CANADA'S DEBT HANGOVER

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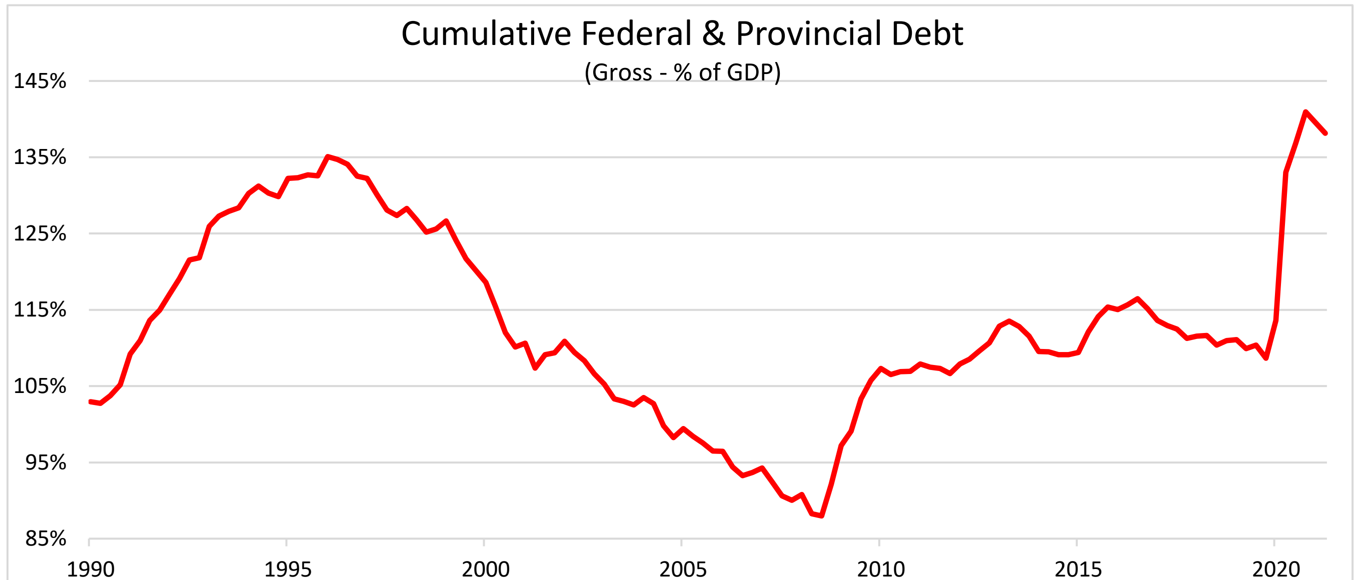
As the spread of the COVID-19 pandemic took hold, the global economy suffered through waves of economic uncertainty, underscored by lockdowns, partial re-openings, and further lockdowns. Amid the volatility, governments and central banks around the world responded with unprecedented levels of fiscal and monetary stimulus. However, with the major industrialised nations moving to fully open their economies, questions remain as to how to reduce the unneeded stimulus and how to deal with the accumulating debt burden. Various 'debt crises' have punctuated much of history with the derogatory acronym PIIGS[1], which emerged in the wake of the financial crisis, being only one of the more recent examples. At the time, serious debt problems in Europe gave rise to the PIIGS headlines. These were the nations that represented the largest investment risks and lenders were hesitant to hold their debt, without the incentive of materially higher interest rates. Longer-term investors will recall Canada's own brush with a debt crisis in the early 1990s. In some ways the current circumstances are different, as virtually every developed nation has borrowed heavily since the first quarter of 2020. And, for now at least, interest rates remain at, or near historic lows. Nevertheless, financial markets can be expected to favour those nations where fiscal probity returns first. The relative fiscal health of national balance sheets around the world will provide the competitive advantage of lower refinancing rates as the outstanding debts begin to come due. Having access to professional advice and maintaining a well-balanced portfolio during periods of significant change can allow smoother sailing for individual investors across choppy investing waters.

