Fidelity Connects

Will Divergence Between Canadian and U.S. Rates Persist?

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Pamela Ritchie: Hello and welcome to Fidelity Compass. I'm Pamela Ritchie. The Bank of Canada has trimmed its key policy rate by 25 basis points to 4.25%. This is the third consecutive rate cut by the Bank of Canada, which is now ahead of the Fed, leaving investors to wonder if the divergence between Canadian and U.S. rates will persist on.

While shelter costs continue to play a major role in pushing up inflation interest rate cuts are feeding into lower mortgage interest costs. Are markets willing to look through the housing issue in Canada, and how is the macro picture impacting our next guest's core plus strategy?

Joining us today to discuss all of this and more, including their yield curve expectations all through a fixed income lens, are Fidelity Portfolio Managers Sri Tella and Lee Ormiston. Great to see you both. Welcome. How are you?

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Lee Ormiston: Good, thanks. Good to see you too.

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Pamela Ritchie: Great to see you and we'll invite everyone to send their questions in for Lee and for Sri as we go through this conversation. We can put those to them as we go along. If you don't mind, Sri, I'll begin with you. We all know what the numbers are and the decision was and so on. It's quite interesting to see some of the data that's come in over the last, even just last week really, and then have a central bank governor actually comment on it. I'm kind of curious what you feel that's done maybe to the mood music in a way.

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Sri Tella: The data has been slowing over the last little while; inflation has been coming down. The Bank of Canada was one of the first to sort of acknowledge that and started cutting rates this summer. I think the market started to price in a pretty aggressive rate of cuts but I think with the commentary yesterday, really the Bank of Canada started to validate some of that market pricing, sort of acknowledge the slowing in the data and sort of managing that and sort of conveying that the upside and downside risks are much more balanced now. Given that we've seen that softness, I think the real big thing yesterday was the Bank of Canada validating market prices and indicating that they're on this continuous path towards moving rates lower over time.

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Pamela Ritchie: Lee, pick up on that for us. This is discussion of the pace, ultimately. Actually, it's a question you just said off-air you don't really like when it gets put to the bank governor but why not do it all now if it's getting kind of priced in, anyway? That's sort of the perpetual question. Sorry, got to put it to you.

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Lee Ormiston: Why not do it all now? We haven't seen what inflation and unemployment do, so they need to watch and see as that evolves. That was sort of his question yesterday when he was asked did they discuss doing 50? He didn't answer it. They said that they're committed to 25 for now and that if things decelerate even more then they could do more.

Right now, we've got the market pricing a little more than one cut every meeting for the next few meetings. Over the next 12 months, we see about six cuts priced in the market for the Bank. For the Fed the market actually has nine cuts priced in over the next 12 months. So pretty aggressive cutting cycle here.

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Pamela Ritchie: Sri, what if, for instance, so this is priced in, we're just asking the question why not do it ... pull it forward if we kind of know that's where we're going. What sort of effect do the cuts have potentially, or not have, as we go along if they're all priced in?

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Sri Tella: The pricing of a number of cuts down the road are definitely going to have an impact. For example, if you look at where 5-year rates are in Canada, which influences mortgage rates, they're already pricing in a pretty aggressive path of cuts but we still do need to see the Bank of Canada validate those cuts in order to keep the valuations there. We will start to see an impact, even starting to be felt now. That's part of the reason why the Bank of Canada isn't necessarily going to do it all at once because they really need to see what the impacts of the cuts to date will have over the next little while.

Monetary policy operates with a lag and given that the Bank of Canada was the first country to start cutting rates, first G7 country, and has been the most aggressive so far, they really need to take the time to do that at a measured pace and see how these cuts have an impact. Because the risks are balanced between upside and downside, they want to be careful that they don't overshoot in the other direction as well.

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Pamela Ritchie: I feel like the word you're not saying is inflation could come back. Is that correct? Is that a risk?

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Sri Tella: I would say it is a risk but not as much as it used to be. We talked at the outset before this about if I had to pick between inflation and a recession, what was probably a higher risk? I would say that we probably tilted towards recession at this point. I'm not suggesting that we're headed towards one but if you had to pick between the two, recession maybe has become a bit more of a risk because of employment data starting to soften, both in Canada and the U.S., and employment tends to be a bit of a lagging indicator. That's one aspect of it.

There are still inflation risks that the Bank of Canada has to be careful of. For example, wage growth while it's come off its peak is still relatively high and it's focused around, more recently it's been related to high paying service jobs. But there's been a lot of union wage negotiation settlements over the last number of months that still need to filter through. So, wage growth probably isn't going to come down as quickly as the Bank of Canada would like. So, there are still some risks. Of course, shelter, the supply-demand of housing in Canada leads to a dynamic that keeps prices elevated even as things are weakening. That's something else that the Bank of Canada has to be mindful of.

