GUARDIAN CAPITAL

FIXED INCOME OUTLOOK

H1 2022

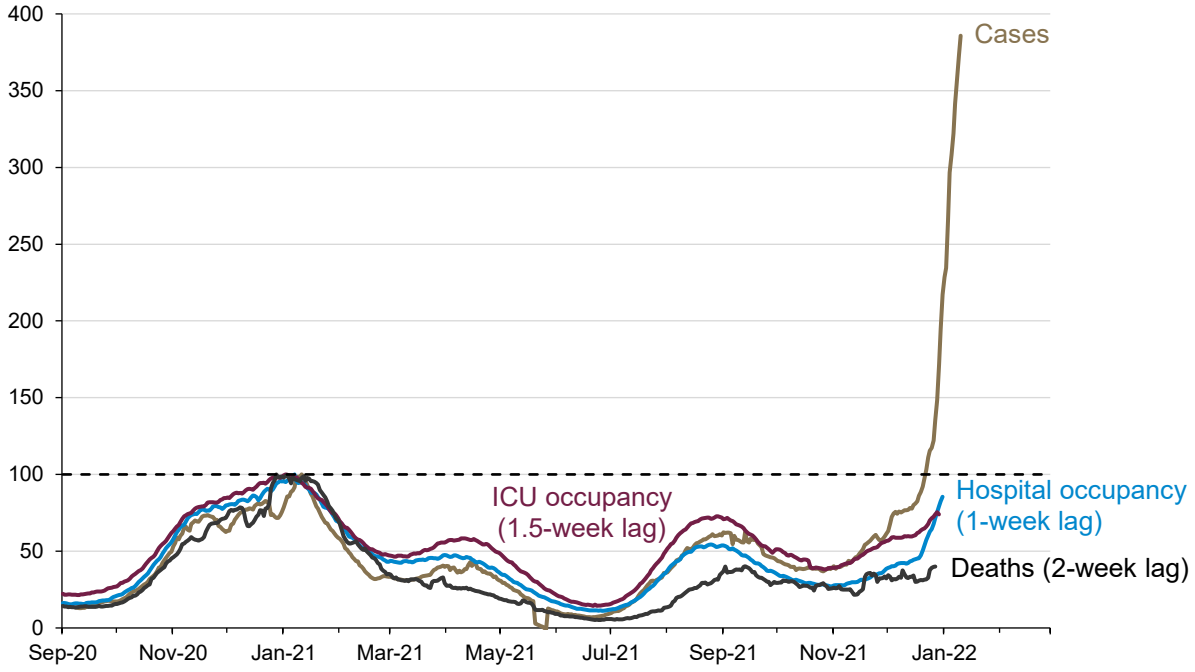
ONE MORE TIME, WITH FEELING

One phrase that instills doubt and fear in the minds of economists and historians alike is, “This time is different.” It is rarely, if ever, the case that this ends up being true and, at best, to quote American humourist Mark Twain, “History doesn’t repeat itself, but it often rhymes.”

As the world rides yet another wave of COVID-19 infection, there is much trepidation over how this new wave and its resultant impact actually are different from the last three, and if this may represent the beginning of the end of the pandemic.

While the new dominant strain of the virus (B.1.1.529, or “omicron”) is clearly highly transmissible, as evidenced by confirmed case counts skyrocketing worldwide (which undoubtedly vastly underestimate the true scope of contagion), it has so far proven to be less virulent (having a lower ability to cause severe symptoms) than its predecessors. Rates of hospitalizations, especially those requiring intensive treatment, and deaths have largely decoupled from infection rates, holding at lower levels than earlier waves.

Confirmed COVID-19 cases, hospital occupancy, and deaths, G7 excluding Japan
(percent of last winter peak)



Data to January 10, 2022; source: Bloomberg; Our World in Data; Guardian Capital

Whether this is due to this iteration of the virus being inherently more benign, the increased immunity across populations established by prior infection (or more importantly, vaccination), the significant progress at managing and treating illness or, more likely, the combination of all of the above — it is being viewed by epidemiologists as a positive development that could well indicate that the ebbing of this current wave will bring the pandemic to a close.

