

Episode 5: What's in Canada's New Federal Budget?

John Pagliacci

[00.00.01]

Hey everyone, and welcome back for episode number five of Guardian Capital LP's "Buy The Way" podcast. As always, I'm your host, John Pagliacci, and I am joined once again by Mr. Baseball, David Onyett-Jeffries, for a discussion on happenings as always in-and-around markets over the past month. Before we get into things, I did want to start with the most important topic which is, man, what a World Series. David, I don't know about you, I'm still reeling from that heartbreaking loss in game seven. I understand you were there in person. How are you? And how was that?

David Onyett-Jeffries

[00.00.31]

I'm honestly, from a baseball perspective, fantastic, right? I don't even find it that heartbreaking. The expectations for the team coming into the season were low, so pretty much all gravy. And like, as a pure baseball fan, what more can you ask for than game seven and then game seven going into extra innings? I did have the benefit of being there. I had a friend who lucked out and had some extra tickets, and I got them at face value so I didn't have to do the absolutely obscene resale market. But it was, again, amazing being in there. But the energy was very different than other games because there's that underlying tension. There was no euphoria. Everybody was sort of on tenterhooks the entire game. But I wouldn't trade it for the world.

John Pagliacci

[00.01.12]

Yeah, it was something. You know, you and I both growing up were pretty competitive baseball players. So the fact that my kids haven't taken to it has been a little bit soul crushing. But to see them standing up at the TV with me, shouting at the TV and understanding the anxiety like I do, was an experience that I was grateful for. So bring it on. Looking forward to spring training already, as I'm sure you are. So here we go.

David Onyett-Jeffries

[00.01.36]

Counting down the days.

John Pagliacci

[00.01.38]

All right, let's focus on some financial stuff here. Episode number five, as I mentioned, obviously we just saw recently the Canadian federal budget get announced. So I figured it was timely that maybe we devote our entire episode today to centering our discussion on that. So, we'll start there. Unlike some areas of the finance world that I think are just a little too nerdy for a lot of people to be interested in. I think with the federal budget, it often gets pretty broad attention because of its potential impacts on, really the everyday lives of us as Canadians. I understand with this budget it was almost 500 pages long. So I highly doubt you've gone through every page with a fine tooth comb, but you do certainly have some takeaways to share with us. So I want to sort of extract those out of you here. To start, let's maybe start very high level for those that are less familiar with the budget process in Canada, how often is this, or how often, I should say, is a new federal budget released? When does this one actually take effect? And then in broad terms, what are some of the main areas or objectives that the budget tries to accomplish?

David Onyett-Jeffries

[00.02.42]

Yeah. So diving into the nerdiness of sort of the actual process of everything, the federal budget is released once a year by the government. Prior to this year, the budget was typically released in the spring, typically late March or early April, and it coincided with the end/beginning of the fiscal year. So

in Canada, for the federal government, fiscal year runs April 1st to March 31st. So they released the initial budget in the spring and then in the fall. So typically around this time of year, they would present an update which has any sort of material changes that would be put in place. So one of the reasons that the budget was delayed this year, obviously was related to the timing of the federal election, which was at the end of April. But also at the same point, the new government has decided to shift to a fall budget going forward, as part of their attempt to, I guess, as they call it, modernize Canada's budget approach. So the move brings the budget estimates for the upcoming fiscal year. So when we're talking about presenting a budget, it's their spending and investment initiatives for the next year and typically like a five year time horizon. But by moving it into November, it actually amplifies the processes for anybody who relies on federal funding for their own fiscal years. So rather than, once your fiscal year is already started, getting the new updates and information about the allocation you're going to get if you're, let's say, a provincial government or a municipal government or an agency or business that relies on federal funding, by releasing the budget now before so there's a decent runway before the end of the fiscal year, it allows better planning at all levels of government. So in terms of how the budget works, they lay out their investing and spending priorities for the coming year, but also over basically a five-year time horizon. And obviously, the exception there is if we're talking about the pandemic period, when the uncertainty about everything that was going on greatly shortened those forecast horizons. But for the current one it's the new government. They can lay out sort of their agenda for the coming five years. And emphasizing these goals and supporting the domestic economy against what we're going through, fairly significant adjustments, especially in terms of the relationship that we have with the US, given their adoption of less friendly policy positions. But just keeping it broad terms to start out with, the main focus of this year's budget was really just investment in infrastructure and putting initiatives in place to support private investment to really improve Canada's productivity and competitiveness. In this what is, a changing and different world with this new regime in the US.

