EP 111 | Playing the plan: Mawer's Canadian bond portfolio

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Andrew Johnson: **00:40** Welcome back to another edition of "Playing the Plan." Today, we have Crista Caughlin with us. Crista is the lead manager on our fixed income portfolios here at Mawer. Crista's also a key member of our Mawer softball team, which as I understand may not be at the top of the standings, but definitely having fun out there. Crista, for your benefit, we're going to stick to bonds instead of softball today. So, welcome back to the podcast.

Crista Caughlin: **01:03** Thanks for having me back. We like to call ourselves the "O-fer" team [laughs].

Andrew Johnson: **01:08** I think our listeners will completely understand where you're coming from there. We don't need to explain it. It probably gives you an idea where you're sitting in the standings right now, too.

Crista, it's been a wild five, six months in the bond market. Can you give our listeners a bit of a recap on what's been shaking out since the last time we spoke?

Crista Caughlin: **01:25** It's definitely been another rough six months in the bond market. I think the last time we spoke was October or November, and there's a few things that have happened since then. I think the main thing that's happened is inflation continues to surprise to the upside, which is really causing central banks to become more aggressive with respect to the tightening cycle.

01:46 So back in November, or the last time we spoke, inflation in Canada, headline inflation, was around 4.5%. Today it's at 6.5%. We've seen a similar thing happen to core [inflation]. It was at 3.75%, today it's 5.75%. And this is really something that's playing out globally. Headline inflation in both the U.S. and Europe is above 8%.

Crista Caughlin: **02:11** Now, this has caused central banks to become significantly more aggressive with respect to the tightening cycle, as you can imagine. Back in November, we were expecting, or the market was expecting, about five rate hikes by the Bank of Canada to end the year at around 1.50, maybe 1.75.

02:30 Fast forward today, we're six months into the year, the bank has already hiked those five times. We're sitting at 1.50 and the market's pricing in another eight hikes by the bank, so another 200 basis points by the end of the year, which would take the overnight rate to Canada up to 3.50.

02:47 Obviously this tighter policy has resulted in a significant move higher in interest rates as well as the material flattening of the yield curve. So, to put some numbers on that one, the 10-year rate last time we chatted was 1.75. Today it is 3.55, so 180 basis points higher. It's over doubled in the last six months. The shorter end of the curve, the two-year rate, has had an even bigger move. It started at 1%. Today it's sitting at around 1.30 last time I checked, but I think it's actually up to around 1.40 today, so that's 240 basis points higher. So, it's over tripled.

03:27 If you have 10-year rates moving around 180 basis points higher, two years, 230, the curve's actually flattened around 50, 60 basis points this year. So, at the same time that we've seen rates move higher, we've seen spreads widen. So the average spread on the DEX universe went from 110 to around 160 today. So corporate spreads are out about 50 basis points.

03:52 That move higher in spreads is really a function of increased growth concerns that come alongside higher inflation and higher interest rates. Obviously, the move higher in rates as well as wider spreads has caused negative returns in bonds.

Andrew Johnson: **04:09** You just hit on a lot of the topics that we talked on last time, too. So we're going to get into revisiting some of that shortly. And we talked last time, I think, about, it's not the absolute level of rates that really is prohibitive to stock returns or bond returns, it's the rapid move in which you get to those levels. And you just certainly outlined some pretty rapid moves that have caused some upheaval in bond markets over the last six months or so.

Andrew Johnson: **04:34** You and I get to chat every week. As you said, it's been roughly six months since we recorded a conversation on the podcast. And the last time you were on, you also gave us this great overview of how you and the team work with all of that uncertainty of the macro environment. Of course, the second-order impacts of big changes that happen in the world, and then how you ultimately construct a portfolio to be resilient in the face of all of that.

04:58 So I thought, as I said, we could revisit that framework this time around. You spoke last time about some high-level themes and then some scenarios that could unfold in the context of those themes. Why don't you give us a quick refresher on what those themes are, and if there's been any changes to your thinking around them. And just, if you're forgetting what you said six months ago, we talked at a high level about this concept of a global debt overhang, so the level of global debt that's out there. We talked about China's credit cycle and how they're navigating that. And then, finally, something that I think is on a lot of people's minds now, which is the shifting objectives for both fiscal and monetary policy makers. So, what's the latest on those?