Of course, the end of the pandemic does not mean that COVID-19 disappears, just that the disease progresses to being endemic; meaning that it remains a constant in the population but is far less impactful, such that it does not represent an "emergency" — infections will arise predictably and at consistently low rates, with few people becoming severely ill.

Once this point has been hit, life can generally be expected to slowly return to something akin to what used to be considered normal, with restrictions on daily life fully rolled back and economic activity permitted to resume at full capacity once again. Current thinking is this normalization process will not just be a story for 2022, but for the first half of the year.

Indeed, judging by the progression of the disease in South Africa, the omicron epicentre, the wave could well be expected to crest in the coming weeks, with a fairly rapid ebbing coming thereafter — with healthcare systems in the hardest-hit areas being largely spared much of the extreme pressures experienced a year ago.

BREAK ON THROUGH (TO THE OTHER SIDE)

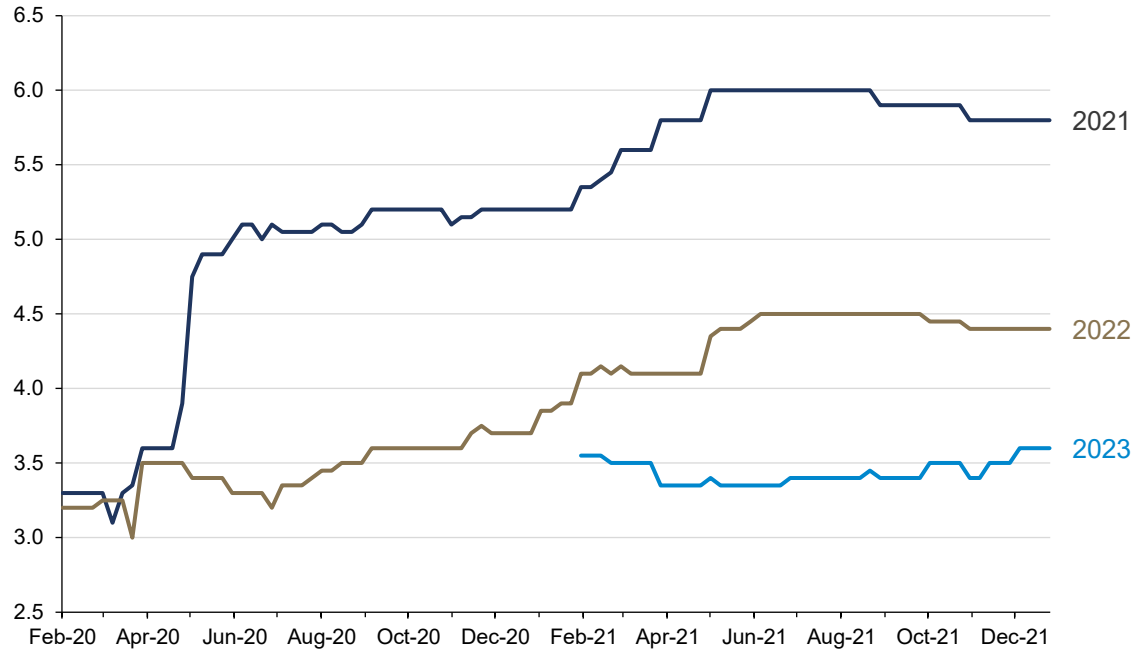
The fact that the pandemic has been part of life for nearly two years now has meant that people and businesses have adapted their lifestyles and operations to fit the backdrop. This has been a key reason why each successive wave, and consequent introduction of stringency measures, has generated a smaller macroeconomic wake.