LIFTING THE CURTAIN

While federal officials have been quick to tout Canada's relatively low debt-to-GDP figures, the top line numbers do not tell the whole story. Most other countries do not also have debt issuers that approach the scale of Canada's provincial borrowers. The debt of the individual provinces is often overlooked when examining the national data. However, few would question that if push came to shove, the federal government would step in to prevent an outright default by any province. Further, federal accounting changes[2] have allowed the assets carried within the Canada Pension Plan and the Quebec Pension Plan to count against the debt for the purposes of reporting 'net debt', despite the fact that the government would not be permitted to use these assets to repay that debt. No other G7 nation practices these accounting measures. Even though the pre-pandemic 2019 federal budget boasted a Canadian debt-to-GDP measure of 30.8%[3] at the conclusion of fiscal 2018-2019 (the government did not table a budget in 2020), the ***gross*** federal debt represented 42.5% of GDP (first quarter 2019) and with the addition of the

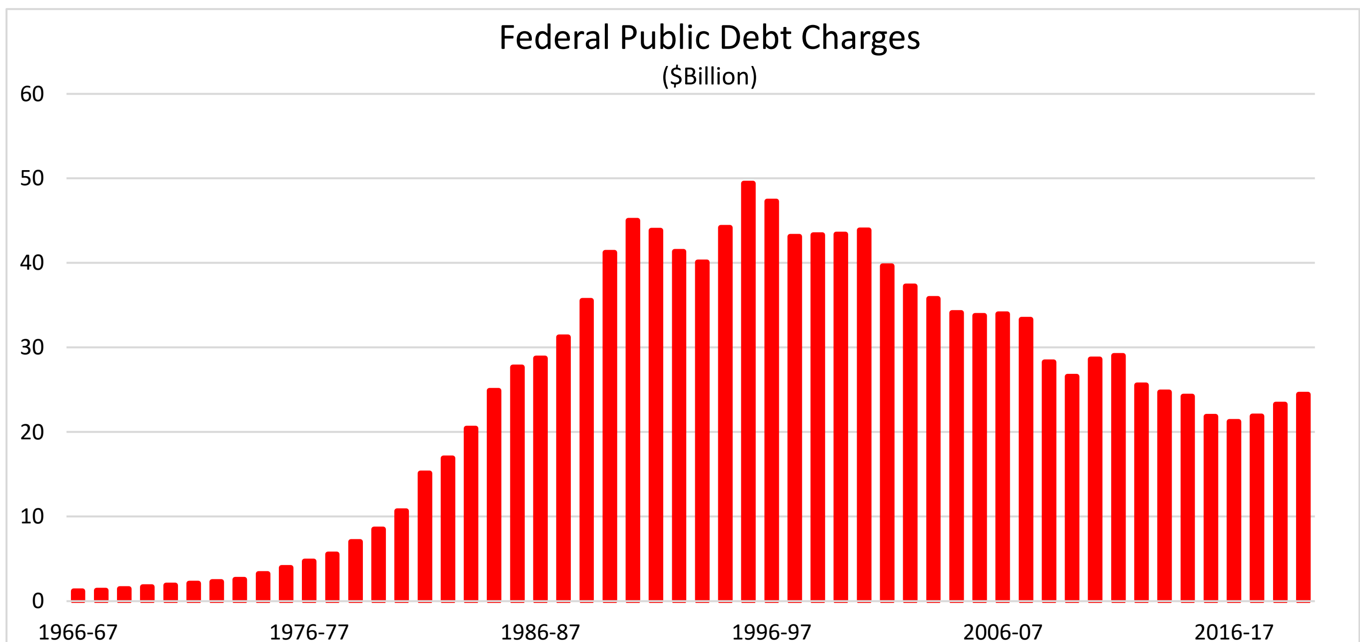
[1] Portugal, Italy, Ireland, Greece and Spain.
[2] Introduced in 1996-1997 by the Department of Finance (Prime Minister Jean Chretien and Finance Minister Paul Martin).
[3] Budget Plan 2019 – Table A1.2, Department of Finance Canada

provinces' debt, the total was a staggering 111.1% of GDP at that time. As can be seen in the accompanying graph, by the fourth quarter of 2020 gross debt as a percentage of GDP reached 141.0%, higher than the prior peak of 135.1% (first quarter 1996) and now the highest on record dating back to 1990.



Source: Statistics Canada

According to the latest federal budget, interest payments totalling $24.4[4] billion were made to the holders of the government's outstanding debt in fiscal 2019-2020. As can be seen in the graph below, this was well down from the historic high of $49.4 billion seen in fiscal 1995-1996. However, it still represents a significant burden and accounts for more than half of the $40.4 billion[5] that the federal government spends on health care transfers to the provinces.



