

A Strategic Approach to Investing Across the Capital Structure

Dan Bastasic

Senior Vice-President, Investments & Portfolio Manager
iA Investment Management

Moderator:

Adam Elliott

President & CEO
iA Clarington Investments

The following is a summary of a webcast held on June 6, 2022.

Macro overview

- The money supply is the key driver of financial markets, and inflation has historically been a monetary issue.
- We seem to be following the 1970s playbook, but in a more muted way.
- The money supply that's been injected into the system has been roughly equal to GDP – something we haven't seen since the 1970s.
- I don't think we'll see a repeat of the 1970s, but I do think that what we get for the next couple of years will rhyme with what happened back then.
- In the 1970s wages were increasing, which we're also seeing today. There was also little in the way of globalization at that time, and today we're seeing a process of deglobalization. And in the 1970s, unions were quite powerful before seeing some of that influence get rolled back starting in the 1980s, which I think is reversing somewhat today.
- I think the higher rates of inflation we're seeing will probably last for about three years or so from the money supply peak.
 - This is similar to what happened in the 1970s, when inflation peaked about three years after the money supply peaked.
 - We're currently about 1.5 years in from the money supply peak.
- I think next year inflation will come down to about 3.5%, then we'll see some volatility before it stabilizes towards the end of the year or into 2024.
- Importantly, if this happens it doesn't mean you can go back to the investment strategy that may have worked for you in recent years. A ~3.5% rate of inflation is not the ~8% we're seeing today, but it's also not the ~1.8% we were used to in recent years. This has all kinds of implications for Federal Reserve interest rate policy and investment returns, making a strategy that worked five years ago very risky going forward.
- Historically the 10-year bond yield has been about equal to nominal GDP, so if you think next year's nominal GDP will come in around 5.5%, the 10-year should be around 4–4.5%, kept down about 100 basis points as a result of quantitative easing.

- All the things that kept valuations at around 16x earnings from the 1950s up to the 1990s are starting to come back.
 - Deglobalization will put upward pressure on prices, as will rising wages.
 - The peace premium is gone.
- We believe this is not an environment where you want to be chasing future earnings – Shopify, for example. We prefer to focus on dividends, high-quality companies, sustainable growth rates, impeccable balance sheets, and yields within corporate credit that after inflation will give you anything from a breakeven up to a 3–4% return.
- Having a holistic, flexible and risk-conscious approach to investing is critical, especially in this type of environment. We've always invested this way because we know it can adapt to virtually any type of environment. Unique to our approach is our ability to invest across the capital structure – wherever we see the best opportunities for our clients' money.
- Also very important is that all of my investible assets are invested in the funds I manage alongside my clients' money.

Q&A

What are your thoughts on the correction we've seen in the technology space?

- For the past couple of decades, technology companies benefited from muted growth (~2% on a real basis if we were lucky) and declining interest rates.
- While I don't expect a decade of brutal technology returns, you shouldn't abandon a fundamental approach to investing when looking at these companies, which means paying attention to cash flows, earnings, competitive/product moats, secular tailwinds, etc. You don't want to be paying today for something that might happen in 10 years.
- My view is that technology's day in the sun could be sometime next year.
- What I think will happen – and we're preparing ourselves for this – is that bonds probably bottom between now and September (give or take a month), equities probably bottom after that (sometime between September and late-October/November, but maybe even early December), the Fed slows down and inflation next year is somewhere around 3.5%. This could produce a bit of a relief rally next year, with money flowing back into higher-growth names. You could see a ~12-month tactical trade into technology.
- We shifted a lot of our capital from the U.S. into Canada a few years ago, and now we're starting to think about shifting out of Canada a little bit and getting back into the U.S. market at some point next year. The environment I've described is not so great for metal price expansion and commodity price expansion, and therefore for metals/commodity securities, which Canada has a lot of.

You have a fairly high weighting in Canadian equities and fixed income. Is this a concern at this point?

- Not right now, as valuations in the Canadian market are still at historical lows relative to the U.S. (not as great as they were 2–3 years ago but still pretty low).
- There's still an inflation threat so Canada is a logical place to park your money because of the inflation hedge you get from commodities.
- I'm not that worried near-term (~1–2 years), as I still think there are reasons to be invested in Canada, but there could be some market turbulence here in the next six months.

What moving goal post concerns you the most?

- The biggest near-term risks:
 - Clearly the Fed is committed to 2% inflation; as noted, I think inflation goes to ~3.5% in early 2023 based on changes I'm currently seeing.

- o The Fed will be aggressive for longer than the market thinks, in my view. We saw -1.5% GDP in Q1 and we are on trend for < 2% in Q2. This could put us into a recession by the end of the year. Valuations aren't pricing this scenario in, and many companies are not pricing this in given their business models are less defensive. Defensive exposure in the IA Clarington Strategic Funds is > 30%.
- Biggest long-term risk:
 - o Housing and housing in China. Cap rates in China are very low relative to the rest of the world, where housing is relatively expensive to begin with. Interest rate increases could cause a pretty serious wealth effect next year in China as well as globally.
 - I've been calling for a "short-term" market rally for a few weeks now (it seems like it started a couple of weeks ago). The clearer it becomes that inflation has peaked the more likely it is that we get relief rallies that will fade towards August/September (a couple of near-term goal posts in terms of price movement). If this works out and the Fed doesn't stay overly aggressive going through the fall, we should see a cyclical recovery in stocks and high-yield bonds in 2023.

Visit iaclarington.com/10years to learn more about Dan Bastasic and the IA Clarington Strategic Funds.

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

The information provided herein does not constitute financial, tax or legal advice. Always consult with a qualified advisor prior to making any investment decision. Statements by the portfolio manager or sub-advisor responsible for the management of the fund's investment portfolio, as specified in the applicable fund's prospectus ("portfolio manager") represent their professional opinion, do not necessarily reflect the views of iA Clarington, and should not be relied upon for any other purpose. Information presented should not be considered a recommendation to buy or sell a particular security. Specific securities discussed are for illustrative purposes only. Mutual funds may purchase and sell securities at any time and securities held by a fund may increase or decrease in value. Past investment performance of a security may not be repeated. Unless otherwise stated, the source for information provided is the portfolio manager. Statements that pertain to the future represent the portfolio manager's current view regarding future events. Actual future events may differ. iA Clarington does not undertake any obligation to update the information provided herein. The information presented herein may not encompass all risks associated with mutual funds. Please read the prospectus for a more detailed discussion on specific risks of investing in mutual funds.

Commissions, trailing commissions, management fees, brokerage fees and expenses all may be associated with mutual fund investments, including investments in exchange-traded series of mutual funds. Please read the prospectus before investing. Mutual funds are not guaranteed, their values change frequently and past performance may not be repeated. Trademarks displayed herein that are not owned by Industrial Alliance Insurance and Financial Services Inc. are the property of and trademarked by the corresponding company and are used for illustrative purposes only.

The iA Clarington Funds are managed by IA Clarington Investments Inc. iA Clarington and the iA Clarington logo, and iA Wealth and the iA Wealth logo, are trademarks of Industrial Alliance Insurance and Financial Services Inc. and are used under license.

iaclarington.com