The prospect of a less severe and quickly receding wave could give policymakers the ability to scale back stringency measures that were reintroduced, in fairly short order in the weeks ahead — and it is notable that many regions (the US and UK most notably) barely saw anything in terms of renewed restrictions.

This would seem to suggest that the impact on global growth could be nothing more than a blip, especially if activity is permitted to resume to pre-pandemic levels across even the hardest-hit industries once we find ourselves on the other side. The effective lack of movement in global growth forecasts would indicate that this view is in line with the current consensus — growth is expected to slow over the coming 12 months versus the robust recovery rate of 2021, but still remain well above the trend rates that prevailed prior to the pandemic.

WORLD ANNUAL REAL GDP GROWTH FORECASTS

(year-over-year percent change)



Bloomberg consensus forecasts to January 7, 2022; source: Bloomberg; Guardian Capital

Again, the restraint on economic growth over the last two years has not been due to a weakness in demand, but due to constraints on the supply side.

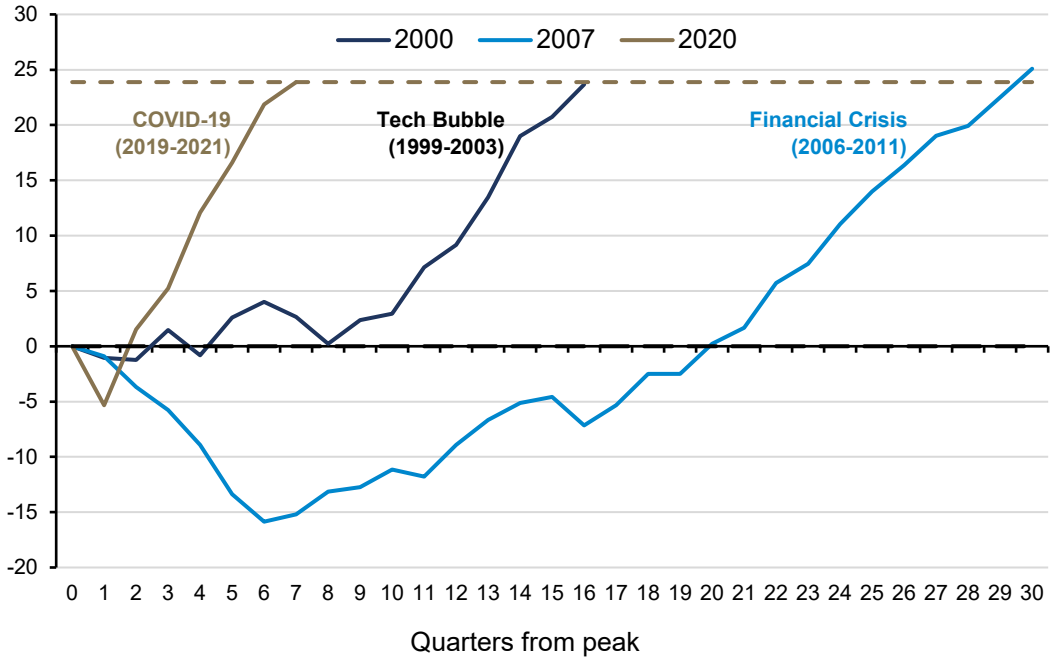
The pandemic-related shutdowns and resultant job losses created adverse impacts globally, however, in stark contrast to previous demand-driven economic downswings, governments stepped in to fill the income void that resulted from lockdowns. The G7 economies rolled out massive slates of relief measures amidst the pandemic (estimated by the International Monetary Fund at US$14 trillion, roughly 20% of the group's aggregated gross domestic product) to support their domestic economies.

The income boosts combined with the restrictions on economic activity that significantly limited spending (especially on services, which typically accounted for two-thirds of household budgets prior to the pandemic) to see savings rates surge across the globe. Estimates suggest that at least US$3 trillion more than normal has been socked away by households across the G7 economies since the beginning of 2020.

