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EP 161 | Quarterly Update | Q2 2024

[00:00:00] Kevin Minas: Hi everyone. In this episode of the Art of Boring, I talked to fixed income Portfolio Manager Crista Caughlin for our quarterly update. We discuss what drove markets in the second quarter, including the Bank of Canada finally getting off the sidelines, as well as the excitement around artificial intelligence (AI) continuing to push global equity markets higher; some thoughts on the inverted yield curve and why the recession that an inverted curve is supposed to forecast hasn't happened—at least yet; and finally, how we're positioned across our portfolios.

[00:00:33] Disclaimer: This podcast is for informational purposes only. Information relating to investment approaches or individual investments should not be construed as advice or endorsement. Any views expressed in this podcast are based upon the information available at the time and are subject to change.

[00:00:50] Kevin Minas: Crista, nice to chat with you today.

[00:00:51] Crista Caughlin: Yeah, thanks for having me again.

[00:00:53] Kevin Minas: I always enjoy hosting the quarterlies because it's a chance for us not only to talk about public equities but also the macro landscape, what's going on in rates markets, credits, and, of course, how that feeds into equity markets. You're an excellent person to speak to for that given your fixed income focus.

This quarter was a particularly interesting one, as it was the first time the Bank of Canada got off the sidelines with its first policy action of the cycle. I think that would be a great place for us to start. Can you walk us through the policy action that we saw in the quarter as well as the underlying economic data that prompted that action?

[00:01:27] Crista Caughlin: We're at the beginning of global central banks starting the easing cycle. They're shifting from tighter policy to something less restrictive, particularly in economies where we've seen growth weaken and inflation move closer to target. This quarter, we saw both the Bank of Canada and the European Central Bank (ECB) lower rates by 25 basis points (bps). In both cases, the central bank has communicated that any easing is going to be slow, moderate, & data-dependent.

What does that mean? If inflation starts moving higher again or starts surprising to the upside, they're going to slow the pace of easing, maybe even stop altogether. But it also means that the easing cycle is going to look a lot different than the hiking cycle. When they were raising rates, inflation was moving rapidly higher, so they needed to hike rapidly. They were hiking 50, 75, even 100 bps in any given meeting.

Currently, inflation is easing at a gradual pace, so the easing cycle is going to be gradual; they're going to be cutting gradually. In terms of what to expect going forward, unless there's a more material slowdown in growth or employment losses, we should expect to see the Bank of Canada cut in 25 bps intervals. We shouldn't be surprised if they skip a meeting or two here. And again, outside of a recession, we think they'll cut 100-150 bps this cycle. Get back to 3.0-3.5%.

[00:02:56] Kevin Minas: To your point there about slow and steady cuts, even meetings where we don't have cuts, the Fed has not moved as of yet. So there is at least a little bit of divergence in central bank policy. Do you expect that to continue? Do you expect that to widen? How would you characterize the different moves across

the central banks? Do they need to act in unison?

[00:03:15] Crista Caughlin: Can there be a divergence in central bank policy? Yes. The Bank of Canada can continue cutting rates while the Fed is on hold. Can it be a material divergence? Will the Bank of Canada start cutting, while the U.S. is raising rates? I think that's less likely. The way I think about it – the important thing to remember is – at this stage, I wouldn't actually classify what's happening as a major divergence. We're at the end of a global tightening cycle. What I see happening now is countries are tweaking policy to sort of better fit their domestic markets.

However, all central banks are still in restrictive territory. When we look at Canada, we obviously have higher debt levels, which is contributing to growth being slower and inflation being lower. So they're tweaking policy to factor that in. In the U.S., growth has been more robust, so they may not need to ease as much, but the main takeaway or the thing I keep in mind is both countries, over the next year, are going to maintain a restrictive policy and start inching toward a neutral stance.

[00:04:14] Kevin Minas: One thing we used to hear a lot of—at least I've heard less chatter about it of late—is about the yield curve inversion. It's something that has been the case for, correct me if I'm wrong, at least a year or two, where shorter-term yields are higher than longer-term yields. That's obviously starting to be addressed with the cuts, but the curves are still inverted. From what I recall, that was supposed to be a sign of imminent recession. And obviously, that's not come to be at least yet. If you could just give us an update on the state of the curve and what's going on in terms of the signals that that might be suggesting.

