Active Insights Podcast with CS McKee: "I think in this market in particular, it's a great time to have an active manager as opposed to a passive allocation."

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, Chief Investment Officer and Portfolio Manager with CS McKee, will discuss the fixed-income market, positioning for fixed-income portfolios and the outlook through the end of the year.

CS 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. 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 to taxable fixed income investing.

Brian, the Federal Reserve has been holding rates at current levels. Inflation has improved but remains a concern. Economic growth has been resilient, but federal deficits are challenging. We also have significant geopolitical tensions and U.S. federal elections in November that potentially impact markets. Where do you see the fixed income markets currently and what's your outlook for the rest of 2024?

Brian Allen:

Well, if we first take a look at what's going on in the Fed funds market or the expectations for the Federal funds rate and go back to March of last year, we had beginnings of what so far has been a short-lived and not too severe banking crisis. We saw moves in the Fed funds rate of 1.5% from March to May, then up 200 basis points from May to October. We've bounced around so much so that in the last 12 to 13 months, we've seen fully 550 basis points in swings for the expectations of Fed funds this year.

We finished the end of last year on a very strong note, but this year, we've certainly retraced quite a bit of it. It seems inflation is not cooperating as much as the Fed or the market would like, so there are certainly interesting opportunities out there. I think that we're really playing it fairly cautiously at this point. We see evidence of more muted risk taking on the part of investors. The credit quality of funds seems to be on the upswing, and that's true in the other spread sectors as well. So the market's cautiously biding its time trying to get a read on when the economic information will be satisfactory to give the Fed the green light to cut rates.

Mark Goodwin:

Thanks, Brian. Are you finding valuations to be broadly at attractive levels or does this vary across segments of the fixed income market?

Brian Allen:

Yes, back in the fourth quarter of last year, a little context. Everything was for sale. It was really a question of you could spend every dollar you had on, certainly the mortgage market was very attractive. Credit market had widened quite a bit. It really was the worst case scenario at that point. The Fed had yet to signal their satisfaction with the level of rates, the Fed funds rate at that point in time, and inflation was still a little bit sticky at that point. We had some signs obviously, that inflation had come off the peak, but the improvement had slowed at that point. Some seasonality came into play, so a number of factors really led to higher rates and wide spreads. Since then, obviously we all know November, December was the best two months in bond market history for performance and I think enthusiasm carried it a little too far.

Again, we got into this year, the expectations for Fed funds have been somewhat reversed. The spread sectors are doing well versus treasuries, but only on a marginal basis. There's concerns about the consumer who has really defied most prognostications about their continued strength and spending. Consumer confidence has come off just a little bit. There are signs of credit quality deterioration in both the corporate market to a small extent, but in the consumer market as well.

So we're shifting a bit from credit exposure and really increasing our focus on more government securities. We were very active, had been for years in the callable agency market, but that sector in particular has done very well this year. Mortgages had a bit of a setback in the first few months, so we continued to shift our focus more towards the agency mortgage market and now have a slight overweight versus the balance in the index for that sector. And that's the first time in 15 years for us. At least for now, we definitely are being rewarded for being somewhat smaller in assets under management and being more nimble. Volatility is sometimes difficult to live through, but it definitely provides us some good opportunities.

Mark Goodwin:

That's helpful. Where are you seeing the best opportunities to put new capital to work right now?

Brian Allen:

Yes, specifically within the markets. In addition to mortgage agency securities, we found there's some spread widening in the asset-backed and agency CMO market. CMOs collectively are somewhat cheap to pass throughs. We're getting into smaller detail here, but the securities are more attractive, fill needs along the yield curve better than corporate or agency mortgage pass throughs do.

And switching back to the asset backed market, there again, we've seen some weakness in subprime borrowers, the lower rated tranches of issues, but all spreads have widened a bit in that sector and we've been through enough economic cycles from 2000, 2001 through the great financial recession and 2020 as well. We've battle-tested a number of these security types and the AAA securities have yet to lose a dollar of principal, so we find that we're being paid pretty well for owning AA- and AAA- rated securities on the very short end of the yield curve.