John Pagliacci

[00.05.22]

So I don't think it's a surprise to anybody that Canada now, for a number of years, has been facing some economic challenges. We talk about underinvestment and relatively poor productivity growth. And that was even before Trump and the more recent aggressive shift in US trade policy added to those pressures. From my standpoint, I certainly haven't got into the weeds of this budget, but it's my understanding that the new Liberal government has really shifted gears away from what we've seen in the past, this sort of sugar high of handing out money to people to try to stimulate economic activity. And the new government is actually moving more towards significant long-term investments. Would you say that's a fair characterization?

David Onyett-Jeffries

[00.06.03]

Yeah, for sure. That is a fair assessment of what it is. The emphasis of this budget is on investment over spending, and actually on the spending side the difference between the operational budget and the capital budget, they're actually trying to restrict the operating budget near-term with more emphasis on the spending aspects. And now, from that perspective, this is a welcome development from a more long-term economic perspective. And it puts the focus on the ability to execute the plans in order to reap those benefits because improving infrastructure, supporting business and business investment in particular, it's not an immediate boom. It's something that will take time and require execution in terms of how the policies are put in place, how the funding is specifically directed and, the ability to, even over the next five years because of things, how they develop and move, you have to adjust those priorities and maintain everything being in place rather than cutting a check in the current time and expecting people to go spend, which is this again. Talk about the sugar high, this immediate impact. It's delayed gratification more than anything else, which from a macro perspective is fantastic, it just puts a lot more pressure on actually getting things done.

John Pagliacci

[00.07.16]

Well, I mean, that's good to hear on the surface. I mean, it certainly sounds like the prudent thing to do to sort of get the country back on better footing from an economic standpoint. I think it should help to pay dividends over the long term if things are executed properly, as you say. I suspect, though that these investments, or I think they're being called "nation building projects", these are not going to be cheap, and we're going to need to probably increase a fair amount of, or raise a fair amount of debt to fund them. Is that right? Or are we looking at the government putting higher tax rates in place, for example, to help drive more revenue?

David Onyett-Jeffries

[00.07.48]

As it's currently laid out in this budget, these are debt and deficit finance projects. It is important to realize that this is not a majority government in place right now. It is still a very slim, but it is a minority government. So the reality of trying to push through, from a bureaucratic standpoint, push through extensive changes on the revenue side of the equation, are much more likely to be met with pushback than just increasing the red ink. There's always this more willingness to take on debt and kick that can down the road, rather than putting the immediate pressure on households and businesses at this point in time. And actually if you look at their forecasts and projections, the revenue projections are actually expected to be lower across the forecast horizon relative to what was laid out in the last fall economic statement, which was released about a year ago. And then you go back to the 2024 budget in April of last year. A large chunk of that reflects the downgrade economic forecast. But there's nothing in these plans that expect to see an increase, like the increased spending and investment, the outflows from a government perspective being offset by new inflows. So there's no indication as of yet. Things can change, especially over a longer time horizon. But more stringent tax policies are not on the table as of yet.

John Pagliacci

[00.09.03]

So we are going to be adding a fair amount of debt then to our balance sheet as a nation, how does that debt load or debt-to-GDP or deficit stack up relative to other developed countries that we might be up against? In your view, is this sort of a manageable or prudent amount of debt that we've committed to taking on, or are we getting a little bit out over our skis, do you think?

David Onyett-Jeffries

[00.09.26]

