EP 127 | Is the 60/40 Portfolio Dead? And more fixed income questions answered

Andrew Johnson (00:00):

Hey everyone, this is Andrew. In this episode, I sit down with Crista Caughlin, the lead portfolio manager on our fixed income strategies here at Mawer. We start off this conversation diving into the raging debate about the 60/40 portfolio, then Crista walks us through the craziness of the bond market in 2022 and how her and the team adapted to that throughout the year. We then wrap up the conversation with how things look today and what's on her mind as the rest of the year unfolds. With that, here's my conversation with Crista.

Disclaimer (00:52):

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Andrew Johnson (01:08):

Hey Crista, welcome back!

Crista Caughlin (01:10):

Thanks for having me back.

Andrew Johnson (01:12):

Before I jumped on here, I was thinking that your entire time here at the firm has been tumultuous to put it lightly [laughter]. To recap, you joined just prior to the pandemic and the shift to working from home. I think you were actually the last person that I saw in the office at that time. We sit pretty close to each other in the office and I think I came over and introduced myself and did a little fist bump because we really were at that time where we didn't know what the heck was happening out there. And so you step in and you navigate 2020, you get through 2021, 2022 rolls around and even more change has come with that.

So, I was just curious, what's it been like being in the driver's seat these past few years?

Crista Caughlin (01:54):

It's been great. I started at Mawer the day the world shut down, basically. So, I was in the office for one day. I don't recall meeting you, but I'm sure I did.

Andrew Johnson (02:06):

I'm very memorable.

Crista Caughlin (02:07):

I picked up a laptop. There was about five people in there at the time. Everyone else had gone home. I've basically been home ever since.

Andrew Johnson (02:15):

Right. Well, with so many changes over the last couple years, there is actually one thing that you and I have discussed that never changes, and that's the debate over the 60/40 portfolio. I don't know about you, but my newsfeed is getting full of this once again, and the main reason this time is that many balanced investors saw both bonds and equities produce a negative return over 2022. So let's start there: is this finally the death of the 60/40 portfolio?

Crista Caughlin (02:43):

Yeah, it's definitely a very topical question. I think it's the number one question I've gotten asked since I've started, really. And yeah, like you said, it was a really tough year for 60/40 portfolios in 2022. We saw that correlation breakdown, which meant the 60/40 really struggled because we saw both bonds and equities underperforming. Now the good news, if you could call it that, is at the end of last year around the time where we started seeing the probability of a recession increasing, we did see that correlation come back.

And so, given a recession is a scenario we think that could happen, we do believe our portfolios will really still benefit from having both bonds and equities as part of their strategy.

Another thing I'll point out is that even during that '70s inflationary period, bond yields fell when we were in a recession. So, having bonds in your portfolio even during the 70s was really beneficial.

And I guess the other thing I'll mention is when we're talking about 60/40, those portfolios have seen pretty solid returns over the last decade. We've had a backdrop of central banks lowering rates, keeping rates low, adding just an extraordinary amount of liquidity via QE, and that really saw both bond returns and equity returns doing really well, which created double digit returns for that traditional 60/40 portfolio.

Now, central banks could do that and they could be that supportive because we were in a dis-inflationary environment. Maybe we're going back to that, but I think if we're in an environment where inflation remains higher or at the higher end of central bank targets, and central banks are less supportive, I think one of the things we should be prepared for is the fact that 60/40 portfolios might actually have a lower return over the next decade than what they did the previous 10 years.

Long story short: 60/40 is not dead, but we should probably expect lower returns in the future.

Andrew Johnson (04:38):

Certainly a discussion that we've had a lot with our clients not just in the last year, but really going back 10 years ago, like you mentioned, double digit returns out of a balanced portfolio was the odd thing. And now what I'm hearing from you is perhaps shifting into a more fundamentally driven market, whether that's earnings from businesses or a more healthy bond outlook, that should set us up for bringing back that correlation even though we might be faced with lower returns going forward.

Crista Caughlin (05:07):

Exactly.

Andrew Johnson (05:08):

All right, well, let's move into the discussion around last year specifically, and why don't you just set the stage for us here and, as much as you probably like to forget it [laughter], refresh our memories on what happened out there in the bond market in 2022.

