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The economic definition of inflation is a general rise in prices and a fall in the purchasing value of money. There are generally three accepted causes of inflation: demand-pull, cost-push, and built-in. Without getting too technical (ie. commenting on Robert Gordon, Milton Friedman, the Philips curve, etc.) we are arguably currently experiencing a demand-pull inflationary moment in that aggregate demand is outweighing aggregate supply or more simply put: too much money is chasing too few goods. The current inflationary situation would appear to be the result of years of central bank monetary policy easing allowing governments to extend their profligate fiscal policies. First, we had the inflation fighting '80's when US Fed Chairman Paul Volker aggressively raised short-term interest rates to 20%, resulting in a global recession. A four-decade long period of low inflation followed (the so-called Great Moderation) which, despite a number of market events (Tech Wreck, Savings & Loan crisis, etc.) didn't lead to inflationary pressures we saw in the '70's. Then we had the Financial Crisis in 2008 which led to monetary easing (and brought us the term Quantitative Easing – QE) which saw central bank balance sheets expand to "save" the world economy. During this phase government debt also ballooned (the value of publicly traded US Treasuries is now more than $23 trillion) as fiscal policy expanded to cure our economic ills. Despite improving economic circumstances and record low unemployment post 2008 central banks failed to materially reduced their balance sheets and governments continued to run deficits. Next up was the unfortunate arrival of a pandemic in 2020 which, understandably, resulted in more expansionary policy responses from central banks and governments to shore-up declining economies.

Since 2008 we have experienced a period where there was a central bank "put" anytime economic circumstances portended a financial asset downturn (ie. stock markets). These policies had the unintended consequences of asset inflation (higher stock markets and housing prices) but with a lack of consumer inflation. During this extended period there were even concerns that economies might be subject to deflation and that a similar situation to that of Japan (an extended period of no growth and falling prices) may afflict Western economies. As the prospect of deflation raised its ugly head Central banks were actively targeting higher inflation to raise inflation to their 2% target level – remember that period.

Now we are encountering a period of higher inflation, which seems to have taken central banks by surprise, and despite their insistence to the contrary, doesn't appear to be transitory. There is still the feeling that a return to low inflation normality is imminent and bond yields will decline and asset prices will rise once again. This begs the question: is the period of inflation-free monetary stimulus over and what are the consequences for asset prices in general and bond yields in particular? To answer this question, we need to try to understand developments which determine the macro-economic environment. Was it the actions of the US Fed in the early

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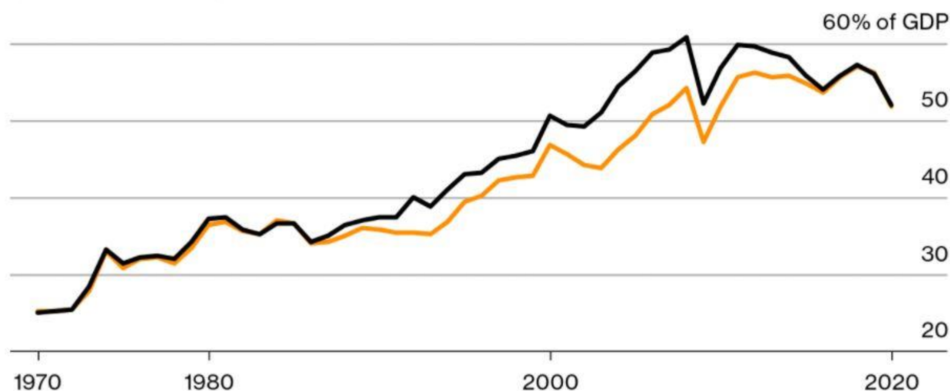
'80's that set the stage for the Great Moderation or were other factors at play? The inclusion of China into the global trading system had a massive dis-inflationary global impact and due to the fact that expanding international trade inflationary pressures were capped (not, apparently, due to monetary policies), bond yields started a long-term decline and global poverty levels fell dramatically. Global trade peaked in 2008 at 61% and has declined to just 52% in 2020 and since 2020 we have suffered through a pandemic, a kinetic war in Europe, increasing climate change manifestations, and the greatest supply-chain dislocation in years. Therefore, if we look through the lens of declining global trade trends, even when we exit the likely upcoming recession it is questionable that price stability will be restored. As central banks attempt to inject stimulus in the future there will be more immediate inflationary consequences and as the chances of any meaningful near-term reduction in the vast amounts of central bank borrowing, built up during years of quantitative easing, diminishes so too does flexibility. Bond yields were suppressed for such an extended period that it led to distorted asset allocation decisions which manifested into the 2008 financial crisis - monetary accommodation did not necessarily lead to lower inflation but did lead to financial market fragility. Quantitative easing will likely be around longer than expected and thoughts of a return to a "normal" low inflationary 2% environment are likely misplaced. Current bond yields do not represent long-term equilibrium and certainly do not discount persistent inflation and this, unfortunately, will adversely impact all manner of assets.



