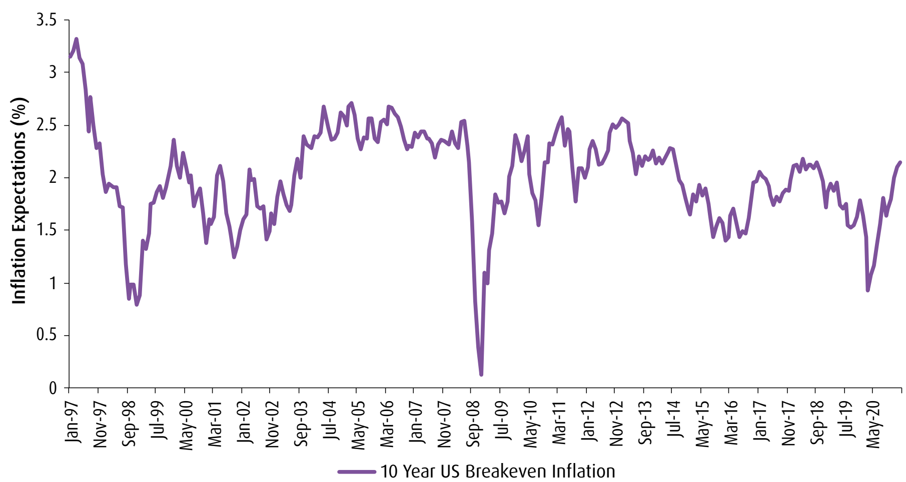
Inflation and Interest Rates

Current Market Conditions: What is the Market Saying?

The U.S. Federal Reserve stated back in August 2020 that they would adopt a policy of "average inflation targeting," meaning they would allow inflation to run beyond its 2% target "for some time."

In response, many indexes notched new highs to close out 2020, as the market looked beyond the economic woes brought upon by the COVID-19 pandemic to price in the eventual recovery. Fast forward to March 2021, inflationary pressures have indeed started to dominate market sentiment, as a sharp surge in January producer price index in January (1.3% MoM, the largest gain since 2009) reported in mid-February seemingly reminded the market of inflation. Inflation expectations rapidly ran up, with the market now calling for an average inflation rate of 2.15% over the next 10 years, which is roughly in line with the Bank of Canada's (BoC) and the U.S. Federal Reserve's (the Fed) initial inflation target of 2%.



Source: Bloomberg. February 26, 2020.

Inflation Forecasts: What are Economists Thinking?

Many economists are forecasting inflation above 2% in 2021 and 2022. This prediction is based on several facts:

- The Fed has stated they will allow inflation to run above 2% for a sustained period before hiking interest rates and the Bank of Canada will likely follow.
- Monetary stimulus that flooded the market in 2020 in both Canada and the U.S. is at historic levels.
- Government spending has skyrocketed in order to prop up shut down economies. In Canada, the stimulus package is to the tune of $100 billion, while the U.S. has just passed a colossal $1.9 trillion stimulus bill..
- A Democratic sweep led by the Biden Administration points to an increase in overall government spending, with control of both the Senate and House increasing the likelihood that these bills will pass.
- Energy prices are rising, with the WTI Crude recently crossing $60 per barrel for the first time since the pandemic. As the vaccine is disseminated and the economy reopens, the demand for oil should increase. Ultra-low energy prices in 2020 was a large contributor to the below-average inflation rate.
- Commodity and Material prices are rising; gold, silver and copper all rallied sharply throughout 2020. As these inputs become more expensive, the overall cost of goods will eventually be passed on to consumers.
- Cost-push inflation of COVID-19 related expenses: Many goods and services have had increased input costs based on investing in PPE, sanitary requirements, and increased wages for front line workers. These will also be pushed forward to consumers.

How can inflation impact the markets?

Inflation expectations can move markets quickly as investors adjust interest rate outlooks. As an example, bond markets reacted wildly in late February 2021, which saw benchmark government yields jump when investors exited bonds, as higher inflation could render the bond payments even less valuable. Longer-term bonds with cash flow streams well into the future are therefore subject to higher duration risk, and are correspondingly more sensitive to inflation expectations.

