LORICA
INVESTMENT COUNSEL INC.

December 2020

What We Think...

We look forward to 2021. It is hard to imagine more uncertainty than what we experienced in 2020, but from a capital markets perspective 2009 was worse. Our lives were plenty upended in 2020, but policy-makers had the benefits of a dress rehearsal during the credit crisis which enabled them to respond quickly and effectively to stabilize markets and the economy – as much as possible. With the deployment of the vaccine in progress, the US election out of the way, Brexit resolved, some key uncertainties have disappeared, although many still remain. There are still big unknowns related to the virus: mutation, vaccine production, distribution, acceptance, efficacy, number and severity of subsequent waves, etc. The global economy is still vulnerable and as yet, no-one has addressed how the mountains of corporate and government debt will be dealt with. And geopolitical risks will not easily dissipate, given the growing assertiveness of China, the boldness of Russia, the desperation of Iran, and a new administration in Washington.

When news of the virus eventually made its way out of China and it was clear the world was facing a pandemic, the knee-jerk reaction of capital markets was not surprising: sovereign yield curves fell and steepened, yield spreads widened, and equity prices fell. However, policy-makers, with the benefit of experience, responded with coordinated actions. Central banks lowered rates to near-zero and implemented QE programs to create liquidity and backstop government and corporate debt markets. Governments enacted fiscal policies to subsidize households who were facing severe losses of income. The swift and convincing response precipitated strong capital market returns for the remainder of the year for risk assets, overall – although there were definitely winners and losers. Figure 1 shows quarterly total returns for selected market indices in Canada and the US. Clearly, the initial reaction to the pandemic was a flight to safety of sovereign debt. However, a quick rebound followed the policy response, and as the year progressed, investors were more secure taking on risk of corporate debt and equities. Notably, US investment grade corporate bonds faired better overall than high yield – again a consequence of winners and losers, but in the riskier debt space. Lofty valuations in the tech sector drove equity markets, evidence by the huge gains of the tech-rich NASDAQ 100 versus the diversified S&P 500. Sadly, the S&P TSX, with its large exposure to energy and financials and only 10% to technology, trailed the S&P 500 by about 11% (US dollars).

Figure 1: 2020 Index Total Returns

	FTSE Russell Canada Federal (Non-Agency)	FTSE Russell Canada All Corporate	Bloomberg Barclays US Treasury	Bloomberg Barclays US Corporate	Bloomberg Barclays US High Yield	S&P TSX	S&P 500	Nasdaq 100
	(% local currency)							
Q1	5.69	-2.48	8.20	-3.63	-12.68	-20.90	-19.60	-10.29
Q2	2.30	8.09	0.48	8.98	10.18	16.97	20.54	30.30
Q3	-0.21	1.34	0.17	1.54	4.60	4.73	8.93	12.62
Q4	-0.45	1.80	-0.83	3.05	6.45	8.97	12.15	13.09
Annual	7.42	8.74	8.00	9.89	7.11	5.60	18.40	48.88

Source: FTSE Russell, Bloomberg & Lorica Investment Counsel Inc., December 2020.

Policies directed at supporting the economy, softened the impact of lockdowns and closures on specific sectors and households, but did not prevent recession in 2020 – Canadian and US 2020 GDP growth are expected to be -5.7% and -3.5%, respectively, according to the median estimate from Bloomberg's survey of economists. Expectations for 2021 are for a strong economic rebound off a relatively low base, with the median forecasts of 4.4% and 3.9% respectively. Optimism for economies are based on rapid vaccinations and eventual herd immunity. We think that a recession for 2021 is unlikely, but that subsequent waves of the epidemic are inevitable which will slow economic growth to levels below the median forecasts – look for uneven growth throughout the year. Government fiscal policies will support households, but it is not clear that income subsidies will find their way directly into the economy to boost growth. As was the case in 2020, uncertainties surrounding the virus are likely to continue to favour savings over spending (see Figure 2).