So one of the reasons why the government's able to take on sort of these debt and deficit profiles without getting major blowback from the bond market, because if you were to do the parallel in the 1980s and early 90s, if there's something like this with this large magnitude of deficits and therefore the debt that comes with it, interest rates would go up because there's this question about fiscal sustainability that plays out. But in the current scenario, Canada is not sort of this loan beast that in terms of taking out this much red ink. Pretty much every developed market economy in this current environment is really just adding more deficit and debt spending. A lot of it is in response to what's happening in the US. But you're seeing these large scale infrastructure and government spending plans, even in the likes of Germany which traditionally is the most tight fisted of economies. So, you're seeing that play out. So it's more consistent, like everybody's doing this. And then second, on a relative basis, and everything in finance and markets has got to be looking relatively, Canada's is in a comparably better fiscal situation, even with respect to the magnitude of debt and deficits versus any of its peers. Now, it's absolutely the case that deficit spending and the result of debt loads is not exactly the most positive situation. But when we're looking at a relative basis and looking how we stack against our peers, the analogy is that Canada's the smartest kid in summer school, right? It's always tough to say whether or not debt is prudent, and especially that goes in a situation where interest rates are no longer zero, because it means that more revenue is going to go towards servicing that debt, which in turn means that taxpayers are getting less bang for each of their tax dollars. But when we're talking about prudence and we're talking about sustainability, this current plan, well, obviously worse than was previously projected, it's nowhere close to being as profligate on a relative basis, especially given the size of the economy, versus the deficits that were run in Canada in the 70s and 80s. Not to mention

what we're seeing stateside. So as it currently stands, there's no real indication that this is going to be problematic. Especially if these fiscal plans yield the positive economic results down the line. But at the same point adding more debt is never sort of the best case scenario. But again, if we do see the execution, we do see this improvement from an infrastructure spending, enhanced productivity and competitiveness that can come out of it, you could argue down the road whether or not that's worthwhile. So much of it right now is contingent on things actually materializing on the positive economic front to see.

John Pagliacci

[00.12.10]

Well, you talked about bang for buck there. So I want to ask you where is all this money intended to go. Have they actually earmarked it out in the budget specifically for certain projects or have they bucketed it out accordingly? I'd be curious to get that from you. And you know, we go back to the World Series, I was watching that, like I said, with the kids and every other commercial was the same Ontario ad promoting the benefits of mining critical minerals from the Ring of Fire. So I have to assume that's part of the agenda. But again, are there specific projects that you could point to as part of the budget or how granular do they get?

David Onyett-Jeffries

[00.12.42]

Yeah, so that's one of the benefits of having a document that is 493 pages. And that's not including the wide array of appendices that are included, but they list specific projects and they have a lot of other sort of broad thinking strategies that they want to go. So you mentioned critical minerals. So one of the things they lay out is this critical mineral minerals strategy, which is still in the early stages. And it requires further development, but is looking to enhance investment and develop areas like Ontario's Ring of Fire, British Columbia's Golden Triangle, the Slave Geological Province in the Northwest Territories and Nunavut, to really take advantage of the resources that we have been endowed. But other than that, so broad buckets that they list, there's things related to trade and transportation infrastructure so that can come down to improving container terminals in Quebec and improving the transportation for liquefied natural gas in BC. There's a lot of emphasis on supporting development of natural resources, I mentioned. Core public infrastructure, so water, wastewater management, and transit. So things that improve sort of everyday life that you don't really pay that much attention, like not the sexiest projects. And then other things like national defense. So Canada has this commitment to NATO to, what is it, 5% of government spending or 5% of GDP is going towards defense spending to sort of shore that up to meet these broader requirements. And then there's also a big chunk of it, and this is a little bit more not as clearly defined at this point, but it's investments in emerging technologies, investments in innovation and supporting scientific research. So you can go through the document and there's tons of things and different sections that are listed in there. But those are sort of, they do go into a granular level, but it's a fairly broad based. It's not specifically concentrated on one thing. It's sort of trying to maximize the potential areas that they find are the most important. And again, it's a big budget covering a big economy, and looking to increase spending over a series of years. So it's not just the next 12 months. It's looking out into the 2030s.

John Pagliacci

[00.14.57]

Well, it sounds big. It sounds like there's some aspirational points in there. So that's potentially exciting. Like you said, let's hope that we as a country can execute on them and move things forward. If we maybe shift gears a little bit here and talk in terms of the budget for what they lay out for individuals and/or families. Should people be expecting to get anything out of this budget in terms of sort of giveaways or anything like that, or other lower taxes or credits, anything of that nature for individuals?