[00:04:43] Crista Caughlin: As you mentioned, the yield curve is still inverted in Canada. The Bank of Canada overnight rate is 4.75, which is obviously higher than the Canadian 10-year rate, which is closer to 3.50. The way I think about the yield curve is...when the yield curve is inverted, it suggests that the market believes policy is restrictive. If policy is restrictive, it's because you're trying to slow growth; you're trying to slow inflation.

Obviously, if you keep policy restricted for an extended period of time, you typically end up in a recession. I don't know if a lot of that has changed. You kind of alluded to this, but right now the yield curve's been inverted for almost two years. That's definitely longer than average. On average, it's about a year and then you see the recession. However, it's actually not the longest on record. In the late 80s, we saw the yield curve remain inverted for over two and a half years before the recession showed up.

For me, the takeaway is that policy is restrictive, growth is slowing and probably going to continue slowing, and when that happens, there's a good chance that we will end up in a recession at some point, but the timing is unknown.

[00:05:51] Kevin Minas: You mentioned earlier in one of your responses about the neutral rate. Central banks are going to try to move toward a neutral rate. Another term for that is R-star (the letter R and then *), which is really that long-term neutral rate where growth is either the policy is either not accommodative or restrictive.

It's kind of in that sweet spot. There's been talk of whether that R*—that neutral rate—should be higher going forward than it was in the past because of inflation issues, deglobalization, and demographic shifts. Do you think that that's still a relevant conversation? Is that neutral rate potentially going to be higher through this cycle than last cycle? Because that, of course, would have implications on what central banks are going to do in terms of how much they might cut.

[00:06:30] Crista Caughlin: The first thing to keep in mind is the neutral rate is highly theoretical, but it is one, as you mentioned, that central banks use to gauge how tighter easy policy is. Has it drifted higher? I think there's a lot of evidence that would suggest it has. I think the real question is how much higher. In Canada, for example, the

Bank of Canada thinks it's somewhere between 2.25% and 3.25%. They've recently just moved that modestly higher. It's probably close to that, probably closer to the higher end of the range. Maybe it's 3%, maybe it's 3.5%.

Canada still has a lot of debt to work through, which is restricting growth and inflation. We did get a boost from immigration, but I think the pace of that is slowing. Although I think the neutral rate is higher in Canada than pre-COVID, I think there's a lot of structural issues that we still face, which will restrict how high rates can go.

Now, I think the harder question is the U.S. The Fed believes the neutral rate, or the long-term average Fed funds rate, is 2.8%. But if you go back in history pre-financial crisis, the neutral rate was thought to be 4-5%. It was really through the financial crisis, post-financial crisis, that it declined materially. And that made sense. There was a significant amount of private sector deleveraging that was happening in the U.S., which was restricting growth. That deleveraging has happened. Growth is in a much better state. Inflation is higher. I don't think it's out of the question to think that the neutral rate actually goes back to a level similar to pre financial crisis. At the very least, it's likely higher than what the Fed is pinpointing today.

[00:08:06] Kevin Minas: If I was to summarize that: Growth is decelerating; obviously, we've started cuts in some jurisdictions or are perhaps start them in others. Inflation maybe being a little bit stickier than the long-term average, but it is being tamed. If we were to shift to asset class returns and what sort of happened in the actual capital markets.

Let's start with equities. Overall, it was a very strong quarter; varied by geography, a little less so. For example, Canada, the U.S., and some other global regions had very strong returns. A lot of the same themes that we've probably been talking about for a good year, year and a half now.

Nonetheless, if you talk about some of those key themes, particularly in the context of returns, relative returns—at least for some of our funds—have been a bit weaker. We've had less AI exposure, particularly semiconductor exposure. That's hurt us a bit over the last particularly three months and even the one year quite significantly. Not in every asset class, but generally speaking, across the equity platform. If you could walk us through some of those key themes, that'd be great.

[00:09:01] Crista Caughlin: As you mentioned, equity markets did quite well this quarter, most reaching new highs, and it was really a continuation of what we saw in the first quarter. Similar to Q1, the strength was primarily driven by a narrow segment of the market, notably technology or really anything related to technology. From a sector perspective, obviously information technology led all sectors in terms of performance, as the demand for semiconductor chips continued.

