Inflation Fears - Fixed Income Outlook

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[Patrick O'Toole
Vice-President, Global Fixed Income
CIBC Asset Management]

We said at the beginning of 2021 that inflation would be the issue this year. It'd be higher than the consensus thought in the first half of 21 and remain higher in the latter half of this year. Now I think it's interesting that we think it's actually going to be a bit lower than the consensus expects in the latter half of 2022.

[Images of U.S. and Canadian currency.]

We think inflation is going to be a bit sticky at the current elevated levels and probably won't peak until Q1 2022.

But will move back below two and a half for the third and fourth quarters next year.

[Inflation drivers]

Now our view that inflation will be moving lower soon is really based on GDP, which peaked in the U.S. in the second quarter of 2021, and in Canada, is likely peaking in the second half of this year. But we see it slowing due to a few factors.

[The Capitol building in Washington. Parliament of Canada in Ottawa.]

One, there is going to be less government support.

[The exterior of The White House. Aerial view of the Bank of America tower. Low angle views of an American flag on Wall Street and a Canadian flag in downtown Ottawa.]

For example, fiscal policy was about a 12% boost to GDP this year and be flipped to about a 5% drag in the next year. And in Canada, a budget deficit to GDP was about 6% this year. We expect about half that next year.

[Parliament of Canada in Ottawa. The Capitol building in Washington.]

And the U.S. budget deficit, the GDP was 15% this year, and we expect 6% in 2022. So that's a big hurdle.

[A woman sits on the floor in her living room looking over an invoice. A cheque is signed.]

I also think household income will take a hit from less government transfers, and governments are also going to do less quantitative easing next year.

[The exteriors of the Federal Reserve building and the old Bank of Canada building.]

The Fed is expected to be done their bond purchase program by June 22 and the Bank of Canada finished theirs in October of 21.

[Laptops on an assembly line. Aerial views of shipping containers. A sparsely stocked warehouse.]

In addition to the drag on inflation that should result from slower GDP, supply chain bottlenecks should also diminish for the next four quarters, as countries reopen more fully.

[Images of delivery men moving cardboard boxes.]

There still are some lingering concerns. Unit labour costs, which are one of the best predictors of where inflation is headed; they remain contained in Canada, but they have spiked higher in the U.S.

Now there's other inflation drivers.

[High angle views of an oil pipeline, cars on an assembly line, and the aisles of a supermarket.]

There's the fear that has been driven by higher oil prices, car prices, food prices and wages going up. Regarding commodities, yeah, they're up, but many are well off their peaks.

[High angle view of a lumber yard. Low angle view of large iron drums and a cornfield. An oil tanker and platform in the ocean.]

You can look at lumber, iron ore, corn, copper, even oil is down. And in wages, average hourly earnings have been higher in the U.S., not really much in Canada, but there's something called the Atlanta Federal Reserve Wage Tracker.

[Aerial views of downtown Atlanta.]

And that does a better job of telling you where wages are going.

[Teenagers working on laptops. A man in his 30'8s works at a desk in a stylish office. A group of 30-somethings sit at a table together. A busines man in his 60's types on a laptop.]

It shows that all the pressure is really among the 16-to-24-year-olds. 25 to 55's, their wages aren't really rising anymore on a year-over-year basis than they were pre-COVID. And 55 plus, their year-over-year wage growth rate has actually fallen.

[Timing of interest rate hikes]

We have had central banks spook the market a little bit here.

[The exterior of the Federal Reserve building.]

The Fed by announcing they're going to taper their bond purchase program and end it by middle of next year by June, meaning they could be setting the stage to hike rates as soon as the third quarter next year. That's faster than the consensus had expected.

[The exterior of the old Bank of Canada building. Parliament in Ottawa.]

And in Canada, the Bank of Canada talked about the output gap closing in the second quarter of 22 and saying it could hike in the middle quarters of 22. Again, that's sooner than expected.

So, the futures markets moved very quickly. And I'd argue too quickly to price in hikes, particularly here, where they see four to five Bank of Canada rate hikes in the next twelve months. And about two Fed funds’ hikes.

And let's remember, the futures markets are notoriously wrong and too aggressive in expecting rate hikes.

[The exterior of the Federal Reserve building.]

And we think the central banks are going to be more stubborn than the consensus expects, given their focus on full employment. The Fed and the Bank of Canada both have a plan to slowly raise rates when they've seen a recovery for all groups.

[A man looks over a checklist in a recycling facility. Workers at an oil derrick. Delivery men moving boxes. A woman works at a laptop. Workers in an autobody repair shop. A large meeting in a boardroom.]

But there may come what I call, like, a "Mike Tyson moment."

[Boxing gloves lying on the mat of a boxing ring.]

Like Mike said, everyone has a plan until they get punched in the face. The central banks have a plan, but the bond market may derail their plans.-Bond yields or longer-term interest rates, they could still move up a little bit, but nothing too excessive.

That's mainly because we see GDP, even though it's slowing, it's still going to be fairly healthy around 3% both in Canada and in the U.S. in 22. And inflation moving back down to the low

twos. So, a bit higher bond yields probably is warranted, and the bank could be hiking rates, but not as much as the market currently has priced in.

[Impact for fixed income investors]

What does a nervous fixed income investor do in this environment? Clients buy fixed income for basically three reasons: usually diversification from volatility of stocks, they buy them for income, and they buy bonds, also, for capital preservation. None of these things really have changed. I mean, regarding diversification, let's look at starting point. Well, bonds currently today the benchmark in Canada has just a little above a 2% yield.

[Patrick O’Toole looks at market data on a bank of monitors.]

Let's look at stocks. At the current, what they call the cyclically adjusted PE multiple of ten-year average. Let's look at the U.S. market.

[Time-lapse shot of downtown San Francisco.]

The San Francisco Fed says that stocks historically have returned about 0% real over the next ten-year period when you're at the current level of that cyclically adjusted PE multiple in the U.S. So, it could be that bonds and stocks have similar returns for the next ten years on an after inflation basis. It's not overly exciting for either asset class.

[A man points to a paper with bond market data. Patrick O’Toole and various analysts look at market data on banks of monitors.]

So, the starting point tells us that you better still have some bonds as a ballast in your portfolio, and there's no change regarding income. They still provide income. And yes, it's lower than historically, but so are growth and inflation when you're looking at inflation on longer run averages, not the recent experience. In capital preservation, there's no change there, so all the reasons for owning bonds still exist.

[Patrick O’Toole looks at market data on a bank of monitors.]

To me, it comes down to what do I buy in my fixed income sleeve? And that should include products that have some high yield bonds some foreign bonds, maybe private debt, etc. So, look at maybe a shorter-term duration products if you think rates are going to rise more materially.

[Patrick O’Toole and various analysts look at market data on banks of monitors.]

So, you need more levers in a low interest rate world. You shouldn't be reducing your levers and reducing your diversification by getting out of bonds. They’re still an important lever for investors.

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