We have lift-off… almost

January 2022

The Bank of Canada and the Federal Reserve made their first policy statements of 2022 yesterday, and both appear to be using the same playbook. Both banks affirmed their commitments to slow inflation by raising rates - just not yet – and reduce their balance sheets (as a separate process) afterwards. Both banks also indicated that inflation is being driven by supply chain bottlenecks, fiscal policies, and tight labour markets, but that the first two factors would likely dissipate later in the year. Yesterday's market reaction to the Bank of Canada was reasonably sanguine, noting that the Government of Canada OIS curve is already pricing in about six hikes this year, while the reaction to the Fed was to price in another half hike, such that Fed Futures are now pricing in five hikes this year. Today, long-term yields have fallen, and yield curves have flattened.

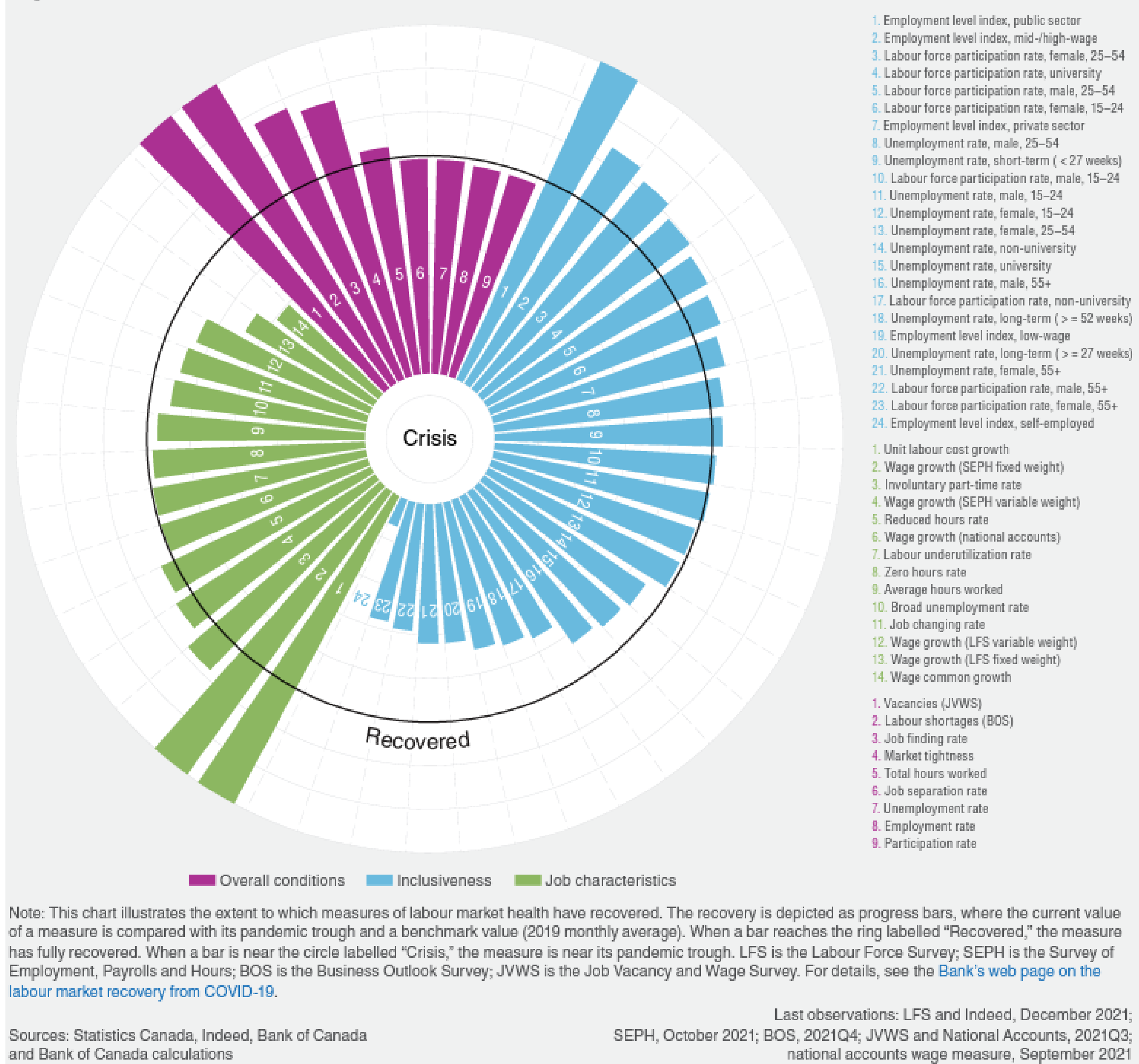
So, what is the actual playbook? We think that both central banks are firmly committed to the view that inflation will subside later this year as supply chain bottlenecks sort themselves out (a possibility) and fiscal support is reduced. We had been very supportive of this view until wages had become an issue. As the first wave of the pandemic passed, and the economy rebounded, US average hourly earnings had risen – this is a volatile series that doesn't necessarily capture wage trends. However, a more reliable indicator – the employment cost index, later rose (the latest reading was 3.7% yoy as at Q3), which is indicative of embedded wage pressures. Powell, during his post-announcement presser today, went to pains to stress how the job market was so strong that it would not be particularly sensitive to interest rate increases. Won't that same strength mean that wage pressures won't be that sensitive to interest rate increases? We feel that this is a bit of an inconsistency that suggests to us that central banks will be hoping (praying) that supply chain corrections and reduced fiscal support (ignoring the risk of healthy household balance sheets) skate inflation on side, while they raise rates slowly enough to allow for this scenario to unfold.

