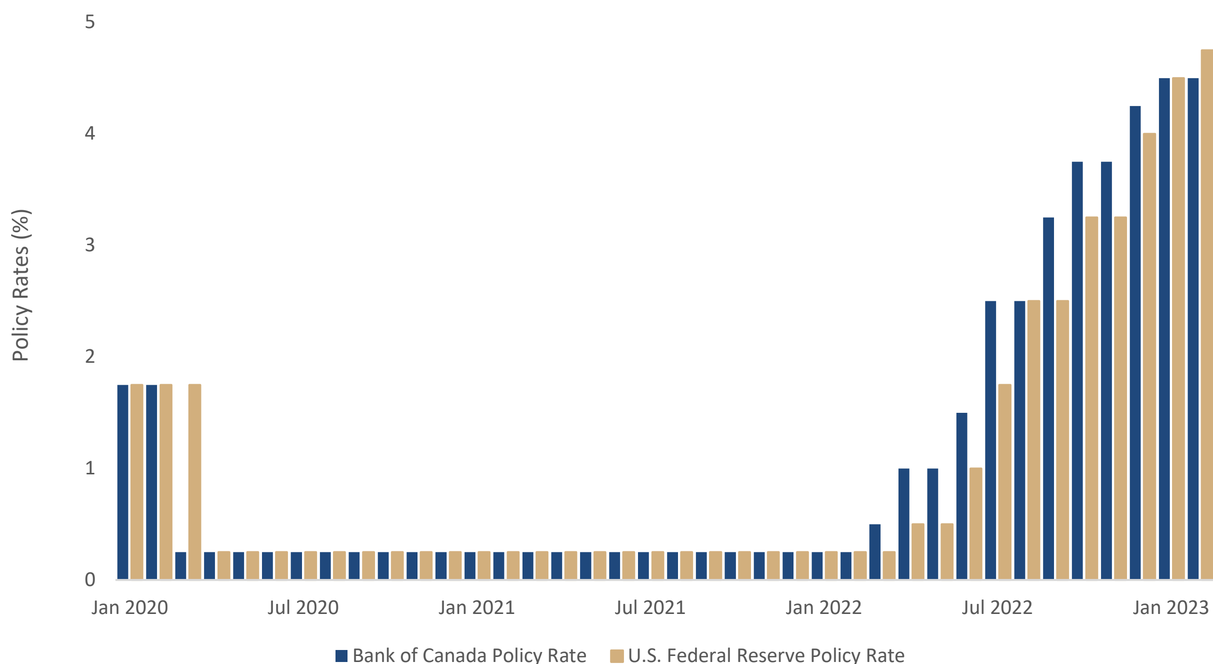
Central Banks are Leading the Charge Against Inflation - But Nobody's Following

Inflation has been on an upswing for two years. Central banks are raising interest rates to reduce inflation while governments seem to be doing the opposite. Some major economies might avoid a recession, but that may not be a good thing. In this paper, we explain some of the forces impacting the fight against inflation.

The Fed and Other Central Banks are Fighting Inflation

The pandemic has been unique in many ways. For many participants in, and observers of, financial markets, one of the more impactful developments has been higher inflation. It was nearly two years ago that inflation measurements started to jump to levels not seen in many years. Many observers were quick to deem the new pickup in inflation as "transitory" rather than something to be overly concerned about.

