BARENAKED MONEY PODCAST: EPISODE 8

Inflation's Impact, Supply Chain Disruptions, Toilet Paper

Speaker 1:

You're about to get lucky with the Barenaked Money podcast. The show that gives you the naked truth about personal finance with your hosts, Josh Sheluk and Colin White, portfolio managers with WLWP Wealth Planners, iA Private Wealth.

Colin White:

So Josh, bunch of talk about inflation. Good thing, bad thing, necessary things, scary thing, apocalyptic thing. There's lots of different versions of this out there. Why don't you lead us through a little bit of an exploration of the potential impact of inflation from an investment perspective?

Josh Sheluk:

Right. We're going to cover a lot today. Inflation from an investment perspective is going to be one of them but you're going to make sure that we don't forget what this actually means in practical terms for people as well. So I will kick it off on the investment side of things. And I'm just going to start with something that a lot of people have been talking about for the better part of the last 10 years now, really, since we went through the big recession that we had in 2009. And that's that the government is printing money, this whole idea of printing money, I used air quotes there for our listeners, and what that means because people are thinking, "Okay, if you're printing money, that's necessarily going to lead to inflation." There's a direct line between the two of them. And so I guess I'll just start by debunking this little bit.

Josh Sheluk:

The idea of printing money is basically, as we know the government, the central bank, they have control over how much money, how much physical paper money or money in the bank for example, is in circulation to some extent. And so this idea is that if they're putting more money in circulation, that's going to devalue the currency hence leading to inflation. And there's some real economic theory behind that. The value of our Canadian dollar, for example, is just a supply and demand thing. So if you increase the supply of the Canadian dollar, economic theory posits that should decrease the value of this and then hence everything costs more money to buy. But what we've seen over the last 10 years is this massive printing money, again, quote unquote "printing money" thing that has not led to really much inflation at all over the last 10 years.

Josh Sheluk:

And so what really happened was central banks put this printed money into the banks. The actual retail banks and commercial banks like you and I would go to to take our money out, whether that's TD, RBC or another one. But the banks didn't actually lend out a whole lot of this money. And we can debate all day about what the reasons for not letting this money work, but I think it was a combination of people, one not wanting to borrow the money, to spend on things and banks, knowing that at some point they're probably going to have to give this money back to the central bank so they don't want to lend it

up. So the fact that this money was printed, it doesn't really mean that there's going to be inflation unless you see this money actually get into circulation.

Colin White:

And when you say the circulation Josh, that comes down to something that again has started to geek out, the velocity of money. If you give somebody a bunch of money and they just put it in the bank and leave it there, that's not going to drive up the demand for pretty much anything. So not only is money have to get air quote, print it, it's actually got to get used for something and that's not a straight line, at all.

Josh Sheluk:

Yeah. There's a million things that really go into inflation. And I'm probably exaggerating when I say a million, but not by much. So this idea that government prints money, we get inflation, uh-oh, that's a bad thing, that's way too simplistic. And there's so many different relationships that are out there that you need to consider before we can draw that direct line. So we talked a lot about theory and that's kind of boring for a lot of people but there are some things, some other factors that have, I guess, a more tangible link to inflation. And one of the things that you wanted to make sure that I brought up was wages and how wages to people and employment, I guess more broadly speaking, actually flow into inflation. So let's just take it at its most simple level.

Josh Sheluk:

More people employed that means more people have more money to spend. They go out and buy more things, higher demand for things should lead to inflation, all else equal. So there is a direct link between number of people employed and the thought that at some point with a higher number of people employed, lower unemployment rate, there should be more inflation. And part of that is a wage's discussion as well. So as more people are employed, it should get harder for businesses to find qualified workers, which means they need to pay those qualified workers more to attract them. So for example, if you're working at local McDonald's and Wendy's down the street says, "I really need somebody to flip burgers here. I'm going to offer an extra five bucks per hour for anybody that comes and works for me from McDonald's." Well, that person that's getting five bucks more an hour, they're going to have more money to spend on things. And again, higher demand for goods, generally speaking should lead to inflation.