We'll get into the portfolio itself, but I'm more looking for just a general overview of the market and what you and the team were faced with.

Crista Caughlin (05:28):

I think the biggest surprise of 2022 was one, how elevated inflation was, and then two, how aggressive central banks were.

As we ended 2021, we had strong growth numbers. We were adding a significant number of jobs to the economy. Inflation in Canada—headline was just under 5%, core was just under 4%, but 2021 really was a rebound year. We had just come off the worst recession in history, and so it wasn't surprising to see those elevated numbers. Now as we went into 2022, supply chains were reopening, growth was slowing from elevated numbers, central banks were beginning to tighten, fiscal stimulus—which was highly supportive in '21—was reversing and was going to be a drag on growth. And so all those things that were pushing inflation higher were really about to slow and reverse, and so therefore the expectation as we headed into 2022 was that inflation would begin to slow.

Unfortunately, as we now know, the opposite happened and inflation continued to move higher into 2022. Now there's a few reasons for this. First, we were hit with some geopolitical events: the war between Russia and Ukraine, which caused energy prices to skyrocket, which really added pressure to headline inflation.

But also, with the power of hindsight I would say, is the fiscal stimulus we saw in '21 really created a tremendous amount of excess demand that as we started '22, it still needed to be worked off. So commodity prices increasing alongside an economy that was already in excess demand caused inflation to continue increasing in 2022. Obviously we saw year over year numbers increase, but I think what was more concerning was we were seeing the quarterly and monthly numbers continue to increase in 2022. And so the first half of '22 inflation was actually higher than it was in '21, and that really pushed central banks to tighten way more aggressively than people were expecting at the beginning of the year.

Crista Caughlin (07:28):

The Bank of Canada raised rates around 400 basis points. They went from 25 to 425. They've since in January hiked one more time and so they're now sitting at 4.5%. Down in the U.S. we had a similar move by the Fed. The Fed went from 25 basis points to 4.5%, and this morning [February 1, 2023] they actually hiked another 25, so they're now sitting at 4.75%.

For context, in Canada, that is the fastest pace of rate increases we've seen since the mid '90s, and it's a similar story on the level perspective. We have to go back to late '90s, early '00s to see a time when the Bank of Canada rate was actually higher than what it was today. So we've seen a significant move in interest rates and a significant tightening of financial conditions.

What does that mean for the rest of fixed income markets? In Canada, we saw 10-year rates go from 175 to 350, so they've doubled. We saw spreads widen 60 basis points from 115 to 175 and we saw the curve invert.

So, the twos tens curve was at +60 at the beginning of the year and it was inverted by 75 basis points by the end of the year. That is the most inverted the curve has been since the '80s. So obviously with interest rates increasing, spreads widening, we saw negative returns for fixed income portfolios in 2022.

Andrew Johnson (08:53):

And with longer term yields so much lower than the current short-term yields that are out there—one-years, basically from three years on it starts to drop off—what's it going to take for that to get out of the inversion, but really just to bring up longer term yields to better reflect reality?

Crista Caughlin (09:13):

There's really two ways that could happen. So, I think what you're asking is, how do we un-invert the curve basically [laughs].

There's two ways that that can happen. One is the central bank has to cut rates lower and that will invert the curve. So you take those short-dated interest rates, which are now sitting at 4%, 4.5%, and you push those back down to 2% or something like that. So the central bank cutting interest rates, that's one way that will steepen the curve. The other way, which rarely happens, is the curve just has to readjust on its own. If you get a better growth outlook from the market and the market starts recognizing or realizing that central banks may stay on hold for a while, that long end could adjust higher.

Andrew Johnson (09:57):

Basically what you're saying is that standing here today, we have to get through the recession story and see that reflected in yields in terms of better growth going forward for the economy and businesses.

Crista Caughlin (10:10):

I think that's right.

Andrew Johnson (10:11):

Let's talk about the portfolio itself and how things went there. We've talked in the past, Crista, the last few times that you've been on about themes and scenarios that you generally operate with. First of all, what were those heading into this year? And you touched on that briefly already.

