WHY HAS INFLATION BEEN SO DIFFICULT TO TAME?

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While inflation has come down considerably from its peak last fall, it remains stubbornly high compared to central banks' target of 2% for most developed countries. The most popular view is that central banks will get inflation closer to the 2% target by late 2024 or early 2025 with either no recession or a mild one, but the reality is that there are a variety of potential economic outcomes. The best way to protect portfolios is to diversify the investments to hold some securities that should do well in each environment rather than positioning solely for one potential result.

Economic forecasting and investing can be humbling professions. About two years ago when analysts, market strategists, economists and portfolio managers saw inflation rates spiking up, the conventional wisdom was that this higher inflation rate would be transitory, meaning it would be short-lived and quickly return to the 2% central bank target (this was largely based on the fact that we had been in a low inflation environment for 15+ years despite ultra-low interest rates and high government spending). These forecasters (and the market) expected that if interest rates were increased by just 1-1.5% in total, this would be sufficient to change consumer behaviour for inflation to decline back to target. There was an expectation that the economies of most developed countries would slow as a result, but then return to a moderate growth rate of 1-3%.

Two years later, interest rates are substantially higher (5% in Canada, and above that level in the United States) following one of the fastest paces of interest rate hiking cycles in the modern era. Central bankers across the developed world are now saying interest rates will have to remain higher for longer to subdue inflation, regardless of the economic impact. While inflation has decreased considerably from its peak, it remains stubbornly higher than target, with employment levels and the economy remaining strong. This has left many investors nervous, confused, and uncertain as to how to position their portfolios.

MEASURING INFLATION

While everyone generally agrees on the definition of inflation (the difference in cost for a basket of goods and services over a certain period), it can cause confusion as inflation can be assessed a few different ways. Most people, including the media, use the Consumer Price Index (CPI), which in Canada is run by Statistics Canada. CPI measures how much it costs to buy a fixed basket of goods and services from one year to the next. Based on this measure, it appears that inflation is coming down quickly and approaching its target. After peaking at 8.1% in June 2022, CPI in Canada has steadily declined to 2.8% in June 2023.[1] The US is on a similar path as CPI has dropped from 9.0% in June 2022 to 3.0% just one year later.[2] Based on these measures, it seems surprising that the Bank of Canada raised rates in June to 4.75% and then to 5.0% in July after previously pausing in the spring. The US Federal Reserve recently increased its rate to 5.25-5.50%, also after pausing. But the other inflation measures tell a more troubling story.

INFLATION APPEARS TO BE COMING DOWN…

Canada		US	
CPI June 2022	8.1%	CPI June 2022	9.0%
CPI June 2023	2.8%	CPI June 2023	3.0%
Difference:	-5.3%	Difference:	-6.0%

[1] https://economics.td.com/ca-cpi#:~:text=Consumer%20price%20inflation%20cooled%20to,key%20downward%20force%20on%20inflation.

...BUT CERTAIN INFLATION COMPONENTS ARE STILL CONCERNING

	Canada
Food	+8.3%
Shelter	+4.8%
Services	+4.2%
Inflation, excluding energy	+4.4%

Core CPI in Canada, which excludes energy and food, the more volatile components, is just under 4.0%.[3] Energy costs, which were one of the prime reasons for the inflation spike in early 2022, have declined by over 21% in the past year, and goods inflation, which led to the initial rise in 2021, has declined to 2%.[4] It is the stickier components that are now the concern, such as food, shelter and services, which have increased by 9.1%, 4.8% and 4.2%, respectively.[5] (Although it is interesting to note that a large part of the increase in shelter costs has been due to increases in mortgage rates, which has been driven by the Bank of Canada's interest rate increases).

