TD Wealth

Inflation 101

Market Insights

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Wealth Investment Office

Inflation 101

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It's been over 30 years since inflation was dinner-table conversation. Most of us have heard about the dreaded stagflation of the 1970s and 20% interest rates, but many investors have never actually experienced a prolonged period of inflation. Food prices are now up nearly 10%, gasoline is up around 50%, and mortgage costs are set to rise as central banks aggressively hike interest rates.

Faced with the unknown, many investors are running scared. In fact, last quarter was the first time in 35 years that stocks and bonds both lost money simultaneously. But before we do anything rash, it's important to get some context. In this primer on inflation, we try to answer the basic questions that have preoccupied many investors for whom inflation is a new and scary concept. Think of it as a first step to understanding this strange new environment.

1. Why are prices going up?

As is often the case, there isn't just one reason — there are multiple causes that contribute to rising prices. The big picture is that prices go up when demand (or perceived future demand) exceeds supply, and ultimately that happens when demand rises much faster than supply, or when supply falls much faster than demand.

Sometimes, it's very easy to see a link between world events and rising prices. The pandemic closed many businesses and disrupted supply chains, stopping the production and transportation of many items, but because of generous government benefits and low interest rates (fiscal and monetary stimulus), demand for goods actually increased. So, with increased demand and reduced supply, it was only natural for prices to rise. Memorable price spikes in the auto and lumber industries are a good example of this. More recently, the Russian invasion of Ukraine has caused oil prices to rise because Russia is one of the largest oil producers in the world, and people feared there would be a disruption of supply — something that has partly come true.

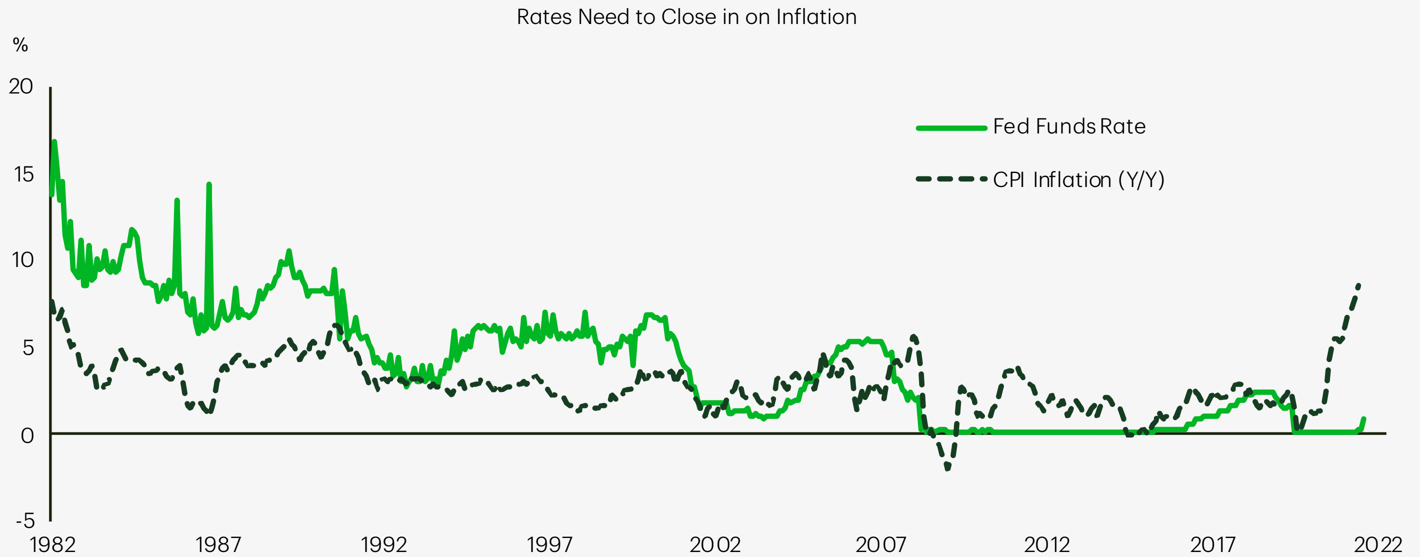
Another way to look at it is from a monetary perspective. When the supply of a particular currency rises, the value of that currency falls relative to other currencies. When the economy stalled at the start of the pandemic, central banks dramatically boosted the monetary supply by creating dollars to purchase bonds from the government, which in turn allowed the government to distribute benefits. They did this to enable people to survive income losses and to encourage spending to bolster the weakened economy.

