Short term fundamental headwinds and record low yields limiting active relative value opportunities in the sovereign sector

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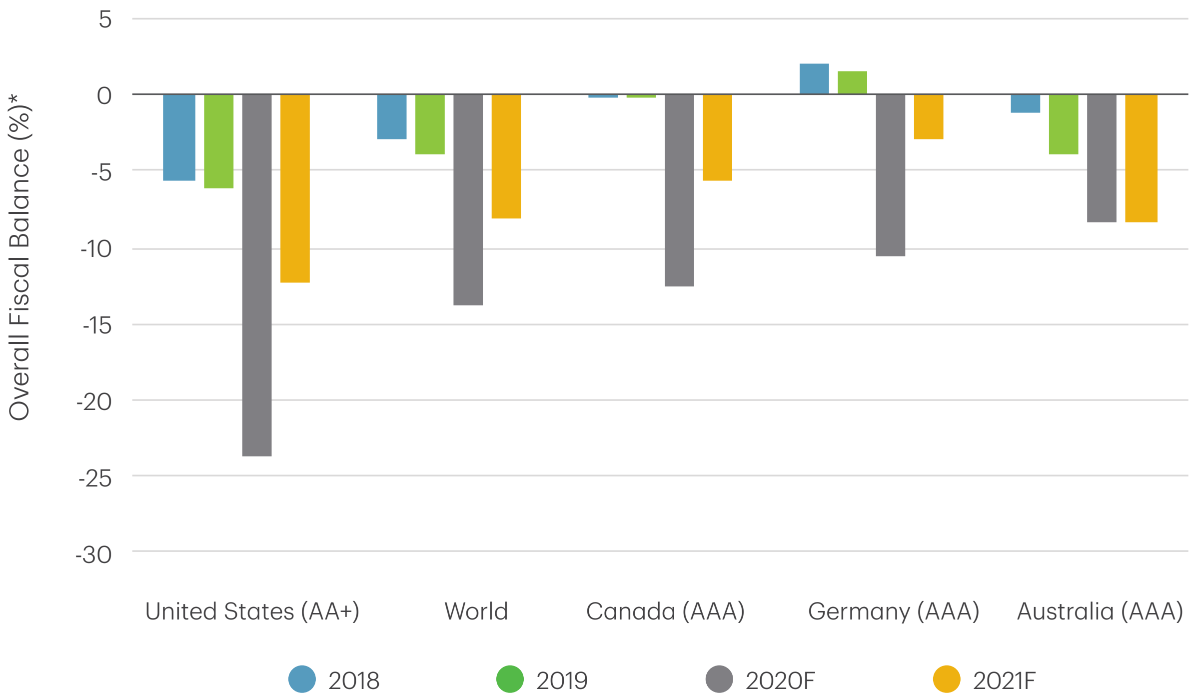
In our publication, we collaborated with TDAM's sovereign credit analysts to provide an inside look on how we are gauging the impacts of the health pandemic on the fundamental economic landscape in Canada, across the provinces and various municipalities. We note that sovereign fundamentals around the world are under pressure in 2020, as governments have pledged large and necessary fiscal support measures.

Sovereign fundamental credit profiles can remain under pressure given fiscal stimulus in 2020

When looking at the major impacts of the COVID-19 health pandemic around the world, the most prominently observed deterioration can be seen in the fiscal and economic profiles of government issuers, two of the major sub-components in our sovereign credit analysis process. Given the shutdown of global economies to help combat the pandemic, it is no surprise that economic fundamentals have come under strain this year, with a rebound in economic activity expected to playout in 2021. Therefore, at this time, we are placing additional emphasis on the impacts to the fiscal and economic sub-component of our analysis and in the exhibit below we show that like other sovereigns around the world, Canada's fiscal profile is forecasted to deteriorate in 2020.

Exhibit 1: Increased fiscal support expenditures will weigh on fiscal balances around the world in 2020

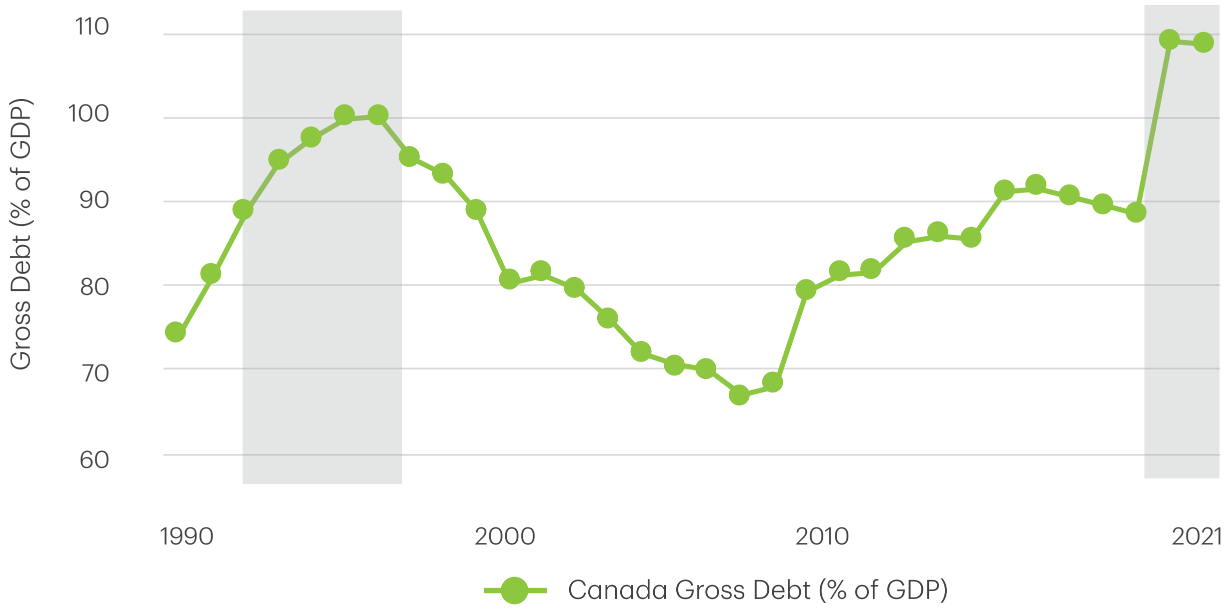


Source: IMF World Economic Outlook, June 2020 Update.
*Net Lending/Borrowing (% of GDP)

