Benefits and Pensions MONITOR Meetings & Events WEBINAR

Inflation, Interest Rates, and Your Fixed Income Exposure

Foyston, Gordon & Payne Inc. Investment Counsel

The fact that there have been negative returns in the bond markets in 2021 for the first time since 2013 resulted in many investors turning their attention to their fixed income portfolios, says Kimberley Woolverton, Executive Vice President, Head of Distribution, at Foyston, Gordon & Payne Inc. (FGP) In a Q&A with Ryan Domsy, Executive Vice President & Portfolio Manager, Co-Head of Fixed Income, FGP; during the *Benefits and Pensions Monitor* Meetings & Events 'Inflation, Interest Rates, and Your Fixed Income Exposure' session, she said a major economic theme that has consistently dominated headlines in 2021 has been inflation. This has resulted from some dramatic inflation data after many years where inflation has been well-controlled at modest levels.

Prior to the pandemic, said Domsy, the economy was actually in pretty good shape. Growth was at moderate levels and inflation was running slightly below target levels, but was relatively steady. Since then, the data has been highly inconsistent as it has been impacted from the fits and starts of the global recovery, but also from base effects from weak GDP during the periods of broad lockdowns.

Now, despite the fits and starts from the COVID variants and lockdowns, what is really clear is that the consumers are really in a strong position in most developed countries. This is what's really driving strong demand.

This has also translated into inflation data that has been noteworthy and inflation has been running at much higher levels than what was broadly expected during the height of the pandemic.

Woolverton: Why do we keep hearing that inflation will be transitory?

Domsy: One thing I always like to remind myself about inflation is that it's really not a good or service, it's a product of collective expectations. These expectations are increasingly hard to shake once they become entrenched.

Certain aspects of inflation can be transitory from time to time, but generally most inflationary and deflationary forces are quite persistent. Examples of a transitory impact could be spikes in commodity prices due to temporary mismatches in supply and demand.

Core inflation data is also important as it strips out food and energy, which often experience more short-term price volatility because of short-term supply and demand imbalances. It is actually showing strength with much of the pressure currently coming from consumption of goods.

Woolverton: What should we expect from interest rates moving forward?

Domsy: With inflation expected to run well above trend from the last decade, higher rates are most likely to be the fallout. This will likely be the most important driver of fixed income returns, both in the short and medium term.

However, the impact of these higher rates will constrain returns on traditional fixed income portfolios which, I expect, will result in quarters with negative returns. At current low levels of yield and the resulting durations, there's not much room for traditional fixed income portfolios to absorb losses from higher rates before it leads to those negative returns.

Woolverton: With the outlook for traditional bond portfolios being constrained in a rising rate environment, what are you recommending to clients?

Domsy: We think it's important to ensure that clients are investing in solutions that have additional levers to pull to help mitigate the duration risk while also maintaining the real core attributes of a bond portfolio. We believe that core plus provides the best balance as these solutions have the tools to protect from the losses that result from rising rates, but also provide the protection a portfolio needs in case there is another market correction, like the one we saw at the beginning of the pandemic.

Woolverton: What happens if interest rates don't go up? How would a core plus fund perform in a falling rate environment?

Domsy: In the event interest rates fall, most hybrids and mortgages would still see some positive returns from their duration component, which would be somewhat mitigated from spread widening. However, the net result would be that prices are flat to modestly higher in an environment of severe market stress.

With a core plus solution, you need to have a deep understanding of the attributes and risk profiles, so you can actually mitigate risks, rather than just enhance returns. **BPM**

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