Quadrant Private Wealth

Inflated Inflation Worries?

QPW Perspectives – November 2021

Higher prices have been a prevalent part of many personal conversations these days. Whether at the grocery market, the gas station or the home renovation store, increased prices are evident, leaving many to wonder how much further prices will continue to increase. In a similar fashion, inflation headlines have dominated recent financial market news, as the impacts of higher prices make their way into economic inflationary indicator measurements. For some, this can create questions regarding whether their long term financial goals are being impacted or if their investment portfolio is optimally positioned for an inflationary environment. In the following, we will explore these themes.

Inflation – Some Perspective

It's important to acknowledge the distinction between prices and inflation. Inflation is not simply about prices going up; inflation measures the rate at which prices are increasing. A large and progressively increasing value can indicate an acceleration in the rate at which prices are increasing.

In Canada, the most widely used measure of inflation is the Canadian Consumer Price Index ("CPI"). Statistics Canada measures CPI by looking at the price changes for a common basket of goods and services that Canadian consumers purchase. The value of this index is reported monthly. Some news sources will often quote the most recent percentage change in the index on an annualized basis which can be misleading as the most recent month is unlikely to reflect the entire year. It is more meaningful to look at changes over periods of time such as year over year to understand short term inflation changes while longer time periods, such as five years, may be more relevant when looking at long term inflationary trends. This is not unlike assessing portfolio performance. The table below illustrates how varying measurement periods can influence inflation perceptions:

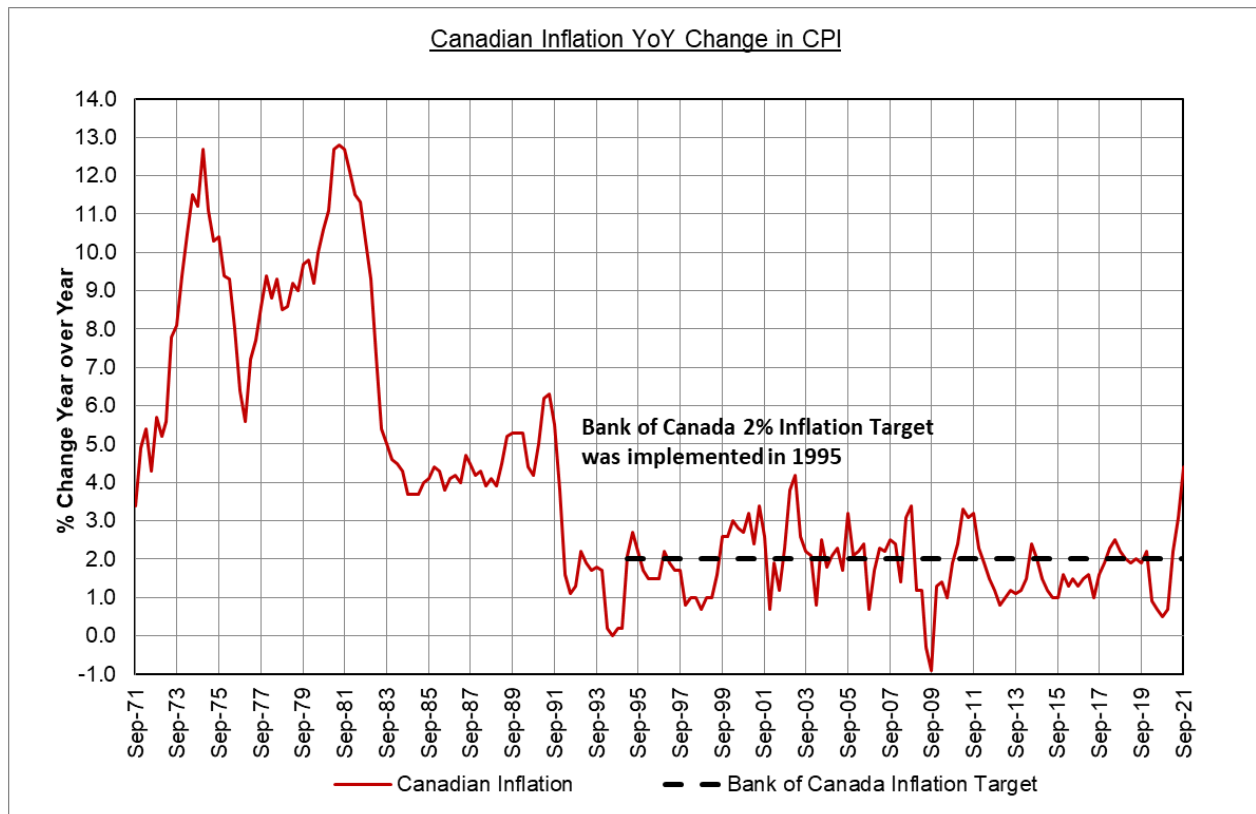
Canadian CPI Percent Change

As of	1 Year % Change	5 Year % Change (annualized)
30-Sep-17	1.55%	
30-Sep-18	2.22%	
30-Sep-19	1.87%	
30-Sep-20	0.51%	
30-Sep-21	4.38%	2.10%

Source: Statistics Canada

As can be seen, based on the most recent data, inflation can be viewed as 4.4% on a one-year basis or 2.1% annually over the past five years. It should be noted that data reported for the past year was largely driven by the effects of the pandemic and is likely not an appropriate representation of a long term inflationary trend.