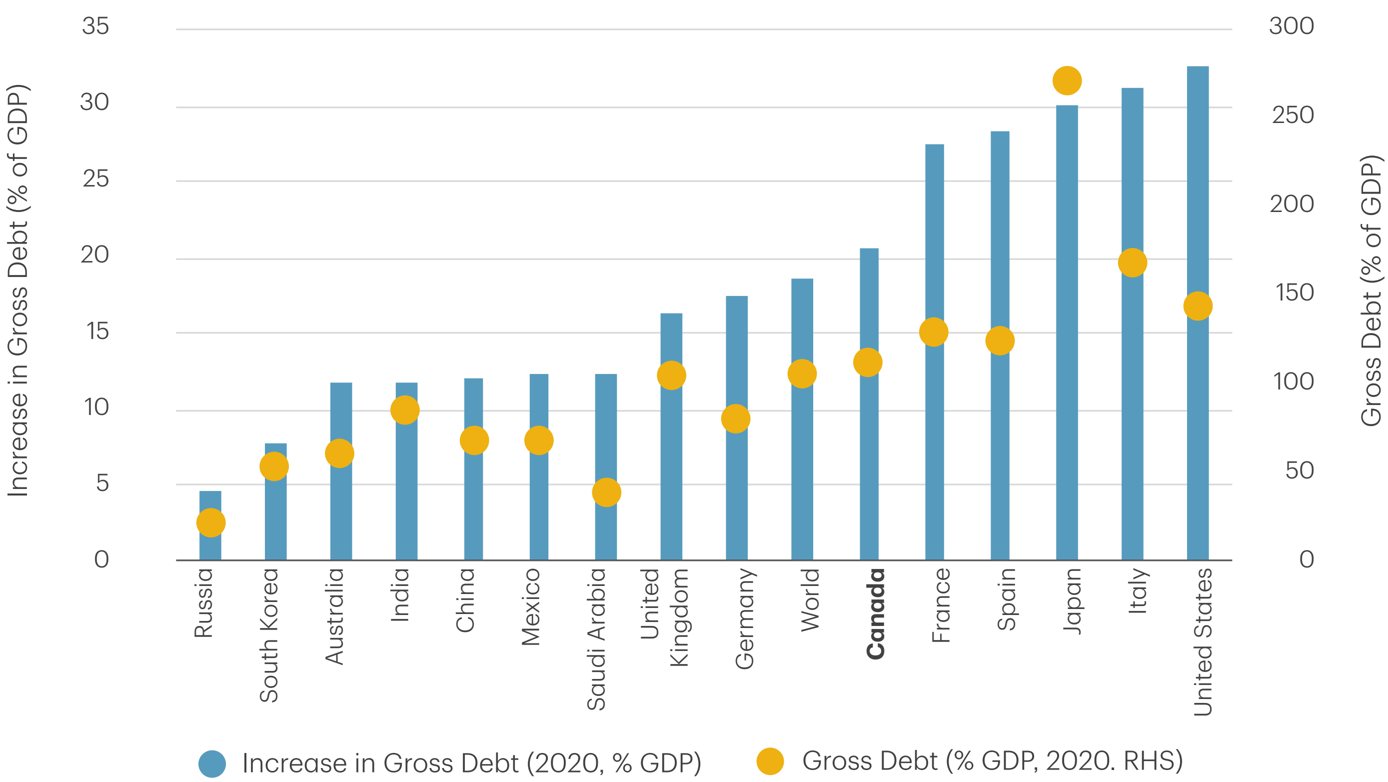
The sharp increase in fiscal risk around the world comes from dual impacts, as the massive slowdown in economic activity is being combined with the passage of significant emergency fiscal lifelines, therefore shocking both revenues and expenditures simultaneously. In the Exhibit below, we showcase that the projected general government deficit in 2020 in conjunction with a sharp contraction in global growth, will likely cause sovereign's gross debt to grow materially by the end of 2020. Note that credit ratings are inherently relative and if we compare the fiscal deterioration in Canada to global peers, we can see in the second chart in **Exhibit 2** that Canada's forecasted increase in its debt/GDP ratio is in-line with the world average and when compared to other high quality sovereign credits like the United States, the deterioration in public finances on a relative basis appears much less dire.

Sovereign

Exhibit 2: Canada's fiscal situation is expected to deteriorate



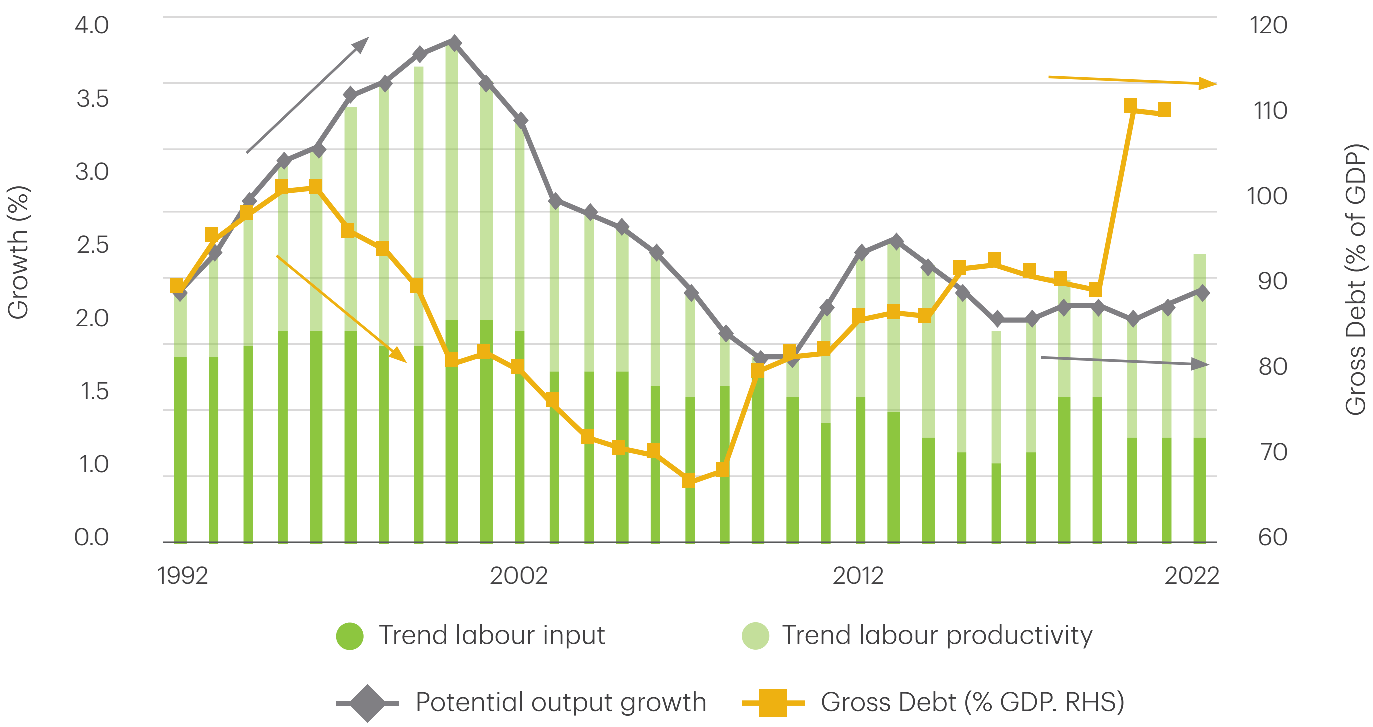
Source: IMF World Economic Outlook, June 2020 Update.



