MFA Pooled Investment Fund Quarterly Market Update

Q1 2021

Municipal Finance Authority of BC

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As of March 31, 2021

Interest Rates

Global economies continued to experience strong and swift recoveries as vaccine roll-outs allowed for lockdown restrictions to ease, and as a result, most central banks' growth projection for 2021 improved materially. In light of the robust economic rebound, rising inflation pressures permeated the market and caused bond yields to increase meaningfully over the quarter. The volatility in bond yields was further exacerbated by a number of technical factors at the end of February; as a result, that month the 10-year Government of Canada (GoC) bond yield experienced its largest one-month increase in over a decade. GoC bond yields increased precipitously across all tenors of the yield curve during the first quarter, and the yield curve steepened as a result of the improved economic outlook. Overall, the rise in yields is partly a function of the normalization of yields back to pre-pandemic levels.

Looking ahead, the majority of bond market participants have revised their expectations, and now anticipate yields will be modestly higher over the next year as a result of the improving economic outlook. Our view is generally in line with what is priced into the bond market; however, we do believe that yields are likely to exhibit modest volatility in the near term as rising inflation, especially in year over year measures, is likely to contribute to investors' apprehension that central banks' commitment to allowing inflation to run higher than 2% could lead to longer term inflation risks. Ultimately, the concept of average inflation targeting could be the correct course of action to revive the economy, but that doesn't preclude a lapse in investor confidence in the interim.

Real Return Bonds

The market's expectations for long-term inflation (estimated as the difference in yield between a nominal and real return bond) rose alongside nominal bond yields, moving 0.2% higher to end the quarter at 1.7%. The damage to liquidity conditions in the real return bond (RRB) market in early 2020 has now been fully repaired, primarily as a result of the BoC's continued support via its asset purchase program. While market-implied long-term inflation expectations have risen, they remain below the BoC's 2% target and in line with levels of the past decade.

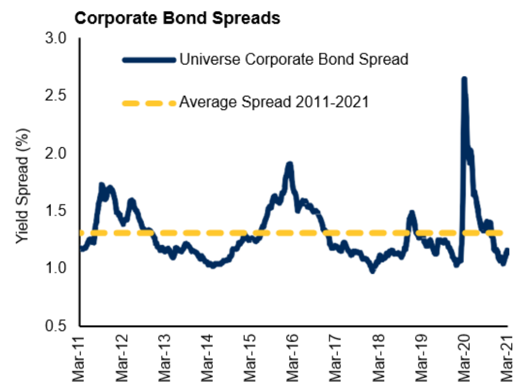
Actual inflation, as measured by the Consumer Price Index (CPI), has stabilized mainly due to the recovery in the price of oil, though it remains muted. Inflation is anticipated to print higher over the next few months, which is in part a reflection of the current low CPI base level as a result of the significant price declines at the onset of the pandemic. However, the anticipated higher inflation print is expected to be transitory. Overall, we believe market-implied long-term inflation expectations are likely to continue moving higher over the medium term.

Quasi-Government Bonds

The outlook for provincial economies has gotten brighter as vaccination campaigns accelerate and government stimulus measures continue to provide a significant boost to the recovery. That being said, the damage done to the labour market will take some time to fully heal, and the resumption of activity in certain industries such as the hospitality sector could be a bumpy process. As such, the provinces stayed active in the primary market, issuing approximately $30 billion of new supply during the quarter to help mitigate any potential setbacks on the path to recovery. Provincial bond spread levels were resilient despite the ample new supply coming to market, with broad spreads unchanged quarter over quarter. One notable development during the quarter was the BoC's announcement that it would let its Provincial Bond Purchase Program (PBPP) expire in May, as bond market conditions remain robust and the liquidity environment remains healthy. Note, the BoC only bought around $17 billion of provincial bonds since the initiation of the program last May (program size limit was $50 billion). Overall, the announcement was broadly expected by market participants and therefore had minimal impact on provincial bond spreads.

