Beutel Goodman

Canadian Monthly Fixed Income Report

BEUTEL GOODMAN Investment Counsel

July 30, 2021

Market Snapshot

Canadian Rates

	Current	Change (Basis Points)		
		Month	QTD	YTD
3 Month T-Bill Yield	0.17%	2	2	11
2 Year Bond Yield	0.45%	-5	-5	26
5 Year Bond Yield	0.88%	-10	-10	46
10 Year Bond Yield	1.25%	-19	-19	54
30 Year Bond Yield	1.76%	-8	-8	55

	Current	Change (Basis Points)		
		Month	QTD	YTD
3 Month U.S. T-Bill Yield	0.06%	1	1	-3
2 Year U.S. Bond Yield	0.19%	-6	-6	6
5 Year U.S. Bond Yield	0.69%	-18	-18	33
10 Year U.S. Bond Yield	1.24%	-21	-21	31
30 Year U.S. Bond Yield	1.89%	-17	-17	24

Currencies

	Current	Change (%)		
		Month	QTD	YTD
CAD/USD	1.25	0.8%	0.8%	-2.0%
EURO/USD	0.84	0.0%	0.0%	3.2%
Trade Weighted USD	92.17	-0.3%	-0.3%	2.5%

Equity Indices

	Current	Change in TR (%)		
	(Price Index)	Month	QTD	YTD
S&P 500	4395	2.4%	2.4%	18.0%
S&P/TSX	20288	0.8%	0.8%	18.2%

Credit Index OAS

	Current	Change (Basis Points)		
		Month	QTD	YTD
Investment Grade	103	5.0	5.0	-16.0
High Yield	294	26.0	26.0	-66.0

Commodities

	Current	Change (%)		
		Month	QTD	YTD
WTI Crude Oil (US$/bbl)	$73.95	0.7%	0.7%	52.4%
WCS Crude Oil (US$/bbl)	$59.37	-0.3%	-0.3%	79.0%
Gold (US$/ounce)	$1,814	2.5%	2.5%	-4.4%

Source: Macrobond, Bloomberg (for Credit Index OAS)
As of July 30, 2021

Market Commentary

In July, we saw signs of waning economic growth, at least on a rate-of-change level, which was enough to inject uncertainty into risk markets and continue a rally in global interest rates. The U.S. 10-year rate fell by 24 basis points (bps) over the month and the Canadian 10-year fell by 19 bps. In addition, the multi-month oil rally that saw the WTI (West Texas Intermediate) spot rate go from US$35.79 per barrel in October 2020 to US$73.47 by the end of June, stalled in July as OPEC + Russia agreed to return to pre-pandemic output levels. After falling sharply mid-month, by 9.6%, the price of WTI quickly recovered to finish the month 48 cents higher than the previous month-end. This shock, coupled with concerns over the fast-spreading Delta variant and a rollover in economic growth expectations when viewed on a rate-of-change basis, caused credit spreads to widen and risk assets to diverge.

While economic prints continued to come in strong throughout the month, they missed expectations, creating concerns that we have reached a peak in economic expansion. This has led to worry over a potential monetary policy error. U.S. GDP grew by 6.5% in Q2 (Seasonally Adjusted Annual Rate SAAR), a faster pace than the 6.3% (SAAR) in Q1. However, this number missed lofty economist expectations of 8.4 %. The IHS Markit Flash U.S. Services Purchasing Managers' Index® also missed preliminary expectations of 64.5, coming in at 59.8 on July 23[1]. The strong June CPI print of 0.9% month over month in the U.S. was not enough to stall the rally in long-term rates; instead, it led to concerns that the inflation data is transient and that it could lead to a U.S. Federal Reserve policy error, driving long-term rates even lower. With respect to labour markets, data was stronger in both Canada and the U.S. than the previous month, but has yet to reflect the strength of a reopening in either country.

The Federal Open Market Committee (FOMC) kept policy unchanged during its July meeting while acknowledging the strength of the recovery. The July 28th statement noted the economy is getting closer to achieving the standard of "substantial further progress" towards the FOMC's goals of price stability and maximum employment. This standard is the threshold to begin tapering their balance sheet purchases, which for now continue at a pace of US$120 billion/month. In Canada, the Bank of Canada (BoC) held its policy rate steady at 0.25% and released its July Monetary Policy Report. The BoC continued to taper the weekly pace of its bond purchases by $1 billion to $2 billion per week. This reduction is driven by optimism towards the outlook, which remains strong, even though the BoC has revised its 2021 growth estimates down from 6.5%, to 6% year over year, while raising its 2022 and 2023 growth forecasts to 4.6% and 3.3%, respectively.

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Provincial spreads widened by one basis point in July, with peripheral provinces underperforming. As we entered the summer months, domestic provincial bond supply slowed to $6.5 billion in July versus $8.8 billion issued in June. The Province of British Columbia revealed that the 2020-21 budget deficit was $2.7 billion lower, at $5.5 billion, than the $8.2 billion originally budgeted. The faster-than-expected economic recovery, including the job recovery, led to higher income taxes, and hence the upward revision. Alberta released its 2020-21 annual report, which showed a deficit of $16.9 billion, a $3.2 billion improvement from the last projection in February 2021. The improvement was boosted by higher-than-expected natural resource revenue and lower spending. In Newfoundland and Labrador, the federal government announced a $5.2 billion agreement to complete the Muskrat Falls hydroelectric project. Under the terms of the agreement, Canada will give an estimated $3.2 billion in annual financial transfers to the province between now and the end of the project, an amount equal to the interest it earns in the Hibernia offshore oil project. In addition, the province will also receive $2 billion in federal financing, half of which comes in the form of a federal loan guarantee. The other half is billed as an investment in Newfoundland and Labrador's transmission system that carries Muskrat Falls' power from central Labrador and distributes it across the island.

