Desautels Capital Management

Honours in Investment Management

Industry Overview

Economics Team

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Fixed Income Fund

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Wenhan Hu, Senior Analyst
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Collin Wang, Senior Analyst
Owen Anderson, Junior Analyst
Ben Doherty, Junior Analyst
Ryan Murray, Junior Analyst

September 28, 2022

DESAUTELS Capital Management
Gestion de capitaux

McGill

Executive Summary

Fixed Income Fund – Fall 2022 Strategies

Duration

- Aggressive rate hikes and a return of early-retirees will **soften** the **labour market**
- Rate hikes and **housing unaffordability** will balance the housing market and stall housing price increases
- The Fed will be **unable to engineer a soft landing** due to a combination of policy ineffectiveness and lag
- The Fed likely to overshoot before turning dovish once a recession is triggered; terminal rates to be lower than market expectations → **Long duration**

Currency

- **Overweight USD**
  - Fed to be more hawkish than the BoC in the short-term (1) as the Fed ramps up QT and (2) given Canadian households' high indebtedness calling the BoC to be more cautious moving forward
  - Fiscal policy as a counterpoint to USD. Risk mitigation
  - CAD as a commodity currency not benefiting from spike in oil prices

Credit Rating

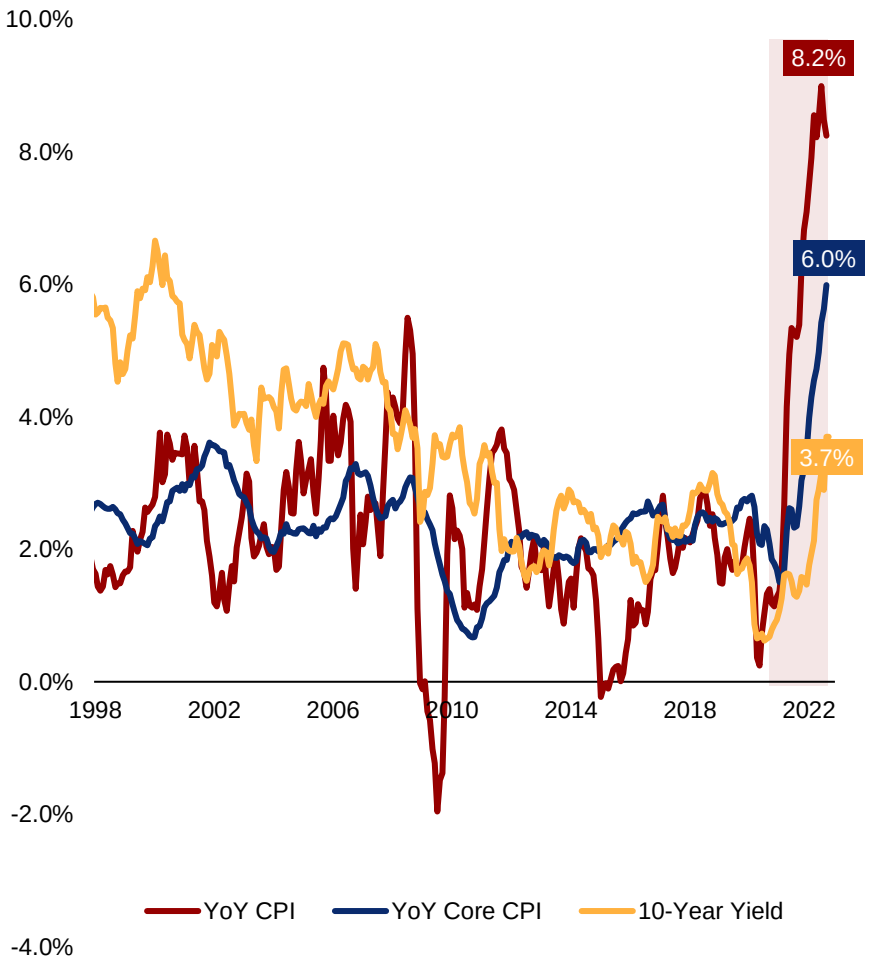
- Very few inefficiencies in the IG space
- We forecast a ~2.8% default rate in the HY segment by June 2023, slightly below market consensus
- **HY is relatively attractive** since 1) recession follows a period of de-levering, 2) no short-term maturity wall

Sector Fundamentals

- Overview of credit fundamentals across sectors
- Select sector analyses from a fixed income investing point of view

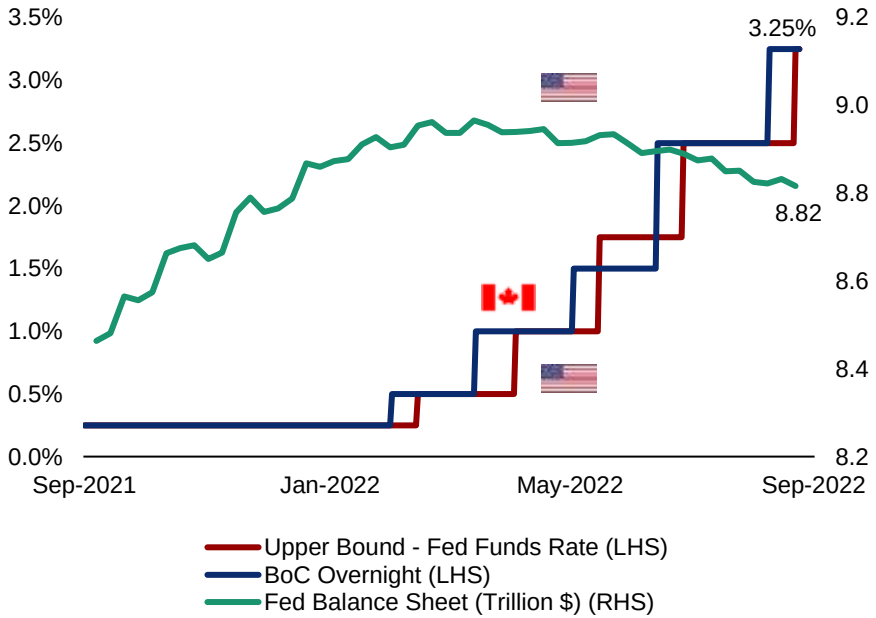
What's Up with the World?

Fiscal stimulus shoots inflation to 40-year high



> *U.S. central bank is **not afraid to keep rates where they are, or go higher**, for as long as it takes to **rein in inflation**.*
>
> *- JPow @ Sept. FOMC*

Central banks react through aggressive rate hikes and QT



Rising interest rates mechanically lower bond prices

Source: Bloomberg, FRED

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Rates

SECTION I

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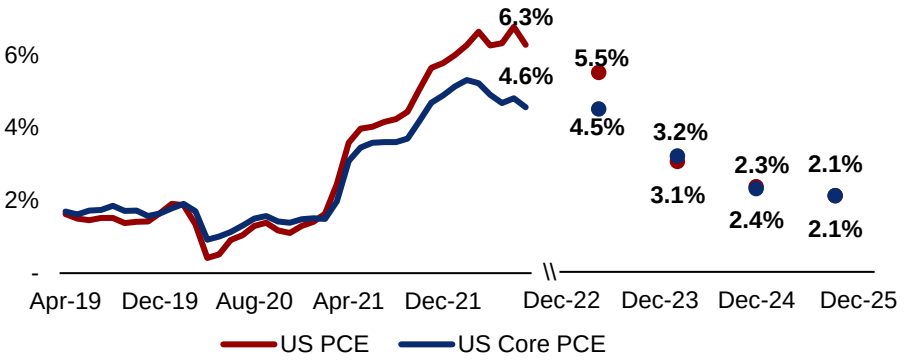
Market Views on Inflation

Inflation expected to show increasingly visible sign of a peak and a move lower

PCE expected to peak this year, then moderating down to ~2%



3 factors driving inflation

1. **Resource Utilization Gap**
   (e.g., output gap or unemployment gap)
2. **Lagged Inflation**
3. **Inflation Expectations**

The arguments for both sides of the inflation debate

Cooler Inflation

Expect inflation to surprise on the downside

- **Closing supply-demand gap:** Core goods inflation (22% of CPI) to tamper as supply chains normalize and businesses' capacity utilization rate continue increasing
- **Cooling housing market:** Housing prices (33% of CPI) expected to fall as demand wanes and inventory rebounds
- **Declining short-term expectations:** Short-term inflation expectations have and might continue to move down with gasoline prices

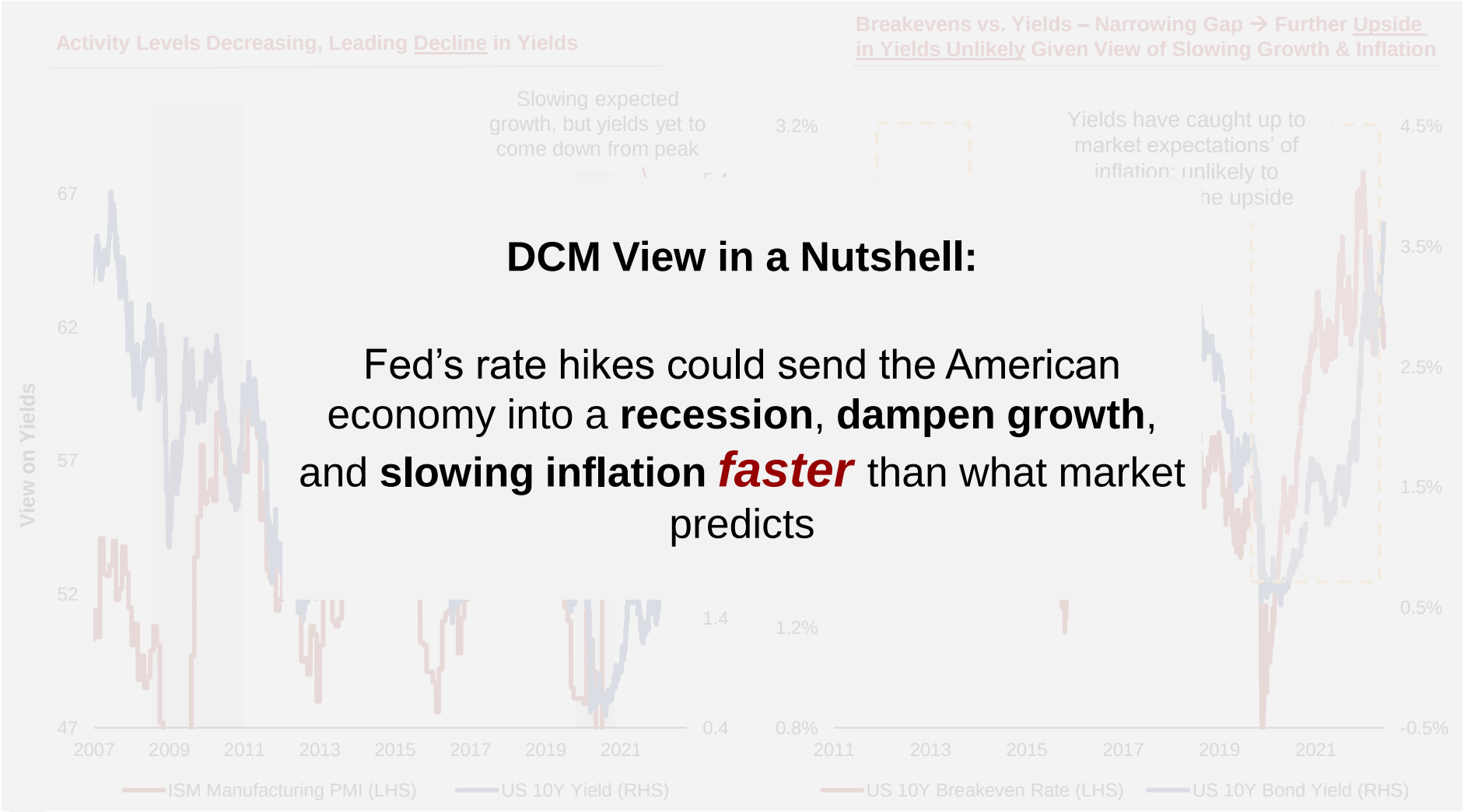
Hotter Inflation

Expect inflation to surprise on the upside

- **Unemployment gap:** Labour markets are still tight in the US, with high level of job openings (+1.8% from Jun. to Jul.) and low unemployment rate (+0.2% from Jul. to Aug)
- **High demand for services:** Rising demand for services and the lagged response of prices to wages may exacerbate inflationary pressures
- **Unanchored inflation expectations:** Higher dispersion in longer-run inflation could threaten price stability

Resource: Federal Reserve Bank of Cleveland, Dallas, and St-Louis

Markets vs. DCM



DCM View in a Nutshell:

Fed's rate hikes could send the American economy into a **recession**, **dampen growth**, and **slowing inflation *faster*** than what market predicts

The Fed likely to overshoot before turning dovish; terminal rates to be lower than market expectations → justifying long duration

Inflation Outlook & Currencies Allocation Roadmap

Is inflation expected to run hotter or cooler? How will it impact interest rates?

Inflation Outlook

- Labour Market
- Housing Markets
- Central Bank's Approach

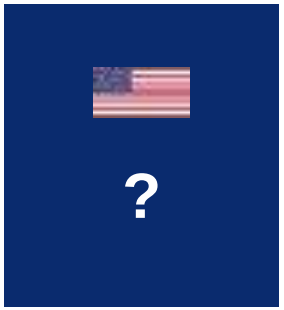
US vs. CA: which currency is more attractive?

Currency Allocation vs

- Growth
  - GDP, consumer growth
  - Labour market
  - Fiscal policy
- Inflation, monetary policy
- Risk (flight to safety)
- Commodities outlook

DCM View:

- Inflation is transitory
- Fed will become dovish
- Rates will surprise on the lower side



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Labour Market Analysis

SECTION I.I

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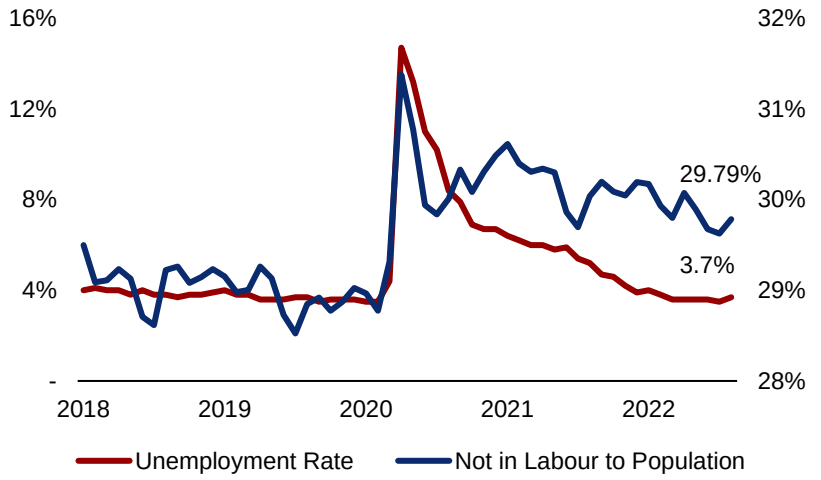
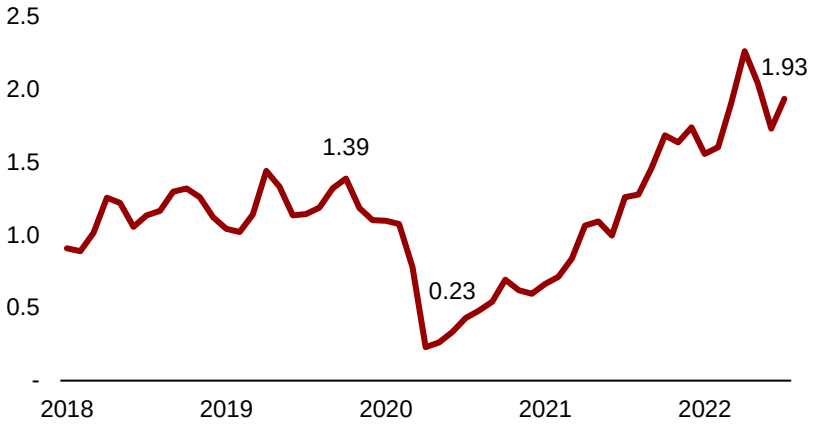
Labour Market Overview

Large surge in retirements and people leaving labour force have lead to tight labour markets

% Population Not In Labour Force vs. Unemployment Rate



Job Openings to Unemployed Population



Snapshot of the US Labour Market: Pre- and Post-Pandemic

	Unemployment Rate	Vacancies to Unemployment	Total Job Openings	Not in Force (% of Pop.)
February 2020	3.5%	1.23x	7,006,000	95,393,000 (28.8%)
July 2022	3.5%	1.98x	11,239,000	98,690,000 (29.6%)

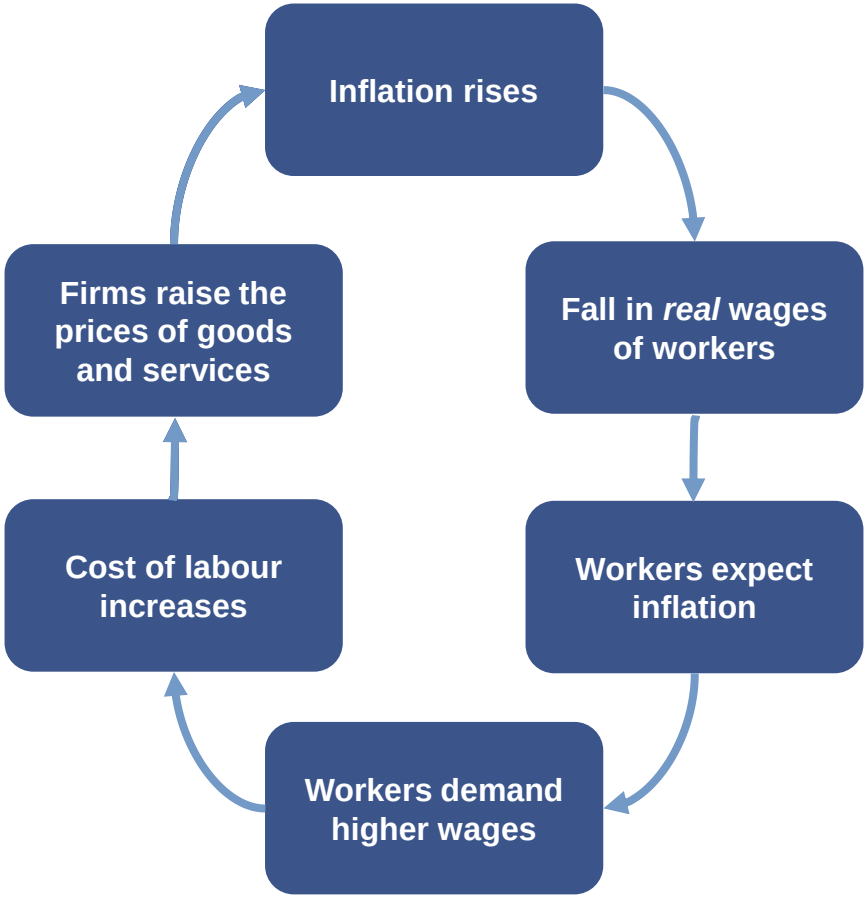
US Labour Market is Missing Over 3 Million Workers Compared to Pre-Pandemic Levels

