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EP 146 | Quarterly Update | Q4 2023

[00:00:00] Kevin Minas: Hi everyone, in this episode of The Art of Boring, I talked to Fixed Income Portfolio Manager, Crista Caughlin. We discussed the key economic developments in the fourth quarter, including growth levels and inflation, why financial markets have been so resilient, and how we're reflecting our current views in the portfolios we manage.

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[00:00:53] Kevin Minas: Joining me today is Crista Caughlin, Lead Portfolio Manager of the Mawer Canadian Bond Strategy and the Mawer Money Market Strategy. Great to chat with you today, Crista. Thanks for joining.

[00:01:03] Crista Caughlin: Thanks for having me, Kevin.

[00:01:06] Kevin Minas: Fantastic. So, let's jump right in. I'd like us to start by setting the stage for our listeners around the macroeconomic forces that shape the markets in Q4. Can you walk us through the key developments and where we are in the economic and business cycles?

[00:01:20] Crista Caughlin: Yeah. I want to start by saying there was a lot of volatility this quarter. We saw interest rates fall materially, equity markets had a fairly large rebound, and inflation had a decent decline. It's almost like there was a shift that happened in Q4. However, when I look back, it really was Q3 that was the anomaly. And Q4 was really just a reversal of what we saw last quarter and really more in line with the trend we have been seeing all year.

[00:01:47] Crista Caughlin: So, let me start with the economic backdrop. If we take a look at growth, I think I mentioned last quarter that from a data perspective, the change was somewhat marginal. Growth was marginally better in Q3. PMIs had bottomed in June and moved higher. That was somewhat reversed in Q4; growth was marginally worse.

The reality is, growth hasn't changed that much over the last few months and few quarters, really. Whether it be employment markets, consumption, data, retail sales, even industrial production.

[00:02:16] Crista Caughlin: Everything's sort of been running at similar levels in the second half of this year. The one area where we are seeing a bit of a change is in Canada. Canada had a negative GDP print and saw consumption basically flat for the second quarter in a row.

And so consumer spending has really started to slow in Canada. And I think that's really a function of the fact that we're starting to see higher interest rates and really, a decline in that excess savings making its way through the economy.

[00:02:47] Kevin Minas: So, the economy has remained quite resilient in the face of very rapid and substantial interest rate increases throughout 2022 and into 2023. 2023 was supposed to be the year of the recession, and that, of course, didn't end up panning out. Are we still waiting for the impacts of higher rates to sort of make their way through the economy? So, those lagged effects that you hear so much about? Or do you expect things to remain resilient for the next little while?

[00:03:12] Crista Caughlin: First, I'll talk about 2023. There were definitely a number of people, myself included, that was expecting a larger slowdown in economic growth and had a real increased probability of a recession. Obviously, that didn't happen to the extent that we were expecting. And I think there's a few things in my mind that really drove that resilience in 2023.

The first one is savings, particularly in the U.S. I think that excess savings was really underappreciated and allowed consumers to handle price increases and allowed them to handle those higher interest rates. The other thing we saw happen was on the fiscal policy side. There's a number of regions. that continue to run recession like fiscal deficits or fiscal policy. Canada, the U.S., even areas in Europe, all saw their deficits increase in 2023 versus 2022. And that really acted as a tailwind for growth.

So, in terms of the next question regarding “are we through the worst of it,” or “are rate hikes still impacting the economy,” I don't believe we've seen the full impact of rate hikes.

[00:04:14] Crista Caughlin: You know, the last rate hike was six months ago. It's unlikely that's been felt in the market yet. We also know the full impact on mortgages, particularly Canada, hasn't been felt, whether it's variable payments haven't changed, or fixed mortgages haven't reset. I think the real question, though, is as those rate hikes continue to make their way through the economy, will it cause a recession?

Obviously, that's yet to be determined. Our view is that in Canada, the probability is much higher. You know, I've already mentioned that we have seen a negative GDP print, and we've already started seeing weak consumption numbers. The other thing to keep in mind, or I guess the other question to ask is, “will central banks lower rates fast enough that we may never see the full impact of where rates are today in the economy?” And I think that's what's really driving that soft landing scenario.

[00:05:04] Kevin Minas: Just as a follow up to that, does that suggest, given, I guess, the macro backdrop that you mentioned between the two countries, as well as higher debt levels perhaps in Canada on a per capita basis or the government level, does that suggest that the Bank of Canada, once central banks start getting into cutting mode, might be a little more aggressive in cuts or less aggressive? Like, do you see a divergence between the Fed and what the Bank of Canada might do in the next year or two?

[00:05:26] Crista Caughlin: I think there is a scenario out there where the Bank of Canada is going to be forced to cut rates more materially than the Fed or more materially than what we will see in the U.S. And really for a number of the reasons that you've already suggested, particularly the debt environment. And it's not that uncommon for the Fed and the bank to move in separate or different directions or different magnitudes. You know, we saw it in 2015, 2016 when we had the energy crisis. I think there's a scenario where something similar happens over the next few years.

[00:05:56] Kevin Minas: What's the picture like for inflation?

[00:05:59] Crista Caughlin: I talked earlier about Q3 being an outlier, and that's exactly what happened on the inflation front. Earlier we saw inflation slowing and then last quarter it spiked higher, which was really the catalyst for rates moving higher and that higher-for-longer narrative that central banks were talking about.