Colin White:

Yeah. And I saw something you watch, when unemployment rates are really low, labor participation is really high, but then the little bit of spill over that can happen is all of a sudden there's such a shortage of labor here. All of a sudden, you see things begun to be outsourced. And that's where you start to see call centers showing up in different parts of the world or Canadian tax returns being done in different parts of the world. Companies, when it gets to a certain point, it gets too hard to find labor in one location, all of a sudden there's a financial incentive for them to do. So again, if that labor is a little bit cheaper than that can be slightly deflationary, right?

Colin White:

So again, to Josh's earlier point, this does get really nuanced really quickly. But labor it's just something that's a little bit closer to people to understand that again, if somebody down the street offered you an extra 10 bucks an hour to do the same job because they were really, really, really in a tough spot, that's inflation and that's how it feels, that's how it looks and that's how it can move.

Josh Sheluk:

Yeah. And you mentioned deflation, so that's sort of the opposite, right? Inflation, average prices in the economy or countrywide going up, deflation opposite, then happen average prices going down. And it's unusual to see sort of persistent deflations were right across the board but there definitely have been some aspects of that over, let's just look at the last 10 years. And one of the reasons that you mentioned that has directly tied into deflation is globalization. And there's been an uptick in globalization for several decades now. And again, you mentioned it, if you can get cheap labor elsewhere outside of the country, then that's going to have somewhat of a deflationary pressure on the economy. The other thing that I've been reading a lot about recently is that there's been a real sort of cap or restriction on labor units over the last several decades.

Josh Sheluk:

And that also has led to a little bit more power for businesses, a little bit less power for employees and putting sort of a ceiling on how much wages can rise over that period of time. So there's a lot, a lot of different things to look at and weed through when we talk about some of the reasons or things that we're missing when it comes to inflation. But I guess generally speaking, what we want to think about when we think about inflation is again, it's just an intersection of supply and demand sort of economy-wide. So anything out there that's going to lead to higher demand for things like, for example, people going back to work and getting paid more, that's going to put some inflationary pressure on the economy.

Josh Sheluk:

On the other side of that spectrum, last year, COVID great example, people out of work, people can't buy anything. So you have less demand, that's going to lead to deflationary pressure and we actually saw that spill through to some of the numbers last year when it comes to inflation. And then you can look at supply side of the equation as well. So what we've seen again with COVID is there's been some supply chain disruptions. So you've seen less supply of things like, hey, toilet paper. I don't know if there's actually a supply chain disruption, you aware? But people thought through us.

Josh Sheluk:

So maybe this is more of a demand thing than a supply thing, but let's say the supply chain was disrupted for toilet paper. Oh boy. All of a sudden the cost of toilet paper is going up. And then, similarly you flood the market with something on the supply side or all of these goods come to the market, whatever it is. And then all of a sudden people are like, "Well, I'm not going to pay that much for good X because there's so much of it out there. I can walk down the street and find it thrown away on the corner." So these are sort of the broad strokes of inflation when we think about this topic.

Colin White:

Well Josh, okay, so let's take that and turn it into what does that mean for an investment portfolio? Because again, I don't think that we've got a firm opinion one way or the other, it is a potential of what we're dealing with right now. It's not a for sure thing but we could be looking at inflation. So let's explore for a second for everybody what it means to an investment portfolio.

Josh Sheluk:

Yeah, sure. So it means a lot. It means a lot. And depending on what you're investing in, it could mean different things. Which means this is going to be a difficult conversation to have in a very succinct way. But let me break it down in sort of three broad asset classes for you. And the first is bonds. It has a pretty direct link with bonds in your portfolio. So a bond, again, just for our listeners to recap, bond is basically you're lending money to somebody, they're going to give you interest payments over a set period of time at the end of that bond with the end of 10 years or 15 years, whatever. That bond comes due, they're going to pay you back your principal.

