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THE BIG PICTURE

Tightening, again

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Given the persistence of "low for long" monetary policy employed by virtually all of the world's major central banks, it may be only the longest-tenured investors that can recall the bygone days when interest rates rose and fell in patterns that corresponded to a business cycle. The economic recovery from the COVID-19-induced recession, now underway in North America, has produced far greater inflationary pressure than anticipated. Traditionally, the standard central bank response to rising inflation would be to "tighten" monetary policy by raising interest rates. Given the near-universal use of quantitative easing (QE) programs, the first move to tighten policy this time has instead been be a reduction or cessation of these asset purchase programs. Once these taps are fully turned off, monetary tightening can be expected to be a combination of raising interest rates and the outright sale of assets that these central banks have accumulated on their balance sheets. Regardless, the era of near-zero interest rates and unparalleled central bank asset purchasing is set to end. The interrelation of economic growth, interest rates and the financial markets means that regularly reviewing one's financial plan and taking advantage of professional advice is the best way to help navigate these volatile times.

Policy shifts

While it seems like a distant memory, financial markets suffered through what is now colloquially referred to as a "taper tantrum" during the summer of 2013. Not surprisingly, current U.S. Federal Reserve Board (the "Fed") Chair Jerome Powell learned from his predecessors and has been cautious to avoid repeating this episode. In order for Powell to clearly telegraph his intentions and circumvent another tantrum, the press release that accompanied the September 2021 Federal Reserve Open Market Committee (FOMC) meeting, stated that "the Committee judges that a moderation in the pace of asset purchases may soon be warranted." Further, the update to the FOMC's "dot plot" indicated that officials were evenly split (nine of 18) on their expectations for an interest rate hike in 2022, up from seven of 18 in June. At the subsequent meeting in November 2021, the Fed followed up by announcing a $10 billion reduction in monthly purchases of Treasury bonds and a $5 billion reduction in monthly purchases of mortgage-backed securities. Similar moves are now anticipated until QE is wrapped up.

Likewise, the Bank of Canada (the "BoC") announced that it was holding interest rates steady at its November 2021 policy announcement window. However, the BoC surprised market participants by stating that it was "ending quantitative easing and moving into the reinvestment phase." This means that it will purchase Government of Canada bonds solely to replace those that are maturing. Further, the press release acknowledged the continued bout of inflationary pressures, stating that energy constraints and supply bottlenecks "now appear to be stronger and more persistent than expected." In the BoC's updated

economic forecast, consumer price index (CPI) growth is now expected to be 3.4% for 2021 (up from its July forecast of 3.0%), 3.4% for 2022 (versus 2.4%) and 2.3% for 2023 (versus 2.2%). Conversely, GDP is expected to grow by a smaller 5.1% in 2021 (versus 6.0%) and by 4.3% in 2022 (versus 4.6%), but by 3.7% in 2023 (versus 3.3%). The press release underscored a significant shift to a more "hawkish" stance with the probability of interest rate hikes moving closer along the current timeline. In both the U.S. and Canada, the markets responded reasonably well to these policy shifts, but it was clear that interest rates would soon be rising.

Previous cycles

As outlined in the accompanying table, previous tightening cycles have varied considerably. Since 1994, there have been five tightening cycles in the United States. The duration of these cycles varied from 517 days to 1,323 days. Cumulative increases in rates were as small as 25 basis points (a basis point is 1/100th of one percent) and as large as 425 basis points. However, as starting interest rates also varied widely, the cumulative percent increases ranged an even more exaggerated 4.8% to 1,800.0%. The BoC is often criticized as simply being in lockstep with the Fed. The table below demonstrates the contrary. Domestically, over the same period, the BoC orchestrated seven tightening cycles with differing properties. The duration of these tightening cycles experienced a wider range, from a low of just 173 days to as long as 1,695 days. Conversely, the cumulative increases in rates were more narrowly confined (between 75 and 300 basis points). Here at home, the cumulative percent increases in rates ranged from 26.3% to 166.7%. Even though metrics around prior cycles can provide a useful backdrop, it can be expected that the pending tightening cycle will be difficult to predict. The heightened indebtedness of households, businesses and governments translates into far greater sensitivity to upward movements in interest rates. Raising interest rates, to fight inflationary pressures, increases the risk of cooling off the economy too quickly and potentially returning it to a recessionary period. Undoubtedly, central banks will be very cautious as they move down the road to tighter monetary policy.

