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# EP 142 | Quarterly Update | Q3 2023

**[00:00] Anum Siddiqui:** The third quarter of 2023 is in the books, and on this episode of the podcast, we sit down with Fixed Income Portfolio Manager, Crista Caughlin, to discuss what happened over Q3. We talk about how the market pulled back over the quarter and what the drivers of this pullback were. Recurring themes of high inflation and interest rates are touched on, but we also cover how the consumer is faring in the current environment. Finally, we chat about our thoughts looking forward, and we walk through how we're thinking about our portfolios.

**[00:36] 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.

**[00:51] Anum Siddiqui:** Hello everyone, I'm Anum Siddiqui and today we'll be reviewing the third quarter of 2023 with Fixed Income Portfolio Manager Crista Caughlin. Crista, thank you so much for joining us today.

**[01:02] Crista Caughlin:** Oh, thanks for having me.

**[01:03] Anum Siddiqui:** Crista, let's start off with a recap of what happened. Now, over the third quarter markets across the board were down, which in the case of equities was a change from the first two quarters of the year. Did the market get ahead of itself in the first half of 2023, and did it correct a little bit as a result?

**[01:20] Crista Caughlin:** Yeah, I do think the market got ahead of themselves a little bit. If you think about what happened in the first half of the year, there was a combination of a few things that really acted as a tailwind to markets. Inflation was slowing, and in some countries, it was actually very quickly closing in on central bank targets.

And so with inflation slowing, it meant central banks were not only closer to the end of the tightening cycle, but they could actually start easing and bring rates back down to a more normal level. And this was happening while growth was, although slowing, it was sort of holding up, so that excess demand was declining. So, think inflation slowing, central banks closer to easing, and we're not in a recession—they were all real tailwinds for a risk assets.

**[02:02] Crista Caughlin:** That was the first half. I would say this quarter, we saw parts of that narrative start shifting. I think the main shift that happened was with central banks and the fact that they are much further away from bringing rates back down to normal than previously thought.

If we look at the data—growth started picking up; global PMIs bottomed in June. And although globally they remain below 50—so, still contracting—they've stopped falling and in some cases, actually started increasing. With respect to inflation, inflation again came out modestly stronger. Still slowing, but not quite as much as people thought. In some cases, it's gone sideways. In Canada, actually, inflation actually spiked this quarter.

**[02:42] Crista Caughlin:** So, from a data perspective, the change this quarter seemed somewhat marginal; sort of marginally higher growth, marginally higher inflation, but the implication for central banks was quite meaningful. Central banks started communicating that they're going to take longer to bring rates back down to normal. And so said another way, rates are going to be higher for longer, which really created a headwind for risk assets.

**[03:10] Anum Siddiqui:** Okay, that's a good summary of what happened in the equity markets. What exactly happened in bond land over the third quarter?

**[03:18] Crista Caughlin:** As I said, rates pushed higher over the quarter. In both Canada and the U.S. we saw 10-year rates increase almost a hundred basis points. And the real catalyst for this, which you know, I think was also the catalyst for pushing equity markets lower, was the Fed and the Fed dots.

Previously, the Fed had indicated they were going to cut about a hundred basis points next year, and they're now saying they're not going to start normalizing rates until closer to the end of the year. The other thing we saw happen in bond markets was the curve, which had been deeply inverted and started steepening out. And again, it comes back to central bank communication.

At this stage, central banks are saying they're not going to tighten more, they're not going to increase rates more, but they're going to stay at these elevated levels for a longer period of time. And so this caused the longer end of the curve or that 10-year point to increase more than the shorter end of the curve. So, this 'higher for longer' narrative has been a real headwind for equity markets, as well as caused both rates to increase and the curve to steepen.

**[04:25] Anum Siddiqui:** Okay, so rates are going to be higher for longer—is that because the fight against inflation is and will take longer than we originally expected?