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Pamela Ritchie: Lee, can you pick up on that? This is sort of the filtering through discussion of whether these cuts can come in roughly in the right amount of time for when some of the mortgage payments need to get reset. There's sort of a bolus of them coming through in '25, '26. I guess it's sort of a heading it off at the pass situation, delicate balance because of all the other pieces of the economy that are in there. Just talk about the filtering through elements that we're sort of sitting with right now.

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Lee Ormiston: The rate reset in 2025 that we're going to see that everyone is talking about, that is a big deal. That is part of the impetus for the Bank to get going now and get going sooner than later. We've seen anecdotes of people rolling mortgages much shorter in anticipation of lower rates later. That reset wall has only grown. We do think, though ... Sri pointed out that the 5-year rate probably won't change much if the path of rate cuts that the market has priced is realized, just probably still have 3% 5-year rate six months, nine months from now if the path of rate cuts if the forwards are realized. That will help people at the margin if you've got a shorter maturity reset, you know, right now the market is pricing like a two-and-three-quarter policy rate a year from now so that will help.

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Pamela Ritchie: That will help. That's potentially a long way off. Do you think, Sri, that the markets are willing to look through? It seems like actually they're starting to look through, because it's so well telegraphed, the housing element of what's going on in the Canadian economy. It does feel like we're looking a little further out past it, even Bank commentary and so on. What do you think?

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Sri Tella: I think broadly, yes, rates are coming down. The maturity wall from a bank perspective, the banks have always kind of indicated that from their perspective, yes, there is a concern, but they've been doing a lot to manage people that are at risk. They've been proactively trying to get people to refinance. Also, from a bank's earnings standpoint it's not as much of a concern because they are well diversified, and the reset sort of portion is only a small portion of their overall mortgage book. And generally performance of mortgages has been pretty strong even though delinquencies probably ticked up over the last little while.

I do think that there are still concerns but given that the Bank of Canada has signaled that rates are coming down, I think that that's alleviated some of that concern. If you think about resets over the next two years, they don't happen all at once or at the beginning of the year. They happen over the course of the next two years. And so, if rates eventually kind of, if the Bank of Canada validates forward pricing and continues to cut rates into the middle of next year you're going to be at much more manageable levels for a lot of these resets.

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Pamela Ritchie: Lee, pick up on sort of the U.S. story. We are linked to it in every possible way in our economy. The housing situation is obviously different but ultimately there's a big jobs number coming out tomorrow that we can't really ignore. It's going to be, we think, fundamental to how we see things unfold in terms of Fed policy. Just take us there and sort of the divergent story.

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Lee Ormiston: A couple things on that. The first thing I would note is that Powell has emphasized employment or unemployment more recently and they're really watching that. They had been concerned about some sort of a price wage spiral with strong jobs market. Now they've turned to that; they're focused on it. There's a lot of discussion about the Sahm Rule, that's been triggered and does that precipitate a recession? Tomorrow's number, does it validate the payroll number we saw a month ago? Does it show that hiring is slowing quite a bit in the U.S.? Around 150 is the number for steady stay and if we come in below that again then you've got some weakness in the U.S. To Sri's point, housing isn't a problem in Canada until people start losing jobs. That's really the focus.

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Pamela Ritchie: Therefore sort of the labour story. Let's take this to the core strategy that you're managing. Ultimately this is sort of the broader dashboard of what's going on. Take us to how you're investing it, ultimately. We'll swing back, there's more to say, but Sri, broadly speaking, this is where we are. This is the sort of set of risks you're dealing with, flows into bonds at this point. How are you managing that?

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Sri Tella: There's a bit of a delicate balance between what's priced in as well as what fixed income offers. While there's a fairly aggressive path of rate cuts priced in and they need to be validated by central bank action, at the same time fixed income has become a much more attractive asset class and so we're seeing a lot of money going into fixed income which is keeping rates probably a little bit, maybe even lower than they might be and there's an increasing demand for corporate bonds.

From our standpoint, we continue to be optimistic about the outlook for fixed income. At a minimum, you've got a yield that you're earning on a portfolio and from a duration standpoint, while we don't generally deviate too much from the overall benchmark duration, we're probably operating much more neutral given that there is still good demand for fixed income and a case for fixed income.

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Again, as I said, if you had to pick between inflation and a recession, we're probably thinking more about recession risk. That would warrant wanting to have exposure to duration but at the same time given that we're pricing in a pretty full rate-cut path, that has us leaning on the cautious side. That kind of leads us to neutral positioning. When we think about credit product, we still like credit because of the demand and the yield but where exposures are a little more focused and we're a little bit more defensive where we are taking that risk because of where valuations are.

