Mark Noble :
Hello, I'm Mark Noble, Executive Vice-President of ETF strategy at Horizons ETFs, and welcome to the latest episode of Generation ETFs, our ongoing podcast. Against the backdrop of strong equity returns and incredible levels of fiscal and monetary stimulus in the wake of the COVID-19 pandemic, it has been an exceedingly challenging year for fixed income investors even if they have mainly avoided catastrophe by being invested in bonds and other fixed income instruments over the last two years. The challenge many investors face is this. Many investors need income, particularly the large cohort of investors in are nearing their de-accumulation years. This would be the baby boomers and those entering their key retirement years. The problem is, yields are extremely low. This means that investors are not getting compensated for the risks they take on in fixed income investing the way they did even as little as a decade ago. The rules and risk of fixed income investing has changed.

Mark Noble :
For example, non-investment grade yields are in many cases lower than what investment grade yields were a decade ago, which means that the risk to generate an income in the traditional target range of three to 5% that most retail investors are targeting, is exceedingly difficult without taking on additional risks. Those risks can be quite high as well as the world is still to reconcile the long-term effects of the pandemic and the monetary tools we've used to combat its economic consequences. Here to help us understand this global macro-economic environment and how income investors can best navigate it is Barry Allen, the founder and CEO of DMAT Capital, which is the sub-advisor for three of our actively managed fixed income ETFs. Barry has had a long and storied career that spans more than 35 years managing global fixed income portfolios and we really thought it would be great today to have him come on and help provide some perspective on what he thinks investors can expect in the coming months and where he is finding opportunity in this challenging environment.

Mark Noble :
Barry, thanks as always for being with us today.

Barry Allen:
Great to be here, Mark.

Mark Noble :
I think where we'd like to focus initially today is just on this idea of inflation that we keep reading, if you read Bloomberg or you follow CNBC, they're always talking about transitory inflation and then you'll have a number of market commentators who come on and say, "No, this is actually a head fake from supply chain issues and accommodated fiscal policy." I think a lot of other people come on and say, "No, we're entering into 1970's, early '80's style inflation. Where do you fall on this spectrum of debate and what's your understanding of where we might be able to expect interest rates and inflation really pan out over the next year or so?

Barry Allen:
Well, I think the discussion around whether inflation is transitory now it is more of a creation of the media. I really strongly believe that that's not the correct question. I'm definitely in the inflation is transitory camp, but as I said, the really important question is how long is that transitory period going to last? And are we going to have a period of stagflation? But if you go back, you have to realize that after the great financial crisis in '08 we did all the monetary and fiscal stimulus and everything and we had an almost 13, 14 year period where you couldn't get inflation to 2%. And all of a sudden, inflation is now about 5%, but we measure inflation versus prices last year and last year was the global pandemic and in second quarter of last year, we had prices fall the most in any quarter in history since the 1930s.

Barry Allen:
So you have to put it in perspective. I strongly believe that the comparisons in growth and inflation peaked at June 30th, 2021, because that's one year after Q2 2020 whereas our economies were locked down. And now the debate is about how long is it going to take to normalize this process? And I do believe that we could have a period of stagflation here. I don't think it's going to be a multi-year situation, but I've spent enormous amount of time over the last 15 years analyzing inflation trends and so on because of what happened after '08 and I'm of the conclusion that we're still in a deflationary environment which we're just in a blip because of the pandemic. I think that debt demographics and technology are the primary forces driving inflation down and COVID has made all three of them, much, much stronger. The amount of debt we've piled on... We've added 50% to the world's debt stock in the last year and we, to put that in perspective, we doubled the world's debt stock from '08 to 2019 and then we took 2 or 300 years to get to 2008 to build up that debt. We doubled it in 10 years, and then we added 50 or 60%. So that's not a very attractive thing, but inflation is, as I said, I think it's transitory. The inflation we're seeing now is not because inflation is rising dramatically. It's because it's being compared to prices that fell dramatically in 2020 and so far it's been supply driven. It has been demand driven. I think in hindsight, COVID will have proven to be very deflationary in the long-term. One of the big questions that I ask and I can't get an answer to, everybody talks about supply chain interruption and especially chips. And my question is, if we're producing the same amount of chips today as we were in 2019, why is there a global shortage of chips? And I think the answer to that is that COVID brought the next 10 years of technological developments forward because we were forced to do that. Everybody is automating and the politicians who think they're doing a tremendously good thing for the world by raising minimum wages and causing labor shortages to drive unskilled labor wages up, two, three years down the road we're going to find out that if you're an unskilled laborer you're not going to have a job because it's all been automated and the trigger for that was COVID.

