NCM

Core Global/Core International

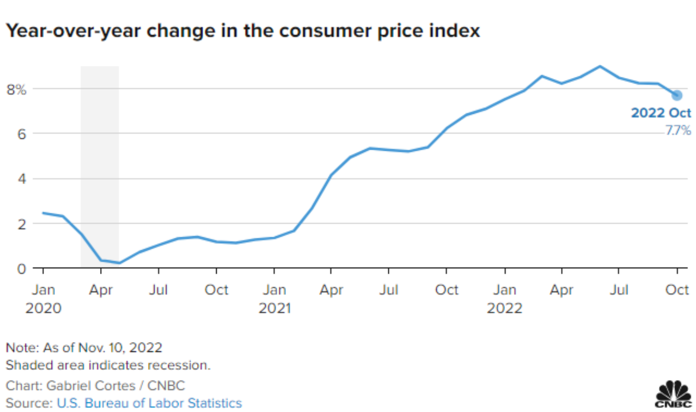
NCM Monthly Commentary for November 2022

Phil D'Iorio, CFA
Portfolio Manager
Cumberland Investment Counsel Inc., affiliate of NCM Asset Management Ltd.

Has Inflation Peaked?

Inflation has been a problem for global economies throughout 2022 on the back of supply chain bottlenecks, inventory shortages, as well as rising prices for food, shelter, and wages. In response to the highest level of inflation in 40 years, central banks around the world have been raising interest rates to fight against sticky levels of inflation. For most of the year, it felt as though it would take a very long time for central banks to win their battle against inflation. More recently we have received some signs which suggest that there might finally be some light at the end of the tunnel. The first positive signal was on November 10th when the U.S. Consumer Price Index (CPI) data was released by the Bureau of Labor Statistics. The Consumer Price Index is a broad-based index which measures the costs for a wide array of goods and services. For the month of October, the CPI index rose less than expected which provided a new sign that inflationary pressures might be starting to cool. As seen in the chart below, the index increased by 7.7% from a year ago, which was better than consensus estimate of 7.9%.

CHART 1



Source: U.S. Bureau of Labour Statistics

On November 23rd, a few weeks after the encouraging inflation report, the minutes from the Federal Open Market Committee stated that Federal Reserve officials expect to switch to smaller interest rate increases soon. The minutes specifically stated that a substantial majority of participants believed that a slower pace of interest rate increases would likely soon be appropriate. According to the minutes the justification for a slower pace of rate hikes is related to the lagged effect of monetary policy in terms of its effect on economic activity. This past Wednesday Federal Reserve Chairman Jerome Powell confirmed what had been stated in the FOMC minutes when he said that the U.S. central bank could scale back the pace of its interest rate hikes as soon as December.

Overall, we received a healthy dose of good news on the inflation front during the month of November. But then on the morning of December 2nd the U.S. jobs data was released. Nonfarm payrolls in the U.S. grew by 263,000, which was well above the consensus estimate of 200,000. More importantly, average hourly earnings jumped 0.6% for the month, which was double the consensus estimate of 0.3%. On a year-over-year basis wages were up 5.1%, which was also well above the consensus estimate of 4.6%. At the time of writing stock markets were trading down on the news given that strong wage data might strengthen the case for the U.S. Federal Reserve to keep raising interest rates.

Although wages remain sticky, there are other areas of the economy that are moderating including commodities and housing. Oil prices have fallen by more than 30% from the peak reached earlier this year. Meanwhile, home sales in the United States declined for the ninth month in a row in October as higher mortgage rates have cooled the market. Pending sales have also weakened according to the Pending Home Sales Index which is a leading indicator for the housing sector compiled by the National Association of Realtors. During the month of October, the Pending Home Sales Index fell 4.6% on a month-over-month basis and declined 37% on a year-over-year basis.

Taking everything together, we believe that inflation is moderating enough such that we are likely in the late stages of the interest rate hiking cycle. If this turns out to be the case, it will have far reaching implications. First and foremost, getting closer to the end of the rate hiking cycle would increase the chances of a soft landing whereby the U.S. economy may avoid an economic recession. Second, it has significant implications for the stock market. Expectations about the possible end of the rate hike cycle will have an impact on the 10- year U.S. Treasury yield. In the last 5 weeks the 10-year U.S. Treasury yield has fallen from its peak of 4.33% to approximately 3.6%. The 10-year U.S. Treasury yield is a key input for stock market valuation tools and the significant drop in the 10-year can help explain why the stock market has been strengthening in recent weeks. Finally, the end of the U.S. interest rate hiking cycle would have significant implications for the US dollar. The greenback and US-based investments have attracted significant flows from investors in 2022 not only because of higher yields that are available relative to other regions around the world but also due to a flight to safety given the geopolitical situation that evolved between Russia and Ukraine. Since reaching a peak in late September the DXY has fallen by nearly 10%. The DXY is a U.S. dollar index that measures the value of the U.S. dollar relative to a basket of foreign currencies. On the day of that favourable CPI print on November 10th, the U.S. dollar suffered its largest single day decline since 2009. In previous cycles, a peak in the U.S. dollar has often been followed by stronger returns in Europe and Emerging Markets. We are encouraged by this phenomenon given that we have significant exposure to European equities in our Global and International mandates and many of the European companies we own have substantial footprints in emerging markets.

Notwithstanding the recent data on wage growth, we believe that inflation is on the cusp of reaching its peak and we believe that we will continue to see a moderation in the inflation data as in the months ahead. Monetary policy always works with a lag so it takes time for interest rate hikes to impact the economy and this phenomenon plays into our thinking. Despite our view of moderating inflation, some questions remain. At the top of the list of questions; How long will it take to get inflation back towards the 2% level that the US Federal Reserve is targeting? And can the Fed reach this level without inducing an economic recession? These questions are a key source of debate in the market and there are no clear-cut answers. At this juncture, it is too early to declare victory and say that we are completely out of the woods. Despite this uncertainty, we are comforted by the fact that we own high-quality companies with significant competitive advantages, strong balance sheets, and proven management teams. Even if we face a recession these types of companies can withstand challenging economic environments and they typically emerge stronger on the other side as they are well positioned to gain market share during economic disruptions.

NCM Asset Management Ltd.
Head Office 1850-333 7th Avenue S.W., Calgary, AB T2P 2Z1 | 310-99 Yorkville Avenue, Toronto, ON M5R 3K5
client services: (877) 531-9355 | toll-free: (877) 431-1407 | info@ncminvestments.com | ncminvestments.com