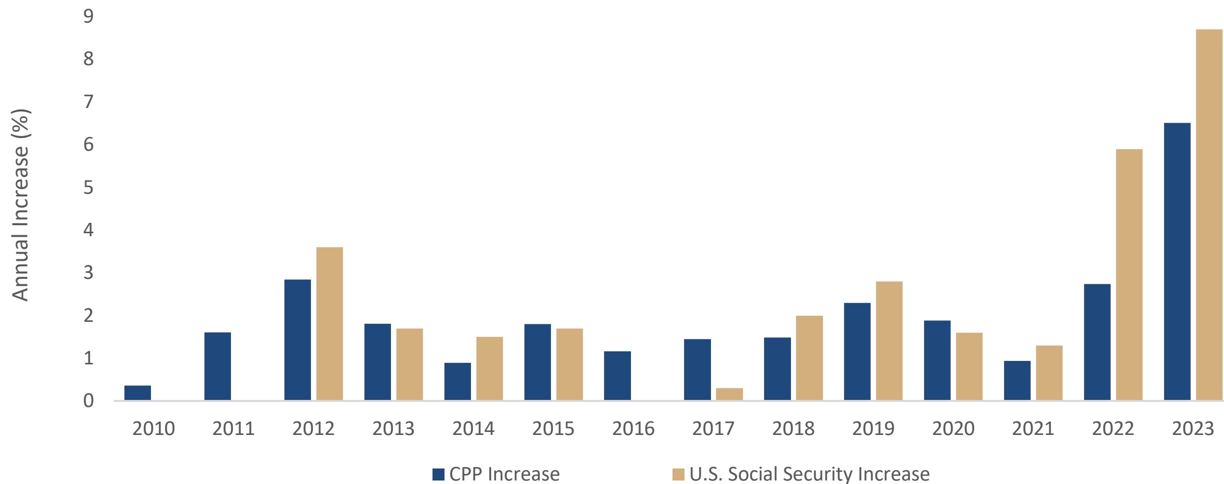
Unfortunately, this prediction has proven incorrect. Instead, we have witnessed a broadening of the factors contributing to inflation, which we expect will be much harder to contain. Although the U.S. Federal Reserve (the Fed) and other central banks have scrambled to catch up and tame inflation through aggressive monetary policy tightening, their actions have been met with increasing fiscal stimulus by governments, expansionary spending by businesses (particularly wage increases), and a general easing in financial conditions. Despite the stubborn persistence of high inflation, the odds of a recession are now quite low in the near term, which will likely make the fight against inflation even more challenging as we progress through 2023. The avoidance of a recession could mean inflation stays above central bank targets in the coming years.



Source: Bank of Canada, US Federal Reserve

High inflation is a problem, and even though the Fed and other global central banks (including the Bank of Canada) are fighting inflation with aggressive changes in monetary policies, other government entities continue loosening fiscal policy through higher voluntary spending and through programs with automatic inflation indexation. Here are a couple of examples:

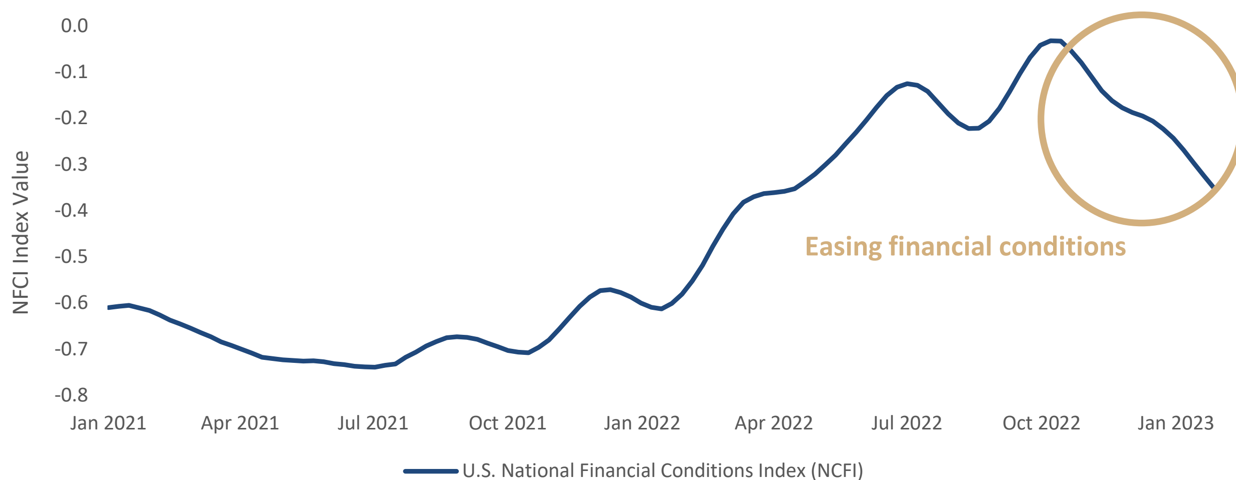
- **Voluntary spending/easing:** Inflation Reduction Act (U.S.), proposed tax cuts (U.K.), Alberta's Affordability Action Plan (Canada).
- **Programs with automatic inflation indexation:** Social Security payments increased by 8.7% in December 2022 (U.S.), Canada Pension Plan payments increased by 6.5% in January 2023 (Canada), and many other public and private sector defined benefit pension plan payments increased as a result of indexation.



