Investment Commentary

EQUIUM CAPITAL

November 2017

U.S. Inflation: Dazed & Confused

Since global central banks began to expand their balance sheets in earnest during the depths of the Great Financial Crisis, expectations for an acceleration of inflation have abounded. The Nobel prize winning economist Milton Friedman's quote, "Inflation is always and everywhere a monetary phenomenon", has been trumpeted by critics as the key risk to trillion-dollar asset purchases and zero interest rate policies. While many dismiss the discussion as academic and not nearly as interesting as placing bets in the Amazon corporate death pool ($20 on FDX), the implications for investors, savers and economies cannot be understated. Here's our take.

Despite central banks tripling their collective balance sheets to over $18 trillion USD, inflation levels remain below target across every one of the G7 economies (Chart 1). In September, Janet Yellen, Chair of the Federal Reserve, admitted that the Fed's understanding of inflation was "imperfect" and that the shortfall of inflation was a "mystery". Setting aside how this might rate as justification for spending $4T dollars, the real question is: should we expect this paradox of excess liquidity and low inflation to sustain? Our view is no.

Although the structural headwinds of ageing demographics, technology and excessive levels of debt will remain, we are beginning to see signs that cyclical inflation may pick up in the short-term. One key indicator is the rise of commodity prices and specifically copper, which is up +40% over the last year. "Dr. Copper", with its end-use across a broad swath of industrial applications, has historically correlated well with economic growth and inflation expectations (Chart 2). Add to this our recently discussed upward bias on the price of crude oil and we see input prices as likely to rise across the industrial complex.

Further, the excess capacity that has weighed on goods inflation seems to be disappearing as strong global economic activity has steadily mopped up supply. Manufacturing capacity utilization rates across some of the world's largest exporters (Europe, Japan, South Korea) are all near cycle highs. Note that China, where export prices have been on the rise, is the critical variable here as analysts estimate prices on roughly 40% of the core consumer basket in the U.S. are influenced by China. All told, we are seeing these factors begin to drive up inflation measures such as the Fed's Underlying Inflation Gauge, which tends to exhibit better forecast accuracy and has in the past led the traditional core CPI measures, portending further gains in the near-term (Chart 3).

Chart 1 | Global Core Consumer Price Inflation
source: OECD, Equium Capital

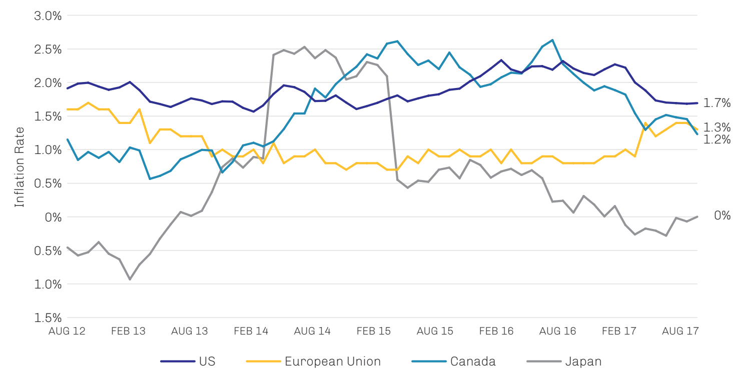


Chart 2 | Copper Futures Price & Expected U.S. Inflation
source: Bloomberg, Equium Capital

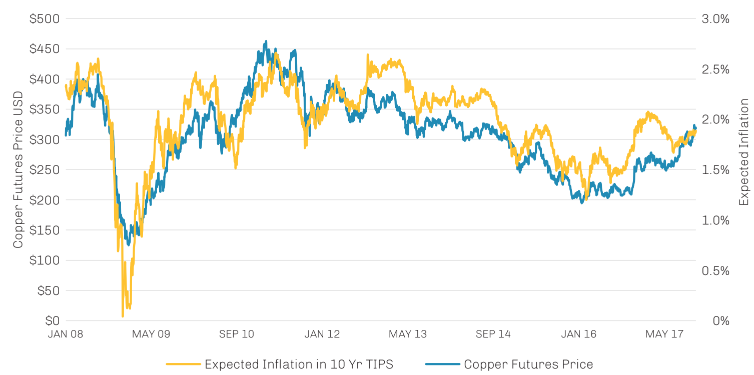
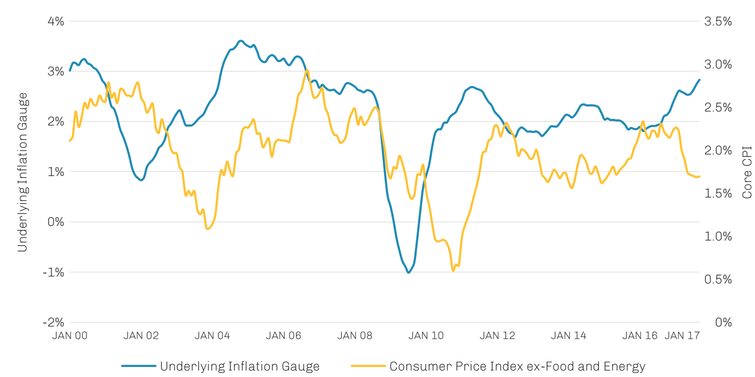


