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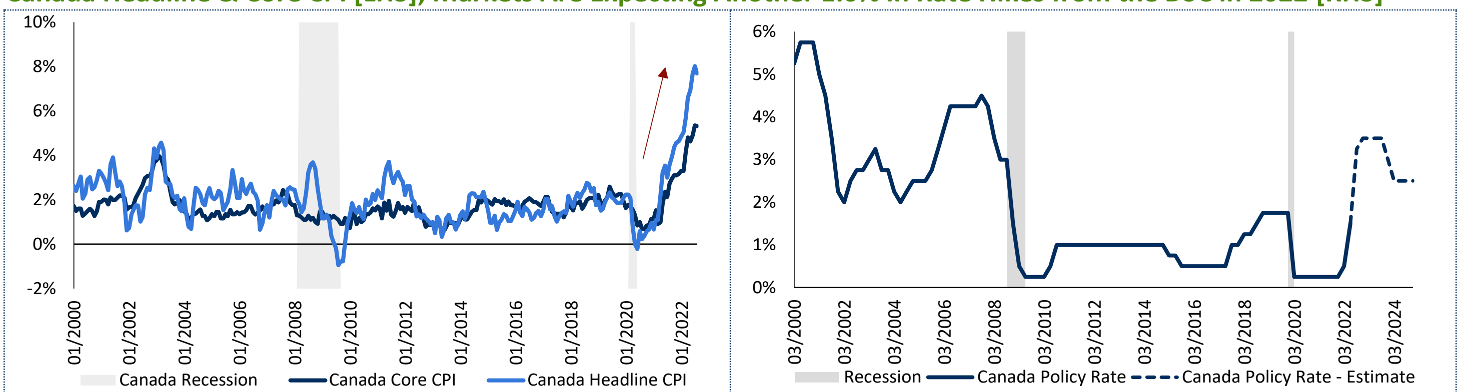
Inflation Fever Breaking?

We are now 8-months into the year and it is not surprising that the "inflation fever" is still top of mind for most. While it's reassuring to see that inflation fever is moderating, albeit from 40-year highs, we believe it is a bit too premature for investors to assume that the return towards more normal levels of inflation will be a smooth descent from the peak. Rather, we expect the path forward will be a volatile one with many ebbs and flows along the way.

As we touched on briefly in our January **Insight & Strategies report**, we were anticipating inflation to remain elevated and above the long-term trend of 2-3% for longer than most were expecting, with risks to the upside rather than to the downside. Fast forward approximately two months following the release of our January report, and we have a war raging in Europe with the Russian invasion of Ukraine. This unprovoked invasion of a sovereign nation resulted in a slew of global sanctions being imposed on Russia, the Kremlin, President Vladimir Putin, and many close allies to Russia. This, coupled with the continuation of a widely unpopular zero-COVID-19 policy in China, resulted in the exacerbation of ongoing supply chain disruptions that have become a norm since the start of the pandemic. To state the obvious, these two independent events resulted in an upside surprise to inflation expectations which few were expecting, and prompted central bankers globally to act more forcefully with rate hikes.

While we have seen some moderation in inflationary pressures more recently, including in the July Consumer Price Index ("CPI") report (CPI rose +7.6% year-over-year ("YoY") versus expectations of +7.6% YoY and versus the June CPI release of +8.1% YoY), the details of the report gave us little comfort to change our outlook on the path of inflation. In particular, the month-over-month decline was primarily driven by a drop in gasoline prices, while several other components of the CPI basket continued their ascent higher including food prices and the prices of services most impacted by the pandemic (incl. hotels, air transportation and restaurants). Since the Bank of Canada ("BoC") pays particular focus to the core CPI – which excludes volatile components such as energy and food - when it comes to making monetary policy decisions, we expect the continued uptick in the cost of services to keep the BoC anchored in their hiking path into year end. As shown below, markets are currently expecting rates to rise another +1.0% by year-end.

Canada Headline & Core CPI [LHS]; Markets Are Expecting Another 1.0% in Rate Hikes from the BoC in 2022 [RHS]

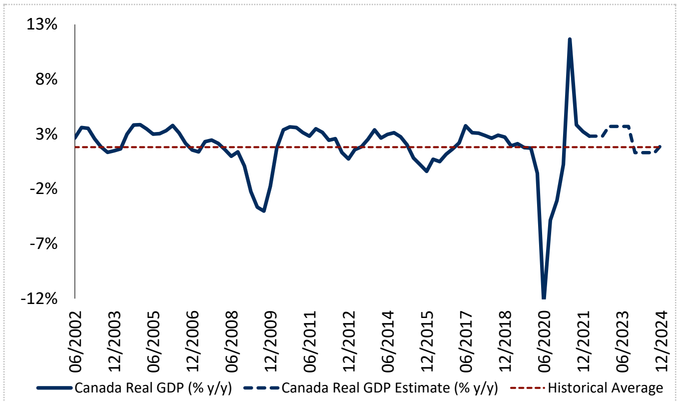


Source: FactSet; Capital Economics; Raymond James Ltd.; Canada CPI as of July 31, 2022; Canada Policy Rate as of June 30, 2022, updated quarterly; Canada Policy Rate Estimate as of August 26, 2022.