Source: IMF World Economic Outlook, June 2020 Update.

Earlier this year, Fitch Ratings took action and downgraded Canada's public credit rating from AAA to AA+, while other major public credit agencies have maintained their AAA ratings despite the fiscal and economic deterioration forecasted. Note that the last time Canada lost their coveted AAA rating was in the mid-1990s, coincidently marking the last time the country's debt to GDP ratio approached similar levels as it will this year. With this key metric forecasted to exceed 110% in 2020, expectations that Canadian policy makers may find it more challenging to improve this ratio meaningfully over the coming years. In the **exhibit below**, we highlight that Canada benefitted from a period of strong economic growth in the 90s which helped support natural deleveraging from peak levels. However, given the COVID-19 pandemic shocks to the Canadian economy and only moderate labour productivity growth, potential growth is expected to be lower than it was three decades ago.

EXHIBIT 3: Strong growth in the 1990s allowed Canada to deleverage from peak debt to GDP levels naturally. At this juncture, the current growth outlook will likely not provide the same runway for rapid deleveraging.

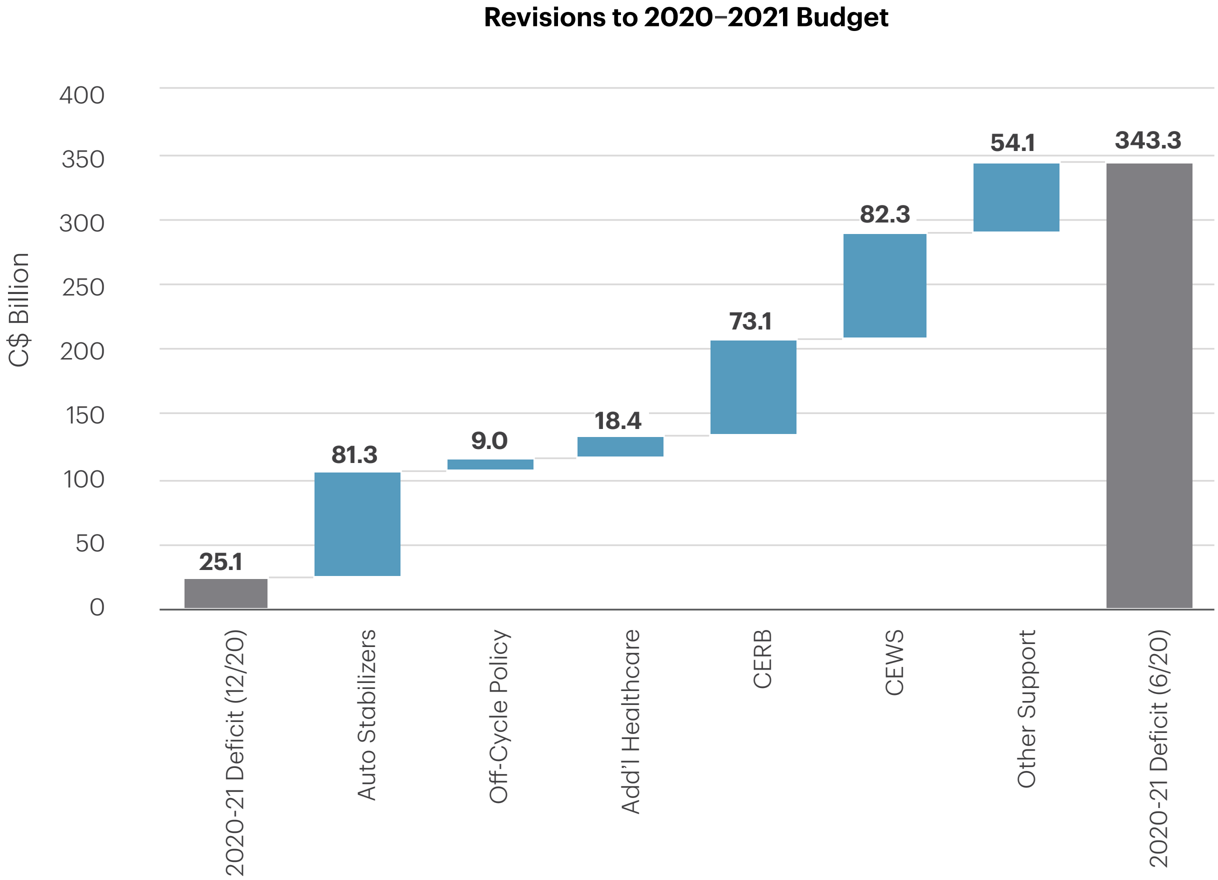


Source: Bank of Canada, TDAM. As of September 1, 2020.

Potential

Without robust levels of economic growth, as seen in the early 1990's, fiscal consolidation must come through a sustained effort of deficit reduction over several years such that the debt/GDP ratio takes on a downward trajectory. With fiscal stimulus dominating budget revisions in 2020 (**Exhibit 4**), and our belief that further stimulus down the road may be necessary, we believe most nations (including Canada) are likely to contend with an elevated debt to GDP ratio for some time. Positively, in Canada, the vast majority of stimulus (e.g., CERB, CEWB, etc.) is temporary rather than structural and can be reversed once economic conditions normalize.

Exhibit 4: Most revisions to 2020 deficit forecast are dominated by stimulus measures, which are temporary and reversible during the recovery