Moreover, thanks to strength in global financial and residential real estate markets over the last two years, despite the historic shock created by the pandemic, aggregate household net worth has surged and now stands 25% above its pre-crisis peaks in Canada and the US — it took four years for American households to get to this point after the tech bubble burst at the turn of the millennium and 7½ years after the financial crisis.

US HOUSEHOLD NET WORTH

(percent change from pre-crisis peak)



Data to Q3 2021; source: US Federal Reserve Board; Bloomberg; Guardian Capital.

Furthermore, it is perhaps most notable that it has not strictly been a case of the rich getting richer. In fact, recent data from Canada and the US indicate that wealth gaps have actually narrowed since the onset of the pandemic, as those households at the lower end of the wealth spectrum have recorded comparatively larger gains in net worth over this period.

This rapid, substantial buildup of wealth (particularly among the less wealthy cohorts that typically spend more of their gains in net worth) has underpinned strength in household spending on goods over the last year, and there is little reason to anticipate consumers will be restrained once activity is permitted to fully resume. There appears to be no need to rebuild lost savings, something that historically has been a factor limiting the speed of recovery from past economic crises.

In other words, it would appear that there still remains substantial capacity for consumer spending (which accounts for roughly 60% of global economic activity) to be a driving force for over the coming year. This is especially the case if there is more clarity on the outlook that leaves households more confident in the job market backdrop and more comfortable making decisions for more than just the near-term, as has largely been the case since the pandemic arose.

UNDER PRESSURE

For goods producers (especially those peddling consumer goods), this environment has been almost an embarrassment of riches. Current data and forward-looking surveys indicate that order books are bulging and among the biggest problems are keeping storerooms stocked as production, both domestic and international, has struggled to keep up. Inventories have drawn down significantly, compounding underlying demand strength as the need to replenish depleted stockpiles (and likely to higher levels than prevailed pre-pandemic given the recent experience of difficulties maintaining supply channels), adds to the backlogs.

An ebbing pandemic and improved clarity on the path of the economy in the months ahead will go further to support robust demand for labour and increase comfort with moving forward with a much-needed increase in capital investment. This, in conjunction with the potential for full-scale production with minimal future disruptions, should help supply backlogs — notwithstanding some likely lingering effects of the latest upswell in COVID-19 cases on links in the global supply chain, particularly in China, which continues to adhere to a “COVID zero” policy.

Any progress on balancing out the supply-side of the equation would go some way to easing price pressures that have been bubbling up and, combined with fading “base effects” and lower-cost services re-establishing their share of the household budget in the coming year, will almost assuredly result in inflation moderating in the year ahead from its multi-decade highs of late.

With that said, the price pressures have so far proven to be more persistent than previously assumed, and there is scope for this “stickiness” to continue into the New Year. Reasons include, but are not limited to, increased inflation expectations filtering into vendor/labour contracts; a reversal of some earlier globalization efforts as businesses on-shore production to reinforce supply chains; monetary and fiscal stimulus being sustained longer than anticipated and further underpinning demand; the increased push to transition toward more renewable energy sources and related emphasis on sustainability; and, of course, the wave of COVID-19 impeding the improvement of supply/demand imbalances.