Crista Caughlin: **05:36** Yeah, so I'll start with the easy one—China's credit cycle. So the last time we spoke, policymakers were targeting a slowing money supply, which we thought would have a direct impact on growth in China, which would then obviously have a direct impact on global growth. And we actually saw that play out. China was slowing fairly materially by the end of the year. And then by December, we started seeing a shift. There was an economic policy meeting, which really focused on stability in China. Monetary policy would be measured, it would be targeted, fiscal policy would take up the majority of the easing. But the real key was they weren't going to do an all-out push in terms of policy. They were going to focus on just stabilizing their economy. Unfortunately for them, they then got hit with another wave of COVID and another round of lockdowns, which created more downside pressure on growth.

06:31 But what was important for us was really the response that policy makers had to that increased downside pressure on growth. In spite of that renewed pressure, they continued to focus on stability so they didn't overstimulate their economy. We did see money supply increase modestly, but it was nowhere near what we've seen historically when they were trying to stimulate their economy. And so what this means for us is that we don't believe we're going to see a large boost in global growth coming out of China.

Crista Caughlin: **07:01** The other theme that we've spent a lot of time on is the shifting policy objectives. The last time we spoke, we talked about there was no real shift in policy objectives. It was the largest contraction we had seen in growth historically, which was met by the largest policy response. I think this is an area where we underappreciated, really, what happened, particularly on the fiscal side.

07:25 We did see a large policy response. It's not clear that the objectives were different, but in hindsight, there was obviously something very different about fiscal stimulus we saw in 2021 versus historical periods. And the best way, really, to explain it, to understand the differences, is really to look at what happened in 2020 versus 2021. Both times, both years, we got direct payments to the economy. But in early 2020, we all remember, the economy completely shut down. Job losses were off the charts. We saw, I think, close to 20 million job losses. This resulted in significant income losses. So, those direct payments were really meant to fill the income gap, or the income hole, and it was successful. You had a large decline in income, which was offset by fiscal stimulus.

08:14 In 2021, we also had another round of lockdowns, but this time the economy had shifted. And I think this is what we didn't appreciate. Companies had figured out how to make money in the lockdown, there was actually no real job losses, which means there was no income losses. So that fiscal stimulus wasn't filling in a hole, it was just piling on top of income that already existed. And so that excess income ultimately led to excess demand and higher prices. The one thing to remember here is that it was a one-time cheque that won't be repeated. And so to maintain that level of spending, we have to see either wages rise or borrowing to pick up. And right now we are seeing a small amount of wage increases, but the big change we've seen this year is we've seen a pretty decent pickup in credit growth.

09:06 And so that actually dovetails into our last theme, which is the global debt overhang. We are seeing borrowing increase. We're seeing debt levels increase. It's something we're monitoring, but there's nothing to say that that can't continue to increase. There's no level of debt that becomes constraining to an economy. The real constraint ends up being the ability of an economy to service that debt. And so that's where a lot of our focus has been over the last six months and a lot of the research we've done, particularly in Canada, which has elevated household and private sector debt levels.