Source: Canada Fiscal Reference Tables, Department of Finance. November 2020.

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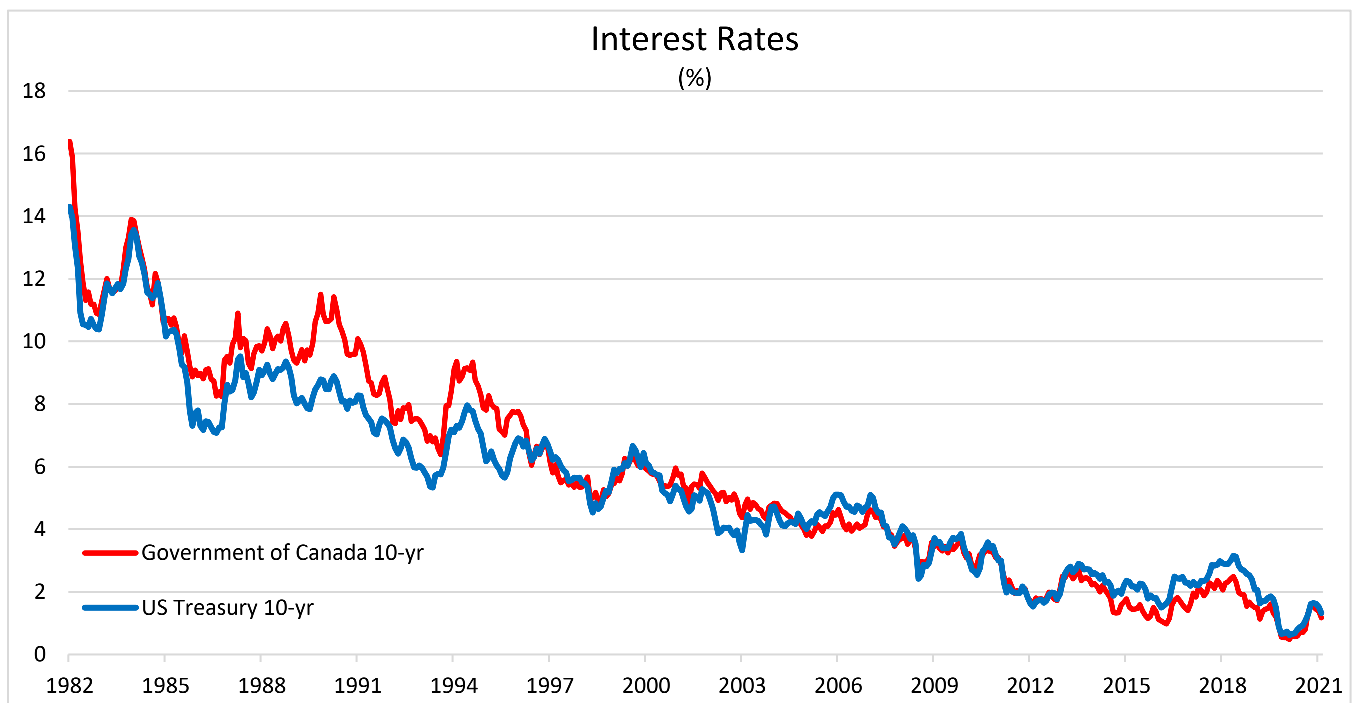
[4] Budget 2021 - Table A1.4, Department of Finance Canada

[5] InfoBase, Government of Canada.

