MARKET SPOTLIGHT—MAY 2023

A look at how monetary policy and the energy transition could drive long-term investment gains

Inflation in Canada and the US has come down significantly over the past year but remains far above rates compatible with a permanent return to 2%. In this issue of *Market Spotlight*, we examine how central banks aim to enable each country to realize the long-term economic gain expected from a return to low inflation.

In this issue, we also take a look at how investment in low-carbon energy technology can enable the energy transition.

Economic gain expected from a return to low inflation

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> If the policy isn't hurting, it isn't working.
>
> ***—Sir John Major, former UK Prime Minister and Chancellor of the Exchequer***

This sentiment, originally expressed in ancient Greek literature and more recently in a series of Jane Fonda workout videos, aptly captures the current view of many central banks. This includes the US Federal Reserve (Fed) and Bank of Canada (BoC).

The principal goal of most central banks is price stability. This objective is often defined as an average annual rate of increase in the Consumer Price Index (CPI) of 2%. Inflation moved sharply away from this target during 2021 as economies experienced a Covid-related spike in supply bottlenecks, followed by a surge in spending. Central banks responded by aggressively raising policy interest rates in an effort to slow spending and head off an increase in wage costs otherwise likely to perpetuate the inflation cycle. Borrowing rates and mortgage costs have risen sharply.

Through a combination of weaker base effects and easing supply bottlenecks, Canadian and US CPIs have recorded impressive declines over the past year. From June 2022 peaks of 9.1% and 8.1%, respectively, CPIs had fallen by April to 4.9% and 4.4%. So far so good. And yet still a long way from success. Employment growth remains strong in both countries. Wage cost inflation is far above rates compatible with a permanent return of CPI to 2%. Central bank medicine starts to bear down on growth and inflation only once policy becomes restrictive. Fed Chair Powell thinks we have reached that point. But as we all know, medicine only permanently cures the ill if you complete the prescription. The Fed and BoC will likely keep policy tight until rates of unemployment rise well above current lows. Economic hurt is on the way.

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Central banks are inherently pragmatic. They recognize policy tightening comes in many forms. Recent banking stress in the US will likely lead to a further tightening in lending standards. This will reduce the amount of credit available, particularly to small businesses, to invest in new equipment and to maintain current levels of payroll. Some retrenchment is likely, leading to weaker growth, higher unemployment, and a further fall in inflation.

As the opening quote highlights, Sir John Major has a particular aptitude with words. Jane Fonda is arguably pithier: "No pain, no gain," she famously proclaimed. The US and Canada appear set to experience the pain of economic recession. Through restrictive monetary policies, the Fed and BoC aim to enable each country to realize the long-term economic gain expected to derive from a return to a low-inflation environment.

Investment is a catalyst for the energy transition

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One of the key actions required to make meaningful emissions reductions over the long term is investment into innovative low-carbon technologies across multiple sectors. It's estimated that for Canada to reach net-zero greenhouse gas emissions by 2050, over $100 billion of investment needs to occur each year in areas like building retrofits, grid transformation, and technological breakthroughs. However, current statistics show that Canadian start-ups focused on climate tech have been underfunded relative to their global peers. In 2021, only 5% of Canadian venture capital investment was allocated to these companies, compared to a global average of 14%.

We expect this capital investment gap to close significantly over the short term, as a result of new tax incentives, an increase in dedicated climate funds, and increasing urgency from countries looking to decrease emissions. Recently, the Business Development Bank of Canada announced a new sustainability venture fund focused on financing tech companies looking to create sustainability-enhancing technology systems. A lot of climate funds today focus on the more greenhouse gas-intensive industries such as steel, cement, and electricity. This new sustainable venture fund, however, fills a gap in investment for companies looking to create new efficiencies and drive emissions reductions through technology and software.

While investment from both public and private sources continues to flow into clean technology, the scale of investment needs to materially increase in order for Canada and its global peers to fully transition to a new low-carbon economy.

Investors in CIBC Asset Management's Sustainable Investment Strategies are helping to close the investment gap through the annual Impact Donation. For 2023, CIBC Asset Management will be donating $28,000 to the Energy Transition Centre, a collaboration between the University of Calgary, Innovate Calgary, Avatar Innovations, and the energy industry.

About CIBC Asset Management

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Across a spectrum of investment solutions, we commit to best-in-class research. Dedicated sector and regional analysts focus on industry research and security-specific idea generation. Our investment professionals leverage deep and diverse expertise by sharing proprietary research across asset-class teams. By sharing insight across asset class teams, we maximize opportunities to add value to our client portfolios.

We provide our clients with our research insights and expertise on industry issues and themes that matter most to them.

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