Institutional Quarterly

This Issue

BMO Global Asset Management

Summer 2022

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The History of Inflation: A Closer Look

An astute observer of longer-term trends, Fred Demers, Director, Multi-Asset Solutions Team, helps institutional investors avoid recency bias by drawing insights from the history of inflation.

Summer 2022

Fred Demers

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"Inflation is when you pay fifteen dollars for the ten-dollar haircut you used to get for five dollars when you had hair."
– Sam Ewing

A bird's eye view of history

Anyone who studies the roughly 2,500 years of modern human history will find a surprising number of inflationary periods that have occurred across the world. The Roman Empire, for example, tried to fool its citizens by reducing the amount of copper used in their coinage. But merchants were smart enough to notice the minting value had diminished, which led to an increase in prices for a bushel of wheat and other staple goods. France had a similar experience in the 18th century when Napoleon Bonaparte used huge fiscal deficits to finance his expansionary wars. And, of course, it famously took a wheelbarrow filled with deutsche marks to buy a loaf of bread in Germany under the Weimar Republic.

In the case of Napoleonic France, economists like Adam Smith had only begun to understand the relationship between borrowing and inflation, the consequences of government debt, and the impacts on real economic growth. We learned then that you cannot create wealth out of thin air. Of course, if a tangible commodity were to be newly discovered, such as when Spanish explorers uncovered gold inventories in North America, the intrinsic value of those physical assets could indeed expand a country's wealth. But with fiat currencies, it's a zero-sum game. Every dollar you borrow to spend today comes at the expense of consumption tomorrow. That's why for many institutional investors the word "inflation" rhymes with monetary policy.

The quest to tame inflation

During the Great Depression of the 1930s, we saw an outright deterioration in living standards as price growth consistently outpaced GDP. It was a massive destruction of wealth that, among other things, contributed to the outbreak of World War II. However, the post-war economics looked extremely different—there was a massive capital drain from the U.S. to Europe as money flowed across the Atlantic as part of the Marshall Plan to rebuild the continent. Exchange rates were carefully managed such that Germany's deutsche mark, France's franc and Italy's lira did not surge on the capital influx. The countries needed policy controls in order to maintain a competitive position and rebuild their manufacturing capacity to satisfy the growing appetite of U.S. consumers.

Later on, in the 1970s, policy makers embarked on a 50-year crusade to solve the business cycle. In addition to managing the money supply, central bankers believed it was possible to control the risk-free lending rate with enough dexterity to smooth out the business cycle. I would argue their track record has been disappointing.

"Inflation is taxation without legislation." – Milton Friedman

There is no natural law saying central banks should control the overnight rate—it is a modern concept. However, one policy innovation that's beyond debate is the establishment of central banks as the lenders of last resort. There's no debate on that front. Having an independent entity to provide liquidity without any concern for profits has been incredible for the stability of markets. A private bank must, by nature, turn off the credit tap when the future becomes uncertain, but a central bank can afford to interject as much as is needed for the system to resume normal functioning.

Many investors worry that the current environment is reminiscent of the 1970s and early 1980s when inflation peaked at 14.8%. The comparison is understandable: the current standoff over Russian energy production has echoes of the OPEC oil embargo, and rises in the Consumer Price Index (CPI) are at levels not seen in more than 40 years. However, the underlying demographics are entirely different. Back then, Baby Boomers were moving into the cohort of workers and increasing their wages, whereas now the situation is reversed in many Western countries (and Japan) given that the same generation is actually leaving the workforce. This aging dynamic creates deflationary pressures that should ultimately prevent the U.S. economy from sliding into another decade of 1970s-style stagflation.

Central banks' strategies for crisis management have also changed significantly. In the past, former U.S. Federal Reserve Chairman Paul Volcker used to favour hard medicine—raising the overnight interest rate to nearly 20%—to "kill the beast" of inflation. His aggressive and decisive policy actions kickstarted back-to-back recessions. By contrast, it's become apparent in the past year that Chairman Jerome Powell's Fed was behind the curve on inflation, hesitating to raise interest rates until the CPI was already well beyond the Fed's target range. They unfortunately waited too long to cool down the economy and, as a result, we're now seeing a resurgence of runaway inflation.