HISTORY, HOPEFULLY NOT REPEATING

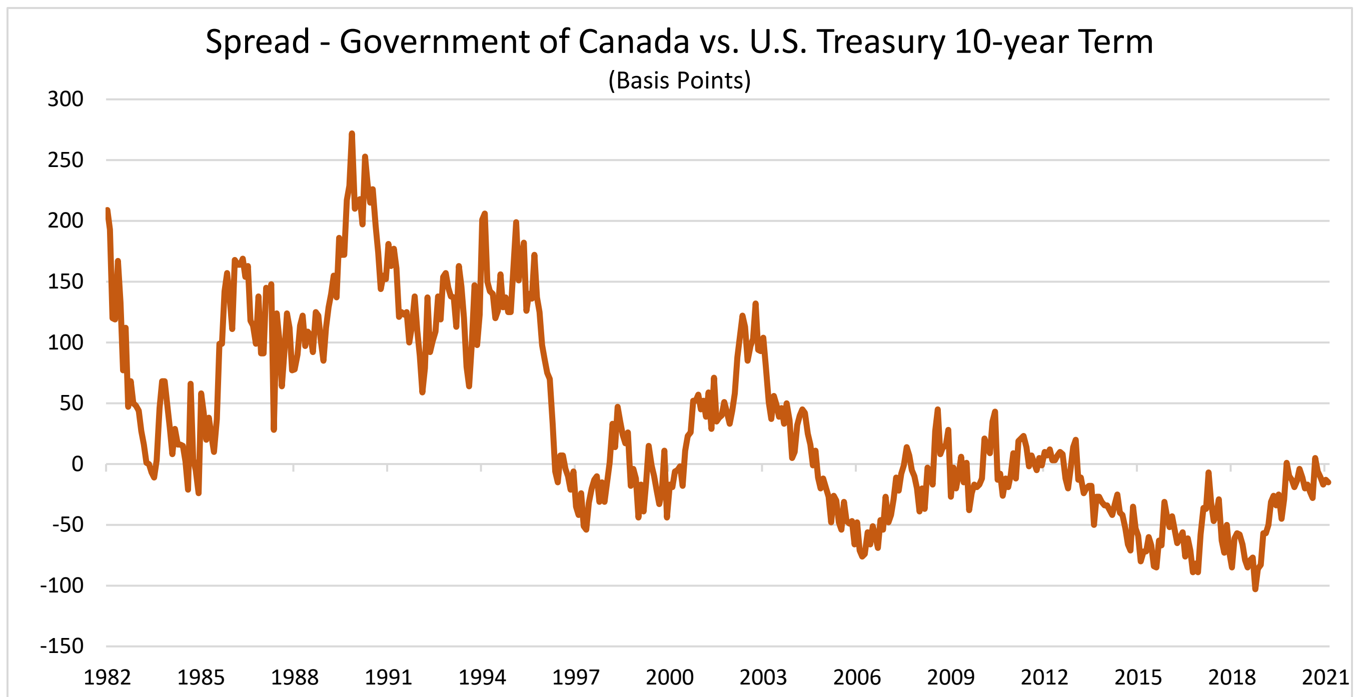
In January 1995, a biting Wall Street Journal article entitled 'Bankrupt Canada?'[6] dubbed Canada "an honorary member of the Third World in the unmanageability of its debt problem." It further suggested that the International Monetary Fund might have to step in. At the time, the Canadian dollar was worth less than US$0.71 and 10-year Government of Canada bonds yielded 9.34%. By comparison, U.S. 10-year Treasuries were paying a comparatively modest 7.78%. Even though the federal government brought in an 'austerity' budget in 1994, it included deficit spending. By the time the federal budget was tabled in 1995, most analysts agreed that Canada's borrowing was unsustainable. Difficult political decisions were forced upon the federal and provincial governments. Material spending cuts were accompanied by tax hikes. The effects were seen quickly and a small budgetary surplus was recorded for fiscal 1997-1998. Once begun, the downward trend of gross debt-to-GDP continued for more than a decade. The onset of the financial crisis in 2009 saw a resurgence of government borrowing that did not end, in spite of consistent economic growth between 2010 and 2019. Canada's Parliamentary Budget Officer recently made headlines, as published projections suggest that the federal government will continue to run deficits though to 2070[7]. In essence, the budget actually will balance itself, but only after the better part of 50 years has passed. Further, this assumes that economic growth continues and interest rates do not change, materially.

INTEREST RATES



Source: Bank of Canada; U.S. Federal Reserve Board

[6] "Bankrupt Canada?" Wall Street Journal, 12 January 1995, p. A14.
[7] Fiscal Sustainability Report 2021, Office of the Parliamentary Budget Officer