Josh Sheluk:

So let me say that, okay, Colin, you're going to lend me a hundred bucks over the next 10 years, I'm going to pay you 10 bucks a year until at the end of that 10 years, I'm going to pay you back your hundred bucks. Well, if inflation is going up, you're going to be pretty pissed off because that 10 bucks or that a hundred bucks that you're getting one, two, three years or 10 years down the road, it's going to be worth a hell of a lot less then than it is today. On the flip side, me as a borrower, I'm going to be thrilled if inflation goes up, because that means that in future dollars, the real tangible cost to me is going to be a lot less than it is today. So if you're a borrower, "Hey, bring on inflation." That's awesome for you. If you're a lender or a bond holder, inflation, not so good. So it depends what side of the spectrum you're on there.

Josh Sheluk:

Now, the other thing, well, we can look at the stock market. And again, as stocks tend to be a little bit more complicated when it comes to the different interaction of these variables. So inflation, generally speaking can be thought of as a positive thing for stocks, as long as it doesn't get too high, right? And there's a lot of data going back a hundred years or so, that kind of bears this out. Because most businesses they can pass on some of these cost increases to their customers.

Josh Sheluk:

So if you see an inflation going up, you go to the grocery store, the grocery store saying, "Well, inflation is going up, I'm going to jack up the price of the loaf of bread." You're going to be willing to pay it because you know inflation is going up. "You know what? My loaf of bread costs an extra 10 cents today than it did a week ago and no big deal." So that grocery is going to be making a higher revenue and potentially a higher profit as well. So to the extent that that company can pass on price increases to its customers, "Hey, that's good for my bottom line. That's good for my profits."

Josh Sheluk:

Now you could have a business for example, that they have higher input costs or higher cost of their goods. And they're not really able to pass on a lot of the cost increases to their customer. And in that

case, your top line, your sales stay roughly the same, but your costs go up, well that's putting pressure on your margins and actually decreasing your profit margin. So that could be a negative.

Josh Sheluk:

So I guess it depends on the type of business that you're in, but generally speaking, market-wide, a little bit of inflation is good for stocks. Too much inflation becomes a bad thing because then it just becomes really tough to control your input costs. It's tough to pass on all of these price increases to your customers. And then you can have a bit of a spiral where things get a little bit messy.

Colin White:

Well, I think the other point to make here is that there are examples like real world, real time examples that have unfolded over the last number of years. And again, based on talking with people, because I always like to understand the business models of different things. The restaurant industry is a great example. I mean the cost of a meal at a restaurant hasn't really changed a lot over the last number of years, what somebody's willing to pay for a hamburger. But the input costs have gone up hugely. That's one of the reasons you're seeing a proliferation of the major chains, like the Boston Pizza's of the world, because they've turned the food into a bit of a formulaic thing because they've been under such, there's such unwillingness of the population to spend a lot more eating out.

Colin White:

So, they've had to get a lot more efficient with the types of food that they serve and how they serve it in order to drive the cost to a point where they can stay in business. So those industries, and different industries have had different experiences, where they do have the ability to charge more for their product or they don't. And so these kind of little nuance pressures have played out over the last every period of time. So, this is a little bit more of a macro-economic thing, because again, this is going to be seen to be a wider based thing, which is kind of why it's become a bit more topical right now, but it's not new. There's lots of companies who've dealt with this exact conversation continuously. It's not a new conversation. It's something that's already baked into a lot of business models.

Josh Sheluk:

Yeah. We can look at dozens of these different examples and another good one that kind of gives you a real life and very, I think, close to home example, so to speak of how this can affect businesses is with home builders. So home builders, I think it's pretty well-documented now that over the last 12 months, lumber prices have approximately tripled. So if you're a home builder and you agreed to sell somebody a house for 500,000 bucks last year, and today, when you're actually building that house, your prices of lumber three times higher than they were last year. Well, you're saying, "Oh, no, my profit margins are shrinking a little bit here." So that could be something where it takes a little bit more time to play out in terms of the inflation numbers and for that business to be able to pass through some of the cost increases. But that's a real example that people can see a sort of on a day-to-day basis and we've talked about real estate a lot.

