LORICA
INVESTMENT COUNSEL INC.

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What We Think…

The Virus

The World Health Organisation declared COVID-19 a pandemic on March 11 at which point there were 118,000 cases in 114 countries and 4,291 deaths. Nearly four months later (as of July 8th) there are 12,260,000 cases in 216 countries and 554,074 deaths. (All data according to www.worldometers.info.) Unfortunately, the number of cases continues to grow at an alarming rate as some countries struggle to control the first wave, while others grapple with re-openings. It appears that the pandemic will continue until a vaccine is found (there are 152 in development) or some sort of herd immunity takes hold.

We have seen across the globe how relaxing social distancing constraints too quickly leads to a resurgence of cases which then leads to the re-imposition of constraints. The US, unfortunately, serves as the best example of the difficulties associated with re-opening a nation's economy. Too many US states have had to go back and shutter parts of their economies that were prematurely re-opened; it remains to be seen if these re-closures will be enough to gain control of the virus. The range of re-openings and re-closures across the US also point to the difficulty in predicting how the broader economy will respond over the course of the pandemic.

Without "game-changing" treatments or a vaccine, there are essentially three different actions that can be taken to control the virus: lockdowns; change in social behaviour; and testing, contact tracing and quarantine. Lockdown's are the least preferred strategy, given the economic damage that ensues, and the reality of population exhaustion and rebellion. Change to social behaviour, while generally more acceptable, is wrought with difficulties as there is a wide range of prescribed changes and most importantly, compliance. The holy grail is test/trace/isolate which permits the greatest social freedoms, but which is dependent upon gaining control of the virus (i.e. eliminating most community spread and having excess healthcare resources) and having infrastructure to test and trace quickly and effectively.

The US is not ready for test/trace/isolate despite significant political pressure, as cases are growing too rapidly, and many states are running too close to ICU capacity. Most states are vacillating between various degrees of behaviour modification and lockdowns. Canada, perhaps because of a more relaxed approach to government, is very gradually relying on personal control of behaviour, but is still under lockdown in significant parts of society (camps, gyms, etc.). In general, the difficulty with modifying behaviour when it is left to individuals is that too many don't comply. This will be an ongoing problem for many western countries, where we are likely to see complacency lead to outbreaks. It is still unclear where and when test/trace/isolate will be sufficient to contain subsequent outbreaks or if partial lockdowns will continue to be necessary. The US experience suggests that we are not past the point where even the most hesitant governments will refrain from re-imposing lockdowns.

The Economy

In Q2 (the first quarter of the pandemic), the global economy is estimated to have collapsed by around 10% according to both the OECD and the Economist Information Unit (EIU). The WSJ Economic Survey of the US economy has second quarter real US GDP growth averaging -33.5% (with a fairly significant standard deviation). We accept that it is extremely difficult to estimate the impact of the pandemic on GDP given the range of lockdowns that have been employed across the globe and the varying degrees of government policies enacted. But it is clear that a huge hole has been made in Q2 growth, the magnitude of which has not been seen since the Great Depression.

However, most economic forecasts have 2020 GDP growth much higher than for Q2, implying a substantial rebound in the second half of the year. The same OECD and EIU forecasts (mentioned above) have 2020 GDP growth at -4.6% and -2.5%, respectively; and the average WSJ forecast for US 2020 GDP is -5.9%. Are these rebounds realistic? With no end to the pandemic in the foreseeable future, we will not see global economies get back to pre-pandemic normal. We believe the most likely scenario for countries across the globe as oscillation between social distancing constraints and lockdowns, which unfortunately, will continue to handicap economic growth.

With ongoing behaviour modification and partial lockdowns likely until conditions are met for an end to the pandemic, it is difficult to envision anything but a moderate bounce to the US and Canadian economies. Hopefully we will not revisit the severe lockdowns of March and April and the resultant loss of economic growth that followed – although the pandemic is headed in the wrong direction in the US, it seems that the threshold for the previous level of lockdown, is far greater. Nevertheless, restrictions on behaviour and partial lockdowns will ensure that significant parts of the workforce remain unemployed and underemployed, global trade and travel will be subpar, and household spending will be limited. A return to pre-pandemic economic growth – a U, V or W-shaped recovery (economists seem to like letters) is not likely, rather, we expect growth to follow the favoured “Nike swoosh” trajectory.

