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EP 185 | Quarterly Update | Q1 2025

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[00:00:00] **Kevin Minas:** Hi everyone, Kevin here. Today I'm joined for the quarterly update by Crista Caughlin, lead portfolio manager of our Canadian bond strategy, and Jeff Mo, the lead portfolio manager of our U.S. midcap strategy. It has felt like an extremely long start to the year. We've had nonstop headlines, tons of news to digest, gyrating markets of uncertainty. And of course, at the start of Q2, we had the so-called "Liberation Day," which was the imposition of tariffs by the U.S., retaliatory actions by other countries, and the major fallout from these actions across, rates, credits, and equity markets. Nevertheless, we are going to start with a little recap on Q1.

[00:00:37] **Kevin Minas:** Equity returns were—at least in international markets—quite strong, particularly in EAFE large cap as well as even emerging markets. Canada was modestly positive overall, though that was largely pulled into positive territory by materials, particularly gold miners. The notable news, or particularly noteworthy news, was the U.S. generally, as well as big tech that took a breather after leading the way for a long time. Core fixed income also saw positive returns as yields generally fell in most major markets. Now, of course, a lot of this in some ways is old news given the major volatility we've seen since the end of the quarter. We're going to cover both periods, both Q1 and what's happened in the last week and a half or so throughout this episode. So, let's start with you, Crista, you can just give us a recap on what drove fixed income returns in the quarter, as well as what's been notable and has happened since the end of the quarter.

[00:01:29] **Crista Caughlin:** So, volatility has picked up since quarter end, however, it really was a theme that has existed since the beginning of the year. Last quarter we talked a lot about the unknowns around the new administration, which direction they would take, which policy levers would they pull first. What we learned over the quarter was that global trade really was going to be at the forefront. The first threat of tariffs happened in early February 1st, I believe. We also learned about DOGE, which was announced at the end of January and we started hearing about government employment layoffs. Now in addition to the unknowns around the administration, we also saw weaker data over the quarter.

[00:02:11] **Crista Caughlin:** ISM is below 50 again, retail sales are a bit softer. The unemployment rate has ticked modestly higher in the U.S.. Q1 GDP growth is now tracking closer to half a percent or 50 basis points, relative to the two snf a half percent we saw at the end of last year. And so we have a lot of unknowns around fiscal policies in the U.S. with the backdrop of slowing or less supportive growth. As you mentioned, Kevin, you know with that as the backdrop, we did see yields fall over the quarter. 10 years declined around 20 basis points ending at 3%, in the U.S., we also started seeing spreads leaking wider.

[00:03:00] **Crista Caughlin:** Uh, investment grade spreads were about 10 basis points wider and high yield spreads were about 25 basis points wider. So we saw a small widening of spreads on the quarter, but keep in mind still very low by historical standards. So that was quarter end. Obviously since quarter end, we've had "Liberation Day," sweeping tariffs, retaliatory tariffs, pause on tariffs...and volatility has really picked up.

[00:03:26] **Crista Caughlin:** We've seen some pretty material swings in both credit markets and rates markets since April 1st. The Canadian tenure is trading between 280 and 325, so a 45 basis points swing over the last few days. In terms of credit markets, Canadian credit was 15 to 20 basis points wider at one point but has tightened back a little since then. High yield markets traded as much as a hundred basis points wider and is now sitting closer to 50 or 60 basis points wider. And so overall, since the beginning of the year, including the last week and this latest bout of volatility, we have yields that are modestly lower...call it flat year to date, and credit spreads are wider.

[00:04:20] **Kevin Minas:** Excellent. Jeff, the same question for you. If you could just give us a recap on the equity markets through the end of the quarter as well as an update on Q2.

[00:04:29] **Jeff Mo:** Sure, Kevin. So, equity markets kind of bifurcated a little bit where Europe did quite well, and the U.S., as you mentioned, took a bit of a breather. Certainly, technology stocks led on the downside. There was particular weakness in some of the mag seven constituents.