Colin White:

So Josh, what does all this mean for hard assets?

Josh Sheluk:

Well, hard assets. So what do you mean by hard assets Colin? Well, I'll explain to our audience, our listeners what do you actually mean. So hard assets is something like commodity-based or something physical and tangible that you can touch. So could be gold, could be a barrel of oil, it could be that lumber thing that I was just talking about or something a little bit more usable, like real estate, for example. That's sort of a good catchall for all those things. So inflation, generally speaking, is as a positive for these types of things. Gold, for example, has a pretty direct line with inflation and when you get sort of that inflationary spiral that we have seen at sometimes, several decades ago, gold tends to do very, very well. And most commodities that are out there because there's more physical good, you do see inflation numbers sort of hit the prices of those commodities. So there's that.

Josh Sheluk:

And then on the real estate side, you usually, going back again, long periods of time, see real estate, appreciate it, approximately the pace of inflation. But this is one that I'm going to kind of throw a wrench in, because we've seen inflation be pretty low for the last couple of decades yet real estate has gone up a lot. Especially in Canada, we did a full podcast on this. So the fact that we may have some inflation in the future, is that good for real estate? Well I'm going to stop people right there. We've already seen a huge increase. And there's a lot of other factors that will influence it like, "Hey, this thing called interest rates." Interest rates go up, real estate might go down.

Josh Sheluk:

So that's what it means for your investment portfolio, but that doesn't necessarily relate to what it means for you, what it means for me, what it means for our clients. So we hear this thing called CPI, talked about all the time in the news and the media and people say, or the media says, "Well, CPI is up, that's bad for you. CPI is down, that's good for you." That's a little bit simplistic, I think, Colin. What does all this mean for the actual individual? What does it mean for our audience?

Colin White:

As important as inflation is to understand global macroeconomic theory and investment theory, it is equally unimportant to the individual for the following reasons. CPI for beginners, which is the consumer price index, which is a Canadian index of a basket of goods, specifically excludes energy and food, because they're seen as too volatile to be measured. Now that doesn't make them any less relevant because you're going to need food. But when it comes to the, the, the towers where they do all the math, if they need something, that's more model able [inaudible 00:18:08], but it something that that they can base pension calculations on. They need something that is reliable. So it's kind of a very abstract number for abstract reasons. Now where it hits you, the individual is, "Hey, my pension or my other benefit is tied to that number. Therefore that will affect my income." But there's a huge disconnect as to what that means to your expenses.

Colin White:

So there's all kinds of examples here. So it really depends on what your basket is. Whenever we measure inflation, it's always based on a basket of goods and how that basket of goods has changed in price over time. To the extent that your basket is different than that basket, it becomes more and more, less

relevant. Less and less relevant, I guess, would be a better way to say that. So if you're putting your kids through school, tuition in Canada is something that has seen double digit inflation, for extended periods of time recently. And some of that is born over the fact that the model has changed, not as much easier to get a scholarship. When I was at school, if you didn't have an average over 90, you weren't getting a sniff, here you walk in with an 80 average, they pass you a check.

Colin White:

So the universities have kind of played a little bit of a game and more so in the U.S. and Canada, but they played a little bit of a game where tuition has gone up quite substantially. However, very few people are paying that price. So one of two things. Number one, how big of an expense is tuition to you? That's relevant. And number two, how smart your kid? That's awful relevant as well. So it becomes very particular to your situation and how smart your kid is as to how much that affected you. The other thing is they talk about food. They take this basket of goods, maybe you're lactose intolerant so dairy doesn't matter to you. Well, maybe the basket of goods is 15% dairy. Therefore it's that much less relevant to you. You walk in to buy steak, oh, that's awful expensive today. "Hey, look, the pork's on sale. I'll buy it." It's called substitution. You can substitute things there and keep your food costs in line, to a point or maybe you can't.

