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EP 164 | Recession Fears and Credit Spreads: A Comprehensive Fixed Income Update

[00:00:00] Kevin Minas: In this episode, I had the opportunity to sit down with Crista Caughlin, lead Portfolio Manager of the Canadian Bond Strategy, and Brian Carney, lead Portfolio Manager of the Global Credit Opportunities Strategy. We covered the latest market-moving economic data and central bank activity, provided an update on the year-to-date corporate new issues volumes in Canada and the U.S., shared our views on the commercial real estate market, and discussed a few noteworthy trade ideas that have made their way into the Canadian bond and global credit portfolios.

[00:00:33] 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.

[00:00:50] Kevin Minas: Welcome back to the podcast, Crista, long-time guest, and hi to Brian, as well. I believe this is your second time on the podcast, Brian. So welcome back.

Let's start, as we always do, on the macro side. Let's get a sense of the data. What economic data has come out that was market moving? What if any central bank activity was there in response to that data? Crista, why don't we start with you?

[00:01:10] Crista Caughlin: It's actually a pretty interesting time to be talking about the state of the markets. We've had a pretty big pickup in volatility over the last few days. We saw the Nikkei 225 fall 12% in one day, and U.S. equity markets were down 5% last week. There was a two-day period where U.S. rates actually fell 25 basis points (bps).

The question, all of a sudden, around the Fed is not, "Will they cut rates in September?" The question is, "Are they going to cut 25 or 50 bps?" Recession fears have picked up now. It's important to remember that markets often have periods of volatility, and our goal is to not be pushed around by it but to stick to the process and stick to the plan. If you do that, the volatility can actually create opportunities.

That's what we like to do. We're going to take a step back and say, "Look at where we are. What are central banks actually doing? What is the economic data actually telling us?" Central banks have obviously started a global easing cycle. As a reminder, we've just had the most aggressive hiking cycle that we've seen in decades. The Fed raised rates to 5.50%, and the Bank of Canada raised rates to 5%. During that time, inflation was the focus, often at the expense of growth.

Over the last month, central banks have shifted their language. They now see the risks as being more balanced. Although they technically haven't reached their inflation forecast or their inflation target, they are within range and are now responding to growth as well. What's been happening with growth? In Canada, growth has actually been quite weak. In Canada, inflation is sitting at around 2.7%, just above target but within range and within sight. But growth has been running at just over 1%, so pretty weak. In Canada, employment markets look okay. We've been adding around 30k jobs a month, but we have started seeing some weakness in full-time hiring, and the unemployment rate has started increasing.

The weak growth profile has really prompted the Bank of Canada to start lowering interest rates. They've cut rates twice. They've cut 50 bps from 5% down to 4.5%, and we would expect them to continue cutting rates at a measured pace. In the U.S., inflation again is running around 2.6%, slightly above target, but within range. Growth has held up much better in the U.S. It's running at just under 3%, call it 2.8%. However, employment markets in the U.S. are starting to look weak. Although nonfarm payrolls suggest that the U.S. has been adding jobs, if you look at the household survey, it would tell you that there actually haven't been any jobs added in the U.S. over the last six months. And that's really caused the unemployment rate to increase over half a percentage point from 3.7% earlier this year to 4.3%. That weakness in the employment markets is obviously going to be a concern for the Fed and will likely prompt them to cut rates in September.

We actually believe they'll cut 25 bps this time around. In terms of the volatility we've seen over the last few days, I think there are two factors at play here. One of them is increased recession fears. I mentioned we have weak employment numbers. We also saw global PMIs fall below 50. In the U.S., ISM, which was already below 50, moved lower. The employment component of ISM actually had a pretty large drop, and it's at levels that typically suggest a recession. If you take ISM employment plus the increase in the unemployment rate, that has increased the probability of a recession in the U.S.

The other thing that's happened this week was the Bank of Japan raised rates. They raised rates 15 bps to 0.25%. For context, out of a very short period of time in 2007, this is actually the highest rates have been in Japan since the late 70s. If we think about that increase in interest rates alongside increased recession fears has caused a lot of volatility in Japan but also globally as we're seeing an unwind of the yen carry trade. To me, the real takeaway from the volatility over the last few days is that it's a good reminder that we're still dealing with a theme that we've had for a while now, which is we've seen a decade of unprecedented monetary policy with zero interest rates, quantitative easing, and Japan, we had yield curve control, and that cheap money just creates imbalances.

