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EP 152 | Quarterly Update | Q1 2024

[00:00:00] Kevin Minas: Hi, everyone. Kevin Minas here. In this episode of The Art of Boring, I talked to fixed income portfolio manager Krista Coughlin for our quarterly update. We discussed what drove markets in the fourth quarter, the reemergence of a more typical return correlation patterns between stocks and bonds. What it's going to take to get central banks off the sidelines and how we're positioned across the portfolios we manage.

[00:00:26] Rob Campbell: Hi everyone. I'm your host, Rob Campbell, and welcome to The Art of Boring, the podcast where we dive deeper into Mawer's investment philosophy and thinking in order to make you, our listeners, more informed investors. Ultimately, we hope to connect you with the people at Mawer who find excitement in "Be Boring. Make Money."

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[00:00:59] Kevin Minas: Crista, thanks for joining me today.

It's great to be back with another solid quarter in the books for equity markets. We saw excellent performance towards the tail end of last year, that continued into the first quarter of 2024, a little less so on the fixed income side, particularly in the rates market, but a little bit of headwinds for investor returns.

Before we go into the details of the various asset classes, I'd like to start the conversation by painting a picture about the state of the economy. How has macro data held up over the last quarter?

[00:01:28] Crista Coughlin: Overall, economic data has come in better than expected. Global manufacturing seems to have rebounded at the end of last year.

We've seen that in Global PMIs, where almost every region is improving. This is especially true in the U.S., where the manufacturing sector seems to be growing again. ISM is back above 50. Industrial production has rebounded. If we take even a closer look at the U.S., employment markets are strong.

The economy is adding over 300,000 jobs a month. Consumption remains robust. Housing has improved. It seems—at least on the surface—that any slowdown caused by rates has been minimal so far, and that was really evident with the GDP numbers. The recent Q4 GDP came in over 3%.

In Canada, it's a similar story. Growth has improved over the quarter. It did have a much weaker starting point than in the U.S., with the Q4 GDP in Canada coming in at 1%. The other difference between Canada and the U.S. is, unlike in the U.S. where consumption remains strong and the consumer remains robust, consumption in Canada continues to be weak.

Overall, from a growth perspective, things continue to come out better than expected. Globally, inflation also continues to improve, as the year-over-year (y/y) numbers continue to come down in most regions. The one exception is the U.S., but I'll start with Canada. Last year, I would characterize the inflation picture in Canada as

being sticky.

Short-term measures were bouncing around 3% to 4%, and Core ended the year at 3.5%. This year, this quarter, started seeing real improvement on the inflation side. Over the quarter, the Bank of Canada's (BOC) core inflation measures are running between 2% to 2.5%.

Headline inflation is now back inside the BOC's target of 1 to 3, sitting at 2.78, so we've seen real improvements on the inflation side in Canada. In the U.S., it's a bit of a different story over the quarter. Inflation in the U.S. is running over 4.5%. This moved the y/ylevel up from 375 to 380.

It's a small increase, but it ended the downward trend that we had been seeing for a while. And given the short-term numbers are quite a bit higher than expected, we expect to continue to see those inflation numbers move higher over the next three years.

[00:03:49] Kevin Minas: Given the macro backdrop that you've painted, you don't have a crystal ball, but nevertheless, you do have to think through the potential implications of this macro data on central bank policy.

What is your read right now for the central banks and how they're interpreting the most recent data?

[00:04:04] Crista Coughlin: The stronger data in general has started to cause central banks to be more cautious around when that first cut will be. A theme we've consistently heard from central banks is that they want to be confident that this higher inflation environment is behind us.

That's because they see the risk of easing too soon and causing another wave of inflation as being much greater than the risk of easing too late and seeing growth deteriorate. That's exactly what we saw play out over this quarter. We have stronger data in the U.S. for both growth and inflation. This caused the Fed to revise their forecast higher, which caused them to push out the first-rate hike.

