Quarterly Commentary

April 2024

What If Inflation Remains Elevated?

The simple, if not particularly satisfying, reply to the above question is that we can then expect benchmark interest rates to remain elevated for longer. This 'higher-for-longer' narrative has ebbed and flowed over the past couple of years, as periodic inflation and economic data—along with central-bank commentary—have, at various times, prompted calls for imminent rate cuts. Such calls have followed a consistent pattern of market participants and pundits overshooting the mark, only for such calls to be consistently dashed by subsequent data that continue to defy expectations. At the time of writing, we are witnessing the slow and steady death of the market's most recent foray into the 'imminent' rate-cut forecast. We started the year with the bond market pricing in over six cuts by the U.S. Federal Reserve (the 'Fed') in 2024. Thanks to the U.S. Consumer Price Index ('CPI') report confirming inflation levels above expectations in March, rate-cut forecasts have again been pushed out. We are now left with less than two cuts priced in for 2024.

This trend of deferrals has been directionally consistent since early 2022, when calls for an impending recession were nearly unanimous, and all financial markets were in contractionary mode. At that time, interest-rate cuts were expected to follow closely on the heels of that all-but-guaranteed recession. Indeed, the downward-sloping yield curve had been flashing that warning signal for some time. These predictions appeared to be coming to fruition when the U.S. Regional Bank Crisis started to grab headlines in March 2023. Yet, here we are, over a year later, financial markets remain strong and relatively calm (rising euphoria over Artificial Intellegince ('AI') notwithstanding), and we have yet to see any major Western central bank cut interest rates.

The slam-dunk U.S. interest-rate cuts that were supposed to begin in March of this year, have now been deferred to June, and may even commence later in 2024 or early 2025. We do believe that interest rates are heading lower in the next 12 to 18 months, but when and by how much will only be known after cuts begin. The U.S. Fed's own interest rate projections, as detailed in the so-called 'dot plot' report, points to lower rates over the next couple of years. Most Federal Reserve members still project 75 basis points of cuts in 2024 (which implies three 0.25% cuts), with a further reduction in 2025. By 2026, the consensus expectation of Fed members is for benchmark interest rates to be in the range of 3%, a significant reduction from the current rate of 5.25%. This projection is driven by their expectation that the Core Personal Consumption Expenditure ('PCE'; the Fed's preferred inflation metric) will fall to 2% from its current level of 2.8%.

The largest price components factored into the PCE measure are medical care at ~20%, housing (including energy for homes) at ~17%, recreation at ~11% and transportation at ~9% (including energy). These weightings differ from the those included in the CPI report, which has considerably higher weighting in housing costs and significantly less focus on medical care and other goods & services costs. Note that 'Core' PCE excludes food and energy due to their volatility. For all of us who have been to the grocery store or filled their vehicle with gas recently, excluding these components seems akin to deciding the winner of a football game without a score – these are important costs that impact everyone in a very real, significant way, even if volatile.

In Canada, we have seen a more significant fall in prices and economic data, including rising unemployment levels and falling GDP per capita. The most recent CPI report for March came in below expectations at 2.9%. As we have outlined previously, Canadian households have much higher consumer and mortgage debt levels. Higher interest rates therefore force more income to be directed towards covering this debt, leaving less available for discretionary spending, a key driver of the economy. Although the Bank of Canada ('BOC') left interest rates unchanged at their most recent policy meeting, there was a greater relative willingness by Tiff Macklem, Governor of the Bank of Canada, to openly discuss the possibility of commencing rate cuts in June of this year. This appears to be much more likely in Canada relative to the U.S., though we believe the BOC remains very cognizant of the potential negative effects too-fast interest rate cuts could have on the already elevated housing market.

When analyzing inflation, we not only consider hard numbers, but also what's driving such numbers, including what market influences prompt movements higher or lower, or cause prices to remain stubbornly rangebound. At any time, there are a multitude of conflicting forces that impose themselves on the economy, consumers, central banks, investors, corporations, governments, etc. Our team continually seeks out data and research from different sources to help inform and guide our outlook on financial markets. Given inflation and interest rates continue to be highly influential on the outlook for markets—as well as the very real-life experience of our pocketbooks—we wanted to provide some insight into some of the data we are evaluating and how we are thinking about inflation beyond the headline numbers.

Much of the below is qualitative in nature, but it hopefully provides some insight into how we view some of the broader topics we believe are ontributing to stubbornly high inflation and elevated interest rates at this point in the business cycle.

