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The fight against inflation

Fears of a U.S. and European recession have been growing of late, and had been growing even prior to the start of the war in Ukraine. Today's recession risks are driven by:

- Monetary policy tightening
- Less fiscal support
- Slowing growth in China (although most recently China announced extraordinary levels of fiscal and monetary stimulus)
- Higher inflation/supply chain disruptions
- More recently the war in Ukraine, which exacerbates inflationary and growth concerns on top of the humanitarian crisis

At the time of writing, it appears the recession risks are higher for Europe than the U.S.

Financial markets do not like uncertainty, and today the only certainty we have is further uncertainty, whether that pertains to the economy, markets or the war. On the economy, the uncertainty is around the probability of a recession in the next 12-18 months. Recessions are feared by investors as they are usually, but not always, accompanied by market corrections, or worse yet, a bear market. A bear market is defined as a market where prices fall 20% or more from recent highs amid widespread pessimism and poor sentiment. We say not always as not all U.S. bear markets in history have led a recession (i.e. May 1946-May 1947, December 1961-June 1962, February 1966-October 1966 and August 1987-December 1987).

In this article we discuss the U.S. recession risks by looking at some of the most recent financial market conditions and indicators, and examine the potential impact on equity markets. We always want to prepare for potential outcomes, rather than predict outcomes.

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U.S. Federal Reserve (“Fed”) raises interest rates for the first time since 2018

On March 16, 2022, the U.S. Federal Reserve (“Fed”) announced a 0.25% increase in interest rates and indicated that it would continue to raise interest rates at subsequent meetings into 2023. It expects short-term rates to be at least 1.875% by the end of 2022, and around 2.75% by the end of 2023. The increase in interest rates marks the official end of the historic wave of stimulus enacted to fight the pandemic shutdown of the economy. But the beginnings of the shift away from purely accommodative policies began around the mid-point of 2021 as the Fed hinted at possible changes to its policy as the economy recovered while the inflation threat was still viewed as transitory.

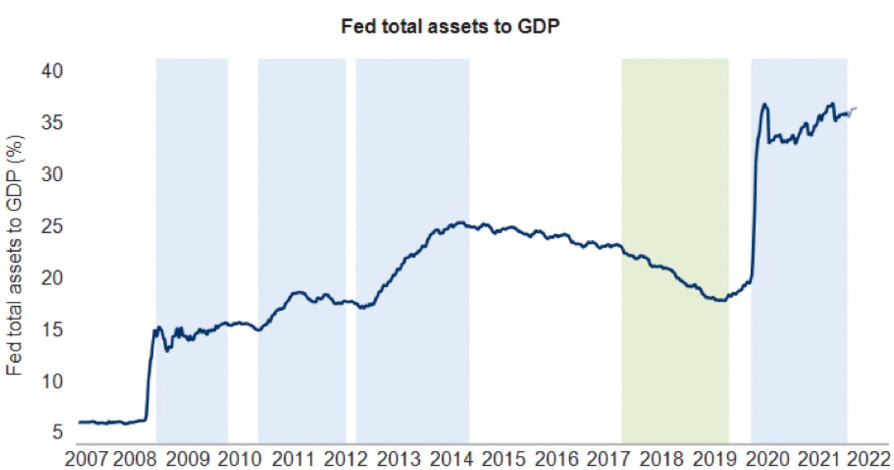
Arguably any sort of signaling of tightening to deal with inflation was more clearly laid out in the December 2021 Fed meetings and subsequent press conference which we believe contributed to the bond market sell off in January 2022. By the end of last year, the rates market was betting that the Fed would take a slow path to raising interest rates due to impact of Omicron. We saw this bet quickly change at the start of 2022 as bond yields started to rise up as the threat of inflation and the Fed’s response to politicized inflation outweighed Omicron, which began to show signs of subsiding.

As well, Fed Chairman Powell noted in December that there was “quite a bit of room to raise rates without hurting jobs.” He reiterated that there is no tradeoff between the pursuit of the employment and price stability goals. The labour market is said to be “historically tight by so many measures.” By contrast, it is inflation that is currently the problem and it is too high. As the market quickly repriced the number of rate hikes for 2022 from less than four to six to seven rate hikes, equity markets corrected as bond yields swiftly increased.

Fast forward to March 2022, and it was clear from the Fed’s press conference that inflation is the Fed’s priority, highlighting an extremely tight labour market, strong aggregate demand and inflationary pressures from the war in Ukraine. To quote Chairman Powell, “No matter what happens, this is a committee that is determined to use its tools to make sure that higher inflation does not become entrenched. And so we are determined on that front and will deal with what comes. This is a modal or most likely expectation but we will deal with what comes whether it’s better or worse.”

