## Fidelity Compass

**Inflation on the Rise? What it means for institutional investors**

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**Pamela Ritchie:** Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. Inflation intrigue, there are few topics in the business community and investment world dominating the headlines more than the issue of rising inflation. After nearly three decades of relatively low and stable rates, June's Consumer Price Index report recorded the largest year-over-year increase in over 13 years. At the heart of the debate, of course, is whether inflationary is transitory as suggested by the Fed, or whether it will become persistent and entrenched over the longer term. The question top of mind for many institutional investors is how to best protect their assets in an uncertain inflationary environment. To unpack this topic for us and to speak to the various factors at play we're very happy to be joined by portfolio manager, David Tulk, and institutional portfolio manager, Ilan Kolet. Welcome to each of you. Great to see you.

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**Ilan Kolet:** Thanks, Pamela. Happy to be here.

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**Pamela Ritchie:** Great to have you join us here. I'll remind everyone to join in the conversation. There's a Q&A function on the side of your screen, feel free to send questions in for either David or Ilan throughout the discussion here today. For about 30 minutes or so, we'll have each of them to go through some of these topics. Ilan, I'm going to begin with you. I'm going to hit the inflationary topic right, get your expertise on this from your perspective. You look at these numbers all day, every day. What does inflation look like to you?

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**Ilan Kolet:** Thanks, Pamela. I think there's a few things at work right now. There are temporary measures, temporary effects that are happening right now related to the reopening and related to comparisons from a year ago. That's nothing new, that's nothing surprising. Just as the data was shocking on the way into the pandemic, it's fairly shocking coming out of the pandemic. That's the first part, that first bucket sort of temporary and supply chain-related issues. But the second part, which is I think more concerning to us, are the medium-term signals that we're seeing that suggest that inflation, the underlying inflation rate, could be stronger perhaps a year from now than what we've seen for the last 25 years. So, it is important that we separate out those re-opening effects and really stunted supply chains with the medium-term effect, which is higher rates of inflation and policy being permissive of higher rates of inflation, which is, I know something will/we'll also impact.

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**Pamela Ritchie:** We will, we'll go through many pieces of this right now. David, I think I need you to just sort of frame for us as we go into this conversation, really why inflation matters, what it eats away at.

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**David Tulk:** Inflation is a very pernicious shock. It erodes one's real standard of living and that's especially true, I think, for asset managers, especially if they have liabilities that have some link to inflation as well. So, really, what you need to counteract that are assets that have a hedge against that inflation risk because it can wreak havoc on the profile for liabilities. Inflation matters a lot, certainly for us as well, and we think about inflation as being a negative shock for both stocks as well as bonds. Beyond a certain threshold, inflation can be a pretty aggressive detriment to the performance of equities. When we think about what bonds are that promise to pay cash flows into the future, inflation as equally as negative of a shock as well. So, that's the starting point.

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What also provides us with concern as multi-asset class managers is that inflation can cause the correlation between stocks and bonds to move from being negative, which is what we like, to being positive, which means that if both your asset classes are falling, that will provide both a hurt to the return-seeking part of your portfolio and also you think of bonds as traditionally fulfilling the role of insurance and now that part of your portfolio will also be under pressure. So, there's really no place to hide from a multi-asset class manager when it comes to inflation if you don't take some proactive steps ahead of time.

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**Pamela Ritchie:** I wonder if we go through, Ilan, some of the components of inflation. I think most people sort of take a look at the basket. We're talking a lot about wage inflation these days with nonfarm payrolls due out at the end of the week in the U.S. There are many discussions and earnings calls about inflation, there's many, many, components. I wonder if you can sort of put them in order of importance for us and what you're looking at.

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**Ilan Kolet:** I promise to anyone on the phone here, I won't take the next 24 minutes to do this. The composition of inflation is important. When I mentioned temporary factors, comparisons from a year ago, those are things like airfares and car rental services. We shouldn't be surprised that those rates of growth are very, very high because they were essentially closed last year. So, that should not be surprising at all. A lot of the focus has been on sort of the shock and awe that we've seen in some of those components. That, I expect, will fade by the end of this year. Depending on what the path of the Delta variant is, most of the first round of COVID impacts on the CPI and on inflation measures will fade, I think, by the end of this year, the first round.

