

# Manulife bond manager isn't losing sleep over inflation risk

Terry Carr believes Trump's spending plans face roadblocks.

Manager Insight | 23-02-17 | by Michael Ryval

Terry Carr believes that the odds of U.S. President Donald Trump's pro-growth policies becoming inflationary are a little over 50%. "Fifty-fifty would be the base case with anyone's policies. But this tilts it towards 55%-60% -- so only moderately more than the base case," says Carr, senior managing director and head of fixed income at Toronto-based Manulife Asset Management Ltd. "In the end, though, I don't see Trump's policies causing extreme inflation."

The crux of Carr's argument regarding inflation, the bogeyman of fixed-income markets, is that it is extremely challenging to implement policies that have been used to drive an election campaign. "It's one thing to have a bunch of proposals for your campaign. It's another thing to get them through Congress," says Carr, lead manager of the \$1.1-billion [Manulife Yield Opportunities](#).

"We realize that the Republicans dominate the Senate and House of Representatives, and to some degree that is helpful for Trump when he starts to implement his policies," Carr adds. "But his plans appear to be anti-trade and protectionist and could lead to large budgetary deficits as a result of significant tax cuts and infrastructure spending. The Republicans are more likely to respond with budgetary cuts to help offset his proposals."

Carr expects the Trump administration to face a host of challenges as it seeks to spend money on airports and roads as well as cutting personal and corporate taxes. "Republicans have been loath to run deficits of significant sizes and critical of the Democrats. Trump will meet some resistance from his own party," says Carr, a 32-year industry veteran who re-joined Manulife in 2002 after an earlier stint at the firm, as well as at Canada Life, Royal Bank of Canada and New York-based hedge-fund managers Lucerne Partners.

Inflation is running at slightly under 2%, while unemployment is 4.6%. "The last time we were at these levels was March 2007, when

unemployment was 4.5%. To put this into context, at the peak of the financial crisis it was 9.9%, so we are about halfway off the peak," says Carr. "As you try to stimulate the economy, with tax cuts and so on, you are looking at a work force that is effectively fully employed. That's likely to lead to wage pressure."

Bringing home production, another key plank in Trump's campaign, will mean that U.S. companies will have to pay more in wages than when they use Mexican plants, for instance. "This will exert upward pressure on goods made in the U.S. which used to be made offshore. This is another inflationary source." Similarly, tax cuts will put more money into the system, which will chase a fixed number of goods. "This ultimately could lead to inflationary pressures. As people spend their money, prices for goods and services start to rise."

If some of these factors are borne out, Carr expects that inflation may creep up, to just above 2%. "This won't alarm the Federal Reserve too much in the early days. But in the two-to-four-year horizon, I see problems where inflation actually sinks again."

Rising prices eventually dampen demand, Carr argues. If cars cost more, ultimately fewer cars will be sold. "And, eventually, you start to let people go because the cars are not selling." Toward the end of Trump's term, Carr believes that inflation will taper off and unemployment will edge up slightly. "The globalization movement is very much entrenched. And automation has meant less human capital and more technology deployed."

Bond markets sold off in November but have since settled down, as the benchmark 10-year U.S. Treasury bonds is yielding 2.46%, down somewhat from the peak of 2.6%. "Our base case is for the benchmark to drift up to around 2.9% to 3% by year-end," says Carr, who shares duties with Richard Kos, managing director, and Alan Wicks, senior managing director.

To put this in perspective, Carr notes the 10-year benchmark yield hit 3% in late 2013. "This means it will be four years for us to get back to where we once were. We have had a slow growth, low-inflation environment and a cautious Federal Reserve. That's unprecedented and speaks to the long, slow cycle we have experienced," says Carr. "It also tells us that corporate credit will win the game. If you can get a lot more yield than basic government bonds then you will be better off."

Currently, the 5-star rated fund has 35% in high-yield bonds, 19% investment-grade corporate bonds, 7% government bonds, 9% floating-rate bank loans, 2% emerging-markets bonds and 25% common stocks. "We get a lot more yield than the marketplace, and have a shorter duration," says Carr.

The fund has the flexibility to go from 0% to 100% government bonds, up to 100% investment-grade corporate bonds, up to 75% high-yield bonds or floating-rate bank loans, up to 30% preferred shares and up to 50% common stocks. "With this wide range of tools, we can look dispassionately at our mix, versus the marketplace, and take advantage of volatility," says Carr. "It's the best approach, given the environment we're in and an uncertain set of scenarios."

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