As central banks tighten policy, we're going to see some of those imbalances come to the surface. We saw that last year with U.S. banks, and we're seeing it now with the yen carry trade. I think the real question for us is, “Is this volatility just a pocket of volatility or is it something more material?” The answer, in our view, is that it comes down to growth. If growth remains robust, it's likely that this is just a pocket of volatility that will right-size itself. However, if growth continues to weaken and signs of a U.S. recession continue to pick up, we're likely in for a larger downturn.

[00:06:17] Kevin Minas: That's helpful framing as to what's been going on in the markets recently. Maybe if I could just get you to clarify, when you say the yen carry trade, can you just walk us through what that is and what the implications have been?

[00:06:27] Crista Caughlin: The yen carry trade basically comes down to cheap borrowing. It's really about borrowing in Japan at zero interest rates and then investing that money somewhere else and getting a positive return. Remember this is borrowing, which is leverage. So this is leverage investing being funded at low interest rates in Japan. Now, in my mind, there are two parts to that equation, and last week, both parts of that equation took a bit of a hit. The Bank of Japan increased rates, so all of a sudden it's more expensive to borrow. But at the same time, you had recession fears pick up, so the investment on the other side suddenly looks less attractive. If you have both sides of the equation moving against you, that's caused people to unwind that trade, which has caused risk assets to falter.

[00:07:14] Kevin Minas: To your point about suppressed volatility as well as the interest rate regimes that we've seen over the last few years, the double whammy of rising rates in Japan, which is atypical than the rest of the world where rates are coming down. And then the volatility spikes, which are affecting risk assets, which is the

other side of that trade.

Brian, shifting over to you, credit markets. Last time we spoke, I think it would have been in the spring. From what I recall, credit spreads, compensation for taking on credit risk were relatively low, both in investment grade and high yield. How are things sitting now? What's been the behavior in the markets the last four or five months, and what's your thinking in terms of credit spreads right now?

[00:07:49] Brian Carney: Through the first half of the year and really up until last week, it's been smooth sailing for credit investors. Those credit spreads and those risk premiums, for the most part, have generally been grinding tighter since you and I last had a chance to be on this podcast together. Last week, with some of those dislocations and changes that Crista just highlighted, we actually saw a significant widening in credit spreads, the first we've seen this year.

To give you some context on that, global investment-grade corporate bonds – higher-quality issuers – spreads widened about 0.2 of 1%, so that's 20 bps. It doesn't sound like a lot, but it actually is quite a bit. So now the average good quality borrower pays about 1.2% above U.S. Treasuries to borrow money. That's about in line with the long-term average for good-quality corporates. In high yield – lower quality borrowers, Mike Milken's junk bonds – spreads widened about 70 bps last week. They're now sitting at about 4.2%. That sounds like quite a bit, but the long-term average is about 5.5%. So high yield spreads are still well below long-term averages.

Spreads are wider, which typically isn't good for bond prices, but benchmark yields, as Crista pointed out, have been following all of these actions and followings of central banks have led benchmark yields to fall, so the actual impact on corporate bond prices has been fairly muted. In the high-yield world, last week, the index was down about 0.6 of 1%. High yield returns this year are still about 4.6%, which is pretty decent. So, we've seen some widening, which is new to us.

We would suspect, as we move forward into the rest of the year, we could see some additional widening, certainly in high-yield spreads because they're well below those long-term averages. So that's secondary markets. New issue markets have been extremely active in the first part of the year. A lot of that's pre-funding upcoming maturities. We think a lot of it is companies wanting to get ahead of the U.S. election cycle and the expected volatility that's going to surround that. In the U.S., investment-grade companies and high-quality companies have borrowed almost a trillion dollars this year, and that's up about 26% over the same period last year.

In high yield, we've seen issuance of about $180 billion. That already exceeds all of the high-yield issuance for last year. So things are very active in the credit markets in both secondary and new issue.

[00:10:36] Kevin Minas: It sounds like, if I got that right, that high yield spreads are still well below average or at least below average. That's not so much the case on the investment grade side. Any view as to why investment grades moved to a more normalized level in terms of spreads historically but high yields are still relatively rich?

