MFA Pooled Investment Fund Quarterly Market Update

Q2 2021

Municipal Finance Authority of BC

Municipal Finance
Authority of BC

MFA Pooled Investment Fund Quarterly Market Update

As of June 30, 2021

Interest Rates

The global economic recovery continued at a solid pace over the quarter as accelerated vaccine roll-outs globally allowed for lockdown restrictions to ease. Against this backdrop, price pressures were felt in some segments of the economy as increased consumer demand far outstripped a still constrained supply of many goods and services. This imbalance, combined with low base prices as a result of the initial pandemic shock, resulted in meaningfully higher annual inflation readings in Canada and the U.S. during the quarter. These data points, which the BoC and the U.S. Federal Reserve (Fed) have labelled as transitory, were broadly expected and largely priced in by bond market participants, resulting in limited impact on GoC bond yields and inflation expectations during the quarter. This is a stark contrast to the rapid increase in GoC yields witnessed during the first quarter of the year amid signs of an end to the pandemic.

Looking forward, the bond market has adjusted its outlook for yields and now expects short-term yields to rise to a greater degree than long-term yields over the next year. This change reflects the possibility that the BoC may begin to gradually normalize policy rates from current ultra-accommodative levels to account for the improving economic outlook. Our view is generally in line with what is priced into the bond market; however, we believe that yields are likely to exhibit modest volatility in the near term as a multitude of factors will influence the direction and magnitude of yield changes, particularly central bank monetary policy and the future path of the economic recovery.

Real Return Bonds

Actual inflation, as measured by the headline Consumer Price Index (CPI), recorded the fastest yearly increase in a decade and climbed to 3.6% in May. The stark rise is in part a reflection of the low price levels seen in the prior year at the onset of the pandemic. Prices are expected to experience continued upward pressure over the short term as provinces ease public health restrictions, businesses look to make up for lost revenues, and consumers have more places to spend their cash. However, the higher inflation print is expected to be temporary due in large part to the confluence of several transitory factors. Despite headline CPI hovering slightly above the BoC's 1–3% inflation range, the central bank reiterated its commitment to maintaining its policy interest rate at the effective lower bound until its 2% inflation target is sustainably achieved.

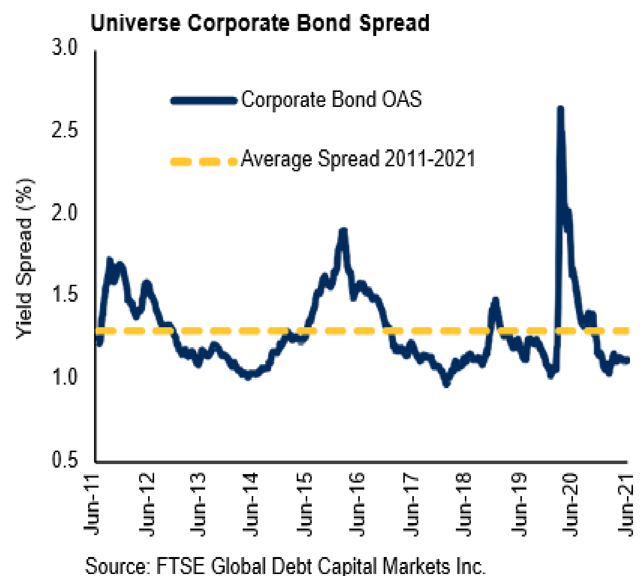
The bond market's expectations for long-term inflation (estimated as the difference in yield between a nominal and a real return bond) was largely unchanged over the quarter, ending June at 1.7%. Market- implied long-term inflation expectations remain below the BoC's 2% target and in line with levels of the past decade. We believe market-implied long-term inflation expectations are likely to move higher over the medium term.

Quasi-Government Bonds

The outlook for the provinces is increasingly more optimistic as restrictions ease and economies continue to reopen, all of which has provided support and positive sentiment for the provincial bond market. Against this backdrop, new issuance remained robust with approximately $41 billion of new supply entering the market. The provinces in aggregate have issued close to 30% of their fiscal year funding needs, putting them slightly ahead of their funding schedule. The market easily digested the influx of supply, and provincial spreads tightened modestly over the quarter, ending June slightly below pre-pandemic levels. Of note over the quarter, the BoC wound down its Provincial Bond Purchase Program (PBPP) in May owing to healthy bond market conditions and robust liquidity environment. Market impact was negligible as the termination of the PBPP was communicated well in advance of the official end-date. It may be noted the BoC only purchased around $17.5 billion of provincial bonds since the launch of the program last May, which was well under the program size limit of $50 billion.

Investment Grade Corporate Bonds

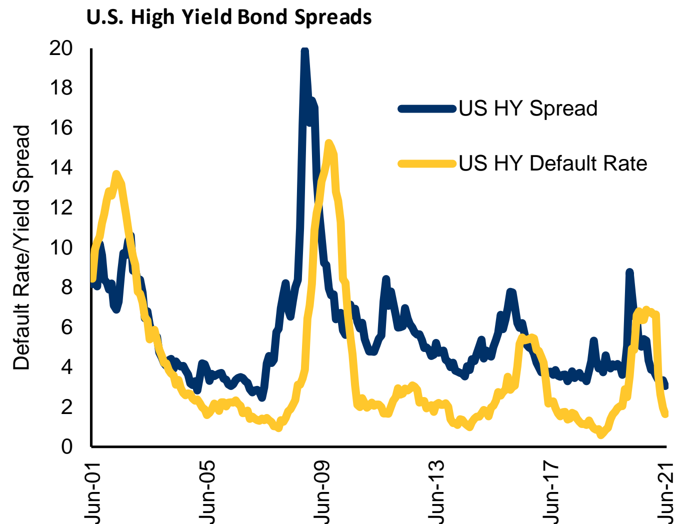
Robust corporate earnings along with sustained and improving economic conditions continued to support investor confidence. Corporate issuers capitalized on this positive backdrop by bringing approximately $41 billion of new supply to market during the quarter, which is slightly less than last year's second quarter pace but well ahead of the long-term average. While the primary market continued to be very active during the quarter, the secondary market has been relatively quiet. This could possibly be a result of corporate bond ETF and mutual fund inflows slowing down, and weakening demand, which could be signalling a fading technical backdrop. Overall, investment grade corporate bond spreads wer were broadly unchanged over the quarter.