[00:04:51] **Jeff Mo:** European stocks being strong through Q1, I think it initially was a bit of a surprise for some people because there wasn't a lot of fundamental strength there. But I think just the relative valuations, depending on the markets you looked at on a relative basis, on a P/E basis to the U.S. you saw anywhere from like a 25 to even a 40 or 50% discount in some European markets.

[00:05:20] **Jeff Mo:** So some of that closed in the quarter as U.S. indices were flat, slightly falling, and Europe, which was generally up. And then I think the big news for Europe was around re-armament. So, as it became clear that the new Trump administration was maybe increasingly serious about pulling the U.S. security umbrella from Europe, or at least threatening to, and reducing force in Europe, I think a big, turning point was, when the U.S. actually sided with Russia at the security council...in essentially not condemning, the invasion on a particular resolution. And so that was a wake up call for many European leaders. And that led to, Germany in particular, pushing and eventually succeeding to increase on defense spending because they have a law saying they can only go past a certain amount in deficit spending per year in the government budget. So that really drove particularly defense stocks. But I think in general, there’s more optimism for Europe. There is a view that, a lot of this incremental spending was just announced by Germany, and it wasn't just Germany.

[00:06:35] **Jeff Mo:** There were other countries that had also increased their spending and most of that would flow to domestic European industry. So, there is a view that there could be revival in the industrial base in Europe. So that certainly was quite positive for European equities, at least to the end of Q1.

[00:06:54] **Jeff Mo:** Obviously with the tariff announcement in early Q2, that certainly caused a bit of a pal closer to home. Here in Canada, things were a little bit tougher. There was uncertainty certainly with tariffs as Crista mentioned. Canada and Mexico were the first countries to be hit with uncertainty on the tariff front, and we also had government uncertainty at the same time.

[00:07:22] **Jeff Mo:** Given that it was a little bit unclear who was going to be Prime Minister, we now know at least from a liberal leadership, Mark Carney is Prime Minister. But, there is still an ongoing election, which is not the best time to have an election when there is a trade war with your largest trading partner.

[00:07:40] **Jeff Mo:** So, Canadian equities, excluding gold, generally didn't do so well and I think a lot of people were just worried. And I think, the Bank of Canada has taken a much more dovish stance with that backdrop compared to the U.S. Federal Reserve. So flipping over to the last week and a half—I won't necessarily repeat

everything that happened—I think most market participants are probably aware of the large impact on equity markets that were caused by the so-called reciprocal tariffs announced by the Trump administration. But, it was just a situation where this is largely psychology driven. The psychology of that kind of came out was... there was this expectation. After President Trump threatened tariffs on Canada, Mexico, and then for the most part pulled back and at least allowed goods that were part of the free trade agreement, USMCA, to be exempt from tariffs...that was sort of the backdrop that investors had in mind. Going into April 2nd when Donald Trump had signaled his intent to put on tariffs to more countries globally, that was the worst case scenario that President Trump would impose tariffs on every single country in the world at pretty high rates. And that seemed to be what happened. Until April 9th when, most of those tariffs, except on China were paused.

[00:09:06] **Jeff Mo:** And so equity markets have gyrated a lot. I think the VIX, which is an index that measures volatility spike to 50, up from I think 20 at the beginning of the year. That certainly caused a lot of angst for investors. But, ultimately after the pause ws announced on April 9th and the subsequent market rally, equities have actually not moved all that much in Q2—I think in the kind of mid-single digit range—but volatility is very high now as the uncertainty created by the on again/off again tariffs really make it hard for business leaders to manage.

[00:09:42] **Jeff Mo:** And in fact, on that point, when we talk to companies, even prior to April 2nd, but certainly after April 2nd, the feedback we're getting from the CEOs of the companies that we invest in, companies we're thinking about investing in, just a lot of comments, not necessarily on the economy being incredibly weak, but just the anticipation of uncertainty causing a lot of businesses to pause investments or hiring for new projects and that sort of thing. And if confidence stays weak for a long period of time, that can start to filter into the real economy.

[00:10:16] **Kevin Minas:** So, we've talked a little bit about what's happened so far with tariffs. Crista, if you can comment a little bit on how you're thinking about the various scenarios of how this could play out going forward. We've seen a lot of activity already. It's probably very difficult to predict what will happen going forward, but how are you thinking through different scenarios and how it might impact the portfolio that you manage?

