LORICA
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What We Think…

COVID-19 has shocked society to the core – not just in terms of health, but also in social, economic and financial terms. The most sinister feature of this virus is that many, perhaps the majority of carriers, are asymptomatic, resulting in a health impact that is only seen with some amount of delay, making it difficult to detect and prevent. While the social cost will not be easily measured, the disruption to all aspects of society is clearly massive. Unlike past crises, this a health crisis, that policymakers (health experts and politicians) are primarily able to combat with the most primitive of tools – quarantine – that the world has used at times throughout its history. It is far to soon to know the scale of the economic costs as the COVID-19 environment (social distancing and all that it entails together with extensive policy intervention) has emerged so rapidly and there are no trends yet to extrapolate. The markets are perhaps the only measure we can use with any kind of haste, but here too we are subject to enormous amount of volatility and the frivolity of investor sentiment.

In terms of dealing with the severe economic effects of the pandemic, there have been a dizzying array of policies that are now being implemented by all levels of government and central banks. Though the impact has been dramatic, we are still at the early stages of this crisis with the trajectory very much unknown. The collapse of employment in the span of weeks says it all. US unemployment is likely to rise from 3.6% in the United Sates (the lowest unemployment rate since the late 60's) to something much higher (there are estimates as high as 30% from the St. Louis Fed). In Canada, we had already been suffering from the decline in energy prices, so our unemployment rates were not as low as in the US; but we too will see high rates (likely the highest ever). Although the collapse in employment will be large, it will understate the number of people not actually working – government programs to keep workers employed through businesses subsidies and the many workers not captured in the workforce are just two examples of how the actual number will be worse.

But the real problem is not the depth of unemployment, but rather the length. If one were to imagine a quick reversal to pre-coronavirus society and commerce in a couple of months, there would be a massive dent in growth and for many, savings, but the economy would quickly regain its footing. But that reversal is impossible so long as there is no cure for the virus. The path from physical distancing, that has become the norm in so many countries, to our customary social life will not be easy or quick. It remains to be seen when western democracies will be in a position to commence this return and how this will happen. We have some hints how public freedoms are gradually returning in China, but the information is scattered and China's approach to quarantining its population is not really comparable to that of the West. There are some suggesting that the Icelandic or South Korean models are perhaps the models to follow for the West. However, Iceland – a tiny Nordic country of under 400,000 people with very few winter visitors – cannot be an example to anywhere, and South Korea has a significantly different culture from most European and North American countries.

We believe that the path of economic recovery will be dictated by the virus and our behaviour more than any fiscal or monetary policy response. Unlike the credit crisis, where investment decisions could be based on expectations that policies (mostly monetary) would eventually underpin a recovery, we don't think the same can be said here. For starters, we don't know how deep the economic hole will be, except that it will be much larger than what befell the Great Recession. Many businesses are completely shuttered and those that are not, are dealing with an economy that is only partially functional. (There are exceptions, groceries and alcohol are doing better than normal due to more eating at home and some amount of hoarding.) Eventually, other parts of the economy will come on-

stream, at which point the question will be how much and how fast. The range of outcomes is wide, considering where we are starting from. Our basic premise is that the broadscale physical distancing policies will last much longer than most currently expect, and that the re-integration of households into social life – school, work, recreation, etc. will be vary drawn out as officials try to walk a fine line between infection, hospital capacity and social life.

It is extremely difficult to gauge what the market is in fact pricing-in, in terms of crisis and recovery, and even more difficult to predict what that crisis and recovery will look like. A survey by McKinsey and Company of US consumers showed about 40% (over 3 separate polls: March 16-17, 20-22 and 23-29) were “**Optimistic:** The [US] economy will rebound within 2-3 months and grow just as strong or stronger than before COVID-19”. About 15% were “**Pessimistic:** COVID-19 will have a lasting impact on the economy and show regression / fall into lengthy recession”. The balance was “**Unsure**: The economy will be impacted for 6-12 months or longer and will stagnate or show growth thereafter”. We think markets more or less reflect the above sentiments and we think that is too optimistic. We do not see any possibility of a relatively sharp reversal and expect some long-drawn-out combination of decline and recovery.