Source: Pew Research Center, St Louis FED

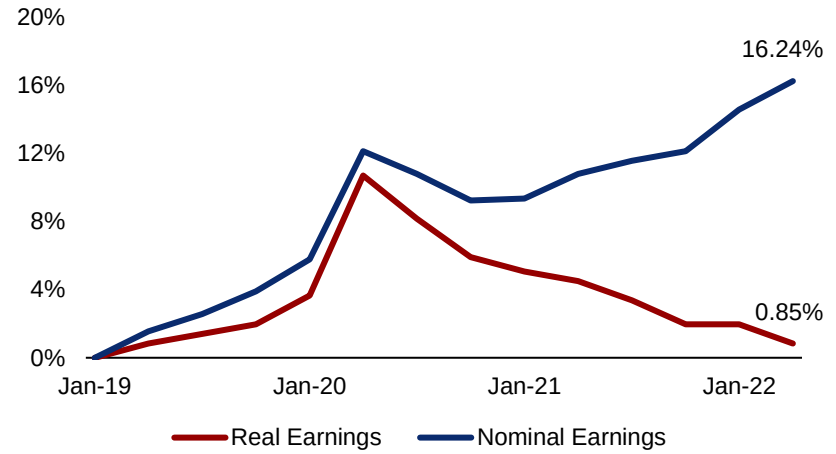
Labour Market Overview

Why do we care? Wage-price spiral

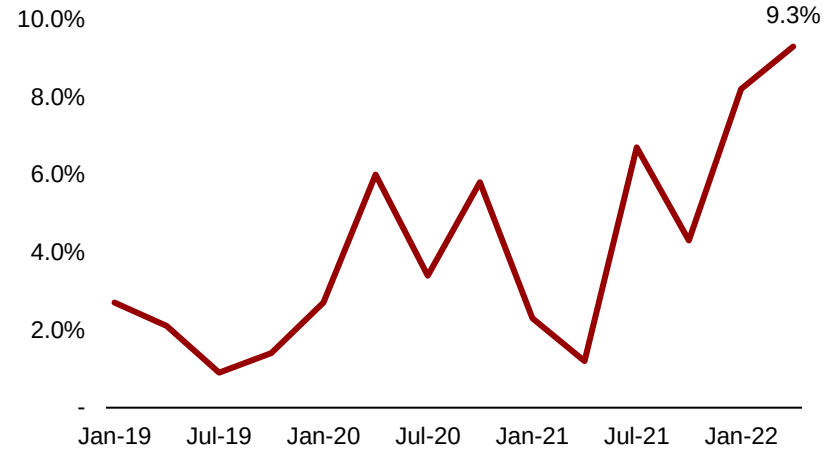
Wage-Price Spiral



% Change in Real & Nominal Weekly Earnings Since 2019



Unit Labor Costs % Change From Previous Quarter



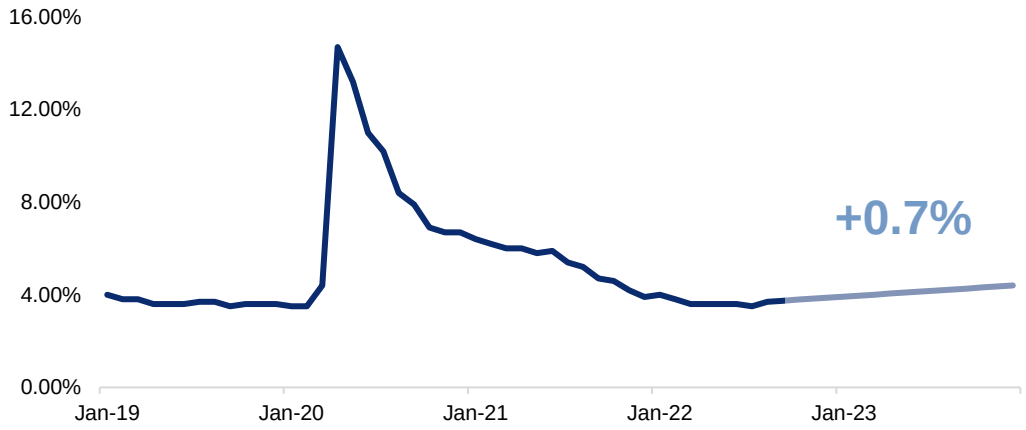
Wage-Price Spiral Has Been Going Strong, Increasing Nominal Wages and Labour Costs

Source: FED St Louis

Labour Market Projections

Labour force will return at a faster-than-normal rate, with unemployment rising as well

US Unemployment Rate Projection



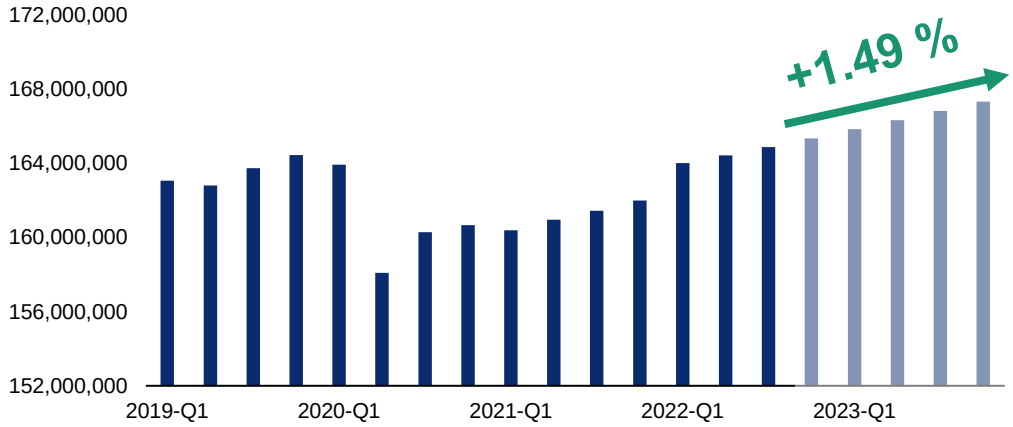
+0.7% unemployment

1.2 million people

"There will very likely be some softening of labor market conditions… We will keep at it until we are confident the job is done."

- Jerome Powell

US Labour Force Projection



+1.49% labour force

4.3 million people

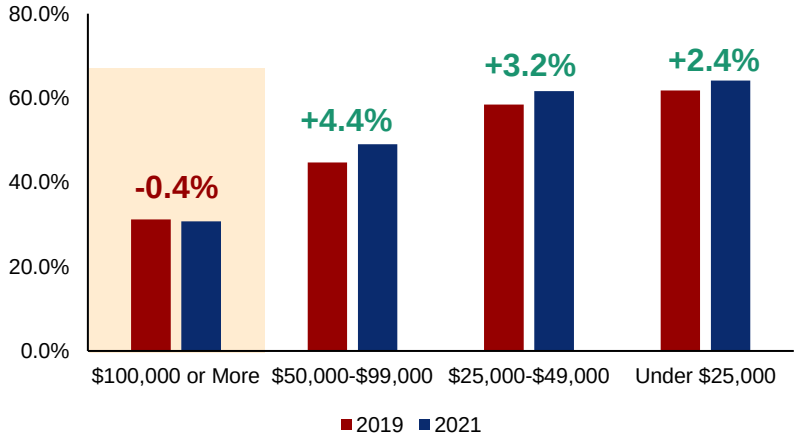
The Labour Market is Projected to Soften by Year-End 2023

Source: CBS News, FED St Louis, OECD

Labour Markets Overview

Return of Young Adults and Retirees Will Increase Work Force and Loosen Labour Markets

Share of Retirees by Family Income Bracket



Labour Participation: Young vs Older Adults

Labour Markets: Less Tight Than You Think

High earners were less likely to lose their jobs and more likely to have paid leave and the ability to WFH

Inflation and rising costs has already begun bringing retirees back into the labour force

People aged **25-54** were more likely to have been fired/quit, but **participation has largely returned to normal**

Participation among **individuals over 55 years** has remained **steady** at the lower levels seen during the Covid-19 recession

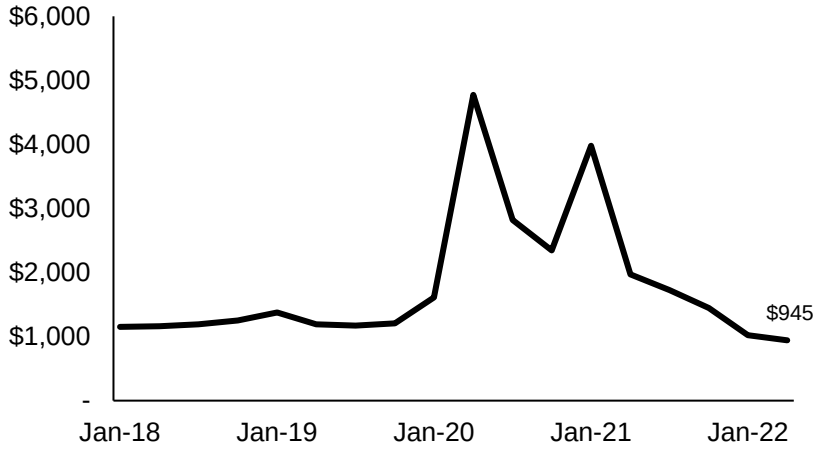
Current Economic Conditions Will Likely Bring Many Retirees Back to the Labour Force

Source: Minneapolis FED, St Louis FED

Labour Markets Overview

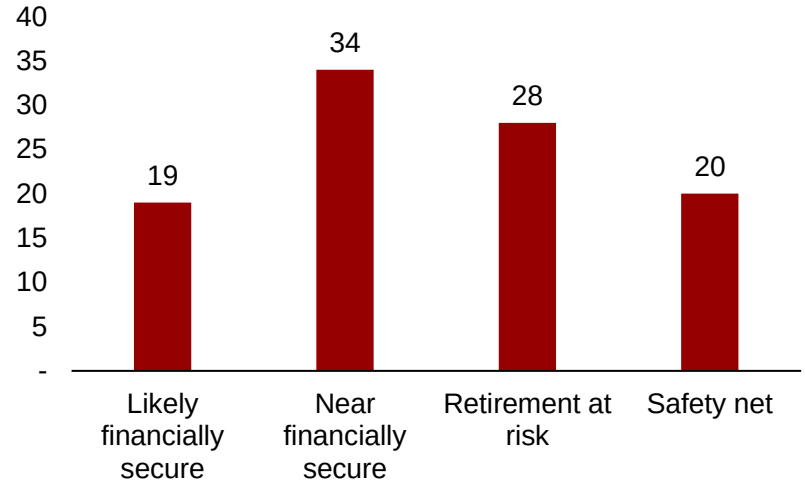
Stagnating Real Wages and Significant Consumer Spending

Total US Personal Savings (billions of U$)



> Many pre-retirees **are running out of time to accumulate sufficient retirement assets**. Just over 80 percent of baby boomers may be unprepared for retirement, according to our surveys in 2021 and 2022.
>
> *McKinsey's Global Banking Practice*

Near-Retirees Breakdown by "Readiness"



> Exacerbating the [retirement] challenge are several macro factors, among them **rising inflation, market volatility, uncertainty about the costs of healthcare** and assisted living in retirement, and a meaningful wave of early baby boomer retirement.
>
> *McKinsey's Global Banking Practice*

Source: St Louis FED, McKinsey

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Housing Market Analysis

SECTION I.II

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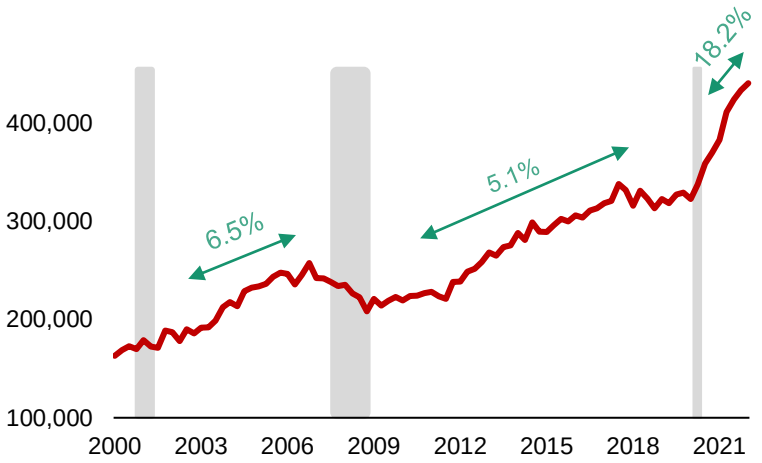
Housing Market Overview

Near future of the housing market is highly uncertain

Median Home Selling Price (2000 – 2022)



Unprecedented Times

Significant home price increases were largely driven by:

- Sub 3% mortgage rates
- Covid stimulus
- Already low levels of supply

The near future of the housing market is highly uncertain

- Wide range of analyst expectations
- US rate hikes affecting demand
- Rate hikes internationally are pulling down prices

Market Expectations

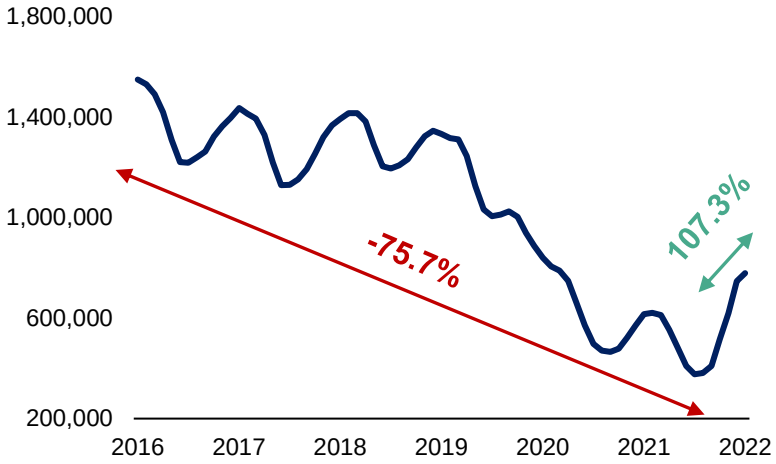
Goldman Sachs

"We expect home growth to stall completely, averaging 0% in 2023… While outright declines in national home prices are possible and appear quite likely for some regions, large declines seem unlikely"

\- Jan Hatzius

Goldman Sachs Chief Economist

Housing Inventory: Active Listings Count (2016 – 2022)



Rate Hikes Internationally are Affecting Housing Prices

BOC raised rates from **0.25%** to **3.25%** since March 2022 → Canadian Home Price Index has fallen **7.4%** since February 2022

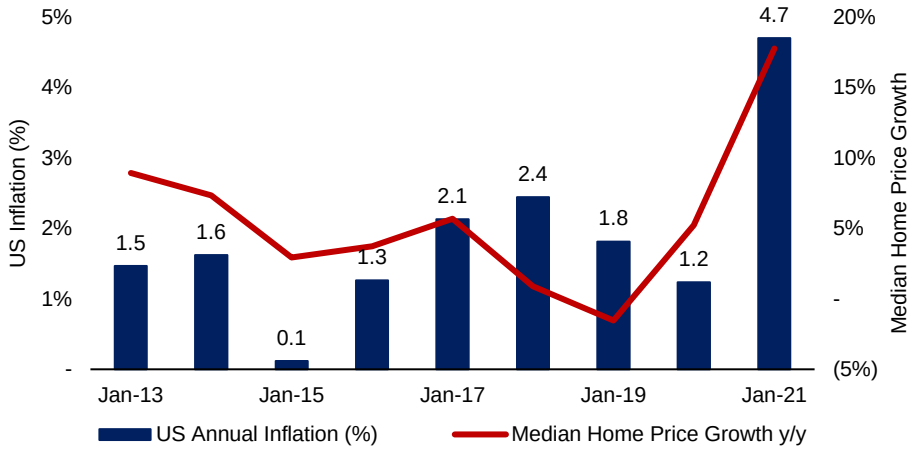
NZCB raised rates from **0.25%** to **3.00%** since October 2021 → New Zealand Home Price Index has fallen **8.4%** since January 2022

Source: Saint Louis Fed, QV, CREA, Goldman Sachs

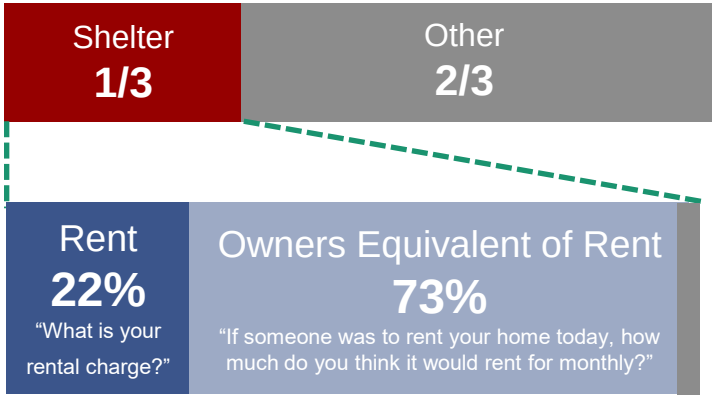
Housing Market Outlook

Home price growth will stall through 2023

Home Price Increases Drive Inflation



Shelter is Most Impactful Component of CPI Basket



US **demand for housing will wane** given **rising mortgage rates**, housing **unaffordability**, and **worsening consumer sentiment**

- Mortgage rate increases will have the largest impact on demand
- Housing is the least affordable it has ever been
- Consumer's outlook on buying and selling homes has worsened dramatically throughout 2022

Approaching a more **balanced** housing market

- Rising housing starts, high rental rate growth, high home sales volume, and low inventory all point towards a more balanced housing market

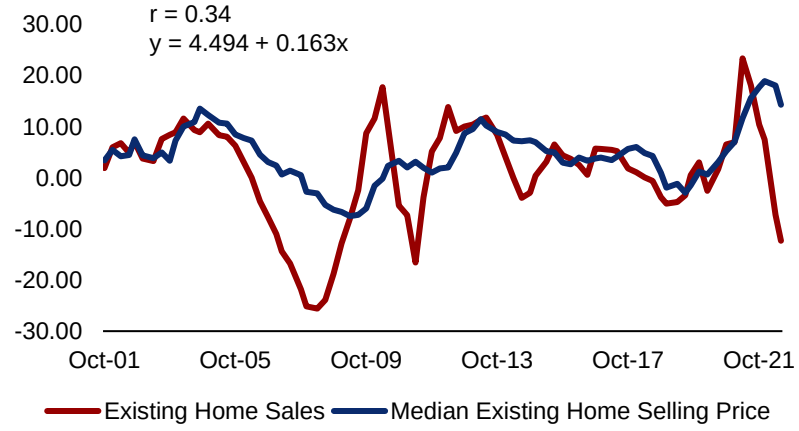
Source: Saint Louis Fed, USBLS

Demand For Housing

Mortgage rate increases will reign in price growth

Existing Home Sales Change and Mortgage Rate Change

Change in Home Sales Volume and Home Selling Price



Mortgage Rate Changes Effect on Prices

Objective: Develop an understanding of the impact that rising mortgage rates will have on changes in median home prices

Methodology: The model estimates the decrease in home sale volume using a projected 30-year mortgage rate schedule. From there, it estimates the change in median home prices using that change in sales volume.

