the art of boring™

EP72 | Playing the plan: Mawer's Canadian bond portfolio

Disclaimer 00:25
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.

Andrew Johnson: 00:40
Okay! Welcome to the podcast, Crista.

Crista Caughlin: 00:43
Thanks for having me.

Andrew Johnson: 00:44
This is the first time on the podcast for you, so thank you for joining us, first of all. It's not actually as if you've been avoiding us—you just joined our team here about six months ago, so we decided to let you kind of settle in before we invited you onto the podcast here. And you've really hit the ground running in terms of running our fixed income strategies here at Mawer. Can you just give our listeners a little background on yourself, and your role on the team?

Crista Caughlin: 01:08
I've been in fixed income for almost 20 years—it's actually just 19 years last month—and over that period, I've worn a number of different hats under the umbrella of fixed income portfolio management. I spent time trading bonds, futures, swaps, CDS way back in the day. I also spent time on the portfolio construction side, developing portfolio construction tools and processes, but I would say the majority of my career really has been spent on macro research and macro strategies within the fixed income portfolios. So, that would include interest rate strategies, curve duration, as well as overall sector strategies.

Andrew Johnson: 01:48
Well, first of all, I had a flashback there of CFA exams with all the CDS talk and the swaps and things like that. But clearly, a lot of experience in this realm. Like you said, you've worn a few different hats.

Andrew Johnson: Our bond portfolio, in most cases here at Mawer, is situated within a balanced portfolio, where you've got equities on the other side of things. With you taking the lead on things, just in your words, [could you] just talk a little bit about what role fixed income or bonds plays in investment portfolio here at Mawer?

Crista Caughlin: **02:19** At Mawer we often talk about this idea that bonds are the shock absorber in times of equity distress. Really what we're saying there, is, by including bonds in your asset mix, you're going to get better risk-adjusted returns just through the power of diversification. And I think the most recent period of equity volatility is the perfect example of this.

Bonds are one of the best-performing asset classes this year, so including them has enhanced your returns, while at the same time dampening the volatility of your portfolio.

Andrew Johnson: **02:48** And given where overall interest rates are currently, there is a lot of talk out there these days of the role that bonds do play in the portfolio. What's your view on that?

Crista Caughlin: **02:58** That is a big question right now. You are seeing yields at all-time lows, but the correlation to equity or the correlation to risk assets continues to hold here. We've seen it continue to hold in Europe over the last decade, even though they've been at zero interest rates. So we think the role of bonds within a balanced portfolio will continue to offer attractive diversification characteristics.

Andrew Johnson: **03:22** One of the trends that I think has been persistent for some time related to bond investing in particular, has been the fact that we've been living through this period of increasing debt around the world. Whether it's been governments, corporations, us as individuals in our households. And one of the questions that we ask often around here is, so what? What is the "so what" of increasing global debt? Why does it matter?

Crista Caughlin: **03:48** For us, one of the reasons it matters, or the biggest reason it matters, is really the implication it has on growth and interest rates. If you think about what debt is from a high level, all else equal, debt pulls forward future spending. So you borrow today, you spend today, you pay that back with future income. So when households and corporations are increasing leverage, economic growth—all else equal—is better than it otherwise would have been.

Crista Caughlin: By the same token, if the economy is attempting to deleverage, growth is going to be slower than expected. So, understanding changes in this metric really matter for understanding where expected future growth was going to go, which is going to be an important input into understanding where company revenues are going to go, changes in inflation, currency, as well as changes in interest rates—which is the most important part for us.

Andrew Johnson: 04:39 Now, the story that I'm familiar with, at least regarding shorter-term debt cycles kind of goes like this (and I'll let you confirm or deny it for me here): we usually have some growth, we increasingly use debt to fuel that growth, we overdo it at some point, we have some sort of crisis, it hurts, and then we get to work at paying down the debts that we accumulated during the growth phase.