The FTSE Canada All Corporate Bond Index returned 0.92% for the month. Credit spreads traded in a tight range, ending July 1 bp wider. From a ratings perspective, the BBB and A segments underperformed the AA ratings bucket by 1 bp. From a sector perspective, banks and utilities outperformed while Telecoms and Oil & Gas underperformed.

On the corporate bond front, the pandemic story continues to improve in Canada, which is expected to enhance economic performance and continues to support the fundamentals of corporate spreads. Vaccine rollout improved in Canada, with 70.4% of the population receiving their first dose and 55.71% of the population fully vaccinated as of July 30, 2021[2]. Full reopening requirements have been met in most provinces with others very close to meeting targets. During the month, results of the telecom spectrum licence auction came in much higher than analysts had been expecting and led to underperformance in the sector. Also in corporate news, the battle for Inter Pipeline between Brookfield Infrastructure and Pembina ended, with Brookfield Infrastructure winning on a higher bid.

New issuance continues to be quite strong in Canada, at $12.31 billion during the month compared to July's 5-year average of $7.7 billion. Of the corporate new issuance, $7 billion was issued by banks. The upgrade/downgrade ratio for the month of July was a healthy 1.67x, highlighting the improved credit fundamentals of companies.

The FTSE Canada Universe Bond Index increased 1.03% in July. The Provincial and Municipal sectors outperformed, returning 1.24% and 1.23%, respectively, as yields fell. The Federal and Corporate sectors underperformed, with returns of 0.85% and 0.92%, respectively.

Footnotes

1 "IHS Markit Flash U.S. Composite PMI™" https://www.markiteconomics.com/Public/Home/PressRelease/5c13aaa0acb3461eb9acd7113cd2bb40
2 "COVID-19 vaccination in Canada" https://health-infobase.canada.ca/covid-19/vaccination-coverage/archive/2021-07-30/

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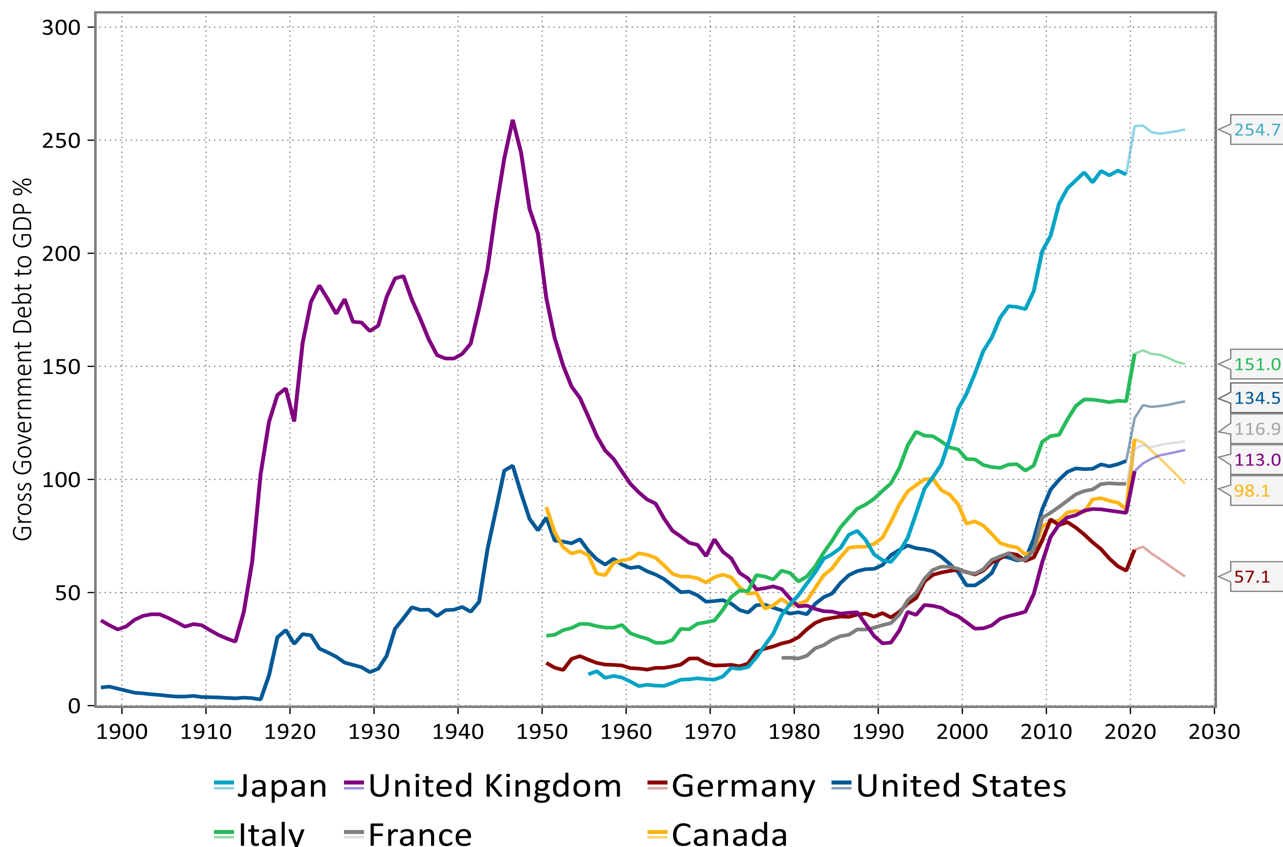
Topic of the Month

