Fidelity INVESTMENTS

Rate hikes and their consequences

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Key Takeaways

- Central banks have gotten themselves behind the curve
- Bonds likely to remain under pressure, but equities still may have some room
- Canadian assets may outperform in the short-term but face significant medium-term challenges

The COVID-19 pandemic dealt an unprecedented blow to the global economy and financial markets. The double-barreled response of massive fiscal support and a dramatic easing of monetary policy was equally unprecedented and helped avoid the worst-case outcome of a prolonged global depression. But as we navigate the aftermath of this shock-and-awe response, the sharp rise in inflation to levels not seen in a generation has made clear that the economic framework used to guide the actions of central banks was ill-suited to the task at hand. By not recognizing the extent to which supply was constrained by the pandemic, central banks are set to rapidly raise interest rates to bring inflation under control. This significant tightening in monetary policy will have a profound impact on the performance of financial markets and is reflected in the positioning of the multi-asset class funds we manage for Canadian investors.

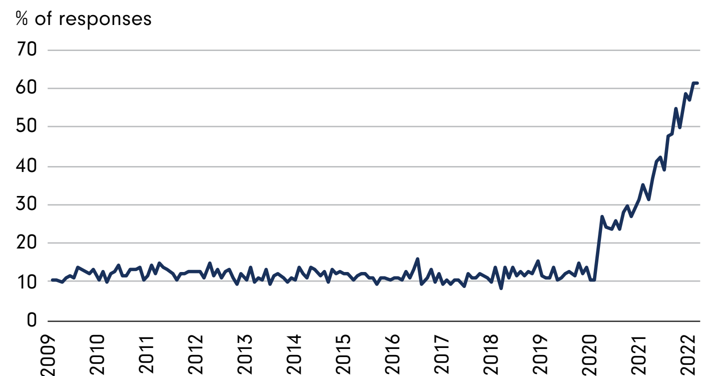
How did we get here?

Central bank thinking, and the models they use to represent the economy and guide policy, have evolved through recent cycles to view inflation as a function of the difference between actual and potential GDP. Defined as the "output gap", the economic slack created when actual GDP is lower than potential GDP should put downward pressure on inflation and require looser monetary policy as an offset. Similarly, when actual GDP is higher than potential GDP, a positive output gap should lead to inflation and require tighter monetary policy to bring inflation down.

But the problem is that the model assumes actual GDP reflects demand because supply is assumed to be flexible. That is often true. But it's not now. Supply is constrained, in a way we haven't seen for many years (see Exhibit 1).

EXHIBIT 1: Supply is the constraint

Percent of Canadian independent businesses reporting product shortages or distribution constraints.



Source: Canadian Federation of Independent Business.

And it's broader than just the well-known 'supply chain bottlenecks', although those have clearly contributed – if you've only got parts for three cars, you're only making three cars, no matter how many cars people want to buy. It's also the pandemic-related restrictions – if restaurants are ordered closed, the supply of nice meals out is zero, no matter how many people want one. It's also the scarcity of workers – if you only have five applicants for ten job openings, you're only hiring five people, at least until you figure out that you might be able to lure more in if you pay them more. And it's the scarcity of raw materials – usually the higher commodity prices we've seen would spur an expansion of supply, but new projects in extractive industries are coming under increased scrutiny amid environmental and other concerns.

Another way of saying this is that central banks (and most market economists) are conditioned to seeing everything as a demand shock. Monetary policy is a demand-side tool. It is ineffective against supply-side shocks, and if it tries to offset their growth-dampening consequences, the result is inflation. That was the essential lesson of the 1970s and one that is having to be learned again. If all you have is a hammer, everything looks like a nail; this was a screw.

Fixing the mistake

Markets are beginning to figure this out. For months, market discounting was generally consistent with the central banks' story – with slack ostensibly remaining in the economy, inflation would come down fairly quickly (even if it wasn't purely "transitory"), permitting the normalization of monetary policy to be gradual. That view has now changed. Market expectations of the US Fed funds rate by the end of next year, for example, have risen from 2% to 3% in just the last month, with strings of 50 bps hikes now making their way into forecasts (see Exhibit 2). This is appropriate, in our view. Central banks have mistaken supply and demand and now must fix it.