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The second thing, which will fall out of the data at various points in time, so, it'll be a little bit trickier to spot, are supply chain disruptions. Supply chain disruptions, we all know that they've affected things like vehicle prices and used vehicle prices. It's not normal for used vehicle prices to be up 45% from a year ago. That's abnormal. When supply chains are normalized, and that's also happening, I think that effect will fade as well.

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The third part, and this is where things get interesting, is what happens to the labour market and to service inflation. Whenever I talk about the underlying inflation pie, one-quarter of it is goods prices, so that's the stuff that you buy at Costco, and three-quarters of it are services. The most important determinant or input into a service price is the price you pay the person doing that service. It's not the part at the mechanic, it's the person's time. Our view is that when we emerge from this pandemic, labour will have stronger bargaining power and that bargaining power could push up wage growth and then firms have a choice whether to eat those increasing cost pressures out of margins or pass on price increases. They never did that, they didn't pass on the price increases in the 10 years following the financial crisis and we think now that they will. So, you will see higher wages turn into higher service prices, which could lift underlying inflation.

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**Pamela Ritchie:** David, I wonder if you can add to that. When Ilan talks about supply chains, one of the things I think about is the supply chains for everything to do with houses and homes and we're all living in our homes longer. But it's an interesting piece of it, just the housing equation. I don't think anyone is unaware of how expensive housing is really all over the world, in fact. What sort of pieces of rental and other components of inflation do you look at on the housing front?

[00:08:28]

**David Tulk:** I think housing is an important part of the story. You're very right to point out that it's not just a Canadian phenomenon, although that's something you see very clearly in our own backyard. It truly is global. It's a function of the interest rate environment. It's one of the maybe intended benefits of what the Federal Reserve and other central banks are trying to achieve, not only to generate a wealth effect to provide greater ammunition for future spending, but a number of factors are there to also try to propel the economic recovery further. When it comes to the inflation story, you do get forms of imputed rents, basically a service price of what it takes to run your house. In the United States, that's a really important part of the inflation calculus that Ilan spoke of. It's interesting because we do get some leading indicators in terms of market variables or survey data points that look at dynamics within the housing market where there are certainly signs, especially as rent moratoriums start to come off, that you could see additional pressure there. When we think about the persistence of inflation, a lot of the factors that Ilan spoke to, I think will be inherently transitory, but there are some of these stickier issues that we would look to, and housing is certainly one of them, where that can contribute to the higher inflation story going forward.

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**Pamela Ritchie:** I wonder if we sort of weave it in here, I think we are spending more time in our homes. People are spending more time, more money on their homes. You just wonder if some of those components that deal with that are also in this inflation discussion. The person who comes to fix your dryer charges more than they did last year, that's for sure.

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**Ilan Kolet:** Absolutely. We've all been at home for a long time working from home. I think my wife is ready for me to work from the office seven days a week instead of five at this point. David did allude to the importance of housing. In the U.S., it is the single most important determinant for underlying inflation. The thing that explains it the best is the health of the labour market. The ongoing recovery in the U.S. labour market will be the most important determinant, in my view, of what will drive underlying shelter prices, which will drive underlying inflation. As we see the labour market recover, that will provide some lift to shelter and sure enough, it already is. Shelter is rebounding very, very quickly in the U.S., and in my mind, that's just confirming evidence that the 2022 profile for inflation is likely to be stronger than what we've seen for the past 25 years.

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**Pamela Ritchie:** With some of this discussion of inflation, David, I wonder if you can outline the rather delicate dance that central banks have to be doing right now, and I guess to an extent, how coordinated are they, they used to be, and how much are they just following the Fed. The Fed still on some level is taking into account some of these components globally for countries, right?

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**David Tulk:** That's a really good point because the Federal Reserve has that connotation of being the global central bank insofar as their influence definitely extends to every corner of the world but in actual fact, they are primarily focused on the United States. So, they do consider foreign developments only insofar as it affects global financial conditions, which then spill into the United States. They think about global conditions in terms of determining what foreign demand for U.S. exports look like but by and large, when it comes to underlying price pressures, their two concerns are price stability, in addition to full employment in the U.S. You think of it from the perspective of the rest of the world looking in and this can create a number of tensions.

