LORICA

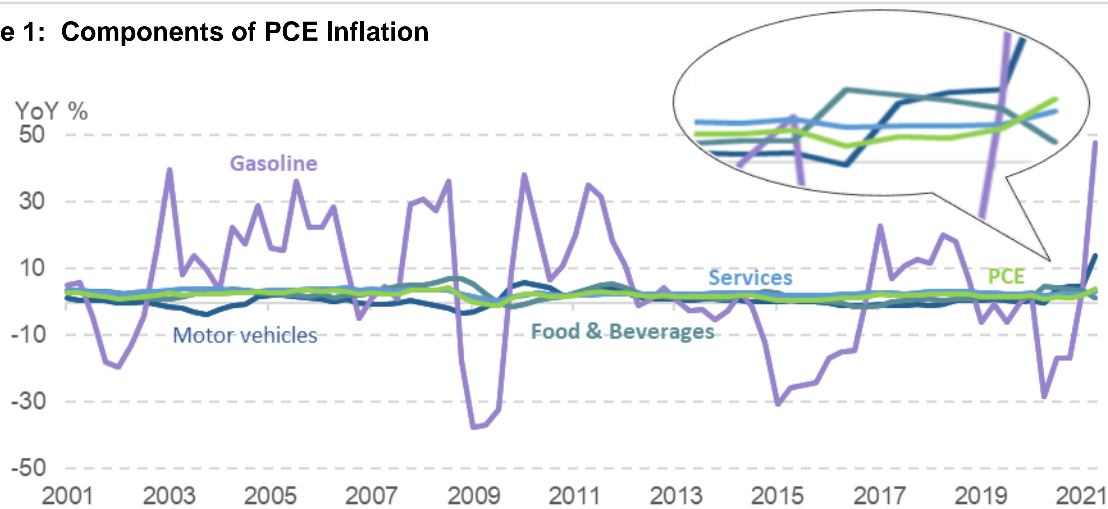
What We Think…

September 2021

INFLATION

Our view on inflation has not changed – we are still firmly in the *transitory* camp – but inflation pressures have continued to mount and exert upward pressure on nominal bond yields through higher "breakeven" inflation rates. Clearly, a significant portion of the bond market believes inflation pressures will not abate soon, and will ultimately drive yields and policy rates higher, so we thought it appropriate to explain why our view on inflation has not changed.

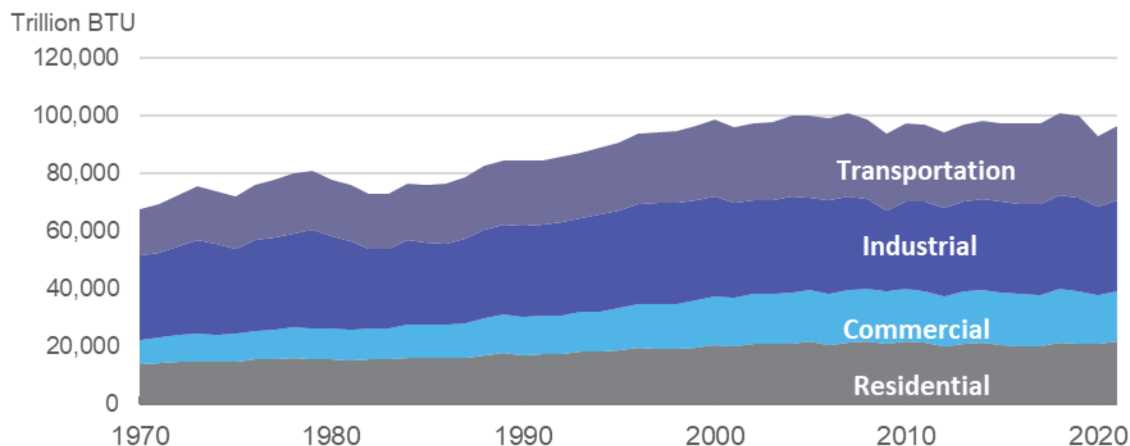
Figure 1: Components of PCE Inflation



Source: U.S. Bureau of Economic Analysis & Cidel Asset Management, September 2021.

