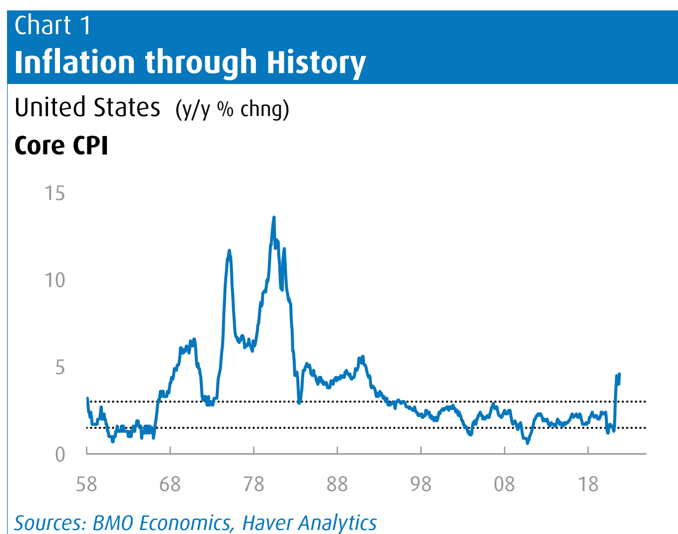
Livin' on the Hedge
Inflation and Your Finances

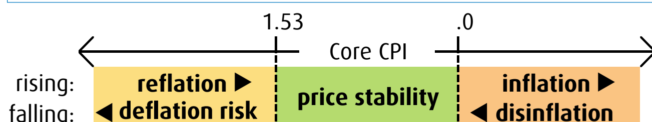
January 2022

This article is reprinted with permission from a Special Report published by BMO Economics Research. For the original report, **click here**.

The inflation and interest rate landscapes are shifting dramatically, with persistent strength in the former and upside risk mounting for the latter. While much of the attention was on the blowout 6.2% year/year reading on U.S. headline inflation in October, possibly more telling was that core CPI inflation rose to 4.6%, the strongest since 1991. Canadian inflation also matched a 30-year high in the month. Mid- to short-term bond yields have also moved higher as central bank tightening looms large. The Federal Reserve has begun to taper asset purchases, setting up rate hikes in the second half of 2022. The Bank of Canada has wound down its QE program with an eye on rate hikes around the middle of this year, if not sooner. We continue to believe that inflation will be more persistent than most initially thought, and that interest rate hikes could come sooner, unfold faster and possibly result in a level that is somewhat higher than most have assumed. For investors, **it's worth dusting off the old inflationary playbook** and giving it a closer look.

Chart 1 shows the evolution of U.S. core inflation since the late 1950s, while *Tables 1 and 2* report average real returns of various asset classes over that period, broken down into different price environments as follows:





Price stability (46% of the time): This is the goal of central banks, where core inflation runs near the target range — we use 1.5%-to-3% in this exercise. The vast majority of the past two decades was characterized by this goldilocks environment, which was of great benefit to most asset classes. Not too hot to weigh on bonds, while not cold enough to reflect weak economic and earnings growth. Equities, Treasuries and real estate have all posted solid real returns through these periods.

Deflation risk (6% of the time): The only environment historically that Treasuries have outperformed equities on a sustained basis is when inflation falls below 1.5%, and is decelerating. We experienced this briefly in the early-1960s and early-2000s, and then most infamously during the financial crisis. Note that the nature of the latter episode and the small sample results in very weak average returns for U.S. real estate and equities.

Reflation (2% of the time): Deflation risk subsides and inflation accelerates back toward target. This has proved to be the most favourable environment for equities, with total real returns in both Canada and the U.S. pushing well into double digits. Major bull markets in the 1960s and post-2010 account for most of the strength, for this very small sample.

Inflation (23% of the time): This is what we're really focused on now, as price growth moves above 3% y/y and is accelerating. Historically, this is not a good time for financial assets in general, but there are some relative safe spots — it's important to emphasize again here that we're looking at **real** returns (i.e., after removing inflation; so, naturally, the nominal returns have a bigger hurdle rate during times of inflation). Treasuries are the clear loser in an inflationary environment. This typically comes as central banks tighten monetary policy, long-term interest rates rise and price increases erode the value of interest payments.

On the flip side, equities have been able to scratch out more neutral real returns, acting as an insulator against upward price pressure. The TSX has outperformed somewhat in inflationary environments, as one would expect given a

higher concentration in sectors like energy and materials (including gold), and a relatively low concentration of growth-oriented names that would see valuations cut deeper in such an environment. And, the value of **dividends becomes increasingly important** in protecting total returns. For example, the TSX Index value alone has eroded at more than 1% annualized on average through these periods, but the total return has netted a positive return after inflation. Real estate also typically holds its value well.

