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EP98 | Playing the plan: Mawer's Canadian bond portfolio

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Andrew Johnson: 00:40 Welcome everyone to another installment of Playing the Plan. Today we're talking with Crista Caughlin, Portfolio Manager for our fixed income strategies here at Mawer. So Crista, welcome back to the podcast.

Crista Caughlin: 00:52 Yeah, thanks for having me again.

Andrew Johnson: 00:55 I was just thinking: last time that we had you on was over a year ago now, so way back in 2020. And it was the first time that you were joining us; you were six months or so with the firm. I think we talked about many of the major themes that are influencing how you and the team are constructing the bond portfolio, and I want to revisit some of that today [to] get a sense as to where we are. But first, this is, as I said, a little sub-series of episodes that we call "Playing the Plan," so remind what playing the plan means for the bond portfolio and ultimately what role bonds play for our clients here at Mawer.

Crista Caughlin: 01:28 I think bonds in the context of your larger asset mix portfolio— Mawer has often talked about them in terms of being a shock absorber. And really what that means is by including bonds, it gives your portfolio better risk-adjusted returns just through the power of diversification. And so we saw bonds had a tough year this year, they've underperformed, while equities have done really well. But this time last year, we were kind of seeing the reverse, and that really just demonstrates that idea of better risk-adjusted returns over the course of a cycle.

Andrew Johnson:	**02:03**	Great recap. I was going to give you instructions to do it in 30 seconds or less, and I think you nailed that anyway, so thank you for that. I think ultimately for us here at Mawer, we are a fundamental, bottom-up investment manager but we're macro aware—and I think that's most evident when you and the team are building our bond portfolios given the influence that the economy, fiscal, monetary policy...all of those things can have on changing the playing field, essentially, for fixed income as we move through time.
	02:28	That's really what I wanted to get into today: the process that you and the team work through to incorporate the current and the potential macroeconomic items into your portfolio construction. So, let's start at a very high level and then we can kind of work our way down into the details. So, what's the overall goal of your process to incorporate macro elements? Again, from a high level, what does it look like?
Crista Caughlin:	**02:49**	The goal of the macro process is really to guide the positioning of the portfolio with respect to interest rates and overall credit spreads. So what should the duration of the portfolio be? Where on the yield curve offers the most attractive opportunities? Is it sort of that five-year space? Is it that 30-year space? Or how much spread product do you want your portfolio at any given time?
Andrew Johnson:	**03:10**	And where are we at today, just generally speaking from portfolio construction? You mentioned where should we be duration wise, maybe in various sectors. Where do we sit today?
Crista Caughlin:	**03:20**	We have a slightly shorter duration relative to our benchmark. We have what we would call a curve flattener on right now, so we have less exposure in that two-year, five-year—that shorter part of the curve—and more exposure in the longer data term, sort of 10-year, 30-year. And we're overweight spread product right now: we're overweight corporates, overweight provincials.
Andrew Johnson:	**03:42**	Brings to mind a quote from Howard Marks, and I'm going to paraphrase it, but he essentially says, "We can't know where we're going without knowing where we are." And that sort of feels like your view on trying to understand where we're at from a macroeconomic standpoint. So, what does the whole macro process look like? How do you start from nothing and go to where you're going to start making portfolio decisions?

Crista Caughlin: 04:03 There's a number of steps in the process. We start with themes. These are things that we think will affect the economy, will affect interest rates over the next...sometimes five years, sometimes 10 years, sometimes one year, to be honest, but we start with a number of themes. And then what we do is we really dive into those themes, understand them, and then we create scenarios. A lot of times people will talk about a base case, a bull case...

Crista Caughlin: 04:29 What we think about is just scenarios in general, because we realize that there's numerous ways that the economy can unfold and we want to be prepared regardless of how that happens. So we flush out scenarios and then we flush out what I would call, a "financial market outlook" for each scenario. So, what do central banks do in that scenario? What do interest rates do in that scenario? And then what do credit spreads do in that scenario?

Andrew Johnson: 04:58 Okay, well that was the high level, now let's get into the nitty gritty. So what are the themes that are most prominent in forming your view of the world currently?

Crista Caughlin: 05:06 So there's three high level themes we're thinking about this year. One of them is just this global debt theme. It's been front and center for a while. The second one is China's credit cycle, and this is a theme that has come and gone, but something we're paying closer attention to this year. And then the third one is just this idea of shifting policy objectives, both monetary and fiscal. Are fiscal policy makers changing their objectives? Are monetary policy makers changing their objectives? And what does that mean?

05:34 To talk a little bit about the global debt theme first, we talked a lot about this in the last episode, so I won't get into too much detail here. I think the main takeaways are that debt pulls forward future growth, so if your economy is increasing leverage, growth is better than what it would've been otherwise, but if you're decreasing leverage, it will be slower. We just went through a period where leverage was increasing. Governments were borrowing at all-time highs, we sort of had record fiscal deficits. But even in the private sector we saw borrowing increase—mortgage debt and the housing market was kind of on fire this year. And that's not just in Canada, but globally we've gone through a period where debt has increased.