Mark Noble :
And we've seen that with the... Back to your deflationary thesis. I mean, we've seen that with the wages and employment, right? You have low unemployment and unfilled jobs and primarily it's because they think because the wages aren't high enough, but it doesn't mean that the wages are actually increasing to your point. What you likely have is constant emptiness or replacement by automation for those levels of employment.

Mark Noble :
And we saw something similar between 2011 and 2015 as well, where we had a little bit of an inflationary spike in 2013 when there was a taper in August 2013, but then very quickly back to 2015, two years later, no economic growth, we're back into a deflationary cycle, so I think there's a lot of credence to what you're saying there.

Barry Allen:
Yeah. And I really think that there... As time plays out, we're going to find out that COVID was actually very deflationary not inflationary. But obviously there's this, the way we measure inflation is prices today versus prices [inaudible]. And prices are much higher, but the peak in inflation and growth I think has passed us, and the real debate is how quickly or slowly is growth and inflation going to decline over the next couple of years?

Mark Noble :
Well, this is a really nice segue to the next question I have because on the Horizons Tactical Absolute Return Bond ETF, which you're sub-advising for, which is ticker symbols HARB, right now that ETF has quite a long duration. It's obviously got a lot of different asset classes. But if we aggregate the duration, it's about 17 years currently.

Mark Noble :
So I'm imagining that one of the reasons for this is your view here that we have seen kind of a peak in interest rates and inflation, which means that your risk-adjusted return benefit is better to be slightly longer on the curve. Would that be accurate?

Barry Allen:
Yes, it definitely is. And it goes back to the fact that 10 year treasury yield peaked right at the end of June. Growth peaked at the end of June. Inflation peaked at the end of June. And now, reality is setting in, and the question is how quickly is reality going to set in?

Barry Allen:
But I can tell you why, I mean, the duration of our government bond positions, the total duration is around 17 years, but our government bond positions are over 20 years. And that's a function of, that we think, that inflation is declining, growth is declining.

Barry Allen:
But also, and this is even more important, if you look at every survey and every Wall Street strategist and economist, they all are looking at inflation today versus last year. And they think that, well, if inflation is at 5%, how can the bond, the 10 year yield be at 125? And therefore, we need to see higher rates.

Barry Allen:
And so, the 90-plus percent of the people think that rates are going up, and the bond market accordingly is positioned the shortest it's been in, like right now, since June. And June was when bond deals were rising. So you've got a combination of the fundamentals and technicals where everybody's on one side of the boat. They all think rates are going up. They all think growth is going to be sustained at these levels.

Barry Allen:
And I've been doing this a long time, and I know when 95% of the people think something's going to happen, something else happens. And I'm not expecting this, but if we get a 15 or 20% correction in the stock market, which I actually thought would happen this year, but now I've kind of pushed it out to next year... I think we could get a five or 10% correction fairly soon in stocks, but I don't think we'll get a 20% one. But if you get that, then you're going to see the 10 year treasury yield go below 1% again.

Barry Allen:
And so, we trade the market actively based on our technical indicators. Our technical indicators are telling us to be long. And if we get a significant rally, like we have been for the last few days, then we'll start to shorten duration.

Barry Allen:
But primarily the big picture is we're positioned primarily in government bonds with long duration, expecting some time in the next several months that you'll get a material correction in equities, a material widening of credit spreads, and then we'll be able to sell our long duration bonds at much higher prices than today, and go into the high-yield market, which is kind of my favorite part of the credit market, at seven or 8% yields instead of 4% where we are today.

Mark Noble :
Well, and I think, you're raising a really important point on the treasury side. I think both advisors and investors in Canada, I really still don't think they appreciate the value of treasury. So you can have these periods where maybe tactically you're underperforming a bit, but not realizing this convexity of returns that you get with the treasury market when you do have a correction, pretty much makes it the best risk-off asset class there is.

Mark Noble :
And our whole proposition here is that we're in a yield-starved environment with a high level of risk. Well, your risk-reward trade off in treasury is actually pretty good because you do get a little bit of a sell-off, but your upside potential on a significant risk-off event is huge.

Barry Allen:
Yeah. I mean, just look at '08, the S&P 500 went down close to 40% and 30 year treasuries went up 40%. So if you happened to be positioned that way, you actually broke even. And if you were 50/50 S&P 500 and 30 year treasuries, and most people would've killed to have a zero return in '08.

Mark Noble :
Yeah, or even March of 2020.