Mark Goodwin:

Brian, you and your team are active investment managers with a focus on bottom-up analysis. How are you currently positioning the portfolio of the North Square McKee Bond Fund, Ticker symbol NMKBX, given your thoughts on the broader fixed income market?

Brian Allen:

Looking at it in the bottom-up framework or point of view, the security as previously mentioned is where we find the most value, in addition to the individual security makeup and weightings within the portfolio. A bigger picture, we have vacillated somewhat between a neutral and somewhat steeper yield curve exposure expecting a steepening to occur. That element of our approach has yet to really yield any benefits, but the further we go and with the expectations about Fed funds, the number of Fed funds rate reductions coming this year, I think we'll eventually be rewarded for a return to normalcy.

It's been an extended period of time for the yield curve to be inverted, and if we're not to head into recession, we still think that the curve will at least approach, the flattening will continue, a less inversion will occur and a drop in inflation, though it's been somewhat delayed, will really turbocharge that point of view and we'll see, I think a flattening or an un-inversion of the curve, hence moving into a steepening later this year.

Mark Goodwin:

Do you have any key concerns or risks you're monitoring that could cause a significant shift in your market outlook and likewise, the way you position the portfolio?

Brian Allen:

We have some concern about the geopolitical elements to the market. Certainly the situation in Ukraine continues, not sure how things play out ultimately in the Middle East, if that conflict expands to any degree. Ongoing concerns about our relationship with China. Also, a number of major national elections in economically important larger countries this year. A greater degree of turnover potentially in leadership than we've seen in the past few years, or didn't want to say concerned, but certainly very cognizant of what's going on and the ripple effects or any trends that may emerge from a change in the nature of leadership across the developed markets and larger EM (emerging market) countries.

Mark Goodwin:

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

Brian Allen:

Yes, I think in this market in particular, it's a great time, first of all to have an active manager as opposed to a passive allocation. We can certainly take advantage of opportunities that you won't benefit from in a passive approach and for the first time now, and certainly if you go back to 2021, '22, the bond market was either not very attractive because yields were very low, or the transition from ultra-low rates to higher rates led to significant price losses in bonds of all types.

So we're now in 2023 and 2024, looking at the yield curve that's positive versus the rate of inflation across the board. We're almost, in many cases, we are back to historic levels of real yields that make bonds attractive. You couple that with an elevated level of prices in the stock market and especially narrow leadership, some concern about just how aggressive the Fed or how long they're going to stay at higher rates and what disappointment that may represent for the broader markets. Really the best diversification sort of, of all of these factors point to a bond fund that's, again, actively managed, focused on high quality and liquidity, and that I think provides the best source of diversification going forward.

Mark Goodwin:

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

Brian Allen:

My pleasure. Thank you.

Thank you for tuning into 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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Definitions of terms used in this podcast:

Basis points, otherwise known as "bps," are a unit of measure used in finance to describe the percentage change in the value or rate of a financial instrument. One basis point is equivalent to 0.01% (100 basis points = 1.0 percent).

A **CMO** is a collateralized mortgage obligation, and refers to a type of mortgage-backed security that contains a pool of mortgages pooled together and sold as an investment. Organized by maturity and level of risk, CMOs receive cash flows as borrowers repay the mortgages that act as collateral on these securities.

Duration is defined as the average maturity of all bond payments, where each payment is weighted by its value. In fixed income investing, duration is an essential tool for risk management, as it measures the sensitivity of an asset price to movements in yields.

The **yield curve** shows the interest rates that buyers of government debt require in order to be willing to lend their money over various periods of time — whether overnight, for one month, 10 years or even longer. An **inverted yield curve** is considered to be unusual; it reflects bond investors' expectations for a decline in longer-term interest rates, typically associated with recessions.

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