Investment Grade Corporate Bonds

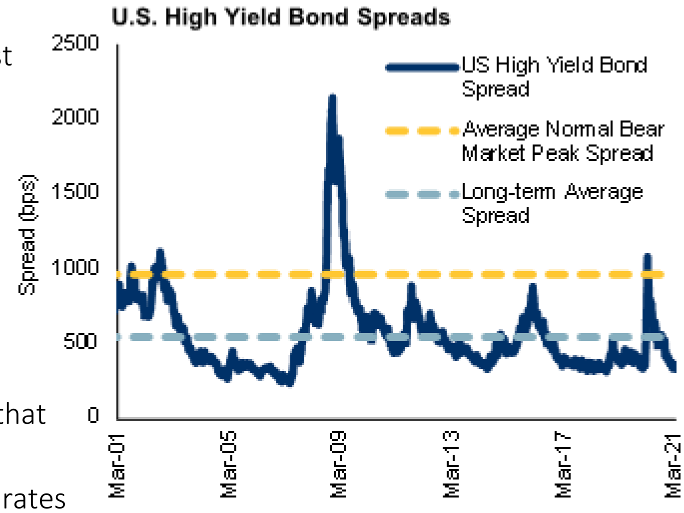
Canadian investment grade corporate bond spreads were broadly unchanged over the first quarter. With the healthy functioning of markets and corporate bond spreads hovering near pre-pandemic levels, the BoC announced that it would let its Corporate Bond Purchase Program (CBPP) expire in the coming months. Overall, the BoC purchased 76 corporate bonds for a total of only $250 million out of a program size of $10 billion. Despite the fact that only few purchases were made, the corporate bond market was able to thrive on its own. Looking forward, there is comfort in knowing that the BoC has the ability to reinitiate the CBPP should the bond market come under stress again. In terms of new issue supply, corporate issuers continued to capitalize on robust demand from investors, with approximately $33 billion of new supply coming to market during the quarter, which is roughly 6% ahead of last year's strong pace.



Source: FTSE Global Debt Capital Markets Inc.

From a fundamental standpoint, the elevated levels of debt in the Canadian economy among both consumers and corporations remain a key concern. Canada's household debt to gross domestic product (GDP) is one of the fastest growing in the world, reaching about 110% in Q3 2020. Compared to our U.S. counterparts, the divergence is unusually large – but hasn't always been. The ratio of household debt to GDP in the U.S. was 78% in Q3 2020, about 32% lower than Canada. Only 10 years ago, Canada was flat to the U.S. As for corporations, mergers and acquisitions are off to their fastest-ever start to a year in Canada, driven by a combination of low interest rates, high valuations, and an improving economic outlook. It appears as though an increasing number of issuers are willing to assume more debt in order to access funding at low rates, even at the risk of a rating downgrade, with the expectation of reducing leverage in the future.

High Yield Corporate Bonds



Source: Bloomberg, RBC GAM. US high yield daily bond spreads represents the ICE/BofA US High Yield Bond Index as at March 31, 2021. Normal bear market excludes the great financial crisis

The recovery in high yield bonds extended into 2021 as high yield spreads tightened a further 50 basis points over the first quarter to approximately 335 basis points, well below the peak of 1,087 basis points witnessed last spring. The broad high yield market returned 0.9% in the first quarter. While this return seems modest, it compares favourably to investment grade bonds which generated negative performance as they faced the headwind of rising interest rates.

Investor confidence in financial markets and the companies that issue bonds within them continued to improve during the quarter. This confidence, along with a fear of higher interest rates in the future, prompted corporations to continue shoring up balance sheets at affordable rates by issuing a record amount of high yield bonds in the first quarter. This meaningful issuance was met by equally strong demand by yield-hungry investors in this low rate environment. In the past, issuance spikes like this one have often coincided with increases in risk-seeking behaviours such as mergers and acquisitions. However, high yield issuers have demonstrated reasonable financial discipline by using bond proceeds for risk-reduction activities such as refinancing short-term bank lines, replacing existing higher coupon debt, or adding to cash reserves.

