Bank of Canada: Let Inflation Run Hot for the Rest of 2021

Description

Since 1991, the guide to Canada's monetary policy has been an inflation-control target framework. The agreement was forged 30 years ago between the Bank of Canada and the former Minister of Finance. Both parties want to promote the economic and financial welfare of Canadians.

The last time the Feds and the Canadian government renewed the inflation target was October 2016. They agreed on a 2% mid-point of the 1% to 3% inflation control range for five years up to December 31, 2021.

Fast forward to August 2021, and Canada's inflation rate increased 4.1% year over year. It was also the highest since 2003. However, analysts think the Bank of Canada will not lift a finger yet and allow inflation to run hot. The policymakers will hold rate hikes in abeyance until the country achieves full economic recovery.

Impact of rising inflation rate

The impact of high inflation is less spending power for households and workers. However, it's not all bad news, based on a recent survey by Lifeworks. The poll results show that employers project an average annual pay increase of 2.5% for next year.

BMO Chief Economist Douglas Porter said the inflation reading in August could be the peak. However, he adds that elevated readings may continue for months due to sustained pressure on energy, food, and home prices. Thus, if the salary estimates fall below the rising inflation, workers could still have less purchasing power.

From the survey results by Willis Towers Watson, the expected salary increase is 3% in 2022. The group's senior economist, Rich Luss, said, "If demand for labor remains high and supply growth is sluggish, we would expect organizations to feel the pressure to increase compensation to attract the employees they need."

Self-sustaining recovery

For Millan Mulraine, the Ontario Teachers' Pension Plan chief economist, the Bank of Canada will most likely maintain the 0.25% benchmark overnight lending longer before raising borrowing costs. He said, "They want to go later. They want to ensure the self-sustaining recovery takes shape and that the output gap closes."

However, Mulraine hopes policymakers will not underestimate price pressures, and that inflation could shoot well beyond the Fed's target in the coming years. If not, it might require more aggressive interest rate hikes.

A market correction could be next

Most investors expect a market correction anytime soon. Nevertheless, high inflation spook investors. The **TSX** has already sunk 670.53 points (3.22%) since posting a new record high of 20,821.40 on September 3, 2021.

If a downturn worries you, the best preparation is to rebalance your portfolio. The financial sector, led by Canada's Big Banks, outperforms the TSX year to date (+22.34% versus +15.59%). However, Canada's second-largest bank is the standout choice in October 2021.

The **Toronto-Dominion Bank** (TSX:TD)(NYSE:TD) has proven time and again that it can overcome economic downturns. The $155.37 billion bank was the only company that reported top- and bottom-line growth during the 2008 financial crisis. After three quarters in fiscal 2021, TD's war chest is overflowing with cash. At $85.37 per share (+22.24% YTD), the dividend yield is 3.7%.

Developing storm

Beata Caranci, TD's chief economist, agrees with other economists' assessment that an interest rate hike will happen when the output gap is closed. Meanwhile, investors must prepare for a developing storm.

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