So, I guess my question is, didn't we just have a pretty serious financial crisis about 10 or 11/12 years ago now? So why are we still talking about increasing global debt? Shouldn't we have seen some sort of deleveraging happen since then?

Crista Caughlin: 05:17 That's exactly right. The credit cycle is very aligned with, sort of, the business cycle. Exactly how you played out. And we did just see a financial crisis. So typically, a financial crisis sees a significant amount of deleveraging. This deleveraging results in lower growth, lower inflation, higher unemployment for a period of time that usually lasts around seven to 10 years. And although the global economic backdrop did experience all of these things, we saw a lower growth environment. We saw a lower inflation environment. We saw employment higher than it would normally have been for almost a decade. But what's interesting is, we didn't actually see any deleveraging happening. What we saw was a debt swap from the private sector to the public sector.

Andrew Johnson: 06:02 In particular, where are we at here in Canada? Has that been the case? Are we a good example to look to, or an illustration for the global scenario that we find ourselves in?

Crista Caughlin: 06:11 Unfortunately, Canada is in one of the worst places in terms of the debt supercycle. If we look at a place like the U.S., we saw debt-to-GDP from the total economy really goes sideways post financial crisis. But what we saw there was a pretty decent deleveraging from the private sector that was offset by public sector leveraging. So that debt swap actually happened in the U.S. So the private sector today, particularly households in the U.S., are better off today than they were in 2007.

Crista Caughlin: In Canada, actually, we've seen something different play out. We've seen, overall, the economy continue to increase debt. We've seen [it] particularly in the private sector; private sector and household debt-to-GDP today is at levels which are typically synonymous to financial crises. So, we are actually in a worse place today.

Andrew Johnson: 07:06 I just want to come back to the "so what" question. What are the implications of increased debt for, like you said, interest rates, monetary policy, going forward?

Crista Caughlin: 07:15 The biggest question for us is obviously, interest rates. And so, all else equal, increased debt levels required lower interest rates. And why that happens…it really comes down to monetary policy. The larger the amount of debt you have, the more asymmetric monetary policy becomes. If you have a large debt load, policy has to be easier to boost growth, which means lower and lower interest rates as debt increases and increases. However, on the flip side of that, the larger the amount of debt you have, when policy is tightening to cool down an economy, it has to tighten less. So again, even on that side, it becomes lower and lower interest rates as debt becomes higher. This sort of asymmetrical monetary policy has big implications for interest rates when debt levels are high.

Andrew Johnson: 08:03 So higher debt…obviously there's an incentive to keep interest rates lower in order to both service that and supplement growth. At the same time, it disincentivizes paying down that debt.

Crista Caughlin: 08:15 Exactly. I guess the other implication there is growth. The more debt you have, if debt is pulling forward growth, then the more you have. At some point, you have to pay that off.

And so, future growth is going to be lower than what it otherwise would have been.

Andrew Johnson: 08:30 You actually touched on this—does it actually matter where the debt is in terms of the impact it has on growth? In other words, is it more driven by debt at the government level, the corporate level, or us as individuals?

Crista Caughlin: 08:42 Yeah, so history tells us that private sector spending has larger implications for growth than public sector spending. The private sector is supposed to be better allocators of capital, and so if your debt is growing at the public sector, you should expect lower growth in the future.