It goes without saying that the implications of a slow normalisation of society have enormous implications everywhere. We will try and break down what we think is a possible scenario for the economy (governments, households and industries), policy (government and central bank), geopolitics and trade and finally, the bond market. A caveat to our outlook is the possibility of a cure – while we think a vaccine will ultimately be found, we are taking a conservative view that it will not be developed (discovered, approved and implemented) in time to avoid our forecast. (The Bill Gates Foundation who are an authority on vaccines, believe one will not be available before 18 months. They are currently financing 8 different trials.) Although we think discovery of better treatments is of vital importance, we don’t think it will offer much in the way of shortening the length of the crisis, as the limitation of hospital supplies, beds and, more importantly, staff will overwhelm those benefits, let alone the difficulties of a discovery.

Governments

The fiscal response of governments at all levels is necessary for a very simple reason – economic survival of citizens. In Canada, too many households are without income and savings to ensure they have the basic necessities of survival – food and shelter. We expect governments are going to have to foot the bill for substantial parts of the population well beyond enforced COVID-19 business closures. (It also remains to be seen if it will be necessary to furlough additional sectors such as residential construction and parts of manufacturing – Ontario has already expanded its closure orders several times.) In our view, most people, investors included, are underestimating how long it will take to get people substantially back to work. Eventually, those out of work will start working, but in a very selective manner and most probably in *fits and starts*. Perhaps some sort of work eligibility permit based on immunity will be implemented.

Federal and provincial government balance sheets will balloon, there is no way around this. Unfortunately, all governments (everywhere) had long ago dispensed with the notion of saving and thus entered the pandemic with compromised balance sheets. Governments first priority will be to get money into households where income has

disappeared, the second will be to preserve those parts of the economy sidelined until better times. The same will be true for governments around the world. It is difficult to know with any precision where government debt/GDP will peak, but safe to say it will be much higher than were it is now. As for how it will eventually be unwound, it is very hard to say. There is no precedent for such astronomical levels of government debt being unwound – we were already close to WW2 debt/GDP levels in the US before the pandemic. The only thing for certain, is that there is no playbook and it will exact significant pain on economies.

We have seen a host of liquidity measures implemented by central banks across the globe aimed at unclogging capital markets, including: ZIRP, expansion of repo programs, relaxation of banking leverage ratios and open-ended quantitative easing (QE) programs. These programs have focused mainly on decreasing market volatility, narrowing bid-offer spreads and improving the conduit of capital through the banking system. Unlike during the credit crisis, QE programs primarily, have not been targeted at flattening the yield curve to facilitate lower lending rates for long-term borrowers. Correctly, bankers realise that no amount of easing will kickstart capital spending nor provide the necessary financial relief. However, central banks will use more QE to support the vast amount of government and corporate borrowing that will be necessary to sustain economies.

Households

The gargantuan loss of employment and the likelihood, for some, that it will last for a while means that many people will be forced to subsist on very little. In the West, this means that many will rely on governments or, for those who can, on their savings. However, lost income, depleted savings and forgone spending cannot be recovered, which together with the difficulty of eradicating the virus, will make a V-shaped recovery impossible. It is reasonable to expect that many households will not quickly return to consumption, needing to mend their finances and forced to examine their prior easy-spending habits. In Canada, high levels of household debt will further complicate matters. Unlike after the Second World War, there will be no victory celebration nor is there lots of government spending capacity to throw at the economy. Never-the-less spending on infrastructure will be targeted, but economies dominated by services and consumption will not easily pivot to widescale projects. Furthermore, central banks will be left with little ammunition, having spent much of their arsenal through the crisis (and before), and having already seen the limited effectiveness of capital market manipulation which had proved lacking for anything but inflating the value of risk assets during the credit crisis. If the last decade has been a slow grind for households, the next will be, sadly, even slower.

