CUMBERLAND

Private Wealth

FIXED INCOME - THIRD QUARTER REVIEW

The Great DEBTpression?

The long awaited summer came and went in a flash as another quarter flew by. Q3 was a bit more trial and error as the reopening of the economy (restaurants/stores/offices) was phased-in with caution in Canada. Covid-19 cases remained low at the start of the quarter but started to spike again as the quarter came to an end.

The Canadian government continues to be supportive to ensure citizens will be able to endure these times of hardships. While there was optimism that people were returning to work and the unemployment rate looked to be declining from the heights of the pandemic, Canada is funding its way through the pandemic with debt. The province of Quebec announced a one-month lockdown for October towards the end of the quarter, setting alarms that this pandemic is definitely here to stay and drawing concerns that other provinces will follow.

Let's recap some of the stats. Arrows indicate trend from last quarter and green means a good outcome.

↑ **$39.86** The closing price of a barrel of WTI crude oil in USD at the end of September 30, 2020 – a decent recovery from a low of -$37 seen in Q2

↓ **10.2%** Canadian unemployment rate for August – still elevated but improved from a high of 13.7% seen in Q2 and is still higher than experienced during the 2008 financial crisis

↑ **+17Bln** increase in the Bank of Canada's balance sheet assets during the quarter to $538bln, still more than 6x larger than during the peak of the 2008 financial crisis

↑ **~343Bln** current estimate of the Canadian Federal Government deficit for 2020-2021, increased since our last quarterly commentary from 250bln. Even during the financial crisis, annual federal deficit did not exceed 100bln at the peak

↑ **+17** number of weeks the Canada Emergency Response Benefit (CERB) extended since our Q2 report as it will last until December 30th (extended by 24 weeks from the initial mandate to a total of 41 weeks now) – a telling sign that the recovery will be slow(er) than initially thought

↑ **+4.6MM** the increase in the number of people tested for COVID–19 in Canada in Q3, bringing the total to 7.36MM since the start of the pandemic

↑ **+54,554** the increase in the number of people confirmed to be infected with COVID–19 in Canada during the quarter, bringing total to 158,758

↑ **+706** The number of people in Canada who died in Q3 from COVID-19, bringing the total deaths to 9,297

Debtpression or Debtphoria?

The quarter was extremely busy and full of action for fixed income portfolio managers. While summer months have historically been dull, with all-in yields so low, governments and companies were busy taking advantage of the cheap money available to them.

Exhibit 1 highlights the amount of debt Canada is expected to issue by the end of fiscal 2020/2021, an increase of 230% from the last fiscal year or a total of $409bln in Government of Canada bonds. The provinces are following suit and shoring up capital, with most issuing at least 50% more debt than the previous year. Alberta, being the worse given the collapse in oil, is expected to issue 218% of more debt. However, with coupons so low, even with the amount of debt significantly higher, total interest payments could actually end up lower (for some) than the total debt issued today over last year's total debt issued - not a bad deal!

The Bank of Canada has been supportive and has bought a total of $138bln of Government of Canada bonds since they started quantitative easing the week of March 30th. Bank of Canada has also bought a total of $9bln of provincial bonds since it started the provincial bond buying program (the week of May 4th). So, while there is a lot of debt, the Bank of Canada has absorbed about 25% of the estimated issuance for fiscal 2020/2021 so far.

The real concern is how the governments will ever be able to reduce the large amount of debt at the end of all of this. Federal government debt will increase to about 50% of the country's GDP at the end of Fiscal 2020/2021 alone. While the COVID-19 situation is still evolving, it is difficult to know for sure who will end up paying in the end.

Exhibit 1: Debt Issuance by Governments

in $millions

	Fiscal 2019/2020[1] Completed	Fiscal 2020/2021[1] Total Expected	Growth year over year (%)
Government of Canada	124,000	409,000	230%
Provincial Borrowings			
British Columbia	8,863	18,770	112%
Alberta	8,976	28,550	218%
Saskatchewan	2,381	4,458	87%
Manitoba	6,292	9,600	53%
Ontario	39,499	59,700	51%
Quebec	19,517	38,607	98%
New Brunswick	2,602	3,401	31%
Nova Scotia	1,609	2,408	50%
P.E.I	202	225	11%
Nfld & Labrador	1,212	3,200	164%
Total Government Debt Issuance	**215,153**	**577,919**	**169%**