For the moment, we are not putting too much weight on high-frequency economic data for indication of what to expect in the future, given the extreme volatility and absence of underlying trends. We expect it to take some time before the data settles down and trends emerge. The nature of the pandemic is such that until it is reliably on some kind of sustainable path – a great unknown, given how much it still unknown about the virus – it will be difficult for the economy to also follow a sustainable path. That being said, the magnitudes of the changes that we have seen in many economic indicators are indicative of the displacements to economies. For example, we have seen the largest monthly job losses and gains and changes to retail sales in the US and Canada on record, during Q2.

The Bond Market

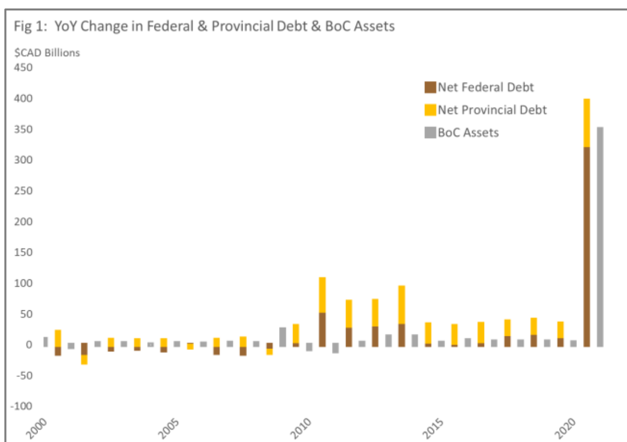
While we expect economic data will continue to be volatile for the foreseeable future, we do not expect the volatility to translate to the bond market. The yield volatility that we saw at the beginning of the pandemic has dissipated and bonds have, for the most part, dropped into narrow trading ranges. That being said, we believe there is still room for more policy action from central bankers to further flatten yield curves in response to more deterioration or disappointing recovery of economies. Although the short-term economic outlook is admittedly poor and bond issuance is at record levels, both have become somewhat irrelevant to the bond market as central banks have assumed control of yield curves through their unprecedented quantitative easing (QE) programs.

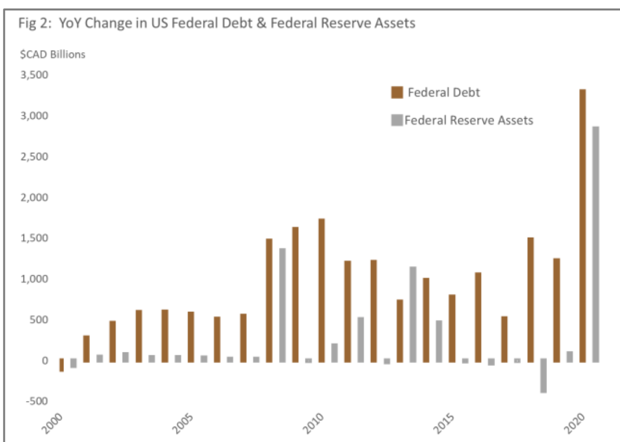
We have entered unchartered territory when it comes to government borrowing and central bank balance sheets. Theory suggests that government leverage (debt/GDP) can decline through either economic growth which enables debt repayment while increasing real GDP, or inflation which increases nominal GDP. In both cases debt to nominal GDP declines, making government balance sheets look better. We do not see the prospect for either of the above scenarios in the near or medium terms; further out, it is hard to predict. But what we do see is a very strong impetus to maintain low bond yields, at least for the short-term area of the yield curve.

At the start of the year, US federal debt to GDP was at 107%; at the end of Q2, it is likely to be above 135% (based on debt outstanding and an estimated decline of Q2 GDP) surpassing the previous record

of 118% after World War II. The massive increase in US federal so far this year (at least 25%) and other public debt has required central bank purchases to maintain low yields. The current QE program is the Fed's second, the credit crisis being the first (it was never fully unwound as liquidating assets proved difficult when increasing the policy rate cushion became a more pressing imperative). The Bank of Canada is new to the QE game – it did not attempt, nor did we think it would ever deem it useful – to use QE to reduce bond yields during the credit crisis. However, we did not anticipate the Bank using QE to absorb record amounts of Canada bond issuance, which it has been forced into doing. We postulate that bond market support from the Fed and the Bank of Canada will not disappear anytime soon, certainly not as long as both governments have excessive financing needs.