Looking at the US economy, the biggest driver of recent household inflation has been largely transportation - related: gasoline and motor vehicle inflation are both running very high. Gasoline and other energy used by households have seen huge price increases, just shy of 50% yoy as at the end of Q2 (See Figure 1), according to the PCE price Index – well beyond anything we have seen since the credit crisis. Granted, household consumption of energy goes beyond transportation (only roughly 1/3 of household energy consumption), but that is still significant.

Figure 2: Energy Consumption by Sector

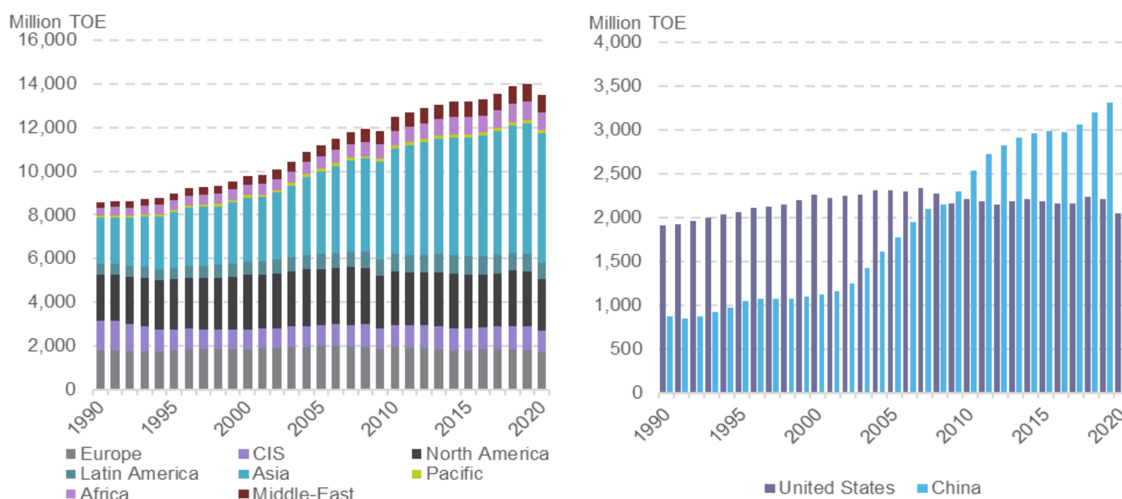


Source: U.S. Bureau of Economic Analysis & Cidel Asset Management, September 2021.

After energy, the next biggest household price increases have been for motor vehicles and parts which have risen 13.5% yoy as the end of Q2. But it is difficult to believe that these price increases will be anything other than transitory, caused by uneven "pandemic" demand, and supply chain disruptions. More importantly, transportation (energy and autos) accounts for only 5.6% of household spending, pressuring consumption on the margin, but unlikely to represent broader inflation.

Looking at US energy consumption by sectors (Figure 2), it is difficult to see a pattern of growing energy demand in the US. Of course, US demand is only part of the global energy demand story. While US energy consumption has levelled off since the beginning of the 2000's, global consumption has continued to grow. Notably, China's overall energy consumption surpassed that of the US back in 2009 and its consumption growth has outpaced the US ever since – China now consumes 65% more energy than the US (see Figure 3). Overall, Asia's energy consumption has driven global energy demand, and this trend is likely to continue. Despite growing overall demand, energy prices were well contained prior to the pandemic, with global supply easily meeting steady demand growth. We still think it difficult to envision a scenario where global demand will outstrip the substantial excess capacity that now sits on the sidelines, and which we believe will eventually make its way to market, leading to lower prices.