Crista Caughlin (10:26):

I'll start with just a quick recap of the process. As you mentioned, we come up with themes and that really helps us guide our research effort. We then come up with economic scenarios for the year, how we think the years could potentially play out. For each economic scenario we create financial market outlooks: what would the central bank do in that scenario? What's the impact on interest rates? Credit spreads? And then we position our portfolio for our highest probability scenario or our base case, effectively, and then we use milestones to really help us understand if we're moving from our base case into an alternative scenario.

So that's a recap of the process. With respect to 2022, we started the year with three scenarios. Our base case was that growth would slow, but it would remain at or above potential. We thought inflation would move back towards target, and we thought central banks would tighten policy, but they would do so at a measured pace.

That was our base case. We had two alternative or risk scenarios: one was that headwinds for growth would emerge and we'd see a recession, and then the other one was that inflation would move higher, causing central banks to be more aggressive in the tightening cycle. I would say fairly quickly in the first half of the year we realized there weren't actually three scenarios, there were really two, and it all came down to inflation. It was whether or not inflation was going to be higher or lower, effectively. And I would say central banks consistently confirmed this idea.

Every single time they were asked what they would do if you started seeing a material downshift in growth while inflation was elevated, their response was always their primary objective was inflation, meaning they were willing to put the economy into a recession in order to get inflation back to target. So, growth became less of a factor, and it really came down to inflation—if inflation was going to remain elevated or if it was going to slow down.

So, at that stage, our scenarios really became inflation started slowing, which allows central banks to tighten less aggressively, or inflation remains sticky, forcing central banks to become more aggressive.

Andrew Johnson (12:28):

When you come back to that process, setting the stage for the base case and the alternative scenarios, what I hear when you say that is, that's our antidote to getting too excited about one over the other. Essentially you're guarding against placing bets on one narrow set of outcomes. Is that fair to say?

Crista Caughlin (12:46):

Yeah, exactly. The way I think about it is if you've flushed out the different scenarios that could happen, even if you have high conviction on your base case, as things play out differently or if they play out differently, it allows you to be more proactive instead of reactive. You've prepared for a different scenario. You know what to look for, you know what your portfolio should look like in that scenario, and so you're not trying to play catch up at the time.

Andrew Johnson (13:11):

Exactly. So, as all of this is unfolding in a relatively rapid moving market as far as bonds go, what were you and the team seeing and reacting to throughout the year and what were some of those decisions that you had to make along the way?

Crista Caughlin (13:23):

Like I said, we started the year with the base case thinking that central banks would be hiking at a more measured pace. And so what that meant from a portfolio perspective is we started the year with a curve flattener, so we were overweight the long end of the yield curve, overweight long bonds, 30 year bonds, and underweight the shorter part of the curve.

Again, it was the view that central banks would tighten policy and flatten the curve, that played out for us. I would say we underestimated how aggressive central banks could be. We were expecting the curve to flatten, but we weren't expecting it to materially invert the way it did. Luckily that helped us. It helped add value on our curve position as well as duration.

We also started the year overweight spread product. We thought growth would hold in, which it did, but like I said, we thought central banks would be more measured.

And so we did expect to see some volatility around spreads throughout the year, but our view is that we would end the year not materially higher than where we started. Now, unfortunately, with central banks tightening aggressively, financial conditions tightening, growth concerns increasing, we saw risk assets underperform and spreads widen, and so that actually detracted from our portfolio returns.

So, coming back to some of the changes we made in the portfolio throughout the year, we did start with an overweight in spread product, but as we shifted the scenario from our initial base case to the one where central banks were going to be more aggressive and inflation was going to remain elevated, we became more tactical with our sector position and really de-risked it when we saw opportunities to do so.

So, overall, we added value in the portfolio, mainly driven by our rates position, which was offset by some underperformance in our sector and credit positioning.

Andrew Johnson (15:08):

Just for our listeners' sake, when you say spread product, you're basically saying anything other than a government bond?

Crista Caughlin (15:13):

Yes, anything other than a Government of Canada bond. So I would include corporate bonds, provincial bonds, and municipal bonds.

Andrew Johnson (15:21):

We're now partway through this year, so 2023. Just for our listeners' sake, we're recording this on February 1st. So what are you and the team thinking about and planning for this year and beyond?

Crista Caughlin (15:32):

Coming back to the process, I'll start with our themes. So as I mentioned, themes are really used to focus our research effort, and so this year we've spent a lot of time trying to understand Canadian household debt, and this obviously relates to the theme we've talked about a number of times over the years, which is that global debt overhang.