Chart 3 | U.S. Underlying Inflation Gauge
source: Federal Reserve Bank of New York, Equium Capital



Equium Capital Management Inc.
36 Toronto Street, Suite 1170, Toronto, ON M5C 2C5
(416) 304-9364 | info@equiumcapital.com

Against this capacity tightening, we see a multitude of indicators pointing to continued economic growth, which should further magnify this upturn. World merchandise trade volume is the highest in 5 years and the Bulk Dry Index, which measures demand for global shipping, has confirmed this uplift. Also, Purchasing Manufacturing Indices (PMIs) are near their recent highs across both advanced and emerging economies (Chart 4) and financial conditions remain very loose with corporate credit spreads near their lows. For fun, we'll throw in a $2T tax cut for the world's largest economy, already operating near full capacity, and we see plenty of tinder for an inflationary bonfire.

As always, we at Equium Capital confirm our fundamental views with the top-down technical trends. If these inflationary trends were really taking hold, we would expect to see confirmation in bond prices and equity sector rotation and this is exactly what we see happening. The U.S. 10-year yield broke above the key 2.40% level in October while the Materials and Financials sectors have significantly outperformed the S&P 500 since the beginning of September (Chart 5). Given the combined positive view, we made several changes to our asset allocation.

We had already begun shifting to more inflationary positioning last month by reducing the Energy underweight (as discussed in last month's commentary) as a result of the sector breaking out of its downtrend. In October, we further added to this skew by purchasing the Materials sector given its exposure to industrial metals and economically sensitive chemical products. We sourced these investments by reducing our interest rate sensitive exposures in Utilities and Fixed Income.

ETF Series Launch (TSX: ETAC)

At Equium Capital, we have made it our mission to pursue all available avenues for delivering value to our clients. One critical aspect of this objective is our focus on innovation and the clear need for our industry to move beyond the stale legacy Mutual Fund model and towards adaptive and transparent funds that provide both value and an elevated level of service to clients. To that end, we are excited to announce the launch of our exchange-traded fund (ticker: ETAC on the Toronto Stock Exchange). Investors will participate in the same strategy with an identical fee structure while benefiting from greater transparency and liquidity. We have gone to great lengths to break new ground and deliver to you a superior product, which has already been embraced by our partners. As always, we welcome your feedback on the ETF series and appreciate any suggestions that you may have as to how we could improve your experience with us. Onward and upward.

Chart 4 | Global Purchasing Managers Index

source: Markit, JPMorgan, Bloomberg, Equium Capital

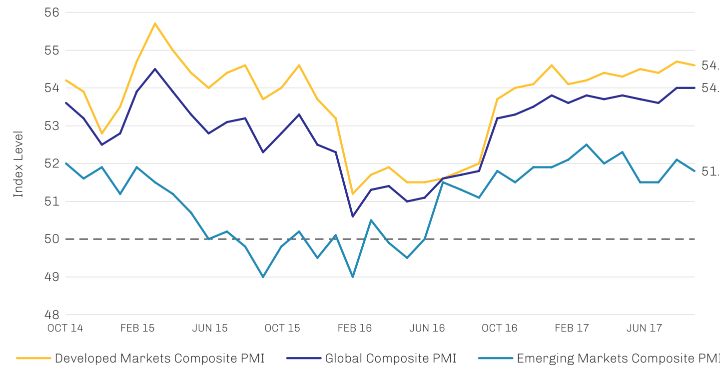


Chart 5 | Financials & Materials Sectors vs. S&P500

source: Bloomberg, Equium Capital

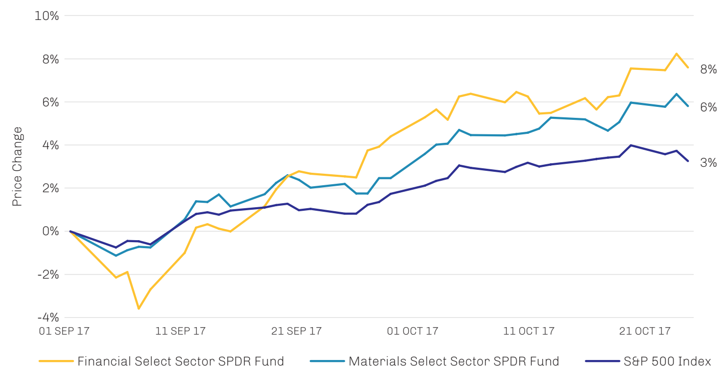


Table 1 | Investment Recommendation Snapshot

source: Equium Capital

	Sector	Region
Overweight	Equities Health Care Industrials Financial Services Materials	U.S. France Germany India
Underweight	Fixed Income Real Estate Staples	Australia Canada United Kingdom

Adam Murl, CFA
Portfolio Manager/Head of Research
adam.murl@equiumcapital.com
(416) 304-9359

Equium Capital Management Inc.
36 Toronto Street, Suite 1170, Toronto, ON M5C 2C5
(416) 304-9364 | info@equiumcapital.com

Cameron B. Hurst
Chief Investment Officer
cameron.hurst@equiumcapital.com
(416) 304-9360