Inputs: Projected 30-Year Fixed Mortgage Rate Schedule Through 2023
Outputs: Change in Median Home Prices y/y

Projected 30-Year Fixed Mortgage Rate Schedule

Q4 2022	Q1 2023	2Q 2023	Q3 2023
6.3%	**7%**	**7%**	**7%**

Moving Average

6.83% **+54.2% Growth y/y**

Projected Volume Change y/y

0.265 + (-0.260) x **(55.2%)** = **-13.8%**

Projected Median Home Price Change y/y

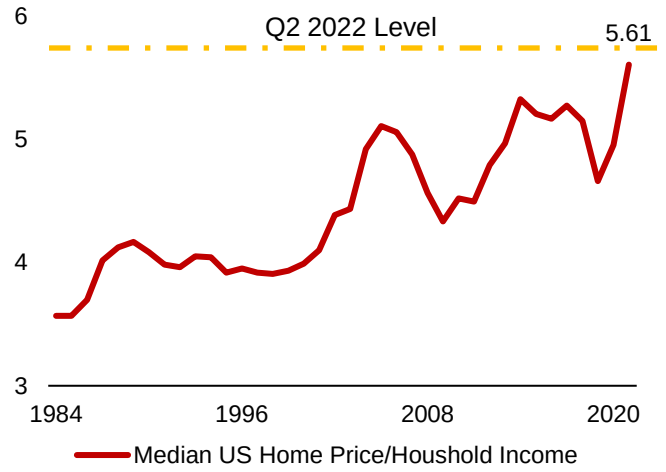
4.494 + 0.163 x **(-13.8%)** = **2.2%**

Source: Saint Louis Fed, Trading Economics

Housing Unaffordability & Rent Growth

Lowest historical housing affordability levels are impacting consumer sentiment

All-Time Worst Housing Affordability Levels



Continued Downward Pressure on Consumer Sentiment

Fannie Mae National Housing Survey, August 2022				
Buying Conditions	Good Time **22%**	Bad Time **73%**	Net Good Time to Buy **-51%**	Change y/y **-20**
Selling Conditions	Good Time **59%**	Bad Time **35%**	Net Good Time to Sell **24%**	Change y/y **-30**
Home Price Outlook	Go Up **33%**	Go Down **33%**	Net Go Up **0%**	Change y/y **-16**

Mortgage Payments % of Median Household Income

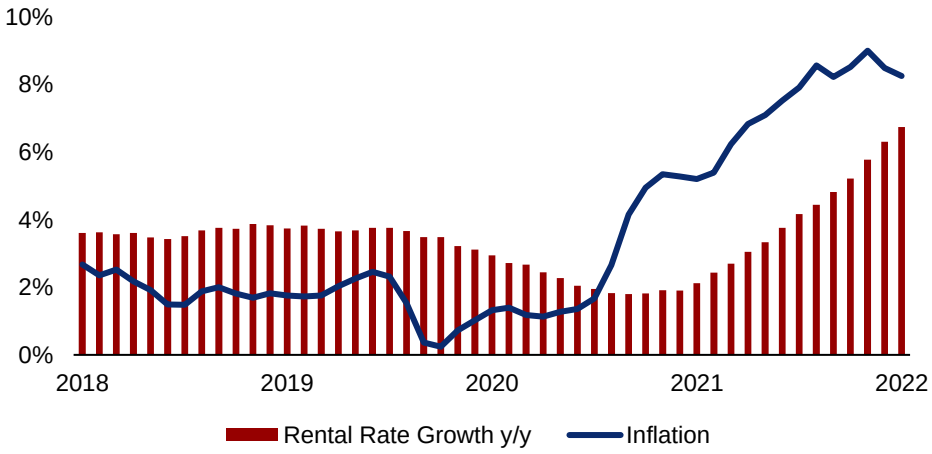
Jan 1st, 2000	Jan 1st, 2010	Jan 1st, 2020
33.5%	**27.2%**	**25.5%**

June 30th, 2022

39.8%

- 14.3% increase in proportion of income dedicated to mortgage payments since 2020
- National Association of Realtors defined mortgages as “affordable” if their mortgage payments do not exceed 25% of income

Rental Rate Growth No Longer Driving Inflation



Source: Saint Louis Fed, Fannie Mae

Economic Real Estate Cycle

Approaching Balance

Sept 2022

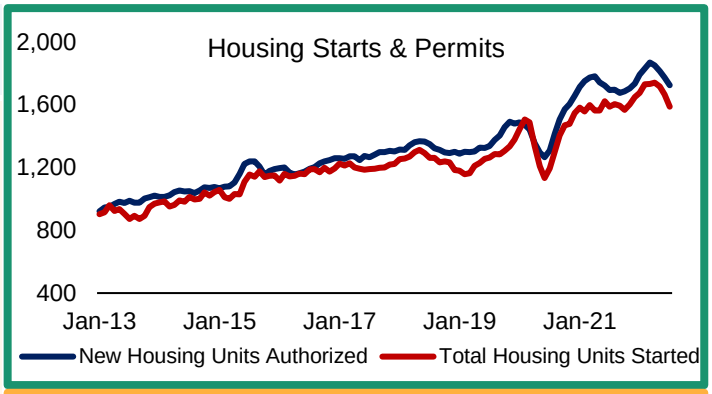
1. Recovery	2. Expansion	3. Recession	4. Excess Supply
Balanced Market	**Seller's Market**	**Balanced Market**	**Buyer's Market**
Low Housing Starts	High Housing Starts	High Housing Starts	Low Housing Starts
Low Homes Under Construction	Rising Homes Under Construction	High Homes Under Construction	Falling Homes Under Construction
Low Rental Rate Growth	Mod/High Rental Rate Growth	Mod/Low Rental Rate Growth	Low/Negative Rental Rate Growth
Mod Home Sales Volume/ Falling Inventory	High Home Sales Volume/ Low Inventory	Lower Home Sales Volume/ Rising Inventory	Low Home Sales Volume/ High Inventory

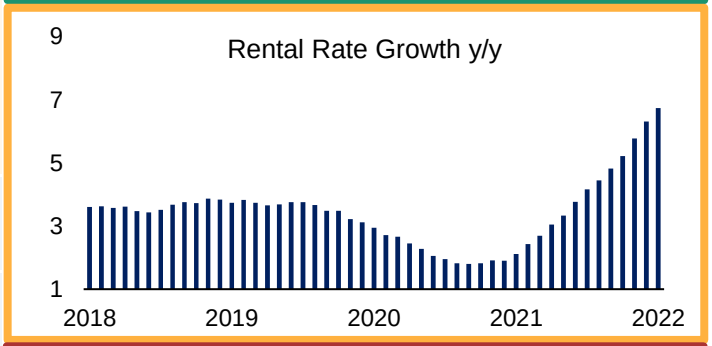
Source: Saint Louis Fed

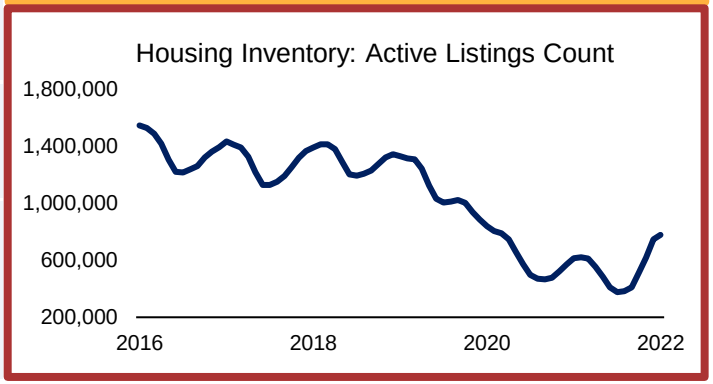
Economic Real Estate Cycle

Sept 2022

1. Recovery	2. Expansion	3. Recession	4. Excess Supply
Balanced Market	Seller's Market	Balanced Market	Buyer's Market
Low Housing Starts	High Housing Starts	High Housing Starts	Low Housing Starts
Low Homes Under Construction	Rising Homes Under Construction	High Homes Under Construction	Falling Homes Under Construction
Low Rental Rate Growth	Mod/High Rental Rate Growth	Mod/Low Rental Rate Growth	Low/Negative Rental Rate Growth
Mod Home Sales Volume/ Falling Inventory	High Home Sales Volume/ Low Inventory	Lower Home Sales Volume/ Rising Inventory	Low Home Sales Volume/ High Inventory







Source: Saint Louis Fed

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Rates Overview

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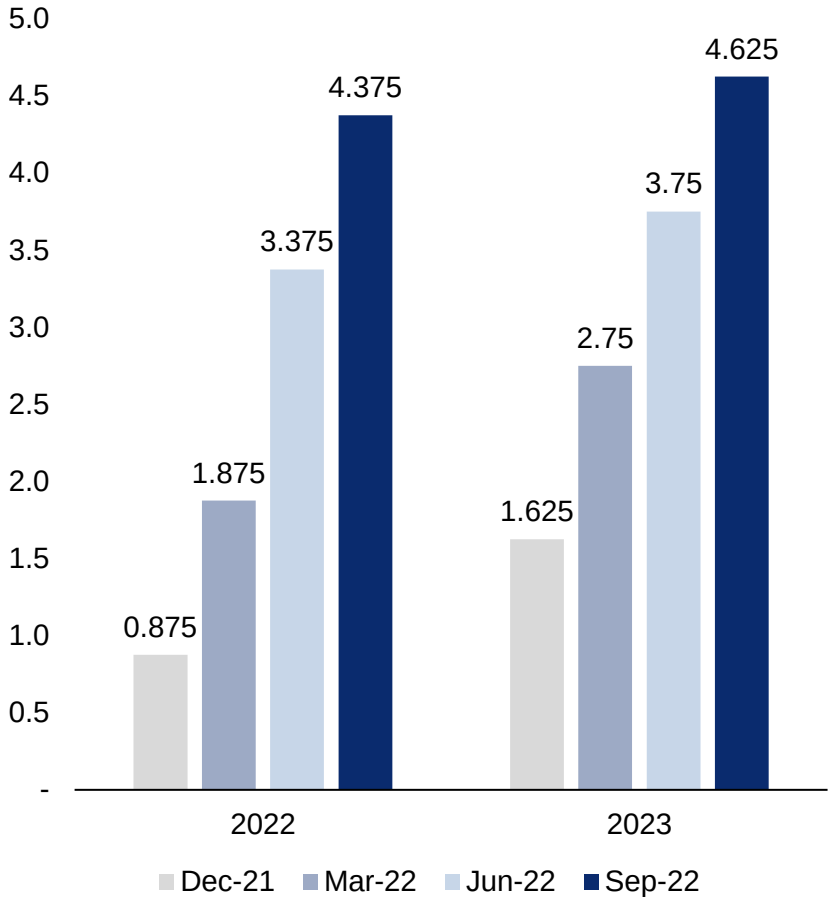
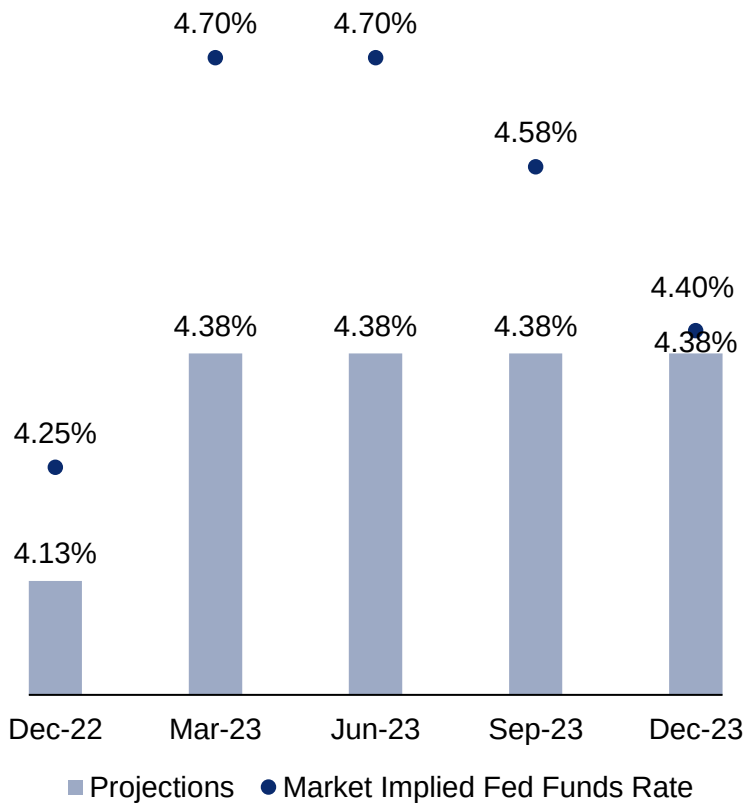
Views on Rates: Markets vs. DCM

Inflation Cooler-Than-Expected → Yields Surprising on the Downside → Long Duration

FOMC Dots Median – Pointing to Further Upmove in ST Rates



Markets Pricing in a Terminal Fed Rate at 4.7%
Our View: Unlikely to Reach this High

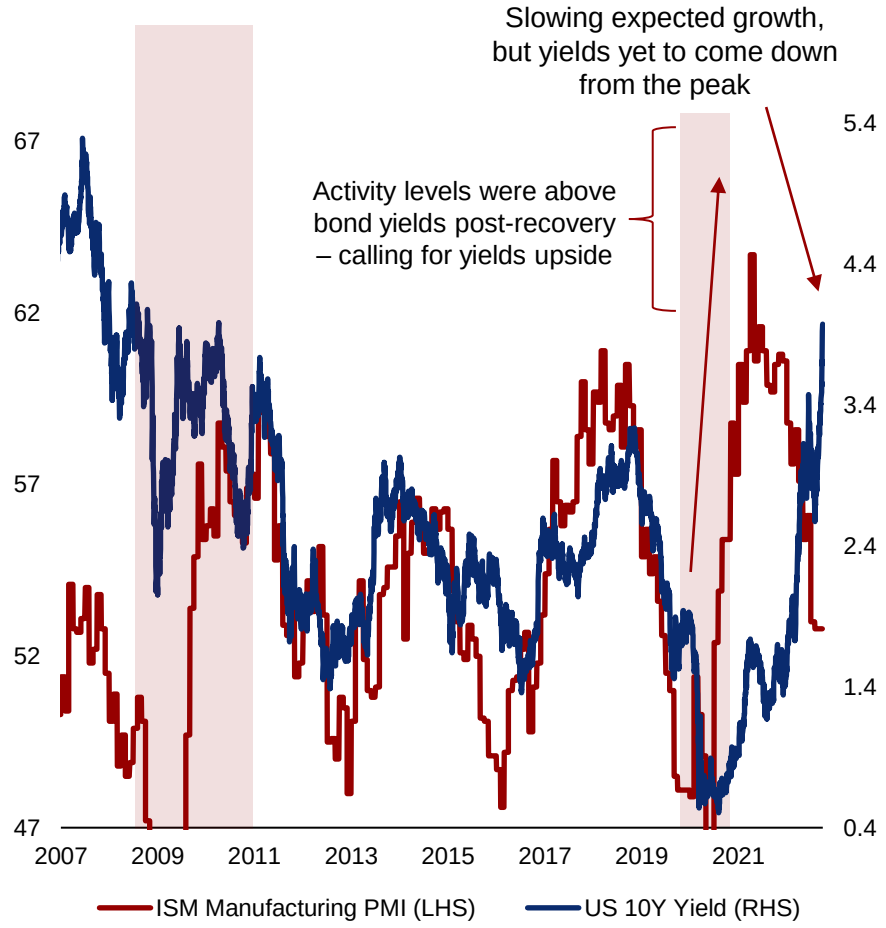


Source: Bloomberg, FRED, CNBC, Goldman Sachs, JPMorgan

Views on Yields: Markets vs. DCM

Inflation Cooler-Than-Expected → Yields Surprising on the Downside → Long Duration

Activity Levels Decreasing, Leading Decline in Yields



Breakevens vs. Yields – Narrowing Gap → Further Upside in Yields Unlikely Given View of Slowing Growth & Inflation

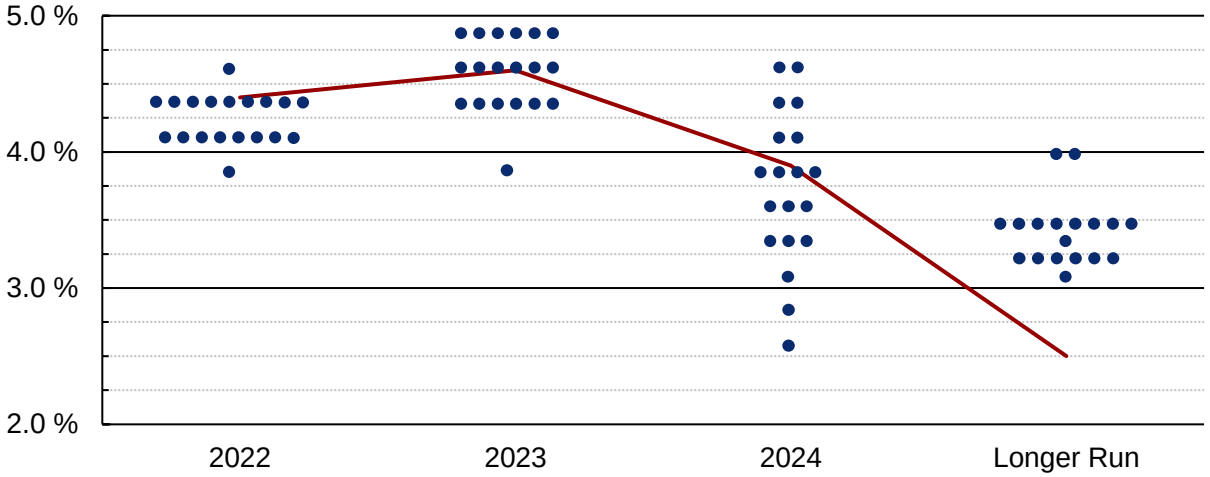
The Fed likely to overshoot before turning dovish; terminal rates to be lower than market expectations → justifying long duration

Source: Bloomberg, FRED, CNBC, JPMorgan

Rates Policy & Lag

Ill-timed policy in all likelihood

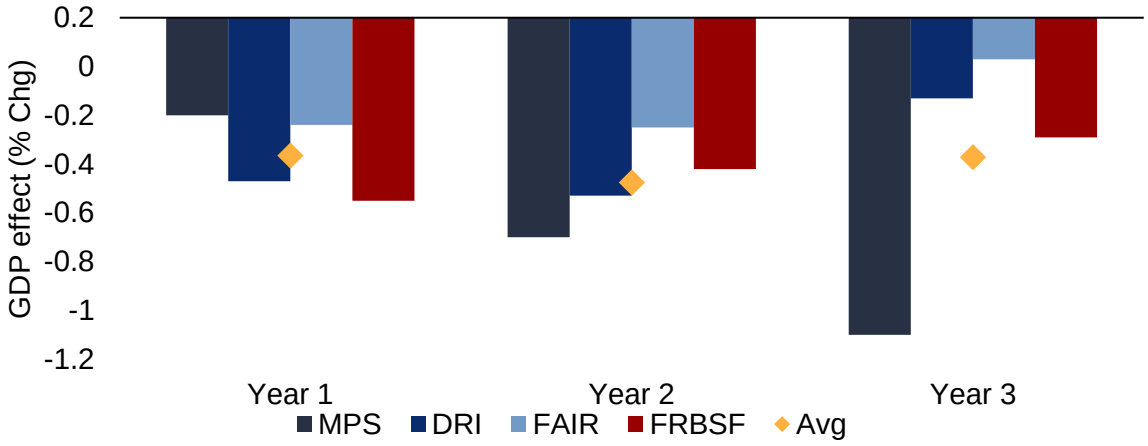
Projected Federal Fund Rates Dot Plot – September 2022



Recall: From June 2021

> *If a **central bank tightens policy in response to factors that turn out to be temporary**, the policy effects will likely arrive after the need has passed. The **ill-timed policy move unnecessarily slows hiring** and other economic activity, pushing inflation lower than desired*
>
> *- Jerome Powell @ Jackson Hole*

Lagged effect of Monetary Policy



Even if inflation were to collapse to 2% today, the Fed has likely already hiked us into a recession

Source(s): FOMC, FRED

Desautels Capital Management

Honours in Investment Management

Monetary Policy

SECTION II

DESAUTELS Capital Management Gestion de capitaux

McGill

Inflation By Component

This is your captain speaking—brace for a hard landing

> *What [the Fed] can control is **demand**, we **can't** really affect **supply** with our policies…so the question whether we can execute a soft landing or not, it may actually depend on **factors that we don't control***
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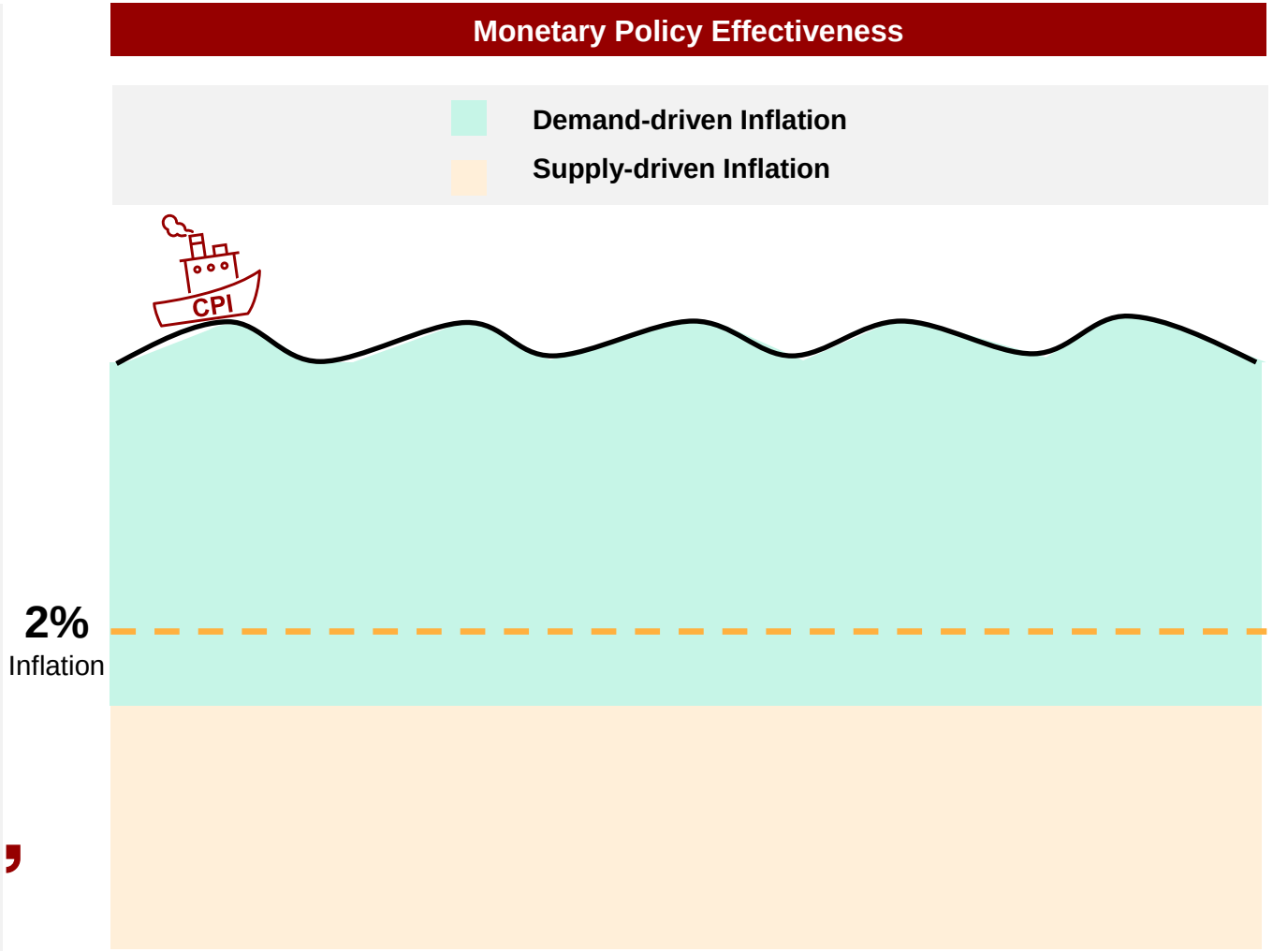