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Pamela Ritchie: Because of where valuations are, because of what's priced in. Lee, I might just ask you to extend that a little bit on the duration piece because it goes to sort of the balance of risk of like some version of inflation. You had mentioned there are some economic data, CPI and so on, that may come back to show not the exact picture we're looking at right now. Talk about duration a bit further.

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Lee Ormiston: As Sri said, we wanted to be neutral duration slightly long in the last little while. Part of that is from some of those seasonality that we're seeing. We've got some internal research that suggests that the seasonally adjusted CPI in the U.S. has been biased down in the second half of the year and then biased up the first half of the year. That's what we saw a year ago, the head-fake that we saw in Q4 on the inflation data. There's the likelihood and there's the possibility that we will see, seasonally adjusted CPI prints in the U.S. coming in lower than they otherwise should be just because of that residual seasonality. That is a factor over the next few months to keep an eye on.

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Pamela Ritchie: Sri, is there any concern about sort of just the debt story in the U.S. and Canada? We have different reasons for sort of looking at it. If you look at some of the commentary to debt markets in the United States, what it takes to essentially fund deficits it doesn't really look like any of that is going to change at this point. Can you comment on that and any real concerns about that, or are they just not real concerns?

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Sri Tella: I think you always have to be mindful of the fact that when governments are spending extra amounts of money and increasing borrowing. I would say that Canada generally, while it did increase its deficit and debt levels significantly during the pandemic and it's still in a much better shape than, let's say, some of the other countries and the U.S. I think in Canada there is a shortage of term debt in the market and so there is a technical demand for it. I think we do need to be concerned about deficits increasing but at the same time there is demand within the Canadian domestic market for some of that increased issuance.

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I think where it becomes more of a concern is on the U.S. side where there's the potential for increased borrowing to keep rates more elevated out the curve. That's something to be mindful of. When we look at election outlooks in the U.S. and now, I guess, after the recent news potentially in Canada at some point sooner than expected, that is something to be mindful of and to watch for that. I think broadly I don't think we see any of that changing or having a big impact in sort of the near term.

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Pamela Ritchie: Are you going to ask for higher yield? Is an investor going to ask for higher yield because of it, I guess is sort of what the material question is there.

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Lee Ormiston: That's for sure. Term premium.

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Pamela Ritchie: The term premium, it stands ultimately to go up. Lee, take us a little bit into sort of the external view of Canada. If you're an investor sitting in another country, lots of money, how do we stack up? Let's go there.

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Lee Ormiston: Sri talked about the deficit. Debt-to-GDP is growing in Canada but not like it is in the rest of world, so we look pretty good that way. Growth is in or slightly below trend growth so that's helpful. Not as strong as U.S. External view is Canada looks pretty darn good. I would say that foreign investors have been interested in purchasing Canadian debt.

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Pamela Ritchie: Sri, anything to add there?

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Sri Tella: I would just echo what Lee said that generally Canada looks at on a global scale. Its economic numbers are pretty good. It's had strong population growth which has supported the economy. It also has been seen as kind of a safer haven to put money in more generally. I think that's been good.

The other thing is now even from a currency perspective, we're by no means currency experts but given that the Bank of Canada has kind of led initially, now that we're starting to see kind of the U.S. catch up in terms of cutting rates and that's potentially a positive for investing in Canada and the Canadian dollar to some extent because we could see sort of that divergent policy start to collapse as the Fed gets more aggressive.

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Pamela Ritchie: Really interesting. That's the divergence story. Let's talk about within the asset classes. You mentioned a bit about corporate. What about the provinces? Lee, we'll start there. It's still been an attractive place?

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Lee Ormiston: Long provincial credit still looks very attractive. We like it. We think that the spread on long provincial debt is very attractive especially when you compare it to a 30-year utility or higher quality corporate debt. The spreads are compressed on corporate debt versus provincials, so we would prefer to be in provincials out the curve. In and amongst the provinces, they have done a fantastic job of funding themself this year. If you think back, what is it, six months ago we were coming out with provincial budgets that were much higher than expected but they've all done a really good job getting themselves funded. On the whole, the provinces ... we're about halfway through the fiscal year, provinces are about 75% funded so they've done a great job getting themselves funded and so there's probably less issuance out of the provinces in the near term and that's going to help spreads there.

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Pamela Ritchie: Sri, I'm just picking up on there was a lot of issuance actually in other currencies at one point for the province. Is that still the case?