The Debt Hangover

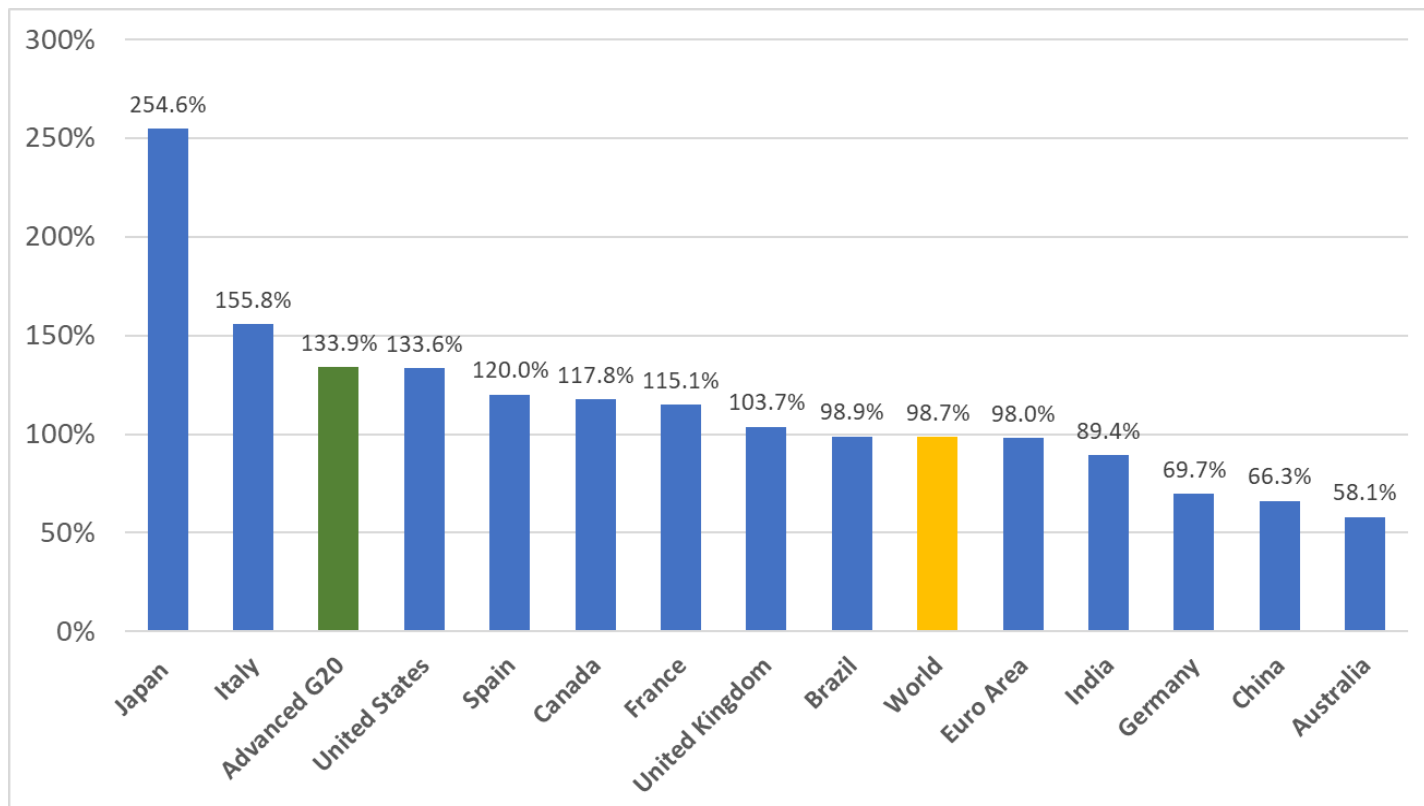
Apart from inflation, the number one question that we get asked by clients is, *what are we going to do about all that debt accumulated during the pandemic?* We first visited this topic in our July 2020 monthly piece titled "Debt Supercycle Part II". Now that the ink has for the most part dried on all the various stimulus plans, we can start to tally the impact. The accumulation of debt is well beyond the rise seen during the 2008 global financial crisis and is the largest since the major world wars in the 20th century (Figure 1).



Source: Beutel, Goodman & Company Ltd., Macrobond, Bank of England, U.S. Office of Management & Budget, IMF, IMF WEO, as of 8/5/2021

Figure 1. G7: Gross Government Debt to GDP
This line graph shows the gross government debt to GDP ratios of G7 nations; i.e., Japan, Italy, U.K., France, Germany, U.S. and Canada. Data for the U.K. and U.S. date back from 1900, and for the others, from the 1950s to 1970s. Data is current to August 5, 2021, and includes estimated levels into 2026. The accumulation of debt is currently well beyond 2008 global financial crisis levels, and global debt is the largest since the 20th century's major world wars.

According to the Institute of International Finance, the global response to the COVID-19 pandemic has added US$24 trillion to the global debt mountain in 2020, bringing it to a new high of US$281 trillion. Global total debt/GDP has surged by 35% to over 355% of GDP in 2020 and government debt/GDP has increased to 105% of GDP in 2020, up from 88% in 2019[1]. Figure 2 provides a breakdown of debt to GDP for selected countries. These elevated levels of debt place many countries in the "danger zone" identified by economic professors Kenneth Rogoff and Carmen Reinhart in their 2010 paper titled "Growth in a Time of Debt"[2]. In the report, the authors argue that using data across all advanced countries, when debt/GDP is greater than 90%, GDP growth is typically lower than countries with lower debt/GDP ratios. In addition to sluggish growth, historically, huge debt buildups have also usually been followed by an uptick in inflation, and/or a financial crisis.



Source: IMF World Economic Outlook, July 2021 Update

Figure 2: Debt/GDP (%) – Select Regions (2020)
This bar graph shows the debt to GDP ratio for 2020 in the following regions, in descending order: Japan, Italy, advanced G20, the U.S., Spain, Canada, France, the U.K., Brazil, the world, the euro area, India, Germany, China and Australia. In 2020, Japan's debt to GDP ratio was 254.6%, the U.S. ratio stood at 133.6% and Canada was 117.8%. This compares to the advanced G20 countries' ratio of 133.9% and the world's 98.7%.

The unprecedented fiscal and monetary policy stimulus was provided to bridge economies over the deep economic effects of lockdowns. These measures in part led to one of the shortest recessions on record. However, with vaccination rates rising and economies strengthening, the focus now turns to how governments are going to address the elevated debt levels. Traditionally, the ways to decrease bloated debt levels include:

(1) Austerity – including measures such as spending cuts and/or raising taxes. This path leads to prolonged slower growth and in some cases increases the chances of running into a period of stagflation. It also may be a difficult path to take due to demographics, as an ageing population likely requires an increase in spending on health care. Global commitments to climate change initiatives will also likely require a significant increase in infrastructure spending.