Colin White:

So when it comes to you making a decision about your finances, that's very personal. And so you should be aware, things are getting more expensive and you need to watch for that. You need to expect that it's going to happen. But to rely on any of the abstract conversations about general inflation rates may have nothing to do with your world. And as you pointed out Josh, real estate is kind of that thing. Everybody's saying, "Oh, inflation is almost non-existent," unless you're trying to buy a house. Inflation's a good word to describe it. So again, I think that's the best example of the disconnect between what the academics are talking about in theory and what people are experiencing in reality.

Josh Sheluk:

It's a great point because you may have a different basket of goods than this CPI measure, right? And actually I would, I'll change that a little bit. You will have a different basket of goods than the CPI measure. So the CPI measure may not directly reflect your costs as an individual. If you're looking for a house while it's probably, CPI is going to really sort of undershoot where you're seeing CPI or where you're seeing inflation in the cost of housing today. But if you're on the other hand looking for a new TV, well, all we've done is seen the cost of a flat screen, high-def TV come down exponentially over the last five, 10 years. So, Hey, you're going to get that TV for really, really cheap.

Josh Sheluk:

And this is another thing that I guess doesn't really get captured in the CPI numbers is changes in quality or changes in safety. For example, you bought a TV 50 years ago. Well, it might've been kind of expensive at the time, but it was also black and white and 13 inches and 45 pounds. I can buy a 10 pound TV today that's paper thin, gives me better definition than real life somehow, is 3D and curved. And hey, the whole thing costs 500 bucks. So it's not too bad, it's kind of a drop in the bucket.

Colin White:

And to bring this full circle and all that we've talked about here today. [Inaudible 00:22:30], the one thing to take away from this and congratulations to those who've made it to this point, here it is, here's your payoff. Being efficient with your capital matters. If you've got a hundred grand sitting in the bank account at 0% interest, there's an opportunity cost there. We can't tell you exactly how inflation is going to erode your personal purchasing power, but it is. Things are getting more expensive, not less. So if you are not efficient with your capital, meaning you don't deploy it in a way to try to maintain its purchasing power, you are falling behind. Now, it is insidious because it's not visible.

Colin White:

You don't get a report every year to say here's how the performance of your assets are. These would be your purchasing power to your basket of stocks. It's not visible, but it is certain. Over time, the purchasing power of your money matters. So the cost of not allocating your capital in some kind of a fashion with the goal to protect your purchasing power is extremely important and valuable. So all of the abstraction aside, keep an eye on that, keep enough money in the bank to sleep on, to make sure you're comfortable and all the rest of it. But that dollar, that extra dollar that you don't need to use in the next few years, do something with it that is going to quit it in a position to still buy you as much milk or buy as much gas or buy you as much heat for your home 10 years from now as it does today. That matters.

Josh Sheluk:

Yeah, this is really changed, I think over the last let's call it two, three decades for us as portfolio managers in terms of how we have to manage portfolios for people. Because, so you mentioned one thing, you can't leave your money in a bank account and it's not going to grow as much in inflation. Well, you can't find anything that's really safe or guaranteed that's going to grow as much as inflation today. I can buy you really solid GIC that's not going to go down at all in value for 1%, but if inflation is 2%, you're getting poor every year. And so that's just not going to work. Similarly with bonds, right? I can buy a safe government bond, 10 year at one and a half percent today. Still not cutting it. So you need to be able to look at your overall allocation from a portfolio perspective and make sure that you're allocating, that we're allocating for our clients in a way that is going to help grow their wealth over time and not make them poor.

Josh Sheluk:

And we have a lot of people that come in today, they say, "Oh, I'm 65. I'm ready to retire. I want to get way more conservative with my portfolio." Well, hold on. How long do you have to go? Right? Are you going to die in five years? No, I don't think so. At least not statistically. You're probably going to be having to plan here for 20, 25 years of continued life and third, even a 2% inflation rate over 20, 25 years. That's going to really add up. So you need to grow your portfolio over this time. And that's why when people are coming through the door today, maybe in their later working years or early retirement years, and they say, "Well, I just want to be safe." Maybe not going to work, right?