Below we discuss the consequences of this for our active asset allocation strategy across the major asset classes.

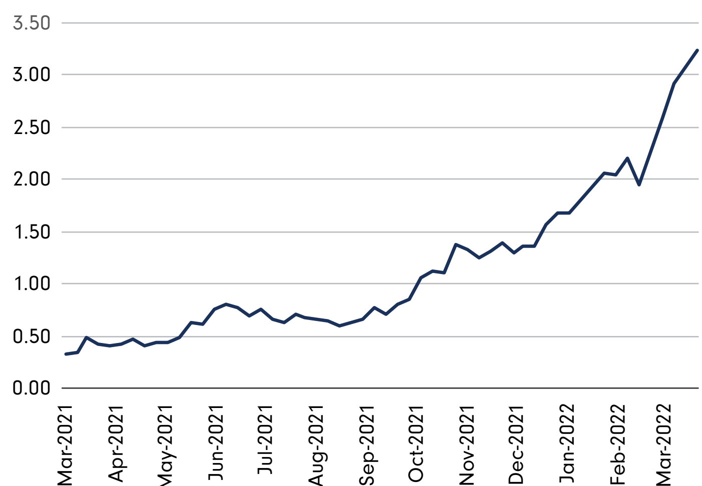
Implications for equities

We are maintaining a small overweight to equities, though we expect to be scaling back the risk profile in our funds as the cycle progresses. Equity markets have thus far shown impressive resilience to rapidly rising expectations of monetary tightening. In our judgment, that resilience in equities owes in part to the view that the Fed's taming of inflation will be 'easy' – yes interest rates will go up by more than previously expected, but they won't need to stay there very long. This is consistent with the fact that near-term market inflation expectations have skyrocketed but long-term inflation expectations have barely budged (see Exhibit 3).

In the short-term, that taming of inflation will indeed probably look 'easy' – measured CPI inflation is likely to fall as the spikes of last spring are dropped from the calculation, and growth is likely to ease but not too much, as the dampening effects of higher consumer prices and

EXHIBIT 2: Sharp increase in Fed rate hike expectations

December 2023 Fed Funds Futures



Source: Bloomberg.

the initial increases in interest rates are cushioned by strong consumer fundamentals and some loosening of supply constraints. Now many have pointed to the recent inversion of the 2-year/10-year yield curve as evidence that growth will fall by much more, ushering in recession. We disagree. Historically, the yield curve has often inverted two or more full years before the onset of recession. The current slope of the 3-month/10-year yield curve, which has generally been a better forewarning of recession in reflecting the relative stance of monetary policy, remain quite steep. And there is some question regarding the information content of longer-term yields, with central banks having bought so much of the market through QE. In short, we do not think the bond market is signaling an imminent recession and do not believe one is coming either. This is all consistent with history, where it's not the first rate hikes equity investors should be concerned about, it's the last hikes.

