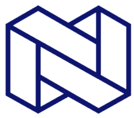

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Active Insights Podcast – CS McKee's fixed income strategy and market outlook: "we are getting to a point where there is some real relative value in fixed income"

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, and Brian Allen, Senior Vice President and Portfolio Manager with C.S. McKee, will discuss the fixed-income market, positioning for fixed-income portfolios, and the outlook through the end of the year.

C.S. McKee is a partner firm in the North Square platform and is sub-advisor for the North Square McKee Bond Fund, Ticker: NMKBX, as well as five asset allocation strategies.

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 C.S. McKee have a proven, repeatable approach to taxable fixed-income investing.

Brian, you and your team work with a broad range of fixed-income instruments. As the Federal Reserve has shifted policy to monetary tightening that has not only impacted headline interest rates, but also interest rate spreads among fixed-income asset classes, where do you see fixed-income markets currently, as we speak here in late September following the fifth consecutive meeting with the Federal Reserve raising interest rates?

Brian Allen:

Well, in the past several months, the Fed has continued to push back against the comments they made in June, which gave the market some indication that they might be closer to the end of the tightening cycle than the beginning. At the very next meeting in Jackson Hole, they did an abrupt "about face", making sure that the market was well aware of the fact that the inflation was their primary concern and that a slow-down in the economy was not of a particular importance at this point in time. So we think the Fed has another 75 basis point increase in store for us in November, that would be the fourth in a row. And probably an additional 50 basis points prior to year-end. And now the market sees one or two 25 basis point moves or a total of 50 early in '23. So volatility remains unusually high. We're certainly at 2020 levels,

very quickly approaching 2008 levels, and have seen some signs of dislocation in the market with liquidity being stretched a bit in not only the spread sectors like corporates and mortgages, but even in the treasury market. So it remains a challenging environment.

Mark Goodwin:

Brian, as we look forward to the fourth quarter of 2022 and into 2023, as you look into your crystal ball, what's your outlook for the economy? Is it a definite recession or possible soft landing? Thoughts on interest rates, the strong dollar, and just fixed income markets more broadly?

Brian Allen:

Yes, I think the estimates for this year are finally coming a little more into line. We'll see marginally positive growth right around zero for 2022. The Fed has estimated somewhere in the growth of about one and a quarter to one and a half percent for next year. I think that's a little optimistic. I don't think they really want to come right out and say they're going to maybe go too far, in saying that a recession, however it is defined, is really in the cards. But I think, again, I take them more for their word with respect to getting inflation under control. There's been increasing talk of the example that we saw in the 1970s, were the Fed chairman early in the decade, Arthur Burns, raised rates to an extent he thought would bring inflation under control. It did for a few years, but then certainly all remember, either by living through it or somewhere in the history books, what happened in the late seventies and how aggressive then Chairman Volcker had to be to finally squash inflation once and for all.

Caused quite a bit of pain in the financial markets for several years. And that launched us on a 40-year bull market in bonds, and one of the best stretches in terms of economic growth and stock market performance. So next year I think we'll see frankly a slightly negative post year over year in growth. I think the Fed, again, has not only reminded the markets that they're not finished raising rates, but unlike the market's assumptions, not to plan on any rate cuts coming next year. The market still holds onto the idea that the Fed in their aggressiveness to slow inflation this year, will go too far with rate hikes and then we'll see something on the order of a one or two 25 basis point rate cuts late next year. But given the volatility right now in the markets, it's difficult to see that far out.

Mark Goodwin:

Thanks, Brian.

You and your team are active investment managers. Based upon your market outlook, are you positioning your portfolio somewhat defensively or are you finding areas to be more opportunistic? And if so, what are those opportunities?

Brian Allen:

Actually, a little bit of both. We're slightly short in duration. In hindsight, would have paid to be much more defensive. But with the volatility in the market has given us and especially a firm of our size, the ability to move in and out of the corporate space. That sector, fairly actively has definitely allowed us a great opportunity in the agency debenture market. The big spike in volatility has gone a long way to

boosting yield spreads relative to treasuries in that space, and we are very aggressively positioned there as well.

And then most recently, so far year to date, looking at today's numbers in particular, mortgages have actually underperformed Treasuries by a slightly greater degree than corporates have. And it's unusual to see that historically, unless there's a great deal of rally in the Treasury market. And in this case where rates rising, mortgage rates have gone from a shade less than 3% to, after today, let's say we're pushing 6.5% dealer positioning. Dealers in general have been less aggressive in maintaining positions than they were, say in 2008. So there's quite a bit of dislocation going on in the mortgage market, especially with a strong dollar and what is normally some significant interest from foreign buyers. But for right now, there seems to be real concern. The Fed has helped the situation somewhat by saying they're not looking to sell mortgages, but when you take away a good healthy portion of the buyer base in any sector, especially with volatility this high, again makes for great opportunities if you're relatively nimble and we're certainly doing our best to get our arms around every opportunity.

Mark Goodwin:

What thing or things would cause a significant shift in your market outlook? And likewise, your portfolio allocations? I'm guessing inflation is the elephant in the room, but that and other thoughts?

Brian Allen:

Really does start and end with inflation and then the Fed's interpretation of where they think inflation is headed. We've looked at the last few months where the Fed has pushed back more and more about ever, or at least in immediate future easing. But they're as focused, obviously as much as the market is, on the trend in inflation, they've got a number of components. The quicker removing of components have definitely shown weakness. Commodity prices have come off quite a bit.

The one unfortunate element to inflation, or maybe top of the list in terms of an unfortunate element to calculating inflation, is owner's equivalent rent that lags the market, lags mortgage rates and home prices by, in many cases upwards of a year. And we think owner's equivalent rent will continue to increase on or at a 7% pace annually, and those increases will continue into the beginning of next year. And given its weight in the CPI of around 30%, it will tend to drag up the total certainly. And it remains a question as to whether or not the Fed really begins to look beyond that, understand the fact that home prices ultimately will drive the better part of owner's equivalent rent. And if we're well off the peaks there and we see weakness in other areas of inflation, that their message may soften a bit, and that will certainly go a long way to a rebound in risk markets and hopefully a cap on market interest rates.

Mark Goodwin:

Brian, 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:

For us, I think, or for the investor, certainly, the advantage here is then going with a firm that is not too large in size and that can actually adjust to changing market conditions, can find value in areas of the

market where larger firms can't. Though we are still at an elevated level of inflation, speaking to the attractiveness of bonds in general, we are getting to a point where there is some real relative value in fixed income at this point, almost diametrically opposed from one to two years ago. The yield on a core portfolio, whether it's a one-to-10-year intermediate product or a full benchmark product, it's between 4.5% and 5%, and there's actually yield now that is more than competitive with the best of what the stock market has to offer.

So, the longstanding “TINA” acronym, that there is no alternative to equities is, well, certainly been proven via cash this year by avoiding equities. But in terms of those looking for an investment that produces at least a relatively attractive level of income, a core fixed income now does that. In fact, just today there was an article about with the rise in rates and the spread widening occurring in the corporate market, that yields are reaching levels where junk buyers are actively or actually finding relative value or are attracted to the high grade markets now. Usually it's a good sign if junk buyers are looking at high grade. That's good for the individual investor as well.

Mark Goodwin:

Brian, thank you for joining me today. It's been a great discussion as always.

Brian Allen:

My pleasure. Thank you.

Diane Merritt:

Thank you for tuning in to our North Square Active Insights podcast. For more information on North Square Investments, our partners and investment solutions, please visit our website at www.northsquareinvest.com.

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