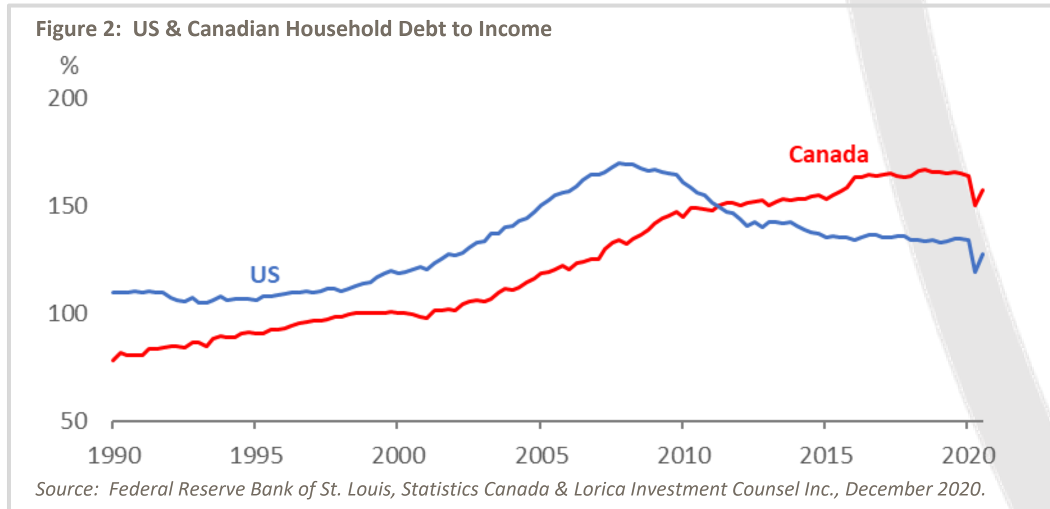


Figure 2: US & Canadian Household Debt to Income

Source: Federal Reserve Bank of St. Louis, Statistics Canada & Lorica Investment Counsel Inc., December 2020.

We believe a lot of the optimism around 2021 growth is based on the success of vaccines, but there are significant questions related to production, distribution, acceptance and efficacy. The favoured (approved in North America) vaccines, thus far, are Pfizer- BioNTech (PB) and Moderna which have projected dose production in 2021 of 1 to 1.3 billion and 0.65 to 1 billion, respectively, which would be enough to immunize at least a billion people. A billion people is significant, but not necessarily in the context of the entire globe. The Oxford-AstraZeneca (OA) vaccine (approved in Britain and India) has much higher production capacity of up to 3 billion in 2021, but with lower expected efficacy. It is not clear how companies will ultimately choose to allocate their production against their order lists. Notably, PB has recently bumped the US in the queue in exchange for its ability to secure necessary ingredients and India has indicated it will not allow exports of the first few months of production of the OA vaccine. Other vaccines from China and Russia, that have been approved locally, could alter the global picture, but the lack of transparency surrounding their trials makes their adoption unclear. Administering of vaccines is also unclear – there are already scores of countries with doses waiting to be used because of inadequate deployment plans, but this should improve. Vaccines offer much hope, but not without much uncertainty.

The US presidential inauguration is just weeks away and with the Georgia senate race finally settled, a considerable amount of uncertainty surrounding the government has been removed. Control of Congress should ensure that Biden can implement his agenda with the minimal of obstruction. We expect fiscal policy to lean towards spending – we doubt the perils of ballooning US government debt will be an overriding concern. There will likely be some change to the geopolitical risks - we anticipate less confrontation with traditional allies. That being said, we feel the enmity towards China that was championed during the Trump presidency and which has weighed on global growth, is unlikely to disappear. Other geopolitical risks, such as those related to Russian interference and Iran's nuclear development are less likely to have major economic impact in the near-term.