North American Central Bank Tightening Cycles (1994 to Present)																
U.S. Federal Reserve Board - federal funds rate^									Bank of Canada - Bank Rate*							
First rate hike	First (subsequent) rate cut	Number of hikes	Duration (days)	Starting rate	Ending rate	Total rate increase	% change		First rate hike	First (subsequent) rate cut	Number of hikes	Duration (days)	Starting rate	Ending rate	Total rate increase	% change
4-Feb-94	6-Jul-95	7	517	3.000%	6.000%	3.00%	100.0%		16-Nov-94	8-May-95	7	173	5.25%	8.25%	3.00%	57.1%
25-Mar-97	29-Sep-98	1	553	5.250%	5.500%	0.25%	4.8%		26-Jun-97	29-Sep-98	6	460	3.25%	6.00%	2.75%	84.6%
30-Jun-99	3-Jan-01	6	553	4.750%	6.500%	1.75%	36.8%		17-Nov-99	23-Jan-01	4	433	4.75%	6.00%	1.25%	26.3%
									16-Apr-02	15-Jul-03	5	455	2.25%	3.50%	1.25%	55.6%
30-Jun-04	17-Aug-07	17	1143	1.000%	5.250%	4.25%	425.0%		8-Sep-04	4-Dec-07	10	1182	2.25%	4.75%	2.50%	111.1%
									1-Jun-10	21-Jan-15	3	1695	0.50%	1.25%	0.75%	150.0%
16-Dec-15	31-Jul-19	9	1323	0.125%	2.375%	2.25%	1800.0%		12-Jul-17	4-Mar-20	5	966	0.75%	2.00%	1.25%	166.7%
Average		**8.0**	**817.8**			**2.30%**	**473.3%**		**Average**		**5.7**	**766.3**			**1.82%**	**93.1%**

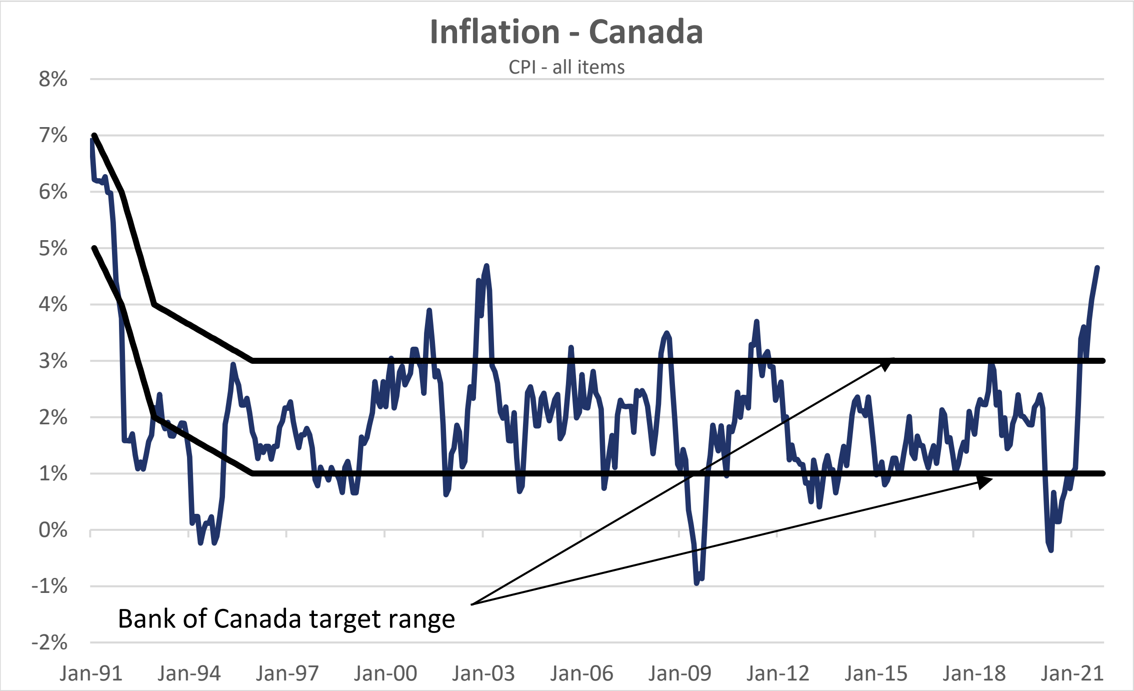
^ On December 16, 2008 the Fed adopted a "range" as the target for the federal funds rate for the first time.
* On April 21, 2009 The Bank of Canada narrowed its "range" for overnight borrowing from 50 bps to 25 bps. The high end of the range continues to be the official Bank Rate.