Policy tool effectiveness is highly dependent on the composition of inflation

Source: FRBSF

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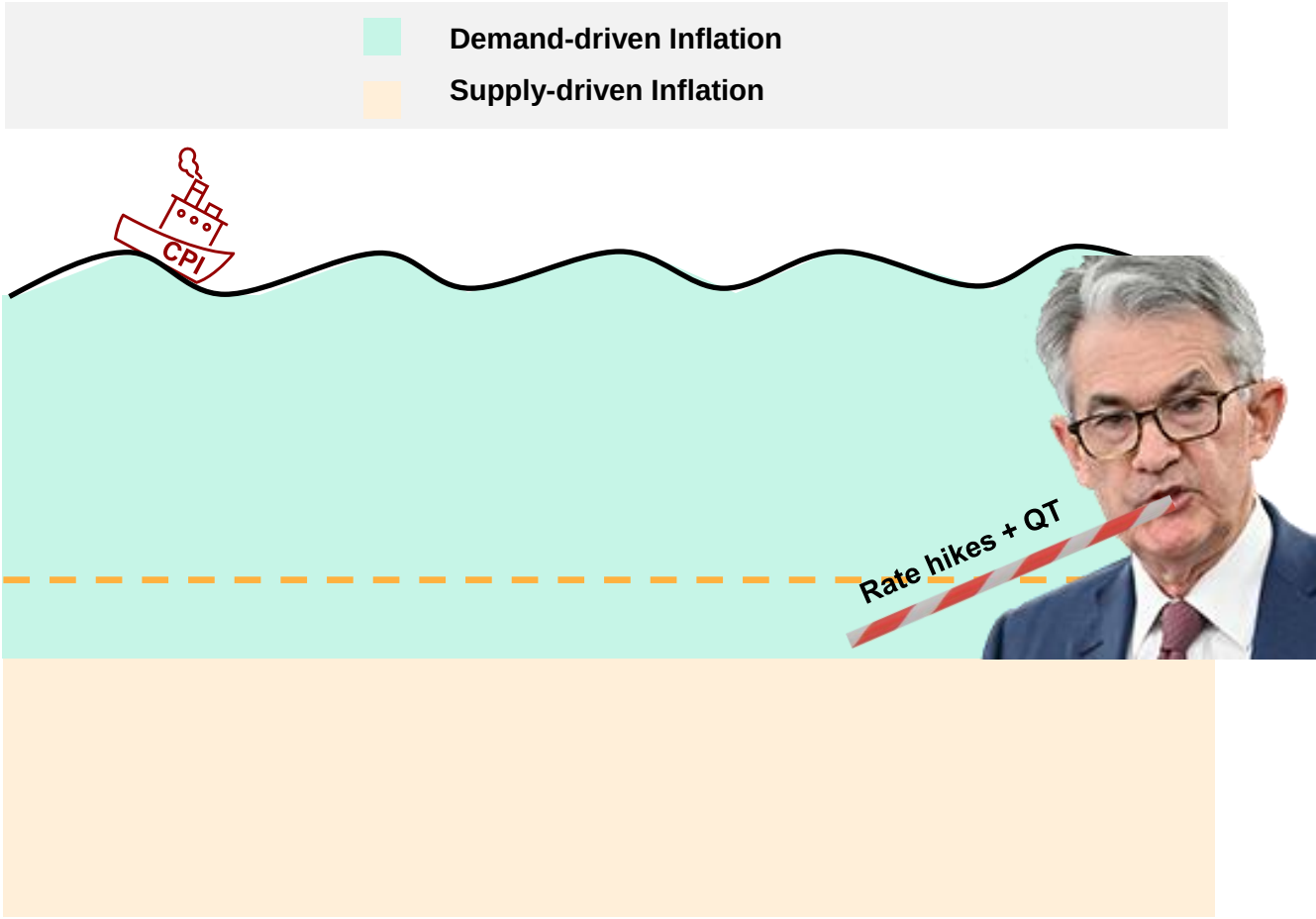
Monetary Policy Effectiveness



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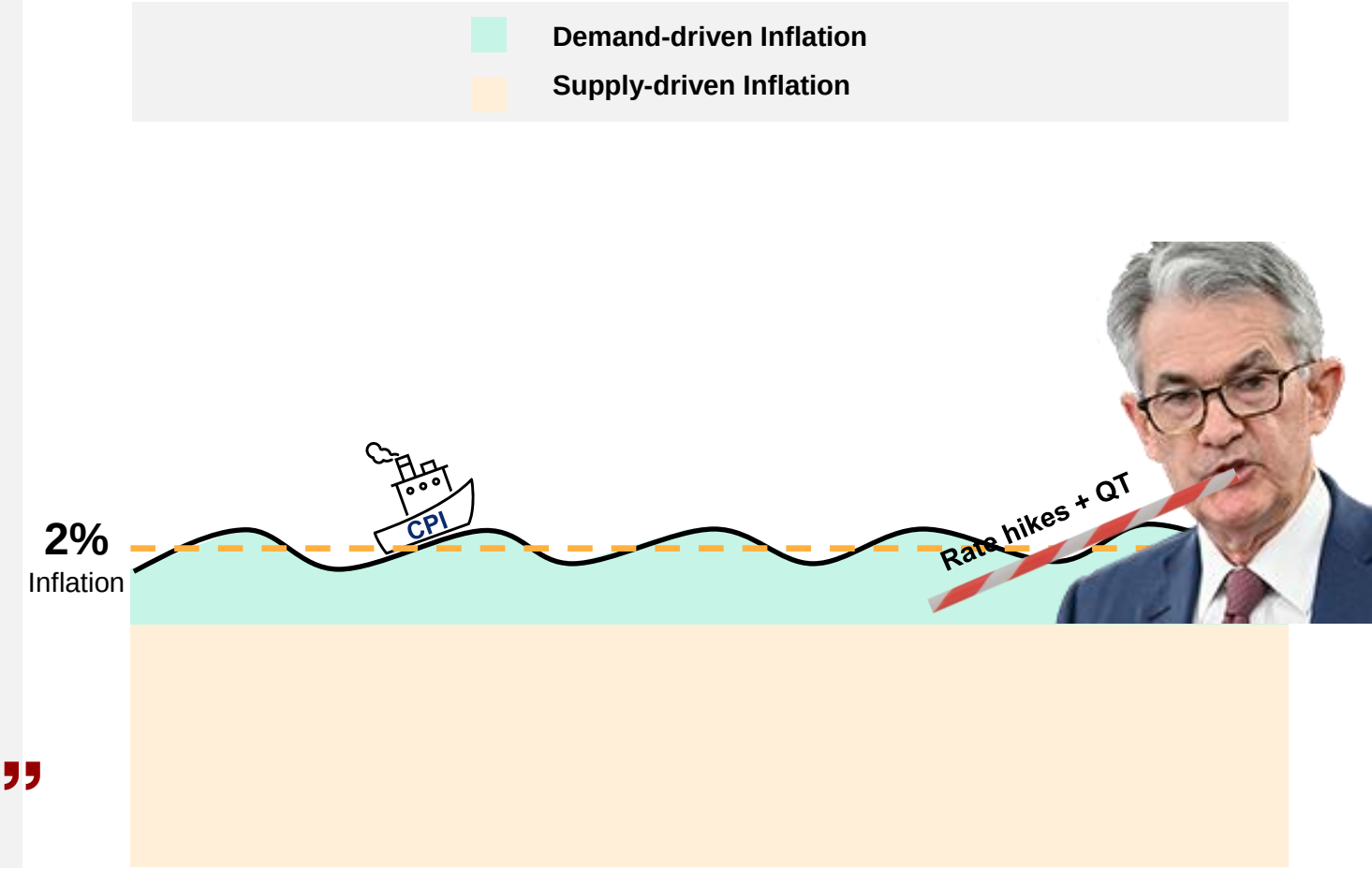

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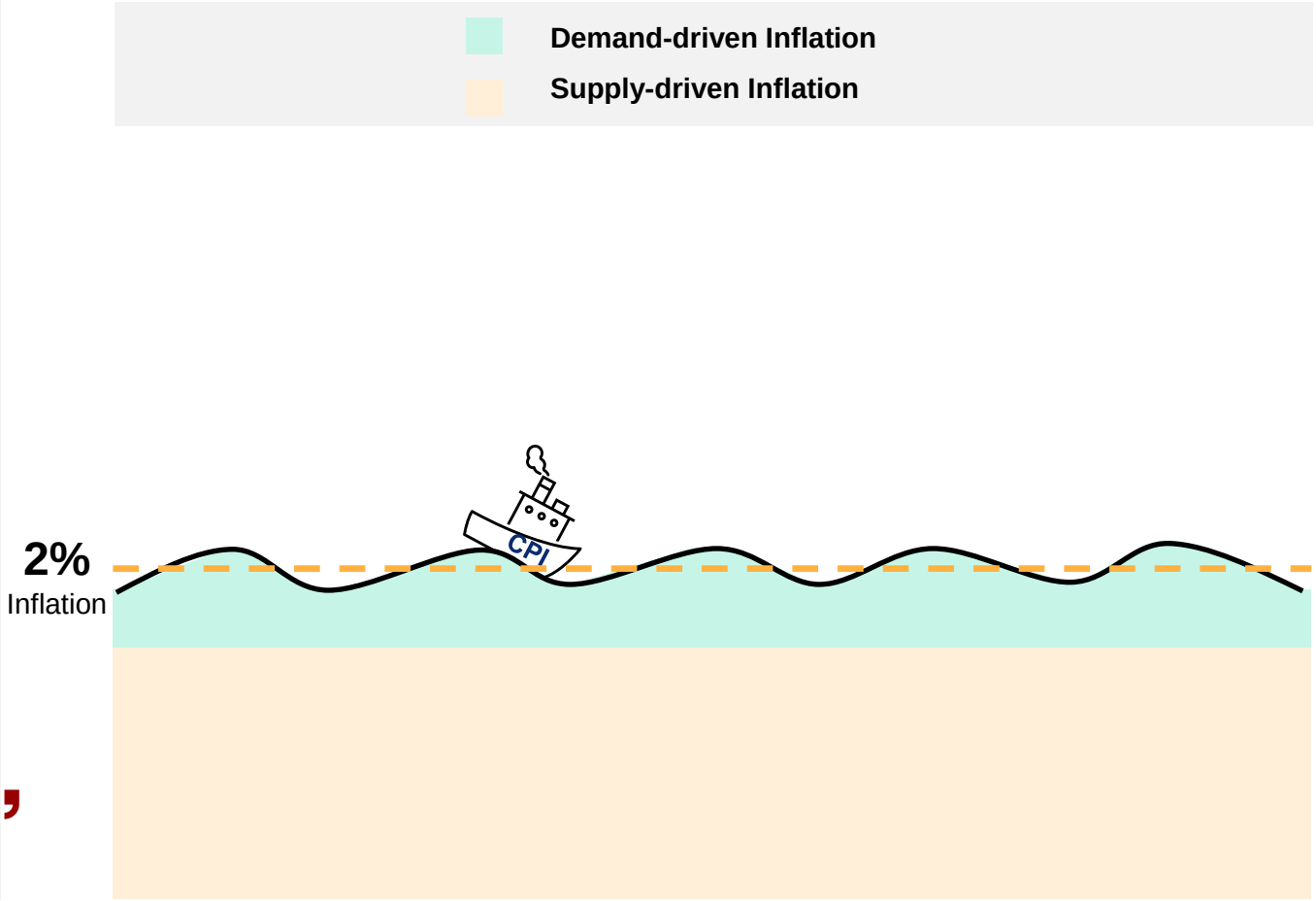

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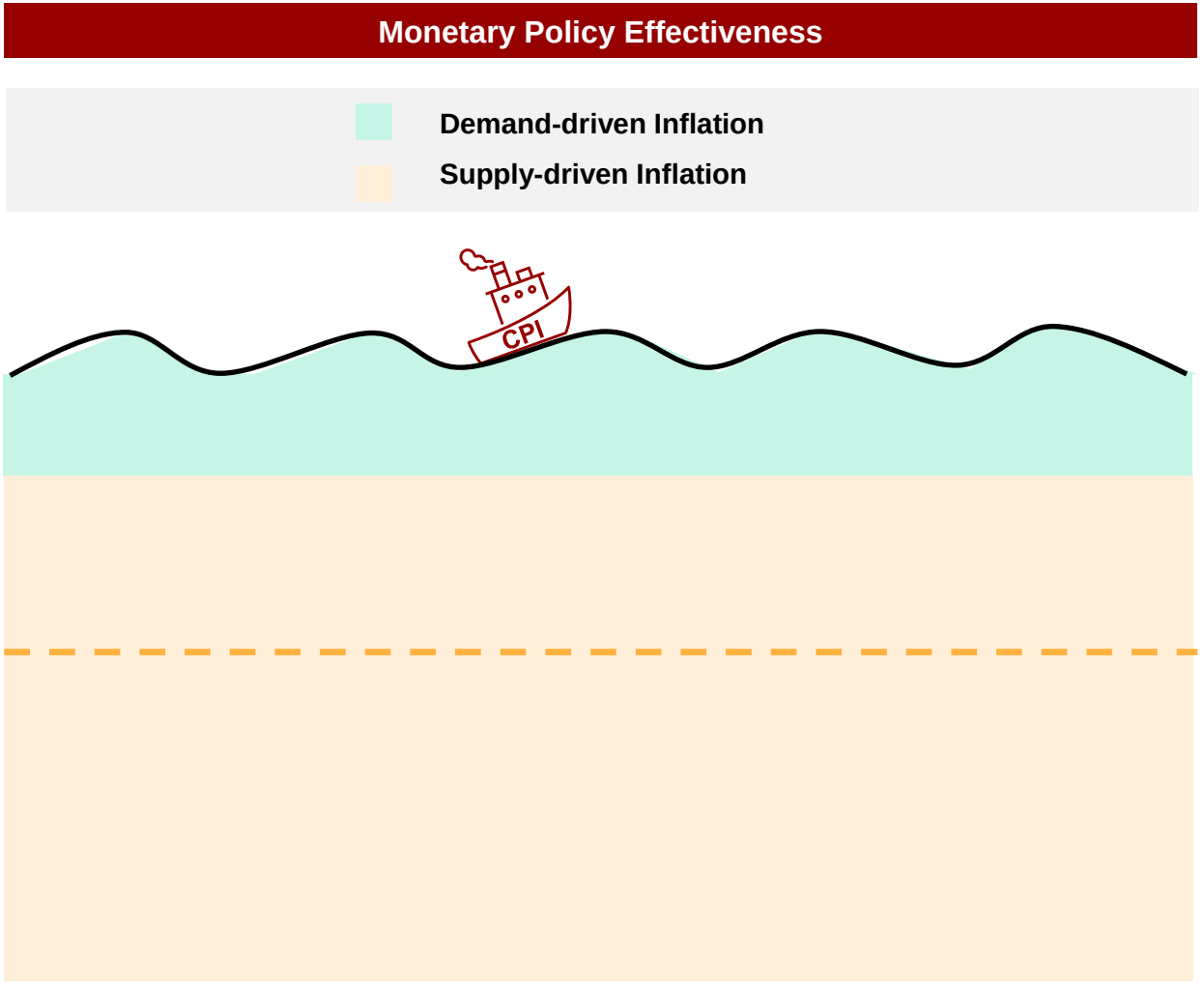

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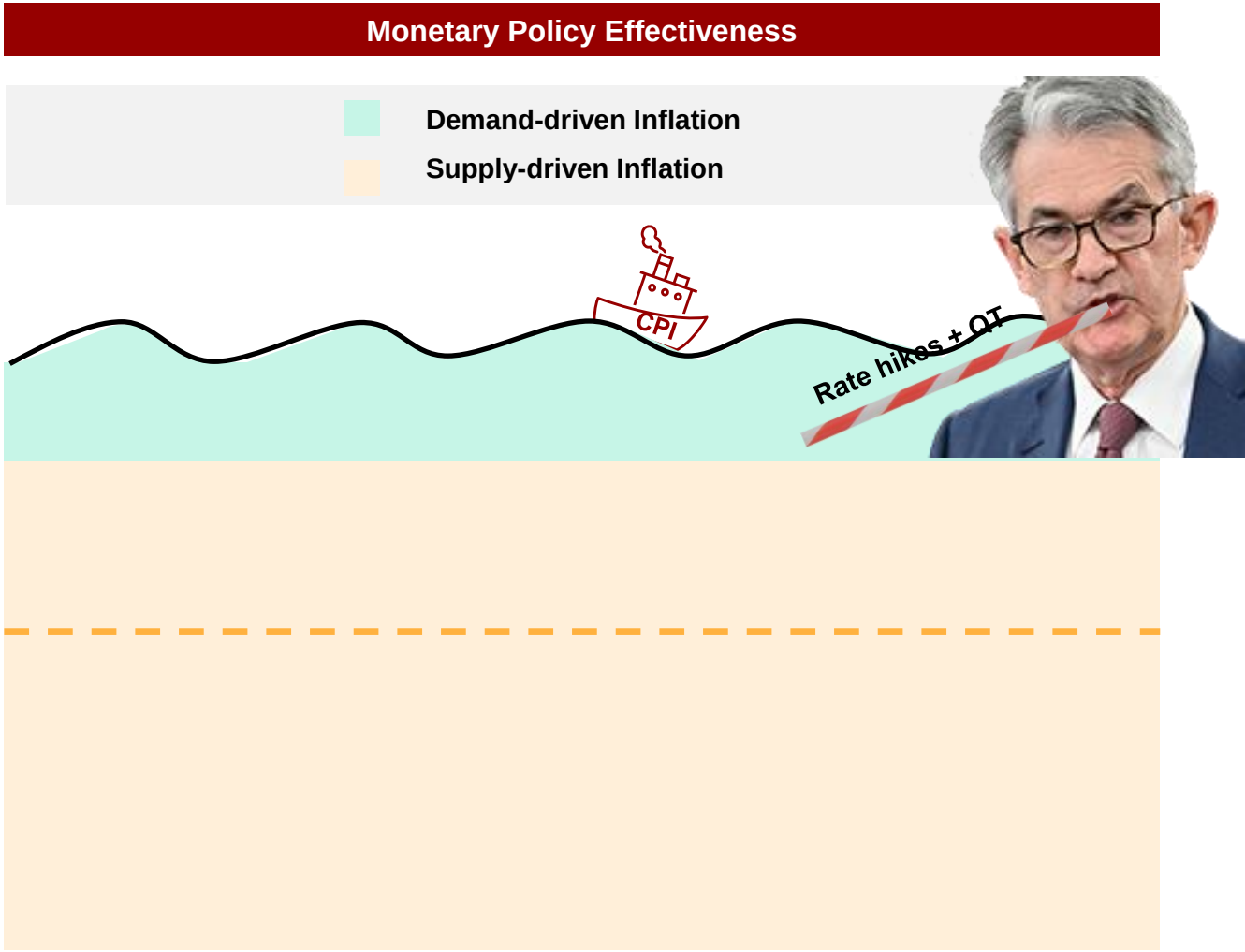

