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EP 178 | Quarterly Update | Q4 2024

[00:00:00] Kevin Minas: Hi, everyone. Kevin here. This week, I'm joined by Crista Caughlin for our quarterly update. Crista is the lead portfolio manager of the Mawer Canadian Bond Strategy, and she is also a member of our Asset Allocation Committee. As always, we discuss important macro data, central bank news, and asset class returns. We also dig into the potential economic and investment ramifications of the upcoming Canadian election, the threat of Trump tariffs, and an update on the Canadian housing market. Always an insightful guest Crista really covers a lot of ground in this interview, which you'll want to be sure not to miss.

[00:00:38] 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.

[00:00:57] Kevin Minas: Another quarter in the books and another year. Nice to see you again, Crista.

[00:01:01] Crista Caughlin: Thanks for having me back.

[00:01:03] Kevin Minas: Let's start with a little bit of wrap up for the quarter and for the year. It was another strong year for risk assets, particularly the equity markets, even fixed income actually did quite well, at least in terms of core fixed income, but before we dig into the specifics of the asset class returns, as we always do, I want to start with the macro. If you can give us an update on the economic data that was particularly market-moving, any central bank activity, things like employment, inflation, whatever you think is most relevant that happened on the macro side.

[00:01:31] Crista Caughlin: So I'll start with a quick recap of what happened over the year: 2024 actually ended up being a pretty decent year for growth, I think, all things considered. If you remember how the year started, central banks had just put through a massive tightening cycle, one of the largest we've seen in decades. We had a drawdown in excess savings that was coming to an end, and fiscal policy was moving from being supportive of growth to being a headwind to growth. And so there were a lot of conditions in place that suggested growth was going to slow materially. Now that did happen in some regions, particularly in Canada. We had a pretty sizable miss to Q3 GDP, but in the U.S., growth actually remained pretty robust. It started the year around 3%, and it seems like it's going to end the year around 3% or just under 3%. In terms of inflation throughout 2024, it continued to grind towards target. I think a lot of the heavy lifting actually happened in 2023. So both Canada and the U.S. started the year around 3% headline inflation. In Canada, we're now sitting just under 2%, so just under target. In the U.S., we're sitting around 2.4%. So in both regions, over the year, inflation continued to grind towards target. I would say the one potential weakness in 2024 was the employment markets. Both Canada and the U.S. added jobs throughout the year, however, the unemployment rate increased as people returned to the labor market. In Canada, the unemployment rate moved almost 1% higher. It's currently around 6.7%. In the U.S., the unemployment rate moved from 3.8% to 4.1%. Although both economies were adding jobs, I think the move higher in the unemployment rate suggested that the employment picture may have been weaker than the

headline number. So to recap, in the U.S., growth remained strong, inflation grinded towards target, and the employment picture was mixed. In Canada, growth was quite a bit weaker, inflation hit target, actually went below target, but again, the employment picture was mixed, kind of similar to the U.S., although weaker than the U.S.

[00:03:39] Crista Caughlin: We think about what happened over the quarter. The trend was the same, but there were small improvements on a few fronts. In Canada, near the end of the quarter, we saw growth improve modestly. So it was running around, maybe even below 1%, and we're now back up closer to 1.5%—still less than what the Bank of Canada was forecasting, but better. On the employment side, we had a surprise to the upside in employment this last month, which moved the unemployment rates modestly lower. In both countries, I think the bigger story was the move in inflation. Inflation moved modestly higher throughout the quarter, still lower than the beginning of the year, but it's a potential shift in trend, and so throughout 2024, we saw inflation grind lower. It's now potentially moving sideways.

[00:04:28] Kevin Minas: The Fed was a lot slower than a lot of other central banks in getting off the sidelines, as you mentioned, in terms of their cutting cycle, that was a much slower tempo than, let's say, the Bank of Canada. That seemed to continue in the quarter. Can you walk us through what actions were taken by the Fed and the Bank of Canada?