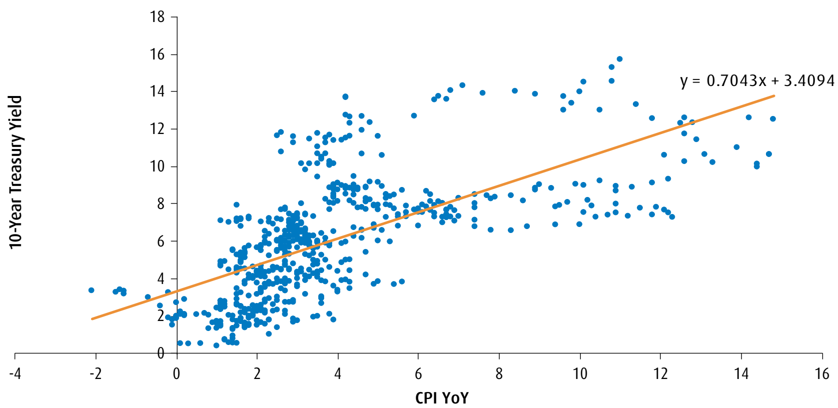
The rise in interest rates also has an immediate impact on equity valuations, as the higher risk-free rate raises the cost of equity. Value stocks, broadly defined as companies with more immediate cash flows, have thus far been relatively shielded from the inflation narrative, as the present value of cash flows are higher as opposed to a high growth stock whose earnings are far into the future. As a result, dividend-centric stocks generally held up better than growth stocks.

A note on interest rates...

The relationship between interest rates and inflation is not always absolute. Generally speaking, lower interest rates induce economic growth by lowering the cost of money, which eventually drives up price levels and leads to inflation. To combat unsustainable levels of price increases, central banks raise policy rates to prevent the economy from over-heating. However, note that this time central banks have shown little appetite to raise rates. In fact, **BMO's Multi-Asset Solutions Team** does not believe inflation will run high enough for central banks to hike rates, as many economies remain ravaged by the coronavirus pandemic. Below is a quick look at the relationships between 10-year US treasury yields, Consumer Price Indices and Federal Reserve policy rates.

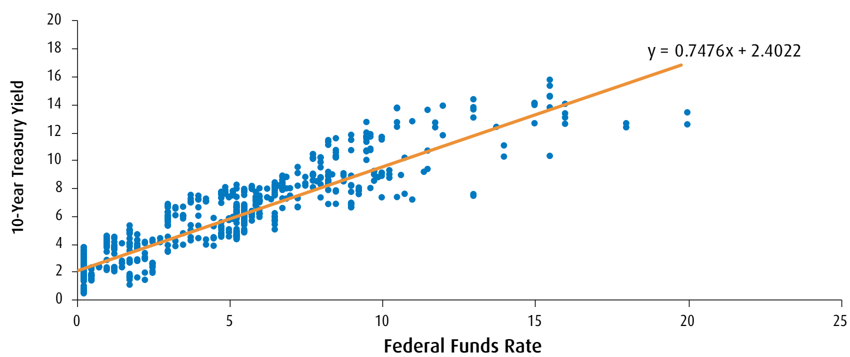
CPI and US 10-Year Treasury Yield

Regression Statistics	
R	0.66
R Square	0.44
Adjusted R Square	0.43
Standard Error	2.38
Observations	602



Federal Funds Rate and US 10-Year Treasury Yield

Regression Statistics	
R	0.91
R Square	0.83
Adjusted R Square	0.83
Standard Error	1.30
Observations	602



Source: BMO Global Asset Management, Bloomberg.
From January 1971 to February 26, 2020.

Over the last 50 years, although there has been a meaningful correlation of 0.66 between 10-year treasury yield and inflation, the relationship is not very linear, with a relatively weak R^2 of 0.44 indicating modest explanatory power. Meanwhile, the correlation of the 10-year US treasury yield and Federal Funds Rate is 0.91, with an R^2 of 0.83. This makes sense, as central banks directly affect short-term rates. Although correlation does not equal causation, the regression analysis illustrates that strong inflation data by itself does not necessarily lead to higher rates, and it is important to take into account central bank rhetoric. Both the Federal Reserve and the Bank of Canada have repeatedly stated that they are unlikely to raise policy rates in the foreseeable future.