From a fundamental standpoint, increasing debt levels in the Canadian economy among consumers and corporations remain a key concern. Consumer debt stood at $2.1 trillion in the first quarter, up 0.6% from the fourth quarter of 2020 and 4.8% from a year earlier as households put more money into the booming Canadian housing market. On the corporate side, the biggest potential headwind continues to be elevated M&A activity as businesses shift away from the protective stance they had at the onset of the pandemic toward more ambitious, forward-looking growth.

High Yield Corporate Bonds

Similar to other risk assets, high yield bonds performed well during the second quarter. Spreads traded in a narrow range but ultimately tightened approximately 35 basis points over the quarter. This extends the recovery streak in high yield bonds to five consecutive quarters since last year's unprecedented pandemic-driven sell-off.



Source: Bloomberg. US High Yield performance represented by ICE BofA Merrill Lynch US High Yield index. US high yield default rate represented by ICE BofA Merrill Lynch US High Yield index to Dec 31 2019, JPMorgan Jan 31 2020 to current

Corporations continued to be very busy refinancing existing debt, and increasingly, funding rising M&A activity after a lull during the pandemic last year. New issuance is on record pace year-to-date but is being comfortably absorbed by strong demand from investors searching for yield. However, any slowing could tilt the supply-demand balance favourably and lead to even further spread compression.

The resumption of business activity and soaring corporate profits have boosted corporate bottom lines. High yield bond defaults were almost negligible over the quarter, allowing the trailing annual default rate to fall to 1.9%, which is down from the peak of 6.8% and below long-term averages. With oil prices now above $70/barrel and economies continuing to re-open, defaults are expected to decline even further (note: the energy sector was by far the largest contributor to defaults over the past year) and possibly approach record low levels later this year or next.

Mortgages

Overall mortgage spreads tightened approximately 15 basis points over the quarter. The sharp rise in underlying GoC bond yields over the past year has been meaningfully offset by spread tightening in the commercial mortgage market. The highest-quality industrial and multi-residential commercial mortgages have outperformed other sectors of the market throughout the pandemic from both a fundamental and spread tightening standpoint. In contrast, growing optimism stemming from the mass rollout of vaccines and th e implications for economic recovery has resulted in an increase in demand for retail and office lending opportunities. We believe this has led to spread tightening in these sectors, whereas multi-residential and industrial spreads have shown signs of stabilization.

While uncertainty remains, the outlook for the commercial office sector has improved as vaccination campaigns have accelerated and lockdown restrictions have been lifted across much of the country. In prior quarters, lenders were focused on more resilient sectors of the real estate and commercial mortgage markets as uncertainty about the long-term impact of the COVID-19 pandemic remained the dominant theme.

Going into the pandemic, industrial development in Canada had lagged demand for many years, especially in major markets such as Toronto, Vancouver, and Montreal, where availability rates have been below 2%. While e-commerce has been the primary driver of this availability crunch, other sectors of the market to experience increased demand for warehouse space include data centres, cold storage, and "last-mile delivery" in suburban markets. Given the limited availability of industrial assets, particularly warehousing space, we expect to continue to see rental growth in this segment of the market.

Multi-residential real estate has historically been the safest core real estate sector because everybody needs a place to live. The sector continues to exhibit a strong long-term outlook driven primarily by limited land availability and high immigration targets. While the pandemic has driven vacancies up and pushed rental rates down across most major cities, this has primarily been in the condominium market, which is different from purpose-built rental buildings. Purpose-built rental buildings are designed and built for long-term rental accommodation, as opposed to other types of rental units such as condominiums, which may be sold or repurposed at any time.

The experience in retail has been notably influenced by the existence and severity of government-imposed restrictions and the ability of retailers to adapt rapidly to the use of online platforms to drive revenue. The experience has not been uniform across Canada, but some indicators are beginning to show signs of revival in retail spending, particularly in provinces that are further along in their re-opening phases. While commercial mortgage spreads are showing signs of stabilizing in the more steady sectors of industrial and multi-residential, lenders are becoming increasingly comfortable pricing retail opportunities at tighter spreads.

Looking forward, despite risk-free rates remaining low by historical standards and the tightening commercial mortgage spreads, we see attractive opportunities on a risk-adjusted basis in the commercial mortgage market. We believe that in the current competitive environment a focus on deal structuring will be important to mitigate potential risks and maintain the appropriate balance between reward and risk.

Bond Market Outlook

Bond yields paused in the second quarter after a significant rise earlier in the year. Much of the good news related to vaccine roll-outs, a reopening of economies and firming inflation was already priced into the bond market in late 2020 and early 2021, so there was little impetus for yields to rise further. Economic growth and inflation are likely to peak sometime during the summer, relieving much of the upward pressure on bond prices. Over the next 12 months the bond market expects yields to rise; we also agree that yields will move higher but likely at a much more moderate pace than in the first quarter of 2021.