[00:04:43] Crista Caughlin: So the Bank of Canada and the Fed, as you mentioned, had slightly different paths this year, and that was because they were both responding to their domestic economies. In Canada, like I mentioned, growth slowed a lot earlier, inflation moved back to target, and so the Bank of Canada began the easing cycle. They started cutting rates in June. They've now cut 175 basis points, taking the overnight rate from 5% down to 3.25%. In Q4 alone, they cut policy rates twice, going 50 basis points each time, for a total of 100 basis points. So over the quarter, they actually took rates from 4.25% to 3.25%. Those larger moves really were on the back of that Q3 growth myths that we've talked about. The Bank of Canada now sits at what they believe is the top end of their neutral range. In terms of the Fed, at the end of last quarter, they had started the easing cycle by cutting 50 basis points. This quarter, they continue to ease. They cut 25 basis points at each meeting. In total, the Fed's now cut 100 basis points, taking the overnight rate, or the Fed funds rate, from 5.5% to 4.5%. And I think really the slower pace of the Fed really is due to the fact that U.S. growth has remained robust throughout the year, which does suggest that their economy can potentially handle higher interest rates. And we've actually seen that with some of the central bank moves. The Fed dots, so to speak, have scaled back the number of cuts they're expecting next year, and they've modestly increased their long-term neutral rate.

[00:06:16] Kevin Minas: So you mentioned the Bank of Canada, two 50 basis points cuts, so relatively meaty cuts. Is that common, or is it more common, I guess, at the start of a cutting cycle, or just if you could just get a little history on doing 25s versus 50s or even, I guess, bigger cuts?

[00:06:31] Crista Caughlin: So historically, 50 basis point cuts have been reserved for more of an emergency-style policy, when the economy is in a recession, or there is a financial stress happening in the markets. I think this time around, given the fact that we were fairly materially above what we would consider neutral, we had a pretty material tightening cycle last year. And in Canada, inflation was back at target, maybe even slightly below target. I think that warranted the larger moves. So it's not an emergency this time, we're not in a recession this time, but central banks wanted to lower rates as they were seeing growth, particularly in Canada, growth missed to the downside and inflation come back to target. I would keep in mind that we are still above neutral in most countries. The Fed is still above what they would consider neutral. The Bank of Canada is now sitting at the top

end of the range of what they believe is neutral. So those larger rate cuts were taking policy from being very restrictive to being slightly less restrictive.

[00:07:37] Kevin Minas: One thing we don't talk a ton about on the podcast is politics. It's hard to not mention a couple of the more politically colored items in the news that might be affecting the markets at least over the next few quarters, perhaps the next few years. So we did see Justin Trudeau, the prime minister of Canada, announce his resignation. And then also you've got in the U.S., of course, President Trump taking office shortly after the recording of this podcast. A lot of saber-rattling around tariffs, some Canadian response as well. Maybe less so on the politics side, but more on the economic and financial implications of some of the conversations that are going on right now and some of the political maneuvering. How do you sort of weigh these various factors? Does it affect your forecasting? What is your general take on both the Canadian and U.S. political situations?

[00:08:24] Crista Caughlin: These are really big questions for the market at this stage. I think there's a lot of unknowns regarding policy or fiscal policy, both north and south of the border. If we start with Canada, the question is, what is the impact of Trudeau stepping down? And to be honest, we don't know what the impact will be until we know who's going to form the new government and what their policies will be. If we think about what it means for the Bank of Canada, it doesn't change anything in the near term. They are going to do what we would do, which is wait for the new leader and get a sense of what their policies would be. The way the Bank of Canada works is they take the fiscal policies from the government and they incorporate them into their forecast, and so fiscal policy was actually expected to be a headwind to growth in 2025, both via lower deficits, but as well given reduced immigration. And I don't think that changes anything in the near term until we know who the new leader is and if those policies are going to change.