Notes: 1. Fiscal year April 1 - March 31

Source: BMO Capital Markets, National Bank Financial, Bank of Canada

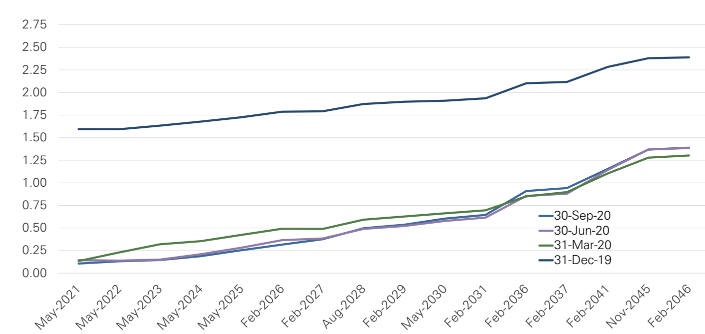
On the Canadian investment grade corporate front, issuance continued to be strong during the quarter as companies took advantage of low all-in borrowing rates. Total issuance was $21.7billion vs. $29bln last year Q3, with year to date corporate issuance 13% ahead of last year at $95.7bln. 5-year investment grade bonds averaged coupons in the 1.5% range, saving companies anywhere in some instances 100 bps[2] to 200 bps for bonds they were trying to refinance and also benefiting from extension of the bond maturity out into the horizon. The yield on the Canadian Investment Grade Corporate Bond Universe is currently 1.91% and has a duration just shy of 7 years.

Quarter Review

During the quarter, the Federal Reserve ("the Fed') kept interest rates unchanged at 0% (lower bound). The expectation is that the Fed will keep interest rates at the lower bound through until the end of 2023 at this point. One noteworthy point during the quarter is how the Fed has changed the illusive 2% inflation target that weighs on interest hikes rates: now, the Fed will target an average of 2% over time, giving them flexibility of inflation volatility in the near term until they see it average 2% before they move on overnight interest rates.

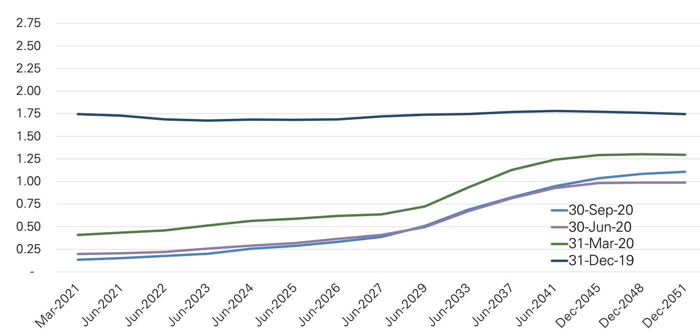
Interest rates for the quarter moved anywhere from -5bps to +6bps, with a slight steepening of the curve in the short end.

Exhibit 2: US Yield Curve



Source: Bloomberg

Exhibit 3: Canada Yield Curve



Source: Bloomberg

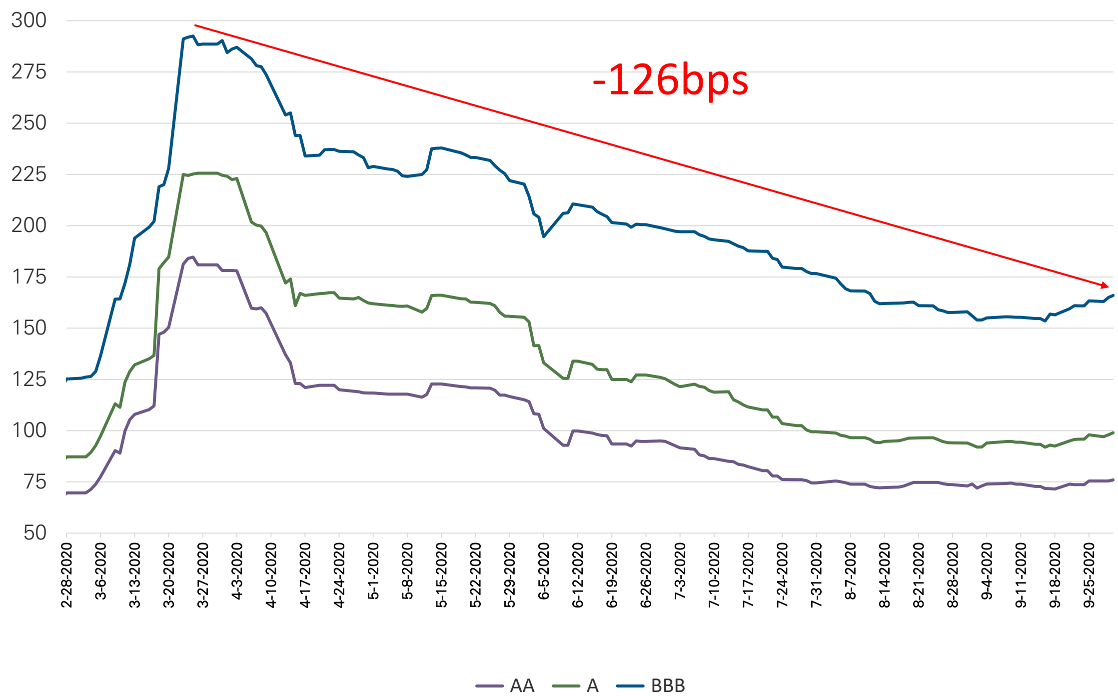
The Bank of Canada kept their overnight rate unchanged at 25bps. Similar to the Fed, the Bank of Canada will keep the overnight interest rate unchanged for the medium term, but has not adjusted any language regarding their inflation target of 2%. Interest rates for the quarter moved anywhere from -6bps to +12bps lower across the curve, with the yield curve a bit steeper in the long end.