(2) Growth – if economic growth exceeds the cost of government borrowing, the government can roll over its debt, and the Debt/GDP ratio will decline without the need to impose austerity measures.

(3) Inflation – reducing the real value of the debt through inflation. While central banks appear to have a tolerance for inflation to run over 2% in the near term, in the long term they are likely to push back against persistent higher inflation levels.

(4) Default – an extreme measure that has been used historically by many emerging market countries but is not an option for developed nations.

Lower for Longer

Low interest rates make the debt burden manageable. This is a theory espoused by scholars and former Democratic policy advisors Larry Summers and Jason Furman as well as the former chief economist of the International Monetary Fund (IMF), Olivier Blanchard. Summers and Furman argue that a cyclically balanced budget likely leads to inadequate growth and excessive financial instability. As a new guidepost, they propose that fiscal policy focus on supporting economic growth while preventing real debt service from being projected to rise quickly or to rise above 2% of GDP.[3] They submit that governments should stop paying attention to debt/GDP as a vulnerability and instead focus on the size of interest payments. The focus on debt-servicing costs highlights the reliance of debt sustainability on the path of real rates relative to real growth ('r-g'). As long as low servicing costs persist, the level of debt matters less.

Blanchard has argued that debt is sustainable when nominal interest rates are lower than nominal GDP growth: the cost of debt service is lower, if not negative.[4] For this theory to be effective, interest rates would have to stay low for a long time. If increased spending sparked runaway inflation, central banks could be forced to raise interest rates beyond growth rates to tame inflation and the sustainability of debt model could collapse.

What About MMT?

No argument about debt sustainability is complete without a discussion of Modern Monetary Theory (MMT). MMT advocates believe governments that issue in their own currency can essentially borrow without limit. No matter how large the federal debt grows, the federal government can always print more money to pay for it. Breaking with conventional economic theories, MMT advocates argue that doing so imposes almost no serious costs or risks. MMT blurs the lines of central bank independence, and government in essence sets both fiscal and monetary policy. The standard case against MMT is that it puts way too much power in the hands of a government whose primary goal is to be re-elected, which will likely result in too much money being spent sparking runaway inflation. U.S. Federal Reserve Chair Jerome Powell is not an MMT proponent, as he stated in his Senate testimony in February 2019 that "the idea that deficits don't matter for countries that can borrow in their own currency I think is just wrong."[5]

No Such Thing as a Free Lunch

Those arguing that debt levels are unsustainable at their core believe what we were taught in economics class – that there is no such thing as a free lunch and that money borrowed has to be paid back. For advanced economies, the problem of carrying very high public debt may not be sustainability, but loss of flexibility in responding to unforeseen shocks. The reason that most countries have to watch their deficit and debt numbers is because, in the event of a shock, demand for their debt may fall sharply.[6] A loss of investor confidence in a safe haven like the U.S. could lead to a sell-off of U.S. Treasury debt by international investors, which could push up interest rates and inflation and crowd out private investment. A working paper undertaken by the IMF studied 188 financial crises since the 1980s and concluded that public debt in its various forms is the most important predictor of fiscal crises.[7]

Keeping interest rates low to manage debt payments can lead to financial instability by fueling asset and credit bubbles. Some warning signs are already starting to percolate, as seen in P/E ratios, housing prices, crypto currency, high yield corporate debt, meme stocks and special purpose acquisition companies (SPACs). Leaving rates at the lower bound is also a form of financial repression. Negative real interest rates may reduce or liquidate existing debts but also become the equivalent of a tax—a transfer from creditors (savers) to borrowers.[8]

Where the Rubber Meets the Road

For bond markets, with elevated debt levels and deficits, there is concern that governments do not have enough capacity to spend during the next recession. With the economy already well into its expansion phase, will there be enough time for governments to address their deficits before the next economic downturn occurs?

This is likely the sticking point for credit rating agencies and there are some emerging signs of credit rating concern. The U.S. remains AAA rated by DBRS, Moody's and Fitch, but Fitch assigned a Negative outlook in July 2021 citing risks to public finances and debt trajectory. We note that S&P has maintained the U.S. credit rating at AA+ since the debt ceiling crisis of 2011.

Canada lost one of its prized AAA ratings when Fitch downgraded the sovereign by one notch in June 2020, but remains AAA rated by S&P, Moody's and DBRS. The Fitch downgrade was a result of the deterioration of Canada's public finances resulting from the coronavirus pandemic. The rating agency is concerned that Canada emerges from the crisis with much higher debt levels. CD Howe produced a recent study on Canada's debt and concluded that under their baseline scenario, the federal debt burden is on an upward long-run drift, with the debt ratio reaching 60% by 2055. Nationally, taking provincial governments into consideration, the combined federal/provincial net debt ratio could reach over 140% under the baseline scenario, and almost 100% even under the more favourable budget scenario (the budget scenario is based on projections in the federal budget and assumes strong economic growth, a modest increase in interest rates and no further changes to spending programs or tax cuts). The only other time Canada's debt burden was over 100% was in the aftermath of World War II.[9]

On the provincial side, deficits have soared and debt/GDP ratios have also increased significantly (Table 1). The pandemic has forced the provinces off the fiscal consolidation path and has significantly pushed back the timing for balanced budgets, leaving them vulnerable to the next downturn. Alberta was downgraded by one notch by three rating agencies over the past year. British Columbia lost one of its AAA ratings. Saskatchewan was downgraded by one notch by two rating agencies also losing one of its AAA Ratings. Also of note, DBRS has placed Newfoundland and Labrador's A (Low) rating on Negative outlook. It is very rare for a Canadian province to be rated in the BBB space. In fact, it has only occurred twice. S&P rated Saskatchewan in the BBB space from June 1992 to May 1996, and Newfoundland and Labrador BBB+ from July 1994 to August 1999.

