Active Insights Podcast – CS McKee's fixed income strategy and market outlook: "everything really swings on inflation at this point in time"

Diane Merritt:

Welcome to North Square Investments' Active Insights podcast. North Square Investments is dedicated to bringing differentiated active investment strategies to financial advisors and investors through our multi-boutique asset management platform. Today, Mark Goodwin, Chief Executive Officer of North Square Investments, will discuss the North Square McKee Bond Fund and CS McKee's investment approach in a changing market environment. Brian Allen, Senior Vice President and Portfolio Manager, will provide us with his insights and outlook for the fund and the market. CS McKee is a partner firm in the North Square platform.

Mark and Brian, we look forward to your discussion.

Mark Goodwin:

Thanks, Diane. As you mentioned, at North Square, we seek out best-in-class active managers for our platform and our partners at CS McKee have a proven, repeatable approach in taxable fixed income investing.

Brian, as Diane mentioned, you and your team manage the North Square McKee Bond Fund, ticker NMKBX, for the R6 share class. This strategy covers investment grade corporates, government securities, as well as mortgage and asset-backed securities that you and your team consider when building the portfolio. Can you give us some background on the objective of the fund and your investment approach?

Brian Allen:

Sure. The investment philosophy and process of the fund mirrors our firmwide approach to fixed income, namely investment grade only, high liquidity, low volatility, consistent benchmark outperformance and superior downside capture. This fund, in particular, is most closely aligned with our intermediate strategy, the intermediate aggregate in particular. Given the market environment present in late 2020, when we launched our first fund, we thought this risk profile was the best choice to provide both diversification to broad portfolios while reducing interest rate risk.

Mark Goodwin:

Before we get into how things expect to develop in 2022, I'd like to get your thoughts on the fixed income market in 2021 and how things shifted over the course of the year. Could you comment on what adjustments you made to the portfolio as the year progressed and how the fund was positioned going into year-end 2021?

Brian Allen:

Sure. To begin 2021, we were a slight underweight duration and the spread sector risk as well. Our outlook for economic growth was improving, but we also saw the first hints of sustainable inflation. Congressional voting results fueled that expectation on January 6th and a notable treasury auction failure that occurred in early February really highlighted the concerns of the market regarding inflation.

Duration increased as we entered the second quarter. A number of our yield targets were hit at that point and the curve had steepened precipitously up through March and we thought it had reached an extreme at that point. Sector allocations were fairly stable through the middle of the year, summer and third quarter. And then we began adding to holdings in agencies, mortgage and credit, as we finished the third and entered the fourth quarter.

In particular, our treasury holdings moved from over 20% of the portfolio to less than 10%, with the majority of that move coming late in the fourth quarter. As inflation continued to push higher the Fed gave up on its transitory moniker for the future path of inflation and callable agency spreads became very attractive in a hurry, a combination of the spike in volatility, as well as a concentration of supply that was stuck on dealer balance sheets. Now we quite often find good opportunities in that space on a calendar basis, depending on the street's positioning.

We remained overweight credit throughout the year, which was a definite consistent plus for performance. Bond issuance last year was just short of $1.5 trillion, second only to the record set in 2020 of $1.8 trillion, but demand for yield was strong throughout the year, both from domestic and foreign investors. Whether you're hedged or unhedged yields in the US market, both in treasuries, mortgages and credit as well were very attractive to foreign investors relative to their home country yields.

The only drag on performance in this sector of the portfolio was that our high-quality bias wasn't rewarded given the Fed's ... the existence of a Fed "put" throughout the course of the year. So that and the pursuit for yield in an otherwise low-rate environment led triple B's to outperform single A's.

Mark Goodwin:

Brian, as we come out of the peak of COVID, we're starting the new year with some headline issues with inflation, the expectation of a near-term shift in Fed policy for the first time in several years, geopolitical tensions with the Ukraine situation and an increase in volatility that we haven't seen in investment markets for some time. Can you talk about how you see the economic environment currently and what's your outlook for the economy in fixed income markets in 2022?

Brian Allen:

Yes, the conflict in Ukraine really compounds the difficulty in forecasting factors, macroeconomic factors, in real time. That said, the median domestic consumer has accumulated quite a bit of savings versus pre-COVID levels. Estimates run as high as a trillion dollars when looking at the middle 60% of US consumers in terms of income and net worth. And I think after two years of being partially or fully locked down due to COVID and given the savings levels that they have, we expect, and this predates the situation in Ukraine, but we expect an adventuresome summer, if you will.

People are anxious to travel and spend. And we think that even in place with the war in Ukraine occurring, that if it reaches negotiation stage in the next few weeks, doesn't spill over borders or worsen to any meaningful degree that commodity costs will retrace some of their recent gains, supply will recover. That's certainly encouraged by the employment news from just today, another 678,000 joining payrolls, and most importantly, the labor participation rate increasing and the first signs of labor inflation leveling off.

So, I think the stage is set for strong consumer demand throughout the second and third quarter. We hope the Fed takes advantage of that by raising rates, catching up. They are clearly behind the rate of inflation, and we expect to see a Fed funds rate closer to 1.25% by the end of the third quarter. Price pressures will continue, but the focus remains on inflation. Any signs of stabilizing or beginning to fall will certainly be conducive to an increase in demand.

What's all too likely to happen though, is the continued increase in raw material prices joins wage gains and owner's equivalent rent and may push inflation slightly higher, at least in the very short run. That may put a dent in demand, but I think ultimately the Fed will ... is now showing a willingness to raise rates starting in March, likely only 25 basis points to begin with, but they've made it clear that if the situation calls for it that 50 basis points is not off the table.