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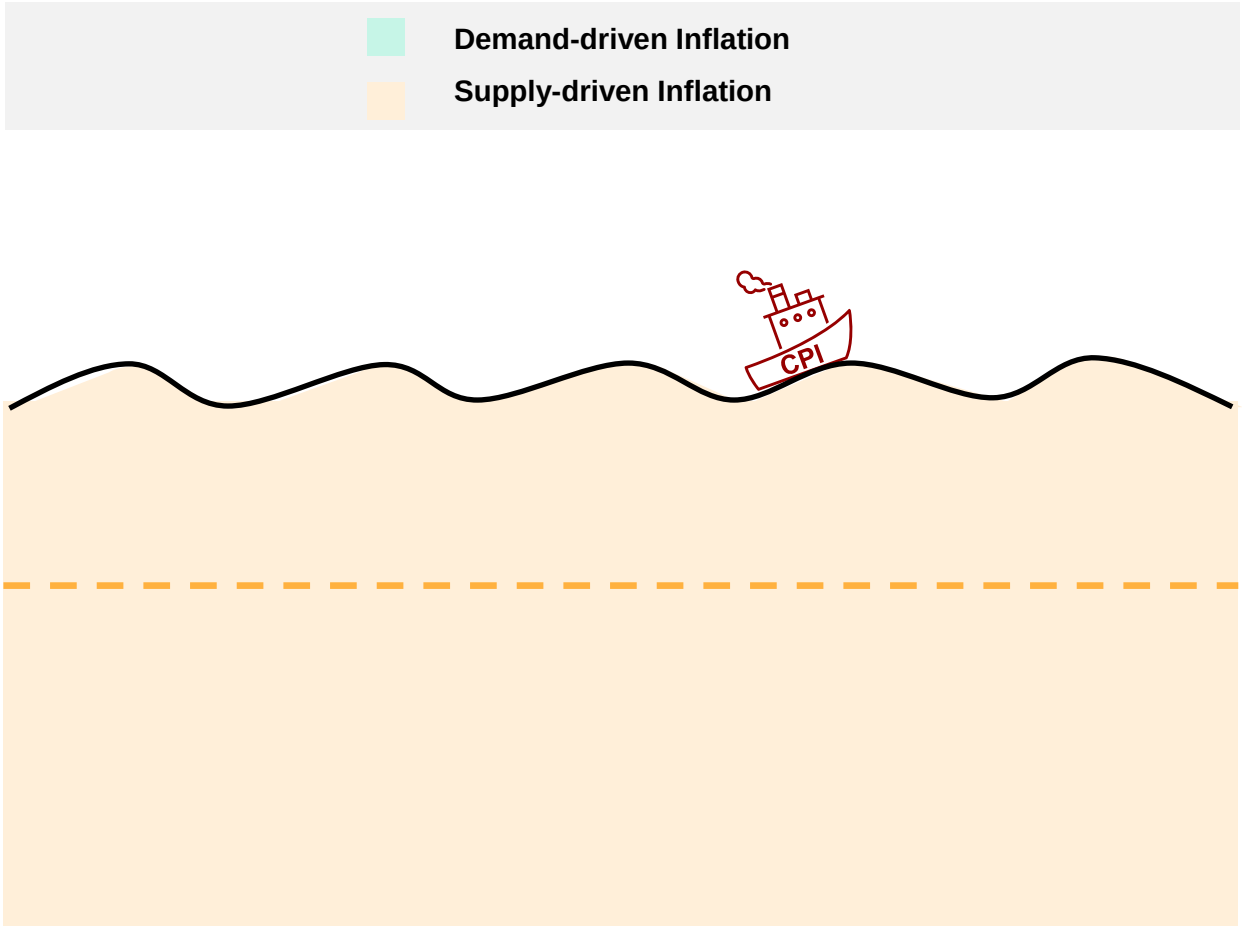

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Monetary Policy Effectiveness

Demand-driven Inflation

Supply-driven Inflation

When **supply-driven** inflation makes up a **high proportion** of total inflation the Fed's tools are less effective; this leads to an increased risk of **policy overreaction**

2%
Inflation

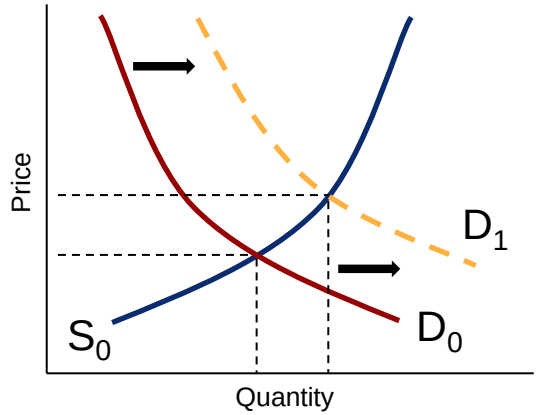
Source: FRBSF

Inflation By Component: Methodology

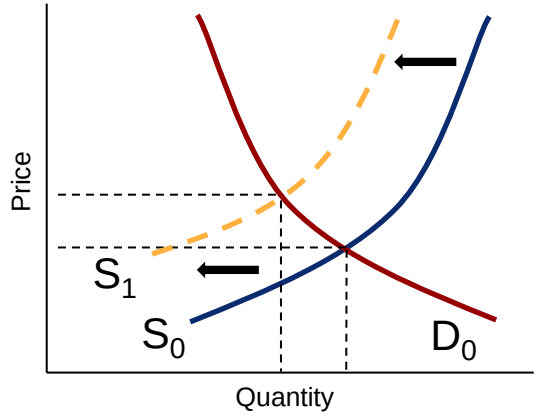
Model developed by Adam H. Shapiro of the FRBSF

Step I

Demand Shift



Supply Shift



Step II

Rolling Regression

Rolling Window: 10 Years

Sampling Frequency: **Monthly**

II Expected Price

II Expected Quantity

Actual — **Expected**

=

Unexpected Component

Typical Baskets

Demand	Supply
Automobiles	Electricity
Food	Common Household Goods

Post-COVID Baskets

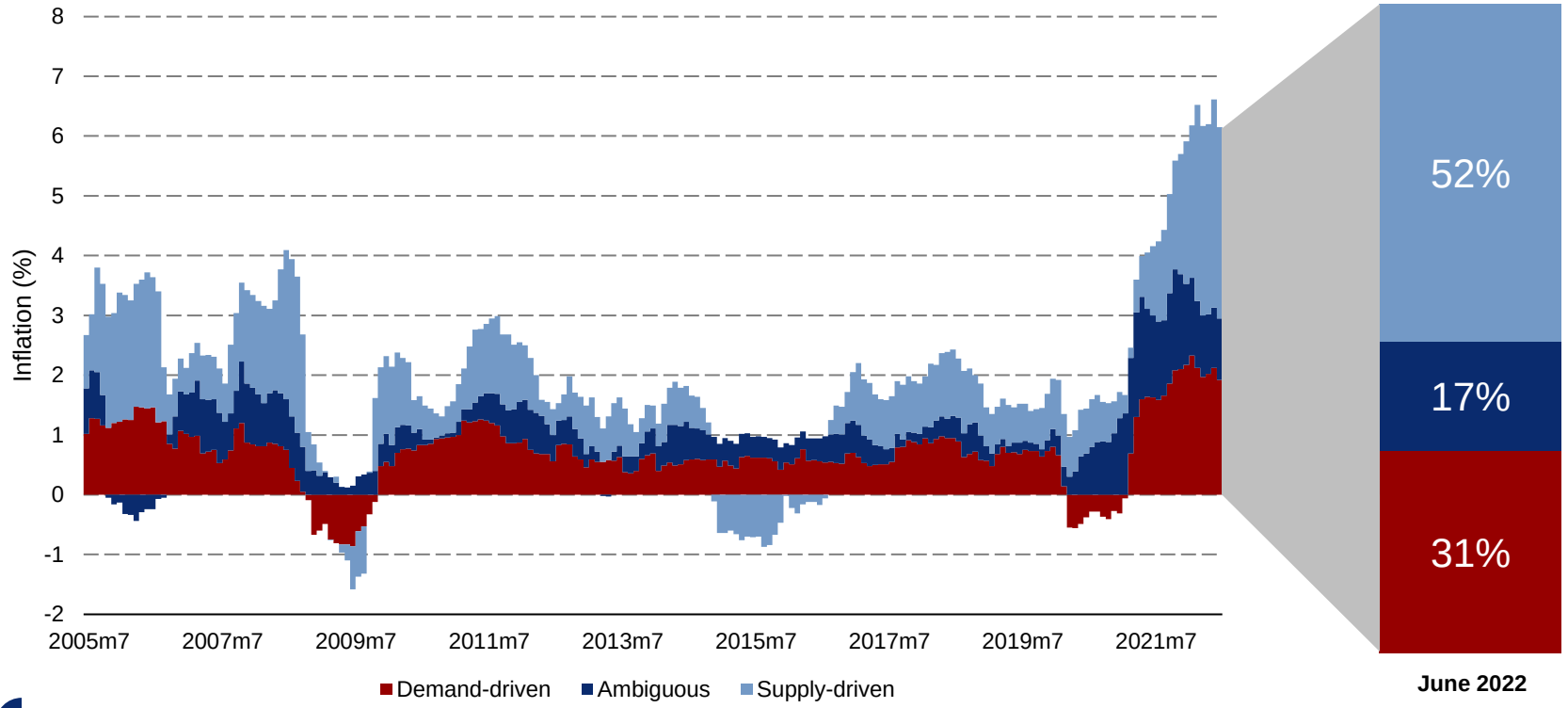
Demand	Supply
Clothing	Fuel
Restaurants	Automobiles
Furniture	

Source: FRBSF

Inflation By Component: Findings Pt II

Not an ideal backdrop for the Fed

PCE Component Breakdown



…**supply factors** explain about **half** of the run-up in current inflation levels. **Demand factors** are responsible for about **one-third**, with the remainder resulting from ambiguous factors.

Adam Hale Shapiro, VP @ FRBSF

With a minimum of 52% unaffectable inflation, the Fed's soft-landing landing strip has narrowed into a line

Source: FRBSF

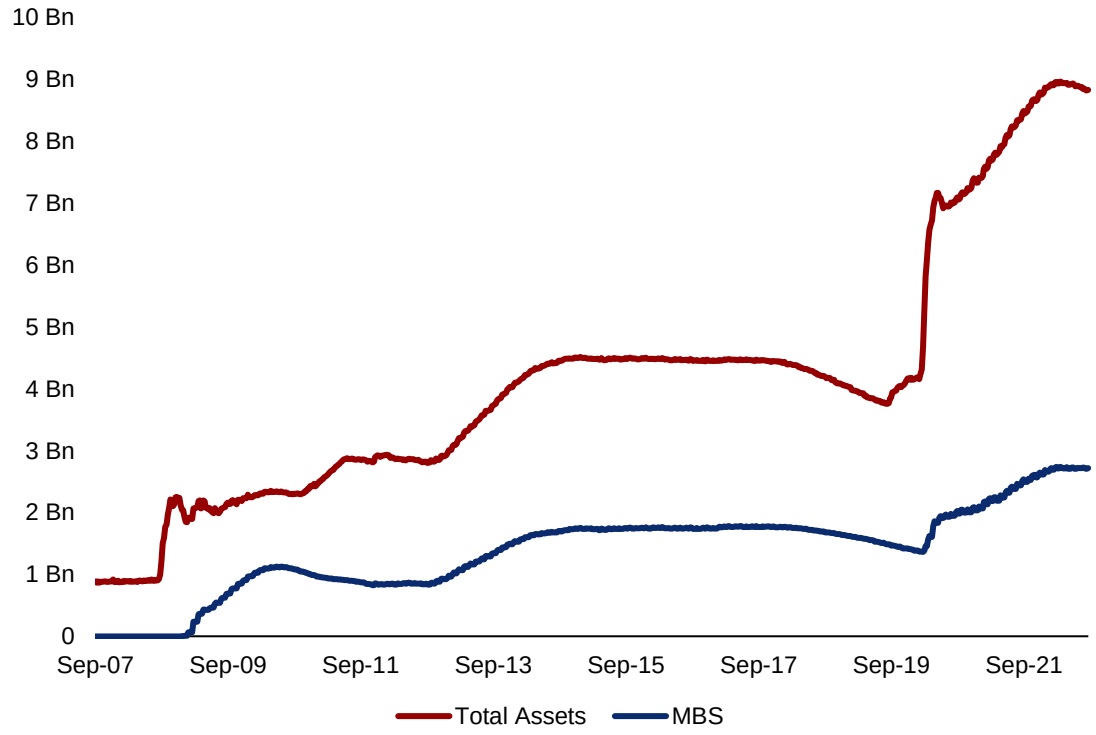
Balance Sheet Policy

Full hawkish steam ahead

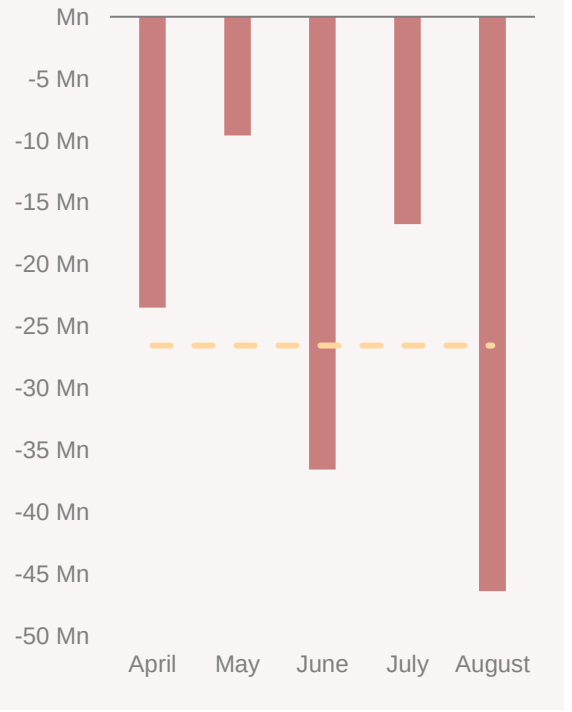
REUTERS

Headline: *Fed's Williams sees no early end to balance sheet runoff*

Fed Total Assets



Balance Sheet Runoff Since Peak



Source: FRED

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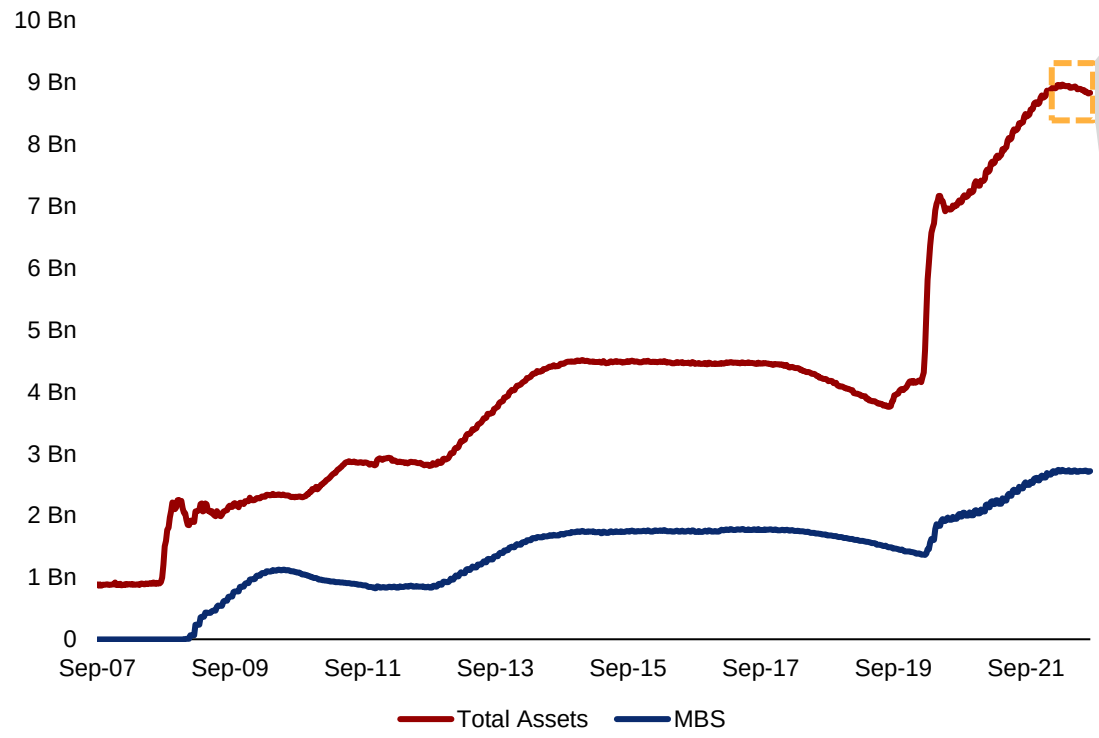

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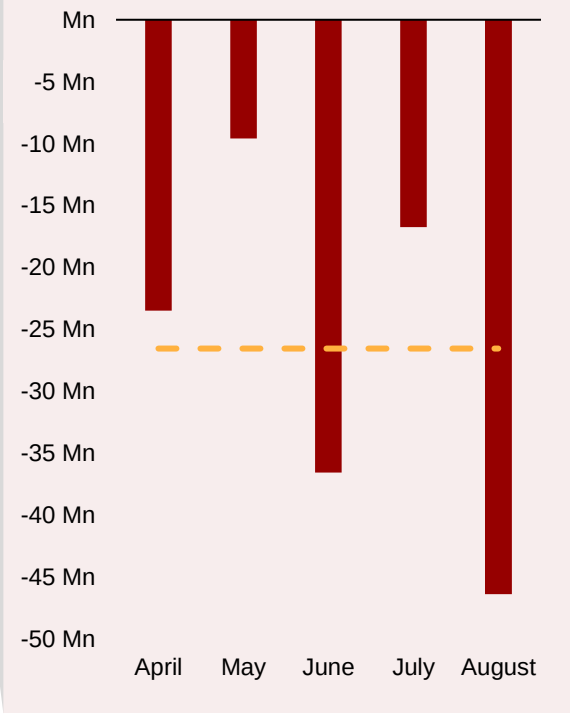

Fed looking to double their runoff target next month

Source: FRED

Inflation Outlook & Currencies Allocation Roadmap

Is inflation expected to run hotter or cooler? How will it impact interest rates?

Inflation Outlook

- Labour Market — Cooler
- Housing Markets — Cooler
- Central Bank's Approach — High risk of hard landing

DCM View:
- Inflation is transitory
- Fed will become dovish
- Rates will surprise on the lower side

US vs. CA: which currency is more attractive?

Currency Allocation vs

- Growth
  - GDP, consumer growth
  - Labour market
  - Fiscal policy
- Inflation, monetary policy
- Risk (flight to safety)
- Commodities outlook

?

?

