HEMISPHERE
CAPITAL MANAGEMENT INC.

Reflections

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WILL INFLATION PERSIST?

From food to haircuts, prices seem to be rising everywhere. A key concern for investors is whether this pandemic-induced inflation will be transitory, as economic growth reverts to pre-pandemic levels, or will persist over the longer term.

North American CPI numbers remain high.

The Consumer Price Index (CPI) in Canada has exceeded 3% since April 2021 and reached 4.1% in August 2021 – the largest year-over-year increase in almost two decades (Fig. 1). The U.S. has set a similar record with the CPI reaching 5.4% in August 2021 – having exceeded 5% since May 2021. Although the large year-over-year increases are partially due to low inflation numbers at the onset of the pandemic (known as the "Base Effect"), the total CPI in Canada has now reached the same point had there been constant 2% inflation since the start of the pandemic.

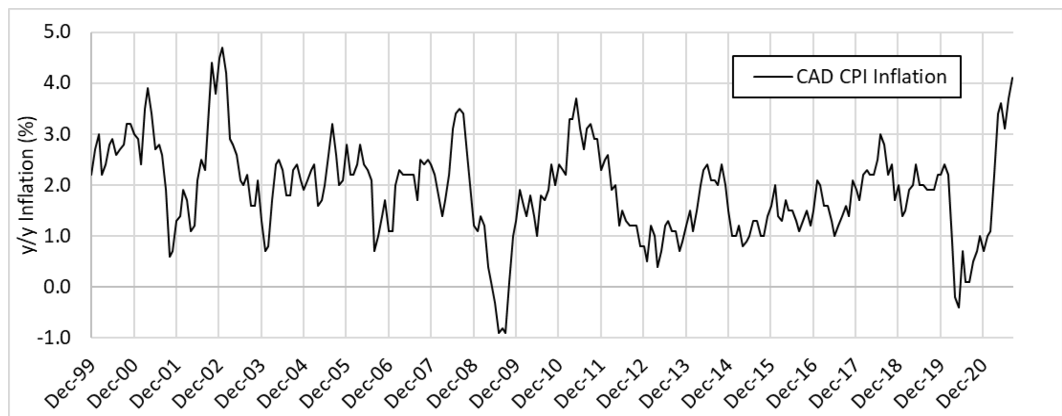

Figure 1: Year-over-Year Canadian CPI Inflation

Bond yields have changed course and are now rising.

After a sharp rise in 10-year Government of Canada (GoC) bond yields from 0.67% to 1.6% to start the year, yields steadily trended down to 1.15% near the end of August - signaling a willingness by investors to accept that inflation will be transitory. Recently this have started to climb again, reaching 1.5% near the end of September as inflation concerns for investors intensify.

Global supply chains remain disrupted as consumers look to spend their savings.

The rapid rise in inflation has been driven by both supply constraints and heightened consumer demand. The pandemic has disrupted global supply chains and exposed the weakness of "just-in-time" inventory as manufacturing has been disrupted. An unprecedented amount of government stimulus and support programs, coupled with reduced household spending during lockdowns, caused household savings to rise dramatically. The rollout of vaccines and easing of restrictions led to a surge in demand as consumers looked to spend their savings.

Climate change and a rising population will continue to pressure food prices.

Though supply-demand imbalances for certain commodities will eventually resolve, others will not be so lucky. Even after the impacts of pandemic-induced supply chain bottlenecks subside, structural challenges in agriculture will remain. The world's population continues to rise, while the amount of farmland has only marginally increased. Climate change continues to impact growing seasons as weather extremes contribute to prolonged droughts and floods. Record temperatures this summer decimated wheat and canola crops in Western Canada as production hit 14-year and 9-year lows, respectively. Higher crop yields are a necessity to avoid elevated food prices.

The transition to cleaner energy alternatives will create gaps in energy production.

Energy has seen similar shifts as storage reserves have dwindled since May 2020 when West Texas Intermediate (WTI) – a benchmark for North American oil - reached lows of under $25 USD per barrel. With the transition to cleaner alternatives, many oil producers are hesitant to invest in additional production and refining capacity creating the potential for supply shortages. Consumers have paid at the pumps, with gasoline prices rising significantly over the past year. Natural gas prices have also shown a remarkable recovery, reaching 10-year highs. With the transition to cleaner energy, more natural gas is needed to fill the gap left by retiring coal-fired power plants.

Labour costs will rise as households look to offset higher prices with higher wages.

The rise of food and energy costs – some of the most noticeable to households - presents an upside risk to inflation. Mounting household living costs will feed the demand for higher pay and intensify existing labour conditions. Pandemic-induced worker shortages have already become prevalent as businesses struggle to cope with rising consumer demand. Many businesses have proposed higher wages or bonuses to attract workers. Wages are historically sticky and any wage increases will persist over the longer term. These higher labour costs will ultimately be passed on to the consumer through higher prices.

With rising interest rates, shorter maturity and less interest-rate-sensitive investments are preferred.

The balance between rising input costs (commodities and labour) and the deflationary effects of the pandemic subsiding (relief for supply chain bottlenecks) will be a decisive factor moving forward. We expect interest rates to rise in the short to mid term as inflation persists. We continue to prefer shorter maturity and less interest-rate-sensitive fixed income investments for client portfolios.

Pricing power will become even more important for companies to manage higher inflation.

From an equity standpoint, we stand to benefit from owning successful companies that can effectively deal with higher input costs and have the ability to increase prices to maintain margins. Companies that are unable to pass on higher costs face margin compression or worse. Whether from strong branding, competitive advantages, differentiated products or constrained supply, understanding a firm's pricing power is critical. A combination of reasonable valuation and strong pricing power is the key to investing in the current inflationary environment.