The central banks also closely monitor the jobs market. A tighter jobs market means a lower unemployment rate and greater bargaining power for workers that typically results in higher wages, which spurs further inflation as companies charge higher prices to compensate. If the labour market remains tight, this feedback loop of higher wages leading to higher prices makes it hard for inflation to decline to the target level. Despite signs of weakening in Canada and the US, the unemployment rate remains near historic lows and there are considerably more job openings than unemployed people (although this gap is closing). Both economies are continuing to add net new workers at a high rate and, consequently, wage growth remains above target.

In the US, the Federal Reserve prefers to monitor the Personal Consumption Expenditure index (PCE) instead of CPI because it tracks what kinds of goods and services consumers are buying, i.e., it reflects how spending habits change and it provides broader coverage of the economy. PCE tells a similar story in the US to CPI. The June PCE rate was 3.0%, demonstrating a continued decline from its 5.4% rate in January and its lowest reading since April 2021, but excluding food and energy costs, the PCE is up 4.1% on a year-over-year basis and rising monthly by 0.3%. Like Canada, the decline in energy prices in the US (19%) explains most of the difference in the past year.[6] Please note that energy prices seem to have stabilized and even started rising recently, so energy costs may add to inflation going forward — another headwind for central bankers.

In summary, while there are very encouraging signs that inflation is decreasing, central banks are focused on seeing the stickier components of inflation, such as food, shelter, services and wages, reach 2% or lower before they feel comfortable that the risk of high inflation has receded. Until then, interest rates will likely stay higher for longer.

INTEREST RATES AND THE ECONOMY

The main tool that central banks use to bring down inflation is interest rate policy. When central bankers want to spur growth and inflation is low or there is a risk of deflation (prices declining over a set time period), they reduce interest rates and may engage in extraordinary measures, such as buying bonds and quantitative easing. By making the cost of borrowing cheap, the hope is that consumers may borrow to buy goods or services and companies will invest in their businesses, which leads to increased production and consumption, as well as economic and job growth.

When inflation is running hot, as it has since late 2021, central banks increase interest rates in the hope that higher borrowing costs will get consumers to spend less as a greater portion of their income must be used to cover interest payments and companies cut costs to maintain profitability.

ECONOMY AND STOCK MARKET REACTION

While higher interest rates have caused growth to slow, businesses have proven resilient as earnings on the S&P 500 grew by 4.6% in 2022 and are projected to not shrink in 2023 as originally expected, but to grow marginally by 0.4% (although Q3 2023 earnings are expected to be down about 7% vs. last year).[7] GDP growth also remains positive in Canada and the US as consumers continue to spend on services and the job market remains fairly strong.

[2] https://economics.td.com/us-cpi#:~:text=The%20Consumer%20Price%20Index%20(CPI,of%20nearly%209%25%20last%20June.
[3] https://www150.statcan.gc.ca/t1/tbl1/en/tv.action?pid=1810000413
[4] In fact, without energy costs included, inflation would have been closer to 4.0% in June.
[5] https://economics.td.com/ca-cpi#:~:text=Consumer%20price%20inflation%20cooled%20to,key%20downward%20force%20on%20inflation.
[6] https://www.bea.gov/news/2023/personal-income-and-outlays-june-2023
[7] https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_072823.pdf

The key questions on most investors' minds are about the near future:

- Will Canada and the US have a mild or deep recession, or possibly no recession?
- Will central banks give up on their 2% inflation target and live with 3% or even 4% inflation?
- When will central banks stop hiking rates and possibly start to cut them?
- What is the best investment strategy (or strategies) during this period of uncertainty?

Please note that while investors are often focused on short-term questions like these, it is the long-term plan which is set out in the Investment Policy Statement and Financial Plan that is most important to meeting investing and financial goals.

MULTIPLE SCENARIO APPROACH

As the past two years have shown, even the best analysts and most detailed research can still lead to unexpected results and what worked in one period (commodities were the place to be in 2022, while technology stocks suffered 30%+ declines) does not necessarily work in all periods (commodity returns have been negative in 2023, while the tech-heavy NASDAQ is up well over 30%). By looking at the potential outcomes over the next year or so, we can get an idea of which asset classes should perform most favourably in different scenarios.