David Onyett-Jeffries

[00.15.24]

They are sort of sparse on that side. Again, the big emphasis on this was more of the spending side, the investment side of the equation. In terms of specific things that related to households, one of the larger

ones, if you want to call it that, is in May, the government announced a middle income tax credit. So they're dropping the first marginal tax rate from 15% to 14.5%. And then there's some other initiatives. So there's a temporary personal support workers refundable tax credit. But nothing sort of material. So the tax bills for average households aren't going to be drastically impacted by these shifts. But it's also relevant to what's not there. So the last few years, we've seen consistently floated in the media the potential of changing the capital gains inclusion tax rate, which impacts investors. So there's nothing in there about that. There's no other tax increases. So, yeah, they're more or less leaving that alone at this juncture. Down the road, when maybe the economic backdrop is a little bit more constructive, they could look to change things, but as of right now, the main focus for sure of this budget was more on the investment side than anything else. And taking more debt to offset that.

John Pagliacci

[00.16.44]

Well, as you said, 493 pages. We certainly can't get into the granular details of all of the budget, but hopefully that gives everyone a nice sort of roundup of the main important points. So really appreciate you highlighting all that for us, David. I do want to pivot now though to, as we do every month, get you to talk a little bit about yours and the Asset Committee's views on different asset classes. So if you don't mind, I wanted to get you to start off maybe with a quick overview of the equity markets and how you and the team are looking at those, before maybe touching on fixed income as well.

David Onyett-Jeffries

[00.17.17]

Yeah, and I will say one of the important decisions when it comes to making investment decisions and asset allocation decisions is when not necessarily to do anything. Just because there's constant movements in the marketplace doesn't mean that everything warrants making a material decision. And as we've watched things develop over the last month, last three months in particular, it really comes down to this idea that economics is a social science, but borrowing from the more hard and physical sciences, if you look at Newton's first law of motion, like an object in motion will stay in motion unless there are net forces exerted on it. So we're in this kind of environment where a relatively, uneasy as it may be, but a balance has sort of settled into the marketplace from an equity side. The earnings backdrop is remaining constructive. We're continuing to see positive, if unspectacular growth. Interest rates aren't moving higher. Inflation is not accelerating. We're seeing sort of continued moderation there. And as a result of that, there's not really a catalyst for a change in the market environment, especially if we're looking through the end of the year. Earnings are holding up. Earnings season has been quite solid across the board. And we're seeing a broadening out in the performance there. CapEx plans are being increased. And a lot of that's tied to the AI trade and AI investments and the potential productivity booms that come with that. We've had the government shut down in the US, but the available data that we've had for the world's largest economy is still pointing to things just generally being constructive. So we get the headline bombs potential every single day, with the new news releases and what it could be. But there's nothing here that's indicating there should be any issue with that wall of worry continuing to get scaled. And the same story sort of goes for bond markets as well. Rate cut expectations have more or less normalized. And if we're looking at the Bank of Canada for the remainder of the year and maybe a little bit afterwards, more or less done. They're at the bottom of their neutral range, there's constant expression. We had, from central bank policymakers, that they are comfortable with the level where interest rates are. The Fed is still leaning towards further cuts. It may not necessarily be as aggressive as some administrators may want, but they're moving in that direction. And as we get more clarity on the data flow in the US, as with the reopening of the government taking place, and we see sort of the normal channels start to come back, you can shore up those expectations. But for all intents and purposes, it looks like a lot of the rates that have been range bound more or less for the last, let's say, 18 months are largely going to continue to be that way. So the yield on offer is more or less what you can expect on return, which isn't particularly terrible. But the balance of risk still favors the risky assets over the safe. And it's sort of the status quo at the moment in time. Like, obviously things can change, but there's a lot of inertia right now, and especially as we typically find in the last month or two of the year, things can just sort of continue to go, unless there is a clear reason

not to, and we just don't see it at this moment.

John Pagliacci

[00.20.32]