"I do not think it is an exaggeration to say history is largely a history of inflation, usually inflations engineered by governments for the gain of governments." – Friedrich Hayek

The politics of inflation

There's a saying that inflation is always a political choice. The argument is that elected officials who try to engineer higher living standards without any real gains in productivity are the original driver of inflation. Case in point: if workers suddenly experienced 10% productivity growth, then a corresponding rise in wages would be validated by their increased contribution to the company or economy. But to increase those wages *without* a comparable gain in output is to effectively re-distribute income from the most productive areas of the economy to the least. It's a subtle balancing act. But policy makers must ultimately remember that spending money, especially printed money, is not a purely additive process.

Inflation is a reflection of the extra dollars that are in the system—money that cannot be matched by our capacity to produce goods and services. And our capacity is limited by finite resources, whether it's oil and gas, land or hours of human labour. This is accepted wisdom. Yet in 2020, we saw governments initiate enormous spending programs as our capacity to produce was constrained by COVID-related lockdowns. Are we surprised this resulted in inflation? We know interest rates can impact demand and asset prices through an indirect transmission process. So, if you send cheques in the mail using the direct linkages of fiscal policy, that money is deposited into real bank accounts and then spent.

People have a propensity to consume. Politicians have a propensity to spend. And policy makers, despite their best of intentions, have a propensity to forget that their actions can have dire consequences for the rest of the economy.

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Notes from Davos: An Insider's Perspective

Kristi Mitchem, CEO of BMO Global Asset Management, shares her first-person impressions of this year's World Economic Forum in Davos, Switzerland—including strategic insights into the outlook for global growth, war and conflict, and key areas of responsible investing.

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Kristi Mitchem

CHIEF EXECUTIVE OFFICER, BMO GLOBAL ASSET MANAGEMENT

In the shadow of Ukraine

The name "Davos" often conjures images of an idyllic, snowy Swiss town—but, this year, uncertainty about the Omicron variant forced the postponement of the annual World Economic Forum until the spring. The buzz from regular attendees was that the tone of the conference was significantly different as a result. As several people put it: sneakers are the new snow boots.

While the weather was less chilly than in the past, the atmosphere was quite sombre. Russia's invasion of Ukraine cast a long shadow over the proceedings. How could it not? At its core, Davos—the world's foremost thought leadership platform—is about discussing emerging issues of a global scale, and presently, there are few issues more concerning than the war. Giving due attention and respect to the conflict—and most importantly, the Ukrainian people—while still addressing other pressing items was a tough balancing act, but ultimately, I think it was done successfully.

The war also offers a window into other discussions and topics of urgency. For one example: food insecurity. Ukraine is the "breadbasket of Europe," and with it under siege, there is some question about the world's ability to provide sufficient and affordable sustenance to areas like the Middle East and Africa. That potential crisis would exacerbate existing inequalities. Everything is connected, and those are the types of complex problems that the World Economic Forum aims to address.

In North America, we still have work to do to bust the myth that investing for good isn't profitable.

What's good for people is good for business

At the conference, I was proud to speak on a panel about the Living Wage. With an overarching goal of reducing inequalities, we discussed solutions for how to encourage more companies to have fair wages that are sufficient to cover the rising costs of living, not just in their own businesses but across their supply chains as well. Academic experts were commissioned to write well-reasoned arguments for a living wage, and their case showed clearly that what's good for people is also good for business.[1]

Paying a living wage stimulates consumer demand and economic growth, and decreases absenteeism and turnover—*all benefits that will eventually accrue to the investor*. I was particularly impressed by Unilever for taking a strongly supportive stance. This year, our panel took place in an annex, while Climate discussions dominated the main congress hall. My hope is that for the next World Economic Forum, we can make Living Wage a centre stage issue.

Overall, I was encouraged to see that responsible investing wasn't treated as a fringe topic at the conference. Institutional investors in Europe have led the charge on RI for years, while the U.S. has lagged far behind. This year, however, we had some of the largest institutional asset owners in the U.S. at our Living Wage panel, which is a very positive sign. In North America, we still have work to do to bust the myth that investing for good outcomes isn't profitable. We must also recognize that greenwashing is a serious problem that has set back ESG efforts to some extent, and that it's important to address these concerns as we push forward on challenges like Climate and Equality.

