Inflation and its consequences

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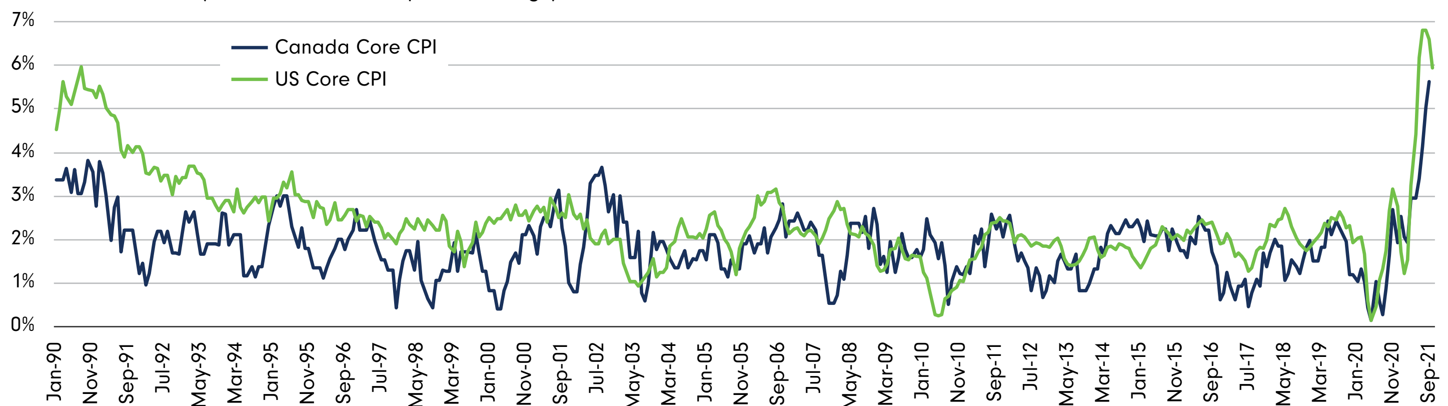
Key Takeaways

- We expect the recent increase in inflation to be more persistent than many believe.
- An inflationary environment requires a different approach to diversification and risk management in multi-asset class funds.
- Our newly launched Fidelity Inflation-Focused Mutual Fund provides a concentrated exposure to inflation-sensitive assets.

Inflation has arrived. Consumer price inflation in Canada is running above 4%, near a three-decade high; similar jumps in prices have been seen in the U.S. and elsewhere. This is not due to base effects or other narrow, temporary influences. Shorter-term measures of core inflation are spiking even more aggressively (see Exhibit 1). This is the strongest surge in prices in a generation.

Inflation is being caused, as always, by a mismatch between supply and demand. Policy makers have stoked demand by stuffing the economy with money; since the beginning of the pandemic, both government debt and the money supply have risen at their fastest pace since World War II. Much of this increase has gone straight into the pockets of consumers, who are also benefiting from the wealth effects

EXHIBIT 1: Inflation spiking

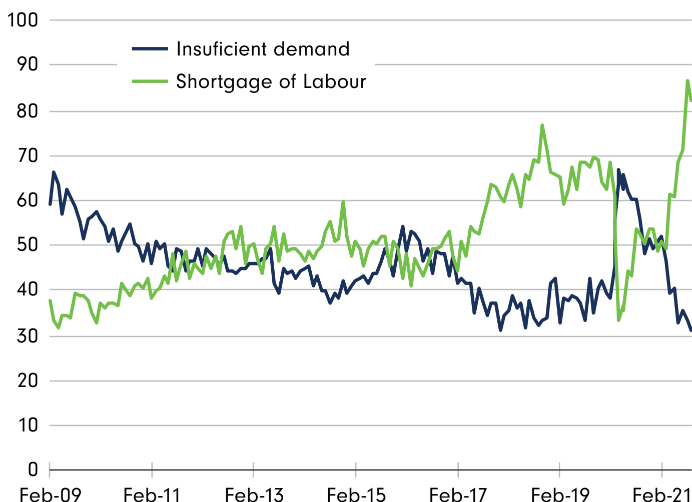


Source: Statistics Canada, Bureau of Labour Statistics, 6-month annualized percent change.
US Core CPI = excluding food and energy. Canada Core CPI = excluding 8 volatile components & indirect taxes

of strong increases in financial asset and house prices. Consumers have the means and the willingness to spend and, as economies reopen, the ability to do so.

