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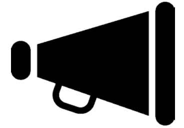

O' CANADA... OR UH-OH CANADA?

What should investors make of the Bank of Canada's recent rate hike?

July 13, 2017

Canada has become the first country in the G7 to join the US in raising interest rates. This has fed speculation the world's central bankers are entering a durable tightening cycle.

What gives? A key theme our Investment Team has been monitoring is a move to "normalize" monetary policy. Remarkably, almost ten years after the global financial crisis, policymakers still have emergency measures in place — from ongoing quantitative easing programs to negative interest rates in many parts of the world. This cannot last.

Now, a shift has occurred in the last month with abrupt and seemingly coordinated hawkish commentary of late from central bankers around the world. Predictably, fears have emerged that higher rates coupled with a potentially disorderly unwinding of unorthodox policies could derail the nascent global growth momentum.

Are these concerns warranted? To some extent, yes. Canada still lies on several macro fault lines — including highly indebted households (which just cracked the two-trillion-dollar ceiling, representing household liabilities of 100.5% of GDP), weak corporate investment and the end of a multi-year uptrend in commodity leadership. What's more, the stronger Canadian dollar is weighing on profit margins, particularly for the oil patch that sells its products in USD and pays expenses in CAD.

However, global central banks, including the Bank of Canada, will almost certainly adopt a gradualist approach to tightening policy. Economic growth and reflation have been encouragingly synchronized across global regions this year, but are modest in historical terms. Inflation is still stubbornly low. And, so-called "escape velocity" will likely be impossible given structural impediments such as aging demographics and high debt levels.

In general, a slow and steady recovery would be a favourable backdrop for risk markets; providing a stable operating environment for businesses while limiting prospects for aggressive tightening.

INVESTMENT IMPLICATIONS

Central bank normalization is very definitely one of our "Super Trends". In the same way that investors took more than a decade after 1980 to believe that inflation would not rise again into double digit figures, today's investors — conditioned by at least 35 years of disinflation and declining interest rates — will take years to become convinced that the secular environment has changed.

In this environment, bond rallies will still present themselves. However, for Western bond market exposures, keep duration strategically short and only tactically take on longer-dated exposures when bonds become overbought. Also, emerging market debt continues to be very attractive, given increasing credit quality and higher yields.

Looking ahead, expect a gradual reversal in yields that will play out glacially over many years. And while a spike in rates is clearly detrimental to fixed income investors, a slow and steady rise allows for a higher reinvestment rate without incurring large capital losses. This is wonderful news for retirees who have had considerable difficulty generating sufficient income in an abnormally low interest rate environment.

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