Update on the IA Clarington Strategic Funds

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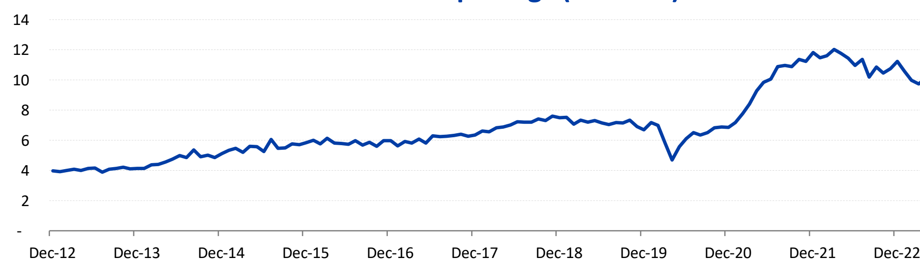
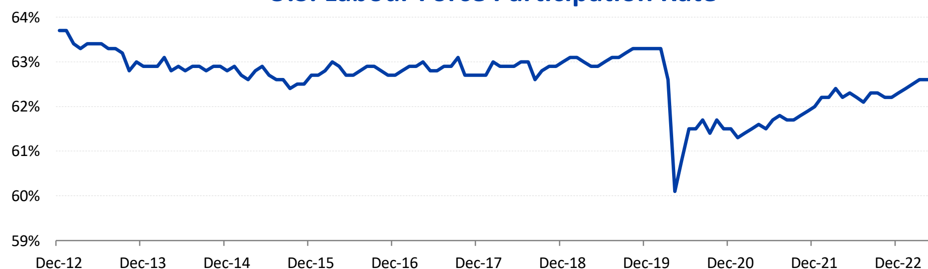
The following is a summary of a webcast held on June 21, 2023.

Do you think we're heading for a deep recession?

- There are two key reasons why I haven't been of the view that we're in for a hard recession:

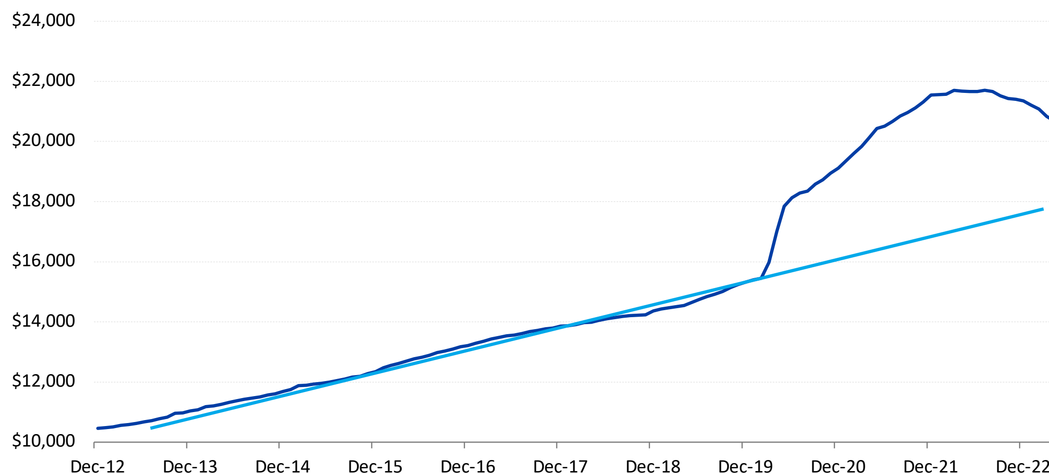
1. Historically, broad-based recessions require a spike in unemployment. I think we won't see that spike until job openings return to trend or participation rates increase close to pre-2020 levels.





Source: iA Clarington, Bloomberg, as at June 14, 2023.

2. The second reason relates to the money supply. Just a couple of years ago we were up to US$5 trillion in excess money supply, and while it's currently not as high, it's still more than $2 trillion above trend. The excess money supply in the system provides a buffer against an immediate economic shock.



Source: iA Clarington, Bloomberg, as at June 14, 2023.

- This should keep the fair value of the U.S. 10-year bond around 3.50% for the rest of the year and inflation at 3.50%.
- The macro backdrop is positive for "higher for longer" yields in credit and a continued focus on quality stocks with higher income and free cash flow.
- The two main risks for next year are the inverted yield curve (it's traditionally been a harbinger of recession), and a possible spike in unemployment claims. But because of the way we've allocated capital over the last number of months, I think we're well positioned to ride this out until conditions normalize.

What are your expectations for interest rates and inflation?

- Inflation is coming down on most of the variables I look at. The last holdouts contributing to excess inflation just started turning over – wages and shelter costs. But I do think it will be difficult to get down to 2% without a deeper recession. For the next year or so, I see us essentially muddling along when it comes to the overall level of inflation.

Given this backdrop, how are you allocating capital?

