



[00:00] Kevin Minas: In this episode of The Art of Boring, I speak with Crista Caughlin, Lead Portfolio Manager of the Mawer Canadian Bond Strategy. We'll dive into the major macroeconomic trends shaping bond markets, examine central bank policy, and explore what's been driving Canadian bond market performance. We'll also discuss our Canadian bond strategy positioning, the biggest risks we see in the market, and why fixed income still matters for investors today, despite the headlines about rising bond equity market correlations.

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[00:48] Kevin Minas: Hi, Crista. Nice to see you today.

[00:50] Crista Caughlin: Hi, Kevin. Thanks for having me.

[00:51] Kevin Minas: The last few episodes that we've had you on, we've been covering the quarterly, so more of a balanced portfolio update. Today, we're going to do something a little bit different, cover fixed income exclusively and the Canadian bond strategy here at Mawer. Why don't we start with the big picture? Over the past year, or even year to date, can you please walk us through some of the most significant macroeconomic trends that have been shaping global bond markets, but particularly the Canadian bond market?

[01:15] Crista Caughlin: Thanks, Kevin. So this question really does tie nicely in with our macro process. On the macro side, we start each year with laying out themes. These are things we think are going to affect the economic backdrop or financial markets over the course of the year. At the beginning of this year, we started with three main themes: trade policy, fiscal stimulus, and what we're calling continued tightening of financial conditions. I'll start by going over those themes, and then I'll talk to one more that we believe is having an impact.

I'll start with the big one, U.S. trade policy. To be honest, we didn't start the year necessarily thinking exclusively about trade because we weren't really sure which direction the U.S. administration would take. Were they going to lean on tax cuts, deregulation, or were they going to focus on trade? We very quickly learned trade was going to be a big focus for them. This had a huge impact on financial markets, particularly earlier this year around "Liberation Day". It's also impacted central banks and how central banks think about policy in the face of trade uncertainty. And then it's obviously had an economic impact. I would say over the last few months, we have seen deals in Europe, Japan. We've seen China's tariffs be paused. This has gone a long way to reduce that uncertainty that existed in financial markets. However, we are still seeing the economic impact of the trade war play out, particularly in places like Canada. Growth is slowing in Canada, exports are down 11% year to date, and we're seeing a slower labor market. Although we've seen the financial volatility decline, we believe the uncertainty around trade will continue to impact the economic backdrop.



Our next major theme is fiscal policy. This has been a theme of ours for a few years. We're seeing governments globally put forward plans to increase spending, whether it's the U.S. and this "big, beautiful bill," whether we're seeing increased spending around defense or infrastructure. In Canada, we know we're going to get a budget in the next month or so. We expect to see increased spending there. Even Germany, which is one of the most fiscally responsible countries in the world, has made changes to their debt brake to allow for increased spending. Now, when we think about fiscal policy, it's typically there to fill that growth gap. If your economy is weakening, fiscal spending comes in and helps boost growth and cut off that downside tail. But what we're potentially seeing today is that policymakers are moving towards an increase in fiscal spending at a time where their economy is still growing. So if you're boosting growth while the economy is at capacity or at full employment, that spending ends up being inflationary. That's a major theme that I would say the bond markets are wrestling with this year. Our final theme is this tightening of financial conditions or the idea that previous tightening is still making its way through the economy. We think this is happening in both Canada and the U.S. In Canada, the mortgage refinancing story is a well-told story. We know it's continuing. We know it's continuing into 2026. It's a headwind to consumer spending. I think what's less appreciated or what's less known is we're starting to see something similar in the U.S. In the U.S., rates are quite a bit higher than they are in Canada. They're above neutral and what this means is the Fed has kept rates at a level that is considered restrictive. And we believe that's starting to show up in the economy. If you look at things like consumer delinquencies, auto delinquencies, even home prices are starting to turn negative here. This is a theme getting less airtime, but we believe it's contributing to the slowdown that we're seeing in growth, which will impact central banks and therefore interest rates.

The last theme I'll touch on is AI. AI is arguably having a bigger impact on equity markets versus the bond market right now, but it is having an impact on current economic growth. When we typically talk about AI, particularly in the context of the economy or the economic backdrop, we talk about long-term benefits. We talk about efficiencies, productivity gains. What does that mean for the labor market? But what we're seeing is there was a bit of a short-term boost to growth related to AI spending, whether it be data centers or just infrastructure around AI. And I think if that continues, AI is not only going to be a long-term secular theme with respect to productivity, but it does provide a near-term positive for growth.

[05:46] Kevin Minas: You touched briefly there on central banks. I don't envy their position right now. It's a lot to navigate some conflicting signals that they're getting from the economy. And then, of course, they control interest rates, which has its own impact on inflation and all of those downstream effects or things that are impacted by interest rates. Let's talk specifically Bank of Canada and the Fed and how they have approached interest rate policy over the last little while, particularly in light of this tension on inflation. And what's surprised you most about their policy decisions and the market reaction to those decisions?

