Investing Across the Capital Structure

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

You've said that you think the next 10 years are likely to look a lot different than the last 20. Why do you think this and what will the key drivers of that difference be?

- Since the early 1990s, markets have been driven by falling rates, downward-trending inflation and longer economic cycles, producing a win-win scenario for 60/40 portfolios.
- Over the last year or two, things started to bottom:
  - o Interest rates were at 5,000-year lows
  - o Inflation was starting to bottom out and looked likely to trend towards a higher mean than what we've expected over the last 20 or 30 years
  - o We've had lower productivity in the last couple of decades
  - o Corporate margins have been lower in the last several months
- Deglobalization is another major trend; it generally causes inflation to stabilize or increase.
- The peace premium is likely gone for the next several years.
- All of these factors suggest that going forward, things are going to look similar to the 1950s, 1960s, 1970s and 1980s, which means you'll see valuations drop.
- You can combat this new normal by doing what we've been doing for the last several years, which means focusing on:
  - o High-quality, high-dividend-paying, low-duration stocks
  - o Low-duration credit
  - o Positive real yields

Has the economic data we've seen over the last week changed what you're doing with your portfolios?

- It hasn't really changed anything. A couple of months ago I thought inflation would peak this summer, and that next year inflation would be around 3.5%.
- The last inflation print was a bit of a shock, and if you look at where it missed, it was all in energy and food – the two things that will cause demand destruction and the next recession, in my view.
- Assuming oil doesn't go to $150 or $160, I still think we're on track for our call of ~3.5% inflation for next year.
- The Producer Price Index figure released a couple of days ago came in under expectations. What I'm hearing from companies is that they're not able to push prices up to cover cost increases, which aligns with the fact that margins have been down.
- If inflation comes down to 3.5%, it has still doubled from what we've been used to.
  - This means you need to invest differently than you did in years past, and that real returns should be an important part of the equation going forward.

The Federal Reserve has come to the rescue of markets for a long time, but many think that now seems to be off the table. Do you agree with that view?

- I don't think the Fed put is off the table; I think the lower bound on it is a lot lower than we've been used to.
  - I think 3,400 on the S&P 500 is probably the new level for a Fed put.
- From a credit perspective, spreads on high yield have to go another 150 basis points from here to push the Fed into put mode.
- We have to remember the Fed can only do one thing in this environment: raise rates and destroy demand. A lower stock market aids in demand destruction because the stock market is the main source of wealth for most people.
- When employment numbers peak and start to turn the other way, you're going to end up getting discussions of a deep recession, and when that happens, the put comes into play.

Where are the opportunities in high yield?

- With a 12- to 24-month view, I would say the outlook is really good.
- There could be a bit more volatility in the near term, depending on what the Fed does and what inflation looks like in the next couple of months.
- You have to price in a bit of a recession on the high-yield side, and yet the fundamentals of high yield are not suggesting the returns/yield you're getting in that space right now.
- If inflation is at ~3.5% next year, you will either break even or lose money in a GIC or 5-year government bond. With high yield currently at 8.6%, you're looking at about a 5% real yield.
- High yield is much higher quality than it was 20 years ago and has low interest rate sensitivity. Default levels look good right now and balance sheets are very good going into any type of an economic slowdown.
- I don't think we're going to get a traditional multi-quarter negative GDP recession. If we get a recession, which I think is likely, it's going to be more of a small real-GDP recession but a positive nominal inflation-adjusted recession, which is not what we've seen in the last 40 years. This would be positive for high yield.

On the equity side, you've talked about allocating away from Canada and energy towards the latter part of this year and pivoting towards the U.S. and technology. Why is this your strategy?

- Stocks will likely bottom out at the end of the year, and growth is probably going to be a lot slower than was expected over the last six months.
- We had a lot of global and U.S. exposure over the last 10 years, then we went below our normal exposure in the last two years because of the factors that have made Canada attractive (e.g. low valuations relative to the U.S.).
  - o Canada will still be a good place to invest, but it's not going to be as good as it has been.
  - o Valuations are a little tighter than they were two years ago, and if you get demand destruction, then metals, gold and energy will suffer. We don't have a lot of weight in those spaces so we won't be that impacted, but we will likely be shifting into some of the high-quality, high-dividend-paying stocks in Canada, the U.S. and globally to take advantage of the environment we're expecting – ~3.5% inflation and interest rates at ~3.5% (maybe 4%) on the 10-year.

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