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MARKET UPDATE – INTEREST RATE VOLATILITY DECEMBER 2021

Interest rate volatility

Central banks play a key role in establishing interest rates and have many tools at their disposal to guide the market. In addition to controlling overnight rates, a credible central bank will also use forward guidance to influence interest rates by shaping the expectations of market participants. Recent changes in forward guidance by the Bank of Canada has been a significant driver of recent interest rate volatility.

In recent communications, the Bank of Canada has moved up its projection of when the output gap will close from the latter part of 2022 to "middle quarters of 2022". While this bodes well for the economic recovery underway in Canada, the bond market reacted by pulling forward its expectation for rate increases. In Canada, market expectations have evolved from 1-2 interest rate hikes to now pricing in 5-6 increases in 2022. As more rate hikes are expected by the market, yields typically rise in the present, causing bond prices to fall, all else equal. This is why many bond funds with higher durations have incurred recent losses.

Similar repricing of interest rate hikes have taken place in the United States, although to a less aggressive extent than in Canada. In our view, market expectations that reflect 5-6 rate hikes in Canada over the next 12 months is very aggressive, especially when fewer hikes are expected south of the border. Given short-term rates have moved up significantly in anticipation of rate hikes in 2022, there is less risk of further rises in short-term rates compared to just a few weeks ago, and thus less reason to move out of fixed income at this point. If anything, the recent increase in rates can offer attractive entry points for fresh capital to be put to work.

Interest rate outlook

Predicting future rates is always a difficult task, especially given the current environment with heightened uncertainties around Central Bank policies and COVID-19. To provide investors with some guidance, we analyze expected Canadian fixed income rates in 3 different economic scenarios:

1. **No Pent-up Demand -** After strong government-induced spending, the consumer runs out of fuel. Disposable income takes a hit as government transfers shrink. Although there is no recession, this scenario is characterized by slower growth relative to our base case.
2. **Base Case -** Positive economic growth remaining above trend, but lower than the market consensus. There is higher inflation in the first half of 2022, which settles towards the long-term trend by late 2022 due to long-term trends in technology, demographics and higher debt loads.
3. **Persistent Inflation -** The supply bottlenecks created by the pandemic are demonstrably hard to fix. Limited supply is met by solid demand as the global economy benefits from the ongoing reopening of businesses. Inflation persists in housing, commodities, goods and eventually spreads to labour costs.

Exhibit 1 – 1 year interest rate forecast

Forecast	Current at December 31, 2021	No pent-up demand 25% probability	Base case 50% probability	Persistent inflation 25% probability
Bank rate	0.25	0.50	1.00	1.25
2 year	0.95	0.55	1.30	1.65
5 year	1.26	0.80	1.60	1.95
10 year	1.42	1.15	1.85	2.10
30 year	1.65	1.55	2.15	2.40
Corporate spread	1.15	1.50	1.15	1.25

Source: CIBC Asset Management Inc., FTSE, as of December 31, 2021.

While 2021 surprised us with the strength and persistence of inflation and the resiliency of the economy that responded sharply to the excessive stimulus measures from central banks and governments, the coming year may surprise to the downside as government support measures wane and as elevated demand for durable goods is satiated. The Federal Reserve and Bank of Canada will likely succumb to pressure from investors to tamp down inflation by raising interest rates a few times this year. Both central banks will also likely take steps to reduce their balance sheets. The drag from reduced liquidity and fiscal stimulus should act to slow GDP and inflationary pressures in both countries. Longer-term bond yields should drift a bit higher as central banks remove the punch bowl. The yield curve has been flattening, perhaps reflecting a view that the Fed could make a policy error by acting too forcefully and too soon.

Conclusion

Investors are often uncertain how to think about currency risk. We simplify what many consider to be a complex topic. There are two distinct decisions. The most important is the strategic decision that addresses the treatment of currency risk inherited from global investments in underlying assets. The second is a tactical decision whether to allocate risk to an active currency strategy with the expectation of adding a diversifying, liquid, and capital efficient source of returns to existing portfolios. Both are impactful decisions. They should be considered independently of one another.

Let’s connect

Should you have any questions about this report or anything else, please do not hesitate to connect:

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652 | 01/2022