Figure 3: World Energy Consumption

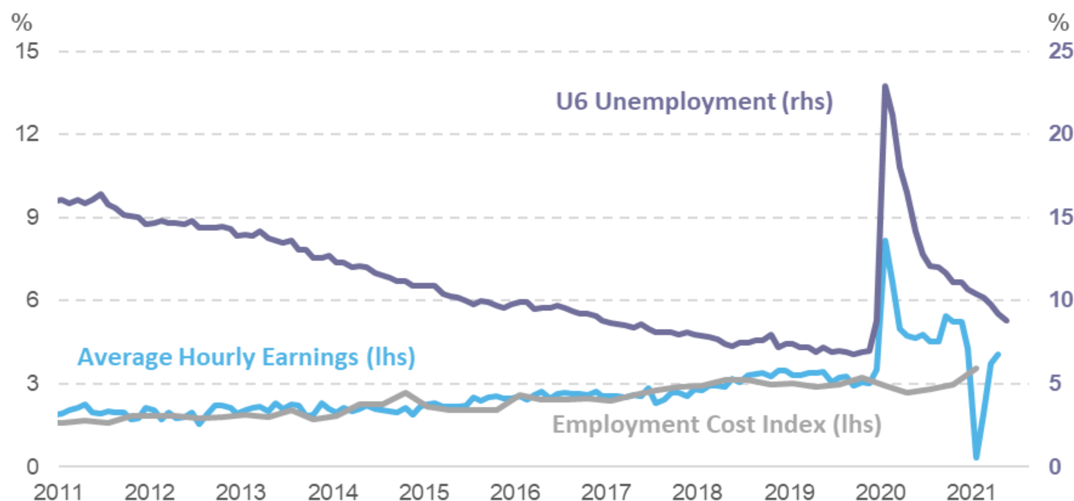


Source: Enerdata & Cidel Asset Management, September 2021

There is a reason that most central banks follow narrow measures of inflation – the Federal Reserve prefers the core PCE, the Bank of Canada a combination of CPI-trim, CPI-median, CPI-common. Food and energy prices are too volatile to be included in good indicators of trend inflation, and historically, high energy prices have not necessarily precipitated higher core prices (see Figure 1). Additionally, while core consumption inflation measures will give a good indication of current trend inflation, we prefer wage measure trends as better indicators of future inflation. Consumption measures describe the inflation being experienced in the economy, but don't necessarily give a good indication of how that experience will translate into a sustainable trend. Rather, consumption inflation, on its own, leaves the possibility that higher prices will translate to slower growth and ultimately lower prices.

Services are responsible for roughly two-thirds of the PCE index. Unlike goods inflation, service inflation has been relatively well contained through most of the pandemic, edging higher this year, but not far off measures seen pre-pandemic (see Figure 1). Those forecasting higher inflation expect that further economic recovery and the current difficulty finding workers will result in persistent service inflation.

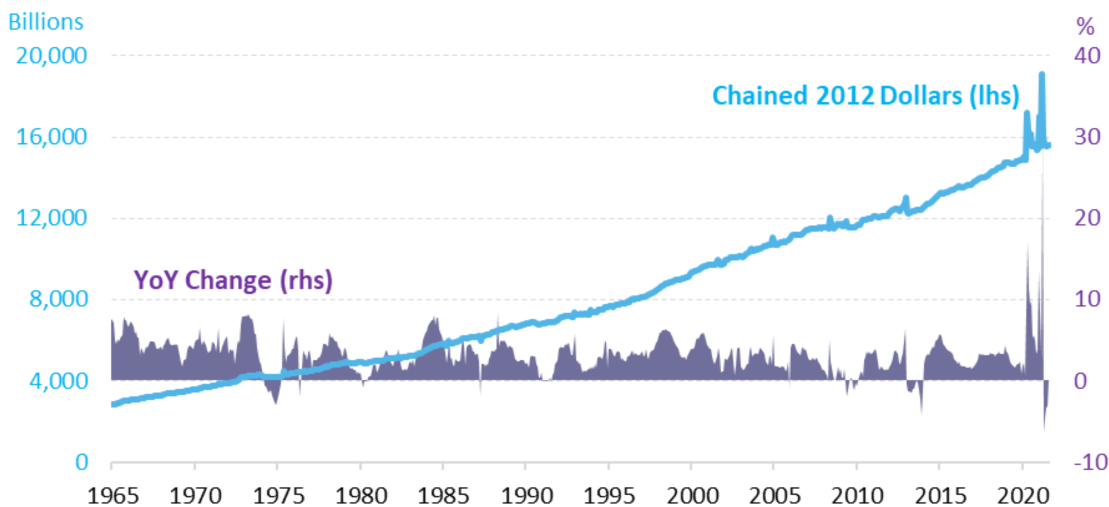
Figure 4: Wages & Unemployment



Source: Federal Reserve Bank of St. Louis & Cidel Asset Management, September 2021