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It was synchronized, certainly going in, in the way that the pandemic hit most countries almost identically at roughly the same time, but as we start to come out, we're seeing more of a differential performance. There are some regions in the world that continue to struggle with the pandemic. There are others that have made significant strides to having addressed it. This is the interesting challenge now where the Federal Reserve will do what's right for its economy. We've heard guidance from them that a taper might be in the offing sometime by maybe the end of this year or into early next year, but rate hikes themselves will be pushed further out, whereas other central banks, and we could certainly get into the debate as to what this means for the Bank of Canada, but conceivably other central banks might need to act ahead of the Fed or maybe even later than the Fed, which can have some pretty strong implications for currencies or conditions within those smaller economies. I kind of think of it, from the Bank of Canada's perspective, as a lot of the cards have been dealt to the bank and that's the virtue of being a small, open market economy, but whereas the Federal Reserve can kind of be the dealer for global central banks. I think that's a very interesting dynamic to watch.

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This is also happening in the context where central banks are thinking more holistically about their mandate. We have thought a lot about and we read a lot about more inclusive growth, so it's not just getting full employment but it's across different groups of the population that have historically maybe been left behind. There's also the notion that the Federal Reserve is trying to instead of think about exclusively future inflation, but make up for prior inflation misses so that can be wrapped into their average inflation targeting framework where bygones are no longer bygones. That can change how the Federal Reserve will respond and indeed it's one of the factors that we would expect that, all things equal, the new mandate from the Fed will keep the Fed on hold for longer, keep financial conditions more stimulative and that can be a bit of a double-edged sword, because it does certainly help the Fed achieve its objective but it can easily get away from them as well.

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One thing that we haven't really spoken of quite yet, and I think it's an important part of the narrative, is expectations of future inflation. What we've seen in prior cycles is that if expectations start to shift higher, those are very difficult to counteract. You want a little bit of that to happen to help motivate spending, but if you get too much of that, again, that can create a much more difficult environment for central banks further on down the road.

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**Pamela Ritchie:** The so-called animal spirits being left to do their magic or create their magic but not getting out of control. Ilan, this brings us... and I'll ask both of you this question... but really to the timing. David sort of pointed out perhaps longer. What data points do you need to look at to guide what the timing will be on seeing tapering, and then ultimately where we see rates rise?

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**Ilan Kolet:** Yeah. This is sort of uncharted territory at this point. We know right now the data is messy and there's a lot of fog surrounding the data. We're going to get a clearer read on underlying inflation by the end of this year and even a clearer read in the first half of next year. But to me, what will be really interesting, and David discussed this, is what will be the reaction from the Fed. I'm not talking about monetary policy actions so much as not open market operations, more so open mouth operations. What do they say in testimony to Congress and in speeches and in interviews, because they've told us that they're going to be very, very permissive and patient to allow the inflation rate to perhaps overshoot, to re-anchor at a higher level, but we've never really seen a central bank... number one, successfully do that and two, actually stick to the plan and let inflation overshoot. We don't have any parameters how long that overshoot will be or what a successful overshoot looks like. There's no rules around it.

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That sort of vague structure, that squishiness, I think, is very intentional because you will have regional FOMC voting members get more uncomfortable with inflation sooner than perhaps the chair. What we will have to do is because we're in this uncharted territory in terms of monetary policy, really a new framework, and it really is a new framework, we'll have to basically see what that looks like. I do think we will start to see prints that looks stronger than what we've seen starting next year. Really, the interesting thing is not necessarily those prints, it's the reaction of policymakers to those prints.

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**Pamela Ritchie:** David, anything to add there? I want to get on to sort of the collision course ultimately of whenever rates do rise or where inflation is, along with the debt that's been issued to combat this pandemic. Anything first just on the timing that you see?