You can see that with the dot plots. Although the median didn't change, the average actually did move. It went from expecting three cuts this year to something closer to two cuts. Our expectation is that if you continue to see stronger data, we will continue to see rate cuts being taken out of the market.

Unless there's a change in the inflation trajectory, we wouldn't be surprised if the Fed didn't make a cut at all this year. Something similar happened in Canada. Growth in Canada came out stronger than expected, causing the BOC to revise their GDP forecast higher. There's a little bit less pressure on the BOC, given the inflation backdrop has been softening.

Unlike the U.S., where growth is running below potential, growth continues to be weak in Canada, despite showing improvement. Overall, if we think about what has changed this quarter in the central bank world, at least with the Fed and the BOC, it's that the stronger-than-expected growth picture is causing central banks to be more cautious around the first hike.

There are two other interesting developments that have happened over the quarter. One, our first developed market central bank cut rates. The Swiss National Bank (SNB) cut rates 25 basis points in March, and they're likely to continue. However, inflation in Switzerland is running below target and has been since the middle of last year.

They made sure they were confident that inflation was behind them before they went on the first cut. The other interesting development was with the Bank of Japan (BOJ). The BOJ has been engaged in extraordinary monetary policy for over a decade now.

In 2013, the BOJ announced they were going to start targeting the monetary base, effectively buying assets on a monthly basis. Not only were they buying JGBs, or Japanese bonds, they were also buying the equity market

through ETFs and REITs. The goal was to boost asset prices in an attempt to boost inflation expectations and ultimately inflation.

At the last meeting, the bank stated that monetary easing, negative interest rates, and yield curve control effectively fulfilled their roles, so they discontinued all of these programs. They moved from negative interest rates, minus 10 basis points, to positive 10 basis points.

They also removed yield curve control. There used to be a cap on how high long-term rates could go. They've removed that cap and discontinued all asset purchases around equities, REITs, and corporate bonds. The reaction so far has been quite muted, as the market did expect the BOJ would start removing stimulus.

However, this is something worth keeping an eye on. There's a lot of unknowns when unwinding policy that's been supporting certain markets for over a decade.

[00:07:28] Kevin Minas: You talked a little bit about where the central banks are, where they might go in terms of potential cuts, and the timing of those cuts.

We saw in the period, or at least in the last quarter, bond yields generally went up more or less across the curve. Of course, that led to poor performance in the asset class in the quarter. Can you give us a little bit of context around the level of movement and what happened as it relates to bond yields?

[00:07:50] Crista Coughlin: Over the last few quarters, the market's been bouncing around this idea of higher for longer multiple rate cuts, and this quarter really was no different. We started the year, and the market was pricing in six rate cuts by both the Fed and the BOC. Over the quarter, the market's taken a lot of that back.

In the U.S., we're now just expecting over one rate cut. In Canada, they're expecting two. This obviously had an impact on longer-term rates and rates across the curve, so longer-term rates moved about 50 basis points higher over the quarter. The Canadian 10 Year is now sitting at 3.65%, and the U.S. 10 Year is sitting at 4.50%.

[00:08:29] Kevin Minas: What was the general feeling in the credit markets? Even in terms of new issues, where did spreads move? What was the overall tone?

[00:08:35] Crista Coughlin: The story over the quarter in credit space was that global growth is improving and inflation is moderating. If you think about the end of last year, central banks had signaled that they were done raising rates, meaning the next move would be a cut.

Now keep in mind, central banks aren't cutting because they're worried about growth or because they're not worried about a recession. They're cutting to get back to more normal level of interest rates, or a neutral level. This is a very good environment for risk assets, with growth improving and policy easing.

That's exactly what we saw in credit space. Credit spreads are tighter on the quarter. Canada tightened to around 15 basis points, so the average spread in Canada is 125 basis points, or 1.25%. We had record issuance. Almost $44 billion was issued in Canada in the quarter, which is about 61% ahead of where we were this time last year.