High yield bond defaults continued to subside, having peaked last summer at 7% before improving steadily to an annual rate of 5% by the end of the first quarter. This is still above the long-term average of 3-4%, but well below what was feared during the early days of the pandemic. With global vaccine roll-outs underway and the potential end to COVID-19 in the not-too distant future, we believe that the peak in defaults is behind us.

Mortgages

The social and economic restrictions imposed in response to COVID-19 have impacted many commercial real estate tenants across Canada, but the experience has differed by sector despite widespread and significant support from the federal government. Demand for the highest quality industrial and multi-residential commercial mortgages has exceeded the supply. This has increased competition for new opportunities, and mortgage spreads tightened a further 24 basis points during the first quarter as a result. The sharp rise in underlying GoC bond yields has been supportive of higher coupons on new deals, but this has been partially offset by tighter spreads. All-in coupon rates continue to be attractive for borrowers, as well as to lenders relative to other income-generating asset classes.

The office sector experienced some weakness over the past year, but we continue to watch this area of the market closely as it evolves. We are actively pursuing attractive opportunities where tenant structure is sound, underwriting parameters are conservative, and borrowers are strong.

Within industrial, we are biased towards the light industrial and industrial flex segments, which is positive given these building types are adaptable to a wide variety of uses. Industrial flex space in Canada is increasingly sought after by tech companies and retailers building out their logistics networks. We are aggressively pursuing opportunities based on the fundamentals of this sector, but the challenge is earning a return commensurate with the credit fundamentals in a highly competitive pricing environment.

Multi-residential assets are traditionally viewed as the most stable segment of the commercial real estate market and have held up to that reputation through the pandemic so far. This has attracted significant capital to be invested and has made multi-residential opportunities among the most sought-after sectors of the mortgage market. While vacancy rates quoted in the media have focused on an uptick, this has primarily been in the condo market, which is different from the purpose-built rental buildings that we focus on in your mortgage portfolio. We continue view this sector favourably and believe the rollout of vaccines, resumption of immigration, and the continued growth in employment and students returning to post-secondary institutions will support this sector.

Within retail, we are focused primarily on properties anchored by grocery and pharmacy tenants (Consumer Staples). Our strategy for retail properties has been to invest primarily in strip center retail anchored by grocers and pharmacy tenants. These necessity-based tenancies are defensive in nature and have generally had minimal disruptions and strong operating results amidst the pandemic. As a result, rent collections and occupancy levels for our retail exposure within the fund remain strong, and delinquency rates have been low, resulting in minimal disruptions to our mortgage payment collection. While the short-term outlook remains uncertain, the medium- and long-term fundamentals for retail remain as they were before the pandemic, especially in situations where there is potential mixed-use functionality. Retailers who are able to survive this environment should be rewarded with pent-up consumer demand and high savings rates as Canadian consumers have increased their household savings by an estimated $200 billion through 2020 and rising in 2021, according to RBC Economics.

We are pleased with the performance of borrowers in the portfolio throughout the pandemic and expect the vaccine rollout and ensuing economic recovery to improve the operating environment further. We continue to focus on opportunities in the industrial and multi-residential sectors, but remain interested in all opportunities where reward-for-risk remains attractive. We believe that in the current competitive environment a focus on deal structuring will allow us to mitigate potential risks and maintain the appropriate balance between reward and risk.

Bond Market Outlook

Bond yields spiked during the first quarter as investors digested improving economic conditions, optimism around vaccine rollouts, fresh U.S. fiscal stimulus, and rising inflationary pressures. Looking ahead, it would be reasonable to expect a further move higher in bond yields considering the budding economic recovery and news surrounding the tapering of bond purchase programs by central banks. While we tend to agree with the market that bond yields will move higher from present levels, our sense is that the pace should moderate given the still highly accommodative stance of central banks and in light of the fact that fiscal stimulus and inflation pressures are increasingly being priced into the bond market.