Crista Caughlin:	**09:41**	So, some of the findings from the research that we've been doing is, based on where interest rates are today, we're already at levels—at least in terms of the debt-service ratio—that historically would've caused the consumer to slow down materially. There's a significant amount of variable debt in Canada. I think the majority of the mortgages that have been taken out over the last few years have actually been variable.
	10:09	In addition, mortgage terms in Canada are typically five years and under, meaning there's a large portion of debt that has to be refinanced every year. And all of these are going to be exposed to higher interest rates, which means, all else equal, more income will have to go towards servicing that debt versus purchasing additional goods and services.
	10:29	So, for us, this doesn't really mean interest rates can't go higher. They likely will in the near term. There's obviously momentum behind this higher interest rate, tighter policy environment that we're in right now. But it does suggest that, at least over the medium term, unless we get a material increase in wages, we're unlikely to see rates rise significantly from where we are today. So, this obviously means we're watching wages from here and we're continuing to do work on the serviceability of the debt in Canada.
Andrew Johnson:	**10:58**	And just to help round out the picture on the Canadian mortgage market, as you alluded to, is currently variable in nature and on the shorter term side of things. Compare and contrast that to how the American mortgage market looks, just to give us a better picture of what we're looking at.
Crista Caughlin:	**11:16**	In the U.S. it's actually a very different structure. So in the U.S., the term on the mortgage is typically 30 years. I think a short term in the U.S. is considered 15 years. And so what that means is you actually don't have to refinance your mortgage every few years like you do here in Canada. So you're not actually exposed to higher interest rates the same way we are in Canada.
Andrew Johnson:	**11:40**	Yeah, which is all fine when interest rates are stable or moving slowly, as opposed to people who are refinancing in the current environment after a three or four year term. They're going to get some sticker shock on their rates.

Crista Caughlin:	**11:53**	Yeah. And it doesn't mean the housing market is not exposed in the U.S. New borrowers, or if you're buying a new home, you're obviously exposed to the higher interest rates. So, housing itself is definitely a risk in the U.S., it's just the consumer's ability to service that debt and consumer spending is not exposed in the U.S. the way it is in Canada.
Andrew Johnson:	**12:13**	So it's that second-order impact on the economy, on retail spending, and other forms of spending when we have to tighten our belts and service our debt.
Crista Caughlin:	**12:22**	Yeah, exactly.
Andrew Johnson:	**12:23**	All right. So, those are I guess the high-level themes that you're paying attention to. The next step, of course, as you mentioned, is to think about some scenarios within those. This is actually what I'm really interested to hear your thinking on now, because we have had that significant reaction from the market in the first six months of this year, as we've talked about. So those scenarios—just as a reminder for our listeners that we talked last time on—the first one was just that growth overall was going to continue to be solid, may decelerate somewhat, but otherwise solid. The other scenario that's in there, that you mentioned, was the emergence of headwinds for growth. And then, of course the final one, which you've touched on already, which is the inflation story. So, any updates on those scenarios?
Crista Caughlin:	**13:06**	Really what's happened, or the way I would describe it, is throughout the year we've gone from three scenarios and we've narrowed it down to two. So, we still believe that the idea that growth remains solid exists as a scenario. It was our highest probability scenario earlier this year. The probability has declined, but it's still our highest probability scenario, I would say.

Crista Caughlin: **13:28** We have updated it to reflect the current central bank tightening, but it is one where growth slows. It remains positive. It probably bounces around potential. Inflation starts moving back towards central bank targets by year end. It doesn't hit central bank targets, but it's obviously starting to slow. And this means that policy, which has tightened aggressively and continues to do so, but it does less than what the market's currently priced in. So, if the market's currently believing that the Bank of Canada will hit 3.5% percent by the end of the year, this scenario would suggest we're only going to get to 2.75%, maybe 3% before pausing. And so that would suggest a small decline in rates, but basically for rates to remain around the 3%. With the growth scares out of the picture, we see spreads grinding lower. Although, there's going to be volatility around that. And the big one is the curve will remain flat, but it doesn't go materially inverted. So, that's the first scenario that we think is the most likely to play out.

14:35 The second scenario we're now working with is really a combination of the other two risk scenarios that we had laid out earlier this year. And this is that inflation continues to surprise to the upside and it's forcing central banks to be more aggressive than expected.

14:52 And those two factors combined are adding more and more pressure on the consumer and the economy, and eventually causing growth to roll over, which ultimately pushes you into a recession. So, again, we have the Bank of Canada is 3.5% by the end of the year, according to the market. They could easily go to 4%. Rates are obviously moving higher in this scenario. The curve will materially invert as central banks continue to push on the front end of the curve, push the front end of the curve up. And the growth scare starts bringing the long end of the curve down, and spreads obviously continue to grind wider here as growth slows and moves into recessionary territory.