Those households with incomes and savings will obviously be the best off through the crisis and the aftermath. But almost no-one will get off without a decline in both. Yes, some businesses are expanding through this crisis – grocery, corona-related health and retail shipping are just a few – and will pass some of the gains on to employees. But most businesses will only very gradually return to pre-corona levels of activity. Those providing non-essential goods and services will be subject to pricing pressures, which eventually will translate to incomes. Further down the road, the combination of large debt balances (government, business and household), anti-globalisation forces (discussed later), and wage losses will eventually result in inflationary pressures.

Industries

In the short and medium terms, those industries that provide consumer staples will continue to be in demand. Food, alcohol, health and shelter are obvious inclusions, a less-so obvious is telecom (the internet is a staple) and home entertainment. It will be interesting to see how abruptly food will have changed, as a generation who had become so reliant on restaurants, learns how to cook. Those involved in food production and supply will be fine, those involved in food preparation, unfortunately, will not. We expect catering and restaurants will be slow to emerge from the pandemic and partial openings (reduced density) and delivery will not be enough to satisfy many, already slim, margins. Shelter will be a mixed bag, although people need somewhere to live, there will be many mortgage and rent delinquencies, but with few defaults and foreclosures. It remains to be seen how much of both will ultimately be forgiven. Home construction and sales will slow until there is more clarity for the future.

Discretionary goods and services will be one of the hardest hit areas of the economy. Although apparel has elements of both staple and discretionary, with social life diminished, there will be less demand for new clothing. More substantial durables purchases will likely be deferred or even forgotten. Entertainment and leisure will also be amongst the hardest hit, save for those that can be consumed at home or individually – only a fraction. Anything related to travel will be at very reduced capacity until a genuine vaccine is found. Domestic oriented tourism will eventually emerge as the best in a damaged industry.

The prospects for financials will be a mixed bag. There have been a host of programs introduced by both the government and the central banks aimed at keeping businesses afloat. As the crisis deepens, policymakers are likely to expand and add programs, but it will be impossible to protect many businesses from failing with a ripple effect through financial institutions. Canadian banks are well capitalised and will weather the storm. Insurers will have slightly fewer negative headwinds, given they have significantly reduced their interest rate exposure since the credit crisis. Although, those providing business interruption insurance are exposed.

Utilities and infrastructure will be relatively better off than many other sectors. However, they will not get off unscathed as demand in some areas has dropped significantly in the short-term and will likely be handicapped for some time (e.g. pipelines, highways and airports). As mentioned above, governments will likely, once again, turn to infrastructure to kickstart growth. A significant portion of construction workers, who have been engaged in residential and commercial construction – there are likely to be fewer new projects – will offer a reliable labour pool for infrastructure projects. Unlike the last decade, where there was more infrastructure talk than action, we are likely to see more impatience to get projects started. Although Canada's infrastructure bank has appointed a new CEO, we think it will likely prove inadequate for the task, which will require a more rapid response through more direct government directive and less market consideration.

In addition to the dynamics of the crisis being played out in every country across the globe, there is a larger dynamic, which has become more evident as the crisis has progressed, that is also being played out between countries. Relations between nations have been built over many decades (since WW2) allegedly in mutual interest. As we have moved through the pandemic, what is in mutual interest has become less clear, as countries have been forced to act in self-interest. Although the world is without any leadership to coalesce around, it would be too simple to blame the lack of collaboration entirely on presidents Trump and Xi, as we have seen the same kind of

self-interest elsewhere, even within the Eurozone. It has become necessary for countries to protect their borders and, with the obvious and controversial exception of China, compete for the same healthcare provisions.

We think there will be a move to "de-globalization". The pandemic has revealed deep flaws in today's global supply chains and interdependency between countries. Governments will be motivated to address these flaws, and anything considered strategic or vital, will eventually be sourced at home. This will, of course, be a problem for smaller countries without the economy of scale or resources - it will be particularly difficult for less developed countries. Canada, who has relied on the US through a symbiotic trade relationship, will have no choice but to develop more of its own capacity. This will create new opportunities for employment and capital expenditure but will also likely generate inflationary forces.