[00:10:34] **Crista Caughlin:** Previously we didn't know what tools the U.S. was going to implement first. Was he going to push on sort of the growth positive policies such as deregulation and tax cuts, or was he going to push on the ones that maybe have more negative implications, at least for short-term growth, such as tariffs, trade policies, DOGE. We know now that he's pushing through the harder stuff sooner. And not only is he executing on the more difficult policies, at least from a short-term economic standpoint, they're more aggressive than we would've expected. Now there's still a lot of unknowns.

[00:11:11] **Crista Caughlin:** You know, one minute there's tariffs. The next minute, they're delayed. But what we try and do is sift through the noise by taking a step back and really looking at what the implications of trade policy are on growth and on inflation. Now the direct impact from tariffs are well known. It's a negative implication for growth, at least in the short term. And tariffs, obviously, result in higher prices or higher inflation. But there's also indirect effects from tariffs. And a lot of those indirect effects are around the uncertainty that a trade war brings. And Jeff sort of touched on a lot of these, but that would include things like reduced business spending, reduced business hiring, and reduced consumer spending.

[00:11:55] **Crista Caughlin:** You know, if you're an auto worker in Ontario or if you are in the forestry industry in B.C., it's not unreasonable to be worried about your job security, which likely reduces your desire to spend currently. And then the last one, the sort of more likely unintended consequences of all of this, is really just a tightening of financial conditions and so that's going to have implications on businesses, consumers—really just

growth—as access to capital decreases and the cost of capital increases. And so it is a positive thing that tariffs have been delayed, but the negative growth impacts or implications just due to the uncertainty alone still exist. And so regardless of whether or not tariffs are going to be 10%, 25%, or potentially delayed, inevitably I think the growth picture has gotten worse given the uncertainty. And so, if uncertainty continues for an extended period of time, or if large tariffs do come into effect, the probability of a material growth slowdown has increased, or at least the probability of a recession starts increasing.

[00:13:13] **Kevin Minas:** So that's the more of a macro, top down perspective or lens...some of these tariff risks and the knock on effects of growth and inflation. Jeff, on the equity side of the ledger, how are you and the rest of the equity team taking these tariff shocks, or potential future actions into account when you're doing your bottom up fundamental company analysis? And also are you already starting to see some of those impacts from tariffs flow through to company earnings, or is that something we would expect more in the next coming weeks and months?

[00:13:45] **Jeff Mo:** Yeah, I'll answer your second question first. We aren't seeing the impacts of tariffs flow through yet. Partially because Q1 earnings haven't been reported yet, so all we have is data from December 31st when Joe Biden was still president. However, there could be, small impacts on Q1 earnings as some of the uncertainty, especially for countries that may be traded with Canada or Mexico, there might already be some impacts. And then Q2 obviously would be the big one depending on what happens ultimately with the reciprocal tariffs. As I sort of alluded to in my last comments, we are seeing it from a kind of a business environment or a confidence-to-invest standpoint.

[00:14:29] **Jeff Mo:** And, we're also seeing the equity markets anticipate this. Some companies in the auto supply chain, for example, have been negatively affected from both a stock price standpoint and a sentiment standpoint in some cases. On both sides of the Canadian/ U.S. border hearing commentary from certain auto plants shutting down, I think in Ontario, the Stellantis plant had to furlough their employees for at least a couple of weeks. And so these things will start to filter through. The other piece, and Crista touched on this, is when you have uncertainty in your job security, you will not really want to spend as much. And it's not just job security. I mean, as I said, there, there have been certain workers that have, started to get furloughed. I was also reading, maybe a month ago about a small Montreal company that made furniture and they actually ended up laying off a bunch of workers because just even the uncertainty alone of whether or not companies in the U.S. could order Canadian furniture and get it across the border tariff free, caused a drastic drop in orders for them to the point where they had to have to shrink their business.