[06:18] Crista Caughlin: We started the year with global central banks in easing mode. They're arguably at different stages of their easing cycle, but they all had an easing bias. Then we got the trade war. There's a lot of uncertainty that was created around the trade war. There are a lot of unknowns, not just about policy itself, but about how the trade would impact both growth and inflation. And because of this, central banks moved away from forward guidance and took more of a wait and see approach as they monitored how the economy was evolving. More recently, we've seen central banks shift back to that forward guidance and proactively start cutting rates again. The Bank of Canada has eased twice this year, cutting in January and March. They brought their overnight rate to the middle of their neutral range and then really paused in the face of that uncertainty. As I mentioned, they moved away from setting policy based on their outlook and took that wait and see approach.



Fast forward six months, what they're seeing is less pass through of tariffs onto prices and inflation than what was initially expected. And we're seeing that negative growth impact from tariffs and uncertainty is hitting growth and employment. Q2 GDP was negative. As I mentioned, exports are down over 10%. We're seeing employment declines and we're seeing the employment declines in both trade and non-trade related sectors. That slowdown in growth while inflation seems contained prompted the Bank of Canada to cut rates in September. Our view is they will likely continue cutting rates as we believe the downside growth impacts from trade will continue. We saw something similar in the U.S. where the Fed took a wait and see approach for most of the year. The Fed started the year with the overnight rate at 4.5% and although their dots suggested they were going to continue easing, they paused until recently. And I think it's important to note that unlike Canada which had lowered their rate to neutral, the Fed paused at elevated levels and therefore kept policy restrictive for most of the year. That changed earlier this month. They did cut rates 25 basis points, brought rates down to 4.25 similar to the Bank of Canada. Although they're seeing inflation somewhat sticky and above their target, growth has materially slowed and employment has materially slowed. And so they were seeing greater downside risks to their employment mandate relative to the upside risks related to their inflation.

There's been a lot of questions around Fed independence, particularly on the back of the most recent cut. This is one thing that's surprised me this year. And I think this is one of the risks that we face in the coming months and years. If you look at Project 2025, it talks about narrowing the Fed's mandate, increasing oversight of the Fed. So it's not unreasonable to suggest that there is a risk that Fed independence may become diminished. Having said that, it's not clear to me that this latest cut was the result of political interference. To me, there is a strong economic argument to be made for the most recent cut, particularly given they were above neutral, so they were restrictive and continue to be restrictive. To me, the real sign that Fed independence has been severed will be when the Federal Reserve is not setting policy for the economic backdrop but instead setting policy to appease a government. And this is definitely a risk, something to be mindful of. Arguably, we're tiptoeing towards that, but I'm not convinced the latest cut represents that.

[09:53] Kevin Minas: There is this political pressure, but to your point, it appears that there was the economic backdrop to justify the cut. Flipping that, do you think that perhaps with time, the data will bear out that perhaps they were even a bit late in this cut? Or is this, in your view, the appropriate time for them to have taken action?

[10:08] Crista Caughlin: It's hard to argue that they are late based on the information right now. We have seen a deterioration in the labor market. The unemployment rate is still at a low level, unlike in Canada, where the unemployment rate's been rising quite a bit. And then on the growth side, we got a negative growth print in Q1, but that's rebounded a bit. You could maybe look at the growth side and argue they're a little bit late. But I think overall, it's tough based on the information we know now to suggest that they're late.

You're looking at an economy that's at full employment, and I think that's why people are debating whether this was Fed interference or not. And I think the real key to suggesting that it's not is that they are above neutral. They are restrictive. If they were already at neutral, like the Bank of Canada was, and they decided to ease policy further, I would suggest that that would have been the wrong thing for them to do at this stage. But they are above neutral. They're still restrictive. They are just getting back to a more neutral level.

[11:06] Kevin Minas: Shifting back to Canada a little bit, and we've talked a lot about the macro and the economic



backdrop, the central bank backdrop. Let's talk bond market performance, particularly in the Canadian context. What were the key drivers year-to-date last 12 months for the Canadian bond market? What did performance look like?

[11:22] Crista Caughlin: Both rates and credit have contributed to bond market performance this year. I'll start with credit and spreads. Both provincials and corporates continue to grind tighter. As I mentioned, we saw some volatility around "Liberation Day", but since then, spreads continue to outperform with lower quality names performing better than higher quality names. On average, corporate spreads have tightened around 10 basis points year-to-date. So, not a material tightening, but a continued grind lower. And we're seeing the same thing on the provincial side. Provincial spreads continue to grind lower, and they're tighter around six basis points year-to-date. With respect to interest rates, it's mainly been shorter-dated maturities that have performed well. With the central bank in easing mode, we've seen 2-yrs fall around 50 basis points. Fives have fallen 25 basis points with 10s modestly lower. This has really resulted in the curve steepening. 2-10s have steepened around 40. 5-30s have steepened around 50 basis points. The real sector, almost the only sector that's been underperforming here, is longer-dated rates, particularly 30-year bonds. And this really started happening post-"Liberation Day". And our take on it is that the market's looking at an environment where global trade is decreasing, tariffs are increasing, increased protectionism, increased fiscal spending. And they're saying that this is likely going to cause structurally higher inflation, which does result in the long end being more elevated and causing the 30 years to underperform.