Disinflation (23% of the time): After inflation peaks, most asset classes tend to perform well and post solidly positive real returns. Interest rates are typically falling at this point, and equity valuations are often moving higher again, helping to juice returns. The bull market that set off in the early-1980s is a classic, if not extreme, example of this.

Table 1
Financial Market Returns
Average Annualized Real Returns[1] (% : monthly avg.)

	Gold (US$)	TSX + Div	TSX Index	S&P 500 + Div	S&P 500 Index	10-yr Treas.	3-mo Bill
All periods	**4.3**	**6.5**	**3.2**	**7.6**	**4.4**	**3.1**	**0.8**
Price stability	2.6	6.2	3.6	8.4	6.1	2.5	0.4
Deflation risk	8.5	11.7	8.5	8.8	5.6	10.4	1.0
Reflation	11.4	12.4	9.5	20.1	17.4	2.6	-0.8
Inflation	13.8	2.6	-1.3	-1.1	-4.9	-2.4	0.2
Disinflation	-2.6	9.2	5.2	13.9	9.5	8.1	2.0

Sources: BMO Economics, Haver Analytics *[1] deflated by U.S. core CPI (1962-present)*

Inflation, but why?

One caveat is that aggregating inflation-era returns masks the factors behind many different episodes through history. For example, the 1970s was characterized by an extreme negative supply shock in oil that rippled through the economy and consumer prices. Double-digit unemployment and inflation marked true "stagflation", the worst combination for most asset markets. Importantly, **today's environment does not look at all like stagflation**. While most of the focus is on supply-side constraints, the reality is that **demand is extremely robust, job markets are tight and the unemployment rate is falling**. That certainly is a "less-bad" inflationary environment than some past episodes like the 1970s. Rather, periods like post-WWII rebuilding or the 1960s (social and war-time spending along with low unemployment, low interest rates and new technology) are closer parallels. In all cases, inflationary outbursts are ultimately quashed by tighter monetary policy, and this time shouldn't be any different. In fact, the further central banks fall behind the curve, the more acute the impact of tightening might be.

What to do about it

Historically, **real assets** tend to outperform cash, and even some financial assets can top cash in nominal terms, even if they struggle in real terms. Keep in mind again that the returns shown are after inflation, so even weak-looking equity or real estate returns are much stronger in nominal terms. Also, it's notable that asset prices broadly have already had a tremendous run to this point.

Table 2
Assessed Inflation-Era Performance and Risk

Asset	Return Protection	Risk (volatility)
Gold	High	High
Dividend Stocks	Mid/High	Mid
Commercial RE/REITs	Mid/High	Mid
U.S. Housing	Mid/High	Mid
Cdn. Housing	Mid/High	Mid/High
TIPS	Mid	Low
3-month Government Bills	Mid	Low
Rate-reset Preferred Shares	Mid	Low/Mid
Value Stocks	Mid	Mid
TSX Index	Mid	Mid/High
S&P 500 Index	Mid	Mid/High
International Equities	Mid	Mid/High
Cryptocurrency	Mid	High
Growth Stocks	Low/Mid	High
10-year Government Bonds	Low	Low

Source: BMO Economics

Favour stocks in your portfolio, but choose carefully. **Canadian equities** have shown resilience, while **dividend yield** and **dividend growth** take on increased importance in a real total return context. Higher-growth/higher-multiple areas of the market tend to struggle as discount rates rise.

Pick **companies with pricing power** that are able to pass most wage and cost increases to customers. Firms that face limited competition and sell items with inelastic demand (due to a lack of close substitutes) are likely to preserve capital during periods of rising inflation. By contrast, firms with limited pricing power are often forced to absorb higher costs in earnings. Canada has many names with a rich history of dividend increases that fit the bill.

Real estate has managed to post positive returns through inflationary periods even after accounting for price gains, meaning it has offered good protection. Notably, return data don't include the value of **rent**, which would increase actual realized total returns beyond those shown in *Table 3*. Multi-residential cap rates today, for example would add about 4 ppts to annual returns in Canada, and they are

typically inflation protected, able to rise at least in line with CPI if market conditions dictate (many rent-controlled cities actually use CPI as a benchmark). That said, real estate prices could be tested given the dramatic increase in valuations during the pandemic, especially in Canada. **Commercial real estate** looks less inflated at this point, and should hold up reasonably well with underlying economic conditions still strong, though the office sector faces longer-term challenges from remote working.

Table 3
Real Estate Returns
Average Annualized Real Returns[2] (% : quarterly avg.)