06:14 The other thing we know about debt and the reason why it's so important for us, particularly right now, is that the more debt an economy has, the more interest rate sensitive the economy will be. If you own a house but you have no mortgage on the house, you really don't care where mortgage rates are going. But if you, like me and most Canadians, do have a mortgage, as interest rates move higher, as mortgage rates move higher, it becomes more costly for you to service that debt.

Crista Caughlin: 06:40 And so, you end up spending more money servicing the debt, servicing the mortgage, and less money on other goods and services. And so what does that mean? Again, it sort of means that the more debt you have, the lower interest rates ultimately have to be because the less interest rates need to rise before becoming restrictive.

06:57 The other theme that we're spending more time thinking about this year is China's credit cycle—and this really is an extension of that global debt theme—but most of us know that China is one of the most over levered private sectors globally. They have more debt than the U.S. did prior to their financial crisis. They have more debt than Japan did prior to their financial crisis. Policy makers know this; they've been actively attempting to deleverage their economy to kind of reign in those financial stability risks. But as they've done that, what's been interesting is these mini cycles have happened where China reigns in credit, they cause growth in China to slow, which ultimately causes global growth to slow. They sort of hit that tipping point, they allow their credit to expand again, allowing growth to improve, only to then come back and reign in financial stability risks causing growth to slow. So you're seeing these small mini cycles within the global economy.

07:55 And why does this matter today? Or, where are we today with that? Today we've seen policy makers...they're still actively trying to de-lever. The credit impulse is slowing in China, and policy makers are directly targeting slower money supply, which is effectively targeting a deleveraging campaign.

So, we're kind of at the middle stages of that, but effectively, what we're going to see is China's economy is going to slow, which is going to be a headwind for global growth.

Andrew Johnson: 08:24 And those mini cycles that you mentioned—are those essentially what their policy makers want to see as they kind of navigate their way through this and try to prevent what a lot of people refer to as a "hard landing" as they sort of deleverage?

Crista Caughlin: 08:34 I think it's a byproduct of what they're doing. I think they ideally would like to just deleverage here for the next decade, kind of have that beautiful deleveraging campaign. But in reality, what's happening is they sort of deleverage enough to slow their economy and they need to do something to boost growth in their economy, and so they ease policy to do that.

Andrew Johnson: 08:55 Okay, so global debt overhang, China, you also mentioned policy makers perhaps shifting their objectives.

Crista Caughlin: 09:01 This is something that we started thinking about more last year—just this idea of shifting policy objectives. Let's start on the fiscal side. We just had record high fiscal deficits, but don't forget, we just had the largest growth decline we've ever seen. And so it's not clear to us on the fiscal side that you've actually seen a change in objectives here. We had a huge decline in growth; it was met by equally as large fiscal spend, effectively. The key here is I think now that the economies have recovered, economies have opened up, what are fiscal policy makers doing going forward? And for the most part you're seeing fiscal policy is going to be a drag in the year to come. We're not getting those checks; people aren't getting $1,000 a week from governments. You're not seeing the same size fiscal deficits this year as you did last year. And so it's not clear that there's been really a change in objectives on this side.

09:57 On the monetary side, [in] most developed markets, central banks are inflation-targeting central banks, and the question here really is, has that changed? If we rewind a year, we were in the middle of a crisis—economies were shut down, inflation was higher, but it was driven by supply side constraints. It made sense that policy makers were easy. I mean, they were at emergency level rates—we were kind of in the middle of an emergency. Fast forward a year, it's more apparent that inflation is higher, yes, because of supply side constraints, but it's not solely being driven by supply side constraints. There is some demand, they are causing inflation to move higher, economies have recovered.

10:38 We're now at the stage where central banks need to get off their emergency level policy—either by tapering, by raising rates. And I think a lot of the developed market central banks (Bank of Canada, Bank of England; you've seen central bank raise rates in New Zealand), I think for the most part, there's no real changing objectives with respect to central banks, but we'll see. We really do need to start seeing central banks respond to this better growth, better inflationary environment.

Andrew Johnson: 11:08 So you have your themes laid out in front of you. You mentioned that the next step would be to come up with some sort of scenarios that may play out given those themes. What's bubbling up to the top as some of the more likely scenarios in your eyes?

Crista Caughlin: 11:22 There's three main scenarios we're thinking about this year, and I'll kind of dive into them separately. I'll start with the one I would call our highest probability scenario right now, and that is growth continues to be strong. The pace of growth declines from 2021 to 2022, but it's still at a pretty high level. We're running above potential; economies are opening up; employment markets are looking strong. Inflation remains above target, but the pace of inflation also declines. And so central banks begin tightening, they're slow and cautious, but they're not behind the curve. We think the Bank of Canada in that scenario could increase three, maybe four times next year.

12:06 In terms of financial markets, what does that mean? It means yield curves are likely flatter, credit spreads continue to grind tighter because it is a better growth environment, and interest rates are modestly higher. Now, we realize there's a number of risks out there, which is really the basis for our next two scenarios. There's a number of headwinds to growth. We've talked about China already. China is likely slowing, their credit impulse is slowing, which is going to be a headwind for global growth.