[00:09:18] Crista Caughlin: I think the bigger near-term impact or risk, so to speak, is Trump, and obviously there, there's a wide range of outcomes. In terms of taxes and deregulation, if we do get U.S. tax cuts or deregulation and it spurs U.S. growth, that would likely spill over into Canada and be a positive for Canadian growth. On the other hand, if you get U.S. corporate tax cuts and deregulation, it makes investing in the U.S. more attractive, which could have negative implications for Canadian investment. If you're debating where to build the next plant, or which plant you want to invest in and expand, if it's easier and more economical to do that in the U.S., you're likely to do so. In terms of trade policies and tariffs, this is the big question mark right now. It could obviously have a material impact on Canada. There's a wide range of outcomes. Size is going to be important. Is it a 10% tariff? Is it a 25% tariff? Is it going to be implemented tariffs across the board? Is it going to be more targeted to specific groups of goods like it was in 2018? I think the really big question, at least with respect to the outlook and where growth and inflation goes, is does Canada retaliate? In terms of how tariffs could impact growth and inflation, and therefore for us, how it would impact what the Bank of Canada would do, tariffs themselves are negative for Canadian growth. The whole objective is for Canada to sell less goods to the U.S., and exports are a really large part of our economy.

[00:10:45] Crista Caughlin: On the inflation front, the balance of risk, so to speak, is a little bit more mixed. If we retaliate with tariffs, to the U.S., that's going to result in higher prices, at least a one-time price increase for goods in Canada, assuming businesses can pass those costs through to the consumer. However, if growth takes a hit, the demand side of that equation will cause prices to soften. So there's a price increase and a price decrease effect, depending on how the tariff gets implemented and what gets tariffed. We can look back on the sort of 2018 experience to get a sense of what happened then. We did see growth soften. Global trade deteriorated pretty materially. The impact to inflation was muted back in 2018, although it did grind modestly higher, but it

stayed below that 2% or around that 2% target. I think the big difference and the thing we're most mindful of today, at least when we're comparing 2018 versus today, is inflation expectations. Back then, inflation expectations were well-anchored. Businesses had a hard time passing through price increases to the consumer, and so those higher tariffs weren't actually fully passed through. Businesses just absorbed them. I think today it's a different story. Inflation expectations are elevated. Consumers are used to seeing higher price tags on a regular basis. It's an environment where pass-through is much easier. And so I think the risk today, at least on that front is that although the tariff itself could be a one-time boost to inflation, it could have a more lasting impact by inflation expectations and that would be something the central bank would need to address.

[00:12:30] Kevin Minas: Potentially negative for growth, hard to say though because we don't actually know the policies yet. There actually may be a small negative in inflation, more of a mixed bag. Shifting gears a little bit, you and the team focused a lot over the last couple of years on the Canadian mortgage market, the Canadian housing market, big part of the economy, big part of the corporate backdrop as well, when we think of corporate credit, what your team invests in. Is this an area of concern going into 2025 in terms of the renewal rates or have the Bank of Canada cuts largely ease the pressure that you saw building in the housing market? What is your current view on that sector?

[00:13:01] Crista Caughlin: This has been a concern for us for a while. I think the level of concern has gone down for two reasons. As you mentioned, the Bank of Canada has lowered rates. They lowered 100 basis points this quarter alone. But the other one is the banks seem to be managing this risk really well. They're extending amortization periods. They're working with consumers to find a solution or find a payment plan that they can absorb. Having said that, the risk hasn't completely gone away. We know the number of mortgages that need to be refinanced in 2025 is higher, potentially almost double what it was in 2024. And although interest rates have declined, they're still 200-300 basis points higher than where a lot of these mortgages were taken out. A lot of these mortgages, particularly at the back end of this year, were taken out when interest rates were zero, so rates are still going to be higher. To us, this isn't a U.S.-style financial crisis—people are not going to default on their loans. But it is still a headwind to the consumer. It's a headwind to household spending in Canada, so therefore a headwind to growth.