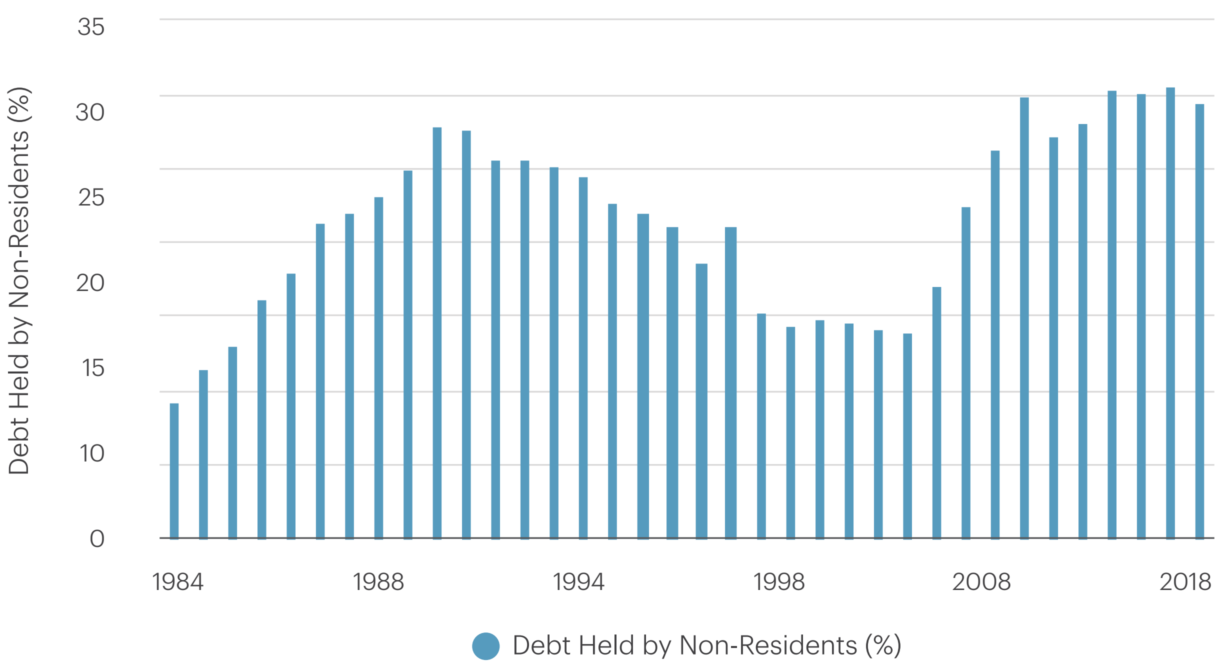
Source: Canada's Economic and Fiscal Snapshot (July 2020), TDAM.

Again, in our analysis process, the fiscal position is one of many risk dimensions we analyze. While we highlight additional risk from the weaker fiscal profile, we also note that the Canadian economy features robust core credit strengths which will continue to be of support. These include exceptional governance standards, competitive economic fundamentals and a resilient external profile. Additionally, as highlighted above, the pressures facing Canada's credit profile are not unique as governments around the world will contend with greater deficits and debt burdens ahead. We acknowledge that the short-term headwinds on the fundamental outlook come only due to support of Canadian citizens and prudent crisis policy action. At this time TDAM continues to favor corporate bonds to sovereign debt given the yield advantage of the asset class, as well as the greater risk compensation.

Strong and stable investment grade ratings are of great importance to sovereigns like Canada, Germany and Australia

While the late June downgrade by Fitch Ratings was not a material market moving event, we believe the importance of government maintaining a strong investment grade rating is high, as a continuous decline in Canada's perceived creditworthiness could eventually impact valuation. Demonstrated below in **Exhibit 5**, non-residents currently hold the largest proportion of Canadian government bonds since the previous peak in 1993. In our view, non-residents are generally perceived as a flightier type of investors when compared to domestic ones. In other words, these investors are more sensitive to any perceived deterioration in credit profiles and the potential capital flight could exert upward pressure on interest rates in this unlikely scenario. While we view this scenario as unlikely given that we do not expect Canada's fundamental credit profile to deteriorate meaningfully, it is important to note that we are monitoring this tail risk event.

Exhibit 5: Increasing non-resident holding of GoCs raises the likelihood of higher compensation for risk if fundamentals deteriorate significantly



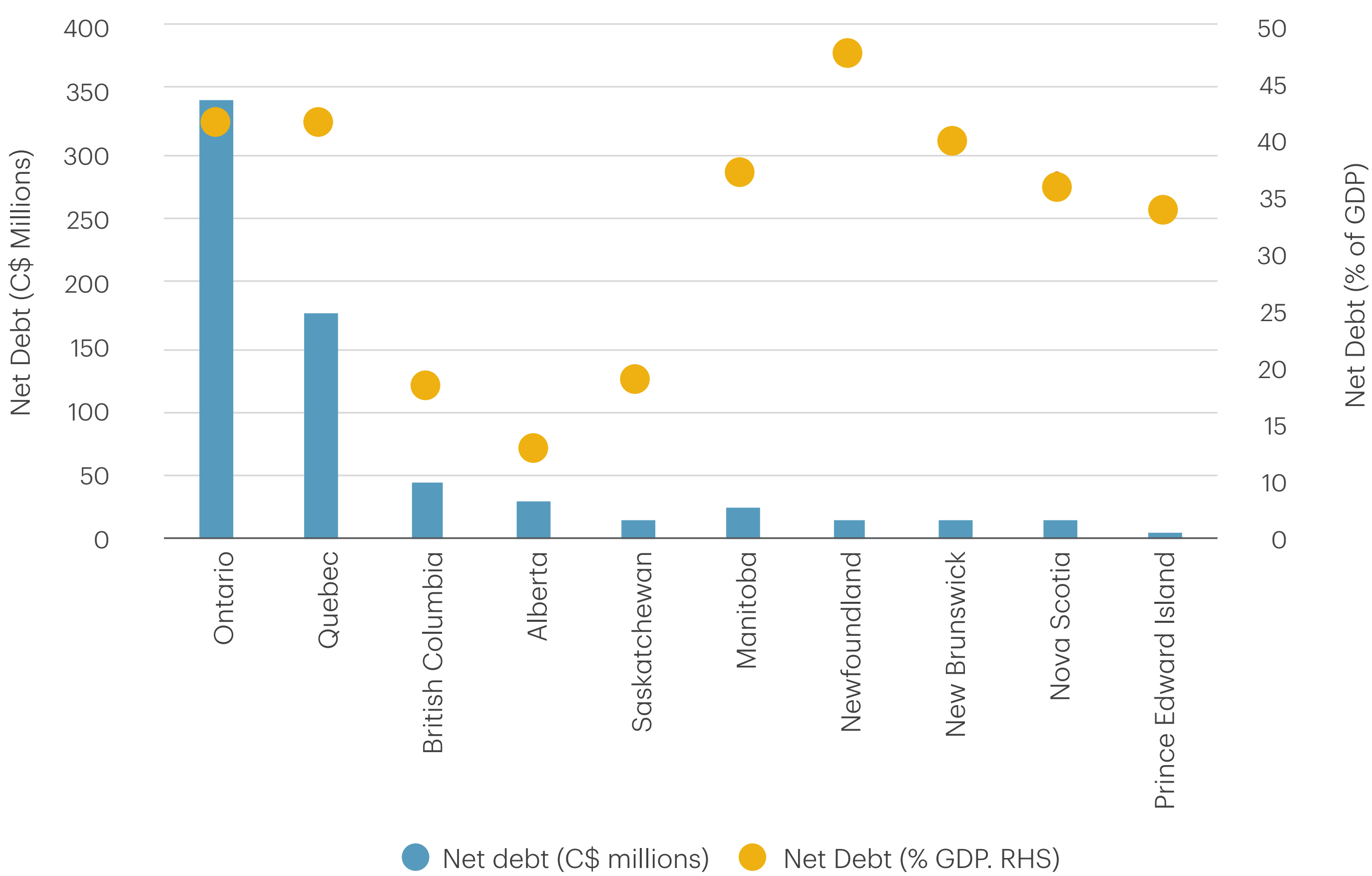
Source: StatCan Fiscal Reference Tables, TDAM as of March 31, 2020.

