To provide context, the 10-year Government of Canada (GoC) bond yield touched a brief low of 0.43% on August 4, 2020 before gradually rising to 0.68% on December 31, 2020. Over the first quarter of 2021, the 10-Year GoC yield climbed to 1.56%, a change of 0.88%. Over this period, the Bank of Canada held its Overnight Policy Rate at 0.25% and has not diverged from its message that policy rates should be expected to be on hold until there is a clear path to a sustainable recovery (Chart 1). But the market seems to have a different view. So what has changed? Well, for starters, inflation has been the hotly debated topic. The “reflation trade” has since taken on a life of its own. That being said, inflation expectations have

**Inflation and Interest Rates: What’s Next?**

We subscribe to the lower-for-long thesis; however, we would be remiss not to acknowledge the fixed income sell-off that began the year. Longer term rates were gradually moving higher in the latter half of 2020, but gained momentum as the year rolled-over and focus turned to policy rates normalizing sooner than expected.

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increased, as described in Chart 2, with more than 70% of Fund Managers surveyed expecting higher global inflation. This is the highest level of inflation expectations in the past 25 years.

High inflation expectations are also showing up in bond prices. One way to observe the level of inflation expectations in bond yields is by dissecting the components of the nominal 10-year GoC bond yield above. First, there is a “real yield”, which is the yield of Inflation-Linked-Bonds, known as Real Return Bonds in Canada. Second is the “inflation breakeven”, which is simply the difference between the nominal and inflation linked bond yields. The latter represents the market’s expectation of annualized inflation over the tenor horizon, i.e. 5-, 10- or 30-year period. The real yield and inflation breakeven provide insights into the factors driving the change in nominal yields over a given period. More importantly, it provides clues into the alignment between markets and central bank policy makers. During the 2021 sell off, it has been the move in real yields that warrants focus.

Due to liquidity constraints in Canadian Real Return Bonds, we look at the equivalent measures in the US market – 10-Year US Treasury Inflation Protected Securities (TIPS) and breakevens. As can be seen in Chart 3, the gradual rise in yields in 2020 was attributed to the reassertion of inflation breakevens. Expectations for inflation moved from depressed depths to levels more consistent with the US Fed’s 2% inflation target. The move in breakevens is surely welcomed by policy makers as it confirms alignment with their new Average Inflation Targeting policy framework where the US Fed will allow the economy to “run hot” and accept inflation overshoots for a period of time to compensate for periods of inflation shortfalls. This has ultimately resulted in the desired steepening of government yield curves.

CHART 2 | Inflation Expectations Now at an All-Time High
Net % Expecting Higher Global CPI

CHART 3 | U.S. 10 Year Breakeven and Real Yields

Source(s): Fiera Capital and Bloomberg as at March 31, 2021.
However, the sharp back-up in rates observed recently has been attributed to a sudden rise in real yields. This has been the case on both sides of the border.

The recent rise in real yields has important underlying influences that are worth exploring further. Real yields are more indicative of expectations pertaining to real economic growth and the future path of policy rates. The resilience of the economy and unexpected snap back in growth has been a primary influence on recalibrating the normalization path and yields in the broader fixed income market. In Canada, despite stringent lockdowns, the economy has continued to grow at a solid pace, retracing much of the lost economic activity experienced in early 2020. With vaccine distributions in full effect and the light at the end of the tunnel in view, there is certainly much reason to be optimistic.

This optimism has showed up in market participants pulling forward their expectations of rate hikes in North America. In fact, as of March 31, 2021, the market has priced the first Bank of Canada rate hike in 2022, which is significantly ahead of the first hike expected by the US Fed. This is despite the US economy having experienced a shallower drop in 2020, less stringent lockdowns, a quicker vaccine rollout and the massive US$2.8 trillion (US$0.9 trillion + US$1.9 trillion) fiscal booster working its way through the economy with more to come! With lots of slack remaining in both Canada and the US, and the former trailing the latter in many regards, the market pricing for rate hikes seems misaligned from fundamentals. Given the leadership of the US recovery relative to Canada, as well as the implications a rate hike would have on the Canadian dollar – think a rising Canadian dollar hurts export competitiveness – it is difficult to envision a scenario where the Bank of Canada comfortably hikes rates ahead of, and more aggressively than, the US Fed.