Well fair enough. I appreciate the roundup there. As we do with every episode when we close out, we get to our “Oh, By The Way” segment. This, of course, for our listeners that are aware, the segment where we highlight interesting or less widely known tidbits of financial information. Some of you may be aware as well that we do put out a monthly commentary called Macro Musings. And as part of that effort, over the last few weeks, I've been doing some research on one of the themes that keeps percolating to the top of headlines and podcasts that I'm in plugged into, and that is the energy consumption needs of AI data centers. So for my portion of the “Oh, By The Way” segment, I wanted to share some interesting tidbits that I came across as part of those efforts. So first off, if you look at the current power grid in the United States, it generates today about 1200 gigawatts of capacity. And if you've been plugged into the headlines, you would have noticed that OpenAI, with their Stargate project, has announced its plan to build a chip network that would consume about 250GW. So you do the math there, that's anywhere from 20 to 25% of all of the energy that is currently produced in the US. That's a big number, and that's putting strain on the grid as it is, as there are data centers already in existence, of course, in the US and more are under construction and planned. But of course, where the demand is rising and supply can't keep pace, electricity prices naturally are going to increase. And I think that that may be coming to a head politically now, as consumers in certain markets that have data centers in their backyard are seeing, in some areas, dramatically higher energy prices, really, during a time when the country is already grappling with an affordability crisis. And that word affordability, I think, is something that we're going to be hearing a lot more about between now and the midterms in the US. Recognizing just how power hungry these data centers are, OpenAI has actually asked the government, on a go forward basis, to commit to building 100GW of new capacity each and every year going forward. What does that number mean? To put that in context, that's the equivalent of the US government building, or I guess with private investors as well, building out 100 nuclear reactors every single year. I mean that clearly, based on the trajectory that we've seen demonstrated, is not going to be feasible with the current technology or the processes that are in place to build these things. If you look back through time over the last a number of decades in the US, a nuclear reactor has taken about ten years or more to build. And so, somewhat ironically then, what I think we might be in a position to see despite the current US administration's drill baby drill mentality, is a substantially broader build out potentially, of renewable energy infrastructure, things like solar power and wind. These are things that I think could considerably increase, particularly as the cost of these renewable sources have come down pretty substantially in the past number of years. And just to underline that point somewhat further, I found some data that shows China's really embraced these renewable sources. They are a leader in sort of energy production globally. They make up about half of all power generation. So half of what they currently produce in China is from renewable sources. They generate, the amount that they generate I should say, from renewable sources, is more than all of the energy that the US or Europe generates from all of their sources, renewable or not. And I think that we talk about the AI race between the US and China. That seems to be intensifying. Certainly the US seems to have the upper hand in terms of the sort of technology and the quality, I should say, of the large language models in terms of training AI. But China increasingly seems to have this edge in terms of energy output and the cost and efficiency of the energy that goes into the AI. So we will see how that develops from here. But I'll leave it there, a little longer than normal, David. But hopefully some interesting tidbits. I'll turn it over to you for what you've got.

David Onyett-Jeffries

[00.24.31]

I'm also going to echo you and keep with the AI theme, and I'll emphasize that these demands on the energy grid, they're not going anywhere. This is more of a secular theme that is going to continue. But one of the sort of fascinating things when discussing markets as it pertains to AI is there's this huge emphasis and concern about the narrowness and the highly concentrated performance of the AI trade. It's the mag seven vs. everybody else, those mega cap tech-adjacent companies. And there's this argument that the markets are becoming sort of detached from economic reality, but I don't think that's

necessarily the case. A great example is that if you're looking at the number of data centers which are integral in sort of the development of large language models and data processing and everything that's associated with the AI world. If you look at the number that exists in the world, it's highly concentrated. So it makes sense that the market response would be very similar. So for example, data center map which is an industry body that keeps track of data centers, by their count, there are just over 11,000 data centers worldwide as of November, so I guess currently. But of those, more than roughly 40% are within the US, right? That's more than 4000 within the US. When you look versus anyone else like the next closest number in terms of data centers, within the borders is the UK with about 500. So there's eight times more data centers within the US than anywhere else in any individual country in the rest of the world. For comparison, China, despite this massive, electrical grid that has the capacity to support more of this, only by their count has 381, which is shockingly comparable to Canada at 294. But ultimately, it boils down to the fact that this is a massive gap. And given that the data is clearly the new hot commodity, to see this concentration in the marketplace and the funds flows going to the AI sectors in the US, it's consistent with what we're seeing of the economic reality. It's just like energy money going to where the oil actually happens to be.

John Pagliacci

[00.26.41]

Good stuff. Well, appreciate your time as always, David. Thank you. That's gonna take us to time for this episode. Great chatting with you. For everybody listening, thank you so much for tuning in. If you are enjoying the podcast, please consider following us on your podcast platform of choice to get all of our latest episodes. We'd also love to hear from you with regards to feedback or areas of discussion you'd like us to focus on in future episodes. You can email us at Insights@GuardianCapital.com to share any of your feedback or questions, and join David and I again next month for one more episode before the holiday break, as we talk about macro musings for December. Thanks again everybody. Take care.

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