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**David Tulk:** I agree with everything that Ilan said with respect to the timing, where it will take until the end of this year to see some of the temporary factors shake out. There will be a cleaner read of the data assuming, of course, that there are no additional shocks that we'll encounter between now and then. The approach the Federal Reserve is taking, it's interesting because they're trying to pair that with pretty definitive comments that they see inflation is transitory. A lot of people have focused on that as saying that the Fed has an Oracle view into inflation. The reality is is that they really don't. They're looking at the same data as the rest of us. They may have more researchers behind the scenes, but still trying to struggle with the same degree of uncertainty. So, it begs the question, why is the central bank so confident in describing it as transitory? I think the answer is is that they kind of have to. They can't say that it's not transitory because if they acknowledge it as not being transitory, either they need to do something about it, or they don't need to do something about it. Given the uncertainties that we're facing in the economy, neither of those options are really that promising at this stage.

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So, they're, I think, in the same boat as a lot of us, where they see elements that are transitory, but ultimately, they will need to react as closer to real time as they have maybe in the past to the risk that there's an undercurrent of inflation that proves to be more durable than what they currently believe. That only really enhances the uncertainty and it's going to be a very challenging time, I think, for the market over the next 12 months as we all try to navigate this uncertainty, both in terms of inflation but also, more importantly, testing the reaction function of central banks as they navigate this as well.

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**Pamela Ritchie:** I'm going to move in a minute to how you're navigating it and positioning essentially for the various outcomes. First, though, Ilan, let's really get a sense from you... the debt, obviously, that has been allowed to fill our coffers, allowed many to save, allowed many to be at this moment in the markets, perhaps less scarred than in previous recessionary environments, what does it mean ultimately when inflation takes off? If inflation takes off, what does it mean for the government debt?

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**Ilan Kolet:** The first thing is, what does debt mean for inflation? When public debt levels are high, you can grow your way out with robust rates of growth. We haven't had that in the developed world since the early '90s, so let's cross that off the list. You can implement austerity measures. That's politically impossible, I think, right now and very, very unlikely. We're moving in the opposite direction. The third one, when you have high nominal debt burdens, is you can inflate. One of the things that we discuss on the team is just that intersection between very, very permissive monetary policy trying to achieve an overshoot, intersecting public policy that almost is incentivized to run inflation higher than it is because of those debt levels. That's the set-up to me for how we actually get to higher inflation.

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I know I mentioned a whole bunch of things about wages and service prices moving higher. That's the arithmetic part of it, but the motivation is the monetary policy motivation intersecting those high debt levels. This is where the policy choice becomes very, very tricky because once inflation starts to move, especially on the service side, it's very, very momentum driven. I think while policymakers think they're going to raise inflation to some optimal level, some cruising altitude and then level off, there's a chance of an overshoot. That's when very difficult policy decisions will have to be made to either rein in inflation or not.

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The implications of that for highly levered households and corporates and governments is problematic. My favourite chart is when people show me, well, household debt service is very low. Of course, it's very low, because rates are nowhere. So, you move that rate a little bit, that debt service becomes a lot more problematic and you can stamp that analogy across households, corporates and governments. I'm sure David has more thoughts on that as well, but that's the set-up for me, really.

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**David Tulk:** I would just offer the narrative that we've seen tremendous coordination between policymakers through the pandemic. I think this is implicitly likely to continue where governments have taken on a tremendous amount of debt and that's to basically help bridge the gap that had opened up in the private sector as everybody was locked down. There are bolder initiatives to continue to fund infrastructure projects over a longer horizon. Central banks, I think, are somewhat encouraged by that because one of the lessons of the great financial crisis is that monetary policy went all in but fiscal policy was more mired in austerity and political infighting. So, they didn't get that double-barrelled approach to accelerating the recovery.

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We now have that in place now, and I think governments certainly do want to encourage a little bit more inflation because that removes some of their real debt burden. If central banks are willing to tolerate that inflation, that's a nice little match that I think can allow, at least temporarily, a pretty good combination of strong growth. It does risk the inflation story, but if that government spending can enhance productivity, maybe that's the overarching goal more so than being worried about inflation. It's one of those really interesting combinations of policy that, again, we don't really have a lot from history to draw from, so we'll all be waiting and seeing the end result.

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**Pamela Ritchie:** That's fascinating, it's really fascinating. I'll put this question to each of you and David, perhaps you want to answer a little bit with positioning, but there is this question, are you hedging for inflation or are you trying to outperform it? I put that to you and maybe you can help us with positioning.