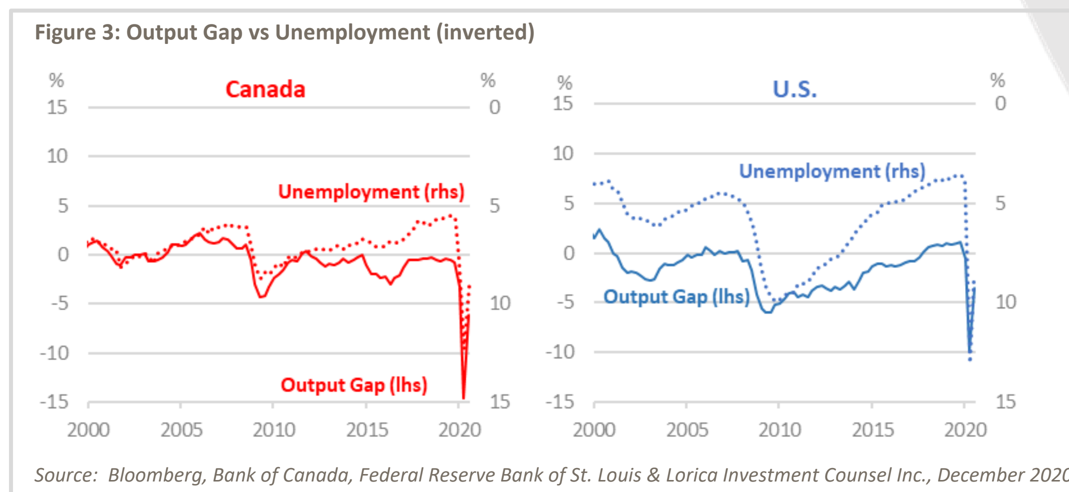
In terms of Canadian politics, we think the minority government will likely not need to work too hard at avoiding an election this year. Though geopolitics are ambiguous, trade relations with the US should improve, but those with China might not. Fiscal policies will continue to be generous – again we expect little concern for burgeoning government debt. Quantitative easing programs which were initiated to facilitate function of debt markets, will continue to support government issuance. Despite nearing a point where Canada's sovereign debt purchases are encroaching on bond market liquidity (provincial purchases have been insignificant), we expect some level of purchases to persist until pressure on yields is no longer a concern and excess government borrowing subsides.

Monetary policy will remain easy in 2021… in 2022… until the output gaps in economies close. In August, the Fed revised its Statement on *Longer-Run Goals and Monetary Policy Strategy* which included a new framework for price stability. The Fed' new framework underpinned the forward guidance in September's FOMC statement which included the following text:

With inflation running persistently below this longer run goal [2%], the Committee will aim to achieve inflation moderately above 2 percent for some time so that inflation averages 2 percent over time and longer-term inflation expectations remain well anchored at 2 percent…. and expects it will be appropriate to maintain this target range [0 to 1/4 percent] until labor market conditions have reached levels consistent with the Committee's assessments of maximum employment and inflation has risen to 2 percent and is on track to moderately exceed 2 percent for some time.

Unemployment rates have risen largely because of lockdowns and behavioural changes forced by the pandemic – e.g. dining, entertainment, recreation. While lockdowns will not likely last, some behavioural changes will, at least for a while or in parts. Additionally, though "creative destruction" is a feature of free market economies, the mountains of debt overhanging businesses and households will make rebuilding more challenging. We believe it will take time for unemployment to return to pre-pandemic levels which should ensure that output gaps persist and warrant easy monetary policy (see Figure 3). While some analysts/commentators are predicting that inflation is inevitable given the buildup of unused government support payments which will be unleashed on the economy as economic restrictions recede – we are not as sure. We think that it is more probable, that effects of the pandemic on spending patterns linger and inflation remains below target for some time.

Figure 3: Output Gap vs Unemployment (inverted)



Source: Bloomberg, Bank of Canada, Federal Reserve Bank of St. Louis & Lorica Investment Counsel Inc., December 2020

A year ago, 10-year US Treasuries and Government of Canada yields were about 100 basis points higher, and both 2-year yields were about 150 bps higher than where they are today. Yield curves fell and steepened in March-April in response to the aggressive lowering of rates and announcements of QE programs by the Fed and the Bank of Canada, as well as to the poor medium-term prospects for the North American and global economies. However, the US Treasury curve steepened a further 25 bps to year-end, while the Canada curve did not significantly change. It is reasonable to conclude that the bulk of curve steepening in both yield curves was due to the sharp decline in short term rates rather than higher long-term inflation expectations. However, in the US, where longer-term rates have risen an additional roughly ¼ of a percent since April (Canadian long yields did not change over that time), the 5-year, 5-year forward inflation expectation rate has risen by close to 40 bps over the same period, suggesting some change in investor expectations for US inflation. Ten-year break-even inflation rates are now at just over 2% in the US and 1.5% in Canada, both higher by about 10 bps than where they were this time last year. You also have to go back to 2018 to find a period when the breakevens were higher for a sustainable period in the US – a period when US GDP was over 3% after struggling to do better than 2% over the prior three years (Canadian GDP was around 2.5% for the same period).