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Currency

SECTION III

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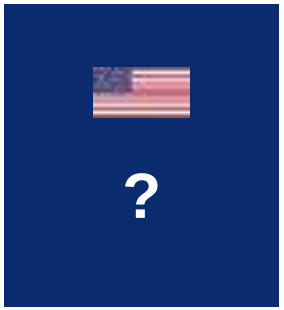


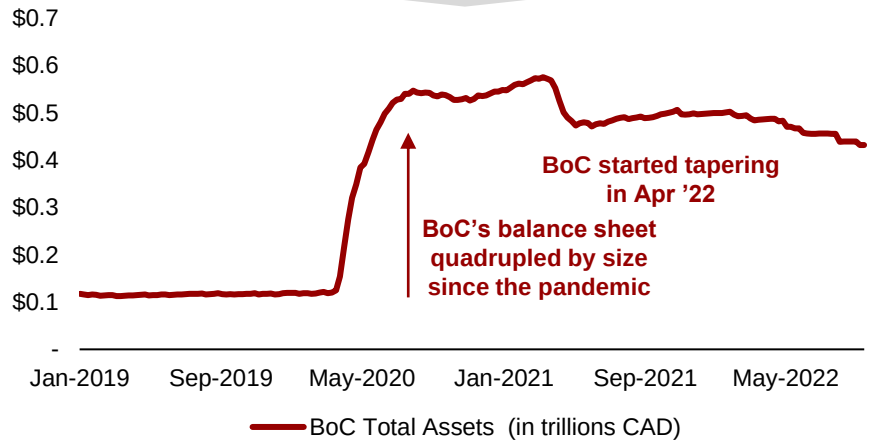
Relative Monetary Policy

BoC vs. Fed

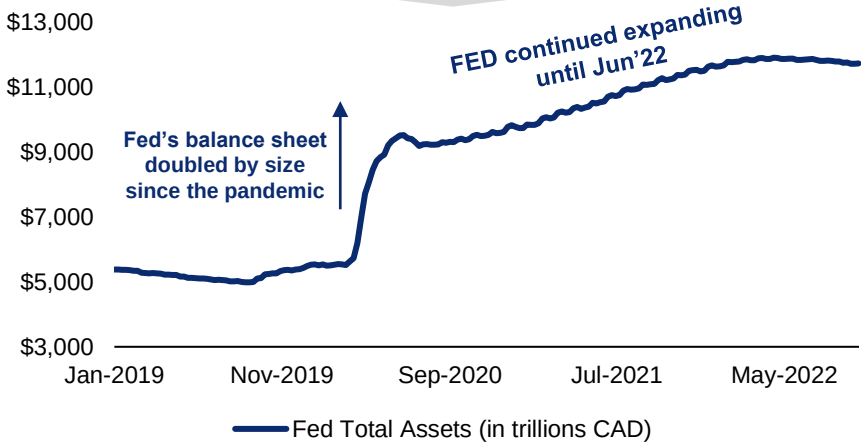
	Bank of Canada	US Federal Reserve
FX Intervention	*Intervene on a discretionary basis and only in the most exceptional circumstances. Last took place in 2011, following an earthquake in Japan that led to abrupt appreciation of the Japanese Yen*	
Interest Rate Policy	3.2 hikes priced in to reach 4.1% terminal rate	8.6 hikes priced in to reach 4.5% terminal rate
Overall Attitude Outlook	More Dovish	Increasingly Hawkish

Tapering in Canada has started earlier than in the US, but the Fed is poised to tighten more

BoC
$2bn asset repurchase per week, down from $3bn in June



FED
$48bn asset repurchase per month since Jun '22; $95B as of Sep '22



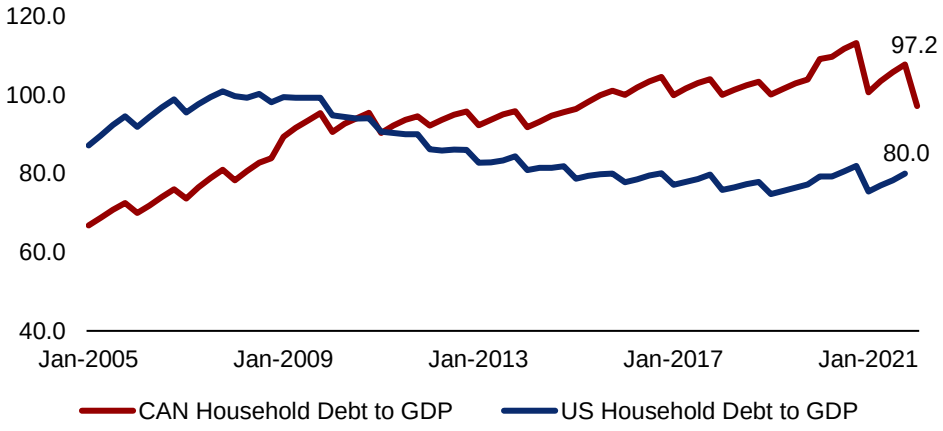
Fed's balance sheet to reach its pre-pandemic size by June 2026 only; quantitative tightening not enough to suppress inflationary pressures

Note: All numbers in CAD unless otherwise stated. Assume USD/CAD exchange rate at 1.33.
Source: Bloomberg, Federal Reserve Bank of St. Louis

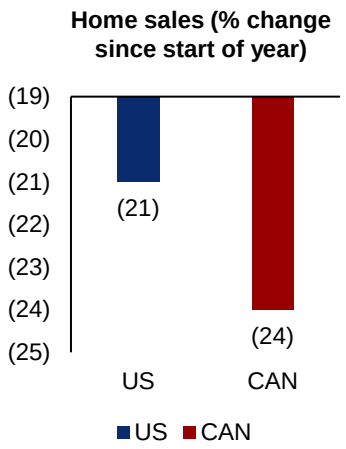
High Household Indebtedness

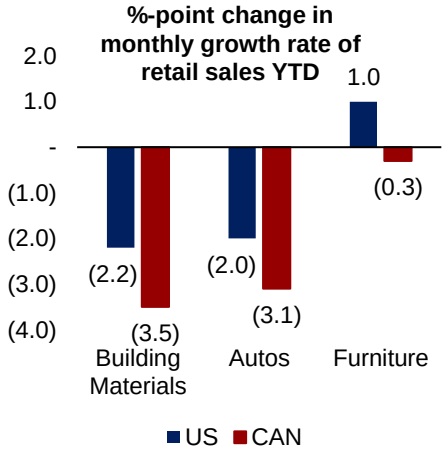
A Key Vulnerability for the Canadian Economy

Canadian households are more indebted than US ones

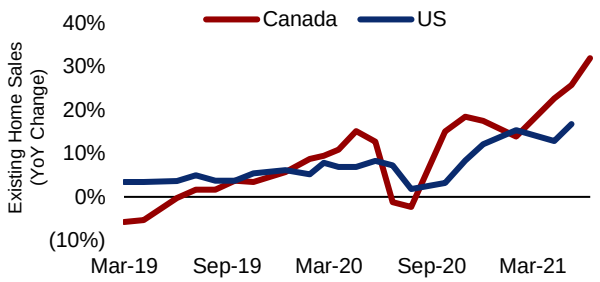


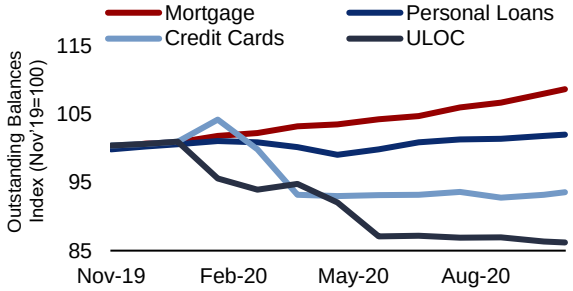
Interest-sensitive areas are also slowing faster in Canada

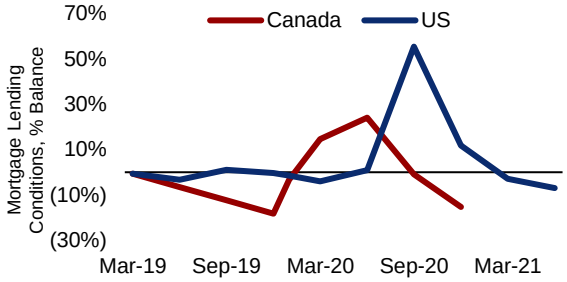




Why are Canadian households indebted?







1 Increasing Home Sale Prices

Real Canadian house prices have increased at a faster pace than disposable income

2 Rising Mortgage Load

~3/4 of Canadian household debt is due to mortgages

3 Favourable Lending Conditions

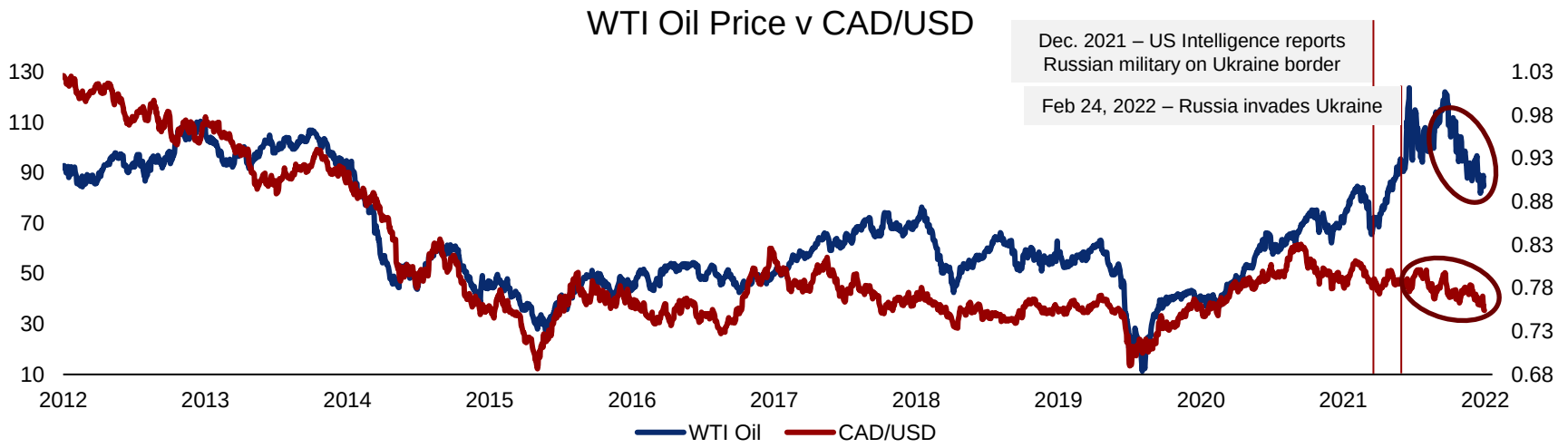
Mortgage lending conditions in Canada loosened earlier than in the US

The BoC should be more cautious moving forward considering households' vulnerable debt positions

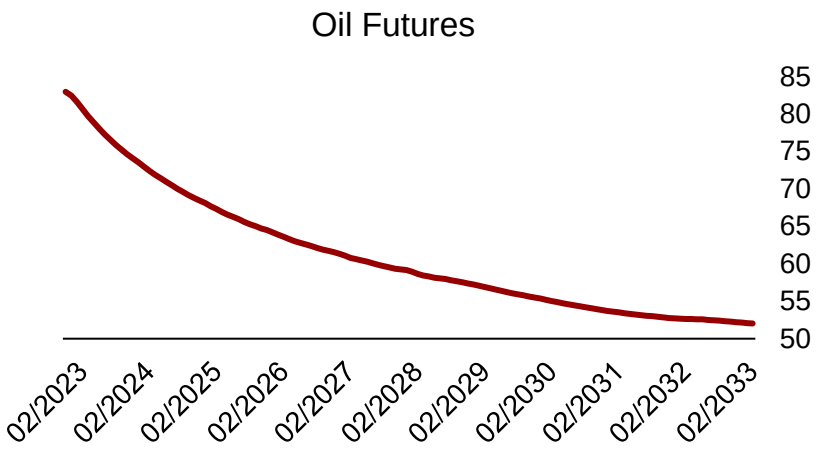
Source: FRED, Bloomberg, TD Economics, CIBC Capital Markets

Commodities

Oil and CAD are “taking a break”



Long-Term Diminishing Oil Prices



Oil Prices and CAD not perfectly in lockstep over 2022

CAD weakening at same rate despite stark oil prices drop. Supply tightening not translating to increase in CAD.

Oil futures suggest discrepancy between oil prices and CAD should close as oil falls. (Market pricing in oil to fall?)

Supply-side pressures keeping oil prices inflated. OPEC >3.5M Bpd below target in August.
(Russia also has some things going on)

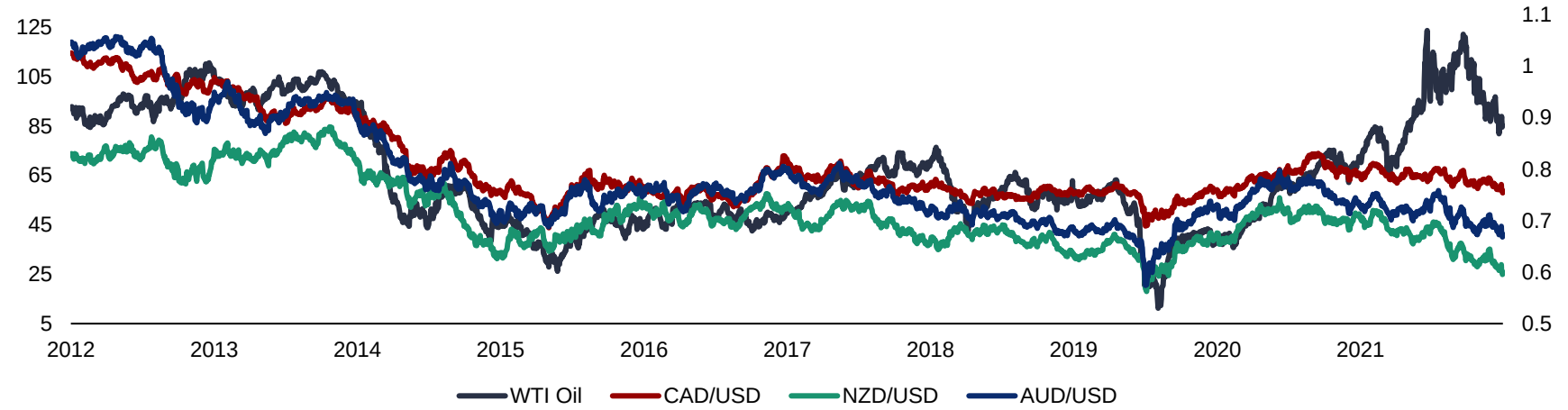
Unique circumstances have led to an uncertain position between CAD and Oil

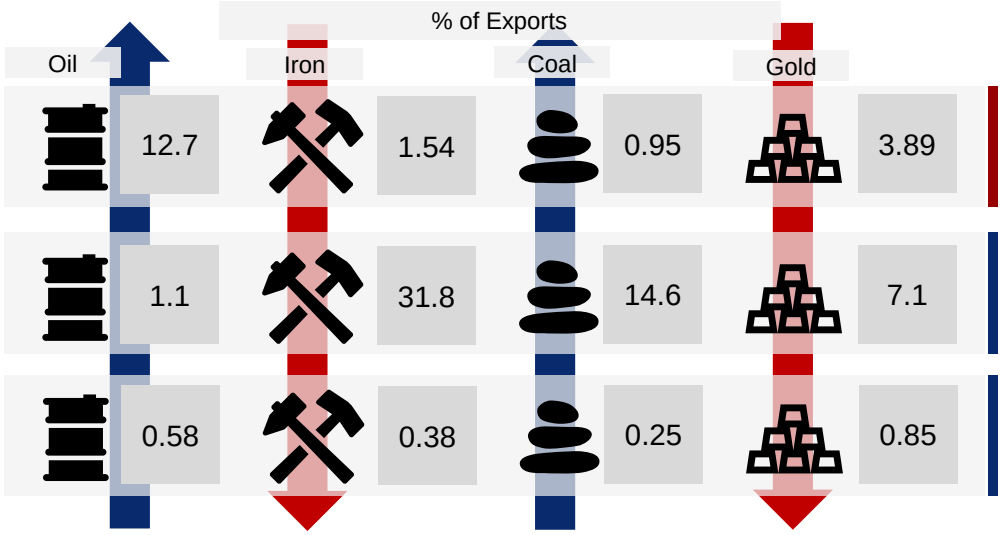
Source: Bloomberg

Commodities

CAD's friends aren't reacting either

Commodity Currencies vs Oil Prices





Other commodity-based currencies faring poorer than CAD

Canada
0.79USD Jan. 3 - **0.74**USD Sep. 26
6.3% Decrease YTD

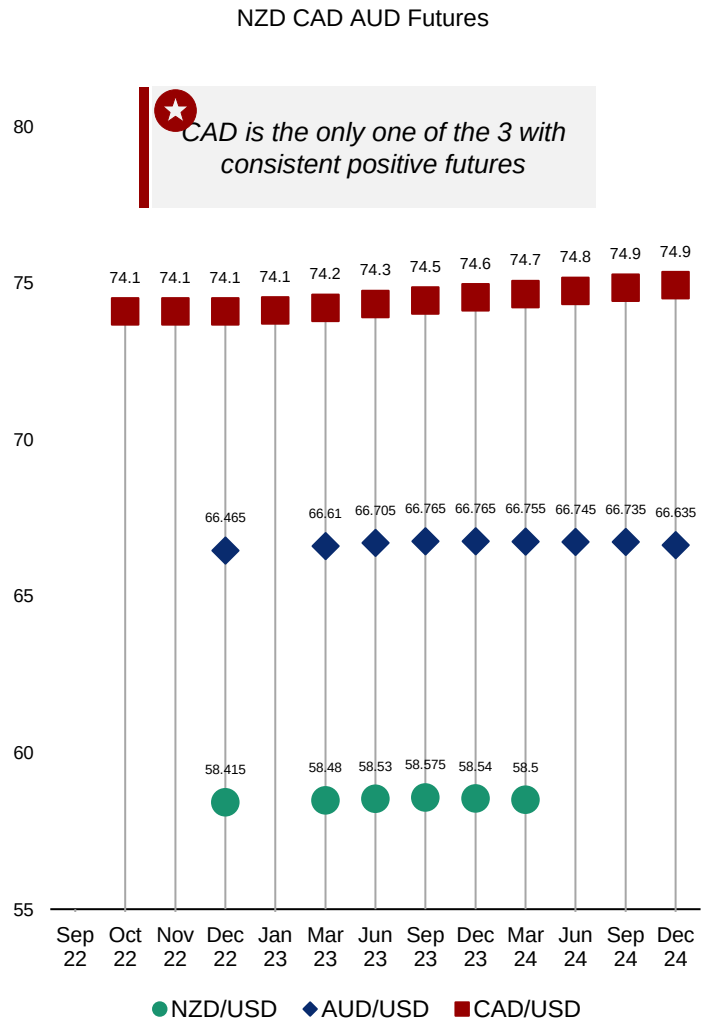
Australia
0.73USD Jan. 3 - **0.65**USD Sep. 26
~11% Decrease YTD

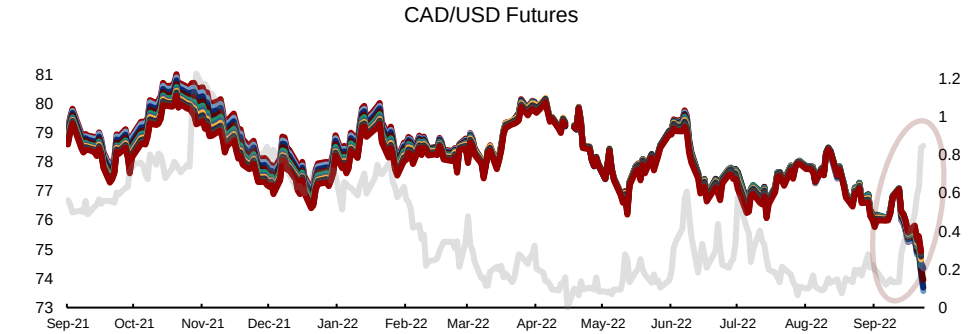
New Zealand
0.68USD Jan. 3 - **0.57**USD Sep. 26
>16% Decrease YTD

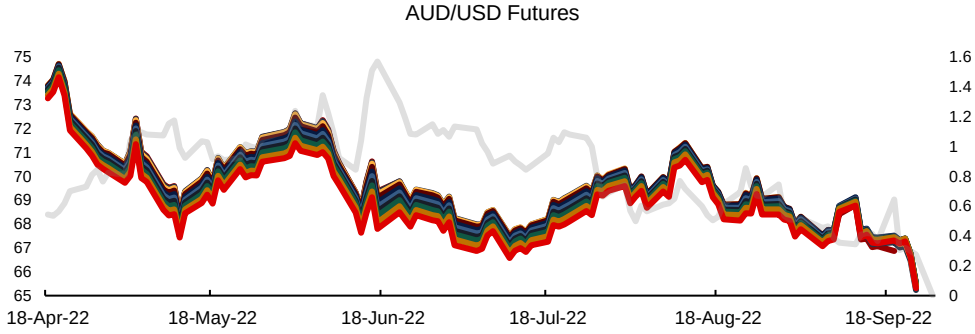
Source: Bloomberg, Yahoo Finance

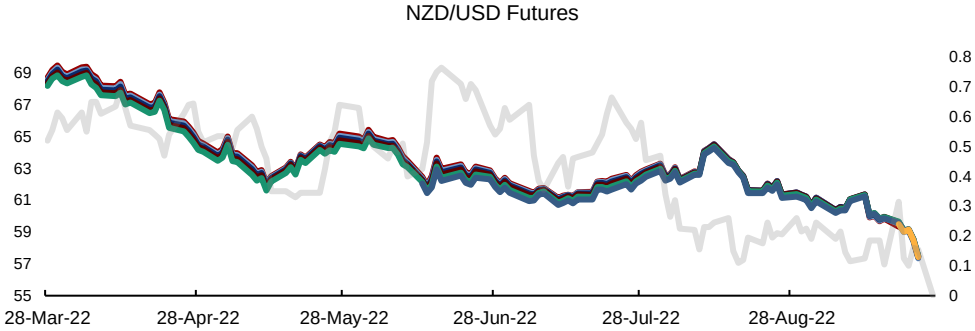
Commodities

Canada's showing off a bit









Recent change in sentiment toward CAD suggests market is slightly bullish

Source: Bloomberg

Desautels Capital Management

Honours in Investment Management

Relative Fiscal Policy

SECTION IV

DESAUTELS Capital Management
Gestion de capitaux

McGill

Canada vs USA

Canada

- Political Climate
- Housing
- Budget

United States

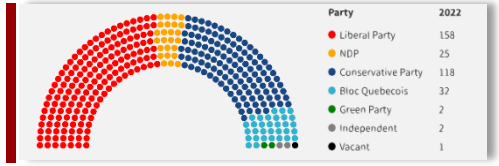
- Build Back Better
- Midterm Elections
- Historic Trends