So, we know Canadian private sector debt is one of the highest globally, we know debt's important because it pulls forward growth, makes your economy more interest rate sensitive. It's not clear if the level of debt matters, but we know for certain that the serviceability of debt definitely matters. And so this year we did a bunch of research to try and understand the breakdown of Canadian household debt, specifically the breakdown of mortgages and the impact that has on the serviceability.

[There were] a few takeaways from that research. I'll start with variable rate mortgages. Almost 50% of new mortgages in 2021 were variable rate. Now, keep in mind that is at a time when house prices were also at their highest. That brought the total number of variable rate mortgages as a percentage of total mortgages to just under 35%. Now, these are obviously exposed to higher interest rates immediately based on the average mortgage, the change in rates. We calculated an increase in interests cost on average to be around $1,000 a month. That's a significant amount of income that is no longer being spent on other household goods and services.

To be fair, it's not quite as dire as that. If you take the variable rate mortgages, they can actually be split into two different categories: there's fixed payment and variable payment. The variable payment means your mortgage payments do actually increase when interest costs increase. That's around 10% of mortgages.

The fixed payment, meaning your payments stay fixed as interest rates rise but you're paying less of your principle and more interest, those are about 25% of mortgages. Now, what's interesting about these is they have a trigger rate and that's the rate when your entire payment is going towards interest. You're no longer paying down principle. And so anything above that rate means your payment does have to adjust. Now, we estimated that to be around $375 on average. So, with the Bank of Canada at 450, we believe most of these mortgages have also seen their payments increase.

Now, the good news is banks are doing things like extending terms or adjusting the terms of the mortgages to help offset some of that increase, but I think there is still a number of mortgages out there that have seen at least small increases in their payments over the last year. So that's variable rate mortgages.

Crista Caughlin (18:10):

The other thing that we noticed, which I think could potentially have an even bigger impact is that around 16% of mortgage debt is part of a home equity line of credit, so a HELOC. With debt taken out on HELOC, they will see their payments increase immediately alongside interest rates.

So again, we backed out what an average payment change could be based on the average size of HELOCs and change in interest rates, and we calculated it to be around $200 to $300 a month. Now, for context, based on the average household income you would need to see a 4% to 5% increase in wages just to offset that larger HELOC payment. The good news is we are seeing wage increases, but keep in mind those are also offsetting higher energy costs and higher food costs.

Andrew Johnson (18:55):

They're also contributing to the general inflation story as well, which is not necessarily a great thing.

Crista Caughlin (19:01):

Yes, exactly.

Andrew Johnson (19:02):

Is it true to say that the rate on a HELOC is already a step higher than what the original mortgage rate would be as well?

Crista Caughlin (19:09):

Oh, absolutely. The HELOC rates have moved one for one with the Bank of Canada rates, so they're up three to 400 basis points this year. 3% to 4% this year.

Andrew Johnson (19:18):

So, we've got wage increases helping to soften that a little bit, we've got banks doing things to help soften that a little bit, but the story [that] remains is that eventually more and more of that household income is going to go to service debt and like you said, it's not going to go back into the economy, it's not going to go into consuming, and that's going to feed into this story and legitimacy of a potential for a recession.

Crista Caughlin (19:40):

Yeah, exactly. The main takeaway for us as we went through this research was it just demonstrated the significant burden on Canadian households due to an increase in interest costs, keeping in mind there's energy costs and inflation and higher food costs are also adding stress to Canadian households.

Andrew Johnson (19:58):

So where does that put you in terms of trying to build a portfolio in the face of this?

Crista Caughlin (20:03):

The next stage of the process really is our scenarios. We have three scenarios again this year we think there's three different ways 2023 could play out. I'll start with our lowest probability scenario, which is a soft landing. This is sort of consistent with what the Bank of Canada is forecasting: inflation moves back towards targets, 3% by the middle of the year, 2% by the beginning of next year. Growth slows to... call it stall speed. They have one or two quarters of zero growth, maybe modestly negative growth. You end the year, so you end 2023 at a positive growth environment before really picking up in 2024. Now with inflation declining and growth slowing, it really paves the way for central banks to cut interest rates back towards neutral, which is... call it somewhere around 2.5%, 3%.