The value of currencies has emerged as an ever-larger part of the inflation equation and the decline in the G-7 currencies versus the US dollar (CAD -8.6%, EUR -13.8%, CHF -7.5%, GBP -17.5%, JPY -20.5% year to date) is not helping. In the past countries were generally comfortable with a weaker currency because this meant that domestic companies could sell goods abroad at more competitive prices, which helped economic growth. However, today is another story with the cost of everything from fuel to food to consumer goods soaring

strengthening buying power through a stronger currency is more important. A weaker currency is not helping exports as economies stall but is abetting higher inflation through higher import prices, and in particular energy costs.

Canada

The most recent measure of Gross Domestic Product (GDP) showed that the Canadian economy was flat in August, after only gaining 0.1% in July and June and since April growth has only averaged 0.1% on a monthly basis. These figures coupled with declining job vacancies are indicative that growth has started to decelerate. Multi-decade high inflation and sharply higher interest rates are weighing on economic growth. While Canada has benefited from strong energy prices, we are not immune to global economic headwinds and higher borrowing costs. A slowing economy won't likely dissuade the Bank of Canada from increasing interest rates so long as inflationary pressures persist. Manufacturing, construction, and wholesale trade sectors have contracted and higher interest rates have contributed to slower real estate activities and falling house prices. Angst over inflation headlines and declining real estate values have led to consumer confidence near record lows, with the exception of those reached during of the depths of the last 2 economic crises. Mortgage rates have moved dramatically higher and have reached levels not seen in a generation. Retail spending has held up and is likely due to the carry over of pent-up demand from the Covid shutdowns. The Bank of Canada is in a difficult position. Higher interest rates are required to dampen inflation while the Canadian economy is weakening due to higher interest rates. Fiscal policy (ie. government spending) is still expansionary which adds fuel to the inflationary fire. Short-term interest rates are heading higher but balancing interest rates to combat inflation while attempting a soft-landing of the economy will be a real challenge. The odds of a soft-landing are small while the odds of a recession continue to grow.

Canadian bond yields rose during the third quarter with the entire yield curve shifting upwards. Overall, the Canadian bond market fell 0.44%, which while down, was the best performing bond market amongst the OECD countries. Shorter dated bonds faired worse as the Bank of Canada raised short-term rates in response to elevated inflation numbers with the BoC raising rates by 300 basis points in just 6 months. While the economy seems to be weakening more than the BoC anticipated inflation continues to be a concern for the BoC and the central bank has re-iterated its commitment to achieve price stability and its target for inflation of 2%. Headline inflation declined during the quarter but core inflation (less the volatile components of food and energy) continued to move higher. Core CPI is tracking over 5% and the BoC cannot be comfortable with those numbers. The BoC is concerned that the longer inflation expectations remain elevated the more entrenched they will become making it more difficult for the Bank to reach its inflation target rate. Unless there is a dramatic reversal in inflation, we anticipate that further rate increases will be necessary for the BoC to achieve its targets. Therefore, bond markets will continue to be under pressure, particularly at the short end.

