A Little Inflation Can Be a Good Thing

Equity Markets

After a lengthy interval of strength, equity markets produced more subdued results to start off 2018, as investors began to fret about the pace of inflation and future interest rate hikes. Canadian stocks lagged most developed markets, with the TSX Composite index falling 4.5% to begin the year. In US dollar terms, the S&P 500 index fell 0.8% while the MSCI EAFE index dropped 1.5%. The weakening Canadian dollar added to returns of foreign markets with the S&P 500 and MSCI EAFE indices returning 2.3% and 1.5%, respectively.

Unusually, sectors thought of as 'defensive', such as Telecommunication Services, Utilities, Consumer Staples and Health Care, were actually the weakest over the quarter, as rising interest rates diminished the attraction of the healthy dividends offered in these industries. In contrast, the more cyclical sectors of Consumer Discretionary and Financials performed in above-average fashion, although still struggled to post positive returns in most markets. Investor attraction for cyclical Information Technology and Consumer Discretionary stocks spread across all markets this quarter, with high profile companies such as Amazon.com and Netflix notably detached from weakness elsewhere.

Fixed Income Markets

North American fixed income returns were flat in the first quarter of 2018. Both Canada and the United States saw rising inflation pressures and accordingly both the Federal Reserve (Fed) and the Bank of Canada increased their overnight lending rates.

The Canadian fixed income market continued to see a flattening of the yield curve. Short term government borrowing rates rose more than rates on longer-dated maturity bonds (and long bond yields actually fell in the quarter) as the market priced an increase probability of rate hikes against a firming in inflation. Two-year Canada debt was offered at 1.78%, a change of 9 points, with 5 year and 10 year bonds offered at 1.97% and 2.09%, moving out 10 and 4 points, respectively. The long bond moved lower in yield from 2.05% to 2.09% which caused the curve to flatten significantly. Spurring the move was an inflation print of over 2 percent, considered the neutral point in the Bank of Canada band.

U.S. Treasury bonds offered higher yields at the close of the quarter, with 2/5/10 year debt all offered at 2.27%, 2.56% and 2.74%, an increase of 45, 36 and 33 points, respectively. The U.S. Federal Reserve bank continued their course of taking their overnight policy rate higher, with many in the analyst community expecting several more hikes in the coming year.

As rates 'normalize' from their post Financial Crisis lows, a benefit of these new and higher rates is the robust improvement of balance sheets. Companies with access to the Bank of Canada or Fed borrowing window will pass on loans with higher margins. Pension actuarial assumptions also improve as bond yields rise, permitting firms with large defined benefit plans the opportunity to shore up deficits and redeploy capital. An unintended consequence of central bank action is to make corporate borrowing more rewarding and also somewhat less risky.

Commentary

It is said that noticing inflation is like noticing the brown spots on bananas: by the time you see the change it is already too late. Inflation is an insidious force, reducing future purchasing power and the value of savings, and it is finally – and thankfully – taking root. Having now moved on from worries about deflation just a year ago – potentially a much bigger problem for investors – the resumption of price increases across the economy has introduced some headlines predicting new cost pressures. The concern is valid: rapid inflation, if it materializes, serves to reduce the purchasing power of future income and consequently reduces the value of stock prices generally. As investors should we fear all inflation? The selling panic of January and February served to confound, the willingness to sell stocks in a market down eight percent to avoid an inflation print of two percent makes for bad math and worse investing. Too much inflation is a bad thing, but a little bit can be the perfect amount.

In a speech given on March 23rd of 2018, Carolyn Wilkins, Senior Deputy Governor of the Bank of Canada said: "Monetary stability – low, stable and predictable inflation – is at the heart of a solid macroeconomy and financial stability." Rising inflation suggests an economy that has more demand than supply, one where producers pay slightly more for raw materials, and provides some pricing power for sellers of goods, services, and finished products. Consumers and producers alike know that their purchasing power will decrease by the value of inflation each year, which encourages the making and buying of goods today. The impact of this excess demand in an economy is to push prices higher meaning margins and profits increase, all else being the same. This greater profitability for corporations should result in wage gains for workers – who then in turn look to pay down debts or spend their money, all of which are net benefits for the economy. Inflation encourages spending today, creating a tailwind for economic growth. There is always the risk when spurring inflation that you can move the needle too far.

Once the genie is out of the bottle it can be hard to put it back – the late 1970's and early 1980's offer many lessons for central bankers on the benefits of containing and controlling inflation as quickly as is possible rather than being forced to move more aggressively and slowing economic growth more sharply in response.

This is why every major central bank in the world uses an inflation target to help determine their overnight policy rates. The Federal Reserve has an expressly stated target of 2%, the European Central bank aims for under but close to 2%, and the Bank of Canada has chosen their band with 2% as the mid-range. Monetary policymakers seek out controlled inflation, and with economies being as tightly linked as they are today it makes sense that a reasonably common base case would have evolved over time. Inflation is likely to be contained in and around two percent a year, if the central banks have their say, and history suggests that is a 'sweet spot' for inflation, with this rate having historically coincided with positive economic growth and stock market returns.

Range in CPI	Avg. Annual Gain in S&P 500	Avg. S&P 500 P/E Valuation
Below 1%	16.3%	24.8x
1% to 4%	9.3%	19.1x
4% to 9%	1.2%	13.6x
Above 9%	0.7%	8.8x

Ned Davis, February 2017, data from 31 March 1947 to 31 December 2016

Inflation normalization should in turn lead to rate normalization. Interest rates trended downwards for the better part of four decades, stopping at one-half of a percent in Canada, zero in the United States, and, remarkably, below zero in many European nations. As economies have grown back into capacity following the various crises of 2007-2010 rates have begun to normalize. Higher rates offered on term deposits, savings, and fixed income investments make savers feel wealthier even as they moderate economic growth. Normalization of bank rates was always going to happen alongside a bump in inflation, and we appear to be moving along those mutual paths in an orderly way.

Perhaps lost in sentiment, the ugliness of the word inflation, is that the base case for central banks feeling the need to take action is starkly positive. Central banks have shown a willingness to be creative when markets and economies needed juicing, but they have only two tools in their toolbox to tap the brakes when it comes to slowing things down - talking about raising rates and raising rates. If rates are moving higher, then the economy is expanding; if rates move higher more slowly then the economy is expanding at a reasonable pace. The long-awaited normalization has begun. Inflation is finally here, investors should cheer, rather than fear, the prospect.