The Fed’s fight against inflation at the expense of growth was confirmed by the sooner than expected timing of additional monetary policy tightening, also known as quantitative tightening. Market participants had expected the discussion of quantitative tightening later in 2022. However, Powell indicated quantitative tightening could begin as early as May 2022, but provided no details around exact timing and the magnitude of the balance sheet run off. The Fed’s position seems clear: reducing inflation at any cost, even if that cost is a meaningful slowing in growth. This brings us back to recession risk.

Chart 1: Federal Reserve Total Assets as % of U.S. GDP (2008-2022)



Source: RBC Global Asset Management, reprinted with permission. As of Jan/2022 W10. Blue areas represent QE, Green area represents QT. Source: Federal Reserve, Macrobond, and RBC GAM.

Quantitative tightening will have more of an impact on market than interest rate hikes

The pace of quantitative tightening, or reductions in the Fed’s balance sheet in its effort to fight inflation, will have an influence on both equity and fixed-income markets. In Chart 1 we show the size of the Fed’s balance sheet which has increased considerably since the start of the pandemic. During the Fed’s last meeting it wasn’t clear what the timing, size and duration of quantitative tightening could be, however the impact on market liquidity and the pricing of risk should not be underestimated.

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Could the Fed change course if it had to?

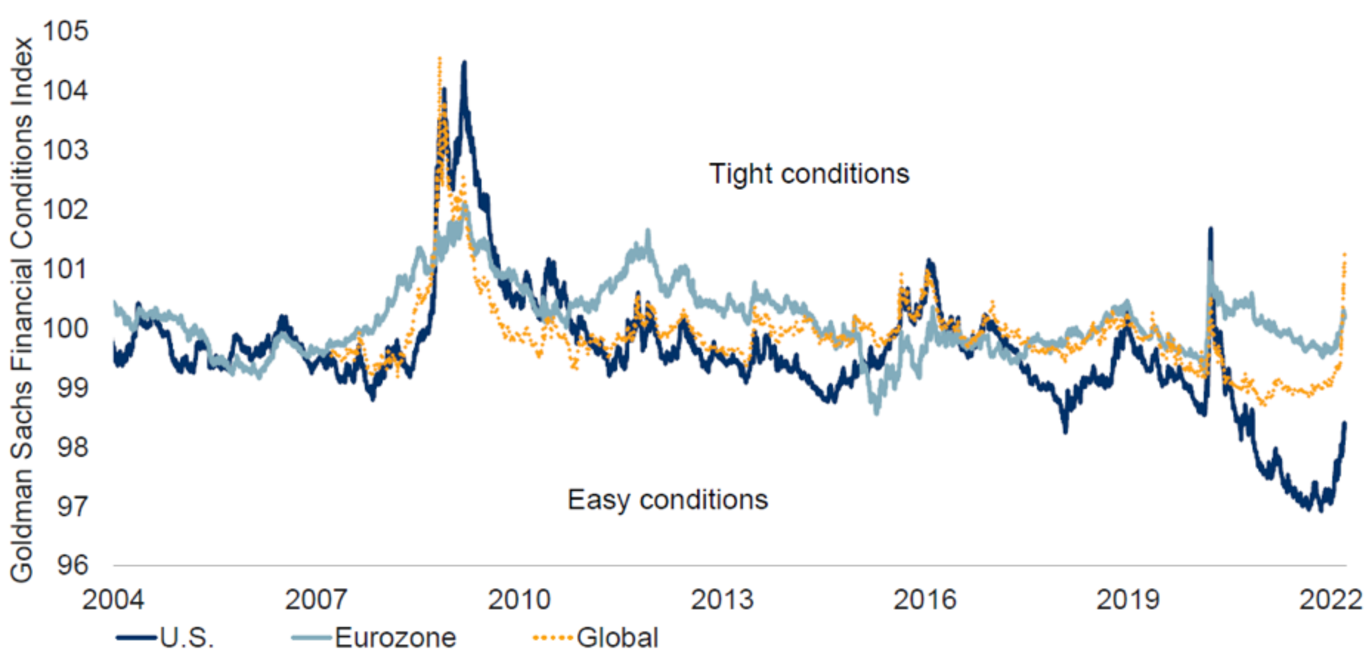
If inflation continues to be persistent over 2022-23, this will likely pressure the Fed to continue to explore more tools in its toolbox to fight inflation at the expense of growth. The fight against inflation in the early 1980s is certainly not forgotten at the Fed, although the parallels to the present are not linear. Suffice it to say, if inflation did persist for longer, the Fed's recent remarks suggests it will do what it takes to get it back under control, likely having learnt from history. We won't comment on the politicization of inflation, nor if the Fed has been too slow to respond to inflation, but these are two factors that go into its stance on inflation today.