Whether the increase in yields is justified or not, bonds have performed disappointingly. The first quarter of 2021 was the worst three-month return for the FTSE Canada Universe Bond Index since 1994¹, surprisingly underperforming the often-referenced June 2013 “Taper Tantrum” event. North American yield curves already discount a significant rebound in economic activity; we are therefore going to require much more good news to push interest rates higher from this point on.

Conversely, our European neighbors have been more insulated from rate changes and do not share the same economic momentum. From 2017-19, North American and European yields followed a similar trajectory. As the pandemic took hold, a significant divergence occurred, where the US and Canada outperformed their European counterparts. The path of North American yields however has been more accentuated, as shown in Chart 4; but have essentially retraced their entire movement and are analogous to pre-pandemic levels – when growth was low and the pandemic was not yet a thing. Have we come full circle and shrugged off the ill effects of the pandemic? Can we extrapolate the recent move to conclude yields will inevitably move higher? The fundamentals need to catch up with the optimism. However, structural forces that have put downward pressure on yields over the past three decades remain in place. These are deflationary forces that continue to be prevalent and, in some cases, have been exacerbated by the pandemic and the associated response. We believe these structural forces will continue to exert pressure on yields and limit further increases in the near- to medium-term.

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**CHART 4** | Normalized Change in Government 10-Year Yields (bps)
Index = 100 as of Jan 1, 2020

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¹ FTSE Russell Global Debt Market Indices
More and More Debt

Governments around the world stepped in with significant fiscal support to help businesses and individuals affected by the COVID-19 shock. This resulted in a considerable accumulation of debt, as governments ran large deficits to fund their support programs. Debt as a percent of gross domestic product (GDP) increased globally with a growing numerator and declining denominator.

The Institute of International Finance (IIF) estimates the pandemic response contributed $24 trillion to the global debt in 2020, bringing it to a new high of $281 trillion². Debt increases occurred in both the non-financial corporate and household sector; however, the lion’s share of debt accumulation fell on the shoulders of governments (Chart 5). The IIF estimates that Canada’s debt growth was the seventh largest among advanced economies with a 27 percentage-point increase in government debt ratios, a result of the large fiscal response by the Canadian federal and provincial governments. The one time increase has effectively exacerbated a trend that has been in place for decades—rising debt as a percentage of GDP. As interest rates have declined over the past three decades, governments, corporations and households globally have taken advantage by further leveraging their balance sheets. For example, from December 2001 to June 2020 the debt-to-GDP ratio for Emerging Market Economies increased from 110.3% to 209.8%, while Advanced Economies increased from 210.3% to 300.9%³. GDP growth has not kept pace with debt accumulation.

Debt is not necessarily a bad thing. When debt is purposed to finance the purchase of assets leading to an increase in productivity, such as spending on new capital equipment or information technology enhancements, it can result in improved income streams that help to maximize profits after accounting for interest and principle obligations. Debt that improves income can have positive future contributions to growing the economic pie. However, much of the debt run-up has been attributed to consumption. For example, Canadian economic growth is heavily reliant on household consumption, the consumer, contributing more than 70% to GDP over the past 10 years⁴, with real estate playing a pivotal role. Borrowing has helped to boost current period growth, but the excessive amount of debt accumulation has little prospects to improve future income. In fact, it may have the opposite effect. Debt servicing requirements draw disposable income away from future consumption and restrain demand for goods. Interest rate increases will burden debt service ratios higher, putting pressure on already fragile borrowers.