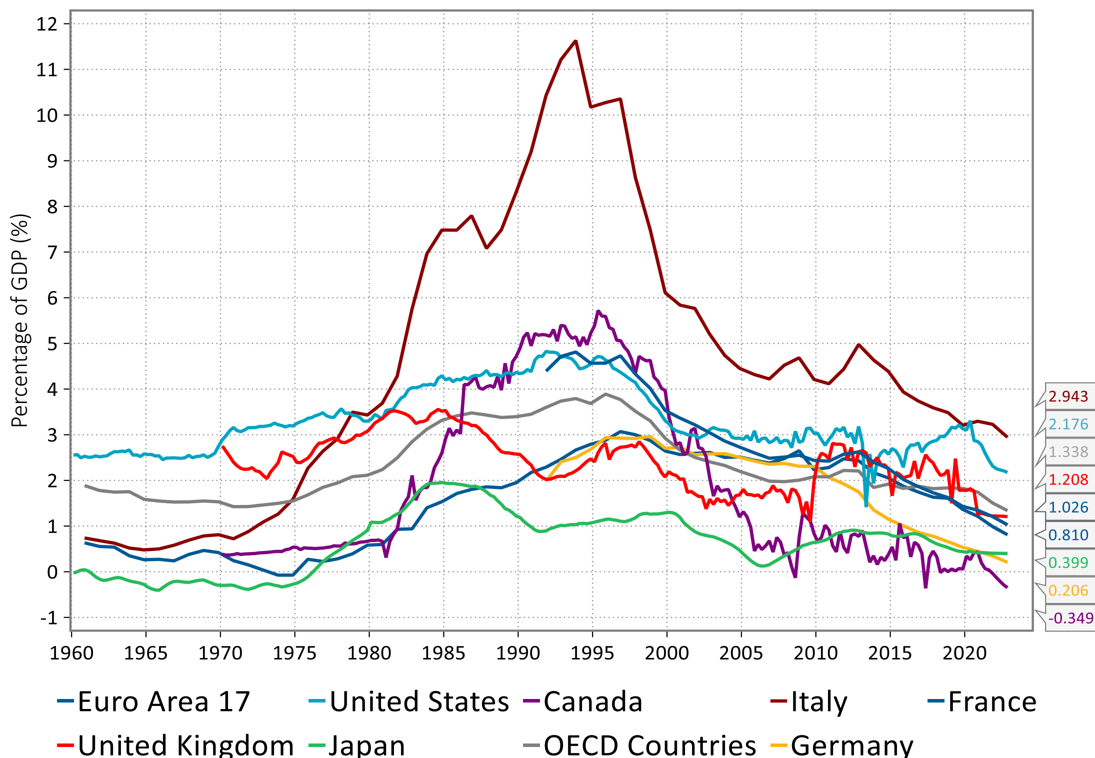
Table 1. Provincial Deficits and Debt/GDP

	FY 2020-21	
Province	**Budget Balance ($mm)**	**Debt/GDP**
BC	(8,144)	20.3%
Alberta	(20,192)	20.3%
Saskatchewan	(1,865)	19.0%
Manitoba	(2,080)	38.8%
Ontario	(38,500)	47.1%
Quebec	(15,000)	45.0%
New Brunswick	(13)	37.3%
Nova Scotia	(705)	37.4%
PEI	(120)	34.5%
Newfoundland and Labrador	(1,644)	51.8%

Source: RBC Economics, Provincial Budgets

The Bottom Line

For now, bond markets are shrugging off debt concerns as interest payments remain low (Figure 3), the central bank tightening cycle is perceived as a long way off, and inflation, while elevated, appears transitory. In the long run, though, the bloated government balance sheets will likely have to be dealt with. Governments and central banks will need to manage interest rate and inflation expectations so that debt does not become an unsustainable problem. The debt debate is becoming even more topical as the debt ceiling wars have reared their ugly head in the U.S. Congress.



Source: Beutel, Goodman & Company Ltd., OECD (Organisation for Economic Co-operation & Development), as of 8/5/2021

Figure 3: Net General Government Interest Payments, As a Percentage of GDP

This line graph shows the net general government interest payments of the euro area 17, the U.S., Canada, Italy, France, the U.K., Japan, OECD countries and Germany, as a percentage of GDP, since 1960. Currently, interest payments remain low, ranging from -0.349% of GDP in Canada to 2.943% in Italy.

Portfolio Positioning

We do expect that interest rates will rise and our portfolios are therefore shorter in duration versus the index. In addition, we do not expect that the magnitude of the increase in rates from current levels is very large, as we believe central banks are mindful of the damage that can be incurred by increasing rates too quickly and/or too high. We have considered how careful the U.S. Federal Reserve is being in its language around tapering and inflation expectations.

On the credit side, we continue to have dialogues with credit rating agencies to understand their tolerance for higher budget deficits and debt burdens at the provincial and federal level. We have zero weightings in the province of Newfoundland and Labrador and some of the other less liquid peripheral provinces.

Footnotes

[1] "COVID Drives Debt Surge—Stabilization Ahead?", Global Debt Monitor, Institute of International Finance, February 17, 2021.

[2] Rogoff, Kenneth and Reinhart, Carmen, "Growth in a Time of Debt", Working Paper 15639, National Bureau of Economic Research, January 2010.

[3] Furman, Jason and Summers, Lawrence, "A Reconsideration of Fiscal Policy in the Era of Low Interest Rates", Harvard Kennedy School, November 30, 2020.

[4] Blanchard, Olivier, "Public Debt and Low Interest Rates." American Economic Review, 2019.

[5] McCormick, Liz, "Jerome Powell Says the Concept of MMT Is 'Just Wrong'", Bloomberg News, February 26, 2019.