[00:10:53] Brian Carney: A couple of things. I think the investment grade new issue calendar has something to do with that. In high yield, when we get into markets like we've had where complacency might be a good word to use up until last week, there's a tendency for investors, both institutional and individual, to reach for yield. If you look at the absolute yield on high-yield bonds, 7.5-8% looks pretty good. So the composition of that yield has now changed: more spread, less benchmark yield, but it still looks pretty attractive. We think many investors are reaching for yield. We don't think that's the right thing to do, but we're just one player in a very big market.

[00:11:35] Kevin Minas: That covers new issue activity in the U.S. Crista, what's been the dynamic in Canada?

[00:11:40] Crista Caughlin: Similar to what Brian mentioned with respect to the U.S. new issue activity, we're seeing record issuance this year in Canada, both on the provincial side as well as the corporate side. On the provincial side, we're on pace to be one of the largest issuance years we've seen in a while. We're looking at $110 billion from provinces this year. Now, a lot of that's been front-end loaded. March is the year-end for provinces, so we're about four months into that or 33% of the way through the year. Yet, in provinces, 55% of their funding needs are complete.

We've recently participated in a new issue, BC. BC is in a deficit. Their debt to GDP metrics are increasing, but we think that's reflected in spreads as it trades wide to Ontario, whose debt levels are actually materially higher. So we bought the new issue BC and actually sold Ontario against it in the Canadian strategies. On the corporate side, again, we're seeing record issuance. The first half of the year saw $85 billion of issuance. That's the largest first half we've seen in a decade. Expectations are for $130 billion in total this year. Again, this would be one of the largest issuance years we've seen in the last decade.

Bumping up those first-half numbers was Coastal Gas Link. Coastal Gas Link was one of the largest corporate deals we've ever seen in Canada. It was 11 tranches, over $7 billion. It was obviously oversubscribed, I think 90 unique buyers. Despite it being priced at sort of the tight end of guidance, bonds still managed to tighten 20 bps in secondary. Or tighten 20 bps on the break.

So that's actually a great story for the Canadian bond strategy. Sandro spent a lot of time on that company before the issue came to market, which allowed us to participate in the new issue and benefit from that tightening of spreads.

[00:13:29] Kevin Minas: Brian, there's been a lot of news about commercial real estate over the last couple of years. Of course, it's well known about the implications that COVID had, whether it be working from home, changing where people are living, single family and multi-residential. Data centers in terms of industrial has been a big theme. Can you give us an update on one, do we have any exposure in any of our portfolios on the fixed income side to commercial real estate? And in general, what's the in-house view on that part of the market?

[00:13:58] Brian Carney: It's a topical sector, return to work or not. Some of us are in the office. Some of us are not. That obviously has an impact on things like vacancy rates, and then rising interest rates, as we know, have an impact on capitalization rates and how real estate gets valued. That obviously feeds through to valuations and how much lenders are willing to lend against certain real estate. Those things – return to work, rising interest rates – are hitting different subsectors of the commercial real estate market differently, different for office than it is for retail and for industrial.

The key point is we currently do not have any direct exposure to real estate, either in the Canadian bond strategy or the global credit strategy. We don't own any commercial mortgage-backed securities (CMBS). We don't own any unsecured debt of real estate companies. That said, we're spending a considerable amount of time on commercial real estate for two reasons. The first is the sheer size and scope of the real estate financing market. It's measured in the tens of trillions of dollars, and what's happening in that market can have certain knock-on effects on other sectors that we are invested in. The second point is we do have indirect exposure to commercial real estate through our portfolio holdings of bank and insurance companies.

To give you one example, in the Canadian bond strategy, we own bonds issued by Sun Life Financial, a Canadian insurance company. Sun Life owns real estate assets, and they have a mortgage book, so they're both an owner and a lender to commercial real estate. As part of our credit process, we look at how much real estate exposure do they have. When we did our investigation, we learned commercial mortgages are about 8% of Sun Life's investment portfolio. When we dig deeper and look at their office exposure – office is the segment of commercial

real estate that we are most concerned about – we know they have a little less than 2% exposure to office within their commercial real estate book.