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³ Bank for International Settlements: Total Credit Series
⁴ Statistics Canada. Table 36-10-0222-01 Gross domestic product, expenditure-based, provincial and territorial, annual (x 1,000,000)
The trends in debt and nominal GDP growth have moved in opposite directions, supporting the idea that taking on additional debt to support current consumption does not lead to increased future prosperity. Chart 6 demonstrates the relationship between debt and economic growth over the past 55 years. Each additional dollar of debt taken on by households, businesses and governments has resulted in lower incremental nominal GDP growth over time. It is difficult to envision a scenario that diverts this trend and leads to an orderly deleveraging, as one requirement would be a sustained acceleration in nominal GDP growth, which has not been the case for many decades. The large fiscal response to COVID and the sharp increase in government debt ratios, although necessary, has effectively been an income bridge to help individuals and businesses to the other side of the pandemic’s impacts. The additional debt is not the productivity enhancing kind. It is focused on steadying a swaying ship in turbulent waters rather than equipping it with a turbo jet engine – a transfer from the government’s balance sheet to the private sector. These measures surely helped to mitigate a much more dire outcome but have low potential to enhance long term growth potential relative to pre-pandemic trends.

Rising debt results in an economy as a whole being more sensitive to interest rates. Rising interest rates increase the burden of accumulated debt by raising debt service costs. This diverts current income to service previous consumption and restrains spending that could have otherwise been put towards goods/services purchases and investments. For spending and investment that require credit, highly leveraged balance sheets have less flexibility to take on additional debt, therefore retarding demand. Rising rates due to improved economic prospects have a self-imposed limit whereby further rate increases ultimately restrict economic expansion as result of the inflexibility created by excessive debt.

Unfavourable Demographic Trends

Demographic trends act as another restraint on consumption and aggregate demand. Canada, and most of the developed world, is getting older. Focusing on Canada, there has been a steady decrease in representation from younger aged cohorts. Currently, individuals aged 50 years or older represent close to 40% of the population, up from 25% in 1995. The share of the Canadian population in the highest consumption bracket, 20-49 year-olds, has declined to about 40%, down from 47% at its 1990 peak. Furthermore, the population cohort of 19 years or less has been in structural decline for the past 50 years. These changes have resulted in the average age of Canadians rising from 30 years to 41 years over the past five decades.

Rising inflation expectations have contributed to the recent bear steepening and inflation prints will represent one of the most important data releases going forward. Are we finally going to break free from a low inflation environment to something that is sustainably higher? One of the big deflationary forces at play is aging demographics. An aging population consumes less over time, which persistently dampens price pressures. There is typically less desire to take on credit to purchase a house, then upgrade to a larger house to accommodate a growing family, increase consumption proportionately to a growing salary, childcare costs, transportation to/from work, and many other necessities during this transitory accumulation phase of life. An overall population that has largely passed this accumulation phase does not provide support to a sustained turbo charged economy, even by today’s low growth standards.

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5 Statistics Canada Table 17-10-0005-01 Population estimates on July 1st, 2020
Too Much Slack for Sustainably Higher Inflation

The track record for inflation over the past decade has failed to live up to expectations and central bank objectives. In the years following the global financial crisis, core inflation measures have tracked below the desired 2% target on average in Canada and the US despite very accommodative monetary policies over most of the period. Chart 7. Central bankers, however, have convinced households and markets that inflation will sustainably rise to their targets, as evidenced by inflation expectations (discussed earlier) and surveys on consumers’ future inflation expectations. As demonstrated, inflation expectations seem to remain persistently above actual outcomes with only a few short-lived exceptions.

Aggressive macro/fiscal policies and the accelerating vaccine rollout may potentially pave the way for normalized economic activity. This has led to renewed market attention on inflation. Base effects are likely to push up inflation in the first half of 2021; however, we expect inflation to remain well contained over the medium term due to excess capacity in the service sector and the residual impacts of COVID-19. Inflation has begun to recover from the depths of the pandemic, but on a year-over-year basis, remains depressed to pre-pandemic levels. Measured core inflation should equal or surpass pre-shutdown levels by mid-2021. This simply represents the impact of the shutdown washing through and the economy returning to an inflationary trend.