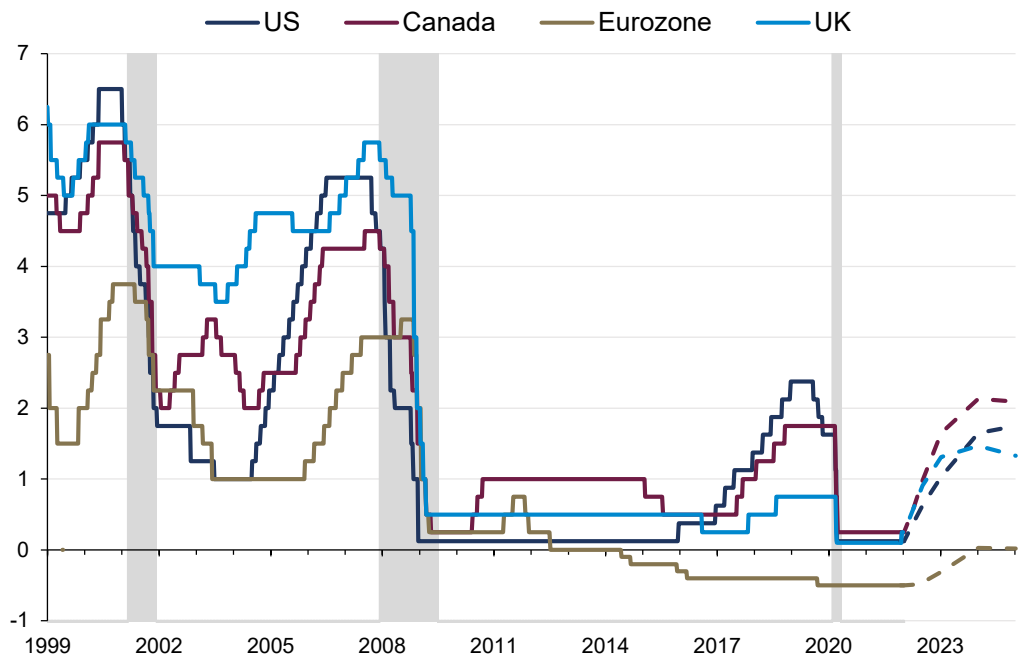
It is indeed the case that market-based measures of longer-term inflation expectations still suggest that while inflation may not be destined to remain at current levels, it is anticipated to persist at levels above previous norms going forward.

This outlook for growth and inflation has prompted a recent shift in the approach to monetary policy. Central banks have begun eschewing a more balanced and cautious rhetoric against the uncertainty plaguing the forecast horizon in favour of a more hawkish bend, with ground being laid for an unwind of crisis-era stimulus measures.

The expectation now is that central banks will begin to rise interest rates in the coming months (the Bank of England already made the first volley of major Developed Market central banks in December 2021) and continue tightening policy in a fairly aggressive manner into year-end — the material repricing of the path for policy rates has put notable upward pressure on market yields, sparking a bout of volatility in risk assets.

CENTRAL BANK POLICY INTEREST RATES

(percent)



Dashed lines represent market-implied forward rates as at January 11, 2022; shaded regions represent periods of US recession; source: Bloomberg; Guardian Capital

A CHANGE IS GONNA COME

Change can be difficult to digest, especially at first, and the attendant uncertainty that comes with the change in the policy environment likely means that volatility will remain elevated over the near term.

As the dust settles and the outlook clears, especially if the pandemic begins to subside in earnest, as anticipated (a very welcome change), it appears that the constructive macroeconomic fundamentals should keep growth momentum on a decidedly upward trajectory.

The strength in consumer finances, potential upswing in business investment and the boost associated with a broader/full reopening of activity (especially in services) should mean that the economy is able to absorb modestly higher interest rates. It is important to recognize that rates globally are still at historically low levels and real rates remain deeply in negative territory, while the likes of the European Central Bank (ECB) and Bank of Japan (BoJ) are maintaining highly accommodative monetary policies and continuing to add liquidity into the financial system.

