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EP 168 | Quarterly Update | Q3 2024 | EP168

[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 also sits on our Asset Mix Committee. We cover what drove markets in the quarter, what got the Federal Reserve (Fed) off the sidelines, and the odds around further policy action in the U.S. and here at home. We also discuss the Goldilocks environment we seem to be in for both risk assets and fixed income and close with some helpful framing around where we are in the broader market cycle.

[00:00:35] 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.

[00:00:52] Kevin Minas: Another quarter in the books. Crista, nice to see you.

[00:00:55] Crista Caughlin: Good to see you.

[00:00:56] Kevin Minas: As we always do, why don't we start with some framing of what happened in the quarter around market-moving economic data as well as any relevant central bank activity?

[00:01:06] Crista Caughlin: Let's start with inflation. Inflation continues to grind lower. In both Canada and the U.S., inflation has actually come in below where central banks were expecting it. Inflation in Canada is now sitting at 2%. Over the quarter, it fell from around 2.9% to 2%, so it's been a pretty big move. In the U.S., the move wasn't quite as big, but inflation continues to grind lower with headline PCE now sitting at 2.25%.

So inflation over the quarter has moved much closer to central bank targets and is effectively at target in Canada. In terms of growth, we have seen some weakness in growth. Last quarter, it seemed like PMIs might be starting to trend higher; this quarter, that completely reversed. We now have 70% of countries surveyed contracting and that includes the U.S. and China.

As a result, global PMIs peaked at the end of last quarter and have now moved below 50. Data-wise, I think the big story over the quarter, at least as it pertains to central bank activity and the Fed, was U.S. employment. The latest release we got last week was actually decent and showed that the unemployment rate was flat over the quarter at 4.1%. But throughout the third quarter, we were seeing a weaker picture with respect to the labor market. I think a big factor was that there was a significant downward revision of about a million jobs over the last few years. I think that rebasing of the employment picture was one of the drivers of the Fed's policy decision.

So in terms of monetary policy, last quarter, we saw the global easing cycle begin; we saw the Bank of Canada and the European Central Bank cut, and central banks started talking about the risks being more balanced. This quarter, that continued. There was a big move out of the Fed. They cut 50 basis points (bps) in September. The ECB – they actually cut a stealth 60 bps. They cut their deposit facility by 25 bps, but their lending rate by 60 bps, and it's really that lending rate that's going to feed through to the economy as that's the level banks borrow at. We also saw the Bank of England cut rates, and this morning, we saw the Reserve Bank of New Zealand cut 50 bps.

In terms of the Bank of Canada, they had two meetings over the quarter, and they cut 25 bps at both meetings. They've now cut 75 bps in total, taking the overnight rate from 5% to 4.25%. In summary, inflation risks have diminished while downside risks to growth and employment have increased, so central banks are responding with easier policy. I would expect global central banks to continue easing here as they move rates toward neutral.

[00:03:41] Kevin Minas: Given that slowdown in economic data and combining that with the Fed taking a larger first cut than what the Bank of Canada did, do you think that that move by the Fed gives the Bank of Canada license to go 50 bps at the next meeting or in a future meeting? Or was that already something that was factored in prior to the Fed move?

[00:04:00] Crista Caughlin: I think what the Fed, the ECB, and now the Reserve Bank of New Zealand have done gives the Bank of Canada a bit more cover to go aggressively if they feel it's appropriate. I think the bigger driver is going to be: Does the Bank of Canada feel like more aggressive policy is necessary at this stage? On that, there are two things I would point to that could suggest the Bank is a bit behind relative to their outlook. The first is inflation. We already talked about inflation falling pretty materially last quarter, definitely faster than the Bank of Canada was expecting with headline inflation at 2%.

The Bank has said in the past, "As you get closer to your inflation target, your risk management calculus changes." So that alone – the fact that they're at target with respect to inflation but still quite a bit above neutral – might suggest to them that they could go more aggressively. The other factor is the growth component, and growth did come in modestly weaker than they were expecting. I don't think the level of growth is necessarily that far off from where they were expecting, but more importantly, there are definitely questions about the momentum of growth. The Bank of Canada had expected growth to pick up here and that doesn't seem to be the case, so that could cause them to go more aggressively.

Having said that, our view is still that they go 25 bps at each meeting, consistent with what they've been doing, but it's tough to say that 50 bps isn't on the table at this point.

[00:05:23] Kevin Minas: We spoke last time about the inverted yield curve with front-end yields being higher than some longer bonds. We started to see a little bit of a normalization that had already started, but we saw a bit more of it in the quarter. Can you give us an update on what happened to the curve?

[00:05:37] Crista Caughlin: We've definitely seen some normalization on the curve. There's the three-month, or overnight, 10-year curve that's still inverted about 100 bps; that's the one the Fed often points to. But the broader curve, call it the 2s10s curve, is now in positive territory. We've mentioned in the past that when curves are inverted, it's because the market believes policy is sufficiently restrictive. If you keep policy restricted for an extended period of time, you obviously run the risk of a recession. So we have started seeing some normalization, but I do think it's important to keep in mind why we've got this normalization.

First, obviously, it's because central banks are easing policy. The Fed has started easing policy, but the other reason is that the market expects them to continue to do so. The market is expecting another 150 bps by the Fed by the end of next year. That would take the Fed funds rate from 5% today to 3.5%. If the Fed follows through with that, we should expect the curve to remain positive. But if the Fed doesn't ease to the extent that the market believes, we should expect the curve to revert somewhat.