Sustainably higher inflation is more appropriately determined by assessing the amount of economic slack, instead of focusing on changes to transitory factors. The Bank of Canada has relied on a measure called the output gap, which in its simplest form measures the difference between the potential output the economy can produce in a given year if resources are fully utilized versus actual output. The former an estimate and the latter measured through GDP and other metrics. Chart 8 shows the output gap in both Canada and the US remains wide following the historic drop in economic activity in 2020. With this framework in mind, the Bank of Canada is expected to look through any near term rise in inflation with a focus on how long it takes to narrow the output gap and potentially generate more sustainable inflation over time. This suggests that the Bank of Canada will remain on the sidelines longer than the market is currently pricing in. The Bank of Canada, as discussed, is also expected to begin raising rates about one year before the US Fed. Given the more muted drop in economic activity, the more stringent and recent Canadian lockdowns, as well as faster
vaccine rollout in the US, the output gap is expected to close later in Canada relative to the US. Although there was an initial strong snapback following the first lockdowns, the path to close the output gap is expected to be gradual over the next several years.

Another barometer of unabsorbed slack is capacity utilization. Capacity utilization refers to the manufacturing and production capabilities that are being utilized at any given time. It is the relationship between the output produced with the given resources and the potential output that can be produced if capacity was fully used. It determines the ability to absorb a rise in the production of output without increasing costs, i.e. without an inflationary impulse due to supply shortages/constraints that could result in higher input cost and wages. A reduction in the rate indicates an economic slowdown while an increase signifies economic expansion. Looking at a well tracked estimate of capacity utilization for the US in Chart 9, the amount of spare capacity in the economy remains high (underutilization). US unemployment increased substantially in Q1/Q2 2020 and remains elevated. While some areas of the economy will recover more fully, other areas will likely be permanently changed. This spare capacity is likely to keep wage pressures down and prevent a wage spiral leading to inflationary pressure. This follows a similar trend where the peak in capacity utilization has successively fallen over the past 50 years, while the recessionary lows have become deeper. This is potentially one of the contributing factors to restrain inflation despite the massive policy accommodation.

Get Active

The sharp rise in rates caught many investors off guard. The silver lining of rising interest rates is that bond yields have reset higher and improved, albeit marginally, the future return expectations for the asset class. We believe that the underperformance of this market earlier this year is a thing of the past. However, the path ahead will have its own new challenges.

In this low yield environment where we expect frequent bouts of elevated volatility, fixed income investors need to be more vigilant while making their portfolios work harder to generate additional return above market indices. Managers with diversified alpha sources and a demonstrated ability to implement portfolio strategies to capture new market opportunities as they arise should be favoured. Notably, a disciplined framework and approach to managing portfolio interest rate sensitivity (duration) and managing exposure across the yield curve can help to improve outcomes in a market where rates are in search of a level justified by fundamentals. Additionally, as investors search for yield to improve returns, high quality credit, such as provincial bonds and highly rated corporate bonds, can be an effective tool to improve outcomes with security selection helping to limit the potential for downgrades and undesirable portfolio volatility. We believe diversified sources of alpha can help fixed income investors meet the dual objective of improving returns relative to market indices while retaining the primary benefits of the asset class – protect capital and provide diversification relative to other asset classes.
Bottom line: Be Opportunistic

In conclusion, we believe there is a lot of optimism already priced into bond markets as evidenced by recent rising rates and steepening yield curves – however, the extreme pace of change in rates is not sustainable nor is it desired by central bank policymakers. Bond markets will continue to face challenges for the next several quarters. Over the long term, we remain convinced that investors will be well compensated for the additional risks they will take on the yield curve. We do not see rates moving to meaningfully higher levels as many of the structural elements that have pushed rates to lower levels over the past thirty years remain in place, including challenged demographics, high levels of debt, and excess economic slack. Investors will be well served with an active approach that is better suited to navigate the evolving market to improve fixed income outcomes.

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