Finding the Asset Allocation Sweet Spot

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The following is a summary of a panel held on June 15, 2022.

We're now officially in a bear market – how did we get here?

Sébastien Mc Mahon:

- As we moved into this year we could see signs of economic overheating, and central banks pivoted to a policy of monetary tightening.
- With interest rates jumping at a rapid pace, bond portfolios have been negatively impacted.
- Earnings and sentiment have also been under pressure, weighing on equity markets.
- You can think of the current situation as being the aftereffect of the medicine given to the economic patient in 2020.

We have seen the inverse correlation between equities and bonds break down. Why did this happen?

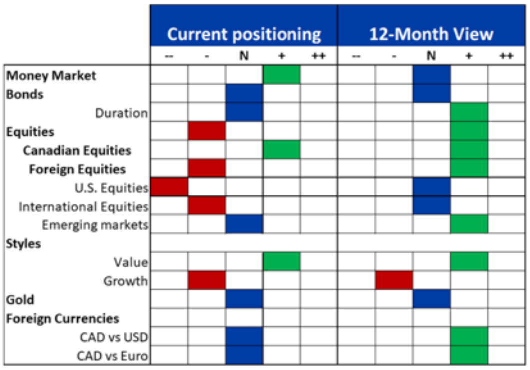
Tej Rai:

- The inverse correlation has been fairly constant for the last 20 years. This this is because the causes of weakness in the stock market – poor earnings, a health crisis, war, etc. – don't negatively affect the bond market in the same way.
- Inflation is the one phenomenon that can lead to a positive correlation between stocks and bonds. When this happens, investors can feel as though there is nowhere to hide.
- In the 1970s and 1980s inflation was similarly the driving force of financial markets.
- But inflation is just one of many macro factors investors must contend with. Our job as portfolio managers is to examine the historical evidence, learn from it, add in the current context – as no two situations are exactly the same – and figure out how best to position the portfolio for the present and future.

How are the portfolios positioned?

Sébastien Mc Mahon:

- We started taking profits off the table at the end of last year and have been moving more towards an underweight position within equities overall as the year has progressed.
- We began the year with a significant underweight to bonds and as we moved forward, we added to our position, reaching close to neutral. We expect to add more bond exposure as we reach a peak in yields.
- The volatility we've seen this year is a good backdrop for active managers.



Source: iA Investment Management, as at May 31, 2022.

How is the current rate hike cycle different from 2018 and what would it take for central banks to pause?

Sébastien Mc Mahon:

- The main difference is that inflation is now at 8%+ in the U.S.
- In 2018 the Federal Reserve was focused on getting inflation back to 2%, as back then it was running well below target.
- Later this afternoon will be the first time we see the Fed hiking rates during a bear market. We are expecting an increase of either 50 or 75 basis points.
- Another difference is that currently, monetary and fiscal policy are working together. This was something everyone was looking for in the 2010s and it didn't happen.
- The Fed is walking a very thin line in trying to keep inflation expectations anchored without pushing the economy into a recession. In our view, it will be very difficult to avoid a technical recession. But a recession is what would lead the Fed to stop increasing rates.

Is moving to cash a good idea right now?

Sébastien Mc Mahon:

- Going to cash would be based on the idea that you can time the market, and research shows it is simply not possible to accomplish this unless you get lucky.
- We take profits when we can, and currently we like the idea of rotating some capital from equities into fixed income.
- Keep in mind that negative years for a 60/40 portfolio are relatively rare – this year is an outlier historically.
- We believe the best course is to stay invested and take the opportunity to rebalance when it presents itself.
- Bonds are getting pretty cheap and we're seeing better prospects looking ahead, so that's where we're going to put some additional capital.

Can you elaborate on your outlook for fixed income over the next 6–12 months?

Sébastien Mc Mahon:

- Government bonds and duration are getting more interesting for us.
- The interest rate on the 10-year went from 1.5% to 3.5% in only a few months, which hurt bond investors. But now that monetary policy is approaching neutral and the economy is slowing down, bonds are starting to make a lot of sense.
- We think it's possible that from now until the end of the year bonds could post positive returns.

In a volatile environment, how important is the "machine" component of your "human + machine" approach?

Tej Rai

- We believe the human + machine approach can add value in any environment, but we think it's particularly valuable during periods of volatility.
- When volatility is high, everything moves more quickly and there is a lot more relevant information to digest. It can get overwhelming very quickly, so having the ability to process vast amounts of data almost instantaneously is a very powerful advantage. It allows us to cut through the noise and focus on key insights.
- For example, asset class correlations used to be calculated using low-frequency (daily) data. With our sophisticated quantitative capabilities, we're now able to incorporate real-time intra-day data, giving us a much richer and more nuanced picture of what is happening in the markets, which in turn makes it easier for us to make better decisions.

How has the iAIM team grown recently?

Tej Rai:

- Implementing a human + machine approach is a very complicated task. It requires tremendous resources and a very skilled and talented team.
- That's why we're focused on building a world-class team at iAIM. When I joined in late 2020, we already had an extremely strong foundation, but since then we've doubled the size of our team, adding talent from some of the highest-calibre asset managers in the world, including the Canada Pension Plan Investment Board (CPPIB) and AQR Capital Management.
- This influx of talent has enabled us to be laser focused on implementing the human + machine approach with the goal of enhancing existed products, such as the iA Wealth Managed Portfolios, and launching new products, such as the IA Clarington Global Risk-Managed Income Portfolio.
- We will continue to grow the team and invest in our capabilities.

What are you watching for in the Fed's messaging this afternoon?

Sébastien Mc Mahon:

- Apart from the question of whether they hike by 50 or 75 basis points, we'll be looking for comments on how far the Fed is from stopping its rate hikes and how worried they are about the economy.
- If you're a central banker right now, you have to make sure inflation expectations remain anchored, which means talking tough about bringing inflation down, even though a lot of the inflation we're seeing is due to supply shocks from food and gasoline prices – so a lot more to do with the war in Ukraine than excess demand (and there's nothing the central bank can do about that).

Is now the time to shift from short- to longer-duration bond exposure?

Sébastien Mc Mahon:

- The timing is good for a shift from short to longer duration, and it's a move we've started to make in our funds.
- At the beginning of the year we had a lot of credit risk (corporate bonds and floating rate securities); we've since scaled that down and gone more towards governments.
- As interest rates move higher, we'll look to add more duration.

Which iAIM mandates are particularly well suited to an inflationary environment?

Tej Rai:

- In general, we look to position all our funds to take advantage of the opportunities of the current environment.
- However, we do think the IA Clarington Global Risk-Managed Income Portfolio is especially well suited for the type of volatility we're experiencing today. The fund is focused first and foremost on downside protection and is positioned to provide consistent income potential to investors.

Visit iaclarington.com to learn more about the funds managed by Sébastien Mc Mahon and Tej Rai.

For definitions of technical terms, visit iaclarington.com/glossary or speak with your financial advisor.

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