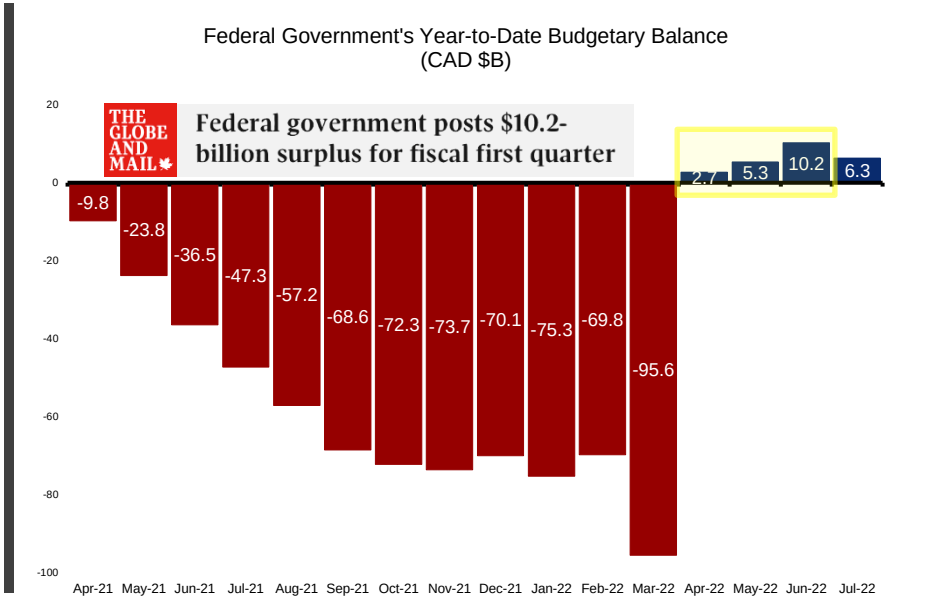
Relative Fiscal Policy

”Justinflation” trends on twitter sometimes…

Canada

- Political Climate
- Housing
- Budget





Surplus isn't expected to be sustainable, but was a pleasant surprise to start the fiscal year

Source: Global News, Globe and Mail, The Fiscal Monitor

Relative Fiscal Policy

Biden's Big Bodacious Bold Battle

Build Back Better

American Rescue Plan (ARP)	American Jobs Plan (AJP)	American Families Plan (AFP)
Covid Relief	Infrastructure	Social Policy
Passed	Failed	Failed
"American Rescue Plan Act"	Passed: "Infrastructure Investment and Jobs Act"	Passed: "Inflation Reduction Act"
March 2021	*November 2021*	*August 2022*
$1.9 Trillion	**$550B over 5yrs**	**Raise: $737B Spend: $437B**
	Roads, Bridges, etc.	Climate Investments

★ *$10k student loan forgiveness*

United States

- Build Back Better
- Midterm Elections
- Historic Trends

Biden's tenure in office will be defined by the outcome of BBB and its descendants

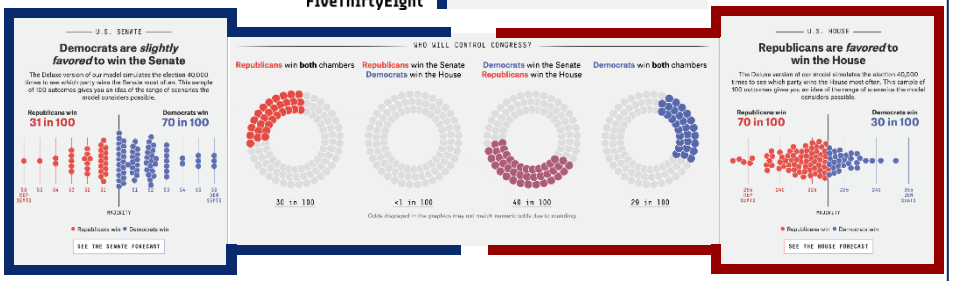
Source: Government Filings

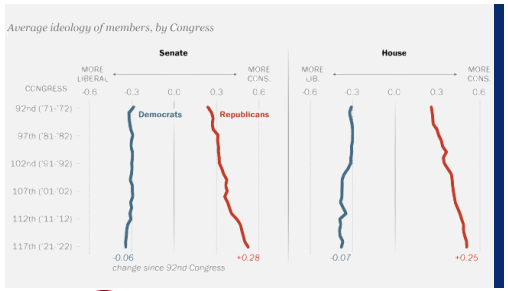
Relative Fiscal Policy

Government doesn't have opt-out fees like SSMU

FiveThirtyEight

-Nate Silver





Partisanship at 50 year high

More filibustering!

Residue from BBB initiatives as main drivers of spending going forward

Corporate Tax Rate to 28%

$15 Federal Minimum Wage

Cost of living as a prime voting motivator

United States

Build Back Better

Midterm Elections

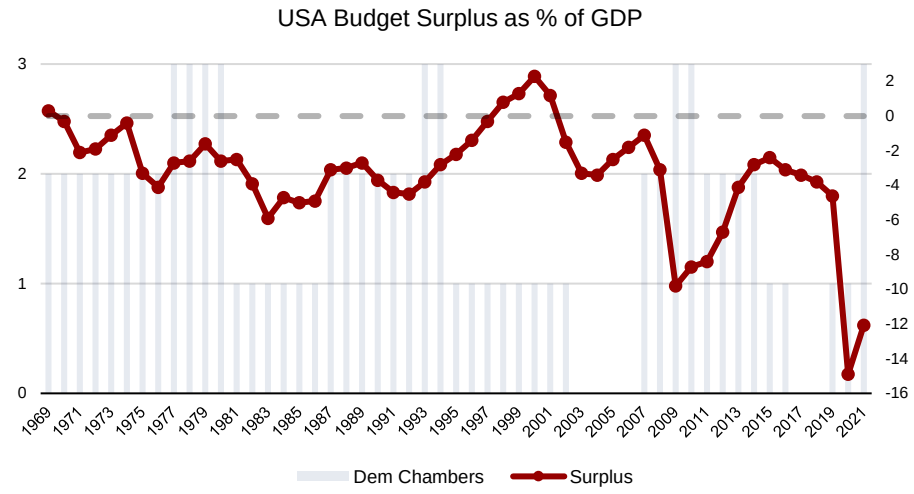
Historic Trends

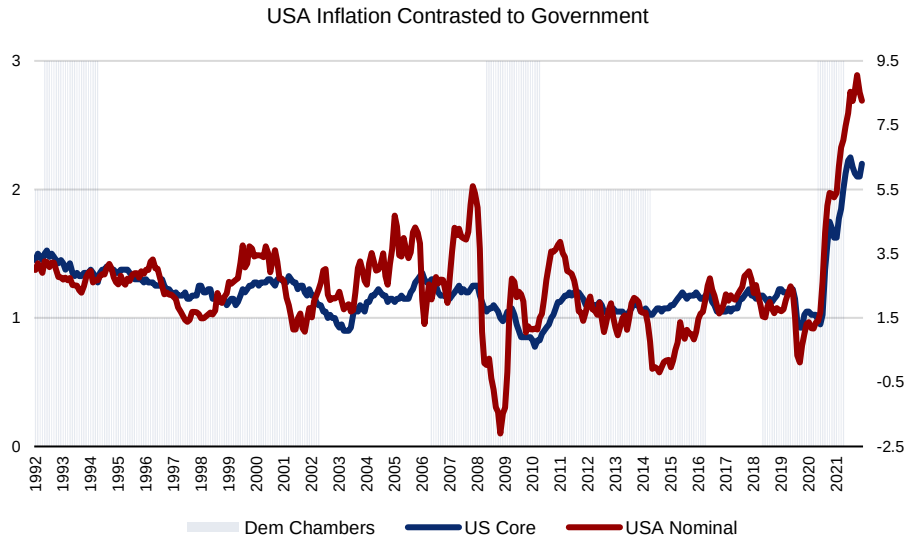
Risk of "trifecta" is minimal but present, split government will introduce gridlock

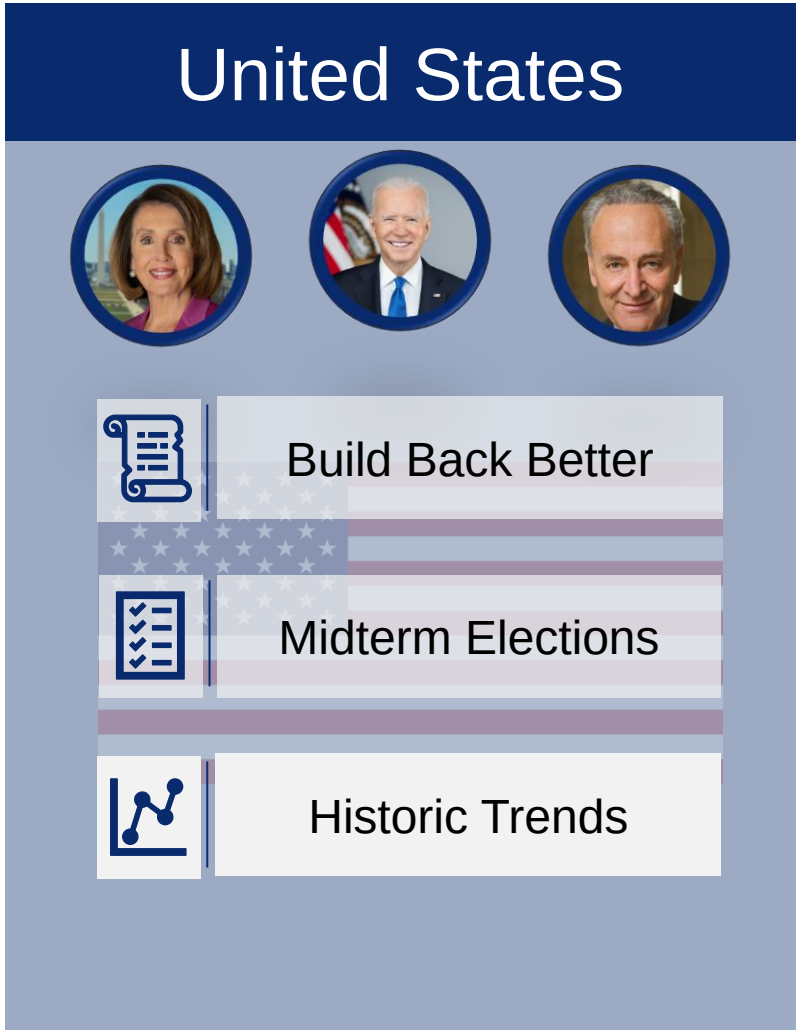
Source: Fivethirtyeight, Pew Research, Government Filings

Relative Fiscal Policy

Looking at inflation and deficits





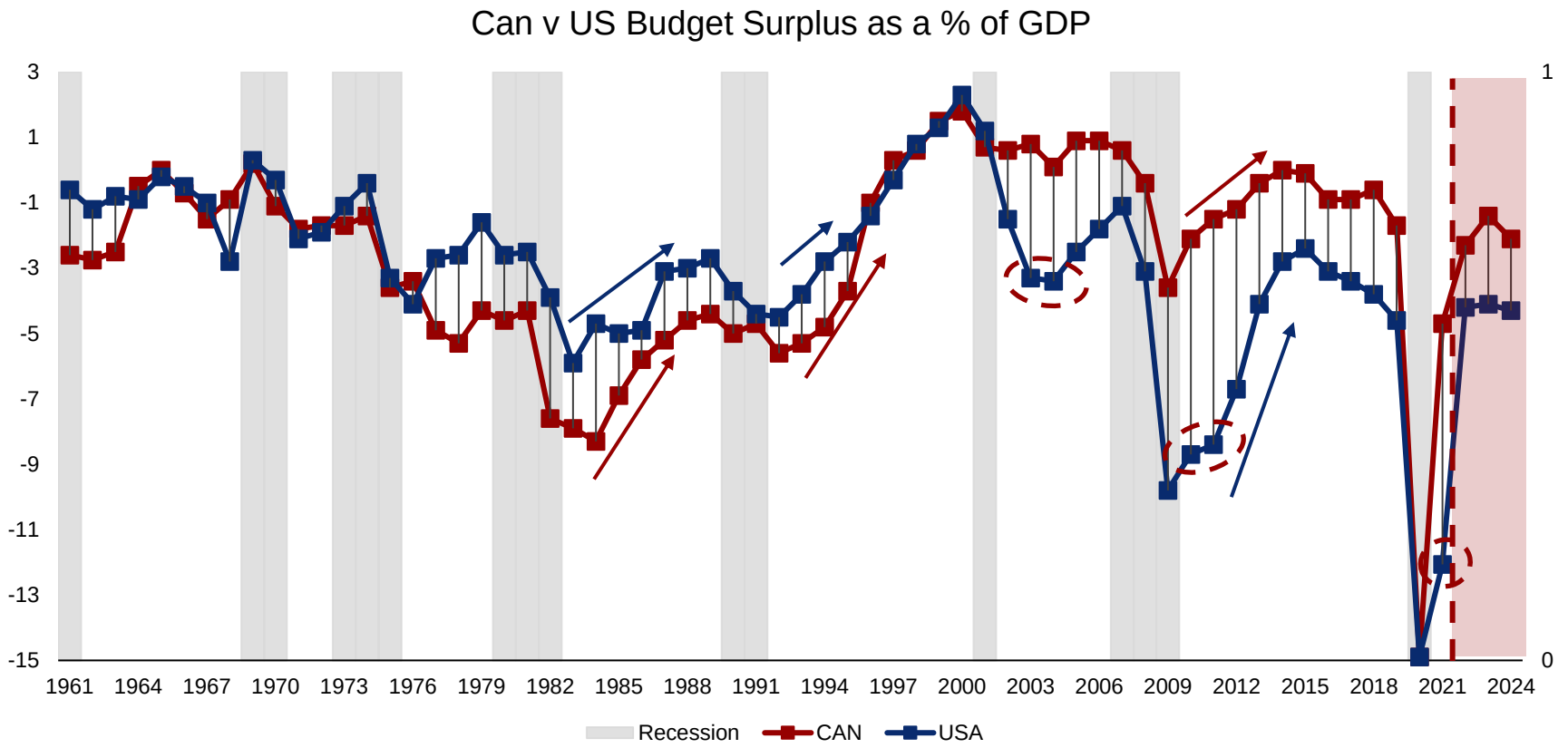


Government in power makes marginal decisions

Source: American Presidency Project, Bloomberg

Relative Fiscal Policy

New century, new dynamic



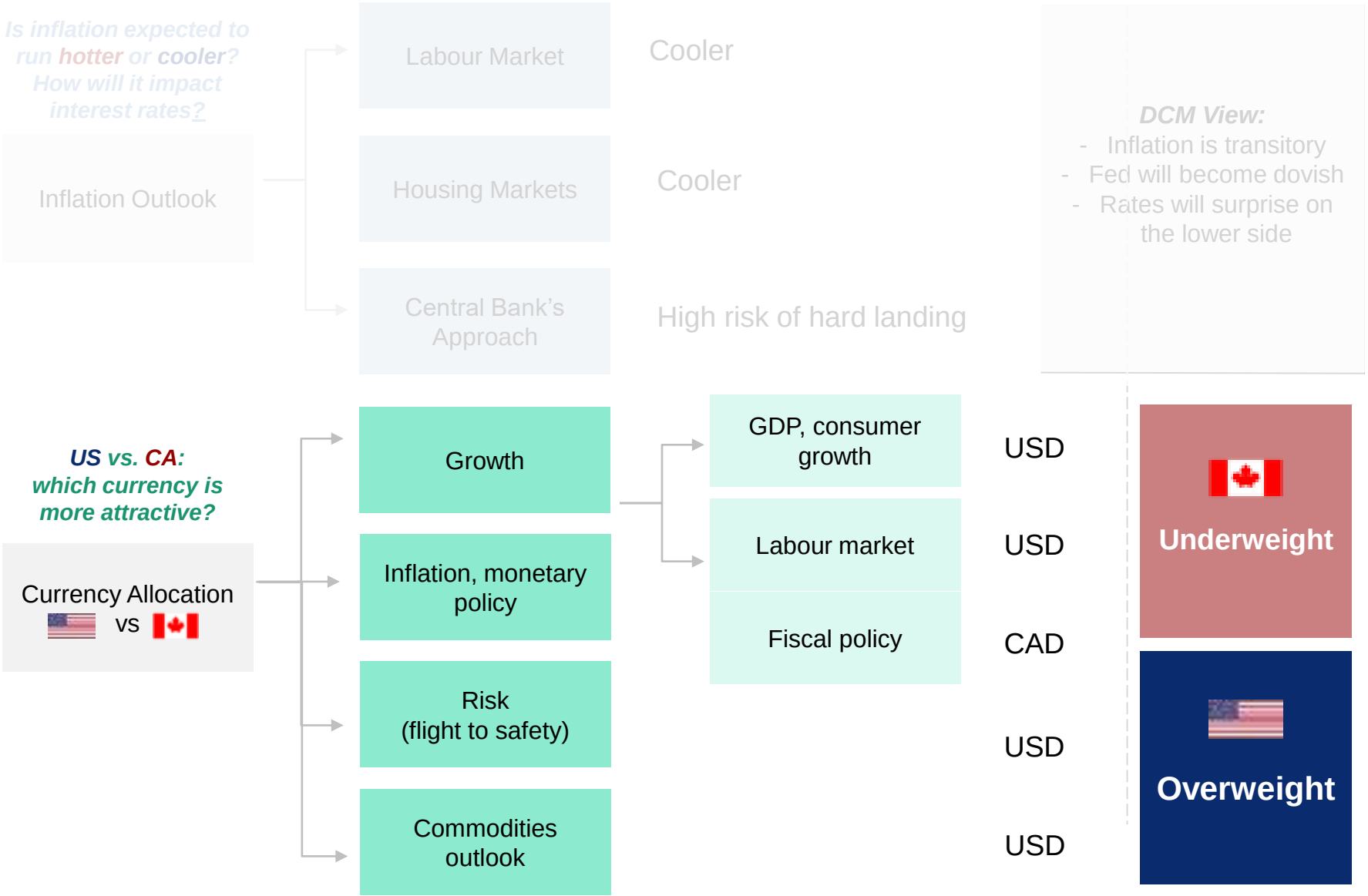
Worse recession performer tends to bounce back more aggressively. If this holds, we expect both countries to improve deficit, but US to cut more than CA to catch up over next couple of years.

USA has reached into more deficits over past 3 recessions (2001, 2008, 2020). Estimates have both economies rebounding to pre-COVID levels.