Now, in this scenario with the central bank cutting, we think interest rates decline modestly and we think given the starting point for risk assets, risk assets outperform, so we see spread tightenings. So that's one of our scenarios.

The next scenario, which I think is our highest probability or our base case right now, is really that recession scenario. As we mentioned before, we've had a significant tightening of financial conditions. We talked about the impact it's having on households; businesses are seeing a similar impact, and we believe that this will have a material impact on spending [for] both households and businesses. We've already started seeing it in interest rate sensitive sectors—auto sales, home sales—but we believe it'll feed into other parts of the economy, which will eventually feed into the employment market. So we're watching things like retail sales, consumer spending, and employment to understand this scenario.

And in this scenario, we believe spreads will widen materially and we believe rates will decline as central banks will have to cut interest rates fairly significantly. So that's the recession scenario, which is currently our base case.

The third scenario is, I would call it our highest risk scenario, which is one where inflation remains sticky. In this scenario, growth does moderate, inflation does decline—we've already started seeing signs that inflation's going to decline—but inflation remains above central bank targets. If growth is slowing and inflation is moving back towards target, central banks can cut rates back towards neutral. However, if inflation remains elevated, central banks won't be able to cut rates and they may even have to hike again. And so this will push rates higher, which will continue to put pressure on the economy and risk assets.

And so what are we looking at or what do we see that makes us think inflation could stay sticky? There've been a number of secular changes that have shifted particularly post-pandemic with deglobalization, reshoring, production. There's been an increase in geopolitical risk, which really could keep commodity prices elevated.

We're starting to see China, the China reopening story is happening, which could again keep commodity prices elevated. Fiscal policy, which in our view is the primary source of inflation last year could continue to add fuel to the fire.

So there's a number of secular changes that have happened, but I would say the real worry for us comes down to the interaction between wages and inflation expectations. We've had elevated inflation for two years now. The longer the inflationary period lasts, the more embedded it gets into expectations, which then feed into wage negotiations. And so we've seen it in the Bank of Canada's Business Outlook Survey where 100% of the respondents believe that inflation will be above the central bank targets. We've never seen that in the history of this survey.

Crista Caughlin (23:52):

Now granted, we have started seeing wages come down on a year-over-year basis, average hourly earnings have come down, but over the last few months we've actually started seeing that tick higher again. And anecdotally, I think we've all heard the stories about organizations and unions asking for double-digit wage increases. And so more and more people are starting to believe inflation is going to remain elevated and as a result, are expecting higher wage increases. And as that happens, you could suddenly see a situation where higher inflation becomes almost a self-fulfilling prophecy. Obviously in this scenario we think interest rates will move higher and risk assets will underperform.

Andrew Johnson (24:32):

The longer that goes on, the longer it goes on essentially.

Crista Caughlin (24:32):

Yes, exactly. So those are our three scenarios: the soft landing, recession, or inflation remains sticky.

At this stage, our base case is that we get the recession. We've seen the largest tightening of financial conditions we've seen in decades against a backdrop of having the highest private sector debt levels historically. Those will have a larger-than-expected impact on the economy, which will result in the recession and job losses.

And so because of that, we've really de-risked the portfolio. On a risk-adjusted basis, we are neutral spread product. We're underweight provincials and municipals with a small overweight in corporates. We've also de-risked the flattener. We've taken the flattener off, we're underweight the belly. And at this stage we're looking for spots where we would increase exposure to that steepener and add duration as we believe ultimately the central bank will have to cut once we're in a recession.

Andrew Johnson (25:27):

So, what I'm hearing Crista, is a good old-fashioned recession, as painful as that can be, and for as long as it can go on, is likely better than that last scenario that you outlined.

Crista Caughlin (25:37):

I think that's right. I think that last scenario will ultimately end up in a recession as well, it'll just be a bigger one.

Andrew Johnson (25:42):

Great. Well, thanks for that. As usual, I get way more than I bargained for in these chats with you. I'm sure our listeners do as well. So, a big thanks for spending some time with me and I look forward as always to checking back in later this year on how things are going. Thanks again.

Crista Caughlin (25:58):

Thanks for having me.