MOST LIKELY SCENARIO: MILD RECESSION, INFLATION DECREASES TO TARGET AND RATES DECLINE

Despite the economy being highly resilient over the past two years, most forecasters still expect the high interest rate increases to take their bite out of the economy. Many analysts expect that growth will turn negative by the end of 2023 or early 2024, further easing inflation and prompting central banks to start cutting interest rates in 2024 or 2025 to help kick start the economy. Please note there are many valid reasons for this view:

- The yield curve (difference in yields between short and long-term bonds) has been inverted (meaning short-term yields are higher than long-term) for over one year. Typically, when short-term yields are higher than long-term yields, this indicates that the markets anticipate interest rate cuts in the future, usually due to declining economic growth.
- The Purchasing Manager's index, which is based on monthly surveys of supply chain managers, shows that manufacturing is in contraction (part of this may be due to costs declining as supply chain and transportation problems in 2020 and 2021 have largely been resolved) and service industries are at only moderate growth levels.
- The Leading Indicators Index, which is an index of various economic surveys and information that tend to predict the direction of the economy, have been negative and declining.
- Lending standards have tightened dramatically per the Fed Senior Loan Survey, both due to higher interest rates and the run on US regional banks earlier this year.

But job growth and the economy have remained resilient.

If we were to enter a moderate recession, defensive, value and high-quality stocks tend to outperform cyclical, growth and lower-quality stocks. Bonds generally outperform equities in most recessionary scenarios.

HARD LANDING SCENARIO

If the slowdown is more severe, investors seek out safety and liquidity. Central bankers also aggressively reduce interest rates to spur economic growth. In this environment, defensive stocks, such as healthcare and utilities, tend to outperform more cyclical sectors like energy, technology or consumer discretionary. Bonds tend to outperform stocks, with the highest quality bonds often doing best, i.e., investment grade outperform high-yield and longer dated bonds outperform short-dated bonds due to interest rates coming down. While this is a possibility, most economists consider it to be low probability. Having some cash available is often beneficial in this environment.

CONTINUED SLOW GROWTH, INFLATION CONTINUES TO RECEDE

There are many analysts who expect our current state to continue: tight labour market, moderate growth and easing inflation. In this environment, stocks should do fine as earnings will increase. Inflation will come down slowly, helping to justify higher equity market multiples, and bonds should do all right too as investors will earn their current yield of 3.5-5.5% on government bonds and 4.5% to potentially double digits on corporate bonds, plus potentially some modest capital gains as credit spreads decrease and central banks begin lowering rates. Mid to high single digit returns for both asset classes would be reasonable assumptions in this scenario.

STRONG GROWTH, LOW INFLATION

While this is probably the least likely scenario, given the current high interest rates, lower savings rate and decrease or stabilization in government spending, there is a possibility that if Artificial Intelligence is truly a revolutionary technological advancement, it could spur strong growth not just for the technology companies that supply the hardware and software, but for all companies that employ it. In this scenario, equities would outperform bonds, which would earn their current coupon rates, but likely no more. Growth stocks, lower quality stocks, small-cap., technology and possibly cyclicals should outperform and likely generate double digit returns.

WHAT TO DO?

