since 1960 - 49 times under Republicans and 30 times under Democrats. They seem to play the game every year to give reporters something to write about for a few days before ultimately deciding to raise it once again.

Gridlock in DC remains an investment risk, but since when is that anything new? Underneath it all there are some very positive trends. US & Canadian economic growth remains strong - U.S. economic growth averaged a 6.4% annual growth rate over the first two quarters of 2021. While GDP growth is expected to moderate into 2022, it is still expected to remain above trend. The Canadian economic outlook remains robust despite near-term softness in the economy. We expect past gains in income, employment, and savings to fuel stronger growth in consumption and business investment next year.

Energy prices have broken out to the upside and there are world-wide shortages and disruptions caused by such factors as supply chain issues and the fact that control over the market's marginal oil supply and oil prices is firmly in the hands of OPEC and its partners. As well, U.S. shale producers continue to stick to their production discipline. Financials and Energy have been the best performing sectors – they continue to have the strongest momentum ratings of all the sectors. I think that this can continue into the New Year. If energy prices remain elevated for an extended period of time though it could weigh on equity markets later on. This is not necessarily a terrible thing for Canadian investors who generally have a higher exposure to the oil and gas sector than others - energy has around a 14% weighting in the TSX. Most portfolios have a much smaller weighting than that but it helps provide a cushion since some other sectors are underperforming.

QUARTERLY COMMENTARY

October has long been judged as the scary month in the stock market. Does it deserve its reputation? Over the long-term in October, the S&P 500 has produced an average gain of 0.8% and has been positive 60% of the time. But with the ghouls and goblins comes volatility. The month has earned its scary reputation with the infamous crash that occurred on October 29, 1929 (Black Tuesday) and the October 19, 1987 crash. Despite the all this I continue to recommend an overweight allocation to equities with a preference for companies that should benefit the most from the recovery process (i.e., cyclical, small and mid-cap equities, value, etc.). Given relative valuations and the earnings outlook, I prefer an overweight allocation to the cyclically sensitive S&P/TSX index vs. the tech-heavy S&P 500 index. Investors should also maintain an underweight allocation to fixed income.

Thank you for your continued trust and confidence. Should you have any questions or concerns at any time or if you would like to have a detailed discussion of your personal portfolio please do not hesitate to let me know.

Sincerely,

Richard