Andrew Johnson:	**09:01**	Likely because they find it harder to reinvest or grow their business, and so on.
Crista Caughlin:	**09:06**	Yes.
Andrew Johnson:	**09:07**	I think that's actually a really good segue, because as part of our process, whether we're looking at equity investments for our clients capital, or in your case, lending capital to corporations/governments, we typically take a probabilistic view of the world, which leads us to consider multiple different outcomes or scenarios that could unfold. What are some of the scenarios that you and the team are currently considering?
Crista Caughlin:	**09:31**	We're currently working with three scenarios. One, where we see growth returning sort of…slow to return. Policy remains easy, but it's only offsetting this slow deleveraging process. And I would kind of classify that as a reflationary environment—similar to what we saw post-financial crisis.
Andrew Johnson:	**09:51**	Can you expand on what you mean by reflation? I think most people know what deflation is and inflation is, but what's reflation?
Crista Caughlin:	**09:57**	I would say reflation really is just this idea that policymakers are pumping a ton of liquidity into the system and that's causing asset price inflation, as opposed to true consumer price inflation.
Andrew Johnson:	**10:11**	Okay, that to me sounds like more of the same. It sounds like what we've observed over the last seven or eight years.
Crista Caughlin:	**10:17**	That's exactly right. I would classify this scenario as very similar to the environment we saw post financial crisis.
Andrew Johnson:	**10:23**	Great. So, interest rates remain low…that tells me that central banks around the world are going to continue doing what they're doing. And actually, we're recording this a little bit before we actually publish it, but just today we heard some commentary that the Federal Reserve in the United States is going to likely keep interest rates near zero for the next couple of years.

Crista Caughlin: 10:45 Yeah, that's right. So, if we are in a similar environment to what we saw post financial crisis, we would expect to see central banks globally remain easy. And we're going to see more and more asset purchases; central bank balance sheets will continue to grow. There is a chance they will move more and more down the risk spectrum. They started off with treasuries, they're now talking about, well, they're now actually buying corporate bonds...if this type of environment is prolonged for the next five years, it shouldn't be a surprise to anyone to see central banks dipping their toes in equities as well. We've seen that in Japan already; Japan started buying equities in 2013. The longer this goes on, the more likely it is that global central banks will be buying equities as well.

Andrew Johnson: 11:33 Interesting. Okay, so more of the same—growth is slow to return, probably going to have easy monetary policy going forward, and like you said, reflation: pumping more of that stimulus into the system. What [are] the other two scenarios that you're grappling with right now?

Crista Caughlin: 11:47 The other two are really the sort of tail ends of that. The one is deflation versus inflation. This deflationary environment, or this deflation scenario, really comes down to the debt overhang that we have. This debt bubble has to come to an end, and the deflationary scenario is one where the coronavirus really was just the tipping point. We've seen an extremely large income shock, which typically creates widespread default cycle. And although we're not seeing it right now, because policy makers are sort of filling that income hole, what we're watching for here is a fiscal cliff. And so, as fiscal policy makers start winding down their stimulus, are we going to start seeing defaults in the private sector, in the household sector? Are those going to start picking up? And are they going to be picking up enough that no matter what central banks do, they've already caused this self-reinforcing downside wave or downside cycle?

Andrew Johnson: 12:48 That, to me, sounds like a lengthy sort of scenario, where we see a lengthy recession occur after we come out of this current crisis. What is likely to happen throughout circumstances like that?

Crista Caughlin: 12:59 That's going to mean rates continue to go lower; we shouldn't be surprised to see negative interest rates in developed markets. Risk assets are obviously going to underperform, default rates are going to spike. At the extreme, this is really the clearing of the system. The good news is, if we do see something like this happen, it sets us up for a positive next sort of...decade or 20 years. But this scenario at the extreme is the clearing of the system.

Andrew Johnson: 13:26 So back to my simplistic view of a credit cycle: you also mentioned a scenario where a possible outcome is that we actually see real inflation as well? [Laughter] Can you take us through that? Because that is something that maybe our listeners are not familiar with—the scenario where we actually see real, solid inflation.

Crista Caughlin: 13:44 This is a risk a lot of people are talking about. But to be honest, this is a risk that people have been talking about for over a decade. When I think back to the financial crisis, the first time we did QE, central banks were flooding the system. Everybody was worried about inflation back then, and we got none.

I think the important thing is to try and understand why we didn't get any inflation back then. And really, what was happening was we had a private sector that was continuing to try and de-lever in the face of all this liquidity.