Source: Government of Canada, U.S. Social Security Administration

Financial Markets Have Left the Fight

It is not only government actions that are moving in opposition to the desires of central banks. Financial conditions that had tightened considerably last year have retraced about half of that move since last October, according to the Federal Reserve Bank of Chicago's National Financial Conditions Index (NFCI). Stock markets are stronger, interest rates across the yield curve are lower, mortgage rates are lower, and credit spreads have tightened - all contributing to easier conditions that central banks have been working so hard to tighten.

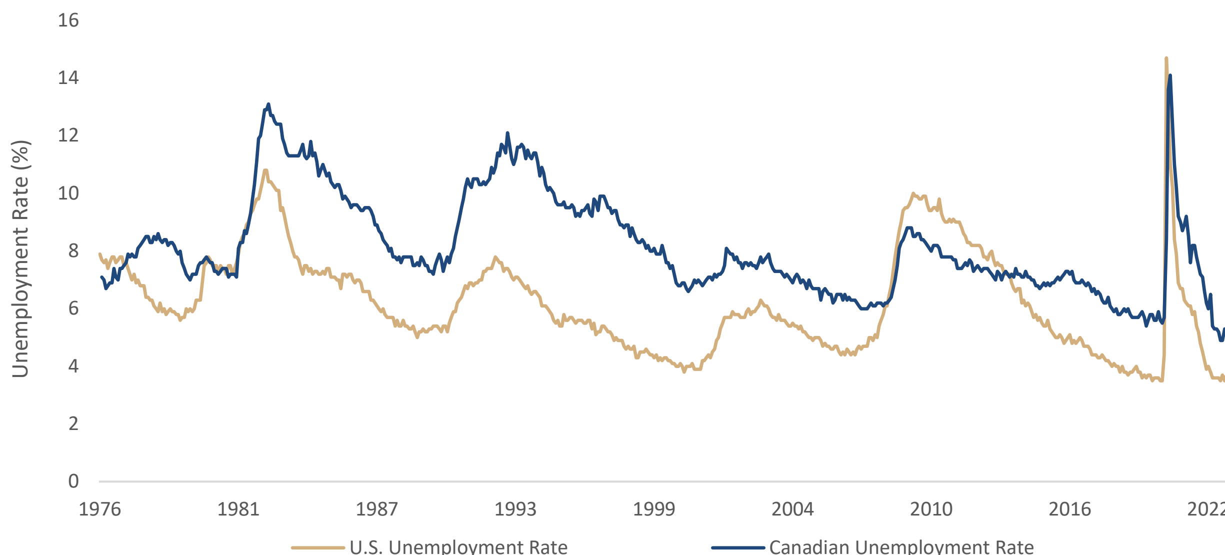


Source: Federal Reserve Bank of Chicago

Labour Markets are as Tight as Ever

With labour markets remaining historically tight, unemployment rates are extremely low in many countries. We continue to believe that the remaining slack in the labour markets in Canada and the U.S. is structural (skill mismatch, geographic challenges, etc.), meaning that wage gains become more likely for a greater number of employees.

- Job openings far outnumber the number of workers looking for jobs.
- The participation rate has rebounded to pre-COVID levels but has not relieved the labour shortage as the U.S. unemployment rate, at 3.4%, is at a multi-decade low.