Source: Bank of Canada; U.S. Federal Reserve Board.

Inflation

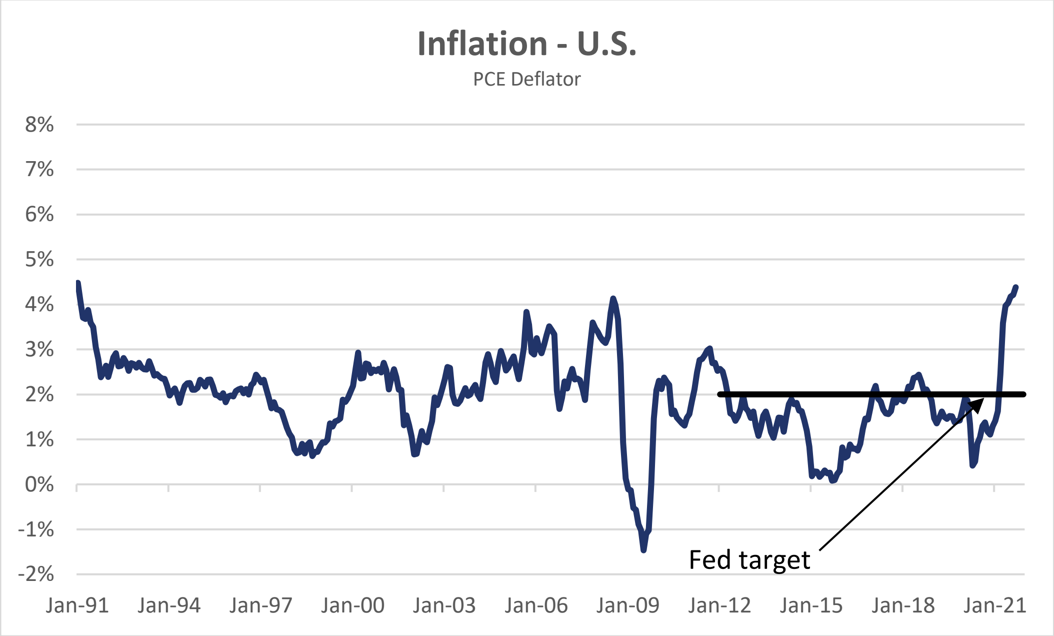
The period between the financial crisis and the COVID-19 pandemic was characterized by widespread concerns over ***deflation***. However, as the North American economies have reopened, concerns over inflationary pressures have resurfaced. The U.S. Bureau of Labour Statistics reported that the CPI rose again in October, climbing 0.9% (seasonally adjusted). The monthly gain was sufficient to return the annual pace of inflation to 6.2% (unadjusted), which is now the fastest pace of inflation since November 1990 (6.3%). This was also the sixth consecutive monthly reading at or above the 5% level, the longest stretch of sustained 5% inflation since the August 1990 to February 1991 (seven consecutive months) period. Domestically, Statistics