Clients tend to work with financial advisors to help them achieve certain goals, such as plan for retirement, help them manage cash flows, leave a legacy for their children or charity and to save on taxes. Advisors, investment counsellors and wealth planners design investment policy statements (IPS) and financial plans to help clients achieve these goals by building out a portfolio that should provide the return to meet those objectives (and hopefully a little more) at an agreeable risk / volatility level, while utilizing all reasonable structuring and investment strategies to save on tax. They also help clients manage risk, provide money coaching to encourage clients to save for their goals and manage the emotional roller coaster of the stock and bond markets. Money coaching, communication, an IPS and planning are the key tools that financial professionals use to help clients remain on track and invested when fear is high and the economy is weak, but markets are cheap, so they can benefit from the next rally. In fact, one study found that clients who work with an advisor had well over three times the assets of an investor who did not work with an advisor over a 15-year period.[8]

In investing, rarely do you get something for nothing. If you want a higher return, you have to generally accept more risk or volatility. The one exception is **diversification**. By buying multiple asset classes and employing multiple investment styles, investors can often earn a higher return at a given risk level. More importantly, because certain investments tend to go up in different environments, diversification often limits the drawdowns[9] that can cause clients stress and anxiety, or lead to poor short-term emotional decisions. These emotional, stress-driven choices can greatly impair the client's investment plan and long-term goals. The chart below is an Asset Quilt[10]. It highlights the returns by year

2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018	2019	2020	2021	10 Yr. Avg	10 Yr. Vol
17.8%	8.9%	15.3%	34.4%	27.9%	31.2%	41.8%	18.5%	31.1%	62.4%	35.1%	9.7%	25.8%	48.1%	26.3%	21.6%	38.5%	28.7%	7.7%	24.8%	17.9%	19.8%	17.7%	20.1%
10.2%	8.1%	8.7%	28.1%	16.8%	24.1%	32.1%	9.8%	6.4%	57.5%	20.2%	8.3%	16.0%	41.3%	23.9%	20.0%	21.1%	17.4%	4.2%	22.9%	16.6%	17.3%	15.2%	15.9%
7.4%	7.9%	1.8%	27.8%	14.5%	12.5%	26.4%	3.7%	-17.2%	52.0%	17.6%	4.6%	15.6%	31.6%	14.3%	19.5%	17.5%	13.8%	3.8%	19.2%	16.3%	14.2%	10.0%	13.3%
6.8%	4.5%	-1.9%	26.7%	11.9%	11.2%	17.9%	2.2%	**-18.3%**	35.1%	15.2%	4.4%	15.3%	**17.2%**	**12.0%**	16.1%	17.1%	9.1%	1.4%	16.8%	12.9%	12.9%	**9.1%**	13.3%
4.7%	4.2%	-3.5%	20.5%	10.9%	10.6%	17.3%	0.9%	-21.2%	17.4%	14.1%	**-0.4%**	13.8%	13.0%	10.6%	14.6%	**8.3%**	**8.5%**	**-1.3%**	16.5%	8.7%	12.0%	9.1%	11.8%
1.6%	3.8%	-7.0%	15.1%	9.7%	**9.7%**	15.4%	**-2.3%**	-26.4%	**17.1%**	13.0%	-1.8%	13.4%	11.4%	9.7%	**8.2%**	8.1%	7.5%	-2.3%	**15.9%**	**8.7%**	**7.0%**	7.4%	11.6%
0.4%	2.2%	**-8.0%**	13.8%	**9.3%**	6.5%	**15.3%**	-5.3%	-28.8%	12.5%	**10.2%**	-3.5%	**10.3%**	7.6%	8.8%	3.5%	7.7%	7.1%	-3.0%	15.8%	7.3%	6.1%	7.3%	10.8%
-5.1%	**-2.7%**	-12.4%	**12.6%**	7.1%	2.7%	11.8%	-7.0%	-33.0%	8.0%	9.1%	-8.7%	7.2%	7.4%	7.0%	2.4%	1.7%	4.1%	-5.6%	14.4%	6.4%	4.6%	6.5%	7.3%
-5.9%	-6.4%	-16.5%	6.7%	6.5%	2.3%	11.6%	-10.5%	-34.6%	7.4%	6.7%	-9.5%	3.6%	4.3%	4.1%	-4.6%	1.4%	2.8%	-6.5%	12.9%	6.2%	3.7%	4.6%	**7.2%**
-11.0%	-12.6%	-21.3%	5.3%	2.8%	1.9%	6.2%	-16.5%	-41.4%	5.4%	2.6%	-16.1%	2.0%	3.9%	2.5%	-8.3%	-1.4%	2.5%	-8.9%	6.9%	5.6%	-3.5%	3.9%	7.1%
-28.2%	-16.3%	-22.9%	-8.0%	1.3%	-6.9%	4.1%	-21.1%	-45.5%	-9.2%	0.0%	-16.4%	-2.2%	-1.2%	-2.3%	-13.3%	-2.0%	0.3%	-18.2%	1.4%	-9.8%	-5.9%	3.6%	4.0%

