Portfolio Advisor

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In a fix: How inflation affects fixed-income investors

After falling gradually for more than 30 years, inflation has been flat for the last decade. But now the prices of goods and services are sharply rising as economies, starting to move past the COVID-19 pandemic, reopen and demand rises. The return of inflation has important implications for fixed-income investors.

Why is inflation on the rise?

In large part, it's due to the response to the pandemic:

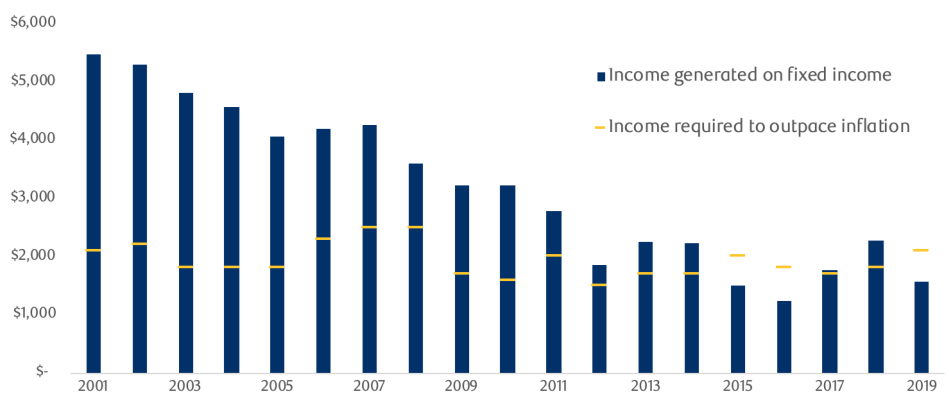
1. Central banks slashed interest rates to historic lows. They also bought massive amounts of bonds (driving down yields) to stave off a collapse in borrowing, and to reduce the burden on existing borrowers – both consumers and businesses – during the economic downturn caused by restrictions imposed to reduce the spread of COVID-19.
2. Unprecedented government stimulus programs injected trillions of dollars into the global economy to ignite demand, thus increasing prices. Some of this wealth – around $200 billion in Canada alone – has been stored up over the last year and is likely to be spent in the coming months.*
3. As the global economy begins to heat up, supply chain issues and commodity price increases are growing.

The bane of bonds

Rising inflation historically brings in its wake rising interest rates and bond yields, in turn reducing fixed-income prices (bond yields move inversely to bond prices). And, rising inflation erodes the purchasing power that fixed-income investors receive. In order to really "make a buck", an investor has to "make a buck" plus a return over and above the inflation rate that their "buck" is being eroded at. In short, they have to generate a real return – the nominal return minus the rate of inflation – to maintain their purchasing power.

As the chart here shows, after many good years, this has become harder to do. Looking at 2020, the real return "gap" has soared – a situation that only appears more challenging this year as inflation increases.

Income generated by fixed income vs. inflation
Based on $100,000



Data as of December 31, 2020. Source: Bloomberg, Bank of Canada, RBC GAM. Bond income based on annual yields for Government of Canada 10-year bonds. Inflation based on median core Consumer Price Index (CPI).

Fixed-income fortifications

Here are a few ways to mitigate the impact of rising interest rates and bond yields:

1. **Increase exposure to short-term bonds:** Short-term bonds are less sensitive to increases in yields.
2. **Consider lower risk-rated bonds:** There are a myriad of fixed-income investments available to investors that offer higher yields based on varying degrees of risk, including corporate bonds.
3. **Offset rising yields with floating-rate bonds:** The yields of these bonds rise in tandem with market yields, inflation and/or interest rates, neutralizing the impact of rising rates.
4. **Deploy bond funds or ETFs:** These investments can help mitigate the impact of rising yields by holding a wide array of fixed-income investments, while managing the risks involved through broad diversification and hedging strategies.

This list is not exhaustive, and it is important to remember that the impact of rising inflation – and consequent interest rate and bond yield increases – can be mitigated but not eliminated. Also bear in mind the recent surge in inflation is expected to be temporary, and adjusting your portfolio based on short-term changes in markets is rarely a good idea.

**Canadian household wealth rose in 2020*, RBC Economics (March 2021).