Flexible fixed income

Event summary

In our April 5 Exchange Event Series event, Konstantin Boehmer, portfolio manager and Co-Lead of the Mackenzie Fixed Income Team and Dustin Reid, Chief Fixed Income Strategist, discussed why it pays to stay flexible in volatile times.

Inflation environment and outlook

- Inflation has been a driver of markets over the last few quarters, with a broad-based increase in inflation seen across both goods and services.
- Russia's invasion of Ukraine has added a further uncertainty, as energy, food and supply chain issues will likely compound the inflationary backdrop for the foreseeable future.
- Russia is a major exporter of energy, hard commodities and agricultural commodities, especially to Europe, which will add to the uncertainty over supply and demand, inflation and growth.
- The added costs seen at the gas pumps and in the grocery stores, coupled with increasing debt carrying costs, will be a shock to households going forward.
- As such, we're in the throes of an inflation spike that will likely persist, with the likelihood of seeing inflation prints close to 10% (if not higher) over the next few months.
- As such, there is little relief in the short term, as central banks adopt an aggressive stance on supressing inflation. Adding the tenuous environment for supply chains and the uncertainties around COVID-19 makes for a difficult short-term solution from central banks.
- With the importance that inflation currently plays in constructing an investment thesis, we like to look at inflation indicators beyond CPI. Indicators published by the regional Fed's (Dallas Fed, Cleveland Fed, NY Fed), allow us to analyze inflation data at a district level, which ultimately feed to the federal level.

Jobs and employment situation

- The Fed believes that the US economy is at the beginnings of a wage price spiral akin to the 1970s and 1980s, given surging consumer prices and tight labour markets. Whether it is true or not, the Fed will adjust its reaction based on this scenario.
- Central banks, both in Canada and the US, have started to tighten policy. However, the degree to which they have recalibrated their tone towards inflation, compared to the last half of 2021, has telegraphed an aggressive policy stance to supress inflationary pressures.

Fed "dots" and how the market is price currently

- The Fed has significantly amended its March outlook from the outlook presented at the September meeting. It's now looking to make significant hikes this year.

- The path for interest rate hikes is well telegraphed and the market expected to get to neutral rate (around 2.5% currently) sometime this year. The neutral rate is an estimated rate level that doesn't boost growth or dampen demand, and can be revised higher or lower.
- It's widely expected the Fed may need to go above the neutral rate to get on top of inflation, which is considered restrictive and could have an effect on the growth outlook.
- The big question is where the terminal rate falls in this tightening cycle, which is very difficult to forecast given the acceleration of prices and the escalating Ukraine conflict. There are indications that the target rate could be north of 3%.
- North American markets have priced in a lot over a short period of time, given the significant moves in the curve and futures levels. However, one can expect that the market has not priced in all the way.
- The ECB, on the other hand, needs to reprice. Some expectations have been priced in since last year, however, there is more room to go.
- Language out of the ECB is becoming more hawkish, and we expect that the evolution of this narrative will continue. We find it challenging to believe the ECB will do nothing until September, given the ramp up in inflationary pressures.

Shape of the yield curve

- We've recently seen inversion take place on some parts of the yield curve. Inflation is running so hot, and rates are so low, that an adjustment is just beginning.
- Central Banks are in a very tough spot right now and their primary lens is squarely focused on inflation. They prefer to engineer a soft landing and prefer to see a mild recession versus stagflation.
- Therefore, we can expect to see further curve inversion, especially given that this may be a relatively shorter hiking cycle.
- The expectation, at least from our point of view, is that a significant slowdown in growth may be felt next year, but it's difficult to say whether we will go into recession.
- An inversion of the two-year and 10-year would be a signal of at least a significant slowdown in growth.

Views on risk and outlook for the Canadian dollar

- We have already seen a repricing of risk, with global risk sentiment remaining very fragile, and the sovereign bond space challenged.
- Earnings season will be important to measure the effects of elevated inflation and supply chain issues.
- The general move in fixed income would be through a bear flattening of the curve. The front end of the curve may move higher, more so than the back end.
- The USD/CAD pair should be looked at through the lens of risk appetite. If equities do generally well and risk appetite is robust, that is generally supportive of CAD. However, an equity sell-off and high-risk sentiment would suggest a higher USD. Oil prices serve to complicate the dynamic.