Provincial sector faces varying headwinds and provincial debt burdens can weigh on Canada's overall creditworthiness

An analysis of Canadian sovereign credit is incomplete without looking at the provinces. Recall that our fiscal metrics are at the general government level, which is inclusive of all levels of government. In this section, we analyze the provinces' outlooks for debt and budgets not only to identify relative value opportunities between provinces but also to complete the sovereign credit outlook for Canada.

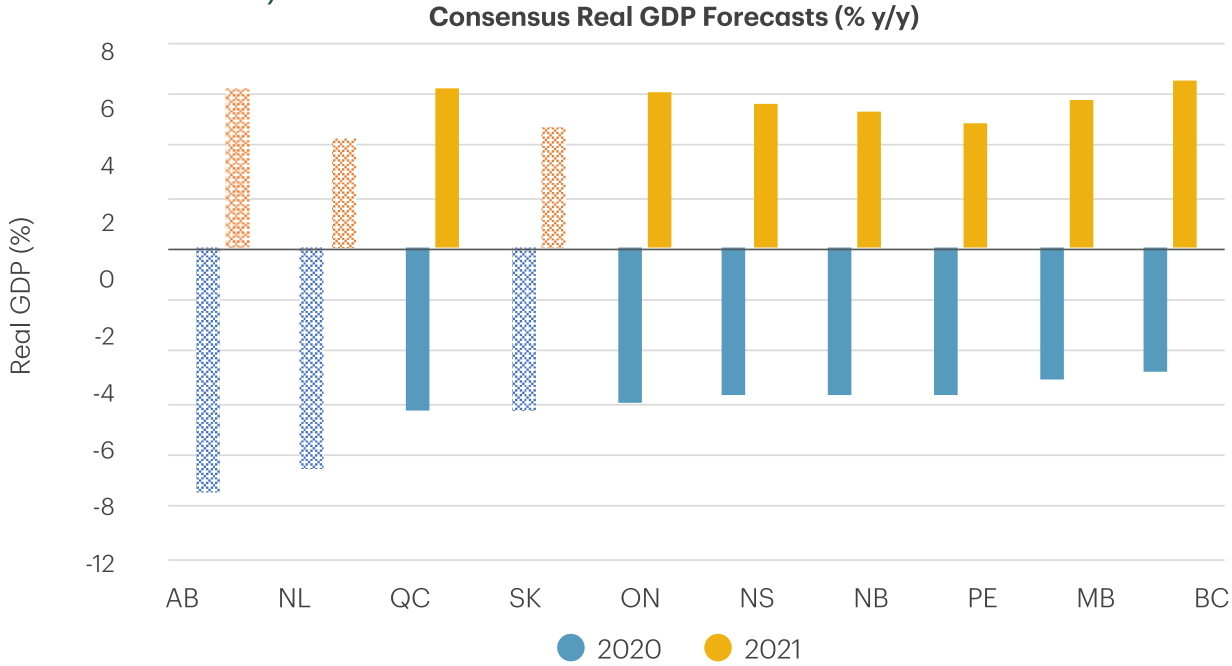
With the onset of the pandemic and declining oil prices, we expect the negative impact on their fiscal profile to vary dramatically by province. Divergent provincial outlooks may not allow all provinces to undertake a fiscal adjustment as quickly or ambitiously. For instance, provincial net debt levels relative to GDP varies significantly from province to province, as seen below in **Exhibit 6**. Even pre-pandemic, many provinces have struggled to rein in their deficits, leading to an accumulation of debt that will create challenges for many. Furthermore, the oil producing provinces (Alberta, Saskatchewan and Newfoundland) have experienced rating downgrades from the agencies and must continue to contend with a stagnant economic outlook and weak royalty revenues, waning production, and weak capital investment into the energy sector. For this reason, oil producing provinces are expected to see significant contractions in economic growth this year, as seen in **Exhibit 7**. Conversely, certain provinces such as Quebec and British Columbia were in structural surplus positions prior to the pandemic and are well-equipped to improve their fiscal situation once COVID-19 risks recede.

EXHIBIT 6: Net debt to GDP varies across provinces



Source: Fiscal Reference Tables, Bloomberg Finance LP, TDAM as of March 2019 FYE.

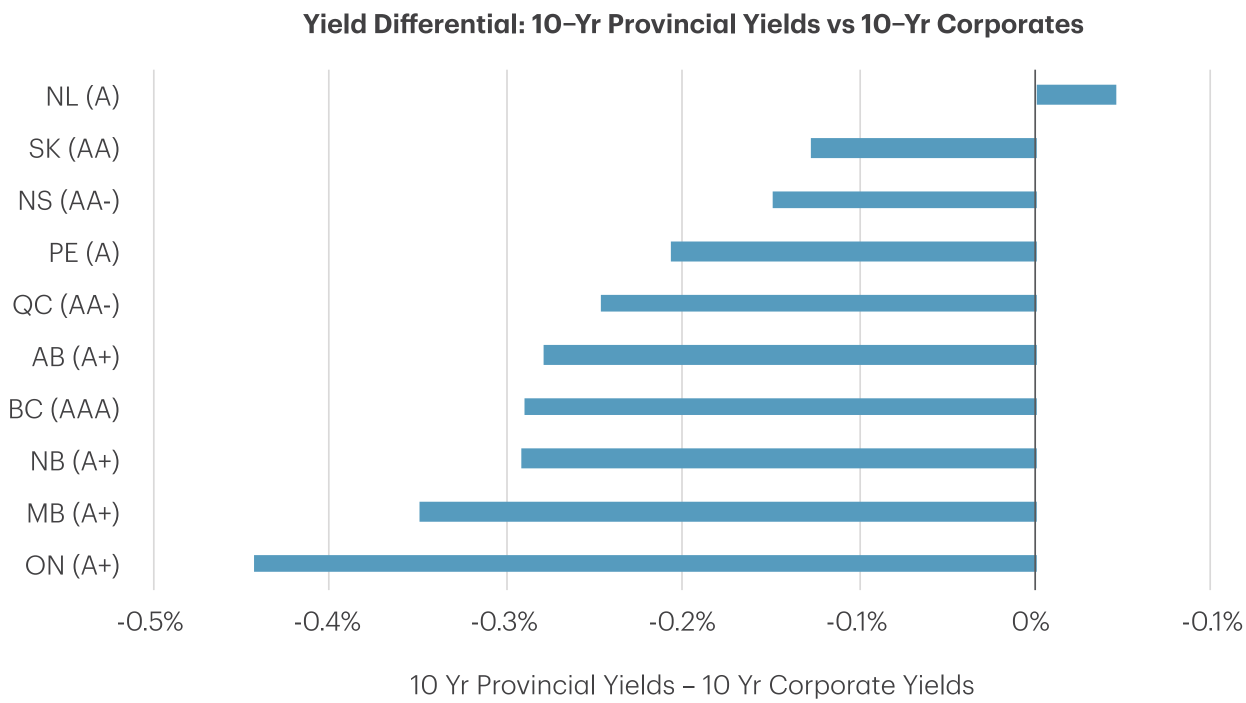
EXHIBIT 7: Oil producing provinces will bear the biggest economic contractions and more modest recoveries (major oil producing provinces shaded below)