12:36 At the same time, the fiscal impulse is turning negative. Those record deficits won't be repeated. That's a headwind for growth. We're now seeing central banks tighten monetary policy, which means tighter financial conditions. Again, another headwind for growth. You could see a scenario where global demand is weaker than expected while central banks are tightening policy. And so what ultimately happens is central banks by the end of next year likely either have to pare back their tightening or completely reverse it. If this scenario happens, we think rates likely end up lower and credit spreads are wider.

Andrew Johnson: 13:13 You mentioned a term in there that maybe our listeners aren't familiar with, fiscal impulse. What's that mean?

Crista Caughlin: 13:18 That really is just the fiscal spend year over year. The deficits were pretty large in 2020, 2021, and that's not going to be repeated, so those large deficits were a tailwind for growth. They provided income directly into the economy. They provided income directly into the economy. With those not repeating, growth has to be made up from some other place effectively.

Andrew Johnson: 13:43 Yeah, so spending from the government relative to kind of the most recent time period last year.

Crista Caughlin: 13:48 Yes. The third scenario that we're thinking about is inflation. I think a lot of people are worried about inflation moving higher, and what does that mean? And this is a scenario really where that inflation that has been sparked by supply chain disruptions turns into demand driven. I think we're seeing a little bit of that right now, to be honest. I think some of the inflationary numbers are being driven by greater demand, but this is a scenario where that continues moving higher, you see wages moving higher. Pent up savings turns into pent up demand. Maybe you see fiscal policy makers pushing through another initiative, monetary policy makers behind the curve.

14:28 It's likely that this inflationary backdrop is the most prominent within the U.S., but global rates will respond to U.S. inflation. And so what do financial markets look like in this scenario? This is obviously interest rates higher. Depending on how it plays out, central banks are effectively behind the curve, which means they're going to have to tighten even more aggressively to tame inflation, and that's typically not good for risk assets, so you see credit spreads wider.

Andrew Johnson: 14:56 So this could push policy makers into a position where they could err on the side of moving too quick.

Crista Caughlin: 15:02 Exactly, yeah.

Andrew Johnson: 15:03 Okay, so what does it all mean for you and the team when you're thinking about the bond portfolio itself? What do you do to build in resilience in the face of these potential scenarios?

Crista Caughlin: 15:13 Yeah, so if you think about how we're positioned: earlier, I talked about the fact that we are shorter duration, we have a curve flattener on, we're overweight both corporate and provincial spread product, and this is a direct result of our view that the highest probability scenario right now is that growth comes out okay, and central banks begin tightening policy, but they don't over tighten.

That really means that we are going to see the short end of the curve move higher than the long end, which is why we are in a flattener. Spreads continue to grind lower, which is why we are overweight spread product, and it's likely that interest rates move higher, which is why we're shorter duration.

Crista Caughlin: 15:57

The one thing that's interesting is in both of the alternative scenarios—we see volatility pick up, we see credit spreads widen. And so, both in that growth comes out weaker scenario as well as the one where inflation picks up and central banks have to tighten even more aggressively, spreads widen.

So, we've been mindful of this and have been decreasing, although we're overweight spread product, we have less risk to that exposure.

Andrew Johnson: 16:24

I would imagine some of that volatility just comes from the fact that the bond market has to digest this news and price things in on a more frequent basis because there's so much changing in the world in those types of scenarios.

Crista Caughlin: 16:34

Yeah, and I think that's one of the advantages of our process is that we flushed out the various scenarios, we flushed out what we think it means for financial markets, we flushed out milestones, and so we are less reactive to day to day volatility. We're thinking more longer term and position the portfolio as such.

Andrew Johnson: 16:55

Yeah, so you don't have to make as many sharp turns as frequently when you're moving through time because you're staying ready rather than trying to get ready in the moment.

Crista Caughlin: 17:02

Exactly.

Andrew Johnson: 17:03

This is a Canadian bond portfolio that we use for our clients. One of the questions that sometimes comes up with clients is what impact does currency play? In particular, how the Canadian dollar behaves out there in the world relative to other currencies. Does that have any impact on our bond portfolio?

Crista Caughlin: 17:22

No, so there's no real indirect impact to the portfolio with respect to changes in the currency. We're a Canadian denominated portfolio. We buy Canadian bonds and so changes in CAD don't really have a direct impact. You could say there is an indirect impact with respect to growth and growth in Canada. If our currency is slightly weaker, that's better for our export sector or vice versa, and that could have an indirect impact with respect to what the Bank of Canada is doing and what interest rates are doing. But no, there's no direct impact to the portfolio with respect to changes in the Canadian dollar.

Andrew Johnson:	**17:59**	All right. Well, a lot of interesting things to keep our eyes on over the coming 12 months and beyond. We will go ahead and pencil you in for another episode next year to check back on these. I'm sure some things will change and of course, some will stay the same, but just wanted to thank you, Crista, for spending some time with us today.
Crista Caughlin:	**18:16**	Yeah, thanks for having me.