How our fixed income mandates are positioned in the current environment

- We ended last year with a significant short in duration positioning across different markets.

- Our views on duration have shifted over the past few weeks given where the market is pricing. We're still short duration, but less aggressively.
- We are neutral on Canadian duration. Canada is one of the most interest rate sensitive markets and we are faced with plenty of interest rate hikes already priced in. It's a challenging market for the Bank of Canada to navigate, as housing plays a disproportionately large role. The high level of household debt in Canada will provide a tricky backdrop for the BOC in balancing inflation with weaker household balance sheets.
- Inflation protection: until last year, we had a significant position in TIPS across many of our mandates. We reduced as the Fed turned much more hawkish on inflation, which would tend not to be good for TIPS.
- However, the Ukraine situation changed the outlook for inflation and hence TIPS.
- TIPS perform well if you have high inflation and rising inflation expectations. Also, higher inflation offer TIPS higher compensation, which is part of the return.
- We will not be surprised to see little more inflation expectations to be priced, but this will be a function of how seriously central banks take it, and how it's starting to affect consumer behaviours. All things that we will watch closely.
- We are overweight TIPS across many mandates.

How can higher rates impact corporate defaults?

- Default rates in the current credit market are extremely low on a historical basis.
- The key is to be forward looking and to evaluate the risk to earnings season, margin pressures, etc. Highly leveraged companies and companies with high levels of floating debt may see an impact on their profitability.
- Credit spreads look reasonably attractive, especially in leveraged loans, but credit selection will be key.

Emerging markets – where are we?

- We had a large position in Chinese government debt which worked out well. Overall yields were about 250 bps over Treasuries but exhibited similar characteristics.
- The spread differential has compressed to about 40 bps over Treasuries, due to falling yields in China and a sharp uptick in US yields.
- We took our profits, as a lot of the trade thesis has disappeared. Further, geopolitical concerns have certainly been elevated which could potentially put China at risk. Even if this is a low probability event, it is something that needs to be considered in light of the environment.
- We remain very selective with other emerging market jurisdictions. We prefer EM jurisdictions that are commodity producers and have started early in their rate hiking cycle. Import reliant countries like India and Egypt are not favoured as they are vulnerable to rising food and energy prices.

Comments around core fixed income – is the worst behind us?

- There remains a decent argument for core fixed income strategies, and the benefits that equity diversification present.

- The Bank of Canada is in a tricky spot – they need to increase interest rates to cool inflation, but they need to be acutely aware of the impact of their actions on heavily indebted households.
- The market has priced in significant rate hikes for this year, which certainly has the potential to create a lot of stress on household balance sheets. It's certainly possible that the BOC may need to revisit policy if stresses emerge.
- We like the optionality of buying duration in Canada if we see stresses build in Canadian housing.
- As for the GIC alternative, they do not have the negative correlation to equities that core fixed income exhibits and you won't get offsetting performance if you have a fallout in central bank policy.

How does the Fed and BOC raising six or seven times this year impact economic outlook? What indicators should we watch?

- Purchasing managers indices like ISM (US) and PMI (Canada) are key indicators to look at for economic activity and outlook.
- The NFIB survey will measure the sentiment amongst small businesses.
- Consumer indicators like credit card purchase data and Google searches can potentially provide signals at the consumer level.

Sustainable bonds: How have they performed better than traditional bonds and what is your outlook?

- Sustainable bonds have done reasonably well, which can be partly explained by the different composition that makes up the group, including different industries in the sustainable sector.
- Structural differences may be highlighted as well, with over-demand relative to the supply that is being issued (over-bidding on new issues) consistently higher than regular bonds.
- Sustainable bonds tend not to be at the front of "sell" programs during a sell-off environment. We expect traditional bond issues will tend to be liquidated first.

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