**[04:36] Crista Caughlin:** Yeah, I think that's a big part of it. Inflation is really driving central banks and central banks are keeping rates higher. If you look at what central banks have done over the quarter, they're all still in tightening mode. The Fed increased 25 basis points, the Bank of Canada increased 25, the ECB actually went twice. But what's interesting is not only did they raise rates, which were somewhat expected, but I think the big change is if you go back and look at what their outlook was for inflation at the beginning of the year versus what it is today—in all cases, they've had to increase their inflation forecast.

So, I think it's a bit of the same story that's existed for the last, you know, call it two years, which is central banks and markets in general have consistently underestimated inflation. And if you think about, you know, if you are a central bank and you're increasing your inflation outlook—particularly next year's inflation outlook—it effectively means you just haven't done enough to control inflation. And so, this idea of 'higher for longer' all comes back to the fact that inflation remains sticky.

**[05:45] Anum Siddiqui:** So, we know that inflation remains high, Crista—I think what our listeners might be interested in knowing is what exactly are the factors that are keeping inflation so sticky?

**[05:54] Crista Caughlin:** Yeah, I mean, I think there's a few things. Energy prices obviously moved higher this quarter and that does feed into inflation. Gas prices are higher, transportation costs are higher. The other things that are happening that are maybe less specific to this quarter, but in our view is really what's keeping inflation stickier than expected—one of them is wages. Wages have remained elevated. They're slowing, but they're still at levels that would suggest inflation remains above target.

And the other thing which I think doesn't get as much airtime, it's a little bit more abstract, is really this idea of inflation expectations. We're a few years into this environment of higher prices. Arguably, we all expect prices to be higher to a certain extent. And if you think about [it]—if you're a consumer expecting higher prices, it makes it a lot easier for companies to pass through future price increases. So, if you're seeing higher input costs, you can pass them through to the consumer much easier today than you could five years ago.

**[06:54] Crista Caughlin:** The other thing is employees are expecting higher wages, so when negotiations are coming around, they're looking for much higher increases today than again they were five years ago. And so I think that's a bit of what's happening here. If people become used to seeing the price of things rise, it makes future price increases easier to pass through.

**[07:15] Anum Siddiqui:** Okay, got it. You did mention energy prices and that's something I wanted to talk to you about because over the third quarter we saw the energy sector stage a bit of a comeback, but in the first half of the year, things had tempered a little bit. Can you speak to perhaps what has changed or what changed over the third quarter in particular?

**[07:36] Crista Caughlin:** I mean, it's been a great quarter for the energy sector. I think we saw energy prices move from, you know, around seven $75 up to $95, which is just over a 25% increase. think the real catalyst for that—there's sort of two things working in conjunction—one of them is OPEC cut production. Those cuts were actually announced I believe in April, and were implemented in May, and they've been increasing. So, the cuts actually happened last quarter.

The other thing that happened this quarter was that it coincided with a rebound in demand. And so, again, if you think about supply side cuts, if you're expecting demand to decline, that has a limited impact on prices because that supply-demand equation remains in balance. But if you're cutting in the face of stronger demand, obviously that's going to cause prices to increase, which is what we saw this quarter.

**[08:28] Anum Siddiqui:** Okay, I see. I do want to switch gears a little bit and go back to the interest rate conversation. Something I know we've talked about internally is the fact that it does take time for higher interest rates to work their way through the system. As of now, do you think we're seeing the effects of higher interest rates, or is that still to come?

**[08:48] Crista Caughlin:** I think we're sort of at early stages of seeing higher interest rates really work their way through the economy. We know monetary policy works with, call it a 12-month lag, so what's happened over the last 12 months? Rates have actually risen 225 basis points in the U.S. and 175 basis points in Canada over the last 12 months. And they're actually still hiking this quarter. So, rate hikes have not made it through the economy just yet.