Now, with inflation at 40-year highs, the exercise is playing out in reverse. Central banks have vowed to raise rates and sell the bonds they purchased (in the process destroying dollars and reducing monetary supply). More importantly, raising interest rates increases the cost of borrowing and decreases people's ability to spend, so this is an effort to cool off all of that demand — to bring it more in line with supply.

2. How long will it last?

No one knows for certain, but it tends to behave somewhat like a pendulum — moving too far one way, too far the other way, then eventually settling in a more balanced middle. We must keep in mind that inflation has been extremely low for a long time now, for reasons both natural (globalization, technology) and manufactured, given the central bank's mandate to maintain inflation near 2%. For decades, the Federal Reserve has been trying to spur inflation by lowering rates. Now, by ending the bond-purchase programs (a practice known as “quantitative easing”) and beginning to sell those bonds (“quantitative tightening”), central banks are trying to bring inflation back down to target. Since the early 1980s, interest rates have gone from around 20% to effectively zero; now they are bouncing back (Figure 1).

Figure 1: Rates follow inflation

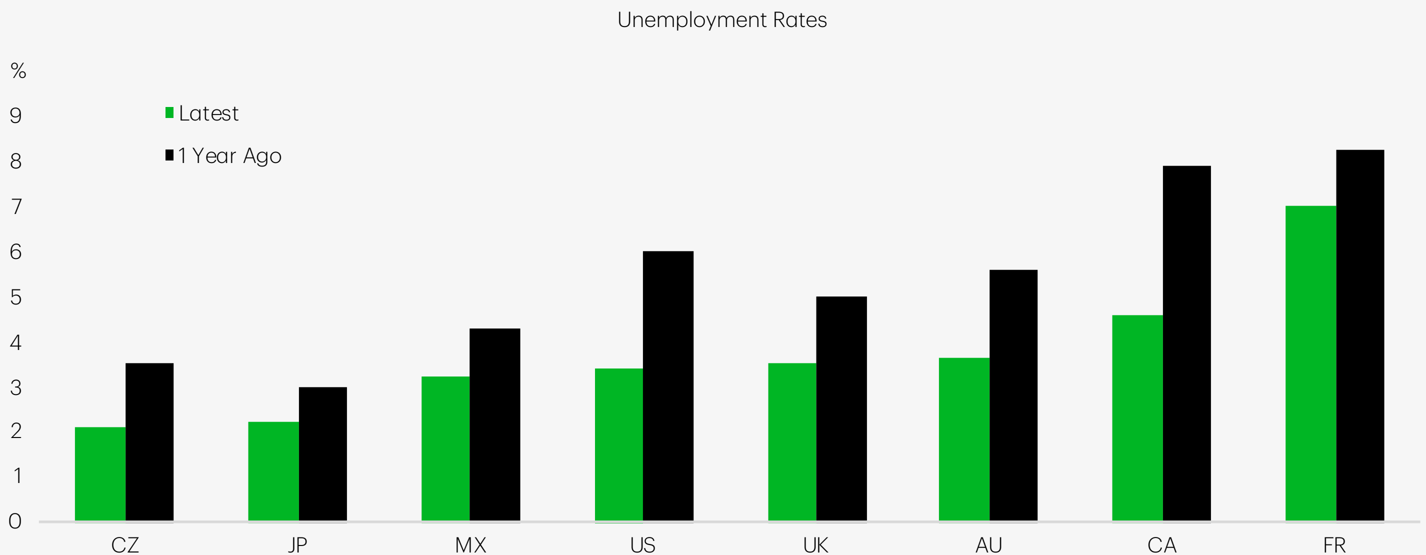


Source: Bureau of Labour and Statistics, Federal Reserve Board, TD Economics as of April 2022.

3. Does this mean we're on the way to a market crash or recession?

Not necessarily. Rising rates are more associated with a strong economy than a weak one, and the labour market is extremely strong right now, with unemployment close to historic lows (Figure 2). The real risk is that central banks raise rates too quickly. If that happens, it could reduce demand faster than necessary, leading to a recession or a market correction — but that's not a foregone conclusion. The Fed is trying to perform what's called a "soft landing," where it withdraws stimulus without driving the economy into a recession. It has done this successfully in the past. Higher rates will lead to less borrowing and purchasing; the question is whether central banks overdo it. In the late '90s — the last time rates rose for any prolonged period of time — tightening financial conditions did have a negative impact on the stock market over the subsequent two years.

