A discussion on inflation transcript
Kelly Bogdanova & Tylar Lunke
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Tylar Lunke: Hello, and welcome to a discussion on inflation from RBC Wealth Management. It's Wednesday, June 9th, 2021. And my name is Tylar Lunke, and I lead the Managed Portfolio Strategies team. I'm joined by Kelly Bogdanova, co-chair of RBC's Global Portfolio Advisory Committee. This recording is intended for RBC Wealth Management clients. And thank you for joining us today. Over the next 10 to 15 minutes, we'll discuss the topic of inflation, why we're seeing it, is it here to stay, and what it means for the economy and your investments. I'm excited to be joined by a colleague well-suited to speak on the topic, Kelly Bogdanova. Kelly has extensive experience with advisors and clients. And as co-chair of the Global Portfolio Advisory Committee, she has oversight and is a key contributor for our Global Insight's suite of publications. Our goal for this discussion is to provide a perspective on inflation and give you a framework to consider when thinking about its impacts. Kelly, welcome. And to get things going, let's level set as to how we got to where we are today. What are the causes of inflation that we've seen to date?

Kelly Bogdanova: Well, Tyler, this bout of inflation that's happening in the U.S. right now, it's essentially an aftershock from the COVID-19 earthquake. The price increases of consumer goods, services are a direct consequence of first shutting down the economy, and then restarting the economy, both in the U.S. and globally, along with waves of sizeable stimulus from Washington and the federal reserve. The stimulus levels were unprecedented in modern history. The combination of these factors has created very unusual supply and demand imbalances for goods and services and price distortions. This has resulted in the buoyant consumer inflation that we're seeing. But with that being said, a key point for investors to consider is that so far, the price spikes have shown up in just a small group of categories, such as auto sales, auto rentals, lodging, airline fares, recreation, furniture, and education. These categories are tied to the COVID-19 pandemic shutdowns and the subsequent reopening of businesses, or they're tied to the related supply chain problems. In April, the magnitude of increases in these seven categories were extreme statistical anomalies, far, far outside of normal patterns.

Tylar Lunke: Now let's talk about how long we expect to see inflation. What would make these higher levels of inflation stick around for a longer period of time?

Kelly Bogdanova: First, we would need to see meaningful increases in domestic wages across a wide range of industries. And this is an important factor, because for inflation to really take root and cause problems for the economy and financial markets, you typically need broad-based wage inflation, the kind that really eats into profit margins of many industries and pushes overall consumer inflation levels higher over a sustained period. So far, certain industries are absolutely seeing wage pressures, especially the service sector, restaurants and retailers, for example. Also, surveys show that small businesses are having a difficult time filling job openings. Many may end up having to hike wages in order to fill positions. But we're really not seeing broad-based wage inflation across a wide variety of industries right now.

A second factor that would make inflation becomes sticky, so to speak, we would need to see outsized and lasting inflation in other major economies, particularly in China, which has a significant impact on commodity prices, and also in the European Union. These are the second and third largest economies in the world behind the U.S., and both are major trading partners. So far, inflation rates in China and the EU have been much tamer than in the U.S. And there are signs that some commodity prices may have already peaked. At this stage, the two factors that would make inflation stick around, higher foreign inflation and broad-based domestic wage inflation are not visible, but these are risks that we're monitoring pretty closely.

Tylar Lunke: So on the flip side of sticky is transitory, a word we're hearing a lot in the news related to inflation and the Fed these days. In your view, how short term of period is transitory?

Kelly Bogdanova: Well, we agree with the Fed that this inflation spat will be temporary or "transitory" as they like to put it. But the challenge for markets and for the Fed is what timeframe are we talking about? And which gets to your question. In other words, just how transitory is transitory? We anticipate that inflation will be above normal for the next few years, and this would include high uncomfortable inflation levels over the next few months before things potentially start to cool off later this year. After a stretch of above normal inflation, we think inflation levels will shift back to below normal in the long run like they were before the COVID 19 pandemic. But the challenge is there's a lot of uncertainty between now and the long run, including uncertainty about inflation levels this year. It could take a number of quarters for financial markets to become confident that inflation is not going to be a long-term challenge. As this gets sorted out, it could actually provoke stock market volatility and even create market pullbacks along the way. This should be taken into consideration for portfolio positioning.