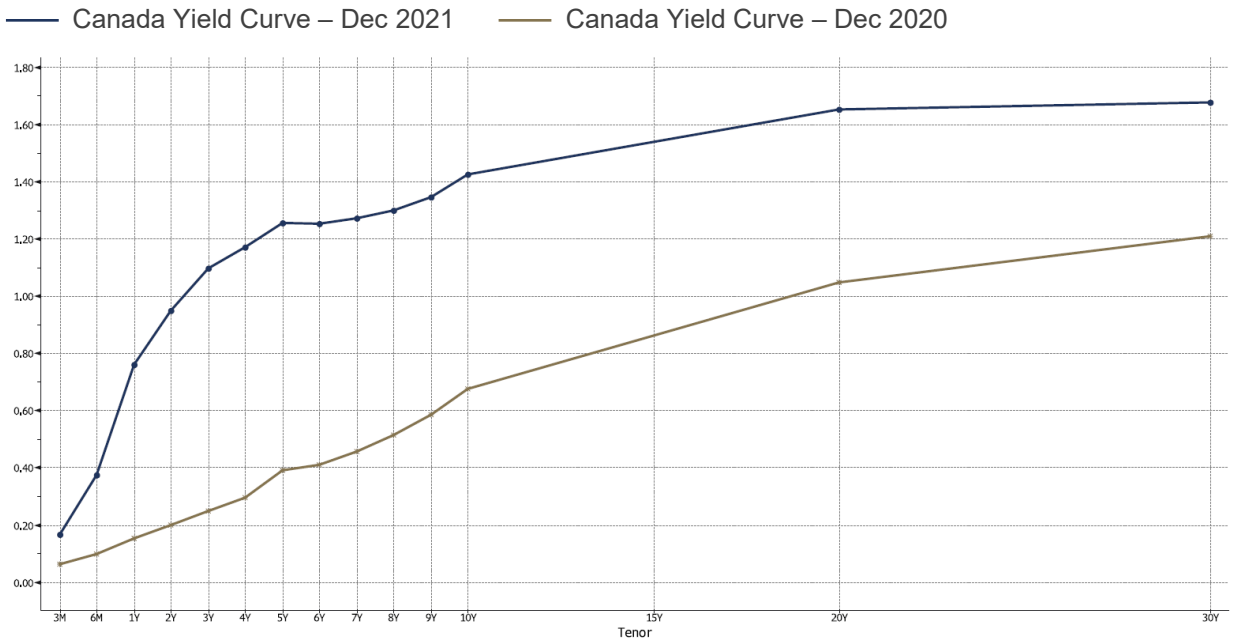
That suggests monetary tightening this year should not be sufficient to knock global growth off its track. That said, while the decision to be more proactive with respect to combatting inflation that could prove detrimental to the economic expansion reduces the risks of policymakers being too far behind the curve, it opens the door to the potential policy error being that central banks prove too aggressive amid a still fragile recovery — and the pace of tightening currently priced into the market certainly raises this potential.

Central banks have historically struggled to calibrate monetary policy in such a way that financial conditions do not tighten too much, too quickly — and ultimately efforts to find a remedy for inflationary pressures ended up being worse for growth than the cause itself. Hopefully this time will be different.

FIXED INCOME CORE OUTLOOK

With emergency monetary stimulus expected to be unwound, fixed income markets have already priced in material increases in North American central bank overnight rates. With an increase in shorter-term yields reflecting expectations, relative value is also shifting to shorter and mid-term tenors when compared against long bonds. While long bonds can continue to flatten relative to shorter tenors of the curve, continuing their relative outperformance, an overwhelming majority of this flattening has already occurred. Relative value opportunities are becoming more attractive in shorter and medium tenors, as opposed to long bonds, which has been the best performing, relative segment on the Canada yield curve over the last number of months.