Barry Allen:
Yeah. Even the same thing, it was the same thing all over again. And you have to realize S&P's up over 100% since March 2020, we haven't had any material correction in 16, 17 months, which is extraordinarily rare. And now, you've got the environment where growth is starting to slow, earnings growth for 2021 is probably going to be negative, and the Fed's talking about tapering. So I can't imagine a better time to take some equity risk off the table and get some negatively correlated assets into your portfolio than right now.

Mark Noble :
This works into where... the positioning on HARB, which I think is really interesting with HARB because it's an absolute return mandate. And again, one of the reasons we came to work with you on this product was that there aren't a lot of alternative fixed income solutions with an idea on absolute returns.

Mark Noble :
Because in the past, you had a high degree, a high margin of error which to be successful in fixed income, but with low interest rates here, we've just talked about your asymmetric risk profile where your yields are low and your risk is the same or higher, it doesn't make for a great asset class.

Mark Noble :
But what HARB allows you to do is have this ability to have a blended allocation across the credit spectrum, across the fixed income spectrum, to deliver an absolute return. And it's not just treasuries. I think one of the interesting things in HARB, for example, is you have some crude oil positions. I'm wondering if you could talk about some of these ideas behind some of these other asset classes, maybe like crude oil, and also you mentioned high-yield. I mean, how do these all fit into a larger idea of creating an absolute return profile?

Barry Allen:
Right. Well, obviously, the opportunity is to take sort of the market risk and passiveness out of it. And whether the market's going up or down, we can generate returns, and we can have a wide number of areas that we can go to.

Barry Allen:
The one area, if you look at risk assets being equities and credit, they're extremely expensive, by every measurement, as rich as they've been in history. But in some of the other areas like commodities, like gold hasn't really gone up, oil has gone up a fair amount, but if you look in the equity world, pretty much the only sector of the equity markets that's cheap is energy. And that's because the long-term view for oil is negative. We're electrifying the vehicle fleets, there's all the carbon capture issues. Every government is trying to make it more and more difficult to search for oil, and the long-term dynamics of oil are terrible.

Barry Allen:
But, coming out of the pandemic, there's a reopening trade. And all the reopening trade, all the hotels and cruise ships and all that immediately took off, and now we're priced as if there wasn't a pandemic. The one single one that stands out is energy. So we looked at it right away and said, "Okay, we like long duration treasuries, but the relative value was also in energy high yield." And that lasted for about a month or two. And now energy high yield, yields not much more than anything else, and it's two or three times the risk.

Barry Allen:
So we basically came to the conclusion that oil is cheap, energy high yield is not, so we might as well just own oil directly. And because there's tons of ETFs where you can do that, we're doing it. We do still have some energy bonds in there as well, but rich-cheap analysis, if you do it properly lowers volatility and you get the same exposure with less risk. I'm not in the camp of a lot of these people, that oil is going to $100. I think it could get to 80, but I'd be selling well before 80. But it's a reopening trade and it makes sense because demand for oil is improving and supply isn't increasing. So, therefore prices remain. So it's kind of one of those one-off things that the mandate and structure of HARB allows us to do.

Mark Noble :
Well, what's amazing about it too is, you still used traditional credit analysis to come to that conclusion that the relative valuation of oil is better than the relative valuation of the credit. So, I think that's an interesting way to look at it, and it fits nicely with HARB, because one key piece of HARB, as you mentioned, or we haven't mentioned actually, it's just that, that's a total return strategy. So all of the return of HARB is capital gain if it's in the HARB complex that's in our corporate class.

Mark Noble :
So again, the idea here is to generate a total return through macro-fixed income analysis. So I think it's a great example of highlighting what this strategy does different and does well versus what's out there in the plain vanilla and different types of vanilla fixed income strategies that inundate investor portfolios these days.

Barry Allen:
Right.

Mark Noble :
Another mandate that your managing for us and sub-advising for us, and has done quite well is HYI, the Horizons Active High Yield Bond ETF. And I was curious though, what is your view on high yield credit in general? Because you have some at HARB and obviously you're managing HYI. Is there still any relative value in this space, or is this an area where you still remain a little bit concerned about the fact that the yields really aren't there to necessitate the risk?

Barry Allen:
Well, I'll say yes and yes.

Mark Noble :
Okay. I figured that was the answer actually.

Barry Allen:
The thing about high yield, is it expensive relative to its potential default risk? Yes. But relative to everything else in the fixed income space, it's a little bit cheaper. So, the thing is, it depends on your long-term view of default rates. And right now the Fed is completely suppressing default rates. And how long they'd be able to do that remains to be seen.