Source: Fiscal Reference Tables, Bloomberg Finance LP, TDAM as of September 1, 2020.

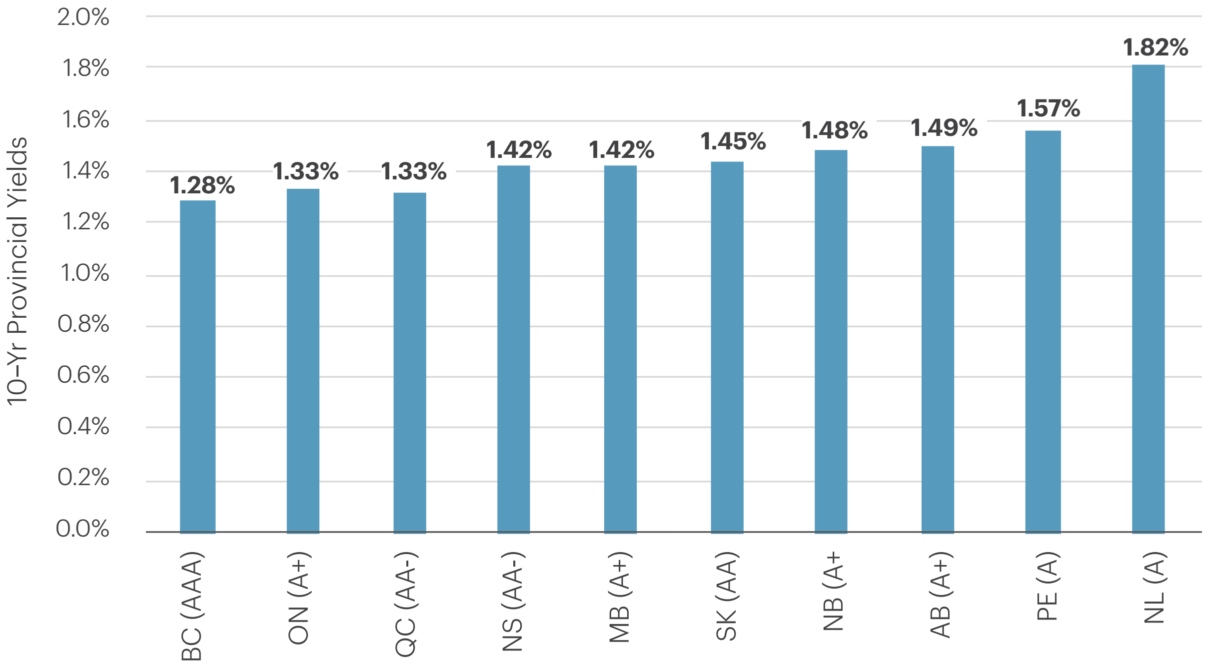
Having said that, the institutional framework in Canada creates a special relationship between the federal government and the provinces via the transfer payment structure. These measures imply a degree of collaboration between the federal and provincial governments, which may lower the probability of extreme tail risk. The market appears to price this in, as we showcase below in **Exhibit 8** that provincial yields are notably lower than equally rated Canadian dollar corporate bonds.

EXHIBIT 8: Provincial yields trade within a narrow range



Source: Bloomberg Finance LP, TDAM as of September 1, 2020.

EXHIBIT 9: Provincial yields trade within a narrow range



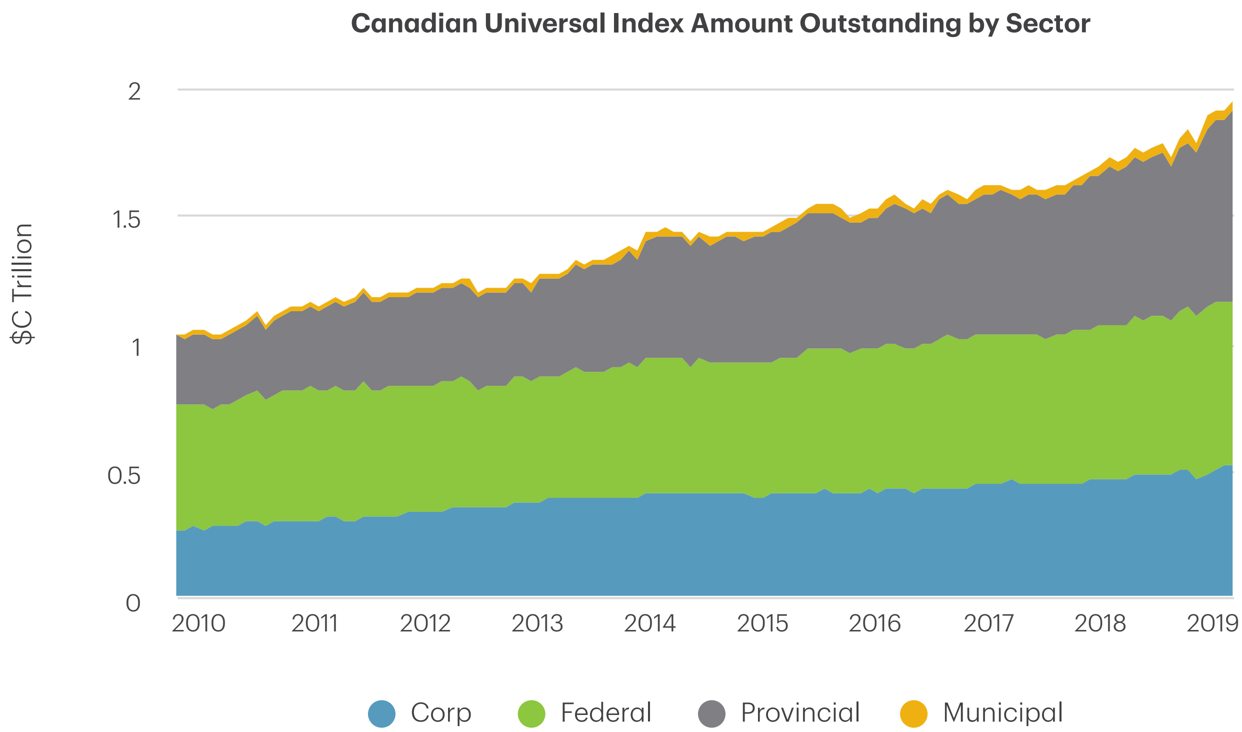
Source: Bloomberg Finance LP, TDAM as of September 1, 2020.