WHAT A DIFFERENCE A YEAR MAKES



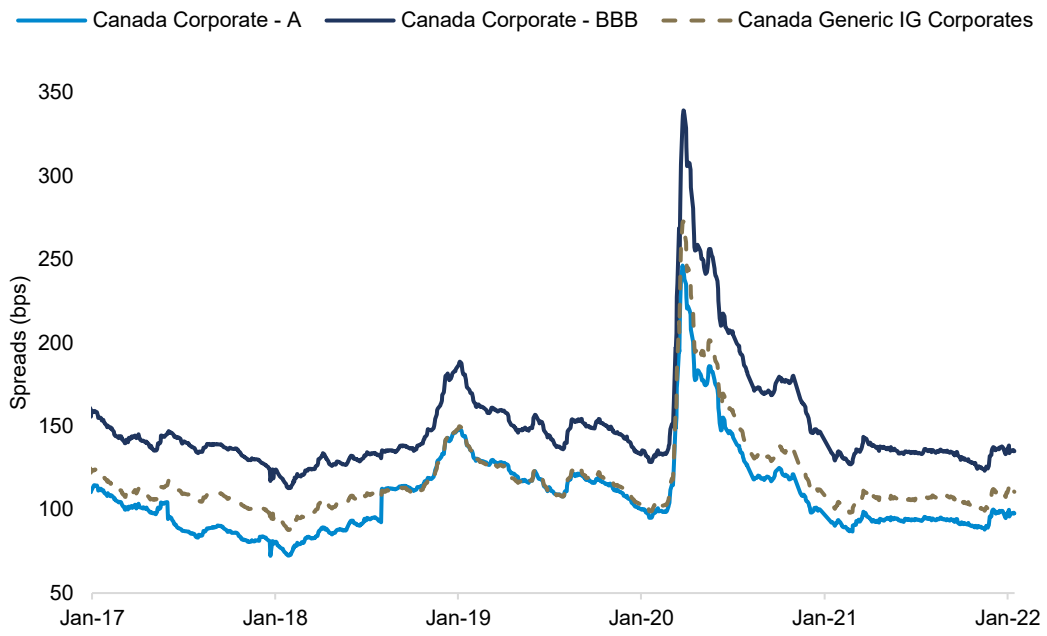
Canada Yield Curve comparison; source: Bloomberg; Guardian Capital

Absolute interest rates in Canada have risen in shorter tenors, but remained range-bound in long bonds, reflecting effects of curve flattening. We expect the Bank of Canada to begin raising interest rates in the first quarter of 2022. Under this scenario, we acknowledge the potential for more flattening in long bonds, despite the considerable amount which has already occurred.

While Corporate and Provincial spreads are trading wider than recent tights, they are trading at the tighter end of established ranges. Corporate credit metrics are, generally, healthy, but government balance sheets, including Provincials, have eroded with larger deficits and greater debt financing necessary to fund emergency expenditures. Entering a tightening phase of the cycle represents a risk to liquidity and spreads. With the US Federal Reserve (Fed) expected to increase interest rates and begin balance sheet run-off, global liquidity, at the margin, will be reduced despite continued stimulus from other central banks.

CREDIT OUTLOOK

Since the advent of the omicron variant in November 2021, and the Fed's hawkish tone change, Canadian investment grade (IG) credit spreads have widened off the tights seen in February and mid-November 2021, and, in certain cases, have widened to levels last seen in December 2020.



Investment Grade Credit Spreads as at January 14, 2022; source: Bloomberg; Guardian Capital, BofA.

Fundamentals for Canadian IG credits are still pretty supportive, overall leverage has come down with the rebound in EBITDA, and despite a large stock of corporate debt, the interest burden of IG corporates is relatively low, thanks to all the refinancing activity of the last couple of years at lower all-in interest rates. In the face of many headwinds, the global economy has demonstrated momentum and, as a result, corporate earnings are still expected to grow; albeit at a slower pace. Further supporting credit is a slowing in primary issuance, with many issuers fully funded with no maturities for at least a year.