Source: Bank of Canada; U.S. Federal Reserve Board

As discussed above, the most recent federal budget shows public debt charges totalling $24.4 billion. With the net debt estimated at $813 billion in 2019-2020, the effective interest rate is approximately 3%. According to the 2021 budget, a 100-basis point (a basis point is 1/100th of one per cent) increase in interest rates would translate into an increase in public debt charges of $3.1 billion in the first year, $5.3 billion in the second, and $8.2 billion in the third, the last projected year[8]. While a 100-basis point increase in rates may seem unlikely, given the length of time extraordinarily low interest rates have already prevailed, large global borrowing programs chasing scarce investor resources may change this. As can be seen in the above graph, the yield on the Government of Canada 10-year bond was 2.33% in November 2018 (compared to 1.17% in July 2021, 116 basis points higher). In April 2011, the yield was 3.27%, not an exorbitant interest rate but still 210 basis points higher than it is today. As well, Canada/U.S. interest rate spreads (the difference between yields on debt instruments with the same maturity) currently favour Canada. As can be seen in the graph above, the spread between the Government of Canada 10-year bond and the U.S. Treasury 10-year bond was -15 basis points in July. As history has shown, this can vary dramatically. In July 1995, Canadian debt problems meant that Government of Canada 10-year bonds needed to pay 199 basis points more than the U.S. equivalent to retain their wary investors.

INFLATION AND THE BANK OF CANADA

The period between the financial crisis and the COVID-19 pandemic was characterized by widespread concerns over ***deflation***. However, as the North American economies have reopened, concerns over inflationary pressures have resurfaced. In the U.S., the Bureau of Labor Statistics reported a 5.4% annual growth pace for its consumer price index (CPI) in July 2021. This is a dramatic acceleration from the 0.1% year-over-year advance seen as recently as May 2020 and is the fastest pace of inflation since August 2008 (also 5.4%). July 2021 data from Statistics Canada showed that the CPI had recorded a 3.7% increase over a twelve-month period. This is well above the 3.1% rate reported in June. The last time Canada experienced a faster pace of inflation was in Mach 2003 (4.2%). Analysts suggest that annual growth in Canada's CPI will likely hit 4% before the end of 2021. Even though both the Bank of Canada and the U.S. Federal Reserve have been clear that they do not intend to raise interest rates any time soon, historically low administered interest rates cannot be expected to persist indefinitely. The question of how much inflation can and will be tolerated remains unanswered.

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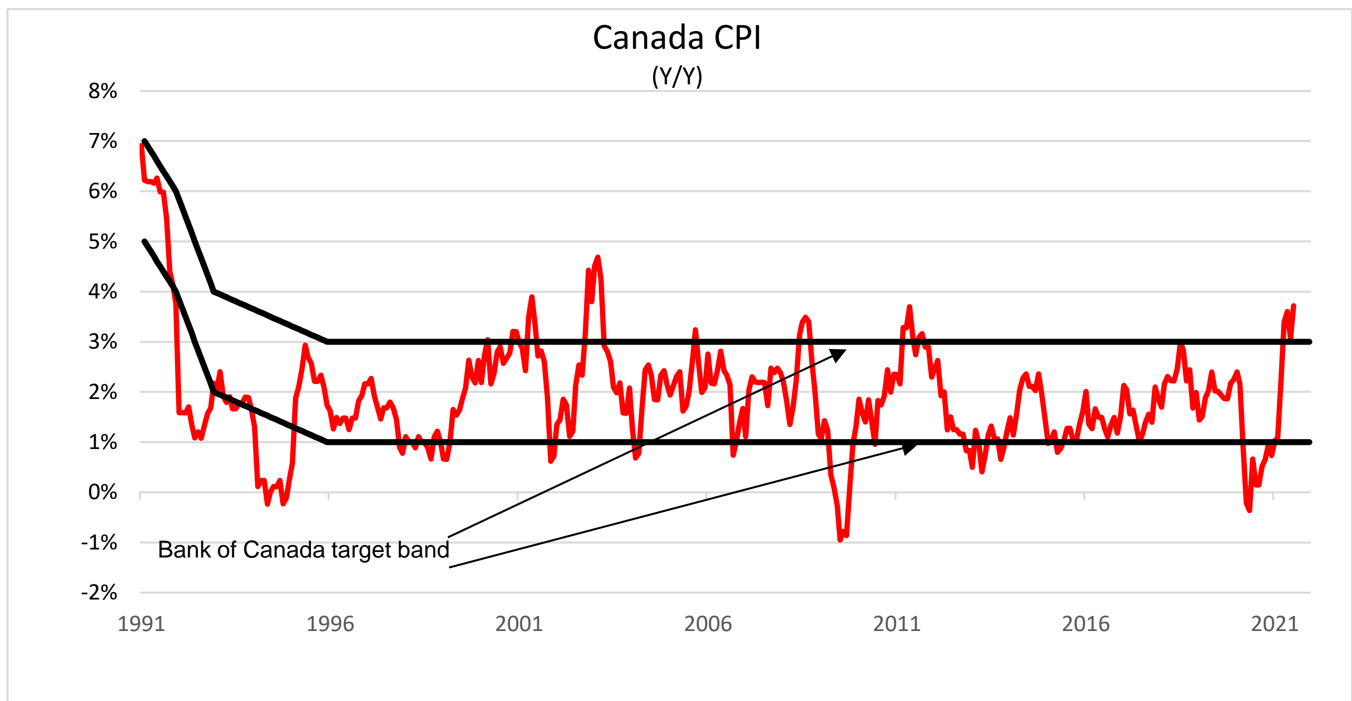
[8] Budget 2021 - Table A1.11, Department of Finance Canada