- Canadian Equity Large Cap
- Canadian Equity Small Cap
- US Equity Large Cap
- US Equity Small Cap
- International Equity
- Emerging Markets Equity
- Global Real Estate
- Canadian Fixed Income
- Global Fixed Income
- High Yield Fixed Income
- Balanced Portfolio

[8] Based on a 15 year period. https://www.rbcgam.com/documents/en/articles/the-value-of-working-with-a-financial-advisor.pdf

[9] 2022 was a rare exception as both stock and bond markets declined by more than 10%.

[10] Source: Morningstar. As at June 30, 2021. Balanced Portfolio is based on 18.5% Canadian Equity Large Cap (S&P/TSX Composite TR), 2.5% Canadian Equity Small Cap (S&P/TSX Small Cap TR), 17.9% US. Large Cap (S&P 500 TR CAD), 3.1% U.S. Equity Small Cap (Russell 2000 TR CAD), 2% Emerging Markets (MSCI EM GR CAD), 16% International Equity (MSCI EAFE GR CAD}, 8% High-Yield Fixed Income (ICE BofAML U.S. High Yield TR USD), 18% Canadian Fixed Income (FTSE TMX Canada Universe Bond), 5% Global Real Estate (FTSE EPRA/NAREIT Developed TR), and 9% Global Fixed Income (BBaBarc Global Aggregate TR CAD.

of 10 separate asset classes. What you will notice is that the asset classes that perform best in one period often perform worst in others, e.g., Canadian Equity Small Cap. The white coloured box, which represents the balanced portfolio, tends to generate returns that are typically somewhere in the middle of the pack. Drawdowns for the balanced portfolio tend to be much smaller than for select asset classes, particularly certain equities, and over longer time periods (shown in the 10-year average columns), the balanced portfolio is one of the few investments to generate a meaningfully higher return (9.1%) vs. its volatility level (7.2%). The balanced portfolio, which represents the diversified portfolio, provides that free lunch. It has the 4th highest return, but the 3rd lowest volatility. Please note that adding other asset classes, such as liquid alternative investments and private assets, can provide additional benefits to further enhance returns while often lowering portfolio volatility as well.

OTHER CONSIDERATIONS AND OBSERVATIONS

Dollar Cost Averaging: For clients who are sitting on significant cash, using a dollar cost averaging (DCA) strategy that you design with your advisor or investment counsellor can be a great way to get back into the market without taking on timing risk. The client and financial professional determine how much in total to invest, and over what period, then buy the target portfolio in equal incremental amounts over that period. The DCA strategy takes emotion out of the investment process, as well as near-term risk, to ensure the client moves towards their long-term goals.

Cash Wedge: Given that cash is yielding as much as 5%, keeping a portion in cash to cover near-term expenses, 3-6 months or longer of cash flow needs, or an emergency reserve is quite reasonable. Knowing that this cash/high interest savings fund is liquid and available to a client if needed can take some of the anxiety away from investing and give the client peace of mind. Please note the cash wedge is not a strategy of determining when to increase or decrease cash to try to time the market, which is typically detrimental to achieving long-term goals. The wedge is in place to ensure that clients are not forced to sell long-term investments at a time when they are temporarily unable to meet cash flow needs. It also serves to provide investors with peace of mind that there are funds available to cover any short-term need.