Figure 2: Labour market is 'drum tight'



Source: TD Wealth as of April 2022

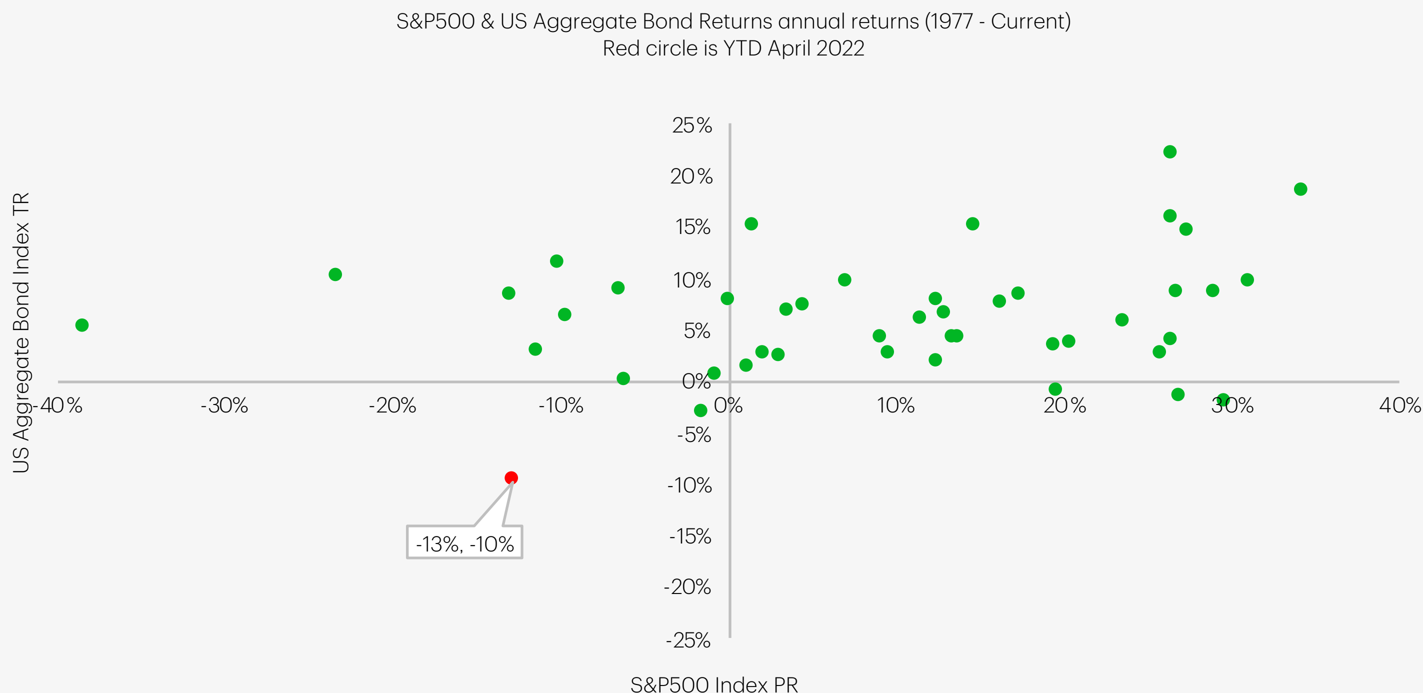
According to TD Chief Economist Beata Caranci, "The urgency of [the Fed] coming from behind on inflation must be balanced against what the economy can bear under one of the most rapid adjustments in history. An error on the front end of this cycle, of having waited too long, can quickly swing into a second error that undermines confidence by overcorrecting. When an economy has already pushed into excess-demand territory, the forces needed to quell inflationary pressures require a sustained period of sub-potential (sub-2%) growth. That thin growth buffer leaves little margin of error for an overshoot on the downside."

4. How will this impact my investments, and what should I be doing about it?

A recent survey by TD Wealth highlighted that surging inflation was the biggest cause of concern among Canadian respondents. And they are right to be concerned; this is a difficult time to be an investor. During the first four months of 2022, the MSCI All Country World Index fell nearly 13%, while the Bloomberg Aggregate Bond Index fell over 11%. It was the first quarter in 35 years where stocks and bonds fell simultaneously (Figure 3), so the vast majority of investors felt the pain of loss and found little safe haven.