We saw something similar in the U.S.: both investment-grade and high-yield spreads were tightening. The U.S. spreads are actually back at all-time tight, so they're back at pre-pandemic tights, which was a very similar level to 2006, 2007 tights. That means there's a lot of good being priced into credit markets right now.

[00:09:48] Kevin Minas: So that sounds like a fairly similar story as the equity markets. The markets had a very strong quarter overall, a continuation of 2023 technology-focused businesses doing particularly well, especially if they had some sort of tie-in to AI or semiconductors.

Let's look at our own portfolios, companies like TSMC which produces semiconductor chips, as well as ASML and ASM International, two companies that produce the critical tools used in the production of semiconductors.

Those businesses did extremely well in our portfolios not only because of the AI theme but also because these businesses have phenomenal competitive advantages, whether due to technological know-how or their reputations.

They've got high barriers to entry, both because it requires tremendous amounts of financial capital to operate in that business, as well as steep learning curves. As a result, they've got great market share. So that was one theme in the portfolios. Perhaps another one that we've seen ticking up as of late would be defense businesses.

We own a number of defense companies across our balance mandate, whether it be Rheinmetall, BA Systems, or BWX Technologies. Given the geopolitical tension flaring up in different regions, the risk they spread into wider conflicts is creating an increase in higher defense spending.

Those are some of the key themes on the equity side. It seems like equity markets have been more or less shrugging off the rise in interest rates, so a rise in bond yields is not necessarily expected to be the case.

What would be your interpretation of that divergence? It's like a reasserting of correlations. Typically, equities and fixed income move in opposite directions. At the same time, from a higher interest rate point of view, that tends to hurt stocks, and we didn't see that in the quarter. How would you interpret that?

[00:11:43] Crista Coughlin: We have seen interest rates move back up. They moved about 50 basis points higher on the quarter. It was a function of the market taking a lot of the rate cuts out. Keep in mind, the market is still pricing in cuts. So if you go from six cuts to 3 cuts being priced in, the overall story doesn't really change.

The overall story is growth is improving. Central banks are going to ease. Having said that, if you go from three cuts to zero—or potentially a hike— that does have a very different impact on risk assets, because that is a very different environment than the market is currently expecting.

[00:12:21] Kevin Minas: That's a great point. One thing we haven't talked about is that earnings were relatively strong in the quarter, especially for some of those businesses. They are seeing that exuberance related to AI. There are some fundamental underpinnings of those stock results. Putting all this together, was there any activity in the quarter on the asset mix side? What's the general view of the committee at this point?

[00:12:42] Crista Coughlin: One of the things we talk a lot about is just how much complacency there is in the market. We're mindful that we may not have seen the full impact of higher interest rates, and you can see that in some areas we are seeing continued pressure.

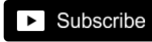
In the real estate sector, you are seeing delinquencies rise in the U.S. Both credit card and auto loan delinquencies are above pre-pandemic levels. In Canada, you're seeing mortgage arrears slowly increasing. And we do know that a lot of refinancing will happen over the next two years. So one of the risks out there is that it's unclear whether the full impact of higher interest rates is behind us.

Other risks involve areas we're talking about, as well as geopolitical risks, both globally and around the U.S. election. Obviously, there's also a risk that this inflation story isn't done. Markets are effectively priced for perfection on that front. Having said all that, we do recognize we don't know how the world will play out.

So, we look to build portfolios that are resilient to cross a number of scenarios in terms of what we did over the quarter. There are no changes in the asset mix. We did trim equities back down to our target of flat, and we continue to be underweight bonds and overweight cash.

[00:13:53] Kevin Minas: Awesome. It's been great chatting with you again, Crista. Thanks for the quarterly update. Looking forward to talking to you next quarter.

[00:13:58] Crista Coughlin: Great. Thanks.



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