Canada reported that consumer prices rose 0.5% (seasonally adjusted) in October, following September's 0.6% gain. However, on a year-over-year basis, the Canadian CPI was up a less alarming 4.7%. Still, this is the fastest pace of inflation in Canada since February 2003 (also 4.7%). Both the data in Canada and the U.S. suggest that inflationary pressures have yet to peak. This will introduce further doubt around expectations that the recent move higher is actually transitory, as both central banks have suggested. Either way, markets will be concerned with where inflation settles once any transitory factors actually do dissipate.



Source: Bank of Canada; Statistics Canada.

Like many other nations, both the Canadian and U.S. central banks have adopted inflation targets. The Bank of Canada was one of the "early adopters." Under then Governor John Crow, the BoC initiated an inflation target in February 1991. The reference benchmark at the time was the CPI, less the effects of indirect taxes. This was to compensate for the influence of the relatively new GST. As outlined in the accompanying graph below, at the time the hope was that inflation could be coaxed down from the prevailing 6.9%. The process was successful and it critically aided in lowering inflation expectations, which is a key driver of price pressures. It was renewed in December 1993 under Governor Thiessen with the 1% to 3% target band being established in mid-1994. Successive renewals occurred through to 2016 with only minor adjustments. Nevertheless, with the next renewal now set for December 2021, questions have surfaced. Analysts have suggested that political interests may introduce a second mandate for the BoC, specifically for the unemployment rate, similar to the dual mandate structure of the U.S. Federal Reserve.



Source: U.S. Federal Reserve Board; U.S. Bureau of Economic Analysis.

Following its meeting in January 2012, the FOMC issued a statement regarding its longer-run goals and monetary policy strategy. The FOMC noted in its statement that “the Committee judges that inflation at the rate of two percent (as measured by the annual change in the CPI for personal consumption expenditures, or PCE) is most consistent over the longer run with the Federal Reserve's statutory mandate.” Communicating this inflation goal was, again, intended to stabilize longer-term inflation expectations. Regardless, both nations have seen “above-target” inflation for several months now.