- Last year we had a very high cash allocation of approximately 20% on average and low duration in our credit portfolios.
- We're now at some of the lowest cash and highest fixed-income levels we've had in the last decade.
- We went from being defensive to cautiously offensive. Our portfolios are bifurcated:
  - About 25% is in quality, higher-yielding (~7%) companies with ~3-year terms on the credit side, along with investment grade bonds as a hedge in case things don't work out as planned.
  - The rest of the portfolio is in either:
    - Lower-duration stocks – companies like Carrier, which have exposure to our tactical call that a) the money supply will stay elevated, b) we won't get a deep recession, and c) the housing deficit in the U.S. will continue.
    - Companies like Northland Power (high-quality names with higher yields). We recently added Northland bonds at 9.5%. If the interest rate environment goes our way, there will be considerable potential for capital gains on this and similar holdings. But even if it doesn't, we'll be clipping a 9.5% coupon.

What are your thoughts on the view that GICs are a good alternative to deploying capital into an actively managed strategy like yours?

- You can get a 3-year GIC at 3.75% or 3.80%, but I can get approximately 4.0% on 3-month corporate paper. With the latter, you're getting roughly the same return, but much better liquidity and flexibility to capitalize on other opportunities as they arise.
- Locking money up in a GIC will work out well if we get meagre market returns over the next three-or-so years, but not so well if returns are up in the double digits.
  - On the equity side, we could see returns of 4–10% plus dividends, and about 9% on the quality high-yield side.

One of the big issues in the equity markets today is the lack of breadth. It's acute in the U.S., with just seven stocks driving the S&P 500's performance this year. It's also an issue in Canada. How do you see that playing out, and what opportunities is it creating?

- I think there will be a broadening out of the market this year, which should be a good thing for us as we have relatively low exposure to technology.
  - I acknowledge the appeal of a company like Shopify, but it trades at 160x price-to-earnings, which should raise eyebrows. Two years ago, I said I don't hold this name because I don't want to pay today for revenue that may or may not happen long into the future. My comment now is, why would I want to pay for revenue that may or may not appear for 5–6 years? The numbers are better now because the stock has gone down about 60% from recent highs, but you're still paying for about six years, and it's still a highly competitive environment for the company.
  - Alternatively, if you look at a company like Air Canada, it doesn't seem to fit perfectly with what we would normally buy (it doesn't have a ton of yield), but we've held the bonds for a very long time and we started buying the equity over a year ago. People have money to spend on travel, the company is in a near-monopoly position, debt capacity levels are going up and the outlook for oil is favourable from a cost standpoint. You're paying 7x earnings for the next 12 months when it should probably be about 10x. The only thing that would derail our thesis is if we did end up in a deep recession, which is not our base case.
- We've been shifting money to U.S. consumer housing-related stocks such as Carrier and The Home Depot, which we've owned for years but haven't had a large exposure to recently. There's a need for more housing inventory in the U.S. as well as a shift towards more efficient heating and cooling systems, so these names should benefit, in our view.
- We have more of a broad-based, high-income, safety-with-growth portfolio, which should position us well as the market broadens out.

Audience Q&A

The Federal Reserve (Fed) has indicated that more rate hikes are coming. How does this fit within your outlook?

- We see inflation at about 3.5% this year and around 2.6% to 2.7% next year. As mentioned, our analysis on inflation is suggesting that many of the key variables have turned over, with wages and shelter being the last two to come around.
- Once the Fed starts to see something close to 2.5%, they're likely not going to keep hiking rates.

With the onshoring of manufacturing and the impact that will have on the labour market, do you think inflation can still hit 2%?

- The U.S. has a productivity problem, which causes inflation to be biased higher, but I think artificial intelligence will improve productivity in the next 3–5 years. This should increase margins or at least keep them stable.
- I think the 2% target gets reached closer to 2025.

What are your thoughts on the Canadian banks?

- We just reviewed a balance-sheet-focused analysis on some of the Canadian banks with a view to the next 3–5 years. From this perspective, we still see value in names like TD Bank and RBC, and to a lesser extent Scotiabank. BMO and National Bank seem to be fully priced.

How do you adapt the portfolio to sector leadership changes?

- We generally don't change our sector exposure by adding or subtracting a bunch of names. We don't get whipsawed because we're not trying to guess what's in or out of favour – we buy individual companies strategically that should stay attractive for 2–4 years and then we tactically allocate more or less weight to them.

Do you think trade relations will improve with China or do you see that relationship going the other way?

- As much as business leaders want more access to the Chinese market, I think the political reality will offset what you may hear people say about positive relations going forward. This is very difficult to handicap at the moment.

What are the key indicators you look at when making macro calls?

- There are so many indicators I look at, but one thing that will always be a point of focus for me is the fact that money talks. If you have money or there is excess money in the system, you may curtail your spending, but you're likely not going to dramatically change your spending habits, so money supply is key.
- We also pay a lot of attention to employment, capital expenditures, monetary policy, and investment in infrastructure (which has long-term, permanent positive impacts on gross domestic product).

Visit iaclarington.com to learn more about Dan Bastasic and the IA Clarington Strategic Funds.

For definitions of technical terms in this piece, please visit iaclarington.com/glossary and speak with your investment advisor.

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