[6] Rogoff, Kenneth, "Is Higher Debt an (Almost) Free Lunch?" Harvard University, February 26, 2021.

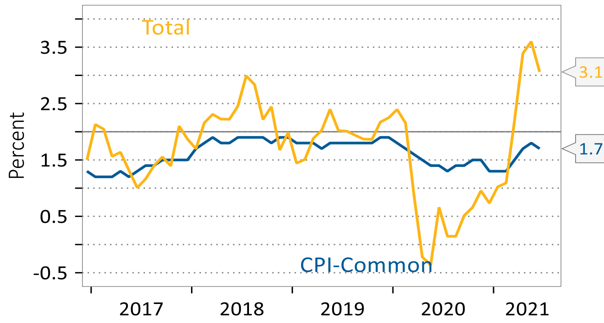
[7] Badia, Marialuz Moreno, Medas, Paulo, Gupta, Pranav, and Xiang, Yuan, "Debt is not Free" International Monetary Fund Working Paper No.20/1, January 2020.

[8] Reinhart, Carmen M., Kirkegaard, Jacob F., and Sbrancia, M. Belen, "Financial Repression Redux", International Monetary Fund Working Paper Vol.48 No.1, June 2011.

[9] Laurin, Alexandre and Drummond, Don, "Rolling the Dice on Canada's Fiscal Future" C.D. Howe Institute, July 29, 2021.

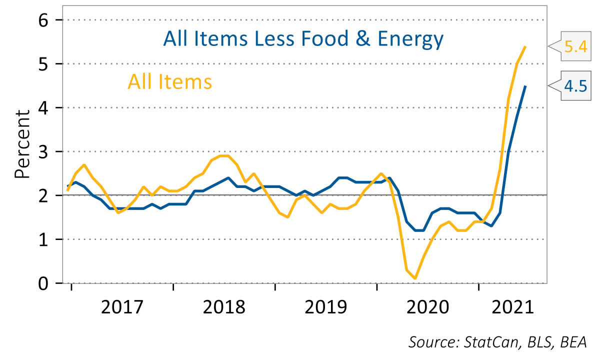
Macro Economic Charts (As at July 30, 2021)

Canada CPI, YoY



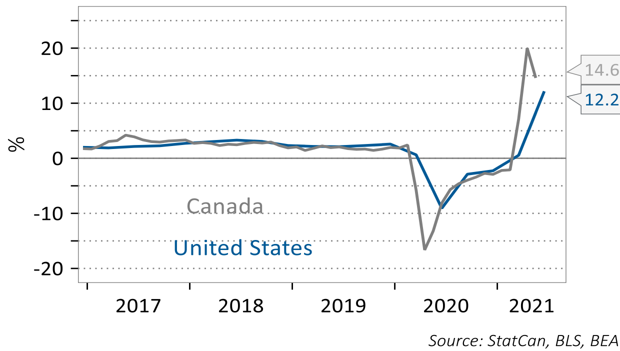
Source: StatCan, BLS, BEA

US CPI, YoY



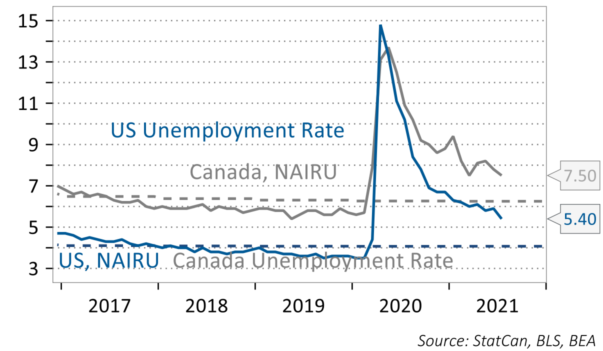
Source: StatCan, BLS, BEA

Real GDP, SA, YoY



Source: StatCan, BLS, BEA

Unemployment Rate, SA



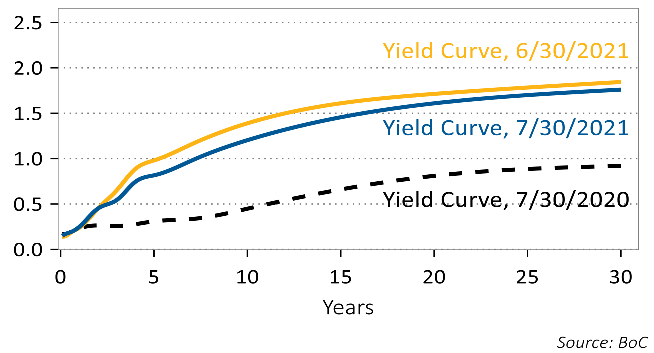
Source: StatCan, BLS, BEA

Rates Charts (As at July 30, 2021)

Benchmark Canada Yields

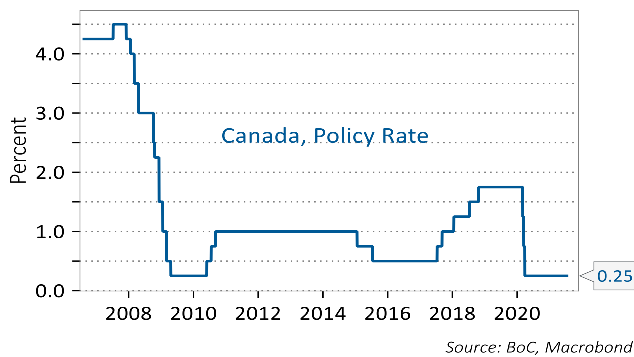
Source: BoC, Macrobond

Canada Yield Curves



Source: BoC

Bank of Canada Overnight Rate



Source: BoC, Macrobond

Sovereign Yields

Country	Overnight Rate	2 Year	10 Year
Canada	0.25%	0.45%	1.25%
United States	0.25%	0.19%	1.24%
United Kingdom	0.10%	0.05%	0.67%
Germany	-0.50%	-0.76%	-0.45%
Italy	-0.50%	-0.45%	0.67%
Spain	-0.50%	-0.58%	0.27%
Japan	-0.10%	-0.12%	0.02%