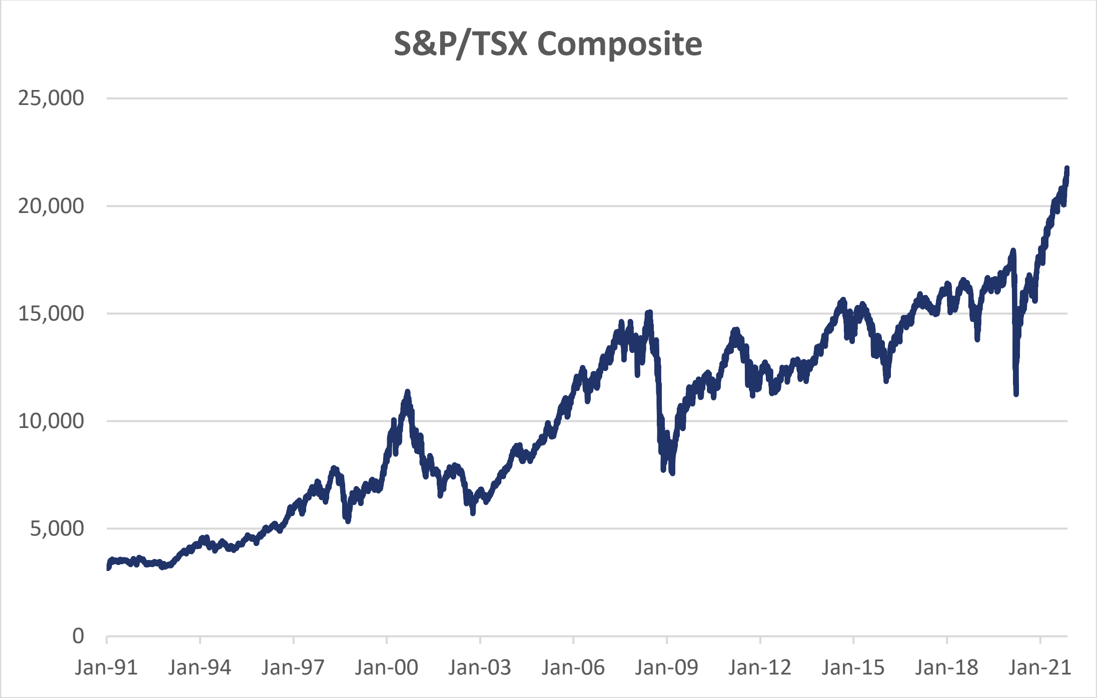
Equity markets

As can be seen in the accompanying table, equity market responses to previous tightening cycles have also varied considerably. The notion that the initial stages of the tightening cycle would result in equity market weakness, which would dissipate over time, is generally borne out by the data. In the U.S., ***on average***, the equity market recorded a 0.5% decline over the first three months of the tightening cycle. This subsequently changed to an average gain of 5.9%, 12.2% and 14.9% at the six-month, 12-month and 18-month marks, respectively. The historical pattern is less clear in Canada. Even though metrics around prior cycles can provide a useful backdrop, it can be expected that the pending tightening cycle will be difficult to predict. In Canada, ***on average***, the equity market recorded a 4.6% gain over the first three months of the tightening cycle. This was followed by rising then diminishing gains. Average gains of 7.1%, 11.3% and then 10.9% were posted at the six-month, 12-month and 18-month marks, respectively. However, the averages tend to mask some vastly different outcomes in each individual case.