Communication services was another top performer in large part due to Google, and the utility sector did quite well. Even that has been impacted by this technology theme, as AI exuberance has led to the expectation that more data centers are going to be built, which is going to lead to more electricity demand. So that theme has really helped our holdings in manufacturers like Taiwan Semiconductor (TMSC), ASM International, and ASML, as well as some of the data providers we hold, like RELX and Wolters Kluwer.

Nvidia is obviously a major winner of this technology theme. This is one we're watching closely at this stage. Our view is the valuation really doesn't properly reflect the wide range of outcomes that could happen to this company. Because of that, we believe it's trading above its intrinsic value. Despite the temptation to chase the current trend, we believe the best strategy is really sticking to our philosophy and sticking to our process on this one.

Another major theme in equity markets has been consumer weakness. There's a growing concern around consumers as high inflation has been eroding purchasing power. Obviously, luxury goods companies, as well as

companies such as Sleep Country and Pet Valu, have been hurt by this. Now on the positive side, Dollarama has done quite well through here, as its business model is more shielded from consumer weakness. Actually, they really benefit when consumers become more price sensitive.

[00:10:56] Kevin Minas: That's been a great recap on the equity side. A little closer to home for you is the credit markets. What is the state of the credit markets? It doesn't seem like spreads have moved too much. Anything to report there that's noteworthy?

[00:11:08] Crista Caughlin: We saw a small winding in credit spreads this quarter. Both investment grade and high yield, widened around three to five bps. Now, keep in mind, spreads have been tightening since the middle of last year. We're close to, if not at, all-time tights, particularly in the U.S. I would classify what happened last quarter more as a stabilization of spreads versus a widening.

In terms of cracks, we're not really seeing anything from a broad market perspective. There are still risks in the commercial real estate sector. That's a theme that's been playing out for over a year, and we expect it to continue to play out. With spreads closing in on all-time tights, we do see the market as being expensive relative to history, and that's resulted in us focusing on higher quality names in both the Canadian and global strategies.

Even in expensive markets, opportunities do exist. I think this quarter, Videotron is a really good example of that. Our process indicated it had a strong market share, and it was really committed to its debt reduction plan, and as a result, suggested that it was trading wider than fundamentals. Last quarter, we saw that thesis play out. Videotron spreads tightened 80-90 bps. Rating agencies actually upgraded the company to investment grade. I think that holding really benefited our global credit strategies, and I think it does a good job of demonstrating what we're doing on the credit side.

[00:12:32] Kevin Minas: I love that example of Videotron because sometimes when we're talking about asset classes, when we say expensive or cheap, we're talking obviously high-level terms, basically the beta in the market, the risk in the market generally, but that doesn't necessarily mean that there aren't any opportunities. There are always underlying opportunities, whether it's the equity markets or on the credit side. It's just really a question of being a little bit more selective, perhaps, when spreads are tight, so when valuations are rich. Then dialing up and down portfolio risk. It's an excellent example.

As always, I like to finish our conversation with an update on any activity in terms of asset mix. You sit on the committee. Were there any updates in the quarter? Are there any key themes that the committee's focused on and any other closing thoughts you'd like to share?

[00:13:13] Crista Caughlin: I think you mentioned it earlier, but it's obviously been a more challenging three months, even 12 months, for our balance strategies. I think this quarter, underexposure in semiconductors, big tech, and AI has hurt us on a relative basis. We do have exposure there, obviously. However, it's just not as much as the benchmark. We also got hurt again by our consumer-focused businesses. Now, having said that, we do believe the right path is to stay true to our philosophy and stay true to our process.

In terms of changes on the quarter from an asset mix perspective, there haven't been any real changes. We do believe risks are elevated at this time, both upside and downside risks. Given we're looking to build portfolios that are resilient to cross a number of scenarios, we continue to be neutral equities, underweight bonds, and underweight cash.

[00:14:03] Kevin Minas: Awesome. Appreciate that. Crista, it's always nice to chat with you, and we'll see you next quarter.

[00:14:07] Crista Caughlin: Great. Thanks so much.

[00:14:09] Kevin Minas: Hey everyone. Kevin here again. To subscribe to the Art of Boring Podcast, go to mawer.com. That's M A W E R dot com forward slash podcast or wherever you download your podcasts. If you enjoyed this episode, be sure to leave a review on iTunes, which helps more people discover the "be boring, make money" philosophy. Thanks for listening.