Source: Macrobond

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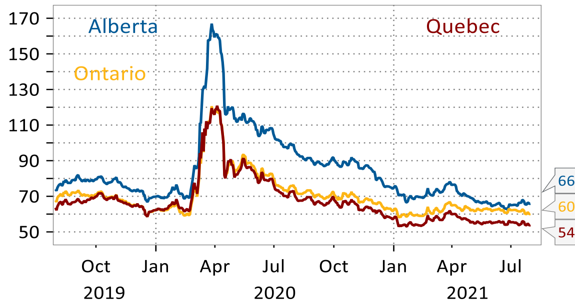
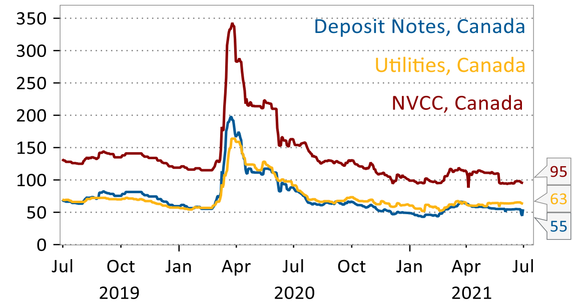
Credit Charts (As at July 30, 2021)

Provincial Spreads, 10 Year



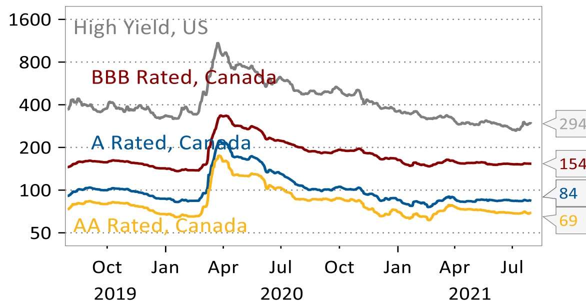
Source: Beutel Goodman, Macrobond

Corporate Credit Spreads



Source: Beutel Goodman, Macrobond

Corporate Spreads by Rating



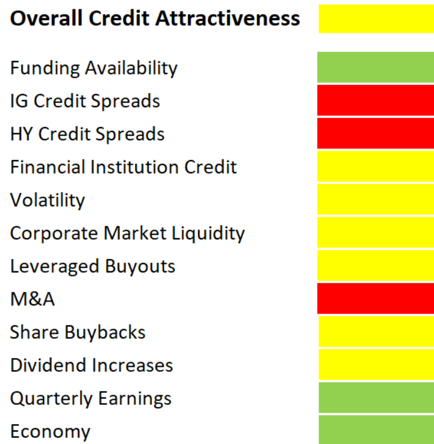
Source: Beutel Goodman, Bloomberg

FTSE Corporate Sectors Total Return (MoM)

Sector	Return
Infrastructure	1.45%
Energy	1.27%
Industrial	0.97%
All Corporate	0.92%
Real Estate	0.80%
Financials	0.58%
Communication	0.57%
Securitization	0.35%

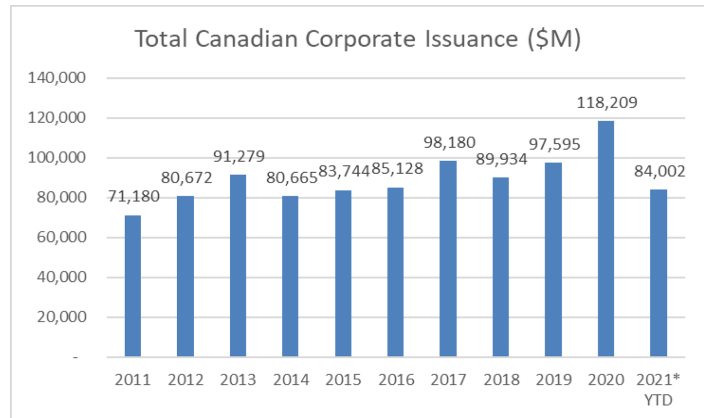
Source: FTSE Global Debt Capital Markets Inc.

Corporate Event Risk Monitor



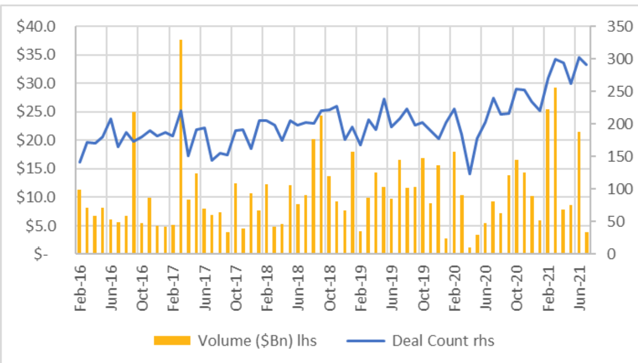
Source: Beutel Goodman

New Corporate Issues in the Canadian Market



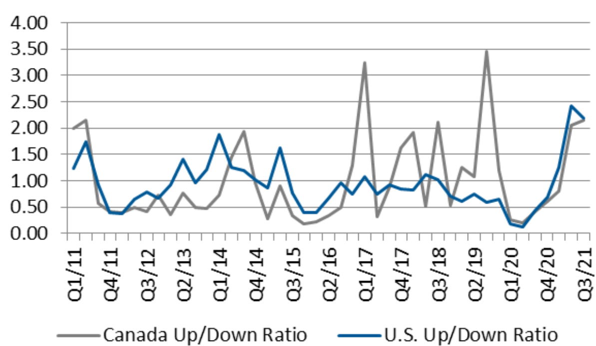
As of July 30, 2021 *Source: Beutel Goodman*