The enormous government and corporate bond issuance coupled with the corresponding enormous government and corporate bond central bank purchases have distorted bond yields and made "price discovery" in the bond market largely impotent. (By "price discovery" we refer to the relationship between bond prices and the fundamental factors that typically drive these prices, e.g. risk-free rates, credit risks, inflation, etc.). QE programs have become the overriding factor driving bond prices. In the US and Canada, government purchases have largely kept pace with government borrowing (see Figures 1 & 2) eliminating the market impact that such a massive increase of government debt should have. Although corporate purchases have been relatively insignificant compared with corporate borrowing, the mere existence of corporate bond purchase programs has provided assurance to investors, that there is central bank support for the corporate bond market. This support has similarly eliminated the impact that the increase of corporate leverage ratios would otherwise have had.





We see the current version of QE in three phases. The first phase of QE was invoked to support the bond market following the knee-jerk reaction to the onset of the pandemic which had caused yields to spike and credit spreads to widen. However, once yields settled, the second phase of QE has been about the absorption of the record amounts of government issuance and as an insurance policy against the record amounts of corporate issuance. (The fact that investors have absorbed the vast majority of corporate issuance suggests a rotation into corporate bonds, despite deteriorating corporate fundamentals.) We think that the Fed will at some point decide to further flatten the yield curve – a third phase of QE is one possibility, the other is yield curve control or YCC. We feel it is too early for this next flattening move, as an additional decline of longer-term yields would likely go unnoticed by the real economy at this time.

So, what is YCC and why would the Fed prefer it over more QE. YCC is fairly easy to understand – it is simply targeting treasury yield levels along the yield curve through the purchase of treasury bonds on

the secondary market. The Fed would purchase an unlimited number of treasuries at specific maturities along the yield curve to keep yields on target. In contrast, through the next phase of QE, the Fed would purchase a prescribed number of treasury bonds at specific maturities along the yield curve to further lower yields. QE does not guarantee a precise yield level, but rather a precise number of treasury purchases, which may necessitate adjustment to future purchase amounts, should yields not decline sufficiently. It is easier for the Fed to control yields through YCC but more difficult to control the impact on it's balance sheet. In both cases, the bond market is distorted.

We wonder if the Bank of Canada would follow with either of phase 3 of QE or YCC? We think Government of Canada bonds would be indirectly supported by either of the Fed's options, hence the Bank should not feel obliged to follow the Fed. At the same time, either strategy would lead to growth of the Fed's balance sheet, thereby creating implicit room to grow the BoC's balance sheet, without (theoretically) jeopardising the Canadian dollar. (We postulate that the largest constraint to BoC QE, is the size of its balance sheet in relation to that of the Fed's – currently the BoC's assets/GDP is close to half of that of the Fed's.) In the event that Canadian yields do not follow US yields lower, we believe the Bank would have policy options.

A Note About Inflation

There has been a lot of discussion surrounding inflation given the amount of liquidity being provided by central banks. Monetary aggregates have increased significantly this year – in the US, M1 has grown by about 35% to the end of June; in Canada M1++ has similarly grown by 35% to the beginning of May. Although unemployment has risen in both the US and Canada, personal income has risen too, with government support supplanting lost incomes in a major way (US personal income is up by 7% YTD SA to the end of May). However, economists surveyed by Bloomberg expect the US PCE deflator to come in at 0.8% for 2020 and 1.7% for 2021, and Canadian CPI to be 0.6% and 1.6% over the same periods. We are similarly unconcerned over the inflation outlook, noting that consumer spending will continue to suffer while the pandemic lingers. We expect savings rates to increase as some households work to replace recently tapped savings, while others are frightened into fixing chronically inadequate household balance sheets.

US five-year implied inflation rose with the US 5-year, 5-year forward inflation expectation rate reaching 1.52% at quarter-end, after hitting a temporary low (since the credit crisis) of 0.86% mid-March. Real Canada and Treasury yields both fell significantly into negative territory during the quarter, and more than corresponding nominal yields (nominal yields are equal to real yields + implied inflation). Notably, the Bank of Canada and Federal Reserve are both including inflation linked bonds (ILB's) – RRB's and TIPS in their asset purchase programs which are likely to have had a greater impact on real yields than nominal yields, given the chronic supply/demand imbalance of ILB's. Although flows into ILB ETF's have risen (investors looking for value or eventual inflation), we feel the increase of implied inflation is unlikely the result of a broad increase of actual inflation expectations.

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