Equity Portfolio Positioning

Low Leverage, Healthy Free Cash Flow

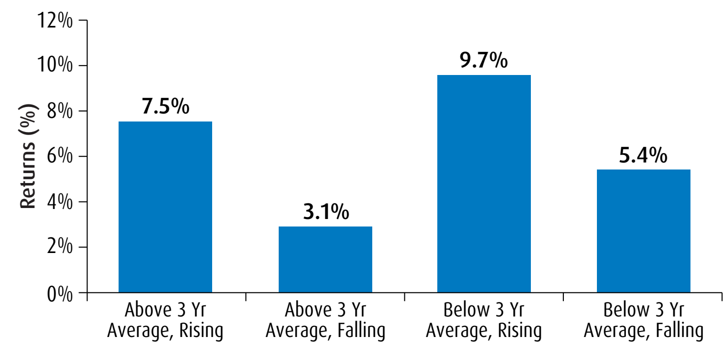
Brian Belski, Chief Investment Strategist at BMO Capital Markets and portfolio manager for **BMO U.S. Equity Plus Fund**, has found that stocks with a combo of low leverage and strong cash flow have tended to outperform when interest rates rise. That should perhaps come as no surprise, given that firms with lower leverage as well as higher cash flows can cover immediate debt obligations without having to raise additional capital. Curiously, his research highlights that the performance of this class of stocks tends to be stronger the greater the rate increases. Brian goes as far as to say that equity investors should not necessarily fear rising interest rates, as it can mean the bond market is anticipating economic growth and staying ahead of inflation. Investors interested in a low leverage, strong cash flow combo can also consider **BMO Concentrated U.S. Equity Fund**, as well as **BMO Concentrated Global Equity Fund**, both ultra-concentrated portfolios that seek to invest in quality stocks with sustainable cash flows, while avoiding overly leveraged businesses.

Dividend Growth Stocks

While passive income vehicles might come under pressure during inflationary environments, companies that consistently raise dividends can provide a solid inflation hedge. In particular, investors should pay attention to bank stocks, a rare breed of income stocks that continues to deliver cash flow in a low rate environment, possess a track record of sustainably raise dividends over time to combat inflation, and whose bottom lines also benefit from potential interest rate hikes. **BMO Covered Call Canadian Banks ETF Fund** and **BMO Dividend Fund** both offer meaningful exposure to Canadian bank stocks, with the latter also owning dividend growers in areas such as Real Estate, Industrials and Utilities.

Stocks With Low Leverage and High Free Cash Flow Post Solid Gains When Interest Rates Rise

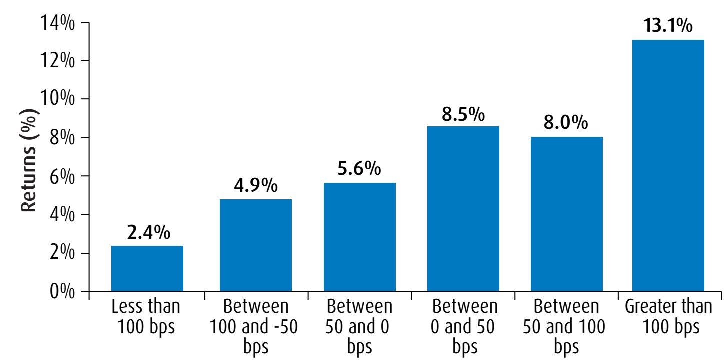
Performance Spread: Top vs. Bottom Quartile by Leverage and Cash Flow Rank. A difference of rolling 1 year performance based on 10 year treasury yield level and direction; monthly data, beginning 1990



Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

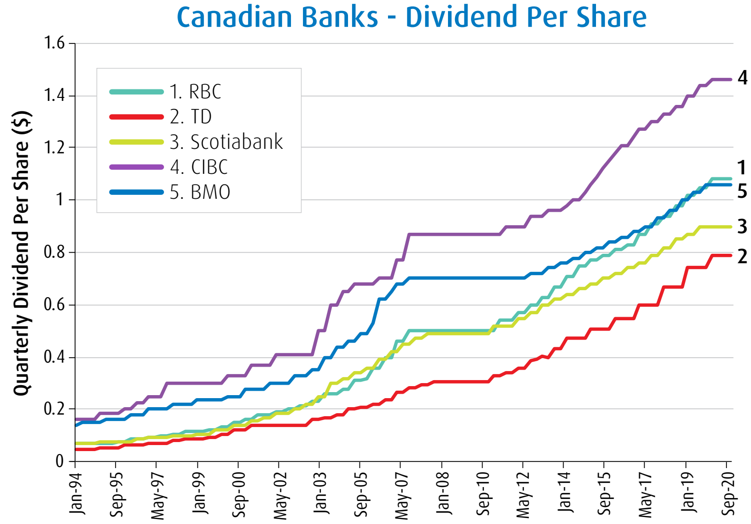
The Greater the Increase in Rates, the Stronger the Performance of Low Leverage + High Cash Flow Stocks