Capital Markets

Central banks and regulators everywhere have taken wide ranging actions to both sustain broad parts of the economy and maintain capital market operations. These actions include: zero or near-zero interest rate policies, forward guidance, securities purchases (QE), enhanced credit facilities and repo operations, direct lending to financial institutions and corporations and relaxed regulatory requirements. In bond market terms, the goal has been less about stimulating economic growth, and more about providing market liquidity. In the early days of the crisis sovereign bond yields declined, credit yield spreads ballooned, and bid-offered spreads widened. Yield curves steepened while corporate yield spread curves flattened.

We have seen a significant narrowing of Canada-US yield spreads as the traditional flight to safety of US Treasuries during crises has dominated the move in mid and long-term Treasury yields. Although governments will continue to borrow on a historical level to facilitate massive fiscal stimulus, central banks will continue to grow balance sheets to facilitate issuance and put a lid on real yields. The Bank of Canada, which managed to escape the credit crisis without having to lever itself, has joined the move, invoking its own open-ended QE program through the purchase of Government of Canada securities, CMBs, BA's and provincial money market and commercial paper.

While the trading of corporate bonds was initially *gummed-up*, central bank intervention, particularly in the US, worked to unclog the market for investment grade issues. However, policymakers deemed that lower-rated issues were of less systematic and strategic importance, allowing the disfunction in the high yield market to persist (recent announcement of Fed intervention in HY will likely change this). While Canadian corporate bid-offer spreads have widened materially, the prevalence of high quality relatively well-capitalised issuers has meant that the widening has been more muted than in the US and markets have continued to function. However, the majority of corporate bond trade activity in Canada has been for shorter maturities, with less price sensitivity, whereas trading of longer-term maturities has been thin resulting in poor price discovery and wider yield and bid-offer spreads.

In the short term we think the pressure on nominal sovereign yields will come from a combination of significant factors including weak growth; deflation; huge government financing; and central bank purchases. Shorter-term yields will remain low as policy rates remain around zero (we do not expect the Fed or the BoC to experiment with negative rates). We do not expect longer term North American yields to fall substantially from their already low levels as QE will be implemented mainly to keep pace with issuance and the eventual shift out of debt into riskier

assets. Over the medium to longer-term, we expect short term rates to remain very low, but long-term nominal yields to rise. Long-term real yields will be higher as central banks eventually end the expansion of their balance sheets. Governments will be forced to inflate their way out of the hole created by massive government debt loads; growing their way out, will not be a realistic option. But it will be a challenge for governments to create the inflation, given the damage to balance sheets across the economy and the reduced arsenal of central banks.

Provincial bonds, despite their overall high credit quality, have not escaped the hit to credit markets during a crisis. However, provincial yield spreads did not eclipse their peak seen during the credit crisis, although, admittedly, we are starting from much lower overall yields. (The widening of spreads is thus greater as a percentage of yield.) As markets settle down, we expect provincial bonds to perform well versus corporates. Provinces will take a fiscal hit and borrowing requirements will increase significantly over the short term. However, it should not be a problem for the provinces as provincial financing programs have a lot of breadth and will be supported by the Bank of Canada's QE program.

Corporate bonds will have additional factors impacting their yields. In the short term, these include risk aversion; deteriorating balance sheets; and industry specific considerations, many of which are negative. Liquidity considerations will also continue to hang over the market, widening both yield and bid-offer spreads. We expect corporate yield spreads to remain wide for some time as investors lose some of their tolerance for risk and, unlike the credit crisis, central banks are left with little they can do repair it. Although yield spreads have already widened significantly, we think there is still risk of further movement. Our portfolios entered the crisis with less credit risk and are therefore positioned to take advantage of more attractive corporate spreads.

Although bond market returns are likely to be low for some time, bonds will continue to offer the most secure option in what will likely be a very uncertain future over the short and medium term. We expect riskier assets will continue to exhibit significant volatility; corporate bonds will also suffer from reduced liquidity. We do not expect that the Federal Reserve and the Bank of Canada will attempt to bring longer term yields lower, preferring to focus on short and medium-term yields, bond market liquidity and credit spreads. In addition, central banks are keenly aware of the implications for savings that come with near zero long-term yields.

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