While we would like to say that all is well on the wage front, the picture is very unclear. In the US, both the Employment Cost Index (ECI) and Average Hourly Earnings show significant increases for the most recent periods (See Figure 4). Pre-pandemic both wage measures had shown steady increases in the period between the credit crisis right and the beginning of the pandemic, as unemployment declined. Since the pandemic began, average hourly earnings have been particularly unstable, moving with unemployment (in contrast to what has generally been an inverse relationship) as the extreme number of layoffs have had an inverse effect on average wages. In contrast, the ECI which measures the cost of labour, independent of employment shifts, has shown a gradual increase. However, personal income growth, while volatile, does not exhibit the kind of pressures seen in the seventies (see Figure 5). Although there has been wage growth, jobs lost to the pandemic (through unemployment and lower participation rates) have not recovered, thereby limiting personal income growth and the transmission of inflationary pressures. It will take some time before overall employment returns to pre-pandemic levels (as we saw following the credit crisis), but we expect pandemic-induced dislocations will dissipate eventually stabilising wages.

Figure 5: US Real Disposable Personal Income



Source: Federal Reserve Bank of St. Louis & Cidel Asset Management, September 2021

YIELDS

Much has been made about the Fed's tapering move that many expect will be announced before the end of the year. Recently, Powell suggested tapering asset purchases could end around the middle of next year, but the Fed has also been careful to give itself lots of latitude on the start date, recognising that the pandemic could easily derail any plans based on the recovery. We would place the odds of an announcement this year at 50/50, decidedly non-committal. Many think that an interest rate increase by the Fed will soon follow – US Overnight Indexed Swaps (OIS) are now pricing in one increase next year. We are less convinced that rate move will happen next year, which leaves room for the front-end of the yield curve to decline slightly as the end of the Fed's zero interest rate policy gets pushed just a bit further into the future.

Investors are expecting the Bank of Canada to be more aggressive than the Fed, given Canada's relative outperformance on the employment front. Canadian OIS are now pricing two hikes in 2022. We doubt that the Bank will outpace the Fed, which leaves more room for the front-end of the Canadian yield curve to decline over next twelve months. For what it is worth, both central banks have been relatively silent on rate increases, with the Fed, however, publishing a consensus forecast through its quarterly dot plots indicating a half-hike in 2022 and three hikes in 2023. Consequently, the very short ends of the Canadian and US yield curves are flat, with relatively steep increases up to five years in Canada and seven years in the US.

Investors expect to see higher economic growth rates in the US, which will precipitate higher real yields. US real forward rates imply that short-term real yields will rise by nearly a percent over the next year. However, US nominal forward rates imply that short-term nominal yields will increase by only 50 basis points over the same period. Further out in time, forward rates imply that both real and nominal yields will continue to rise, albeit at a modest pace, with short-term real and nominal yields both rising by another 50 bps over the following year. This suggests that investors expect inflation expectations to moderate, but to be more than offset by rising real yields. Nominal yields will be higher. Further out the yield curve, forward rates suggest smaller increases over the next couple of years, keeping the mid and long-term parts of the yield curve relatively flat.

We expect economic data to remain volatile while the pandemic continues to infect the economy leading investors to act cautiously. We believe market pricing offers some opportunity for tactical positioning but expect yield curve moves to be relatively modest. It may take more time than investors think for inflation expectations to dissipate, thus placing some near-term upside risks to breakeven inflation rates and nominal yields. On the other hand, there is a risk that growth disappoints, leaving room for real yields to decline, despite already being at very low levels. Ultimately, we see near-term risk of higher nominal yields, with the potential for reversal further out.

Consistent with the potential for higher inflation expectations and recognising that investors are not being particularly well-rewarded for investing further out the yield curve, the portfolios are positioned with slightly shorter-than-market duration, with a slight bias for yield curve steepening. Should yields rise, either through higher inflation expectations or growth surprises, we will look to take advantage of tactical opportunities.

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