The consequences of quantitative tightening and normalizing of monetary policy may be elevated volatility and risk of more severe market declines as the risk of a recession or slowing growth rise. Simplistically the support of quantitative easing, or expanding the Fed's balance sheet, supported financial markets, so the removal of support may have an opposing effect.

Herein lies the risk ahead – the risk of a recession brought on by tightening of financial conditions through tighter monetary policy. But how much "pain" in the markets and economy can the Fed really withstand before it slows down tightening and/or changes course?

Some investors point to the 2018/2019 Fed pivot on interest rate hikes as a prelude to what may lie ahead in 2022 if the stock market declines. Will the Fed come to the rescue of investors? We don't think so, but we could of course be wrong. The 2018/2019 Fed pivot in policy is not helpful for the current framework. Yes the Fed has to be careful of over tightening today, however the pivot back then came after a prolonged period of hikes, not before.

Chart 2: Global financial conditions



Source: RBC Global Asset Management

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Looking at the Financial Conditions Index in Chart 2, and U.S. CPI Index over the last four years (Chart 3), there's a big difference in the set-up today than what we saw into 2018-19. We are a long way from tighter financial conditions and a decline in the CPI Index. Financial conditions then had tightened into a period where CPI was barely above target and starting to come back after the U.S./China trade war-driven price spike. Also, the jobs market wasn't as hot then as it is today. The key take-away is we don't believe the pivot of policy to rescue investors from declining markets will be as readily available as in the past. The fight against inflation is the focus for the Fed.

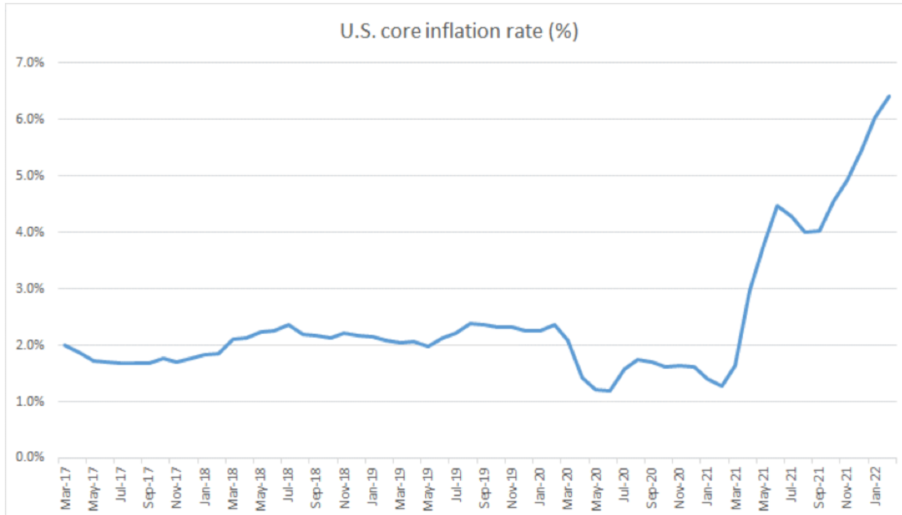
To be certain, extraordinary declines in the bond and stock market will likely be met with softer language by the Fed at some point to perhaps soften the blow of tightening conditions and slowing or declining growth. After all, household exposure to the financial markets has materially increased over the last two years (Chart 4).

Market corrections versus bear markets – what's the difference?

Generally speaking there are two scenarios of market declines that are a concern for investors as the Fed shifts its monetary policy from easing to tightening:

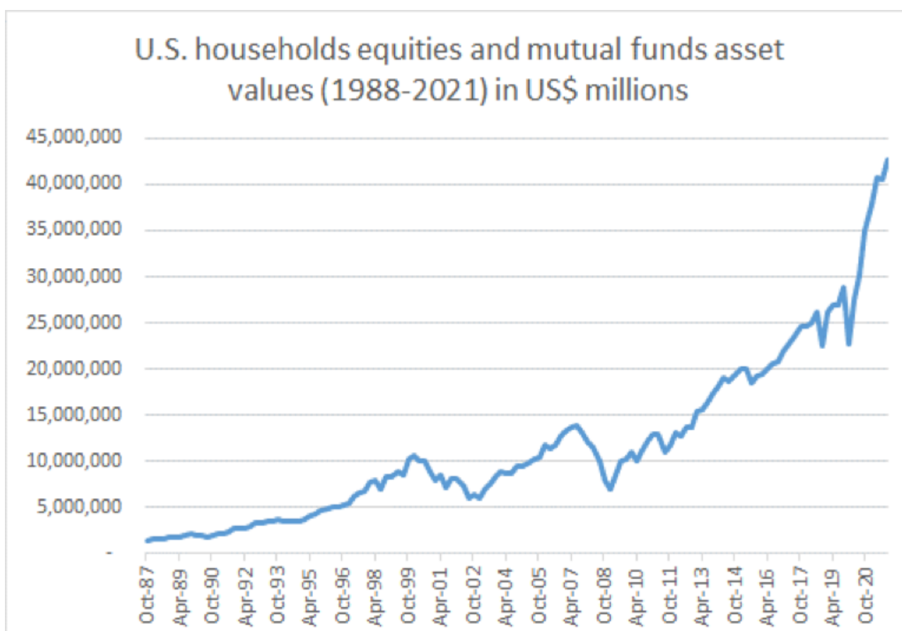
1. **Market corrections between -10% and -20%:** Historically these occur every two years, but have been noticeably less in the last decade so they are unfamiliar to more recent investors. Market corrections of this magnitude are usually shorter in duration.
2. **Bear markets which are defined as a price decline of at least -20%:** These occur about every 5-6 years and are often longer in duration than normal course market reactions.