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Sri Tella: I would have said that through the summer it slowed down a bit but then over the last couple of weeks it did pick up again. We did see a few U.S. deals that printed and definitely the provinces have been active funders internationally. That's helped a lot with domestic spreads and demand. Just to take it one step further, we're also seeing that from the Canadian banks as well. They've been very active in the U.S. market. That's been supportive of the domestic market in Canadian bank spreads as well.

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Pamela Ritchie: We tend to hear from the banks lots of headlines and actually the earnings had some divergences from a fixed income perspective. Are there any rattles or changes or differentials between the Canadian banks or does it all look pretty solid from that side? Is it more of an equity story?

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Lee Ormiston: Sri, I don't know if you want to take it. [crosstalk]

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Pamela Ritchie: Nobody wants to answer that.

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Lee Ormiston: The banks are very solid credits. They're not utilities but they are regulated. What we're seeing out of them from a fixed income perspective is they're in a solid place. Yes, there's been some earnings noise, more of it has to do with one-time events than what they're doing in their core businesses. We do still have an overweight to financials, most specifically the big six or seven banks are the ones we would favour right now.

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Pamela Ritchie: Let's go into some of the other sectors. Sri, can you pick up on some of the other sectors that you're interested in right now?

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Sri Tella: When you look across sectors we're not as exposed or don't have as large exposures to specific sectors that we might have had in the past. Part of that has to do with just general compression of spreads and so we're much more focused on individual names and stories as opposed to sectors overall.

If I had to pick sectors, real estate selectively, the REITs is an area where we still like certain parts of the REIT market and certain credits within the REIT market because real estate had gotten out of favour. It has definitely bounced back when you think about commercial real estate. There are sectors like larger REITs that are focused on grocery-anchored, strip-centre malls. There's also some defensive like in terms of industrial. While industrial has probably not been as strong as it was a couple of years ago it's still a very defensive sector to be in. Spreads are fairly attractive just given sort of that real estate has a bad outlook broadly. That really stems more from things like office real estate, etc.

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We're looking for sectors where companies have de-levered or have stable cash flows. The energy sector, while there's not a lot of producers that issue in Canada, that's an area where leverage has come down considerably. There's a lot of low-cost producers even despite oil softening up over the last little while. They're still poised to do very well. Really, we're focusing more on individual names within different sectors that either have deleveraging stories or are solid companies with stable cash flows.

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Pamela Ritchie: Anything to add to that, Lee? Otherwise I was going to kind of head back to the macro piece.

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Lee Ormiston: I would hammer home the idiosyncratic stuff. We're obviously using our fundamental research analysts to dig into companies and look at valuation. You might have a sector that's beaten up but it might have a company within that sector, an issuer whose cash flows over the next three to five years look pretty darn solid. Our analysts are going to let us get into those idiosyncratic bets just because we have confidence that they're going to be able to pay us over the next few years just looking at cash flow. So, bottoms-up in analysis is really what's helping us right now.

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Pamela Ritchie: What would the Bank of Canada have to do, Sri, to really bungle things ultimately?

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Sri Tella: It's a good question. I think that they've done a really good job of communicating what their sort of outlook is and what they're planning to do. I think that unless there is some kind of shock to economic data, sort of getting pressured into with the market pricing in 50 and being more aggressive on cuts before they really need to be could be a risk. There is a lot of talk about 50. They're getting asked a lot of questions. If they see you kind of get spooked and kind of jump the gun ... I think that it's not so much that cutting 50 would be detrimental to what they're ultimately trying to do. I think it's really more about the signal it sends to the market.

Unless there's some new shock or a real downturn in data, it really sends a signal of panic, I think, to some extent, or it could. I think that's really the risk. I don't think there's a risk on the other side because they've generally committed to cutting rates. Inflation is definitely much more under control and we are seeing things slow down. I think that's really the risk, is that they maybe get pushed into being too aggressive.

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Pamela Ritchie: Lee, just some final thoughts for investors to take away at this point. What do you want to sort of leave with people? What is this moment?

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Lee Ormiston: We're still a fan of bonds even though we've rallied quite a bit. We think that it has a great place in a diversified portfolio. We have rallied a lot but the risks are somewhat two-sided now so this would allow a good amount of ballast in a diversified portfolio.

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Pamela Ritchie: Fantastic. Sri and Lee, I just want to thank you for your time. It's great to see you both and we'll see you again soon. All the best.

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Lee Ormiston: Thank you.

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Sri Tella: Thank you.

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Pamela Ritchie: I want to thank all of you for joining us on Fidelity Compass. If you've got suggestions or future topics or guests that you'd like to see on the show do go ahead and share those ideas with us. More Fidelity Compass webcasts are in store in the weeks ahead.

Thanks for joining us. I'm Pamela Ritchie.

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