Exhibit 9 shows that nearly all the provinces (with the notable exception of British Columbia which is rated AAA) are generally rated within three rating notches (AA- to A) and all provincial yields trade very close to one another, with only ~50 bps differential between the highest and lowest yielding provinces (Newfoundland and British Columbia respectively) despite a roughly seven-notch difference in credit ratings. Given the record low levels of interest rates and our view that interest rates are likely to remain lower for much longer, we believe it is highly unlikely to see provincial debt service costs reach a critical threshold in any province over the near term. Therefore, we believe the provincial sector has no material risk of experiencing real default risk over most investment horizons. As bond managers, we must also account for potential credit spread volatility. Recent history shows us (Greece, Spain, Ireland) that prior to a bailout, government debt and the related government entities can see elevated volatility and sharp spread widening.

The municipal sector in Canada is small in size and offers limited risk adjusted opportunities at this time

The municipal bond market in Canada represents only a very small and illiquid portion of overall debt in Canada, as represented in **Exhibit 10** by total amount outstanding grouped by sector in the FTSE Canadian Universal Index. While this showcases the limited depth of the municipal market and therefore the availability of significant risk adjusted opportunities, it also indicates that municipals are a very small proportion of Canada's general government debt burden. For this reason, the debt of local municipalities does not materially influence the general government fiscal picture. However, we believe that municipalities face unique challenges that do not align with the level of risk compensation presented in the marketplace. We believe there are two main fundamental considerations when assessing municipal debt.

EXHIBIT 10: The municipal sector in Canada represents just 2.1% of the Canadian aggregate bond index

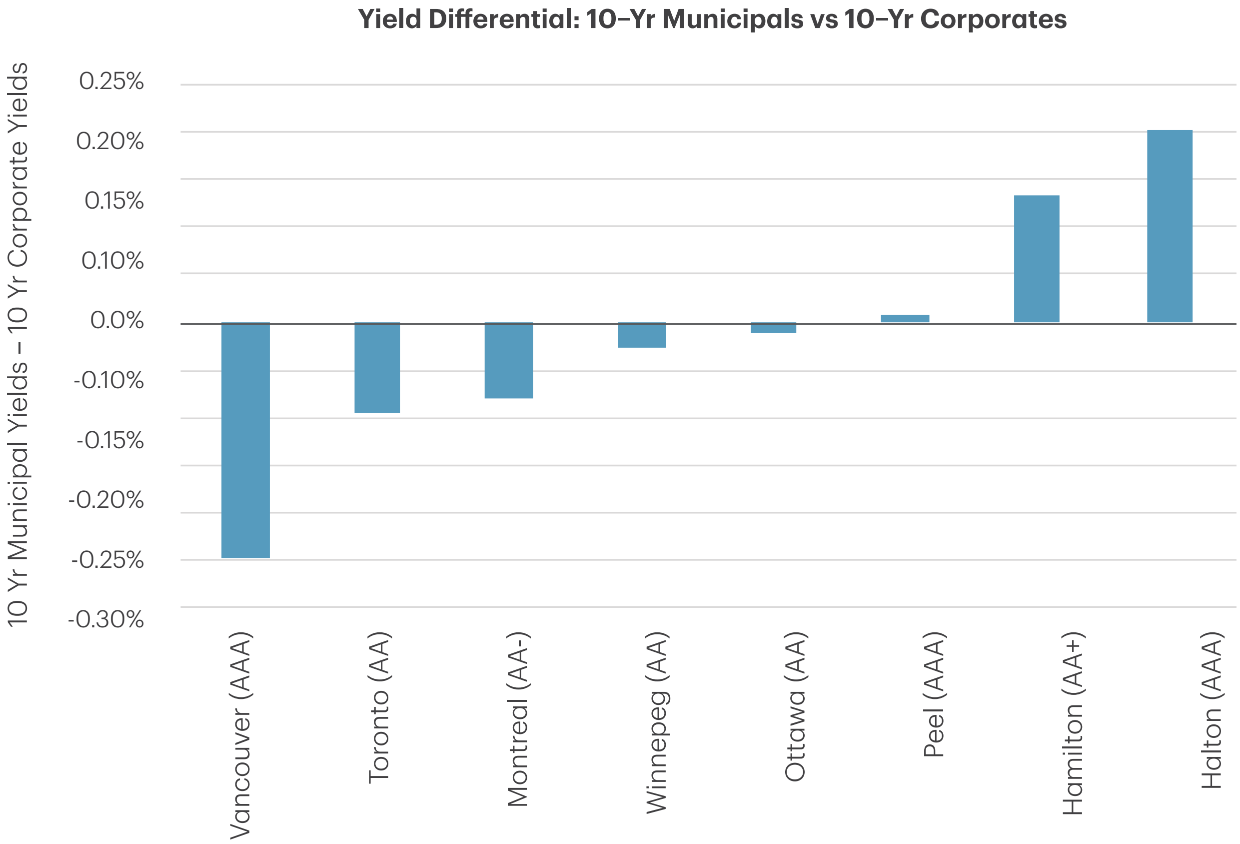


Source: FTSE Indices as of September 1, 2020.

Opportunities

First, municipal governments are legislatively required to run balanced operating budgets and are only allowed to issue debt to finance capital investments. Second, the revenue base for the municipalities are much narrower, essentially limited to property taxes and miscellaneous user fees like transit revenue. While the balanced operating budget mandate and the relatively predictable revenue streams have supported very high credit ratings historically, COVID-19 has likely upended these factors of stability. For example, property taxes were deferred as part of the COVID-19 stimulus. In addition, user fees have also suffered with economic activity plummeting. Meanwhile, operating expenditures (e.g. police, fire) remained generally fixed for the municipalities. These factors are pushing municipalities into operating deficits, which cannot be funded by new debt. While a portion of the $19 billion Safe Restart program will be allocated to municipalities, more money will likely be needed to plug the holes in municipal budgets.