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Canadian stocks declined significantly during the quarter but faired much better than its global counterparts. The prospect of a weakening economy weighed on stocks, however, domestic demand (consumer spending) remained strong and, paradoxically, business investment rose which helped to mute further declines. Corporate earnings remain positive and most sectors haven't felt the impact of higher rates yet. Cyclical stocks were under pressure during the quarter due to an anticipated global economic slowdown. The housing market is feeling the effect of higher mortgage rates and is correcting. Commodity prices continue to be volatile with oil, wheat and lumber prices declining while natural gas prices rose. Stocks have had a bad year and there is considerable bearish sentiment in the stock market which usually means that the market is poised to react to the upside to any perceived positive developments. Unfortunately, until inflation numbers and expectations decline the BoC will continue to raise rates which will provide headwinds for any sustained move higher in stock prices. Higher rates will be a drag on economic growth and also act to reduce the present value of income streams, which is not supportive of stocks.

The value of the Canadian dollar versus the US dollar fell 8.6% during the third quarter. The market appears to believe that the US Fed will be more aggressive than the BoC in raising short-term rates and as a result have sold the Canadian dollar. The BoC will likely match rate rises by the US Fed as long as inflation expectations remain commensurate between Canada and the US. We feel that we have seen the worst of the Canadian dollar sell-off versus the US dollar and expect a rebound in the fourth quarter from recent lows.