Storm clouds—and a ray of sunshine

In terms of sentiment about global growth, the feeling I got from forum attendees was ominous, but not catastrophic. There's no question that there are numerous storm clouds on the horizon: geopolitical conflict; the prospect of stagflation; domestic sourcing and de-globalization; ongoing pressure on energy prices; and much more. At one dinner I attended, a former official from MI6—the British foreign intelligence service—struck a distinctly cautious tone, painting a sobering picture of the Russia situation and the escalating threat posed by cyber warfare. These are challenges we face, and it's essential that we be realistic about them in order to develop effective solutions.

But doom-and-gloom is only one side of the story. Another guest, an investment expert, argued that much of the potential downside of these structural headwinds has already been priced into the market. She believes that the damage has already been done. It's true that we've already seen substantial dislocation in certain sectors. Within that context, it's easier to recognize that while the overall global situation may still be concerning, there are many possible outcomes for economies and the marketplace, and the worst-case scenario is not the most likely.

We're so used to companies, governments, and NGOs trying to make an impact that it's easy to forget the power of people.

The power of people

At Davos, you meet a lot of interesting and noteworthy people who can provide some much-needed perspective. One night, over cocktails, I spoke with an influential philanthropist. He and his wife were at the Forum trying to educate themselves on how to best accelerate change. They're committed to donating their own money to improve society, and they wanted to understand the issues so that they could make the biggest difference. Those types of conversations are, in my view, the real power of Davos, and it's why attending the World Economic Forum can be such a rewarding experience. We're so used to companies, governments, and NGOs trying to make an impact that it's easy to forget the power of people, especially when they're working toward a common purpose.

In responsible investing, there's a sweet spot where a strategy can benefit individuals, corporations, and the world. By focusing on the centre of that Venn diagram, investors can maximize the impact of every dollar. And institutional investors, with the built-in benefits of scale, are uniquely positioned to hit that bullseye.

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[1] Hanna Silvola and Tiina Landau, *Sustainable Investing: Beating the Market with ESG, 2021*.

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Inflation: 4 Key Insights from an Active Fixed Income PM

Inflation has moved from "transitory" to "unanchored" in 2022—as seen in headlines, grocery stores and gas prices. How does the change impact fixed income portfolio managers? Earl Davis, Head, Fixed Income & Money Markets, offers his top four takeaways from the evolution, plus positioning advice.

Summer 2022

Earl Davis

HEAD, FIXED INCOME & MONEY MARKETS, BMO GLOBAL ASSET MANAGEMENT

One: New rules of engagement for central banks

In October of 2021, a leading Canadian financial news outlet asked me along with eight economists to forecast the overnight lending rate for the next 12 months. While most of my peers believed the Bank of Canada was headed toward a 50 basis-point rate hike, I was more skeptical in thinking that we'd see the risk-free rate climb to 275bps. Alarmingly, the pace of inflation was far more aggressive than any of us had expected, which has profoundly impacted the scope and schedule of interest rate hikes in 2022.

With inflation headed towards levels not seen since the 80's, the rules of engagement have clearly changed for central banks. Over the past three decades, the U.S. Federal Reserve (Fed) and Bank of Canada (BoC) had been very successful in using monetary policy as a proactive tool to combat inflation (e.g., If central banks believed growth might exceed the country's economic potential, they raised rates in advance to cool off the economy). This approach resulted in a favourable dynamic where equities and bond prices were negatively correlated over this time. However, as central banks have pivoted away from containing runaway growth to focusing solely on bringing inflation back within the 2 to 3% target, equity and bonds now have a positive correlation between them.

Rather than bonds acting as a hedge to equities, investors are coping with simultaneous losses on both sides of the portfolio. Will this phenomenon be short-lived? It remains to be seen. The Fed and BoC have lost some credibility by lagging behind the curve on inflation this year, and now they have only a small window of opportunity to act before inflation fears become entrenched. This means they could raise rates significantly higher, *and faster*, than expected. However, predicting the schedule of rate hikes has become more challenging in recent months since the Fed announced it will no longer provide forward guidance. The shift gives policy makers more flexibility to course-correct based on new data, and more importantly, it marks the end of an era.