Andrew Johnson: **15:34** I guess, with all of those in mind now, we have to start thinking about and talking about bringing this all together into portfolio construction. And heading into this year, as I recall, I guess duration was slightly lower than benchmark, but I think more recently it's largely been in line with the benchmark. And you were overweight spread products. So in other words, corporate bonds, provincial bonds. But you were, and you mentioned this on the last podcast, you were very mindful of the chances that volatility picks up, given those two scenarios where we see persistently higher inflation and a slowdown in growth. So where do we stand today from a portfolio perspective? And what's on your mind in terms of positioning moving forward, given all that you've mentioned?

Crista Caughlin: **16:15** The two scenarios that I laid out… I would say the first one is our highest probability scenario. However, we do recognize that really, in order for that to happen, we have to see inflation start rolling over. And until then, we're likely firmly stuck in that second scenario. And so what does that mean for the portfolio? If you remember, in both scenarios, we think the curve flattens. And so we are in a curve flattener currently.

16:43 There are parts of the Canada curve that have actually materially inverted already. The 10s30s curve is inverted by 20 basis points, which is at historical lows. But the broader curve 2s10s in Canada and the U.S. is still both upward sloping, so we believe that part of the curve can continue flattening. We think in the short term, there's likely some pressure on rates, but as I mentioned before, we believe that there's a point where the rates have likely gone too high. And so we were underweight duration, but as you mentioned, we just recently brought that in over the last few days.

17:21 In terms of spreads, we have been overweight corporate bonds. We're currently underweight municipals and provincials, so we've been reducing that exposure over the last few months. I would say, absent of recession, spread product actually looks attractive. However, as I mentioned, we won't be increasing that risk anytime soon—at least until we have more confidence that we're not going to go into a recession. And so we would need inflation to start moving over, we would need central banks to ease off some of the current policy that's priced in before we actually really increase our exposure to spread product.

Andrew Johnson: **18:00** Just before we wrap up, Crista, you mentioned inflation earlier. I just wanted to bring back that conversation because you did touch on some of the things that were driving that. But overall, what's been behind the big jumps and inflation numbers that we've seen over the last six to 12 months?

Crista Caughlin: **18:16** So the way we've been thinking about inflation, or the way we've been thinking about the factors that drive inflation, is we've really bucketed it into two categories: shocks, and what I would call "fundamental drivers." So there's obviously been a few shocks since the last time we spoke. I think most people are aware of them. The war in Ukraine has been causing commodity prices and food prices to move higher. I think Russia and Ukraine combined are responsible for a third of global wheat supply and around a fifth of global corn supply. So obviously disruption in that region reduces the supply of those items, which causes food prices to increase globally. Russia is obviously a large exporter of energy, so again, disruption is causing oil prices to move higher.

Crista Caughlin: **19:05** The other shock we saw was one we've seen before, which was another round of COVID, which created lockdowns in China, which continue to put stress on the global supply chain. But what's happening is these two shocks have been happening at the same time where we've been seeing excess demand, particularly in the U.S., driven by fiscal policy. I talked about it briefly when we reviewed the shifting policy objectives, but I think this is a big component to what is driving inflation in the U.S. and globally. It seems like a lifetime ago, but it was really just over a year ago that the U.S. got its second round of emergency fiscal stimulus. And that money has been making its way through the economy, creating access demand, and causing prices to increase.

Andrew Johnson: **19:53** That's a really good thing to highlight, because I think with all that has happened in the last two plus years, it can become very easy to think that a lot of these events and shocks that have happened and the rounds of fiscal stimulus that you mentioned are five years ago, or they feel longer ago because so much has happened in between. So I think that's some good context to think about what's happening in the market today. Because, as we mentioned before, a lot of the volatility that we've seen in the bond market is just bond investors trying to digest all of this news, and the bond market trying to digest it and move through it and price things correctly moving forward. And that can be tough to do when things are so fast moving.

20:32 All right. Well, as always, Crista, this has been a fascinating discussion. I know our clients and listeners are keen to understand the bond markets and the portfolio and hearing from you is certainly educational in that regard. So, thank you for that and thank you for your time.

Crista Caughlin: **20:45** Yeah, thanks for having me.