Intended Impacts from Higher Rates

As we discussed in the August edition of the Insights & Strategies report titled "**Winter is Coming**", rate hikes still remain the primary tool that central banks, including the BoC, have at their disposal to combat inflation. The challenge with this approach however, as we have discussed ad nauseam, is that rate increases while useful in slowing down the broader economy (real GDP growth is expect to increase by +3.5% in 2022, and +1.8% in 2023, but down from +4.7% in 2021), they do little to influence vital structural challenges such as supply-side inflationary impulses across the economy.

Canada Real GDP Growth (% y/y)

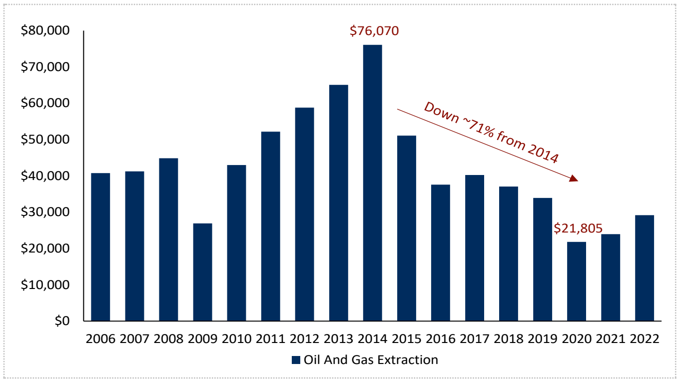


Source: Capital Economics; Raymond James Ltd.; Canada GDP Growth as of March 31, 2022. Canada GDP Growth Estimate as of August 9, 2022.

Energy Prices – Structural Issues

Since 2014, investment in the Canadian Oil & Gas sector have slowed significantly. While we can point to many factors that have contributed to this unfortunate trend – we will save the details and discussion for another piece – the reality is, the significant underinvestment in this sector by companies since 2014 will not be addressed overnight. Furthermore, higher rates will do little to influence/encourage more supply.

CAPEX on Oil & Gas Extraction in Canada

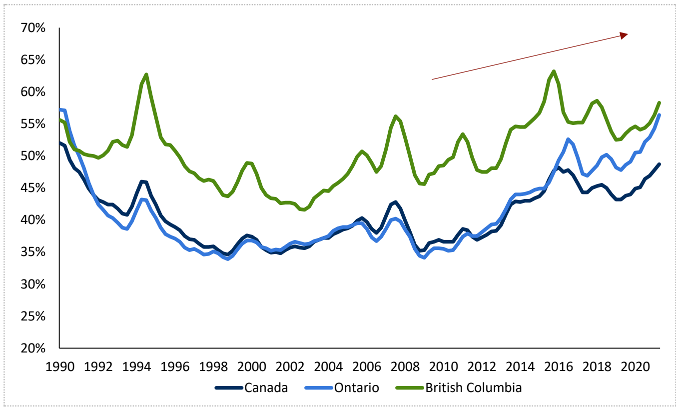


Source: Statistics Canada; Raymond James Ltd; Data as of February 25, 2022.

Shelter Costs – Another "Real" Structural Challenge

With interest rates up over 2.25% since the beginning of 2022 and expectations for further increases on the horizon, home prices have begun their decent from very extreme levels. However, that said, affordability has only worsened as carrying costs have risen, while the persistent shortage of rental stock/supply coupled with an increase in demand from those steering away from home ownership because of higher mortgage rates, has sent rental costs soaring higher. As shown below, the trend has been only higher for shelter costs as a % of disposable income as rates have increased. We believe higher rates will unfortunately do little to resolve these cost pressures over the near-term and in our view will keep the Canadian inflation rate above trend for longer.

Shelter Cost as a Share of Disposable Income



Source: CMHC; Raymond James Ltd.; Date as of December 31, 2021.

Investor Recommendations

Against this backdrop of structural inflationary challenges, which have only worsened since the pandemic, we expect a much more volatile path back towards a more normal inflationary environment, with inflation remaining above the neutral rate of 2% for longer. In this environment, we suggest investors consider some of the following for their portfolios:

- Remain selective and focus on high-quality securities
- Valuation matters, especially as yields rise from record lows; securities trading at extreme levels with cash flows far out in the future (e.g., speculative stocks) will fare worse in this environment
- Focus on assets (stocks/bonds) with shorter durations, all else equal
- Look for securities that offer floating rate coupons
- Consider alternative investments (e.g., private real estate)

Important Investor Disclosures

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