The risks… Labour markets are tight: in Canada unemployment and participation are at pre-pandemic levels, while in the US, unemployment is almost at its pre-pandemic level and there is speculation that the participation rate will not rise quickly to pre-pandemic levels (due to demand/skill mismatch, early retirement, long-COVID, etc.). It is very possible that, with continued opening-up of the economy, limited rate hikes will be unable alleviate wage pressures, irrespective of what happens with supply side factors outside of labour. In this event, what will the Fed and the Bank of Canada do? We think the banks will have no choice but to continue to raise interest rates to quash inflation pressures, potentially landing economies into a recession. Notably, the Bank of Canada revised their global growth forecasts to 3.6% (from 4.3% in October) suggesting that more aggressive monetary policy does not have loads of room for error.

It is worth noting that recent tightening cycles will be less informative of the current tightening cycle. This cycle is less about normalising rates (to some neutral policy rate) – the mantra under Yellen/Powell and Poloz, but more about preventing inflation from embedding itself and upending the economy. While capital markets will always be a consideration for central bankers, equity markets as the "engine of growth" does not bear the same weight as in recent cycles. We would not put much faith in the "Fed Put" if risk assets sell-off in the face of higher rates and still-high inflation.

For the time being, yield curves indicate that investors are confident that the banks will follow through with their commitments to fight inflation, without causing a recession. Front-ends have risen, pricing in rate hikes, while back-ends have been generally under control. Although long-term nominal yields rose during the first half of January, the corresponding rise in real yields was far more significant, implying expectations of reduced inflation and higher growth. While this is a plausible scenario, we think the real yield increase reflects the expected rise in policy rates, not necessarily robust growth expectations. (The gap between nominal and real yields is the inflation break-even and is often thought of as measure of longer-term inflation expectations, but the markets do not trade with the same liquidity and hence are not always a good indicator of market sentiment). Today's yield curve flattening may be early signs that investors are nervous that tightening will be overdone. We feel the risk of higher short-term yields has increased, but that the risk for long-term yields is roughly balanced (inflation versus monetary policy); further out, we think the risks for long-term yields are skewed downwards. Ultimately, we expect bond market returns, over the next year, will be driven by a blend of higher short-term yields and stable to lower long-term yields – an opportunity to take advantage of a change in the level and shape of the yield curve. Investment grade yield spreads should generally fair ok, but credits that are vulnerable to higher rates, will be another source of risk and opportunity.

Below is an interesting chart from yesterday's Bank of Canada's Monetary Policy Report:



Gary Morris, BASc, MBA, CFA
Head of Fixed Income

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