Colin White:

Well, yeah, the challenge is that when you turn 65, it's not like you're going to spend all of the money that week. Just because you turn 65, that doesn't mean all of a sudden you're entirely short term. Yeah. You got to meet your short term obligations, for sure. But you're still, if the statisticians are right, going

to need money 20 years from now. That money shouldn't be sitting in a bank account, because again, it's going to lose... Actually I've read the first person to live to 150 years of age has already been born. So look around the room. Maybe you're in the presence of that person. Now, again, medical science is a wonderful thing, but I think the trends are to live longer, not shorter. And yes, many people live for today. Spend my money, don't want to leave any money behind. But you don't want the music and then you still 20 years left to sit there and wait for the end. Like that's not fun either.

Josh Sheluk:

Yeah. Another thing that's increasing a lot in terms of inflation is healthcare, right? So you may want to have just a little bit of a safety net there for your final years, because if healthcare and long-term care or these types of expenses are coming your way, then you're probably going to need something for that.

Colin White:

Well, yeah. You start to get down the road about the fiscal situation of the governments and what kind of position they're going to be in to meet the obligations we think that they're going to be able to meet at this point. It doesn't have to be an unreasonable person who concludes, "You know what? I'm less confident the government is going to keep doing what they're doing right now, so maybe I need to be in a position to look after myself a little bit more." That's not an unreasonable conclusion to reach and that's not a apocalyptic tomorrow where we're Mad Max and dazzling across deserts, wearing funny masks and stuff. It's not to that level, but it's something it could have in the back of your mind and give it a little bit of weight when you're making your decisions.

Josh Sheluk:

Yeah. I'm glad you brought it kind of full circle back to what the government's doing. Because again, we're not prognosticators, we're not telling you that inflation is going up or inflation is going down or inflation is going to average 5% for the next 10 years. None of that. But I think... I still hear people come through the door and say, "Well, what about inflation?" It's going to be five, 10%, back in the 80s it was X percent. Just to give people a little bit of a history lesson. I'm not really a big history buff, except when it comes to financial history, which I really enjoy. Up until the late 80s, early 90s, central banks around the world did not have a mandate to control inflation. But at that point, so let's call it 1990, they started saying after runaway inflation in the 70s and 80s, "Hey, we need to pay attention to this inflation thing. And we needed to start to control it."

Josh Sheluk:

And ever since then, one it's been their mandate, sort of their sole mandate if you look at the bank of Canada, to control inflation, right? To keep it at a reasonable level. And the Bank of Canada has set that range between one and 3% per year. And two, they've done a very, very good job at hitting that mark on a consistent basis. Not every year, not perfectly, not been able to project it with perfect certainty, but they've done a really good job of staying within that band. So we would be confident to say that inflation will probably stay fairly well controlled, but they made some changes. Central banks made some changes last year when COVID started, that may lead to a little bit more inflation going forward than there has been over the last 10 or 20 years.

Josh Sheluk:

And it was nuanced. It was subtle, but instead of targeting 2% inflation, they said, "Well, we're now going to say we want 2% on average, over sort of extended periods of time." So if inflation runs a little bit cold for a while, under that 2% mark, then they may let it run a little bit hot for a while above that 2% mark on more of a sustainable basis. So we don't think that there's going to be hyperinflation or anything like that, that you should bury your gold in your backyard, but you may want to pay attention to this over the next little while.

Colin White:

So to summarize, this artificially construed number of inflation that they've kind of made up, they want to keep it within some imaginary goalposts for an extended period of time going forward. Did I get it all?

Josh Sheluk:

Yeah, but you should still have a real plan. That's the one plan that should be real about this.

Colin White:

All right, so the grand conclusion here is inflation's a thing. Stuff's going to get more expensive. You should make sure your money tries to keep up. Is that pretty much it?

Josh Sheluk:

You got it. [crosstalk 00:30:33].

Speaker 1:

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