As stocks fall, there is a temptation to sell and hold so-called "safe" assets like cash or government bonds. But from an inflation-adjusted (or "real") perspective, these may be guaranteed money-losers. In other words, cash held in an inflated economy remains nominally stable, but in inflation-adjusted terms, it doesn't go as far as it used to because prices have gone up. There is also a temptation to "reach for yield" (i.e., invest in assets paying high yields in an effort to outpace inflation). This, however, can bring unintended consequences given that the highest yields tend to come with the highest risks. Speak with your financial advisor and ensure that your portfolio's asset allocation is right for you. If it is, stick to the long-term plan and don't attempt to time the market — something we know is virtually impossible.

Figure 3: Worst start for bonds and equities in 35 years



Source: TD Asset Management, Bloomberg Finance L.P. as of April 30, 2022.

Fear is the enemy, not inflation

Inflation-induced volatility can lead to short-term swings in the market, which can be difficult to stomach. While it may be tempting to pull out and try to avoid the downturns, by doing so investors may miss out on a potential market rebound and opportunity for gains while they are on the sidelines. History has shown that the longer an investor stays in the market, the greater the chances of a positive outcome.

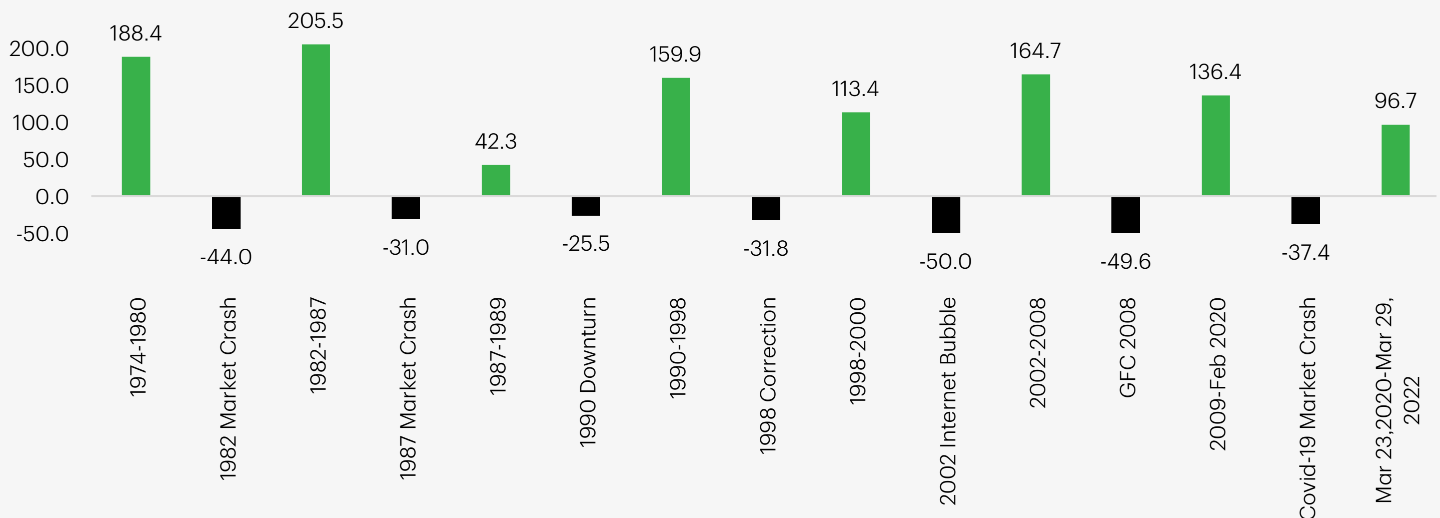
The S&P 500, for example, has suffered through several market downturns (peak-to-trough declines of more than 20%) only to see even stronger rebounds afterwards (Figure 4). Canadian investors also enjoyed nice upswings following periods of market downturns (Figure 5). While past results are not an indication of future performance, it gives us a sense of comfort and rebuilds confidence in our long-term investment plans.

Instead of trying to forecast unpredictable events such as market bottoms, investors should remain calm and focus on things they can control. It's a good time to have a closer look at current investments to ensure a well-diversified portfolio is still in place and is properly aligned to achieve your long-term goals. Leave market timing to the speculators and let time be your friend. Stay invested to improve your chances to reap the benefits of market recoveries.

Figure 4: S&P 500 Contraction & Rebound (%)

Source: Bloomberg Finance L.P. and TD Wealth as of May 12, 2022.

Figure 5: TSX Contraction & Rebound (%)



Source: Bloomberg Finance L.P. and TD Wealth as of May 12, 2022.

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