This quarter we saw a complete reversal of that. So, in the U.S., inflation in the U.S., at least as measured by PCE, was running at around three and a half percent last quarter and was trending higher. And so that's three and a half percent on sort of a three-month annualized basis. This quarter, it's running closer to one and a half [percent].

[00:06:35] Crista Caughlin: Core inflation this quarter is running just over two percent. In Canada, very similar story. The Bank of Canada's core measures were running around four percent last quarter, and they're back down to two and a half percent. Similar to what we were seeing earlier this year.

So on the inflation front, yes, inflation's come down, maybe that trend continues, inflation may continue to move lower, but it's important to remember that inflation still remains above central bank targets. And so I would say there's still a bit of wood that needs to be chopped before we could really say we've won that inflation fight. We're getting closer and the trend is encouraging, but we're not quite there yet.

[00:07:13] Kevin Minas: Given that backdrop, if we were to start talking about asset classes, maybe we can start with equities first. They posted excellent returns in the quarter, capping off what was a fantastic year for the equity markets, broadly speaking, Canada, the U.S., as well as globally. However, the markets were still quite concentrated, with large-cap information technology companies in particular doing quite well. Though, we did start to see towards the end of the quarter perhaps a little bit of

broadening out in terms of the sector exposure that was doing well, which was nice to see.

Should we chalk up those really strong returns to end the year and 2023 in general around growing optimism that central banks are seemingly able to manage to land the economy into that soft landing scenario that's been so talked about throughout the year?

[00:07:55] Crista Caughlin: Yeah, I think that's a big driver of what happened. You know, our CIO often comments that, broadly speaking, equities are driven by earnings and interest rates. And if you think about what happened last quarter, we had inflation coming down, [which] really allowed central banks to move away from the hire for longer message, which allowed interest rates to fall materially. And that decline in interest rates was definitely a tailwind for equities.

At the same time, we had growth or earnings holding up. Again, a tailwind for equities. And so if I think about those two things, interest rates declining, financial conditions easing, alongside a positive growth backdrop, that's really the definition of a soft landing.

[00:08:34] Kevin Minas: When we consider the fixed income markets, they've been quite volatile just in terms of the underlying yields that you see pretty much across the curve. Q4 was no exception—there was a lot of volatility in the rates markets. Can you help us contextualize what exactly happened in the bond markets and your views going forward?

[00:08:49] Crista Caughlin: Yeah, so I've mentioned that last quarter, the backup in inflation caused central banks to become more hawkish. This quarter was effectively a reversal of that. Inflation moved back down. Central banks moved away from the higher-for-longer narrative. At the beginning of the quarter, the expectation was for the Fed to hike one more time in December. The market was pricing in another hike by the Bank of Canada.

As the quarter progressed and inflation moved lower, the market began anticipating that the Fed would pause. And by the time that December meeting came around, inflation had moved back down, not only allowing them to pause, but their projections or their dots actually suggested the hiking cycle is over and the next move would be a cut.

[00:09:26] Crista Caughlin: And so the market's now pricing in almost five cuts in Canada and almost six cuts in the U.S. And so that would take the overnight rate in Canada from 5 percent down to 375, and in the U.S., it would take it from 5. 5 percent to 4%.

Now, that obviously had a big impact on the rest of the curve structure. We saw 10-year rates in Canada fall almost 100 basis points, or over 100 basis points, in both Canada and the U.S. 10-year rates in Canada went from 420 down to 320. And in the U.S., it was a similar story. We were actually touching 5 percent at one point, only to fall back down to 4%.

[00:10:09] Kevin Minas: So, when we look at bond and equity prices over the last few years, they've really been moving in tandem, which is a bit atypical, I guess, by historical standards. So, when you look at a traditional 60/40 balance portfolio, usually your fixed income acts as a bit of a diversifier to the equity portfolio. But that really hasn't been the case of late. Do you think going forward, we'll start to see sort of a reemergence of the more traditional correlations between the two asset classes? So, in other words, fixed income returns helping to actually buffer the equity risks and investors' portfolios?

[00:10:39] Crista Caughlin: Yeah, I think a big driver of the changing correlation was inflation. You know, elevated inflation or an inflation shock is really bad for everything. It's bad for bonds, it's bad for equities. And so you did see that correlation breakdown. I think as inflation moves back towards a more manageable level, we should expect that correlation to resume great.

[00:10:58] Kevin Minas: Great, so, I guess to bring this all together, we've talked about the macroeconomic backdrop, what's happened across the various asset classes… now bringing it to a more of an asset mix level, you sit on our asset mix committee and in the fourth quarter, we did make an adjustment in terms of the asset allocation in our balanced portfolios.

Can you talk a little bit about what that adjustment was and also what was the discussion amongst the committee members that led to that decision?

[00:11:22] Crista Caughlin: Yeah, so we continue to see the risk of a recession as elevated just given the lag effects of tighter monetary policy. And we coupled that with the outperformance we had been seeing in the equity markets. And we thought it was prudent to trim our equity exposure and increase our bond exposure.

In addition, given the sort of more attractive level or attractive yields on bonds, alongside the fact that we do think that correlation between bonds and equities resumes as inflation slows, particularly if we go into a recession, we also moved some of our cash exposure into bonds. And so we now have a small underweight to equities and we continue to be underweight bonds and overweight cash.

[00:12:03] Kevin Minas: Excellent. Well, it's been great chatting with you today, Crista. Thanks so much for your time.