For the remainder of this discussion, year over year Canadian CPI is the measurement time period that will be focused on. The following chart shows Canadian CPI on a year over year basis, going back to 1971.



Source: Statistics Canada

Relative to historical inflation from the past 20 years and the Bank of Canada's stated long term inflation target of 2% which was implemented in 1995, the current rate of inflation on a one-year basis is relatively high at 4.4%. Year over year inflation has not been in excess of 4% since the early 1990s. As mentioned, the current level of inflation is being measured relative to the previous year, during which there were extremely low levels of inflation due to the pandemic. The average annual inflation rate for the past two years ended September 30, 2021 was 2.4% - still above target but not as dramatically as a single year over year comparison would suggest.

In looking at the past year, inflationary impacts presented themselves in several different ways but the overarching message is that because of the pandemic, supply could not keep up with demand which equals higher prices.

- Supply shortages – at different points in time around the world, many businesses were affected by imposed shutdowns and worker absenteeism due to the coronavirus.
- Supply chain issues – Exacerbating supply shortages was the impact of the pandemic on the shipping and transportation businesses, as overseas products and supplies for production were delayed for the same reasons as supply shortages themselves.
- Increased demand – The pandemic created uneven, increased demand for certain products and services such as information technology related products, as more people spent time at home and businesses operating remotely had greater needs.
- Wage pressures – As businesses reopened and looked to rehire, the pandemic brought an awareness of the relatively low wages being paid in certain sectors where employees are working in roles that impact many peoples' daily lives. The hospitality and restaurant sectors are good examples. Well-intended and much needed government support programs such as the Canada Emergency Response Benefit or CERB Program, which paid benefits to

those unable to work during pandemic shut-downs, also made it challenging to encourage people back to work. Consequently, businesses needed to increase salaries to attract workers to come back. Although not explicitly included in the Canadian CPI measure, the Bank of Canada did note earlier this year that upward pressure on wages would also be closely monitored when assessing economic conditions. This is similar to U.S. Federal Reserve practices in monitoring inflationary conditions.

The "transitory" nature of these supply and demand dynamics given the pandemic is often discussed, but the reality is that working through these imbalances is going to take more time than many may realize. Restarting world economies after a global pandemic is not an easy task. And it's not going to be a steady upward trajectory. Recently, former Bank of Canada Governor Poloz likened the recovery process to "trying to get out of a traffic jam". As one identifies opportunities to move their car forward out of a jam, there will be times of forward movement and then times of stopping again as other cars affect your path to get out. This is also akin to comments in our May 2021 newsletter "Fits and Starts".

Should there be Worry about Inflation?

Given the current economic landscape, higher prices are not likely to dissipate any time soon so the question becomes one of how much higher prices could go. As we have noted, there are historical time periods where inflation has been much higher than 4%. But those time periods also preceded the implementation of the Bank of Canada's 2% inflation target (1995), which guides monetary policy decisions. At the most recent Bank of Canada Monetary Policy Meeting, Governor Macklem clearly signalled that higher interest rates are coming, potentially as early as the second quarter of 2022. What this tells us is that we are unlikely to experience the high levels of inflation seen in the past as the Bank of Canada is prepared to step in as needed.

Rising Interest Rates are Coming

When the pandemic arrived, banks and governments around the world did their part to provide liquidity and support. As economies continue to recover, the support will be gradually removed. This will include increasing historically low interest rates.

More often than not, it is the expectation of higher interest rates that impacts fixed income markets the most, as opposed to the official announcement of an increase in interest rates by a central bank. The following, based on the 5-year Government of Canada benchmark interest rate illustrates this point.

Portfolio Considerations

For some, inflation concerns can lead to questions regarding long term financial plans and whether their goals will need to be adjusted. A sound financial plan considers inflation and already takes price growth and inflation expectations into account, meaning that long term goals should not require adjustments due to inflation.

From a pure portfolio management perspective, some may question whether fixed income allocations should be reduced, as increasing interest rates mean declining bond prices. From a diversification and risk management perspective, it is never wise to put all of your eggs in one basket and a long term perspective (decades in many cases) is what the asset allocation of a portfolio should be based on.

That being said, it is important to be mindful of economic and capital market conditions in the shorter term with a view to ensuring that portfolios are not exposed to undue risk. From an equity perspective, we continue to look to our managers to assess and manage downside risk exposure.

In the context of fixed income, we continue to monitor the fundamental characteristics of each sub asset class as well as overall fixed income within a portfolio. Regular and deliberate attention is paid to term sensitivity to interest rates and credit sector exposure across a broad range of fixed income sub asset classes. Each of these will impact how a fixed income portfolio behaves in both a rising and declining interest rate environment. An effective fixed income portfolio manager adjusts these levers and pulleys in a portfolio to adapt during times of increasing or decreasing interest rates. At Quadrant, we keep a purposeful view towards our allocations within fixed income sub asset classes and look to our best-in-class active fixed income managers to appropriately manage risk and return within their portfolios relative to interest rate expectations.

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