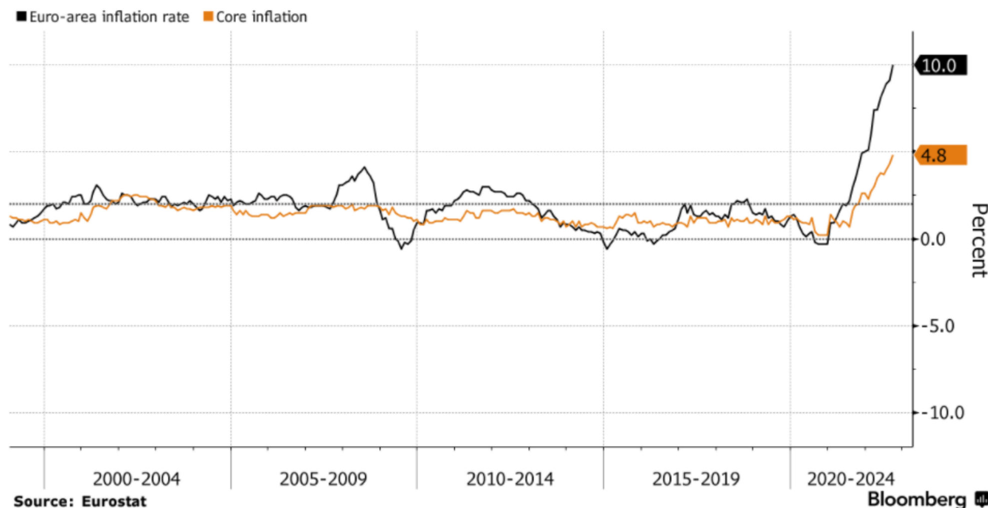
US

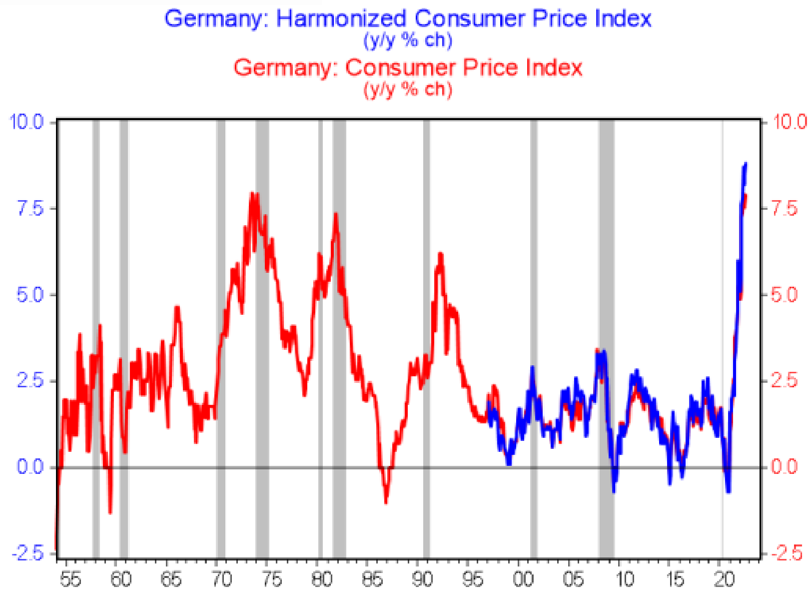
US stocks had another poor quarter and the broader US stock market (S&P 500 index) fell 5.3%. For the year the S&P 500 has fallen 24.77% to the end of September, a dismal showing indeed. The US Fed has been aggressively raising rates and has been signaling that combatting inflation is likely to require more hikes above the current short-term interest rate of 3.5% and will maintain the higher levels through next year. Core inflation recently posted a 6.3% y-o-y rate and underlying price pressures are proving to be stickier than expected. Energy costs have declined somewhat but there has been an outsized gain in food costs, which are up 11.4% in the past year. These rate rises have weighed heavily on the US stock market with interest sensitive and high P/E stocks (ie. tech stocks) being particularly hard hit. Higher interest rates tend to compress P/E ratios and therefore negatively impact high flying tech stocks. Corporate earnings have held up well and unemployment remains low by historical standards but the outlook for a slowing economy due to higher borrowing costs has weighed on sentiment. With the dramatic decline in US stocks this year the market is close to a bottom and any semblance of positive news will no doubt support stocks. For a sustained rebound though the market will need to see that a recession will be modest and interest rates have topped out.

Europe

Europe has had a tough go of it this year and the past quarter was no exception. Bond yields have risen significantly, stock markets have fallen dramatically, currencies have sunk against the US dollar, inflation is up,

energy prices have surged, and a war is raging in Eastern Europe. Inflation has proven to be a real problem for the European Central Bank and the euro zone's economic problems have intensified with the first ever reading of double-digit inflation, piling pressure on the European Central Bank to keep raising interest rates aggressively. September inflation numbers showed that it remains a real problem as headline inflation blew past estimates at +10.0% year-over-year (France rose 6.5% y-o-y in, 9.0% in Italy) while Europe's largest economy Germany posted an increase in CPI of 8.8%. Energy and food once again drove inflation, though an underlying measure that excludes them also topped estimates to reach an all-time high of 4.8%. Euro area labour cost rose a sizeable 4.0% y-o-y in the second quarter after a 4.2% gain in the first quarter. As a result of these numbers the ECB has had to join the aggressive tightening train and increased rates 75 basis points in September. ECB President Christine Lagarde at the European Parliament has opined that policy makers expect to keep hiking "over the next several meetings" to dampen demand and guard against the risk of a persistent upward shift in inflation expectations. That followed comments from ECB Vice President Luis de Guindos when he warned that record inflation is the biggest problem facing the region's economy, threatening investment and consumer spending as it becomes more broad-based. The European Central Bank will continue to raise rates to tame inflation and record-high inflation coupled with aggressive monetary policy will inflict further economic pain.