[00:15:39] **Jeff Mo:** But probably the big one actually would be, what's happening with the U.S. civil service's pretty kind of indiscriminate layoffs largely driven by the Department of Government Efficiency. And I think it's not even that, that many federal workers have been let go, it's the feeling amongst the civil service that the new administration is not supportive of what they do and that anyone at any time could get fired. And so I think from that standpoint, it's causing a lot of those federal workers to be a lot more cautious in their spending. And I mean, that's a pretty large workforce across the country.

[00:16:22] **Jeff Mo:** And you know, they have friends, and they talk to their friends. And so you we're starting to see it in consumer confidence surveys and some of the leading indicators that there is a dampening effect on consumer spending—and this is before we talk about tariffs and certainty if tariffs get implemented.

[00:16:41] **Jeff Mo:** I was just reading in the Wall Street Journal this morning, about Walmart and how they are thinking about navigating the now 125% tariffs on Chinese goods because those tariffs have not been paused. So

even on that standpoint, a lot of...call it more basic goods that are manufactured in China and sold in retailers like Walmart...will be going up in price.

[00:17:04] **Jeff Mo:** And that will affect the consumer's ability to buy goods in, a scenario like, or in a situation where, some people have already lost their jobs and more people are feeling uncertain about their jobs. And then the other thing I guess I haven't talked about very much is the illegal immigration kind of deportation push.

[00:17:29] **Jeff Mo:** I mean the estimates out there are anywhere from 10, 15, 20 million people who are undocumented living in the United States. I mean, that's upward of 5% of the population. And because of the worries of being deported, because of the worries of raids on workplaces and factories, some of these workers aren't showing up at work. Well, they're not getting paid anymore. These are just all small effects that in aggregate add up to a softening in the consumer picture. And I think tariffs are a big part of causing that.

[00:18:01] **Kevin Minas:** No, we focus on the bottom up when we're building portfolios, so the quality of the businesses themselves and the valuation they're trading at. But I'm just curious if, given the kind of volatility and uncertainty we're seeing, does this for you change how you think about portfolio construction? Do you lean or adjust a little bit more or less in some particular way? Uh, or is it that you continue to execute on the process? Are there adjustments that you would make on the portfolio construction side?

[00:18:28] **Jeff Mo:** Yeah. So, by and large, no. I would say that those who listen to our podcast regularly will be familiar with this analogy: the time to fix your ship is in dry dock when things are sunny and you can carefully, methodically build out your ship. When you're sailing through the storm, which we are doing now, it's much more dangerous to go and fix your ship because you might climb above deck and get hit by a wave, and rather than fixing your ship, you end up having more damage done to you.

[00:19:00] **Jeff Mo:** So, putting that analogy aside, I think many of our listeners do understand, but I'll just reiterate again, is that we think of ourselves as active bottom up managers. So, what does that mean? That means we narrow the scope of the prediction that we are making on behalf of clients. So our job as bottom up managers is to predict the future. So we predict how strong the competitive advantages of the companies we buy will be and are. But then for things like how high will tariffs go? How long? Which countries tariffed? Questions like, will interest rates be higher or lower in six months, 12 months, 18 months? Those questions undoubtedly impact equity market returns. But the way we think about it from a portfolio construction standpoint is we need to be passive on those questions. And when I say passive, what I mean is we will have inherent contradictions in the portfolio. So if I can talk, say my own book for a second, in U.S. midcaps, we own a company called FTI Consulting, which is the largest bankruptcy consultancy in the U.S. Their competitive advantage is their brand, they are the most well-known. They tend to win the mandate to work out the biggest bankruptcies such as Hertz Global in 2020 when the rental rental car company went into receivership or into protection, rather.

[00:20:25] **Jeff Mo:** On the flip side, we do own a company called Shark Ninja, which is a small household appliances company. Both of these companies are, wealth creating. They have strong competitive advantages in our opinion. But as you can imagine, when tariffs are maybe higher, uncertainty is higher.

