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What We Think…

The years just prior to the start of the last decade in many ways shaped the decade to follow. The world was just emerging from the Great Recession, which to some extent was fallout from the excesses of the 2000's and even before. The severity of the recession and the subpar recovery (for all but the wealthy) also sowed the seeds for political change across many democracies. This has translated into a new nationalism from both the left and the right, challenging the liberalism that has dominated western nations since the second world war. The growing nationalism within democracies as well as autocracies is clearly impacting policies in many areas: immigration, trade, international relations, etc. While much of this political change is symptomatic of the events of the last decade, we would argue, it is more likely to become a driver in the next. Add in the impact of technological, demographic and climate changes, and it is evident that we will see a decade of significant uncertainty that will be challenging for investors. With this in mind, we present a summary of the most important factors we see driving economies and ultimately bond markets going forward.

Households

As demographics change globally, so too are households and their behaviours. Most developed countries are experiencing significant aging of their populations from a combination of lower fertility rates, longevity due to advances in medicine (drugs and treatments), and stricter policies on immigration. It is also, not just the ageing of the population that is important, but the distribution, with a huge cohort of Baby Boomers moving into retirement years, and their children – Echo Baby Boomers (Millennials) moving through the workforce and raising (small) families. Most importantly, this aging of populations has been accompanied by dislocations in wealth, employment, and consumer and government spending.

Much of today's household wealth is tied up by Boomers and especially those in the preceding (silent) generation who are still alive. A large chunk of these cohorts had the benefit of living through high rates of economic, productivity and wage growth. In addition, population and workforce growth combined with the free-flow of capital internationally to boost real estate prices and generate high rates of return on savings. Although there were sporadic conflicts across the globe, the world had not long ago suffered the tragedies of WW2, and most countries (the west in particular) were content to live according to a new world order that promoted international trade and economic growth.

Although North American economies are facing a shortage of workers, the average actual retirement age has only started to rise, after being stagnant for many years. However, Boomers, despite being far healthier than previous generations, are still retiring well before their life expectancies. For Boomers born in the "second-half" of the cohort, who may not have accumulated the same wealth as their "first-half" siblings, they will likely need to work longer to live through old-age (which is becoming more costly) or to support their children (who are increasingly finding it difficult to get a leg-up). For Millennials (those who entered the workforce this millennium), work has been a mixed bag. Manufacturing jobs, which once defined the middle class, have disappeared in large numbers, replaced by service jobs divided between high paying professions (e.g. engineering, finance) and low-paying services (e.g. hospitality and personal/home care).

With wage growth relatively stagnant for much of the last decade, households have struggled to keep pace with the growing cost of commodities and services. In the US, consumers, who were shell-shocked from the housing defaults that precipitated the credit crisis, have reduced consumption, consequently lowering household debt to income levels. In Canada, where debt to income levels were far lower at the time of the credit crisis, consumers largely avoided defaults. Unfortunately, Canadian households have had no similar introspection (as their US neighbours) and have continued to accumulate debt. Canadian household debt to income levels are now at about the levels where they peaked in the US around the credit crisis. Not surprisingly, household debt has become a preoccupation of the Bank of Canada, who recognises the risk it represents to future growth.

In both the US and Canada, Gens X, Y and Z (those born between 1965 and 2012) have not saved enough (though savings rates are higher in the US). With the disappearance of defined benefit plans, it has meant that most savers have to rely on defined contribution plans, and 401K's or RRSP's to save. But, in both Canada and the US, contributions have fallen far short of what DB-plans would have represented. Although equity markets have had an historic run since the credit crisis – aided by low rates and QE – stock ownership is concentrated amongst the wealthy (and the aged). We expect Canadian households to eventually respond to their weakened balance sheets with a combination of reduced consumption, increased savings, delayed retirement and less household formation (a pattern that is already in progress). Canadian governments will likely respond with more forced savings (through pension plans) and continued immigration (necessary to maintain economic growth and solvent government pension plans). Barring any significant uptick of inflation, we expect the BoC to keep policy rates accommodative allowing households a better chance of reducing their debt burdens.