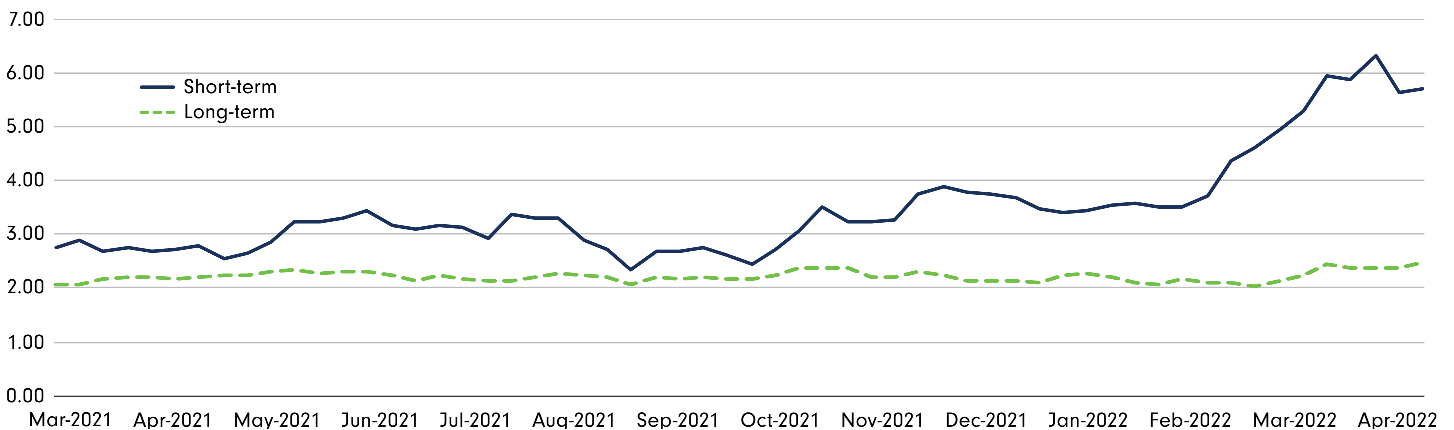
Over time, however, markets are likely to come to understand that the process of taming inflation will probably not be that easy. Supply chain bottlenecks will eventually loosen but the longer-term supply headwinds such as deglobalization and labour scarcity will not. Aggregate demand currently is far above supply, as demonstrated by the broad-based increases in prices. In this context, the moderate taming of demand currently expected probably won't be sufficient to bring inflation fully back to the central banks' target. Ultimately, a recession will likely be required. As above, we don't see that downturn on the visible horizon, but believe it is an eventuality. This will clearly be a challenge to equity markets, one which we will address in the evolution of our risk stance as it takes shape.

Implications for bonds

We remain underweight bonds. Not surprisingly, fixed income markets have been battered by rapidly rising interest rate expectations; the Canadian and US bond markets both lost about 7%* of their value in the first quarter, by far worse than anything seen over the past 20 years. We have long been significantly underweight nominal government and investment-grade bonds, diversifying the defensive parts of our portfolios into assets more resilient to inflation like gold and inflation-linked bonds, which have provided some

EXHIBIT 3: Anchor still holding, for now

U.S. short term inflation expectations measured by the one-year breakeven inflation rate. U.S. long term inflation expectations measured by the five-year breakeven inflation rate.



Source: Bloomberg.

* Source: Bloomberg.

cushion through the fixed income sell-off. We are maintaining this positioning; while some value has been restored in the bond market, as above, we believe that the adjustment to higher inflation and higher interest rates has been significant but incomplete.