[12:53] Kevin Minas: And just so I understand that, can I understand the impact, potentially higher inflation over the long term, that doesn't affect the medium or short part of the curve as much just because it's a function really of central banks driving the bus on the shorter part of the curve?

[13:05] Crista Caughlin: Yes, exactly. The way I think about it is central banks drive the short end, inflation drives the long end. What that means is that the central banks are looking at the growth picture today. And they're setting policy for growth and inflation. And inflation's roughly around 2%. Where the long end of the curve is potentially suggesting that 2% is not the right long-term run rate for inflation. It might be something higher that's creeping up in longer dated maturities.

[13:33] Kevin Minas: Let's talk a little bit about the strategy that you manage, the Canadian bond strategy. If you could walk us through, given all of the backdrop and market history that you've walked us through, how you were positioned throughout the year, and then also areas of opportunity currently that you find most compelling.

[13:49] Crista Caughlin: Our view was that we were going to see a slowdown in growth in Canada. That slowdown was driven by the factors we discussed, uncertainty around trade, mortgage refinancing, immigration policy is another factor that we think is acting as a headwind. So that slowdown really would require the Bank of Canada to continue easing policy, bring rates down to at least the lower end of the neutral range, if not below neutral. And so given that, we've been in a steepener all year, which has done well for us. In terms of credit, we did start the year overweight credit, at least modestly overweight credit. We didn't really see the slowdown triggering a deep recession. However, as we learned more about trade uncertainty, as spreads continue to grind lower, we have trimmed credit even more. Even in the face of this uncertainty that's picked up, as I mentioned, spreads continue to grind lower. They're now through the lows, in Canada at least, through the lows we've seen post financial crisis. So we've seen some decent tightening in spreads over the last few months.



In terms of where we see value, as I mentioned, we believe the curve is going to continue steepening. So we are overweight that five-year area, underweight tens and longs. We do believe the Bank of Canada will continue easing. We see that there are some risks around the secular trends with respect to inflation. And so that could continue pushing the long end higher. On the credit side, we like shorter dated maturities. We think the most attractive area of the spread curve is that three to five-year part of the curve. It really captures the carry. And then given spread compression and given that outperformance of triple Bs relative to single As, we've also started shifting the portfolio into higher quality corporates. We like banks, utilities, higher quality corporates in the three to five-year area of the curve.

[15:38] Kevin Minas: That's the backdrop of where we're at now, what your views are. Having said that, risks never go away. What are the big things that are keeping you up at night for somebody that's managing a bond portfolio?

[15:49] Crista Caughlin: The big risk right now, which has been a risk for a while, really is inflation. Because that will ultimately cause central banks to tighten policy and raise interest rates. We have seen inflation come down in recent years, but it's been sticky around 2%. In Canada, we do believe that that growth slowdown will ultimately drive where inflation goes. But we are mindful that those secular trends, deglobalization, supply chain disruptions, fiscal stimulus could remain elevated and could continue to push inflation higher. On the credit side, we are seeing a modest deterioration in credit. We are seeing an increase of leverage, particularly in the non-financial part of our index. So with spreads at all-time tights and fundamentals slowly deteriorating, there is a risk that something will trigger a spread-widening move here.

[16:42] Kevin Minas: And then finally, for investors who are perhaps feeling uncertain about bonds, particularly given maybe some of the risks you just mentioned, what's your message for them in terms of the role of fixed income? Obviously, you're a fixed income portfolio manager, so perhaps you're a little biased. But nevertheless, how do you think about the role of fixed income in the context of a balanced mandate in 2025 into 2026?

[17:03] Crista Caughlin: We still believe fixed income can and should play a meaningful role in diversified portfolios with yields at higher levels, higher than we've seen in decades. Those high-quality bonds can go back and play the role of diversifier, have that negative correlation when equity volatility increases. And we have seen that through various periods of equity volatility increases over the last year or so. With yields higher, we're finally being paid to wait, collect our coupon, and the higher yield creates more of a cushion against modestly higher rate moves or spread-widening.

[17:39] Kevin Minas: Well, I think that's a great place to end. As always, thanks, Crista, and hope to talk to you soon.

Crista Caughlin: Thanks, Kevin.

Kevin Minas: Hey, everyone. Kevin here again. To subscribe to the Art of Boring podcast, go to mawer.com. That's M-A-W-E-R.com forward slash podcast or wherever you download your podcasts. If you enjoyed this episode, be sure to leave a review on iTunes, which helps more people discover the Be Boring, Make Money philosophy. Thanks for listening.