Business & Trade

The contribution of the business sector to economic growth in Canada and the US has been disappointing for most of the last decade, especially the latter half. Business fixed investment has been essentially flat in both countries (representative of the situation in most developed countries). Developing countries have bucked this trend in investment over the period, but it is has been slowing their too. The trend towards services, the gig economy and globalization have reduced the need for plants and equipment in developed countries. We don't see the trend towards services abating, with consumption continuing to move from goods to services. The future of globalization is murkier, tied up in both domestic and global politics. Countries such as Canada, dependent upon exports will be content to maintain a liberal trading environment, while those countries with large trade deficits, principally the US, will be more interested in radical change.

Although President Trump's re-election this year is no certainty, we think the desire within the US for change to its trade relationships will continue. In fact, we would argue the only thing Democrats and Republicans likely agree upon is tougher US trade policies (particularly with China) and less reliance on existing trade structures such as the WTO. We think that changes to trade policy with China (and others) will be slow to show-up in the US's trade balance; and will be even slower to show up in terms of domestic capital investment and employment. Nevertheless, the world will feel the downward adjustment to trade through slower economic growth and shifting trade partners and agreements.

Although Canada's exposure to US trade is enormous, the reality of a slight US-Canada surplus and the "eventual" ratification of the USMCA, should ensure Canada is not materially exposed to aggressive US trade policy. More prescient will be Canada's ability to navigate its trade relationship with China in light of security concerns relating to Huawei, 5G and the detentions of Meng Wanzhou and the two Michaels. We believe there is a strong possibility that the Canadian government will find itself taking policy action on 5G that will not be popular with Hauwei and China and will only hurt Canada's trade relationship with China. The other noteworthy Canadian trade issue relates to what kind of progress, if any, we see on pipelines and an improved ability to get Canadian oil to market. Unfortunately, a substantial portion of Canadian investment still revolves around the energy sector, and given the indecision surrounding pipelines, especially in-light of the mounting concern over climate change, we believe that investment will likely continue to be a problem in the decade ahead.

Capital Markets

Though the economic recovery following the great recession has been the slowest (and longest) on record, equity markets have not particularly suffered. US and Canadian stocks returned annual averages (assuming dividend reinvestment) of 13.54% (S&P 500) and 6.89% (S&P TSX) respectively over the last decade, fuelled by accommodative central bank policies that encouraged risk-taking. While government bond returns were lack-lustre over the same period, corporate bond returns similarly benefitted from the same risk-taking behaviour found in the equity market and were comparatively strong. For the decade, US Treasuries and Government of Canada bonds returned annual averages of 3.13% and 3.20% respectively, while investment grade corporate bond returns were 5.54% and 4.88% in the US and Canada respectively (all in local currency terms according to the Bloomberg Barclays and FTSE Canada indices). Investors were further rewarded for taking on more credit risk with the average US and Canadian high yield returns of 7.57% and 6.70% respectively over the ten-year period.

Although there is room for Treasury and Canada yields to fall from their current levels, the "flatness" of both yield curves will limit the ability of either curve to fall without a policy change from the Fed and to a lesser degree the Bank of Canada. Both Chairman Powell and Governor Poloz have made it clear that they see no reason to move rates at the moment. We are convinced that the Fed no longer sees the necessity to push rates higher in order to clear room for future policy rate manoeuvres, sensing (we think Powell to be a "sensitive" guy) that rates are nearer to neutral than previously thought. (We wonder if the increasing reliance on QE by central banks is misguided given its questionable track record across central banks?) Investors could still force North American yield curves back to inversion, if legitimate recession concerns were to surface again, although we don't see that likely in the near-term. Our base case scenario is for US yields to drift slightly higher consistent with steady, but unspectacular US growth and benign inflation. Canadian yields will lag those in the US and could drop slightly in the front-end, given domestic issues (consumer debt, housing and trade) that will handicap Canadian growth.

We expect that monetary policy will be primarily data dependent with both the Fed and the BoC content to be late to any kind of increase of inflationary expectations. Inflation was benign over the last decade despite significant liquidity and tight labour markets. While we don't necessarily think low inflation will last forever, we see only a slight and gradual increase as the most likely scenario. Easy monetary policies elsewhere, particularly from the ECB and BoJ, will continue to be an anchor around North American policy rates, and keep money easy, globally. Also, the high levels of indebtedness across-the-board: households (very much a Canadian problem), businesses (having taken advantage of low yields and investor appetite to buy back stocks) and governments (especially a problem amongst developing nations) will make it difficult for policy rates to rise significantly.

