Portfolios RE:Constructed with fixed income

Event Summary

Intro

- In our latest edition of the Fixed income round table, **Hadiza Djataou**, Senior Investment Director with the Mackenzie Fixed Income Team, was joined by **Dustin Reid**, Chief Fixed Income Strategist and **Dan Cooper**, Portfolio Manager and Head of Credit, to discuss the latest on central banks' efforts to contain inflation and learn where the team is finding opportunities. **Michael Evans**, Vice President, National Sales, takes us through Mackenzie's broad shelf of fixed income solutions and highlights strategies to meet your client's needs.

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Key messages:

1) Stubborn and persistent inflation continues to be a key driver of central banks' aggressive policy through the first half of 2022, resulting in strong market reaction and volatility.
2) We are constructive on investment grade credit and have increased our allocations because of a greater comfort with higher quality.
3) The Federal Reserve and Bank of Canada's willingness and ability to manage a soft-landing has decreased in probability while the probability of a hard landing has increased.

Inflation, labour market and rates

- Inflation continues to be a dominant theme driving central bank action as we move into the end of the year.
- We have been of the view for some time that the transitory narrative used to describe inflation early on, did not capture the magnitude or stickiness of the pressures we have seen.
- We are likely past the peak in headline and possibly core inflation for both the US and Canada.
- One of the significant challenges for central banks moving forward will be the path back to a lower inflation level; more specifically getting back to a target of ~2%.
- Higher wages, a relatively tight labour market and ingrained price pressures continue to put pressure on inflation.
- For this reason, we continue to be relatively hawkish on inflation and of the view that inflation may not slow as quickly as the market anticipates.
- Alternative consumer price index (CPI) indicators, such as the ones used by the Fed, point to the presence of continued inflationary pressure even when removing some of the more volatile items in the calculation, such as used car prices, airfares.
- The Beveridge curve is another indicator the Fed is monitoring. It looks at the number of job openings versus unemployment rate. For every person looking for a job there are two openings. This puts upward pressure on wages and further upward impact on inflation.

- The Fed recently increased interest rates 75 basis points (bps) and will likely hike another 125 bps more. This would take the terminal rate (peak for the federal funds rate) to over 4.5%.
- In Canada, the terminal rate will likely be shallower as the market has priced in ~50 bps deviation from the Fed.
- The vulnerability of the Canadian economy to the housing market, and more specifically variable rate mortgages, will in some ways dictate the end of the increases in interest rates in Canada.
- The market was pricing in interest rate cuts in the first half of 2023 or earlier. That narrative has since changed, and the market has recalibrated higher for longer than previously anticipated.
- In our view the Fed and Bank of Canada's willingness and ability to manage a soft-landing has decreased in probability while the probability of a hard landing has increased.

Duration

- We continue to be slightly short to neutral overall duration, as we have been much of the year.
- We have been short particularly on the short-end of the curve on the expectation that central banks would ratchet-up rates in response to inflationary pressures. This was evidenced through our trades in the short end of US and German curves.
- We are neutral in the long end of the US curve and have begun to discuss as a team the idea of being net long in the long end of the Canada curve on the notion that Canada may lead the economic cycle lower.

Credit summary

- It's been a very tough year for fixed income markets overall – you need to go back to 1778 to see a worse year.
- Yields were too low at the beginning of the year; fixed income did not provide that equity risk offset.
- Although we still see uncertainty and volatility ahead, we are getting more comfortable with fixed income and duration.
- We are taking off some hedges and adding some duration to the portfolios.
- We are getting more comfortable with certain areas of credit.

Credit market fundamentals

- Credit fundamentals look good, at least up to this point, with corporate earnings remaining strong through most of the year.
- We are starting to see some earnings weakness, which will happen more and more over the coming quarters.
- Leverage ratios are near historical lows. Companies are not raising a lot of debt and not paying out big dividends. Many had taken advantage of previously low yields to refinance debt and extend. Interest coverage ratios are at record highs as well.
- Fundamentals remain strong, however given the economic backdrop we anticipate things will get worse.

Credit valuations

- The challenge with credit and where valuations currently sit, is to reconcile the view of the economy, what inflation will look like and what to anticipate from the central banks.
- Things do look more interesting from a yield and spread perspective, compared to the start of the year. High yield credit spreads were around +300 bps at the beginning of the year – a level that didn't adequately compensate for credit risk that is always persistent, and for duration risk.

- Yields in the space are now 8.5%, with spreads breaching +500 bps. Indeed, we are at much more attractive levels but with a caveat: current levels are only pricing in a soft landing.
- Credit spreads in past recessions were closer to +1000 bps. However, given that high yield quality has increased over the years, spreads may not get there.
- To adequately compensate for a risk of a recession, spreads at +700 bps would make this space more interesting to us.

How are we positioning credit?

- **Investment grade:** in this environment, credit is basically an "up in quality" trade for us. Investment grade corporates underperformed because of duration, where yields were too low at the start of the year and not providing adequate compensation for risks. Now, yields have more than doubled to 5%, providing an interesting opportunity to reach for yield in a space that carries lower default risk. Within the credit bucket, we have increased our weightings to investment grade credit because of a greater comfort with higher quality.
- **Leveraged loans** were very supportive for returns in the early part of the cycle. However, super hikes from central banks have started to create stress. Although we are active managers and are comfortable with the credits we hold, we have downgraded our loan exposure across mandates, preferring fixed rate exposures.
- **High yield:** we remain neutral in the high yield space and have adjusted our exposures to higher quality. The current yield levels are attractive; however, they need to reflect the backdrop of risks going forward. We will take a closer look at high yield when yields get to double-digits.

Closing

- Mackenzie remains committed to partnering with our clients to ensure they meet their investing objectives. We continue to offer active, index and asset allocation building blocks for all your fixed income needs. Whether you are looking for sustainable products or a single-ticket solution, consider how we can help you build a portfolio to navigate the path forward.

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