Monthly Market Insights

Data and opinions as of April 30, 2022

Central banks confirm hawkish stance

Market moves in April were influenced by the hawkish (cautious on inflation, price stability) language by central banks. Bank of Canada Governor Tiff Macklem stated that higher rates were needed to rebalance supply and demand, adding "everyone wants to know where rates might end up—how high they will need to go. It is important to remember that we have an inflation target, not an interest rate target. We are committed to using our policy interest rate to return inflation to target and will do so forcefully if needed." This confirmed expectations that the BoC's policy changes will be front loaded.

The NEI perspective

Central banks open to tradeoffs between growth, price stability. Many central banks continued to signal upcoming reductions in policy accommodation to address inflation. Expectations for aggressive policy tightening fostered a rise in bond yields, as did recent inflation data and comments from U.S. Federal Reserve officials and the BoC. The BoC raised rates by 50 basis points and alluded to another double hike.

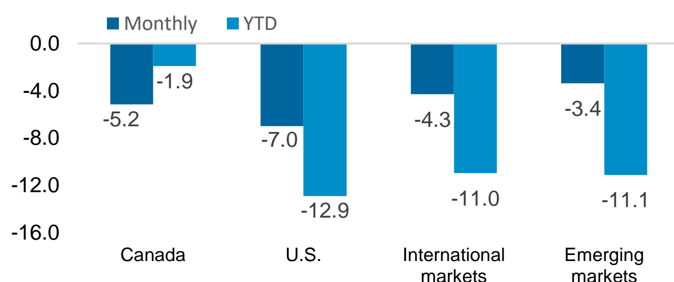
Equity market volatility continues. Developed-market equities had a tough April as investors assessed the economic impact of the aggressive stances of major central banks. The tech-heavy Nasdaq fell 13%, its worst monthly performance since the height of the Global Financial Crisis. The S&P 500 Index was off to its worst start to a year since 1939. Volatility is expected to continue until there are clearer signs that inflation is peaking.

Commodities take a breather. The commodity rally slowed as WTI crude oil traded down to US$105/barrel, off its US$115 highs of mid-March. Copper and aluminum prices also moderated. COVID-19 lockdowns in China and expected softening in global growth should moderate commodities demand and help balance demand–supply dynamics. Supply shocks relating to the Russia-Ukraine war continue to be a risk factor.

From NEI's Monthly Market Monitor for May. Read the full report for more insights.

Equity

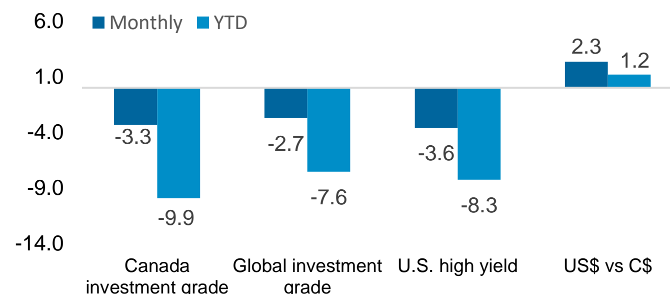
% return in C$



Canada: MSCI Canada; **U.S.:** MSCI USA; **International markets:** MSCI EAFE; **Emerging markets:** MSCI Emerging Markets. Source: Morningstar Direct.

Fixed income and currency

% return in C$



Canada investment grade: Bloomberg Barclays Canada Aggregate; **Global investment grade:** Bloomberg Barclays Global Aggregate; **U.S. high yield:** Bloomberg Barclays U.S. High Yield. Source: Morningstar Direct.

What's "quantitative tightening"?