Performance Spread: Top vs. Bottom Quartile by Leverage and Cash Flow Rank. A difference of rolling 1 year performance based on year-to-year in 10 year treasury yield; monthly data, beginning 1990



Source: BMO Capital Markets Investment Strategy Group, Bloomberg, FRB.

Canadian Banks - Dividend Per Share

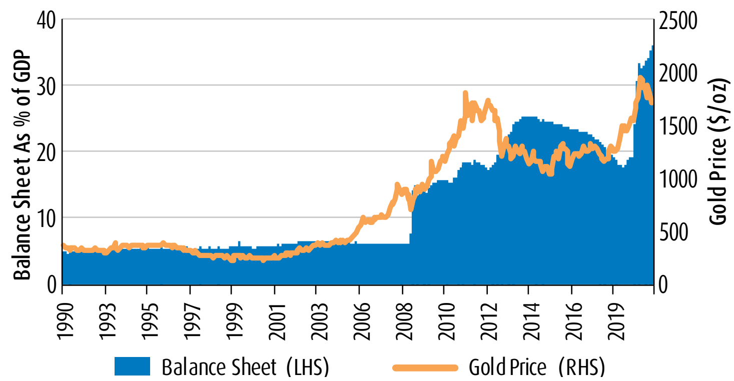


Source: BMO Global Asset Management, Bloomberg. From January 1994 to February 26, 2020.

Gold

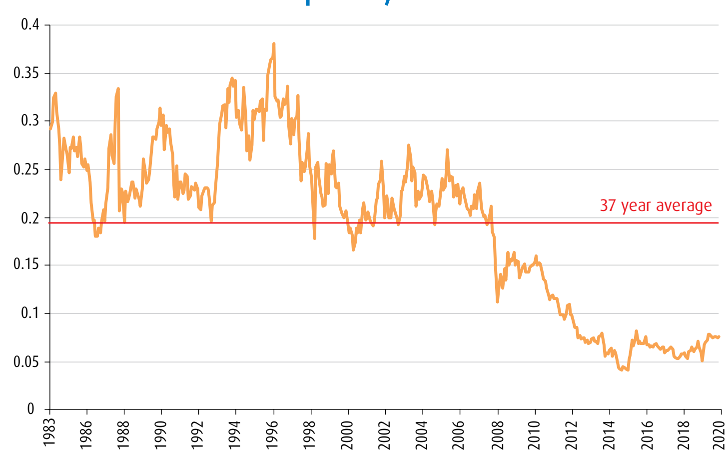
The yellow metal is a non-income generating asset. The asset class is also generally not consumed, and although prices have generally mirrored central bank balance sheets, it is hard to put a finger on what drives the fundamental value of gold. Questions have been asked about its correlation to inflation and thus by extension its inflation-hedging abilities, but what is certain is that a lower risk-free rate decreases the opportunity cost of owning gold. Research[1] from economists Claude Erb and Campbell Harvey has shown that gold has largely held the same purchasing power over 2000 years, irrespective of the price of gold. As such, investors should consider it as a diversifier that represents a good store of value due to its relatively constant supply (unlike paper money which can be printed by central banks). **BMO Precious Metals Fund** is a great way for investors to gain access to gold equities, which continue to trade below its historic average relative to gold bullion.

Federal Reserve Balance Sheet



Source: Bloomberg, December 1990 to February 2021.