Source: Statistics Canada, U.S. Bureau of Labour Statistics

As the labour market has been strengthening, there has been a shift within North American economies pertaining to goods and services consumption. Over the last several quarters, we have witnessed a slowing in the growth of goods consumption while the growth in the consumption of services continues to increase. While services make up a larger piece of the overall consumption pie, the main input to the price of many services is wages. As wages increase, the cost of many services increases, leading to even greater demands for higher wages and risking a wage-price spiral that concerns so many central banks.

Other Long-Term Inflationary Forces Take Hold

Protectionism has increased since U.S. trade wars with China began in 2017. The importance of domestic production capability for strategic goods and resources that started during the Trump era were exacerbated by the onset of the pandemic, and then, more recently, the war in Ukraine. Terms like onshoring and friend-shoring will continue to gain traction, whether it is a corporation rethinking its global supply chains or governments focusing on nurturing strategically important industries or diversifying and protecting the supply of commodities, particularly food and energy. In short, as globalization moderates, so too will its impact as the reliable deflationary force to which we have become accustomed over the past few decades.

The desire and push for many global economies to make a green transition is also having a significant impact as there is a lot of work required to develop green projects and infrastructure, as well as retooling, retraining, reskilling, and re-educating current workforces for the green economy. We continue to believe that this transition will be expensive and will take much longer than most people expect. The underinvestment that the green focus has caused in many commodity and material markets will likely lead to higher and more volatile prices during the long transition phase. At the risk of oversimplifying things, cleaner plus greener equals more expensive goods and services.

Is a Recession on the Horizon?

The view that the global economy is headed for recession in the near-term has already diminished due to a combination of factors, including fading supply shocks, good fiscal supports, and fundamentally healthy private sector balance sheets that are proving resilient against the drag of tightened financial conditions. Recent data, and not just in the U.S., has decisively repudiated the recession narrative that would be an important contributor to lower inflation. Global manufacturing and service-sector Purchasing Managers' Indices (PMIs) were strong in January, with constructive news on orders and inventories, along with an improvement in business expectations for growth this year. Labour markets remain strong.

Wall Street expectations for global GDP growth in the first quarter of this year have already migrated to a trend-like 2.5% annualized rate. While we expect to see some regional weakness, it appears that certain developed economies will not be as impacted in the near term by higher inflation and higher interest rates as the financial markets were expecting in the second half of 2022.

A true soft landing scenario that sees an ongoing expansion, a continued moderation in "transitory" inflation, and lower policy rates later in the year, will be difficult to achieve. The lasting damage from the global pandemic that is restricting global supply will limit the slide in inflation and likely require higher policy rates for longer than market participants are expecting – with a meaningful risk that rates will need to be increased further after the coming pause that has been signaled by both the U.S. and Canadian central banks. It is in this scenario that inflation could finally be wrestled down in the medium-term – at the cost of a meaningful economic slowdown – but unlikely to levels that prevailed over the past decade.

Conclusion

Inflation has now remained elevated for long enough that inflation expectations for many businesses and consumers have started to become less anchored at the traditional 2% level. Given the decrease in deflationary forces in recent years, the expansionary government policies, the tight labour markets, and the stickiness of current wage growth, we expect that inflation will likely remain above the 2% target of the U.S. and Canadian central banks in the coming years.

In this environment, the yield curve will likely move modestly higher as interest rate expectations adjust from the previous decade of artificially low rates and better reflect the higher level of inflation and continued modest economic growth. We expect credit spreads have some room to rally but will likely remain elevated. To navigate this environment within the fixed income landscape, we think that investment in short-to-mid-term corporate bonds is a high-quality option that benefits from higher all-in yields while providing protection from duration volatility. Additionally, fixed income investment strategies that have the flexibility to take advantage of various market segments will offer better yield and risk reduction opportunities in what we expect to be a volatile period in financial markets for the foreseeable future.

And, finally, further to our recent whitepaper, "Inflection Point: The Case for Canada", the impacts of trade, interest rates, inflation, and the climate transition should drive long-term demand for Canadian assets, including fixed income. This should prove to be a very good time to be invested in Canada.

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