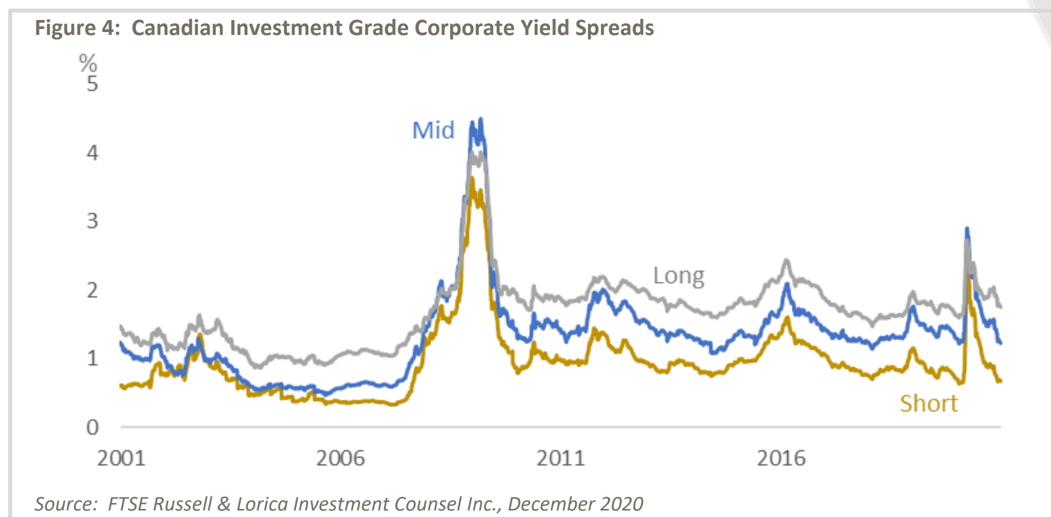
Chairman Powell has made it clear that economic conditions are not close to those necessary for a reversal of rate policy. The September FOMC statement also included the following text:

In addition, over coming months the Federal Reserve will increase its holdings of Treasury securities and agency mortgage-backed securities at least at the current pace to sustain smooth market functioning and help foster accommodative financial conditions, thereby supporting the flow of credit to households and businesses.

Fed policy implies little movement to the front-end of the yield curve and if anything, we think the FOMC will consider more aggressive QE, including Yield Curve Control (see our June 2020 What We Think), to lower long-end yields, particularly if investors continue to push long-end yields higher. At a minimum, we do not see a sustainable rise in long-term yields and bear-steepening of the yield curve as likely.

We are not constructive on sovereign bond market returns, given the extremely low rate structure and our expectation that yields will remain low for some time. We see a more attractive opportunity in the corporate bond market where investors are better compensated for taking on duration risk. Admittedly, Canadian investment grade corporate yield spreads are at roughly pre-pandemic levels (see Figure 4) – before economies had to contend with lockdowns and high unemployment. However, the problems facing the Canadian economy overall are not necessarily those facing Canadian investment grade credits. The relative high quality and narrow range of industries predominant in the Canadian corporate bond universe, has consistently allowed investors to look past some of the spread risks inherent in other credit markets. For example, in the US where the high yield universe has far more critical mass, yield spreads have not returned to pre-pandemic levels, and the number of issues rated CCC+ or lower has increased by 50% from a year ago (S&P). Investors were not compensated for additional credit and spread risk in 2021, with high yield returns below Treasury returns and well below investment grade corporate returns.

Figure 4: Canadian Investment Grade Corporate Yield Spreads



Source: FTSE Russell & Lorica Investment Counsel Inc., December 2020

Both the Fed and the Bank of Canada have provided substantial liquidity and implicit support of corporate bond markets through corporate bond purchase programs for short-term investment grade issues. Implicit, because in both cases little of the capacity of the programs has actually been used (leading the Fed to terminate its program at year-end). Notably, both country's purchase programs provided support for investment grade issues, which for the most part, will not be the problem should solvency become an issue. As with the period following the credit crisis, supportive monetary policy has encouraged investors to take on more credit risk, which has contributed to generally stable yield spreads, with the notable exception of March's outsized hiccup.

The absence of decent returns in sovereign debt will continue to push investors out the credit curve, supporting both the provincial and corporate bond markets. Though provincial fundamentals have deteriorated, we expect provincial bond demand to remain strong given their yield advantage over Canada's and continued QE. We expect Canada's investment grade corporate bond market to remain resilient as central bank support continues and credit metrics remain reasonable. The Canadian corporate market offers reasonable yield pickup and the concentration of high quality issues reduces some of the significant risks facing investors in other riskier bond markets.

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