In today's uncertain environment, we believe it is prudent to have these core beta assets be actively managed, allowing for a dynamic approach to outperform inflation.

Two: The need to be tactical

The pension fund I worked at prior to joining BMO had three mandates for the fixed income desk: manage the beta (duration and credit risk) of a portfolio of approximately $100 billion in assets; produce about $100 million in alpha (active returns); and support other investment teams that had residual interest rate or currency risks in their deals. A key consideration for our team was how to separate the alpha from the beta. Similar to many other institutional investors, we investigated outsourcing the management of passive (beta) investments to a third-party manager and allow the in-house team to focus solely on alpha generation.

In today's environment, some investors believe that GICs are currently a better option than fixed income. With current rates in Canada topping 4%, the appeal is understandable. However, with inflation coming in above 8%, there's a real danger of locking in a loss of purchasing power. Adding to this, heightened volatility (caused by rising rates) can erase benchmarks gains and cause wild fluctuations in prices. Bear markets can oscillate to bull markets, and vice versa, simply based on the market's interest rate expectations. In today's uncertain environment, we believe it is prudent to have these core beta assets be actively managed, allowing for a dynamic approach to outperform inflation.

Case in point: when central banks started to raise rates this year, we moved into higher-yielding corporate bonds. Then, as the recession fears began to grow, we switched gears by adding credit default swaps and underweighting duration to reduce our risk exposure. It worked. Our team was able to outperform the broad index by 75bps during the three months after the March 2022 sell-off, which is a testament to our willingness to seize opportunities wherever possible. We can also get more specific about where we go on the yield curve, what type of credit we choose, and how much we allocate risk across the portfolio.

Our expert credit analysts do a great job of excluding these fallen angels through deep fundamental analysis and relationship-building with management.

Three: Focus on the bright spots

We are currently seeing historically high credit spreads across the market. Investors have access to attractive yields across the spectrum, from 3.5% in investment grade bonds to as high as 10% for high yield debt. Duration still has room to go higher, but we're approaching levels where it makes sense to move up the risk ladder in a balanced portfolio. The challenge is balancing between what's priced-in versus what our expectations are for that segment. For instance, if we believe the default probabilities on high-yield debt are lower than the market expectations, we will cautiously enter the space.

At present, some BBB-rated bonds are at risk of being downgraded. Our expert credit analysts do a great job of excluding these fallen angels through deep fundamental analysis and relationship-building with management. We strive to find the optimal balance between yield and credit quality. Looking ahead, we see new and exciting opportunities emerging in the market for real rates, such as in U.S. Treasury Inflation-Protected Securities and Real Return Bonds (RRBs). Many investors fail to appreciate the

why these assets tend to be mispriced. The fact is any security tied to inflation is inherently a reflection of the Fed policy over time—plus we can trade individual components of the yield, from the nominal to break-even, residual and real rates, giving us more control in an uncertain economic climate.

The fact is we all recognize that the world is inefficient. But where there's inefficiency, we have the potential to earn alpha.

Four: Share the knowledge and be nimble

Over the past two years, we re-organized some of our internal operating processes to help deliver a more comprehensive active fixed income experience. Rather than segmenting the FI universe for each expert, the team comes together regularly to discuss the macro context. Why? Because it's important for all the analysts and PMs to have insight into each other's views and perspectives, as the result is superior risk management.

We currently have four credit experts, one investment analyst and five senior portfolio managers dedicated to the active fixed income mandate. All of us sit down to discuss and debate our views, setting quarterly and annual forecasts that we revisit once every three months. We continually question our strategic approach: Are we over- or underweight credit? Where do we want to sit on the yield curve? How much duration is too much? The answers help set our structural position. In between these high-level conversations, we also meet weekly to exchange perspectives on what's happening in markets and whether a tactical shift is needed in any of the portfolios. The fact is we all recognize that the world is inefficient. But where there's inefficiency, we have the potential to earn alpha.

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