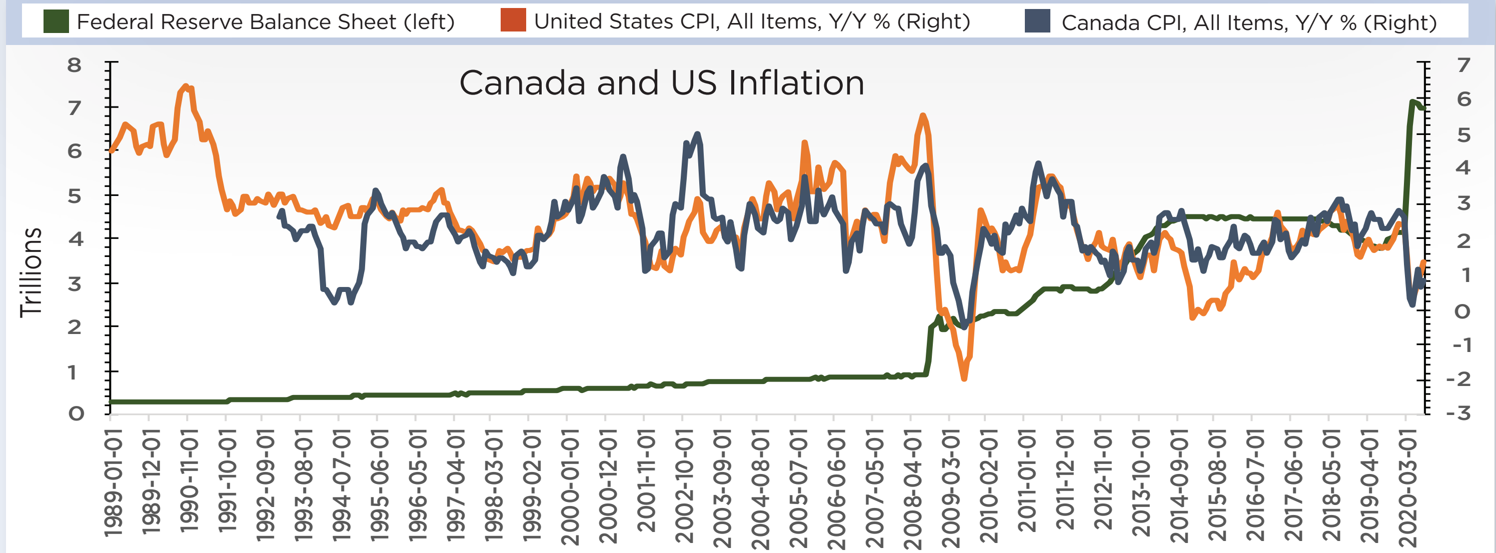
Dramatic expansion of the fed's balance sheet should keeps rates low for some time



Soure: Factset, 1989-2020.

QUARTERLY MARKET OUTLOOK: **FOURTH QUARTER 2020**

Inflation Outlook

After more than a decade of subdued inflation, the economic shutdown put even more downward pressure on consumer prices. The Fed has upped the stakes with extraordinary stimulus and its new approach aimed at allowing inflation to run above its long-term target. We think domestic and U.S. inflation will remain contained in the near run, but we expect it to move higher as the recovery gains traction and over the longer term.

- **Stimulus rekindles inflation concerns –** The U.S. Fed has expanded its balance sheet to a record $7 trillion this year (from $4 trillion), stoking fears that this unprecedented "money printing" will inevitably lead to runaway inflation. We don't share this view. If the Fed stays on the sidelines for too long, inflation could overheat, but we think the underlying drivers of inflation, supply-demand dynamics and the Fed's policy approach have changed from the last time we experienced runaway consumer price increases (mid-70s to early 80s). It's worth noting that following the '08 financial crisis, the Fed grew its balance sheet fourfold ($800 billion to $4 trillion) to a chorus of worries, yet inflation has remained below trend since.

- **The Fed takes a new approach –** The Fed has introduced a new policy strategy aimed at raising inflation toward a more desirable long-term level of 2%, more closely resembling the BoC's policy approach. Whereas the Fed's 2% target was historically viewed as a destination, U.S. central bankers will now allow prices to run above that level for a period in an effort to hit an average of 2% over time. We think this signals the Fed's—along with the BoC and other major central banks'—commitment to keeping highly-accommodative monetary policy in place for the next several years, which should be helpful to the economic recovery and equity markets. We think this can be somewhat effective in raising inflation expectations, though we believe inflation will remain largely contained for the next few years. We do expect a new element of market anxiety down the road in that if the Fed is successful in getting inflation above its 2% target, financial markets are then likely to fixate on "how far above and for how long?" Similar Fed policy worries in 2013 and 2018 spurred market volatility and temporary pullbacks in equity markets as investors recalibrated expectations for ongoing Fed stimulus.

- **Higher inflation down the road –** We think domestic inflation will be modest in coming years, but should gain a bit of steam as the economic rebound gains traction. Recent consumer price readings have shown an uptick in core inflation from the pandemic lows, offering a somewhat encouraging signal that household demand is returning. In coming years, firming aggregate demand should apply some upward lift to consumer prices, and we're watching to see if supply-chain disruptions from the pandemic downturn create a more lasting mismatch in supply and demand that could persistently lift inflation. Over the long term, rising government debt and deficits could also exert some upward pressure, though we think Canada is in a more favourable fiscal position than many other developed countries. While we don't anticipate an excessive spike in prices, persistent inflation does have an impact on consumers and investors. At 3% inflation, prices double in less than 25 years, highlighting the importance of a portfolio and income strategy that can account for inflation over the long term.

▶ *Action for Investors*

An appropriate allocation to equities can help protect your portfolio against the impacts of inflation over time. Consider equities with rising dividend potential, not simply high yields. Ladder your fixed income portfolio across a spectrum of maturities, which can help position for higher rates in the future.

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