Manulife Investment Management

Inflation expectations for 2021

The rapid reopen

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00:00:11 When we get asked about the economic environment for 2021 into 2022, our response is typically a question: do you believe the economic environment will get incrementally better over the coming 3, 6 and 12 months, or worse? 00:00:25 With the increase of vaccinations in Canada and the United States and other areas around the world, COVID will become less and less important to our lives as we move through 2021 and into 2022. 00:00:38 That then begs the question what do we see for the economic environment and in particular, what is of specific focus to investors will be inflation and its impact on interest rates. 00:00:50 The Bank of Canada might have to consider raising their overnight rate ahead of their 2023 target and that could perhaps happen in the back half of 2022. 00:01:01 Now the reason for this is the strength in the Canadian economy coming out of the lockdowns and rebounding to levels that would take us back to 2019 or earlier. We have to also address if we are seeing stronger economic growth and a need by the central banks, at least the Bank of Canada, to start to consider raising rates that this might imply higher inflation. 00:01:27

Now this has been our argument over the course of the last 6 months that given all the monetary and fiscal stimulus that we've seen out of this government in Canada, out of governments in the United States and across Europe and other areas around the world, with fiscal and monetary stimulus equalling approximately 16% of global GDP since March 2020, that one of the consequences of this is going to be stronger economic growth, but that can lead to higher inflation. 00:01:55 Over the last 10 years, inflation in the United States is measured by the consumer price index, averaged 1.7%. 00:02:03 That's fairly low and below the federal reserve's target. 00:02:06 Canada has seen a similar inflation number. 00:02:11 We think that inflation can turn higher. 00:02:13 Now to what level? We're using a target of 2.5% for Canada and for the United States, but sustained at 2.5% with risk to the upside. 00:02:23

We're already seeing evidence of coming inflation with respect to the National Federation of Independent Businesses in the United States that have been telling us through their monthly surveys that they intend to raise prices or have been raising prices. 00:02:39

We also see this through commodity prices using the Commodity Research Bureau's index of commodity prices that we've seen increase over the last 6 months and we've seen it with the Institute for Supply Management purchasing managers' index of prices that has been moving higher as well. 00:02:59

So we're seeing inputs into higher inflation over the last number of months that we believe will result in sustained higher inflation, again, at a target of about 2.5%, but that risk can skew to the upside given a strong economic backdrop. 00:03:17

We do believe that this will prompt the Bank of Canada and the Federal Reserve to move ahead of their 2023 timelines and we could see the overnight rate in Canada or the federal funds rate in the United States move up at some point in the back half of 2022. 00:03:33 Now that's not necessarily today's problem, but in anticipation of this higher inflation, what we believe we are likely going to see is the U.S. 10-year treasury yield as well as the 10-year government of Canada bond yield move higher as they already have this year, but higher nonetheless through the course of this year into next year pricing in that higher inflation expectation. 00:03:56 From the fixed income perspective and the investors especially within fixed income, what this is likely to mean is that we perhaps want to focus less on longer duration bonds as interest rates move up, the price of bonds tends to fall and focus more on shorter duration bonds, typically high-yield bonds and investment grade corporate bonds that tend to respond more positively to the economic cycle and less so to the interest rate environment where we see higher yields yet to come. 00:04:26