	— Housing —		U.S.
	Cdn.	U.S.	CRE
All periods	**2.8**	**1.1**	**0.9**
Price stability	4.0	2.5	4.4
Deflation risk	4.0	-1.7	-6.1
Reflation	2.4	1.4	3.9
Inflation	1.3	1.0	-0.2
Disinflation	1.9	-0.3	-2.3

Sources: BMO Economics, Haver Analytics

[2] before rents; deflated by U.S. core CPI (1962-present)

Other hard assets have a role. Traditional inflation hedges include commodities, notably precious metals, and gold has a strong track record. While not a hard asset, some would characterize **cryptocurrencies** as a form of digital gold, which might make it a modern-era substitute. However, they have a limited track record as inflation hedges, and could well sell off alongside other assets if interest rates rise too much.

Buy **inflation-protected notes**. Treasury inflation-protected securities pay a fixed real rate of return plus a variable return tied to the prevailing inflation rate. The higher is inflation, the larger is the combined payout. A caveat here is that real interest rates are already deeply negative, with inflation-protected notes close to all-time lows. For example, 10-year TIPs are now yielding -1.15%, pointing to very weak returns if inflation instead calms in coming years.

Diversify geographically. Inflation isn't heating up everywhere. Japan's CPI rate, for example, was virtually zero in October. While its economy would still suffer as a global downturn slams exports, it would stand a better chance than nations with high inflation of avoiding a recession given low interest rates.

Park some funds in **money markets** before central banks pull the rate trigger. Though money-market returns are tiny today, they will increase when the Bank of Canada and Federal Reserve raise policy rates, expected in the second half of 2022. Moving funds into debt securities with rising payouts and short maturities, or **rate-reset preferred shares**, also provides flexibility to eventually lock in at higher rates when inflation and interest rates peak, or shift to equities. These lower-duration products have largely preserved capital in the past.

Keep an eye on your debt. Inflation is generally good for borrowers as it reduces the future value of debt. Loans are repaid with money that is worth less than before, and often repaid with wages that are rising faster than when the loan was issued. But rising inflation can be cold comfort for over-extended households if interest rates climb too quickly, straining service costs. For those with already stretched finances and limited wage bargaining power, the safest strategy might be to repay debt if possible, or at least avoid taking on new loans. Consolidating loans in lower-rate products is also a good option.

Lock in borrowing costs. In a rising inflation and interest rate climate, borrowers can save money and reduce default risk by choosing fixed rates. As one example for mortgages, given our base-case forecast for the Bank of Canada to raise policy rates by 150 basis points starting in mid-2022, and an earlier 100 basis-points spread between variable and fixed-rate 5-year mortgages, borrowers would have saved moderately over the five-year period by locking in. More recently, a backup in long-term rates has shifted the balance back to variable rates. Still, the best option depends on your financial situation and risk tolerance. Families in a strong financial position might opt for a variable rate, essentially betting that inflation will retreat quickly, thus warranting less monetary tightening than markets are pricing in. Even if inflation and interest rates kept rising, variable-rate borrowers would still have the option to lock in, albeit at a higher rate than today.

For more information, please speak with your BMO financial professional.

BMO Private Wealth provides this publication for informational purposes only and it is not and should not be construed as professional advice to any individual. The information contained in this publication is based on material believed to be reliable at the time of publication, but BMO Private Wealth cannot guarantee the information is accurate or complete. Individuals should contact their BMO representative for professional advice regarding their personal circumstances and/or financial position. The comments included in this publication are not intended to be a definitive analysis of tax applicability or trust and estates law. The comments are general in nature and professional advice regarding an individual's particular tax position should be obtained in respect of any person's specific circumstances.

BMO Private Wealth is a brand name for a business group consisting of Bank of Montreal and certain of its affiliates in providing private wealth management products and services. Not all products and services are offered by all legal entities within BMO Private Wealth. Banking services are offered through Bank of Montreal. Investment management, wealth planning, tax planning, philanthropy planning services are offered through BMO Nesbitt Burns Inc. and BMO Private Investment Counsel Inc. If you are already a client of BMO Nesbitt Burns Inc., please contact your Investment Advisor for more information. Estate, trust, and custodial services are offered through BMO Trust Company. BMO Private Wealth legal entities do not offer tax advice. BMO Trust Company and BMO Bank of Montreal are Members of CDIC.

® Registered trademark of Bank of Montreal, used under license.

All rights are reserved. No part of this publication may be reproduced in any form, or referred to in any other publication, without the express written permission of BMO Private Wealth.

For BMO Economics disclosures, please click here, https://economics.bmo.com/en/disclosure/

ID5036 (01/22)