[00:20:45] **Jeff Mo:** FTI may do better because, there could be more bankruptcies happening. On the flip side, if all of this goes away and the economy looks very sunny again,, shark Ninja will do relatively better. But the whole point is that we have these inherent contradictions throughout all of our portfolios so that we aren't necessarily shifting one way or the other. That being said, as bottom up managers, we will make certain shifts. And the way we do that is when we are aware of a new business environment. So, on April 2nd, oh, okay...there could be a new

business environment for importers and exporters and those that rely on goods moving across borders. Then we will go into our discounted cash flow models and we will adjust our assumptions.

[00:21:32] **Jeff Mo:** Or in some cases, we would just adjust the range of our assumptions. Those of you who know about our discounted cash flow model have heard about our Monte Carlo simulation. So, what that means on a practical standpoint is we might say the growth rate for 2025 for companies, we used to say had a standard deviation of say 2%, and now we're saying, okay, now this is more like 3% because things are looking more uncertain.

[00:21:56] **Kevin Minas:** it must be a difficult job right now to be a central banker. The Fed was on hold this quarter after three straight cuts to end 2024. The Bank of Canada meanwhile continued cutting. It feels it's a very uncertain environment to be a central banker. This would be the time where you really have to earn your keep. because I think you can make arguments on both sides whether they should be dovish or hawkish. What's your sort of read on that?

[00:22:21] **Crista Caughlin:** Yeah, I mean, you know, central banks are in a really difficult spot right now, which is why I think they're in somewhat of a “wait and see mode.” The Bank of Canada did cut this quarter, the last cut was in March. The rationale for the cuts this quarter have sort of been similar to what we've seen all cycle, which is the starting place for growth was weaker and inflation was lower in Canada. Having said that, I do think the March cut was a a bit of an insurance cut as tariffs were ramping up. And so the Bank of Canada really wanted to make sure that Canada was in the best place possible going into any type of trade war. Now going forward, whether it's the Fed or the Bank of Canada, as I mentioned, I do think they're in a bit of a wait and see mode.

[00:23:08] **Crista Caughlin:** And to be honest, they're in the same place the rest of us are. They don't actually know what the impact of the tariffs will be because they don't know the size of the tariffs. They don't know what countries are going to have tariffs put on. They don't know the duration of them. And so because of that, they can't really offer any type of forward guidance with respect to what we should expect policy to be in the coming months. Now, in spite of that sort of lack of forward guidance, they have been very transparent with respect to how they could act as we gain more information around the tariffs and what they're looking for. And I think the Bank of Canada really kind of summed it up best. They talked about the fact that central banks can't overcome the effects of a trade war. If we do get a full blown trade war and it does cause a recession, it's unlikely the Central Bank will be able to do anything to avoid that recession. They will, however, do everything in their power to help the economy adjust. But keep in mind what they can do will be limited by their need to control inflation.

[00:24:13] **Crista Caughlin:** And so on the inflation front, what are they watching? Well, they're really watching for that potential long-term structural impact on prices. If we do get tariffs, inflation is going to increase. That will be a one-time increase due to the tariff, and that's something they're less likely to really respond to with any kind of force. But what they will be watching for is if that one-time increase on tariffs is going to place additional upward pressure on prices just by rising cost, adjustments to supply chains, shifting to substitution products. And so they're, again, going to be assessing the potential long-term structural impact on tariffs and comparing that to any potential downward pressure that we may get if we do see lower demand.

[00:25:05] **Kevin Minas:** And then what changes did the assets asset mix committee make this quarter, if any, and then I guess even more importantly, how is the committee thinking through all of the current volatility right now?

[00:25:19] **Crista Caughlin:** I think the saying is "be boring," I think. Don't overreact, don't get caught up in the noise. Steven, who's the lead manager of the balanced strategies, I think had the quote of the week: No Hero Trades. And so we've really held a neutral position in equities throughout the quarter, and with volatility and risks increasing, I would expect us to remain neutral for the time being. Within equities, we did make a small tweak. We shifted from U.S. equities towards international, really to increase our European exposure. And Jeff talked a lot about what's been happening in Europe and some of the positive things that are happening in Europe, particularly increased fiscal policy, increased defense spending. And so we think some of these things will obviously benefit Europe and create a potential structural tailwind for them. Overall, we continue to be overweight international. We have a modest overweight to the U.S., and we're underweight Canada. The other thing we did talk about this quarter was adding global credit. We've become increasingly confident in the strategy, and we really do believe it offers a really attractive risk/reward relative to other positions within the balance strategy. And so I would expect us to add global credit in the coming months. It's something you'll likely hear more on in the future.