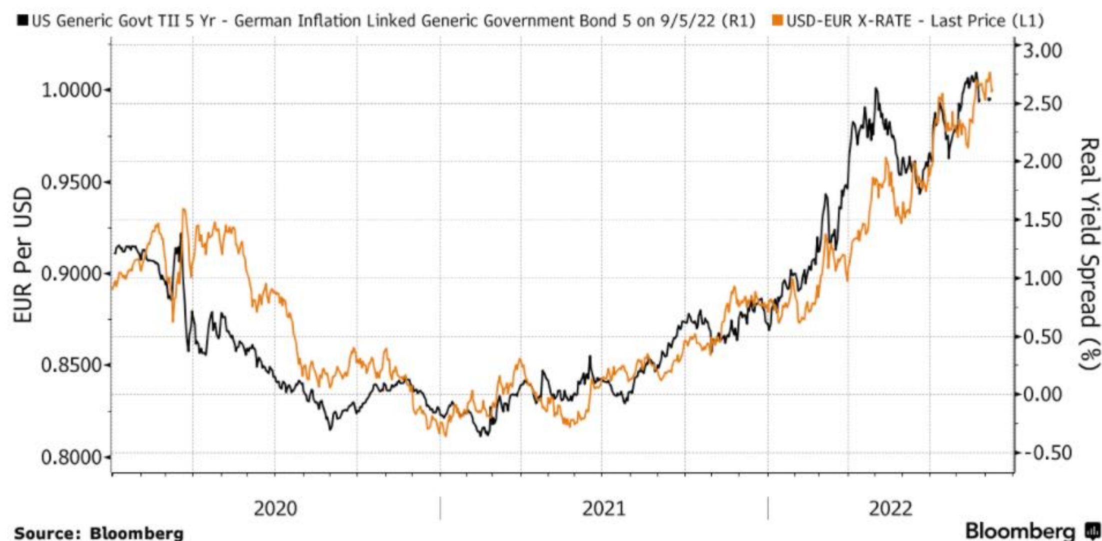


Separately, there have been considerable media ruminations about high energy prices in Europe. Prices have spiked with natural gas prices reaching historic highs. The recent closure of the Nord Stream 1 pipeline prompted a gathering of EU leaders to discuss the energy crisis and an appropriate course of action that all member states can stomach. Preliminary discussion involved an EU-wide price cap on Russian gas, which is either negotiated on a country-by-country basis, or as a group. Naturally, Russian President Putin warned that it was a "stupid" idea and that this could prompt Russia to stop exports to Europe all together. Will he cut off Europe completely? It is possible but at the same time Russia needs income, particularly now to feed its land grab operations in the Ukraine. Hopefully storage levels are high enough and the upcoming winter mild enough such that Europe does not "freeze in the dark."

The broader European bond market declined significantly during the third quarter, falling 3.7%. Yields across the curve rose as inflation figures came in higher than expected causing the ECB to adopt a more aggressive tightening stance than the market anticipated. Price pressures may increase further as Russia starves Europe of gas supplies and with winter approaching policy makers are bracing for even more difficulties. The latest OECD forecasts show that their projection for euro-zone inflation nextyear increased by 1.6 percentage points to 6.2%, notably exceeding the ECB's own outlook. A relatively tight labour market (a recent Eurostat report showed euro-zone unemployment at 6.6% in August) will intensify such pressures. Higher interest rates will eventually impact economic conditions and dampen inflation but this is still some way off. Yields will continue to be under pressure as the ECB's 2.0% inflation target is considerably below current inflation levels.

European stocks declined as higher inflation and higher interest rates, both short and longer-term, weighed on outlook. Sentiment in Europe, similar to the rest of the world, has been negative leading to broader European stocks falling 20.2% year to date to the end of September. Exports have declined and the likelihood of upcoming economic weakness is real. Corporate earnings are coming under pressure and consumer sentiment is trending to the negative. There could be a rally due to oversold conditions but a sustained rebound in stocks will be difficult until inflation starts to trend down and the ECB ceases its interest rate increases.

The Euro fell 13.8% in the third quarter and is down 20.2% versus the dollar for the year. The market has perceived that the ECB has fallen significantly "behind the curve" when it comes to interest rate rising to combat inflation and the inflation figures have not been good. The perception that the US Fed has been more aggressive in raising rates, that the US economy will fair relatively better than Europe, the effects of the war in the Ukraine, and a general retreat to "safety" has benefited the US dollar versus the Euro. Recent trade data showed that the seasonally adjusted trade deficit widened to EUR 40.3 billion, as exports fell and imports rose, hasn't helped either. As the chart below shows real yields (the difference between bond yields minus inflation) have favoured the US currency. The Euro will remain below levels seen at the start of the year until the market sees a moderation in real yield differences.



It is of note that inflation in Switzerland, while still below that of the Euro-area, has prompted the Swiss National Bank to raise short-term interest rates by 75 basis points to 0.50%, which means goodbye to negative rates which the SNB has been mired in since December 2014. Although further rate hikes cannot be ruled out the SNB has signaled a cautionary stance (gas shortage in Europe, power shortage in Switzerland and continuing Covid issues) as well as a downgrade to its GDP forecast. Despite this the CHF has held up well (declining "only" 7.5% this year), Swiss bonds fell 1.4% and stocks declined 4.4% in the third quarter.

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