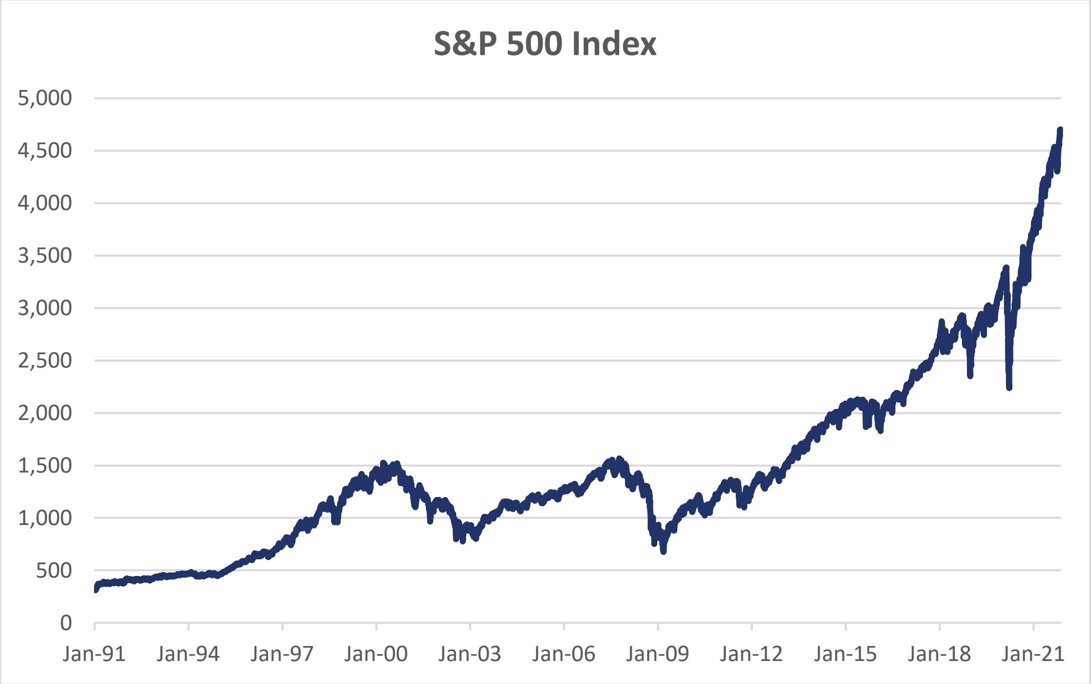
Equity market responses to tightening cycles												
U.S. S&P 500							Canada S&P/TSX					
First rate hike	S&P 500 Start	After 3 months	After 6 months	After 12 months	After 18 months		First rate hike	S&P/TSX Start	After 3 months	After 6 months	After 12 months	After 18 months
04-Feb-94	469.8	-3.9%	-2.4%	1.9%	19.0%		16-Nov-94	4,171.7	-1.7%	4.2%	9.7%	24.8%
25-Mar-97	789.1	12.7%	18.9%	39.6%	32.4%		26-Jun-97	6,453.7	8.1%	1.3%	13.7%	0.2%
30-Jun-99	1,372.7	-6.6%	6.7%	6.0%	-3.8%		17-Nov-99	7,591.3	24.7%	25.8%	17.9%	8.4%
							16-Apr-02	7,841.6	-14.6%	-21.5%	-17.3%	-0.6%
30-Jun-04	1,140.8	-2.3%	6.4%	4.4%	9.4%		08-Sep-04	8,354.8	7.8%	18.5%	29.0%	40.5%
							01-Jun-10	11,572.0	3.7%	13.6%	16.9%	4.7%
16-Dec-15	2,073.1	-2.2%	0.2%	8.9%	17.4%		12-Jul-17	15,144.0	4.0%	7.7%	9.4%	-1.4%
Average		**-0.5%**	**5.9%**	**12.2%**	**14.9%**		**Average**		**4.6%**	**7.1%**	**11.3%**	**10.9%**

Source: Bank of Canada; U.S. Federal Reserve Board; Commodity Systems Inc.

Energy price gains have fuelled equity investors’ interest in Canada. Stock buyers continued to support market optimism, as the S&P/TSX Composite rose to a new all-time high in November. The index closed trading on November 12 at the 21,768.5 level, a new record that marked a 24.9% gain since the end of 2020. A cold snap in Europe that coincided with prolonged low wind speeds left electricity providers scrambling for more conventional energy sources. In late September, coal prices moved to US$200 per metric ton, their highest point since 2008. Similarly, spot prices for West Texas Intermediate breached the US$85 level on October 26, 2021. This was the first move above US$85 since October 13, 2014. With Canada variously ranked as either second or third in established oil reserves, buyers have been supportive as concerns spread that Europe’s energy crunch may be longer lived than first anticipated. Similarly, equity markets in the U.S. have moved higher as expectations of a full economic recovery and subsequent expansion has fuelled buying interest. The S&P 500’s close on November 8 established a new high and a 25.2% gain from the end of 2020. Both markets appear to possess considerable momentum. Their ability to retain this momentum in the face of higher interest rates will soon be tested.



Source: Commodity Systems Inc.



Source: Commodity Systems Inc.

CONCLUSIONS

- The clear majority of the world’s central banks have employed extremely accommodative monetary policy for an extended period of time. With the reappearance of material inflationary pressures, this is now beginning to change
- Changing monetary policy, both domestically and in the U.S., can be expected to heavily influence the markets. While looking at historical developments may be helpful, the full impact this time will be very difficult to predict
- Seasoned investors recall old-school business cycles and have seen mixed market reactions across time. Having the benefit of a properly constructed financial plan and a trusted advisor can help take emotions and the temptation to alter course off the table

For more information, we encourage you to speak to your advisor or visit us at assante.com

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