Canadian Mergers & Acquisitions



As of July 30, 2021 *Source: Bloomberg*

Credit Rating Upgrade/Downgrade Ratio*

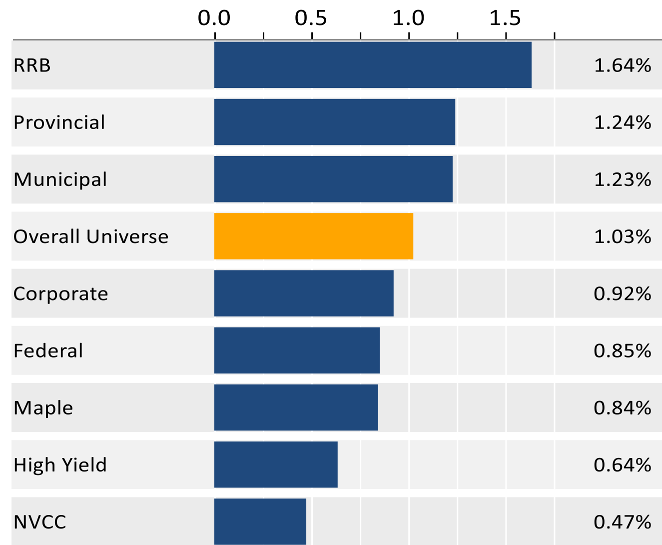


As of July 30, 2021 *Source: Bloomberg*

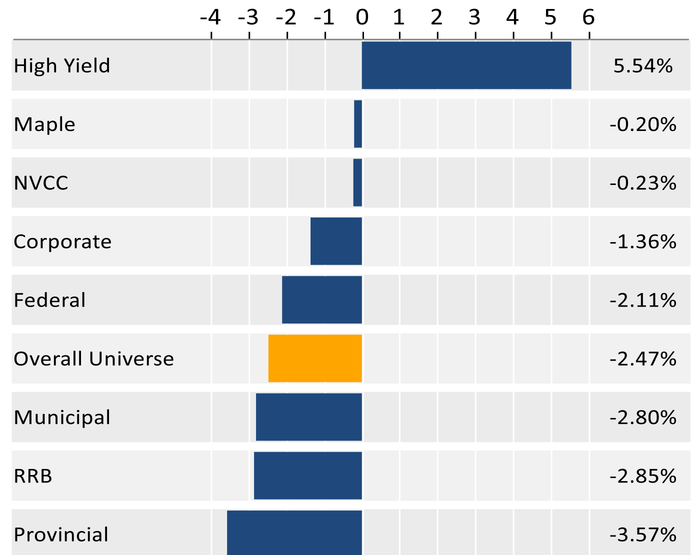
Index Returns

FTSE Canada Universe Bond Index

MoM Return

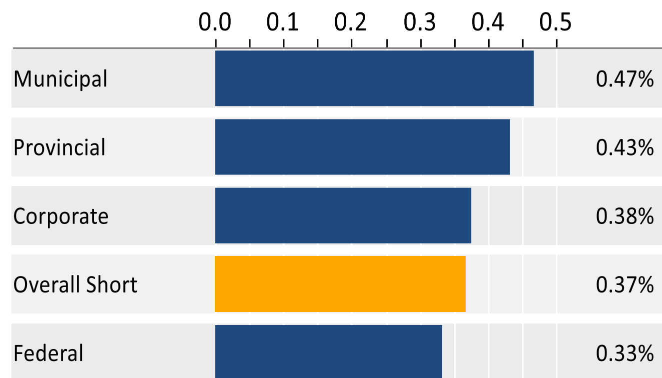


YTD Return



FTSE Canada Short Term Bond Index

MoM Return



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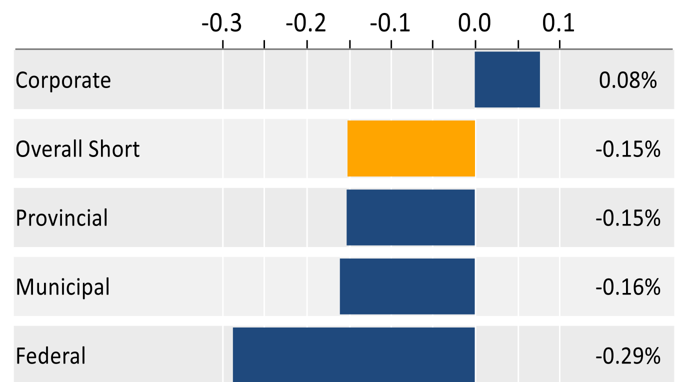
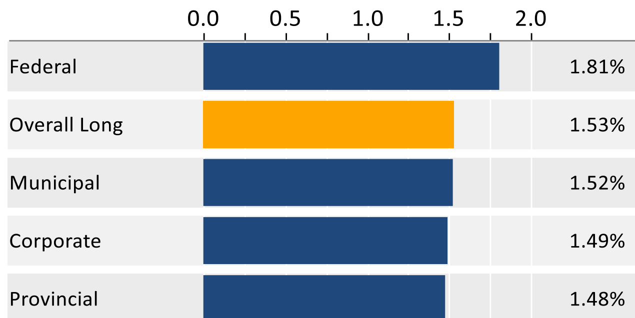
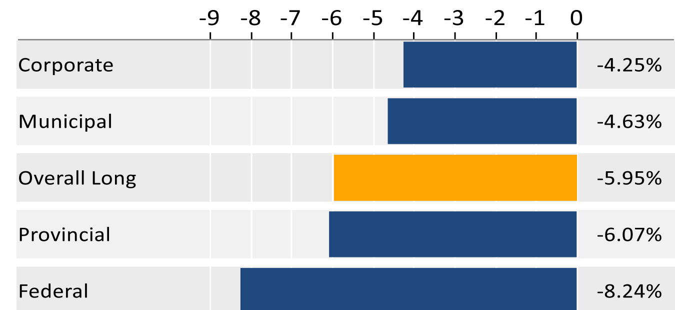


FTSE Canada Long Term Bond Index

MoM Return



YTD Return



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