[00:14:06] Kevin Minas: Shifting to equity returns and asset class returns. It was another very strong quarter on the equity side. Canadian fixed-income returns were flat in the quarter, although very strong over the course of the entire year. What drove performance in the quarter for each asset class? Anything in particular you'd like to highlight there?

[00:14:22] Crista Caughlin: It was a strong quarter for equity returns, which capped off actually a pretty strong year. Let's say most equity markets saw double digit returns in 2024. In terms of themes for the quarter on the equity side, a stronger U.S. dollar, particularly on the back of expectations that Trump policies are going to improve the U.S. growth profile, have really helped companies like Wolters Kluwer and Compass Group. However, being underweight U.S. companies in certain strategies has hurt us. AI obviously continues to be a theme. This helped Taiwan Semiconductor. Unfortunately, ASML, ASML International, which are companies that are really critical to that semiconductor supply chain process, underperformed over concerns around U.S. export restrictions. And then lastly, the financial services actually had a good quarter. Expectations around deregulation, increased liquidity, a steeper U.S. yield curve, have all supported the sector, and this helped our holdings in names like Brookfield Asset Management, AI Financial, and Aon.

[00:15:22] Crista Caughlin: On the fixed-income side, we did see interest rates move higher over the quarter. The Canadian 10-year started around 3%, moved to 3.2%, right in the middle of the range we've seen over the last year. In 2024, 10-year rates moved between 2.8% and 3.8% so we ended the year in the middle of the range. In terms of spreads, they continue to tighten. They're at all-time tights. Both our Canadian and global strategies are sitting in a more defensive stance, just as a result of spreads being at all time tights.

[00:15:54] Kevin Minas: What were the main themes that were top of mind for the asset mix committee in the past quarter? And even going forward into 2025, what are the main concerns?

[00:16:02] Crista Caughlin: Much of 2024 was really an attempt to stay neutral. We were concerned about the hard landing, but we didn't want to get too conservative in case continued market momentum pushed risk assets higher or a soft landing played out. In addition, I think in 2024, we opportunistically looked to increase our bond weight. We did end the year with a small underweight in bonds, overweight in cash, but it was smaller relative to the beginning of the year. I think our strategy going forward remains similar. For now, we're maintaining our neutral stance on equities, underweight bonds, overweight cash. There's a lot of unknowns around the fiscal policies, like we mentioned, both north and south of the border, but to be honest, really globally. Canadian policies could actually make Canada more attractive, and so we're watching to see how that unfolds. Trump policies, we know there's both upside and downside risks. Timing of the implementation of any of the policy changes is going to be a big factor in driving the markets forward. And then just really another theme we're seeing more globally is just higher deficits with France and the U.K., and so all else equal, higher deficits would result in higher neutral rates. So those are sort of the three themes that we're thinking about right now. In terms of portfolio construction, we added to U.S. mid-cap imbalance strategy, and that was really to improve valuations and better diversify our U.S. portion of the portfolio. And so within equities, although we remain neutral, we are overweight U.S. equities.

[00:17:35] Kevin Minas: On the equity side, basically neutral because of the various risks that you mentioned. We are still a little bit underweight in bonds, but it sounds like to your point, there is the risk that these longer-term yields move up further, so rather than actually be overweight there, maintain a little bit of an underweight position, and then should that push upward movement and bond yields occur, you've got some dry powder to leg up. Is that essentially the idea?

[00:17:57] Crista Caughlin: There are still a lot of questions. If you think about the U.S. potentially has a higher neutral rate, we're seeing higher fiscal deficits cause global interest rates to move higher. So there are still a lot of risks around the level or the direction of global interest rates. On the flip side of that, cash yields aren't actually that low still, so cash still does offer an attractive yield right now. And so that's why we're modestly underweight fixed income, looking opportunistically for places to increase that and then overweight cash.

[00:18:30] Kevin Minas: Well, thank you for joining me today, Crista. I appreciate your thoughts as always and look forward to seeing you next quarter.