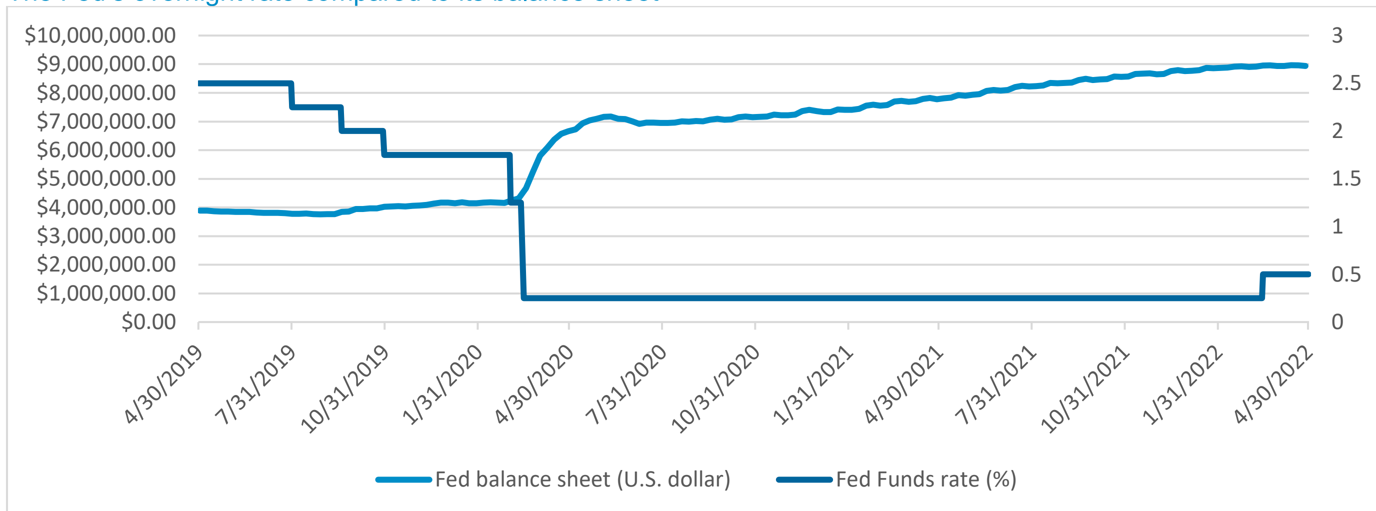
Amid ongoing concerns about inflation, the subject of monetary policy is often in the headline news. The term "quantitative tightening" (or "QT") has been used to signify central banks' intentions to moderate inflation as an added measure to increasing policy rates. With policymakers in Canada and around the world now talking about QT, we should take a closer look at what the term means and how this policy change could affect investors.

To best understand the current policy environment, we should go back to the COVID-19 recession of early 2020. Central banks responded to the deep decline in economic activity by dropping interest rates to their lower bounds and, not being able to cut rates further, stimulating economic growth by purchasing bonds, most commonly government bonds, in large volumes. This was done to push more money into the economy while helping keep longer-term interest rates low. The policy of bond purchasing was known as quantitative easing, or "QE."

However, the COVID-19 recession soon ended. The stimulus induced rapid economic recovery, with demand strengthening and inflation at multi-decade highs. Central banks then needed to scale back the stimulus in stages to prevent excessive inflation and economic overheating. Firstly, the asset purchases were tapered gradually before coming to an end, which was then followed by the beginning of the interest rate hike cycle we are witnessing today. In conjunction with these rate hikes, central banks are also looking to offload the bonds they had purchased previously. This offloading is known as quantitative tightening/QT.

The U.S. Federal Reserve provides a good example of this process in action. In the following graph, you can see how the Fed's balance sheet grew significantly during the early stages of the pandemic, which was also when interest rates were cut. As interest rates are now set to continue to increase, the Fed's balance sheet has levelled off, and through QT is expected to decrease in size.

The Fed's overnight rate compared to its balance sheet



Source: Bloomberg.

Central banks will need to engage in QT to unwind their balance sheets as world economies normalize. It is difficult to predict what QT will do to the economy, as QE itself only became a well-known concept quite recently (starting in the 2000s). However, the BoC and the Fed both have provided guidelines for how the process could happen.

The idea of QT sparked some market volatility in 2022 as investors worried about excess bonds in the market as a result, but contrary to popular belief, the major central banks have not stated that they need to sell bonds. Instead, they are willing to allow their bond holdings to passively roll off their balance sheets as they mature. This more gradual plan helped improve investor sentiment, though QT will still mean that some liquidity will be removed from the economy, albeit at a measured pace.

However, the bottom line is that markets will likely behave differently in a QT scenario. In NEI Investments' view, there will be fewer instances in which "all boats rise with the tide," i.e., when stimulus-fueled positive sentiment causes wholesale rallies in stock markets and/or specific sectors. The individual, fundamental strength of companies, plus their financial results, should assume much greater importance going forward. Investors can therefore stand to benefit from careful security selection through active management strategies, funds, and portfolios for robust investment returns in a constantly shifting economic landscape.

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