COMMENT ON THE MARKETS:

Despite rising equity markets this year, many investors are still concerned given last year's sharp decline, fears of a recession, and due to high inflation and interest rates. The good news is that the current environment offers long-term investors a relatively attractive entry point with reasonable equity valuations in most markets, high bond yields that are greater than the inflation rate and greater access to alternative investments.

Fixed Income: Bonds are offering the most generous yields in approximately 20 years. Long-term forecasts still predict interest rates will return closer to the 2.5% level, so fixed income is likely to offer a high yield of 3.5% to over 5% on government bonds, and from 4.5% to even double digits on investment grade and high-yield corporate bonds, plus the opportunity for capital appreciation when rates decrease. As an example, if yields were to decrease by 1% in the next 24 months, a 10-year Government of Canada bond would generate a return of over 7% per year over the next two years[11] — a very high return on a safe asset.

Equity Valuations: While investors may have heard the comment that equity markets are overvalued, this often is specific to the US market (S&P 500) which is trading at 19.4 times forward earnings vs. a 10-year average of 17.4 times[12] (markets also tend to trade cheaper when interest rates are higher). Most other markets are somewhere between reasonably priced to cheap: Emerging markets are trading below their historical average with a Price-to-Earnings ratio of only 12.1 times, the MSCI World Index ex-US is trading at 13.2 times, and the Canadian market is trading at similar levels.[13] Certain analysts and portfolio managers have also commented that small capitalization stocks, particularly in the US, offer cheap to compelling valuations presently after years of underperforming.

Magnificent Seven: In addition, the 'Magnificent Seven' (Apple, Microsoft, Alphabet, Amazon, Nvidia, Tesla and Meta Platforms) has accounted for approximately 70% of

[11] Based on a current yield of 3.7% as at August 3, 2023 and capital appreciation of 7% over 2 years.
[12] https://advantage.factset.com/hubfs/Website/Resources%20Section/Research%20Desk/Earnings%20Insight/EarningsInsight_072823.pdf.
[13] Source: CI GAM, QIR 2023 Q2 from Bloomberg Finance LP, as of June 30, 2023.

the gains in the S&P 500 this year. If these stocks were not included, the remaining 493 stocks would be trading at or below their historical average and the S&P would have only gained just over 5% vs. closer to 20% YTD.

Artificial Intelligence: If many market pundits are to be believed, Artificial Intelligence may revolutionize our lives and businesses, so why is it that only a select few technology companies have seen their share prices appreciate? Healthcare companies will use the technology to develop new medications and medical devices more quickly and cheaply. Consumer companies will utilize the technology to better meet customer demands and many industries will employ the technology to reduce costs and increase efficiency. Few of these broad potential future gains have been priced into the market currently.

Alternative Investments: CI Global Asset Management (CI GAM) is continuing to follow the lead of some of the world's largest and most successful pension funds, sovereign wealth funds, endowments, and foundations by allocating more assets to alternative investments, particularly private assets. Adding these investments in client portfolios, depending on the client's goals, liquidity needs and risk tolerance, can improve portfolio returns and often generate a meaningful income stream. CI GAM is expected to launch new private asset funds later this year.

CONCLUSION

Managing risk effectively not only involves trying to protect a client from what ultimately happens in the market, but all the potential outcomes that could happen. Over the past three years we have gone through a rapidly rising inflationary environment and one of the fastest paces of interest rate increases in history. Typically, when interest rates have increased by this much and for this long, the economy tips into recession and unemployment rates increase. Yet, equity markets have recovered much of their losses, the job market has remained strong, and the economy has been resilient. While most analysts expect a shallow recession or slow growth, the best way to protect your portfolio in all potential scenarios is to diversify across multiple asset classes and styles. If you are concerned, your circumstances have changed, or you have questions, please reach out to your advisor or investment counsellor directly.

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