[00:26:43] **Kevin Minas:** Awesome. Thank you. Jeff, last question for you before we wrap up. This type of market turbulence is often fear-inducing—understandably so—but at the same time, it does have the potential to present opportunities. You kind of alluded to that a little bit already. In times like this, is there anything, whether it be process oriented, behavioral, et cetera, things that the team relies on to help ensure that we're trying to make, effective decisions in this type of environment?

[00:27:11] **Jeff Mo:** I like how you asked us process oriented or behavioral because that's exactly what I think it is. We have a process at Mawer to manage our behavioral psychology biases. The famous behavioral psychologist Daniel Kahneman wrote in his seminal book, Thinking Fast, Thinking Slow, that we have two brains in our single human brain, sort of that kind of instinctual, reactive brain, kind of a lower order brain. Whenever threats come up, like a market drop, we want to go into fight or flight mode. We want to make hero trades to use an asset mix/Steven Visscher comment. But then we also have our higher order brain—our thinking slow brain. And this brain is highly analytical.

[00:28:00] **Jeff Mo:** It slows down and thinks things through. One really effective way to engage your thinking, slow brain is to have a process. And so when we see tariffs, and say a stock that we like drops, five or 10%, or even more in some cases, we don't just rush out and say, oh, you know, this is a time to buy. Or, oh shoot! A company that we owned is down 10%, we don't want to be holding it as it goes down another 20. Let's go and sell. Rather, you go and look at your discounted cash flow model and say, okay, what happens when, tariffs are higher in this company? How does that actually impact the revenue, growth rate?

[00:28:47] **Jeff Mo:** And even with tariffs, you actually have to think it through because the tariff is not on the selling price of the company, which is the revenue of a company. The tariffs is on the bill of materials, which is a component of the cost of goods sold. And so for every company, it's actually a custom calculation for how much tariffs actually impact them.

[00:29:04] **Jeff Mo:** And so when you've sat down and done that work for an hour or two hours, you're like, oh, okay. Actually, it's not that bad and the markets maybe are actually overreacting. And the other part of the process, I think that really helps us here at Mawer, is our inventory ranking system. And then, more recently, the inventory alert system that we've built out.

[00:29:23] **Jeff Mo:** So in our, our M42 database, we have probably a couple of thousand companies now that are ranked in inventory. With our new inventory alert system, several hundred of those have specific alerts set up that are more kind of standard deviation based on kind of price to earnings ratio or standard deviation of a price in some cases, not against the overall market but against a set basket of companies.

[00:29:54] **Jeff Mo:** The several hundred alerts I alluded to, I'm talking right now about myself because I'm actually not sure exactly how many alerts my colleagues have set up, but these are the companies that we think are higher potential. And so it was kind of funny because last yea—to be fair, the alert system was set up halfway through last year—I got maybe all of 10 alerts, in U.S. midcap. And through Q1, I had 40 alerts, and then through the past week and a half, another 30 alerts on companies that we think are pretty attractive. And so now it's time for the process to shine. It's time for the thinking slow brain to kind of sift through each of these companies one by one and decide, well, how many of them in today's context still make sense and are attractive?

[00:30:43] **Jeff Mo:** Ultimately, can they be more attractive than something in our portfolios currently? And that's what we always do day in and day out. Whether tariffs are zero or tariffs are 125%. We are be boring and make money. And that' what we stand for both before and after these tariffs.

[00:31:07] **Kevin Minas:** Well, it's a great spot to end the conversation. I appreciate the analogy. That's a good one. And definitely having the processes in place ahead of time to be able to take in all of that information and to make it actionable. Really appreciate your time, Crista, and Jeff.

[00:31:23] **Kevin Minas:** Thanks very much for joining. Hopefully we can do this again soon in slightly more positive circumstances.