14:16 So if we fast forward a decade and we take a look at where private sector balances are, and how much deleveraging we've seen in the private sector, you could paint a picture that suggests that the private sector has done their deleveraging cycle. So in the face of all of this liquidity, the private sector actually starts borrowing more. They start spending more. And that will cause velocity to pick up, which could cause a prolonged inflationary period.

Andrew Johnson: 14:47 Can you talk a little bit more about velocity? I'm not sure if that's a term that many people are familiar with, especially with the current environment that we find ourself in.

Crista Caughlin: 14:55 The velocity of money really just…is this idea that money churns through the system. Borrowing is a way to do that. If I borrow a dollar from you and I go out and spend a dollar, that's money that's churning through the system. And so, as you do that, you increase growth, you increase inflation.

Andrew Johnson: 15:14 Just to kind of wrap everything up, we've got this overriding theme of increasing global debt. It doesn't seem to be going away anytime soon. Clearly, you outlined three probable scenarios. There could be more that we're trying to grapple with. There could be in-between scenarios of those as well, or ebbs and flows to each. What does that mean for a bond manager like yourself in trying to construct a portfolio that can be resilient through all of that?

Crista Caughlin: **15:44** What we do is, we start off with: where do we think we are right now? I think our view is that we're in that "more of the same" environment. So, policy is going to remain easy, credit is going to remain supportive, risk assets are going to remain supportive. And so, we position for that environment. Then what we do is, we really try and flush out what it is we need to see to understand if we're going towards either of those other two environments. So, are we going towards that deflationary environment? Are we going towards that inflationary environment? And we want to make sure our portfolio is positioned in a way that benefits, or doesn't get hurt, in those environments.

16:21 And so, some of the things we're watching right now are things like consumer spending, employment. We're watching the debt and deleveraging cycle. We're watching fiscal policies to understand if we're coming close to that fiscal policy cliff. And so although we think that this "more of the same" environment is our base case, our view in the near term is that we're more concerned about this deflationary environment as we see the fiscal cliff becoming a bigger and bigger issue. So we're ensuring that we're positioned so that we don't get hurt in that environment.

Andrew Johnson: **16:53** It certainly sounds like one of the most important aspects of…just thinking generally about multiple scenarios, multiple outcomes, is standing ready to be able to act when you see things change in one way or another—much like a football coach would be watching a game unfold. He's going to make tweaks to his strategy as things move forward. I assume that's similar with you and the team.

Crista Caughlin: **17:17** Yeah, that's exactly right.

Andrew Johnson: **17:18** So what have been some of the recent moves that you've done within the portfolio itself to help not only position yourself for that base case like you talked about, but be nimble enough to make moves into the future?

Crista Caughlin: **17:30** One of the things we've been doing is reducing our corporate credit weight. We've seen spreads move in quite considerably, just on the back of the monetary policy support, and so we've been taking some of that risk down as spreads have tightened. That puts us into a place [where] if we do see a backup because we see ourselves going into that deflationary environment, we have dry powder that we can use if we do see ourselves going into that deflationary environment.

Crista Caughlin: 17:57 At the same time, we're long duration. As we outlined, all the debt that exists out there means rates are going to remain lower for longer, so we've maintained a longer duration position. The other thing we've done—because we do recognize that inflation is a risk that could potentially happen in the future—is we have a curve steepener on. In the inflationary environment, a steepener will outperform as rates move higher, particularly in the long end of the curve.

Andrew Johnson: 18:24 Great. Well, this has been very informative for me, [and] I think our listeners, so thank you for taking the time to sit down with us and chat through all of this. I think the environment that we find ourselves in, especially like we've talked about around interest rates, monetary policy, the effects that it may have on fixed income investing in particular, is top of mind for many people. So, I do look forward to sitting down again in the future and checking in on our thinking. Thanks again for joining me today.

Crista Caughlin: 18:52 Thanks for having me.