We're seeing the same thing… if you kind of look at the micro level, we're seeing some of it pass through if you have a home equity line of credit, which is a variable rate. The interest rate hikes have been working its way through, but if you're refinancing, whether it be a company refinancing their debt or a consumer refinancing their mortgage, we're still at the very early stages of that.

**[09:35] Anum Siddiqui:** Now you mentioned the consumer, which is a natural focus when it comes to the economy. How would you say the consumer is faring, and is there a distinction between Canadian consumers and our neighbours in the U.S.?

**[09:48] Crista Caughlin:** If we're talking about the distinction between Canada and the U.S., I think there's sort of two main things that are different. In the U.S., we have lower debt levels and the mortgage structure is much different. They have 30-year mortgages in the U.S., here we have, you know, five-year-and-under mortgages. So, we are going to start seeing those interest rates hikes make their way through the Canadian economy I think much faster than you would down in the U.S. The other distinction we have is obviously immigration. Immigration has provided a big boost to the economy and consumer spending in Canada.

**[10:24] Anum Siddiqui:** Well, we've looked at the past. I do want to spend some time talking about the future. A question that has been up for debate for quite some time now has been whether or not we're going to experience a hard or soft landing when it comes to a recession. What are some of the situations and scenarios that the team has been looking at and considering?

**[10:43] Crista Caughlin:** I suspect the debate between a hard landing and a soft landing is going to exist right up until we're in the middle of a recession. On the soft-landing side, we have seen a number of things that would indicate the probability of that scenario is increasing. We talked about employment markets are holding up and not just the headline number, nonfarm payrolls, but things like initial claims or JOLTS—some of the more leading indicators of employment which we're softening, have rebounded. Lastly, housing. You know, it's probably one of the most interest-rate sensitive sectors and we've seen a pickup in house prices here, which again, would suggest growth may not be as weak as we expected.

Now, the one thing you do need to see (at least in our view), for the soft landing to really play out, is you need inflation to continue slowing, which will allow central banks to take rates back down to a more normal level.

**[11:35] Crista Caughlin:** I think if you continue to see inflation moving higher, it's not out of the question that central banks will continue raising rates. The more that happens, the higher the probability that we actually go into that recession scenario. If you really think about the rationale for the recession, it effectively comes down to how aggressive central bank tightening cycles have been. Particularly given the amount of debt that exists, the fact that we're still tightening policy, a lot of the previous policy tightening is still working its way through the economy. In our minds that keeps the probability of a recession scenario elevated still.

**[12:13] Anum Siddiqui:** It looks like we'll have to see what the data shows us. Crista, I do want to talk about asset mix. You sit on our asset mix committee, and over the third quarter, there weren't any changes made to the asset mix of our Balanced portfolios. Can you talk a little bit about the discussion and rationale around this?

**[12:31] Crista Caughlin:** From an asset mix perspective, we remain neutral equities, overweight cash, and underweight bonds, so we're really sticking close to home. We remain neutral with respect to our exposures. And that really comes down to this idea that, there is the debate between soft landing and recession. We are still seeing inflation move higher, we are still seeing central banks tighten, and so there's just still a lot of unknowns there.

**[12:57] Anum Siddiqui:** Okay, just to wrap up here, we talked about the market and the economy. Can you talk a little bit about how the team is thinking about managing their portfolios within this context?

**[13:07] Crista Caughlin:** Now more than ever, it's really important to prepare and not predict. So, really understand the different scenarios, how they can play out, build portfolios that offer the best risk-reward across multiple scenarios. And I think the way you do that is by owning well-diversified businesses, companies that have recurring revenue, flexibility in their cost base is really important right now, and companies that refrain from taking undue risk from a leverage perspective.

**[13:34] Anum Siddiqui:** Okay, well, that is a good summary and a great place to end it Crista. Thanks so much for joining us today, I really enjoyed the conversation.

**[13:41] Crista Caughlin:** Yeah, thanks for having me.