Supply is not keeping pace (see Exhibit 2). There look to be both shorter-term and longer-term constraints. In the product market, companies are telling our industry analysts not to expect a full resolution of supply chain issues for a year or more. But even once those bottlenecks ease, there will likely need to be a broader restructuring of activity; the demonstrated fragility of far-flung supply chains will require companies to re-evaluate what, where and how they produce. That is not only true for goods-producing firms; the pandemic-inspired move to more flexible working arrangements in parts of the services sector will render at least some fraction of the capital stock obsolete (think office buildings). In the labour market, there is currently a worker shortage, which will eventually ease as benefits run out and skills mismatches are addressed. But the pandemic-driven spike in retirements, the surge in the long-term unemployed and workers' reconsideration of their tolerance for

EXHIBIT 2: Supply, not demand, is the problem



Source: Canadian Federation of Independent Business Monthly Business Barometer, % Response

lower-paying jobs all imply a longer-term scarring of labour capacity.

When demand exceeds supply, we expect shortages to emerge and prices to rise. That is exactly what is happening. And with neither side of the equation likely to change materially any time soon, there is no reason to expect the higher trajectory of inflation to end any time soon either. Ironically, the insistence among central banks that this inflation is transitory – and on keeping the pedal to the metal on stimulating demand that the economy has trouble absorbing – makes it more likely that inflation will persist. This will make it more costly for policy-makers to fully tame inflation over the long run, if indeed they are willing and able to do so.

Persistently higher inflation poses a threat to both economic growth and financial assets. Growth is not being limited by lack of demand but by lack of supply. For example, motor vehicle production in Canada is down roughly 58% from a year ago.* But it's not that people don't want to buy cars. And it's not that manufacturers don't want to sell them cars. It's that they can't make the cars, due to an acute shortage of chips and other essential parts. The proof is in the pricing behaviour: new car prices are up 7% in Canada over the past year, the largest increase since 1994, with used car prices up even more sharply.* When supply is constrained, strong demand comes out in higher prices rather than higher activity.

With respect to asset prices, this sort of environment poses an obvious threat to bonds, because inflation erodes the purchasing power of fixed coupons, and bond prices are pressured by the eventual need for higher interest rates to combat inflation. The consequences for equities are more ambiguous, depending on to what degree supply constraints hit growth. Companies can benefit from stronger demand amid greater pricing power, but cost

* Source: Statistics Canada

pressures can weigh on margins, and rising discount rates may trim valuations.

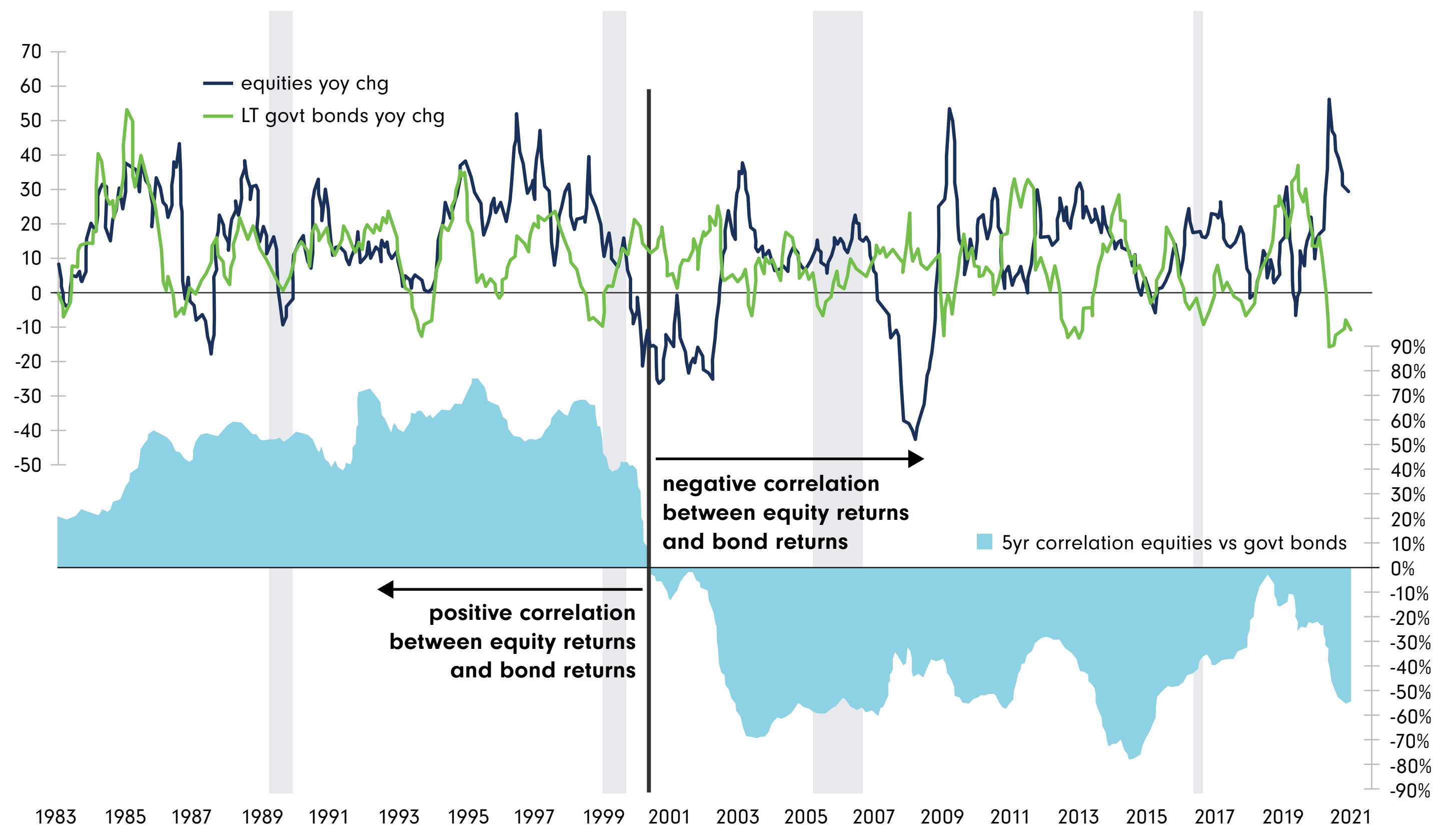
What is clear is the challenge to the negative correlation between stocks and bonds that allowed 60/40-type balanced portfolios to thrive with relatively little volatility for much of the past generation (see Exhibit 3). As a result, an inflationary environment requires a different approach to diversification and risk management in multi-asset class funds. We have been addressing this challenge in our funds in two main ways.