Barry Allen:
But high yield asset class, which generally has a 4% default rate and a 50% recovery rate. So, that means that your expected losses to default every year is 2%. If it yields less than 4%, it's a very poor risk-reward. But relative to everything else, it's in better position. And I'm hoping for a sell-off in the high yield market so that we can become much more aggressive in that fund.

Barry Allen:
And I do think that, at some point, markets don't go straight up forever and we'll get a 20% correction in the stock market, which should be bought. And when you get a 20% correction in the stock market, you'll get a 300 or 400 basis point widening of high yield yields or spreads. And high yield at 7% to 8% will be a significantly better buy than the stock market down 20%, because growth is weakening, the world is highly indebted, the long-term fundamentals, and if you look at equity returns in periods after you've had 100% increases in 18 months, generally you get several years of close to zero returns out of the equity market. And whether we get that remains to be seen, but that's what history tells us.

Barry Allen:
So, the risks with fixed income are always higher interest rates and wider credit spreads. I don't think we're going to get materially higher interest rates. I think the economies are weakening. I think at some point we'll get wider credit spreads. But if the economy is weakening, and with investment, if you compare investment grade to high yield, investment grade spreads, they're at record lows. They don't give you any protection of interest rates rise. And if the economy is weakening, you've got the vast bulk of investment grade companies that are concentrated in the triple B area, so your downgrade risk is significant. When an investment grade bond gets downgraded to high yield, the bonds have to transition to a whole new set of investors and the company, even if nothing has really changed in the company's dynamics, the investment grade bond could go down seven or eight points while it transitions to high yield.

Barry Allen:
So I think that there's a significant amount of downgrade risk in investment grade. And if rates do go up somewhat, there's no protection because credit spreads are at the tightest in history. So the risk reward is take the yield from high yield because the Fed will be motivated to suppress the default rate just as they have been for the last 18 months, because the world is so indebted they can't afford the economy to weaken enough that default rates start to rise.

Mark Noble :
Right, and create contagion across all asset classes.

Barry Allen:
Exactly. So I'm heavily positioned in long duration bonds. If we get a selloff in the equity market, HARB could be up 7% or 8% in that environment. And then we get to buy high yield at 7% or 8% instead of sub-4%. I think that's a reasonable strategy.

Mark Noble :
Yep. Makes sense to me. As always I love your contrarian views on these Barry, and they make so much intuitive sense to me as an investor. So I think they likely make sense for those listening today.

Mark Noble :
I have one last question just in terms of, are there any risks or opportunities that we haven't discussed in the market? Anything that's sort of piquing your interest that investors should be made aware of?

Barry Allen:
Well, I think the markets are at kind of a critical point right now. They don't really know whether inflation is going to continue to rise or how long it's going to be, or when growth normalizes are we going to end up with 1% growth or 2% growth? Or a lot of people, where the market's priced, somehow seem to think that we're going to normalize at three to three-and-a-half percent growth when we couldn't get growth to 2% for the last 15 years…

Mark Noble :
Pre-pandemic, yes.

Barry Allen:
And things are way worse now after, and they're kind of extrapolating things that are an aberration that have happened because the pandemic.

Barry Allen:
I think now is to make sure that you have something in your portfolio that is truly negatively-correlated to the equity markets, because the risk of the equity markets today, it's the highest it's been since June of 2020, because they're at the highest levels and the fundamentals are the weakest.

Mark Noble :
And correlations are high. Like once you're in the equity market, there's no area to hide in the equity market if you have a broad selloff, right?

Barry Allen:
The vast bulk of Canadian fixed income funds are highly, highly correlated to the equity markets. And that's the real proposition, whether we're right or wrong, you will increase the risk/reward of your portfolio if you sell a fixed income fund with 60, 70% correlation to the equity markets to one that's negatively correlated.

Mark Noble :
Exactly. And this, again, goes back to why we have a product like HARB. We have a lot of different actively managed ETFs at Horizons, but HARB really stands out as something that can be an all-weather solution, to use that cliché, but it is an absolute return solution, with the idea it being tactical to maintain positive returns.

Mark Noble :
And with a market environment where there is a need for income, that doesn't go away, clients need income, investors need income, creating something that can manage through these different market cycles that can be negative for fixed income, or negative for equities is more important than ever.

Mark Noble :
So, Barry, thank you for joining us today to give us this insight. I think we try to make this a quarterly thing because the market's changing and you always seem to be really good at contextually grasping what is happening and creating the narrative that I think people can really understand. So thank you as always.

Barry Allen:
Great, thank you.

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