Corporate yield spreads are as tight as they've been since the credit crisis, despite the significant growth of corporate bond issuance over that period. Low rates and excess capital have encouraged investors to focus on borrower's ability to carry debt while ignoring their leveraged balance sheets. The reach for yield has further facilitated the explosion of high yield issues which have been eagerly absorbed by investors. So long as monetary policy remains accommodative and a recession avoided, we do not foresee broad problems for the corporate bond market. However, since the credit crisis, dealers have become more broker than market-maker which limits their ability to prevent dislocation in the event of a change of investor sentiment. We feel that the risk of a sell-off in the corporate bond market translating into a rapid and large widening of corporate spreads, especially amongst less liquid lower quality issues, is very real.

Politics

Uncertainty seems to be about the only certainty to expect from politics going forward. Whether it be the unpredictability of Trump and Johnson, the aggressive determination of Xi and Modi, or the opportunism of Putin and Macron, the agendas of the leaders of the world's largest countries and economies will be difficult to predict and navigate. We expect domestic and global politics to remain in such a state of flux, that will inevitably have a significant impact on growth and bond yields.

Political polarisation appears to be reality in most democracies with those on either side unable and unwilling to listen to the other. The upcoming US election could possibly be the most visible polarisation in an US election we have ever seen, with those voters seeking a middle ground unable to find any natural home. Trump as the incumbent is already a polarising figure within the Republican party, and we will find out if there will be a similarly polarising figure leading the Democrats. A moderate nominee for the democrats (Biden or even Buttigieg) would likely result in some discontent amongst the far-left, but a more palatable candidate across party lines. A "socialist" nominee (Sanders or Warren) would force many voters to elect a "least undesirable" president. At this point, all bets are off as to how the election will unfold, but regardless of who wins, government will have to deal with growing economic disparity among households, the threat from China, the ambition of Putin, etc.

Canada has its own version of political polarisation, but true-to-form, it is on a much-reduced scale and consequence than south of the border. Geographical polarisation, with Quebec and Alberta/Saskatchewan voting along regional lines, has resulted in a minority government with an unclear mandate. However, Canadian minority governments have generally resulted in reasonable governance, so long as the government retains the confidence of parliament. There are many difficult issues facing the government including indebtedness, pipelines and China-policy which will challenge the abilities of the prime minister and his advisors to govern and maintain power.

Democracies beyond North America are also in a state of flux. In Europe, liberal governments are being challenged by nationalist parties. The clearest example is the UK, with the election of Boris Johnson and his Brexit agenda. Representation of nationalist parties at the European Parliament in Brussels has increased for all countries, albeit not anywhere near the levels seen in Hungary (nearly 70%). In South and Latin Americas there is instability everywhere, as populations rebel against governments blamed for weak economies and economic hardship.

Although authoritarian regimes don't have to deal with elections (or at least fair ones), their policies deal with many of the same issues that lead to voter polarisation. China, for example, must continue to raise living standards through rapid economic growth, or is in danger of dissention. Often these domestic concerns intersect with foreign policies, ultimately leading to geopolitical issues that are disruptive to the global economy – we think that especially true, today, of China and Russia. Ultimately, the growing rift between agendas of the worlds most powerful countries, irrespective of political system, will lead to more economic instability.

And finally, what about climate change? Not easy to answer, except that we feel it will fall squarely on the laps of governments to deal with. No one really knows the trajectory or severity of climate change, but increasingly it is becoming an issue being taken seriously by governments and their agencies. (A gauge of how-important it has become – once considered the rock star of central banking, our own Mark Carney will serve as UN special envoy on climate.) While climate change is really an issue that goes beyond government, it will ultimately take governments to coalesce divisive opinion and implement costly programs to influence climate change. What will be the ramifications for households, businesses, governments and economies is impossible to say? Perhaps a slowdown in growth, as behaviour is constrained, and funds are diverted to reducing and avoiding processes and resources that are believed to be at fault.

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