Market volatility continued with the 10-Year Government of Canada bond moving 65% from peak to trough vs. 59% in Q2 and 68% in Q1.

Notes 2: 1bps is equal to 0.01%

During Q3, Canadian investment grade corporate spreads were tighter (anywhere between 9bps to 32bps across the curve and rating categories), with the exception of long AA credit which was wider by 7bps during the quarter (vs. corporate spreads being tighter 39bps to 101bps in Q2). Corporate spreads have now compressed a total of 54bps to 126bps since the peak during the year; however, they are still not back to levels seen right before the start of the pandemic. From the chart below, a 5-Year Investment Grade Corporate spread move of 126bps over the last 6 months would be equivalent to $5 par value on a $100 bond (or 5% move in capital appreciation).

Exhibit 4: 5-Year Investment Grade Corporate Spreads



Source: BMO Capital Markets

The move in the spreads was driven by:

1) Bank of Canada's support in the secondary markets; and
2) Investors' demand for yield

Perception is everything. The Bank of Canada started to buy investment grade corporate bonds on May 26th, more than two months after corporate spreads widened to its 52-week peak. While the uptake for the purchases during Q2 was slow as the Bank of Canada was still figuring out the best approach, during Q2, they bought 9.5% of eligible purchases in the secondary markets (i.e. a par amount of $133.4MM out of a potential of $1.4bln). As Q3 rolled around, investors were salivating for yield and the demand for corporate bonds was high. While the economy reopening was underway and investors were more comfortable with companies' outlooks, the one peace of mind for investors was knowing that if liquidity or spreads were to widen as quickly as they did in March, the Bank of Canada would be there to offer assistance. As a result, new issuance corporate bonds were flying off the shelves: we saw new issuance books as much as 11x oversubscribed (i.e. 11x more demand for the amount of bonds from investors vs. the size of the bond offering a company was willing to issue). Hence, during Q3, while the corporate bond purchase program continued every week on Tuesdays and Thursdays, the Bank of Canada only bought back 0.59% of eligible bonds or a total of $15.3MM par value out of a potential $2.6bln.

Returns for various fixed income asset classes are shown in the table below.

Exhibit 5: Returns for Fixed Income Asset Classes				
Asset class returns	**Q3/20**	**Q3/19**	**YTD 2020**	**YTD 2019**
Bond Universe Index	0.55%	1.19%	7.99%	7.79%
Corporate Bond Index	0.19%	1.09%	6.82%	7.98%
FTSE High Yield Canadian Index	0.84%	2.01%	2.46%	7.01%
S&P/TSX Preferred Index	-1.45%	-0.11%	-2.95%	-1.99%

Outlook & Strategy

Third quarter earnings reports will be released over the next 8 weeks and while we expect some improvement to Q2, it will be interesting how much guidance management teams will offer during their earnings calls.

Things we continue to consider when we are investing:

1) the second wave of infections is starting to transpire, while we know that governments would rather not go back into lockdown, if citizens become too lax with social distancing rules and testing is not easily available for those with symptoms or exposure, it might be inevitable for all provinces not just Quebec;
2) low WTI oil prices will continue to hover around the US$40/bbl and expect it to be very sensitive to OPEC and specifically how Saudi Arabia will navigate their monthly meetings until the end of the year and respond to non-compliant countries; and
3) we still believe that while the Bank of Canada has been supportive of the bond markets and is thought to be a backstop for illiquid bonds, it does not mean companies will be immune to defaults nor bankruptcies.

We continue to do the credit work on our investments and continue to be biased to shorter-dated investment grade corporate bonds for income. We are cautious at this time with stretching for that incremental small amount of yield and adding a disproportionate amount of risk.

At the end of 2019, 89% of the bonds in the Canadian Bond Universe traded above par. At the end of Q1, 79% of those bonds trade above par. Last quarter, 98% of the index traded above par and now, 99% of the index trades above par. All-in bond yields are now even lower than where they started the year. The Canadian Bond Universe Index is currently yielding 1.25% and is 8.5 years in duration – hence we continue to remain cautious on ensuring a balance between the risks and returns.

We hope that everyone had a great summer, is in good health and remains in good health.

Take Care,
Diane Pang

Lead Manager,
Cumberland Fixed Income*
October 1, 2020

*Cumberland Private Wealth refers to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). Diane Pang (a Portfolio Manager at CIC) is the lead portfolio manager for the Cumberland Income Fund and the Kipling Strategic Income Fund. NCM Asset Management Ltd. (NCM) is the Investment Fund Manager to the Kipling Strategic Income Fund. CPWM, CIC and NCM are under the common ownership of Cumberland Partners Ltd.

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