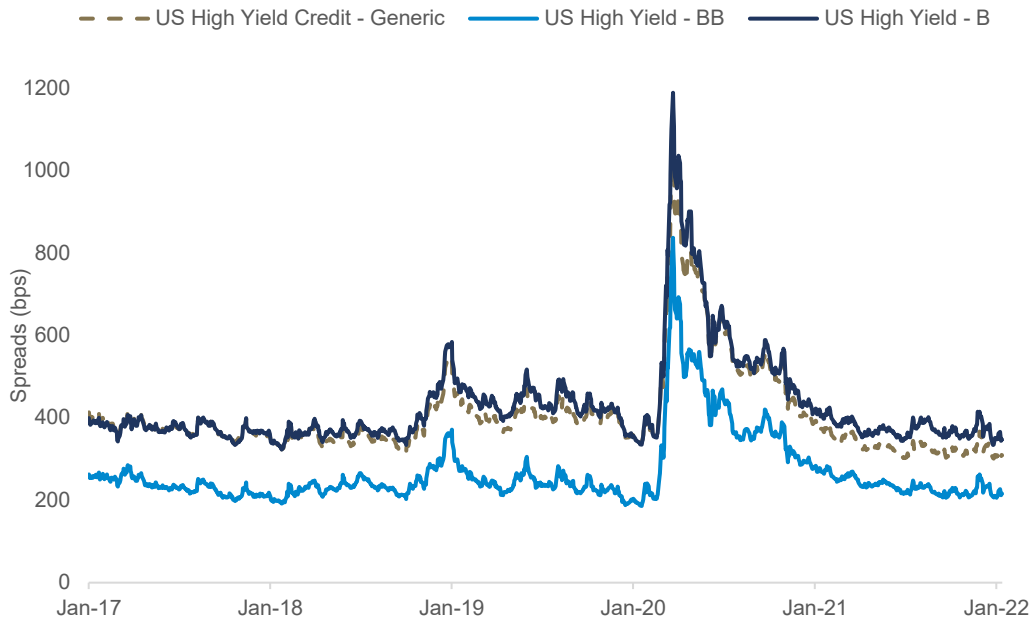
While we are constantly wary of a negative change in risk sentiment because of concerns regarding an aggressively hawkish Fed, we believe that the Fed also does not want to create severely tightening financial conditions as a consequence, therefore limiting how much spreads could widen. Additionally, there remain other large global pools of capital-seeking yield such as the ECB and BoJ, which continue to maintain dovish monetary policy.

We expect the Telecommunications and Energy sectors to continue to have favourable Free Cash Flow profiles going forward, which will maintain their credit quality vs. REITS, which are in certain instances still dealing with very high leverage and are already priced for a full economic re-opening.

HIGH YIELD OUTLOOK

The overall yield offered by high yield bonds continues to hover near record lows, as does the additional yield spread (over government bonds) they offer for added credit risk. As a result,

spreads may struggle early in the New Year as bond markets price in higher interest rates and less central bank accommodation. Ultimately, however, we believe high yield should outperform high-grade bonds in 2022 due to their higher coupons and lower interest rate sensitivity.



High Yield Credit Spreads as at January 14, 2022; source: Bloomberg; Guardian Capital, BofA.

While the economy may struggle in the near term due to ongoing supply chain bottlenecks and shortages of both labour and materials in many sectors, the credit environment remains generally healthy. Economic growth, while uneven, remains positive and there appears little chance of recession on the horizon. Default rates remain low, balance sheets and cash flows are strong, and interest rates, while rising, are still exceptionally low as well. Those positive fundamentals should continue to attract income-hungry investors, supporting both bond prices and relative spreads even if government bond yields continue to drift higher in the near term.

New issue supply will likely be significantly lower in 2022, as companies took advantage of 'borrower-friendly' markets over the past two years to pre-fund borrowing needs. As a result, credit spreads will see no technical pressure to widen due to supply this year.

Within the High Yield sector, single-B rated issues should outperform BB-rated credits, due to the higher interest rate sensitivity of BB-rated bonds. Energy and commodity-related issues will likely be among the best performers as commodity prices remain strong and corporate hedging programs roll forward at higher prices, supporting stronger company cash flows. Within the Energy sector in particular, M&A activity is expected to ramp up in 2022, which could result in windfall returns to high yield investors when investment grade companies become acquirers.

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