First, we have been accumulating cheap inflation-sensitive assets for some time in our Canadian multi-asset class funds, anticipating the eventual swelling of inflation risks. These assets include inflation-linked bonds, commodity equities, real estate equities and gold. We have also recently launched Fidelity Inflation-Focused Mutual Fund, which provides concentrated exposure to these inflation-sensitive assets. As Exhibit 4 shows, this Fund is designed to help investors more broadly protect their portfolios in an inflationary stress environment, while still holding its own in other market scenarios.

Second, we are making more use of currency exposure as a risk management tool. The Canadian dollar is a cyclical currency, highly correlated with global equity prices. Holding defensive foreign currencies is a method of protecting our portfolios against a decline in equity prices, in an

EXHIBIT 3: Inflation will challenge the negative stocks/bonds correlation

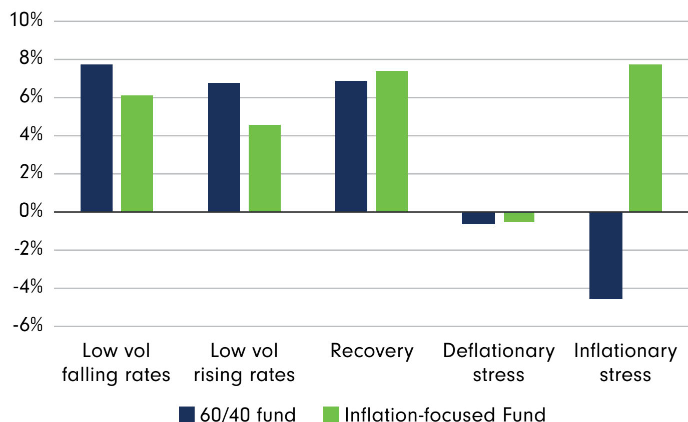
Monthly data



Source: FMRCo, Bloomberg, Haver Analytics.

EXHIBIT 4: Using Fidelity Inflation-Focused Fund to protect portfolios

Historical real return by regime (annualized)



Returns for Inflation-Focused Fund and 60/40 fund derived from benchmark asset performance 1950–2020. 60/40 fund proxied by Balanced Private Pool benchmark (36% S&P/TSX Capped Composite Index, 24% MSCI All Country World ex Canada Index, 14% Barclays Capital Global Aggregate Bond Index, 21% FTSE Canada Universe Bond Index and 5% FTSE Canada 91-Day T-Bill Index).

environment where bonds are unlikely to provide the traditional degree of protection, both because of low yields and the aforementioned potential for stock/bond correlation to flip positive in an inflationary environment.

In sum, we believe that the excess of demand over supply means that higher and more volatile inflation will be a persistent feature of the economic and financial landscape ahead. We have been preparing for this environment for some time and have taken steps to protect our Canadian multi-asset class funds, as always with the goal of maximizing return while managing risk.

David Wolf, David Tulk and Ilan Kolet, October, 29, 2021

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