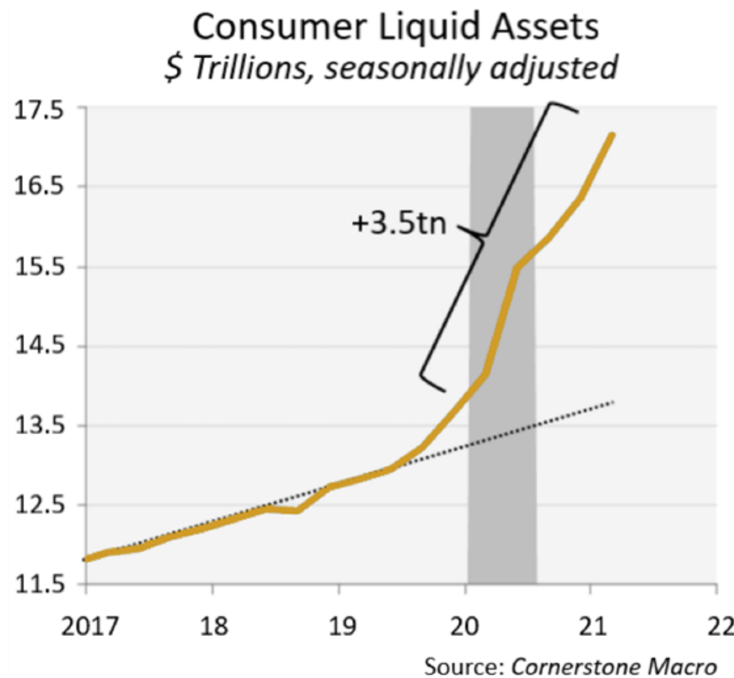
Don't miss the forest behind the pricey pile of lumber

Following more than a year of what can fairly be described as a health, social, and economic odyssey, we seem to be sitting at or near the cusp of transition on many fronts. The effectiveness and relatively wide distribution of covid-19 vaccines has suppressed the worst effects of the virus and, at long last, allowed us to gradually resume our normal patterns of living and interaction. At the same time, the resulting uptick in activity has brought with it a well-reported jump in inflation and worries that central bankers will shift gears and begin to withdraw the extraordinary monetary support that helped to keep economies afloat during the worst of the lockdown.

Of course, it's only natural that the US Federal Reserve and its global counterparts would eventually scale back emergency measures as the economic crisis fades behind us; trouble is, some fear that without an ongoing flood of liquidity, stock prices will sag. To what extent this is true is difficult to say, but the possible parsimony of central bankers shouldn't be weighed in isolation. In fact, much of what might be lost from the monetary component of the ledger could be replenished on the fiscal side, with US lawmakers recently reaching agreement on a $1.2 trillion spending bill and other major nations likely to follow suit to varying degrees. Add bursting consumer coffers and a pent-up desire to spend to this mix and it's hard to imagine that the economy will be capital-starved in the quarters to come.



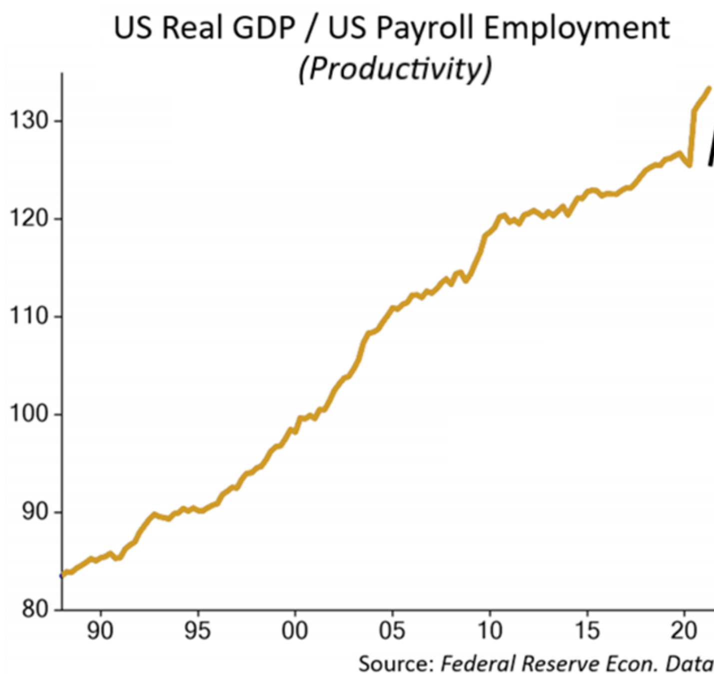
Source: *Cornerstone Macro*

The other contemporary concern hanging over stocks is that the long-lived backdrop of low and falling inflation might have come to an end, which will simultaneously cause interest rates to rise and put pressure on asset valuations. To be sure, the sudden upswing in consumer demand, combined with hobbled supply chains and scaled back production, has resulted in significant price jumps across a host of goods and materials. In the commodities world, however, it is said that the best cure for high prices is high prices – in other words, producers will respond to such signals by boosting output, while customers will delay purchases or switch to substitutes until pricing is rationalized. This phenomenon was on vivid display in the lumber market in the second quarter, with the price per thousand board feet plunging by more than 50% from its May high after tracking a near vertical ascent over the previous year.

In broader terms, debate seems evenly split between fear that we've entered a new inflation paradigm and confidence that what we're now experiencing will pass once deferred demand is sated and productive capacity is restored. Though the future path of inflation is notoriously difficult to predict (*like virtually all market and economic variables!*) we do have one dispassionate and unbiased arbiter to reference

in this regard: *the bond market*. Impervious to the din of the chattering classes and unfazed by headline-grabbing spikes in select prices, the yield curve flattened in the second quarter and 10-year government bond rates in both the US and Canada retreated decisively below 1.5%, both of which suggest a more sanguine take on the outlook for consumer prices.

Behind speculation as to what central bankers might do next and where inflation is headed, however, something important and potentially more enduring has occurred over the past year, as productivity has taken a great leap forward.



If the fundamental economic equation: GDP GROWTH = POPULATION GROWTH + PRODUCTIVITY GROWTH is accepted, then this development is significant – *especially when the demographic profile of most developed countries is exerting downward pressure on population levels*.

We can all sense the accelerated digitization and enhanced efficiency within the economy in our everyday lives, through everything from the replacement of business travel with virtual meetings to the use of QR code menus and mobile ordering in restaurants. In our discussions with company management teams, this productivity thrust is being confirmed, with highlights including:

- Dollarama ramping up the installation of self-checkout facilities in its high traffic stores;
- Enghouse Systems boosting its EBITDA margin by more than 5% on the back of cost savings from reduced travel and a smaller physical footprint;
- MTY's rollout of a pre-ordering app, which has reduced lineups and improved the customer experience at its Cold Stone ice cream parlors;
- Middleby's introduction of a suite of products to allow commercial kitchens to increase automation;
- Union Pacific improving locomotive and workforce productivity (metrics that track miles per train and per employee) by 14% and 11%, respectively;
- And, beneath the surface, Microsoft, Apple, Alphabet, Constellation, Kinaxis and others providing the tools to power the productivity boom.

As clients and followers of our communications will know, we confess to possessing no advantage over our peers in predicting markets, interest rates, inflation or all of the other variables that seem to occupy much of the financial media space. What we are good at, however, is understanding the companies we own and assessing how they're positioned to generate and grow shareholder value in the foreseeable future. Based on our ongoing contact with management teams and our other means of analysis, we remain as confident as ever in the businesses comprising DM equity portfolios.

Hope your summer is off to a great start!