As we do our credit work, we are quite comfortable that that's a manageable level of exposure. We're also very comfortable that Sun Life knows what they're doing as both an investor in and lender to real estate. As we look at indirect exposures, we do that for Sun Life. We do it for our bank holdings, which would include names like Bank of America and J.P. Morgan.

[00:16:30] Kevin Minas: With the Canadian bond strategy, I know one of the trades that you have on, Crista, and you've had on for a while now, has been the steepener trade. Given what's happened with central banks getting off the sidelines here in Canada and potentially more cuts, walk us through a refresher on what the steepener trade is, and what's your current view now that central banks have actually started that activity? Is that trade still likely to be something you see a lot of value in going forward, given the cuts have already started?

[00:16:58] Crista Caughlin: In terms of what a steepener trade is, that's owning the short end of the yield curve. So owning two-year, five-year, or 10-year versus not owning the long end of the yield curve, not owning a 30-year, for example.

In terms of where curves are today, parts of the curves are still inverted, particularly recession indicators. So 2s10s or Powell's favorite indicator, which is the three-month versus 10-year. In both Canada and the U. S., 2s10s is sitting around 15 bps inverted. For context, that was over 100 bps at one point in time and typically actually sits at plus 100. So we should still see quite a bit of steepening out of that curve over the next year.

The 3s10s yield curve, which has historically been known as the better recession indicator, is still over 100 bps. What that's telling you is that at the very least, the markets think that central banks need to lower interest rates substantially over the next year. As far as the rest of the curve, it's actually finally moved into positive territory in Canada and that has been triggered by Bank of Canada rate cuts. As an example, the curve we have on, or the position we have on, is 10s30s. So 10s30s was inverted almost 30 bps at one point and is now sitting at plus six, which has obviously really helped the Canadian bond fund because again, we own more of the 10-year part of the curve and less of the 30-year part of the curve.

It's the 30-year part that's actually increased more. In terms of where we think that will go, we plan on holding this through the entire easing cycle by the Bank of Canada. This curve typically would sit at the low end of a range of plus 40, and at the high end of the range, it would be closer to plus 60. We still think there's a long way to go and a lot of value that can be added through this curve position.

[00:18:53] Kevin Minas: Looking at the portfolios in terms of credit positioning, we talked, Brian, about where spreads are. Perhaps you can go first. Are there any trades that you've put on over the last few months since we last spoke that you particularly want to highlight or other positions that you looked at and the team did the deep dive on and then ultimately chose to pass on?

[00:19:09] Brian Carney: Let's talk about high-yield exposure. I mentioned a few minutes ago how high-yield spreads had widened out but still were well below long-term averages. We have a very limited high-yield exposure in the global credit strategy. We actually have three names: DirecTV, Matter, and Valvoline. Those are companies that have large cash balances, cash-generating ability, and very manageable debt maturities. They comprise, in aggregate, about 7% of the global credit strategy.

As we do our individual investigations in a tight-spread environment, not surprisingly, we come to the determination that we should have relatively few high-yield names. In both Canadian bond and global credit strategies, we do have some names that are in common. One of those is Ford Credit Canada. Ford Credit Canada

is guaranteed by Ford Credit U.S., which in turn has a support agreement from Ford Motor Company. Ford Motor has lots of liquidity. They've got over $20 billion in cash and over $40 billion in available liquidity. We like the support agreement they have in place, and we like the performance of the company both as a seller of automobiles and a financer of automobiles through Ford Credit. At approximately 180 bps over, we think they're one of the most attractive corporate bonds in the Canadian market. We own for credit in both strategies.

Verizon Communications is another name that we hold in common across both strategies. It's a large U.S. telecommunications provider that, for a couple of reasons, has decided to borrow in Canadian dollars. Bonds trade just a little inside where Canadian competitors would trade, such as Bell Canada and Telus. We believe that's justified by their exceptional financial and operating metrics.

The last point I would make following Crista's comment on curve steepeners: in the global credit strategy, we don't have any long-duration corporates for exactly the reason that Crista highlighted. We think there's lots of room for the long end to continue to steepen. If you look at corporate credit curves, you actually get compensated very little in terms of spread for lending for long. So we don't see any advantage in lending long term to corporates within the global credit strategy.

