Fake inflation now, but real inflation coming?

[Upbeat music]

[Fake inflation now, but real inflation coming?]

[CIBC logo]

[Avery Shenfeld, Chief Economist, CIBC World Markets]

We're going to see two little waves of inflation. One in the here-and-now that I would consider to be a head fake. So this is showing up a lot in the U.S. data, we expect to see it in Canada as well, where prices look very elevated relative to where they were a year ago for two largely temporary reasons. One is that prices for many things were simply very cheap a year ago when the economy was in the throes of the worst of the initial Covid wave.

[A super highway on the outskirts of an urban area without a single car]

So everything from gasoline to hotel rooms to plane tickets were obviously very cheap in that year-ago period.

[A person filling up their car with gas. An airport runway. An airplane in flight.]

And it makes the yearly change look impressive. But if you compare prices to where they were two years ago at this time, they don't actually look that elevated. There is another thing going on, which is that in trying to restart the engines of the global economy in a hurry, really an unprecedented upswing, we're finding it difficult to get everything moving smoothly. We had production difficulties in everything from computer chips to mining to shipping goods.

[A computer circuit board assembly line. A close-up of a computer chip. A mining truck driving through a mine. A waterside shipping yard.]

And the result is that some of the things we're trying to buy are in short supply and the prices are therefore, not surprisingly, being pushed up. But again, that's a one-time phenomenon. We're expecting that all of these various disruptions and plant closures that took place when Covid was still around will start to disappear as globally Covid cases come down and it'll be easier to get goods to market and therefore relieve some of that price pressure. So this is a bit of fake inflation.

[Upbeat music sting]

[Real inflation threat]

What I do want to warn you about, though, is that very speed of that recovery that we expect to see over the balance of this year and into 2022 is going to start to bring more of a real inflation threat, which is that by 2022 the U.S. economy first and later in the year, the Canadian economy will be approaching full employment again.

[The New York City skyline. The Toronto skyline. A timelapse of a busy urban highway.]

And we could start to get the usual cyclical pressure on prices in which we have a lot of demand, we're running out of workers, wages start to be bid up, and we start to get some core

inflation that looks more persistent so we can start to see some inflation numbers again in the sort of 2.5% range, maybe a bit higher. And that's a sign of real inflation pressure starting to build. The question is, what will the central banks do about that? We're still pretty confident that the Federal Reserve and the Bank of Canada will take that as a warning sign that the economy is, in effect, starting to overheat late next year, will start to raise interest rates the way they have done in past cycles, very gently initially, but continuing into 2023. And essentially, they will moderate the pace of growth to get us back to the sort of 2% inflation world we're looking for. So as a long-term bet, I would still bet on the side of the central banks doing what they've done in recent decades. The thing that they failed to do back in the 70s, which is use the interest rate tool they have to keep inflation under control.

[Upbeat music sting]

[Implications for investors]

Nevertheless, all this does have some implications for investors. In the very near term, there could be a little bit of an inflation scare, which could lift longer-term bond rates, making the bond market a little bit of a risky place. There are certainly equities that have prices that go up with inflation and where you might benefit from expectations of price increases that may not actually happen, but which the market will build in. But I think the longer-term issue that you have to think about is that if we do need interest rate hikes to keep inflation under control, then ultimately we are going to see short-term interest rates moving up, long-term interest rates moving up as that happens. And it will be the time over the next year to start tilting your portfolio in a way that protects you against those interest rate increases. So, again, longer-term bonds might be a bit hazardous because their prices fall as rates rise. Equities that are valued largely as bond market substitutes may not do as well as they have done. And instead, it's really about shifting your portfolio towards the kind of stocks that benefit from the heating up of the economy that we're talking about as the driver of inflation.

[An oceanside resort. An overhead shot of a resort house with a woman swimming lengths in a pool. A woman relaxing in a beach-side hammock. A bartender preparing several icy drinks.]

And that is the kind of companies whose sales will respond as consumer spending, particularly on services, starts to revive as Covid fades away. So I don't think we're going to see, the bottom line is, the kind of longer term inflation problem that we saw in the 1970s, the kind that really did affect economic growth and equity returns. Instead, I think we're going to see as central banks take their tools in hand, keep inflation at bay after a couple of what might look like scary spikes. And as a result, I don't see inflation as the big risk here for the investment market in the next couple of years. Instead, I think the challenges are still to find the companies that are going to benefit from the revival of the economy. And looking a little harder, actually, for those companies where that's not already fully priced in.

[Upbeat music]

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