At its latest monetary policy announcement, the Bank of Canada stated that it was holding interest rates steady, with its target for overnight borrowing unchanged at 0.25%. In another anticipated move, the Bank lowered its targeted weekly purchases of Government of Canada bonds to $2 billion. This is the third time since the end of 2020 that the bank has 'tapered', reducing the scale of its bond purchases. At the subsequent press conference, Governor Macklem stated that there was "some way to go to a complete recovery." The Bank's updated forecast revealed expectations for GDP growth of 6.0% in 2021, 4.6% in 2022 and 3.3% in 2023. If achieved, Canada's economic output would eclipse the pre-pandemic peak some time before the end of 2021. However, troubling for investors, the Bank also acknowledged that "inflation is likely to remain above 3 per cent through the second half of this year and ease back toward 2 per cent in 2022." Despite this commentary, the Bank's own forecast revealed that CPI growth is expected to fall to 2.4% in 2022 and edge down only to 2.2% in 2023. Since its introduction in 1991 the Bank's Inflation-Control Target has been the focal point of monetary policy in Canada. As can be seen in the following graph, the targeting has largely succeeded. Of primary importance has been the ability of the Bank to manage expectations of Canadians as they have come to, understandably, expect that inflation will remain in the 2 per cent range over the long run. This has served to reduce uncertainties for business and individuals as they make their own financial plans. A change in inflation expectations on its own could fuel an increase in consumer price levels. In line with the extraordinary expansion in fiscal policy, it now appears that the Bank may also be willing to err on the side of greater economic growth rather than inflation containment. The most recent renewal of the inflation target is set to expire on December 31, 2021. It remains to be seen what political winds will be blowing as 2021 winds down.



Source: Bank of Canada; Statistics Canada

Strangely enough, despite Canada's profligate ways, the apparent willingness of U.S. legislators to experiment with modern monetary theory (MMT) may allow Canada to remain relatively attractive to investors. Generally, MMT proponents argue that governments should use fiscal policy to promote full employment, with deliberate deficit spending when needed. The aggressive fiscal policy, in essence, increases the money supply. The primary risk associated with this approach is that once full employment is achieved, inflationary pressures will build quickly. While this relatively new macroeconomic theory has gained traction, history is replete with examples of high or even hyper-inflation where nations have carelessly increased their money supplies. Perhaps most famously, by 1923, the Weimar Republic of Germany was issuing 100-trillion-mark banknotes as prices soared. At the height of the inflationary period, when prices were doubling every two days, one US dollar was worth 4 trillion marks. More recently, as inflation soared beyond 1,000% in 2018, Venezuela simply stopped reporting official inflation estimates. Time will tell which nations will be rewarded with low refinancing costs in the future and which will not.

CONCLUSIONS

- Unlike Canada's experience in the early 1990s, the current debt and deficit issues do not appear to be generating the political will to balance the federal budget. Without some combination of spending cuts and higher taxes, the deficit appears likely to persist for the next five decades.
- All major industrialised nations leaned heavily on stimulative fiscal and monetary policy during the COVID-19 pandemic. The market will reward those countries, which move to adopt greater fiscal and monetary prudence, with lower interest rates and more manageable borrowing costs.
- Experienced investors have lived through debt crises in the past and have witnessed the market forces that accompany these episodes. Taking advantage of professional advice can provide a clearer perspective and help to keep emotions in check during uncertain times.

For more information, we encourage you to speak to your advisor or visit us at assante.com

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