Inflation Factors

- **Rising Government Deficits**
  As Central Banks attempt to suck up excess liquidity in the financial system with higher interest rates and quantitative tightening, increased government spending is unwinding those efforts by borrowing and spending more expansive fiscal agendas. As well, higher overall debt-servicing costs forces more borrowing by governments to cover the interest and increases liquidity in the system. More liquidity and higher interest payments paid to debt owners provides more capital to chase a finite amount of goods. All else being equal, both of these contribute to inflationary pressures.
- **Lower Productivity**
  Statistics Canada describes productivity as a measure of the efficiency with which an economy transforms inputs into outputs. In other words, how much can a worker get done and how much value does it add to the country's GDP. Increased input costs (including labour) and low productivity lead to higher inflation. Canada's productivity has been low compared to similar developed countries for decades. This has been driven by low investment in research and development as well as training and innovation. A recent study

by the Organization of Economic Cooperation and Development ('OECD') ranked Canada number 29 out of 38 countries for labour productivity. We also rank very low in economic growth in Real GDP Per Capita. The U.S. ranks significantly higher in both categories. The Bank of Canada Senior Deputy Governor, Carolyn Rogers, said in a recent speech that "... too often, new Canadians are working in jobs that don't take advantage of the skills they already possess. And too often these people wind up stuck in low-wage, low-productivity jobs." If the record levels of immigration to Canada are to translate into effective support for the Canadian economy, allowing the appropriate use of new Canadians' skills will be vitally important.

- **Artificial Intelligence**
  As AI becomes more widely applied across companies and industry, productivity levels should increase and potentially help reduce inflationary pressures going forward.

- **Housing**
  The housing market continues to be fascinating. With interest rates having increased so substantially, one would have speculated that house prices would have already adjusted downward significantly. Shelter costs in both Canada and the U.S. account for ~30% or more of the CPI. In Canada, mortgage interest makes up over 25% of the shelter cost input. As mortgages come up for renewal, mortgage costs rise, thus driving this particular component of CPI higher. It is somewhat ironic Central Banks' primary tool for fighting inflation could actually be having the opposite effect on one of the most significant components of our inflation metrics.

- **Deglobalization**
  Both economic protectionism and trade tariffs drive prices higher, thereby increasing inflation. Protectionist policies and the degradation of global trade relationships have continued to become more prevalent with the rise of populism in global politics. With so many elections taking place in 2024, this situation has the potential to worsen over the coming years.

Market Commentary

Major equity markets all moved higher in Q1, with the exception of China. Their economy continues to struggle from the fallout of their severely indebted property developers, many of whom have become insolvent. The MSCI EAFE Index outperformed Canada as it moved higher by 8.8%. MSCI Emerging Markets were also slightly positive, with a 4.0% return.

U.S. Equities

The S&P 500 continued to lead global markets, rising under 10% in Q1. There was, however, a change in sector leadership, with Communication Services and Energy replacing the Technology and Consumer Discretionary sectors as the top performers. Real estate was the only negative-performing sector. The Dow Jones Industrial Average was up 5.0% over the quarter.

Canadian Equities

The S&P/TSX Composite Index continued to lag the tech-heavy U.S. market, posting a 5.9% return. The healthcare sector led with an 18.4% return, though the impact of this sector on the overall performance of the index is marginal, having only a 0.4% weight in the overall index. West Texas Intermediate oil prices surged 15% over the quarter, which helped boost the energy sector by 13.1% (which is a 17.2% weight in the S&P/TSX Index). Communication services and utilities were the only two sectors with negative performance over the quarter.

Fixed Income

As interest rates moved higher throughout the quarter in North America, the U.S. Investment Grade Bond Index retracted by 0.47%, while Canada's Investment Grade Bond Index was virtually flat with a 0.18% positive return. Ten-year Government Bond yields moved higher this past quarter, with Canada's 10-year benchmark moving from 3.11% to 3.47%. The U.S. 10-Year Treasury Note continued its recent upward trend from 3.88% to 4.2%. A year ago, March 31st, the Canadian 10-year bond yield was 2.98% while the U.S. 10-year was 3.48%. That is a 16% and 21% increase in rates, respectively, over the past year. So much for consensus forecasts that had predicted lower interest rates being a tailwind for bond prices.

The Borger Griffiths Wealth Management team thanks you for your business and continued trust in us. We look forward to continuing to work with you and your family as we help navigate your financial journey with deep knowledge, diverse experience, and commitment on your side. If you have any questions or issues you would like to discuss, we would be happy to receive your call.

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Sources: The Bureau of Economic Analysis, Bureau of Labor Statistics, Statistics Canada, Federal Reserve Bank of St. Louis, TD Wealth Investment Office, TD Wealth Monthly Performance Monitor, BCA Research, The Globe and Mail, Bloomberg, Mauldin Economics, JP Morgan Asset Management, CEIC

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