Tylar Lunke: So let's move from talking about inflation itself to the impact it has on markets and investing. We'll start with the Fed and interest rates. What do we see as the key questions regarding the Fed, and how that impacts interest rates as well as fixed income positioning from here?

Kelly Bogdanova: Because of the inflation risks and because of the possibility that economic growth could be strong as businesses get back to normal operations and households spend some of the excess savings that were built up during the pandemic, financial markets are already beginning to prepare for the Fed to start easing off of the gas pedal. During the pandemic, the Fed significantly increased the size of its balance sheet by purchasing fixed income securities, mostly treasuries and mortgages, and the Fed lowered its target interest rate to almost 0%. Now, the key questions are first of all, when will the Fed reduce the pace of its asset purchases and eventually eliminate purchases altogether? This process is known as tapering asset purchases. Also, will hot inflation data provoke the Fed to begin tapering sooner, rather than later? This is something that markets are paying close attention to right now. And at what point might the Fed start raising interest rates?

The answer to these questions are tied to the contours of inflation and the economic recovery. Our fixed income strategists still believe the Fed will begin to taper asset purchases in the first quarter of 2022. But regardless of whether it starts at this time or even a little bit earlier, such as toward the end of this year, they don't think the Fed will sell Treasury and mortgages securities outright. Practically speaking, this means the Fed's balance sheet would remain outsized and highly accommodated for financial markets. And this means that the tapering process should have a limited impact on bond yields, given the Fed's stated intention to provide markets with ample lead time before the tapering process actually begins.

Now regarding rate hikes, my fixed income colleagues believed this is still a long way off, with the window for rate hikes only likely to open by 2023 at the earliest, which is in line with current market expectations. They expect Treasury yields to consolidate around current levels until later this summer when the Fed's tapering plans are likely to come into view, which could then push the ten-year Treasury yield modestly higher toward 2% by year end. But keep in mind, this is still a very low level by historical standards. Overall, we would hold underweight exposure to fixed income securities in portfolios. This equates to less than the long-term strategic allocation. Fixed income valuations are quite rich at the moment, and a lot of the good economic news has been baked into these markets. However, there are some attractive opportunities to add income to portfolios in preferred securities.

Tylar Lunke: So the last topic to discuss before we wrap up is the equity markets. What impact of inflation do we expect to see, and how are we positioning portfolios given this outlook?

Kelly Bogdanova: We think that long-term equity investors should look past this latest inflation disruption and continue to moderately overweight equities in portfolios. First of all, in the post-World War II era, the U.S. equity market has generally been able to cope when inflation has been caused by shortages in supply. And that's the case that we're in right now. Companies are typically able to pass on some or all of the inflation and input costs to their customers. And therefore, companies are able to maintain or increase profit margins. And we saw this pattern in the first-quarter earnings reports, and we expect to see it again during the second-quarter reporting season. Importantly, though, looking at the bigger picture, it's still early in the business cycle. Equity bear markets typically transpire late in the business cycle when credit conditions tighten and corporate profits start to decline. The economic data and financial indicators are signaling that those bearish conditions appear to be a long way off. But we do think that heightened inflation risks could increase market volatility. And importantly, they underscore the need to fine tune equity sector positions in portfolios.

According to an RBC Capital Markets study going back to 2004, some of the most economically sensitive Value sectors of the market, and here I'm talking about sectors such as Financials, Materials, Energy, they outperformed when inflation expectations were rising. In contrast, some of the growth sectors of the market like Technology, areas of Health Care, and Communication Services were underperformers. This track record supports our ongoing recommendation to tilt equity holdings more toward Value stocks rather than Growth stocks in 2021, if not longer. So overall, even though inflation will likely be uncomfortably high in the near term and could be above normal for a while, we do think this is a temporary phenomenon, and it's manageable for U.S. financial markets and the economy.

Tylar Lunke: Thank you, Kelly. Really appreciate your perspective today. And thanks to everybody for listening. Please note, there is additional inflation content available from RBC. If you'd like to explore a bit more, then head over to rbcwealthmanagement.com, and then click on the Research and Insights tab. There, you will find Kelly's article on the topic. We know inflation leads to potential worries related to your investments, but we would encourage you to stay in touch with your financial advisor, access various resources from RBC, and make sure your wealth plan is up to date. Thank you all for your time today and for your trust in RBC Wealth Management. Take care and have a great day.