EXHIBIT 11: The municipal sector provides limited yield pick-up opportunities relative to similarly rated corporates, despite insufficient liquidity

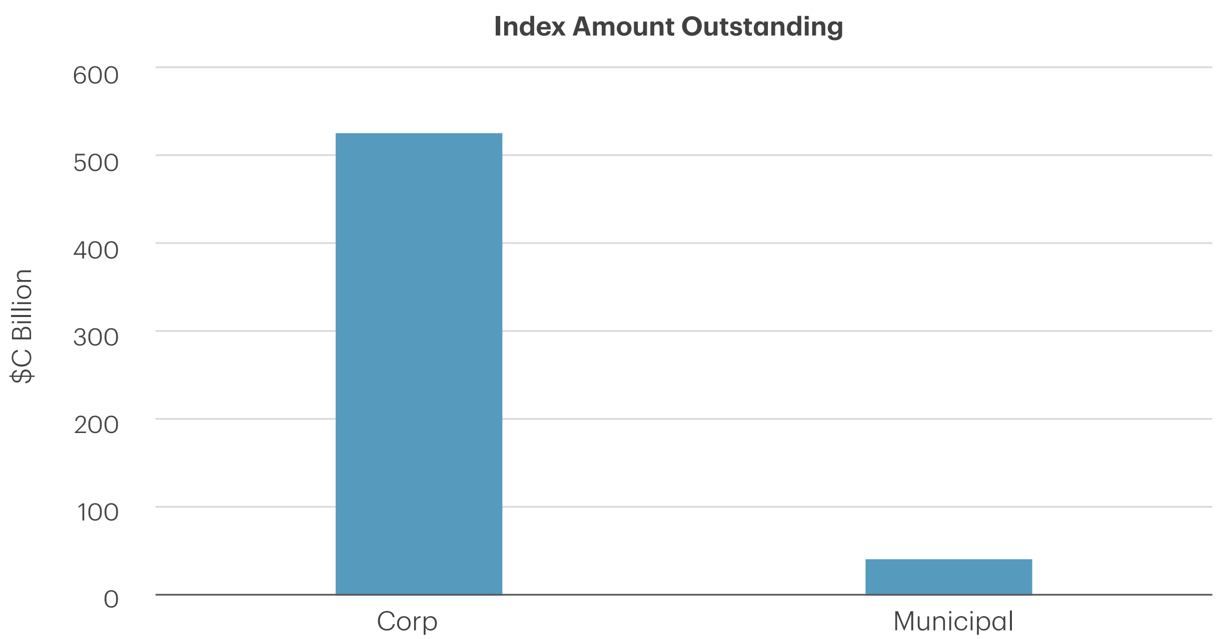


Source: Bloomberg Finance LP, As of September 1, 2020.

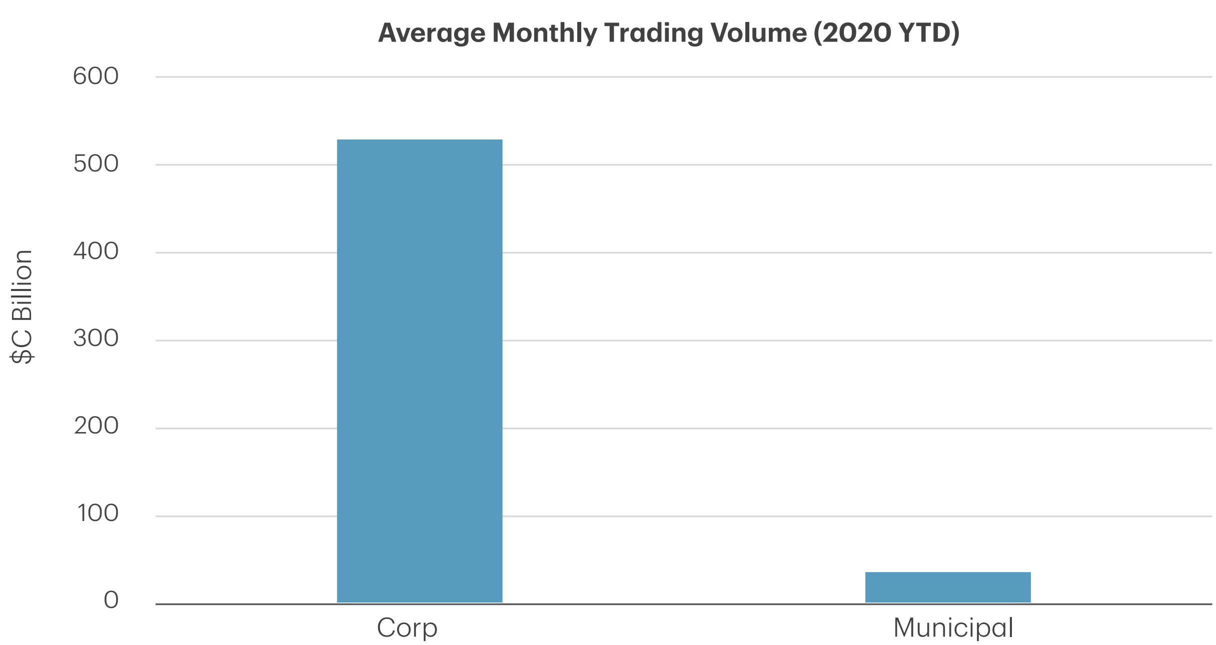
Balanced

While the fundamental outlook offers some level of uncertainty, we see limited relative value opportunities in the sector. First as you can see in **Exhibit 11** above, municipal bonds offer very limited yield pickup opportunities over similarly rated corporate bonds in Canada. This limited yield pickup opportunity comes despite market liquidity issues, which we again showcase below in **Exhibit 12**. The municipal bond market in Canada is 1/12th the size of the Canadian corporate bond market, and average monthly trading volumes in 2020 of just $3.5bn are nearly 1/15th of the average trading volume in the corporate market. In our view, investors compensation for market illiquidity is non-existent given that the majority of the market offers yield concessions when compared to similarly rated corporate bonds. For the many reasons listed above, we continue to see much stronger risk adjusted opportunities in the corporate credit market.

EXHIBIT 12: The municipal bond market offers lower levels of liquidity when compared to the corporate bond market, which is much larger in overall size and has much greater trading volumes



Source: FTSE, As of September 1, 2020.



Source: Investment Industry Regulatory Organization of Canada, As of September 1, 2020.

Assessing fundamental sovereign creditworthiness is an essential part of dynamic fixed income portfolio construction

As demonstrated, the pandemic is creating some fundamental deterioration, and when viewed in the context of record low yields, we can arrive at a conclusion that there is limited risk adjusted value in sovereign, provincial and municipal bonds at this time for active positioning. As we continue to move through the pandemic, the collaboration between our active portfolio management team and our dedicated research analysts allows us to scale risk properly, based not only on market pricing but also on underlying fundamentals, which continue to evolve each and every day. ■

Dynamic

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