[00:21:35] Kevin Minas: Crista, is there anything that you want to add in terms of positions within the Canadian bond strategy?

[00:21:39] Crista Caughlin: We've been concerned about the outlook for a while now. We've been concerned about leverage in corporate markets, particularly at a time when we've seen a material backup in interest rates. This has caused us to focus on two things: one, higher quality names, so names with less volatile cash flows like utilities. North West Redwater is a good example of that. But we've also reduced exposure in names that don't have a clear deleveraging path. Rogers, TransCanada Pipe, I think Bell falls into that category.

We've been focusing on companies that are focused on their leverage. Telus is a really good example of that. Telus has been growing. They continue to take market share, but more importantly, their leverage has peaked, and there's a clear path to deleveraging both through growth but also through lower capex. Telus is a name that we've been building a position in for almost a year, really just given that turnaround in their leverage profile.

[00:22:35] Kevin Minas: Shifting gears a little bit, the last topic that I want to cover, maybe I'll throw this one out as a jump ball and whoever wants to tackle it first, please go ahead, but obviously we're doing this podcast with the two of you, the team has expanded. The fixed income research team, that is, has expanded over the last year or so with Brian joining on the global credit side, as well as a new analyst and new corporate trader. I think we're now up to seven individuals on the fixed income side.

I'm just curious to hear how the growth in the team has been going. Crista, you've been here longer, so you have more history. It probably makes more sense to start with you. If you could just share your perspectives on some of that growth, then we can get Brian's perspective as well.

[00:23:09] Crista Caughlin: I think it's been fantastic. I'm super excited about it. With the addition of both Brian and Sandro, we've significantly increased our depth or bench strength on the credit side, particularly with respect to bottom-up credit analysis. The biggest impact, at least for the Canadian strategies, is that it's allowed for increased focus. I'm still involved on the credit side from a portfolio management perspective, but I can defer all the actual credit research to the credit team and that allows me to spend more time on macro research.

We've also added Morgan Caissie, who's an experienced corporate trader, and she's taken over all the fixed income trading responsibilities. With that hire, we've moved Max over to the macro side as well. I'm really excited about what's happening on the fixed income side from a team perspective. From a research perspective, we now

have individuals who are focused on their area of genius, whether it be trading, credit analysis, or macro analysis. My view is that increased focus is just going to lead to better research and, ultimately, better decision-making.

[00:24:10] Brian Carney: I share Crista's enthusiasm. First off, I would say we've covered corporate Canada extremely well from a corporate research point of view between Crista's efforts and Curtis's efforts before I joined and Sandro joined and Morgan. But as Crista points out, she didn't come to Mawer to be a credit analyst. She came here to be a portfolio manager. I think freeing up Crista's time to help her focus on what she does best is a big part of what we've done. I think that's great, so I echo what Crista said on that front.

As an investment team, the more investigations we can execute—by that, I mean, the more issuers we can look at—the more potential value-add we can generate for our investors. I think that's important. We have three credit analysts now, including myself in that group. I think that's important. We have the capacity to look at a much larger universe of names. And because we can look at more names, we can compare and contrast, and, importantly, compare and contrast versus international names, which helps our relative value analysis that buy in Verizon in the Canadian bond strategy is something that comes about because we have the time to look at Verizon and then compare it versus Bell and other Canadian telecommunications names.

And finally, the last point I would make on the research side is we work very closely with our 40-odd equity research colleagues as we investigate issuers and industries. We have access to something wonderful called M42, which is our catalog of all things issuer-related from research notes to management discussions to opinion changes. Those notes and that catalog go back decades, so it's an incredibly valuable source as we look to identify the most potential value-add opportunities within the corporate universe for the Canadian bond strategy.

[00:26:06] Kevin Minas: Well, I'll just echo both of your excitement. It's definitely an exciting time for fixed income at Mawer. We're certainly not new to fixed income, but it is exciting to have more capabilities. Area of genius is, of course, very important, so that's great to hear that, Crista, you're able to focus more on the macro side of things as Brian and team grow on the credit side.

Thank you for both your time. Great to have you both on the podcast again. It was also excellent to have you both at the same time to get both the macro and credit perspective, and hopefully, we can do this again sometime soon.

[00:26:33] 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.