Mark Goodwin:

Brian, given this backdrop of rising inflation, in part driven by demand for the consumer to get out and live life again, and likely rate increases following very shortly. How are you positioning the McKee Bond Fund portfolio to reflect this environment?

Brian Allen:

We're still slightly short duration at this point. We continue to add to our negative convexity position, namely increased holdings in callable agencies. Valuations there have become very attractive, more so in many cases than we saw in the first quarter of 2020. Now all spread sectors have suffered some under-performance versus their treasury benchmarks this year, but it's acutely true in the agency space.

And we think, again, the concerns about the Fed being behind the curve with respect to raising rates and further exacerbated by the volatility due to the situation in Ukraine, many of those items will calm, if you will, and the influence on the markets will decrease going forward. And as a result, these securities are very attractive from a spread basis and also perform very well in what we expect now will be a mildly rising rate environment throughout the course of this year.

If there is a benefit, and I hesitate to call it that, the situation in Ukraine now leads to Fed expectations of again, just 25 basis points in March, but a consistent path of rate increases throughout the course of the year. This may, in fact, mirror the experience we had in 2004, where the Fed was very clear about their intentions to raise rates slowly but consistently. The market volatility came down quite a bit. It was an orderly transition. The yield curve flattened and in an environment like that agency sector in particular does very well. And we think callable agencies are the best in class in that sector for right now.

Mark Goodwin:

So in terms of looking at the best opportunities in the market today, would you say that those represent the strongest position forward, or do you have some other ideas for adding to the portfolio?

Brian Allen:

Yes, the agency sector, definitely top of the list in terms of relative attractiveness, but won't exclude corporate bonds as well. Given the Fed's presence in the market on and off for the last 10 years, corporate spreads have been largely range bound, if you will, by broad historic standards. That's especially true coming out of COVID in 2020 and for the balance of 2021 where a crush of supply was met with fairly robust demand.

The spreads last year on the sector as a whole were 80 to 100 basis points. We've now hit 130 basis points this year, close to the peak that we saw in 2019. So if this environment ultimately shapes up to be like a return to that timeframe, both with Fed activity, the level of growth and a down trend, we hope in inflation, corporates are becoming more attractive, between 130 level and 150 basis points will continue to nudge up our position in credit, not only on an absolute basis but we're also taking advantage of this opportunity, with respect to volatility, to increase our high beta names from relative to the low risk securities that we've held since early 2021.

Mark Goodwin:

Brian, there's a number of cross currents in the market today from the inflation headwind to the potential for energy prices affecting virtually everything we spend money on, including potential for travel this summer. Can you talk about what would cause a significant shift in your market outlook today?

Brian Allen:

Everything really swings on inflation at this point in time. We've clearly gone from a transitory outlook, which was true for a few months, the middle of last year and well out of the market's mindset, I think even before the Fed officially retired the use of that term, but we've gone from an expectation that inflation would peak in January or February of this year and decline to a mid-high 2% area by the end of 2022. Those expectations are clearly gone at this point.

The market has progressively gone from that viewpoint to quite possibly 3.5 to 4% as a terminal rate, at least December of this year. And right now we're moving even higher. And this is really where the Ukraine effect comes into play. Commodity prices that are already spiraling higher are situations exacerbated by restrictions in the supply of wheat and oil, to name a few things.

Also, shipping has been disrupted, at least one of the most recent reports on a transport ship being sunk near Odessa, Texas probably has implications for firms that write insurance on these ships and therefore in the absence of insurance that will provide yet another crimp on supply.

So, it all gets back to really how this plays out with respect to inflation and what the Fed ultimately does to control inflation, how much they attribute to temporary factors that they admittedly cannot control. And just how aggressive, when it's all said and done, with just how aggressive they feel they have to be to at least keep market expectations for long-term inflation in check. So that will be our focal point, I think for the better part of this year.

Mark Goodwin:

Brian, changing gears, many investors have used passive investment strategies increasingly for their exposure to fixed income in their portfolios. Do you see advantages from CS McKee's style of active management for investors fixed income exposure in particular, given this likely, highly volatile investment environment over the near-term horizon?

Brian Allen:

Yeah, I think this is one of the best times, frankly, for active fixed income management in general, among the asset classes. Core fixed income, in particular, active managers have done generally a good job outperforming the benchmark. It's one of the few areas where you can say that's true, certainly more difficult to prove in the equity space, but in periods of high volatility with rising rates and inflation, I think active management offers a new level of additional, both performance and comfort to the investor.

We, as a smaller firm, can readily and quickly change the risk profile of our fund to take advantage of opportunities that either larger funds cannot execute in any meaningful way or frankly, in parts of the market where many funds simply don't look. Again, the agency space is unique. Our use of the agency space is unique to us and it does offer the opportunity for significant, not only outperformance, but good downside capture numbers, as well.

As I've mentioned in previous calls, fully 50% of our long-term alpha stems from our participation in the agency space. This is a great time for active management to deliver both diversification and absolute relative performance that stacks up well against a passive fund.

Mark Goodwin:

Brian, a final question. How do you see an active taxable fixed income strategy like the McKee Bond Fund being best positioned in the diversified portfolio of an individual investor?

Brian Allen:

Yeah, I say, while one size really doesn't fit all investors, our fund's combination of high quality, high liquidity, the active management, the reasons just mentioned, long-term attractive risk adjusted performance and good diversification versus equities or other high beta assets in a balanced portfolio should make this a fairly appealing option for a wide range of both institutional and individual portfolios.

Mark Goodwin:

Brian, thank you for joining me today. This has been a great discussion as always.

Brian Allen:

My pleasure. Thank you.

Diane Merrick:

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