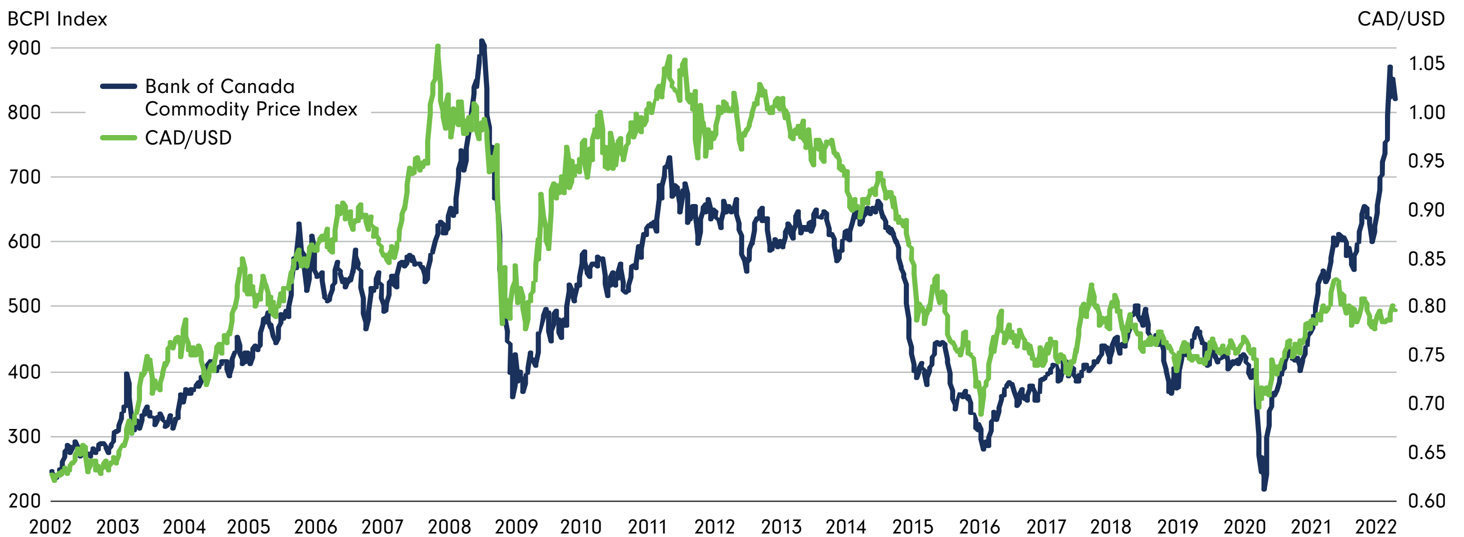
Implications for the Canadian dollar

We have reduced our exposure to foreign currencies for the time being but will be looking for opportunities to rebuild them as we eventually move into what could be a challenging period for the Canadian dollar.

In the near-term, conditions for the Canadian dollar look favourable. Commodity prices have risen, which improves Canada's terms of trade as a large commodity producer and exporter; that relationship implies that the Canadian dollar still has room to appreciate (see Exhibit 4). The boost from commodity prices to Canada's economy also implies more upward pressure on Canadian inflation and more Bank of Canada tightening to address it, thus tending to widen the Canada-US interest rate differential in the Canadian dollar's favour. As a result, our position in the Canadian dollar is the highest it's been since the currency hit its trough around 68 cents in early 2016.

The longer-term prospects for the currency could be quite different, however. As we have long discussed, economic growth in the Canadian economy has been largely driven by the debt-fueled increase in housing market activity for more than a decade. The corresponding increase in household debt prior to and throughout the pandemic has heightened the vulnerability of the household sector and the wider economy. And while an accommodative backdrop for interest rates has long delayed the day of reckoning for the housing market, the increase already observed in interest rates and the expected policy tightening from the Bank of Canada represents a clear catalyst for a correction. For instance, a proxy for the refinancing cost of most fixed-rate mortgages – the five-year change in five year interest rates – showed the largest monthly increase in March since 1994 (see Exhibit 5). A materially weaker Canadian dollar can be expected to accompany the prolonged and necessary period of household balance sheet repair and sluggish economic growth.

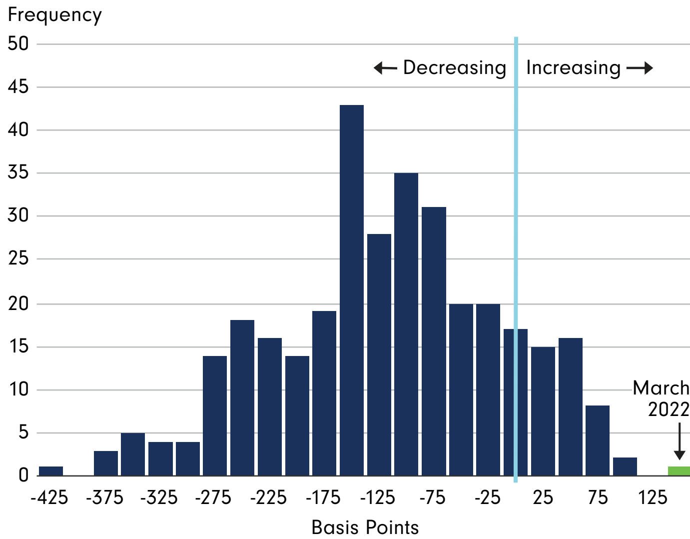
EXHIBIT 4: Commodity prices suggest a stronger Canadian dollar



Source: Bloomberg.

EXHIBIT 5: Sharpest rise in Canadian interest rates in a generation

Distribution of five-year changes in five-year Government of Canada bond yields (1994–2022)



Source: Bloomberg, FMR Canada.

To sum up, monetary policy is as always, a critical element of the market outlook. We expect that the policy mistake that has been made by central banks, and the response to it, will importantly shape the broad contours of both market performance and our investment strategy in coming years. That strategy will evolve, as always, with the goal of maximizing return while managing risk in the Canadian multi-asset class funds we manage for Canadian investors.

David Wolf, David Tulk and Ilan Kolet, April 4, 2022

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