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**David Tulk:** I'll start the answer and certainly invite Ilan to add his thoughts as well. When we think a little bit about the hedge versus looking to outperform, as I mentioned off the top, we think about inflation as primarily being a negative shock to multi-asset class funds. We're trying to provide insurance. In the portfolios that our team manages, we hold an allocation to gold. It is a traditional inflation hedge, it's something that even responds better to unanticipated inflation. If the market ends up thinking that the inflation story is benign and that's proven otherwise, gold is a very powerful asset class to hold in that environment. We also hold explicit protection against inflation in the form of TIPS in the United States and real return bonds in Canada. We have those elements built into the portfolio. They're typically out of benchmark allocation.

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Really, what we want to be able to do is that if the inflation environment proves to be more worrisome than the market currently believes, we can not only protect against the negative impact that inflation has individually on stocks and bonds, but also in a way that we can provide protection against the correlation between stocks and bonds moving from being negative to being positive. A lot of the assets we think of in the context of inflation, that is actually something that Ilan has written a paper on in his prior role as our inflation analyst, so maybe I should just allow him to give himself a bit of credit when it comes to that paper and give a couple of other points as well.

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**Ilan Kolet:** Thanks, David. I'll just mention briefly, and this should be available to everyone on the call, in the prior role before joining the Canadian team, we did examine the asset classes that best hedge unexpected changes to the inflation rate. Unsurprisingly, perhaps… and controlling for growth surprises, we do find commodities, gold, oil, natural resource producing stocks, they do serve that purpose well. You can imagine emerging market equities have a bit of that commodity flair as well. If anyone's interested in that, please reach out to your sales contact and they can pass that along.

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**Pamela Ritchie:** That's great. Yeah, absolutely, it's something that can be brought into it. I'll just round out the discussion. David, you also mentioned off the top that inflation obviously is infecting all of the different asset classes, maybe just zero in for a bit on equities and, ultimately, the discussion of pricing power and how companies are responding to it, if consumers are up for it, essentially. How do you see it long term, inflation, infecting equities?

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**David Tulk:** That's a nice opportunity to maybe talk a little bit about our current positioning that we're holding across the fund. Currently, we are overweight equities and underweight bonds. The motivation for that does pick up on the reopening narrative that we've talked about over the course of the call. We think a little bit about that policy environment is providing an additional lift to equities, as well as financial conditions are likely to remain exceptionally stimulative. In terms of the magnitude of the overweight, we're probably about halfway as overweight as we could conceivably be. The hesitation we have in going any further is that a lot of the good news we've talked about, at least from the growth side, which will go into corporate earnings, has been priced into the market. So, valuation metrics do look somewhat stretched. We know that valuation is not a timing tool per se, but it does limit a little bit of our willingness to get too far over our skis when it comes to that equity market overweight.

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We also think about the equity story from a regional perspective. We continue to be underweight Canadian equities. We think that that's a challenging environment for Canada's economy from the debt perspectives that we've spoken about. Also, and this can be somewhat controversial, but there may be a narrative where the Bank of Canada is forced into hiking before the Fed. I touched on some of the dynamics of that earlier, which means that the Canadian economy being so much more over levered than the U.S. could conceivably hit the wall sooner. So, that makes us pretty cautious in terms of our allocations into the Canadian equity market and indeed, Canadian assets more generally, so we favour instead an overweight to other regions around the world. We're pretty even now, in terms of being overweight the United States, Europe, as well as emerging markets. As I mentioned earlier, we do still have that gold allocation as well as explicit inflation protection on the bond side of the portfolio just to hedge against that risk as well.

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**Pamela Ritchie:** David Tulk and Ilan Kolet, I want to thank each of you for joining us here today and really expanding, I think, the overall view and adding to the discussion. Thank you very much.

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**David Tulk:** You're very welcome.

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**Ilan Kolet:** Thank you.

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**Pamela Ritchie:** Great to see you both. Thank you all for joining us here in this broadcast today. As always, if you have any suggestions for future topics or guests that you'd like to see on the show, we'd certainly be happy to hear your feedback. In the meantime, stay tuned for more Fidelity Compass webcasts in the weeks and months ahead. Thanks for joining us. I'm Pamela Ritchie.

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