Chart 3: U.S. core inflation rate



Source: RBC PH&N Investment Counsel, YCharts. The Core US Inflation Rate is one of the most important metrics for the US Economy. Inflation is also used by the US Federal Reserve to gauge the health of the economy. The Consumer Price Index (CPI) measures the change in prices paid by consumers for goods and services. The CPI reflects spending patterns for each of two population groups: all urban consumers and urban wage earners and clerical workers.

Chart 4: U.S. households corporate equities and mutual fund shares; asset, market value levels



Source: RBC PH&N Investment Counsel, Board of Governors of the Federal Reserve System (US), Households; Corporate Equities and Mutual Fund Shares; Asset, Market Value Levels, retrieved from FRED, Federal Reserve Bank of St. Louis; https://fred.stlouisfed.org/series/BOGZ1LM193064005Q, March 17, 2022. Data is quarterly, in millions of U.S. dollars and is not seasonally adjusted.

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In Table 1 we compare market corrections and bear markets in terms of the maximum unrealized losses, duration in days of the decline and the average one-year forward returns observed once the market bottomed and moved on from there. We use the term "unrealized losses" because these are not realized losses until a sale occurs. They remain unrealized losses provided investors do not panic and sell.

It's important to point out that just because the U.S. may be headed for a recession that not all recessions have resulted in a bear market. For instance, if we extend our historical timelines from Table 1, there have been 26 bear markets since 1929, but only 15 recessions during that time. Bear markets often go hand in hand with a slowing economy, but a declining market doesn't necessarily mean a recession is looming. There also have been 27 bull markets since 1929.

Some additional facts about bear markets that often get overlooked by the financial media and investors as the headlines are in maximum negativity mode:

- Stocks have lost an average of 36% during bear markets.
- Stocks have risen 78% of the time over the last 100 years, and bear markets have only been present about 20% of the time.
- Most of the strongest days in the last 20 years have occurred during a bear market, so the best way to weather a market drawdown is to stay invested.
- Bear markets can be short-lived, averaging a length of 2.1 years but have been as short as a few months to recover back to previous highs so don't try and time the market.

Table 1: S&P 500 Index market corrections (1950-2022)

	All market corrections of at least down 10%	All bear markets of at least down 20%
Average % unrealized loss	-20%	-36%
Median % unrealized loss	-15%	-34%
Max % unrealized loss		-57%
Avg. number of days to reach bottom	195	391
Avg. number of days to reach previous peak	319	774
Average 1-year % return from bottom	30%	44%
Median 1-year % return from bottom	31%	36%
Min 1-year % return from bottom	5%	21%

Source: RBC PH&N Investment Counsel, YCharts data. Data series is time-weighted, in U.S. dollars, from June 12, 1950 to present, before taxes, transactions fees and taxes. You cannot invest directly in an index and past performance is no guarantee of future performance.

The only certainty we have about the near term is more uncertainty ahead. A recession may or may not materialize in the coming year, and equity and bond markets may hold up for the near term and not suffer further correction.

To be prepared for any uncertainty, we reiterate that investors should always be prepared, rather than try and predict. Maintain diversification across asset class, geography, managers, strategy and style. And be patient – time in the market builds wealth over time while trying to time the market destroys it. We'll continue to update you over the course of the year with any changes to our outlook and what we're recommending for portfolios.

As always, if you have any questions or concerns, please contact your Investment Counsellor.

Required Disclosures:

S&P 500 Index: The S&P 500 Index includes 500 companies across many sectors of the U.S. economy. The index is weighted by market capitalization so bigger companies make up a larger proportion of the index than smaller companies. The index is designed to measure performance of the broad US economy through changes in the aggregate market value of the largest US companies.

Canada S&P/TSX Composite: Comprises the majority of market capitalization for Canadian-based, Toronto Stock Exchange listed companies. It is a benchmark used to measure the price performance of the broad, Canadian, senior equity market. It was formerly known as the TSE 300 Composite Index.

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