The question often is: "Now we have a positive curve. Does that mean we've skated by the recession?" And again, I think that's yet to be determined. However, all else equal, a faster, more aggressive central bank does reduce the probability that a recession happens. Now in Canada, it's a very similar story. The one thing I'll note in Canada is that the curve that the Canadian bond strategies have exposure to, which is the 10s30s curve, has also

normalized. We started the third quarter at -10 bps, and we're now sitting at +10 bps.

[00:07:19] Kevin Minas: So as that curve normalizes, you've got the steepener trade on, so it's favorable as long bonds underperform the mid part of the curve. So that's been helpful. Shifting gears a little bit away from economic data and talking about investment returns, it was a very strong quarter overall, both for equities and bonds; a bit of a Goldilocks scenario where both did particularly well. Can you tell us a little bit more about what worked in both asset classes?

[00:07:41] Crista Caughlin: I think it was definitely a really good quarter for asset prices. As you mentioned, equities were up 5-10% on the quarter. A number of indices hit all-time highs. I think what's really positive is that where it was previously artificial intelligence (AI) and technology-driven, equity market performance has broadened out this quarter. With central banks really pushing on that easing cycle, we saw interest-rate-sensitive sectors such as utilities, financials, and real estate all leading the charge in terms of performance.

In addition to equities being up on the quarter, bonds were also up. They were up almost 5% on the quarter. You mentioned Goldilocks – this idea of not too hot, not too cold. I think that's exactly what happened in the third quarter. Growth was weak enough to allow central banks to ease policy, which is really good for bonds and positive for interest-rate-sensitive equity sectors, but it was not too weak that there was an obvious sign of a recession happening. So that Goldilocks environment – that sweet spot where both bonds and equities do well – is what we saw in the third quarter.

[00:08:47] Kevin Minas: So that's absolute returns or asset class level returns. How did our balanced strategy fare?

[00:08:53] Crista Caughlin: Like I mentioned, returns were really strong on the quarter, well above long-term expectations. I think it's important to remember that when you do have big swings like this in either direction, it's probably a bit overdone. So I would caution people toward extrapolating those types of returns, and we shouldn't be surprised if we get some give back on those.

[00:09:12] Kevin Minas: In terms of activity in the quarter for the balanced portfolios, so you are part of the asset mix committee. What, if any, actions did the committee take in the quarter and what drove those actions?

[00:09:22] Crista Caughlin: We continue to move cash into bonds. It's something we've been doing slowly over the course of the year. I think there are really two drivers of that decision. First, cash rates are falling. Central banks are lowering the overnight rate and that's causing yields on money market securities to decline. All else equal, that makes cash less attractive on a relative basis. But the other factor is we do think the probability of a recession does exist, and bonds will provide the portfolio with better downside protection. In addition to inflation falling and central banks at the beginning of an easing cycle, we see the downside risks to bonds as having decreased.

In terms of equities, we continue to be neutral equities, and that's because we really do see the risks as balanced. Obviously, there are downside risks, recession risk, and geopolitical risks, but we do think there's an equal probability that a soft landing plays out. With the risks being balanced, we believe neutral equities is the right thing to do.

[00:10:20] Kevin Minas: What do you make of the contrast between – and you alluded to this earlier – slowing growth, slowing inflation, and employment against a backdrop of a booming stock market and very benign credit spreads? We haven't talked about credit spreads, but they've been very well-behaved for a number of quarters now.

Is this normal late-cycle market behavior? Has the market just skipped past this concept of a no-landing scenario? How do you sort of frame where we are in the cycle? Less about what happened in the quarter and more zooming out across cycles, where would you sort of characterize that we are in this cycle?

[00:10:53] Crista Caughlin: I think it is normal late-cycle behavior, but maybe a better way to describe it is it's normal behavior after the central bank starts easing. You can go back and look; regardless of whether or not the central bank easing corresponded to a recession or if it actually created a soft landing, equities went higher, and spreads went tighter after that first central bank cut.

In both 2001 and 2008, the Fed cut about three or four months before the recession officially started, and equity markets actually went up in those few months before eventually moving lower. In 1995, they cut, but obviously, there was no recession, and they hit that soft landing environment; equity markets moved up and then continued to move up. I tend to think about what's happened over the last quarter as a typical response to easing policy or at least moving into that easier policy environment.

When we think about a framework that helps us understand what drives markets from a very high level, we tend to break things down by growth and policy. I think last quarter, you had both of those things moving in a positive way, which is very good and very supportive of risk assets. So yes, you mentioned growth was slowing, but it's still positive, and policy went from restrictive to supportive. You had tailwinds coming from both those directions.

The question going forward is: “How long will those two factors be tailwinds?” From a policy perspective, we're at the beginning of an easing cycle, so we believe that's going to remain supportive all year, which again is supportive for risk assets. I think the question mark really comes around growth. Is that previous tightening still working its way through the economy? Is growth going to slow even more and potentially go negative? Or is growth going to level off? I think that growth factor is really what's going to drive markets over the next few quarters.

[00:12:40] Kevin Minas: Awesome. Well, thank you very much, Crista. Lots to think about there. I appreciate the framing, as always, and helping cut through a lot of the noise in the markets. A great synthesis of what's happened and what may come. As always, enjoyed the conversation and hopefully talk to you next quarter.

[00:12:54] Crista Caughlin: Great. Thanks a lot.

[00:12:55] 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 dot 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.

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