Gold Equities / Gold Bullion

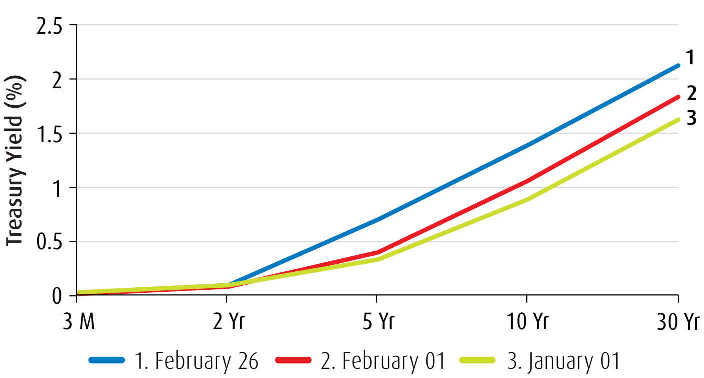


Source: Bloomberg. December 1983 to February 2021.

Fixed Income Portfolio Positioning

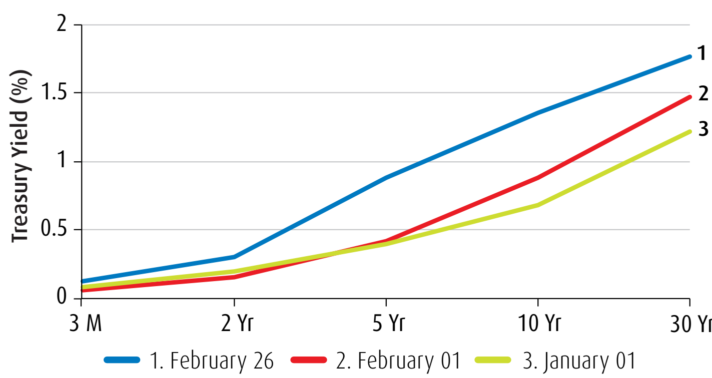
In both the US and Canada, yield curve movements since the beginning of the year have been material. The short-end of the curve has largely been held in place by accommodative monetary policy, while the longer-end has been more sensitive to inflation expectations. BMO's fixed income team believes that while higher long-term rates is in line with the team thesis, steepening has been aggressive and remains vulnerable to central bank activity or disappointment in economic activities.

U.S. Yield Curve



Date	3 Mo	2 Yr	5 Yr	10 Yr	30 Yr
01-Jan	0.06	0.12	0.36	0.91	1.64
01-Feb	0.05	0.11	0.42	1.08	1.85
26-Feb	0.03	0.13	0.73	1.40	2.15

Canada Yield Curve



Date	3 Mo	2 Yr	5 Yr	10 Yr	30 Yr
01-Jan	0.08	0.20	0.39	0.68	1.21
01-Feb	0.07	0.15	0.42	0.88	1.47
26-Feb	0.12	0.30	0.88	1.36	1.76

Source: Bloomberg.

Bond investors who are interested in maintaining lower sensitivity to inflation and interest rates can seek portfolios with lower duration. **BMO Mortgage and Short Term Income Fund** is predominantly positioned in the short-end of the curve with a duration of 2.65, investing in high quality mortgages or mortgage backed securities as well as other short-term securities. Alternatively, **BMO Global Multi-Sector Bond Fund** maintains a reasonably low duration of 4.4, but offers global exposure for investors who seek to diversify geographically, and also takes on more credit risk in a bid to generate higher yield.

BMO Mutual Funds To Consider

	Fund Code		MER(%)	
BMO Mutual Fund	**Advisor**	**F**	**Advisor**	**F**
BMO U.S. Equity Plus Fund	99744	95744	2.20	0.82
BMO Concentrated U.S. Equity Fund	99773	95773	2.03	0.90
BMO Concentrated Global Equity Fund	99213	95213	2.07	0.95
BMO Covered Call Canadian Banks ETF Fund	99765	95765	1.63	0.73
BMO Dividend Fund	99146	95146	1.80	0.70
BMO Precious Metals Fund	99147	95147	2.42	1.10
BMO Mortgage and Short-Term Income Fund	99141	95141	1.28	0.58
BMO Global Multi-Sector Bond Fund	99162	95162	1.30	0.66

Management Expense Ratios (MERs) are the audited MERs as of September 30, 2020.

BMO Global Asset Management

Let's connect

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[1] The Golden Dilemma, Claude B. Erb and Campbell R.Harvey, National Bureau Of Economic Research, January 2013. https://www.nber.org/system/files/working_papers/w18706/w18706.pdf

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