Projections suggest quicker bounce back than in previous recessions

The Fiscal Monitor – Canada, American Presidency Project, Bloomberg

Inflation Outlook & Currencies Allocation Roadmap



Desautels Capital Management

Honours in Investment Management

Credit Quality

SECTION V

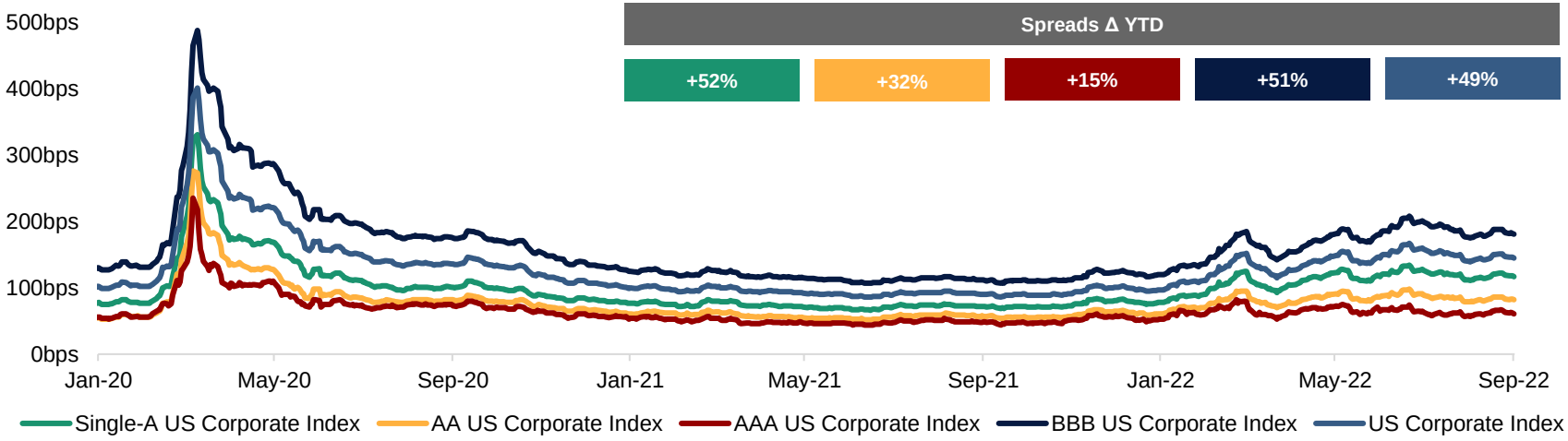
DESAUTELS Capital Management
Gestion de capitaux

McGill

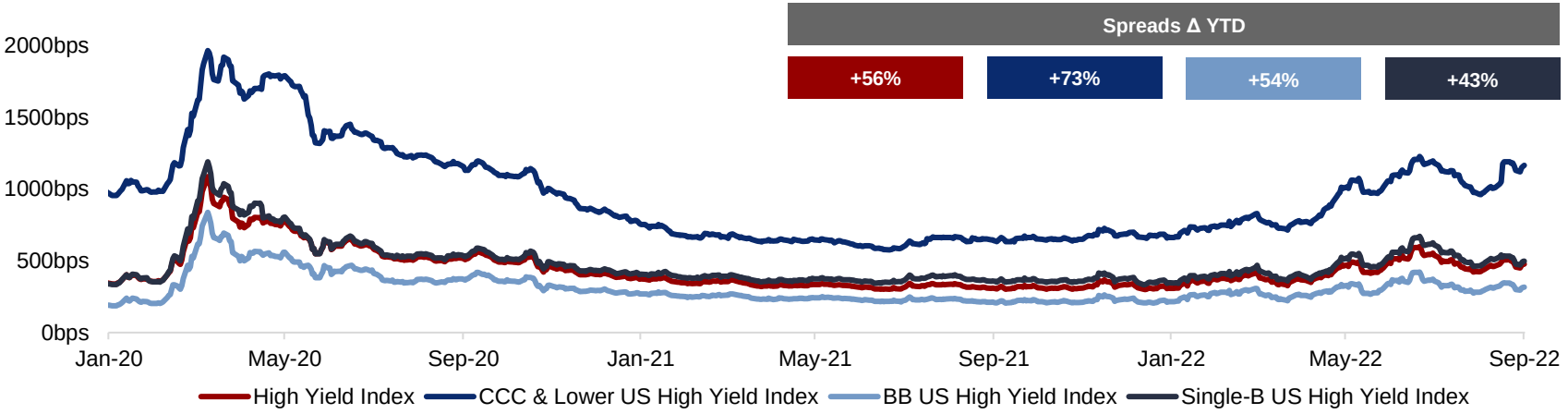
Corporate Credit Spreads

Comparing OAS movements in IG vs HY

Investment-Grade OAS



High-Yield OAS

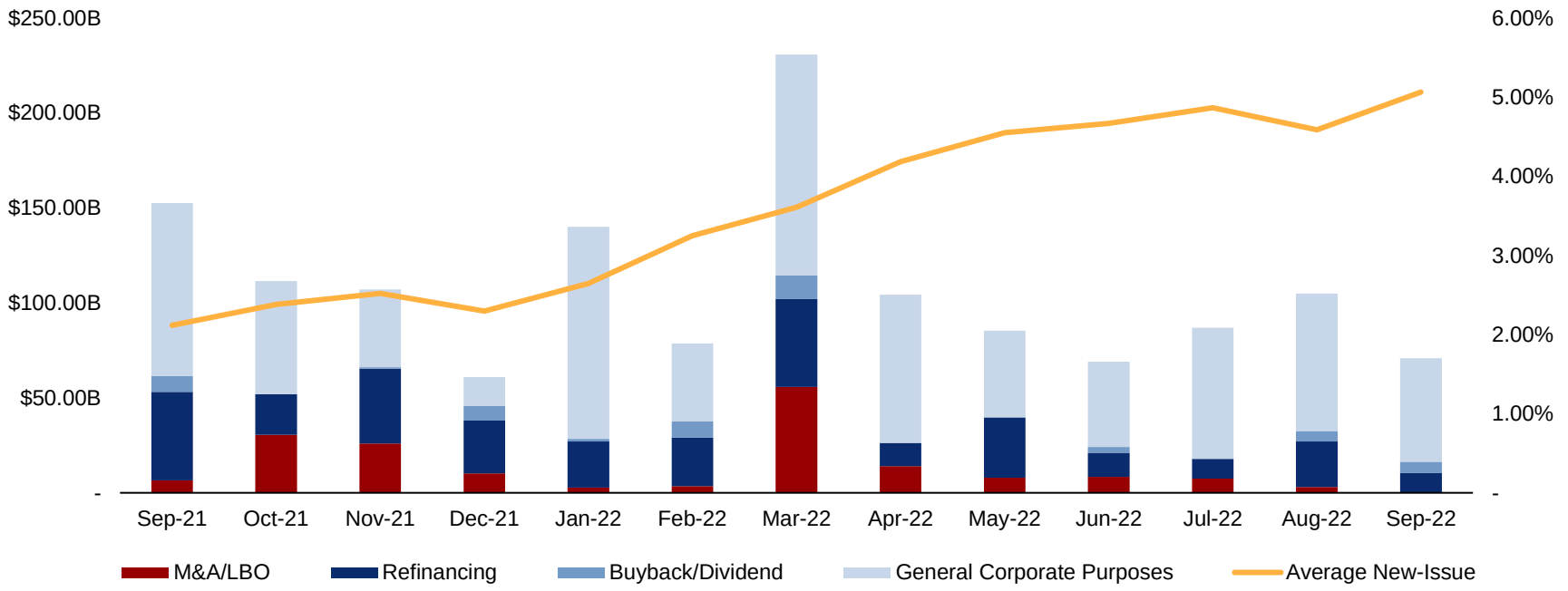


Source: Bloomberg, FRED

New Issuances and Yields in IG

Limited opportunity set in high-grade debt

Investment grade volume by proceeds and average new-issue high-grade yields



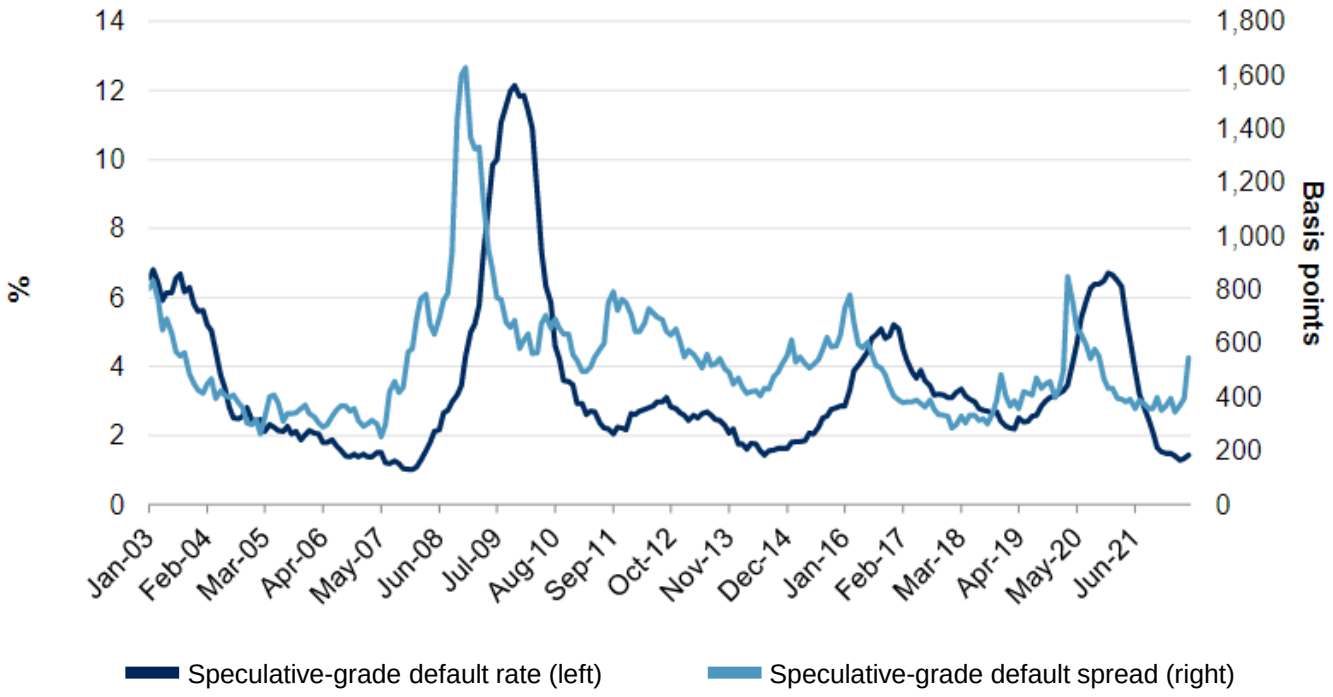
Observations in the IG space

1. Investors are flush with cash and looking for entry points (TRACE indicated a net increase of $500M in high grade debt investments across the curve on September 22)
2. Issuers are incredibly restrained (Sept issuance may fall short of the triple digit mark), while the backlog of investors is rising
3. Opportunities still exist in IG, but have become much more restricted

Source: Bloomberg, FRED

Credit Spreads as a Leading Indicator of Future Defaults

Market often uses corporate spreads to forecast default rates



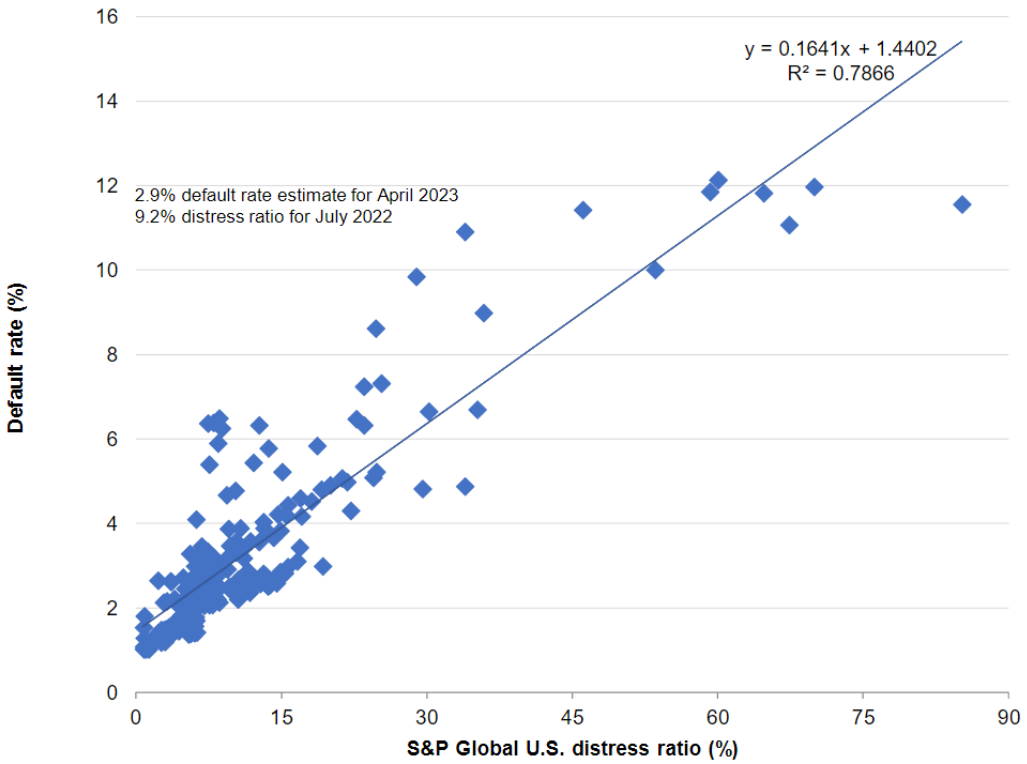
Corporate spreads as a leading predictor of defaults

1. U.S. HY corporate spread is a good predictor of future defaults based on ~ one-year lead time
2. **Latest US HY spreads of ~550 bps point to a 3.4% default rate by June 2023**

Source: S&P Global

Distress Ratio as a Leading Indicator of Future Defaults

Better indicator across all points in credit and economic cycles



Distress Ratio as a leading predictor of defaults

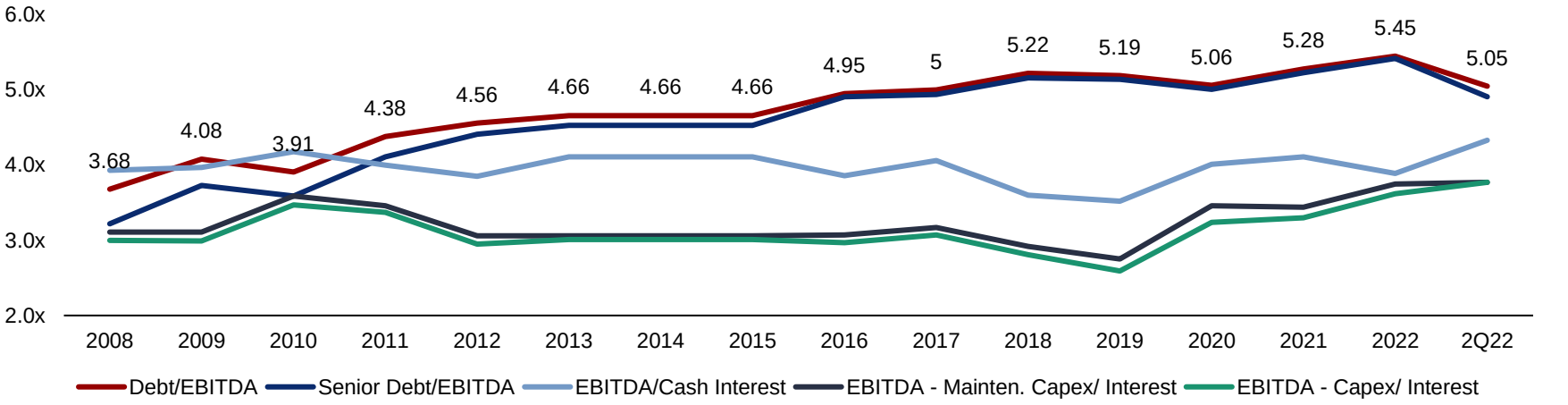
1. The distress ratio, defined as the proportion of speculative-grade issues with OAS of more than 1,000 bps relative to U.S. Treasuries, serves as a good predictor of default rates with a 9-month lead time
2. **Latest distress ratio of 8.3% points to a 2.8% default rate by June 2023**

Source: S&P Global

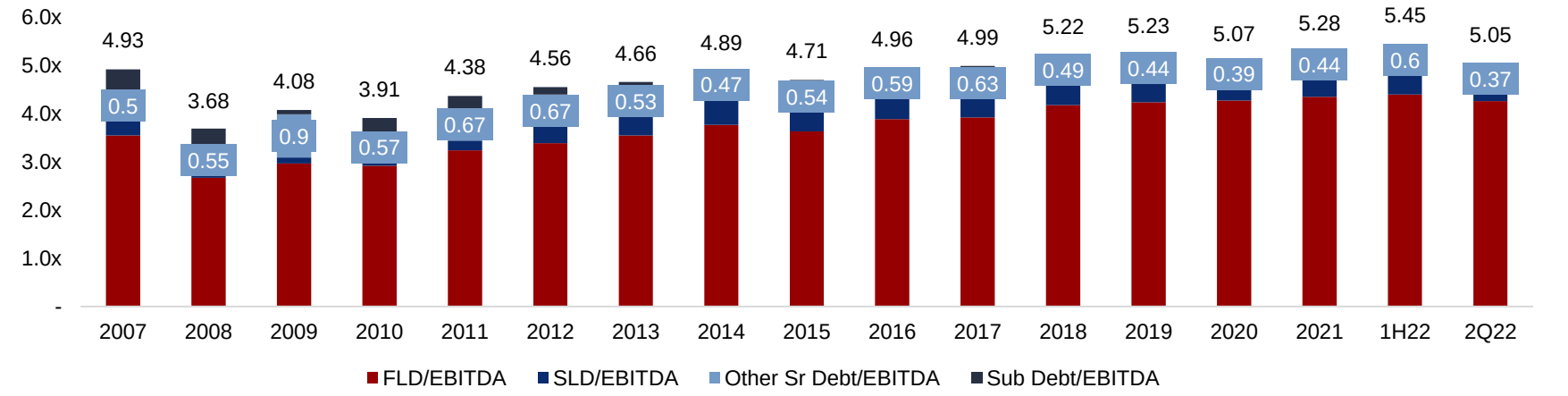
Credit Fundamentals

No material balance sheet deterioration in shorter cycle

Credit statistics for issuers with EBITDA > $50 million



Average debt multiples for issuers with EBITDA > $50 million



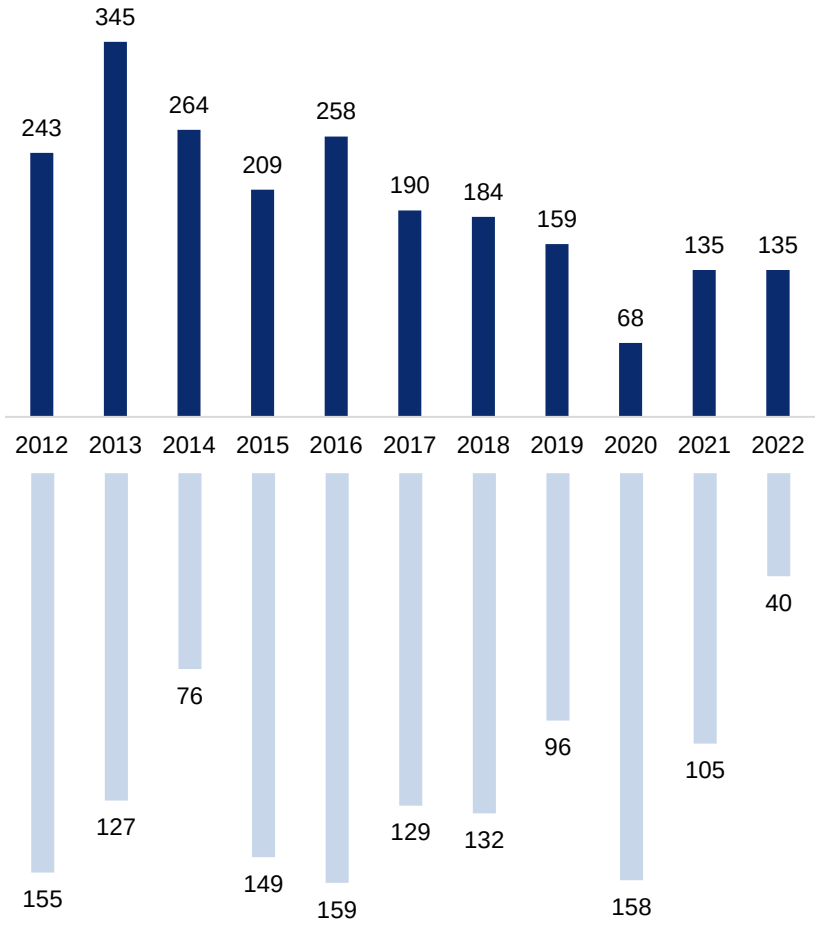
First time in recorded history where downturn (COVID-induced) follows a period where companies are de-levering

Source: S&P Global

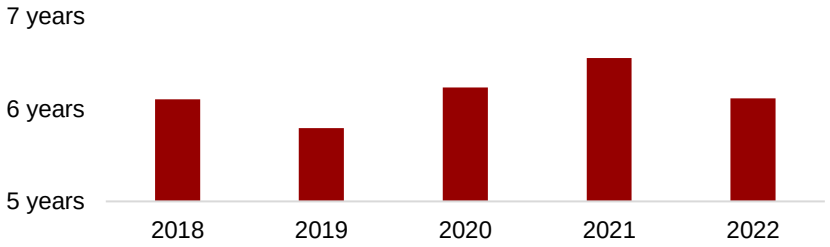
Spread Expansion vs Fundamentals

Credit availability, cash cushion, and de-levering cycle pre-pandemic have led to modest downgrade action YTD

Upgrade vs downgrade rating actions

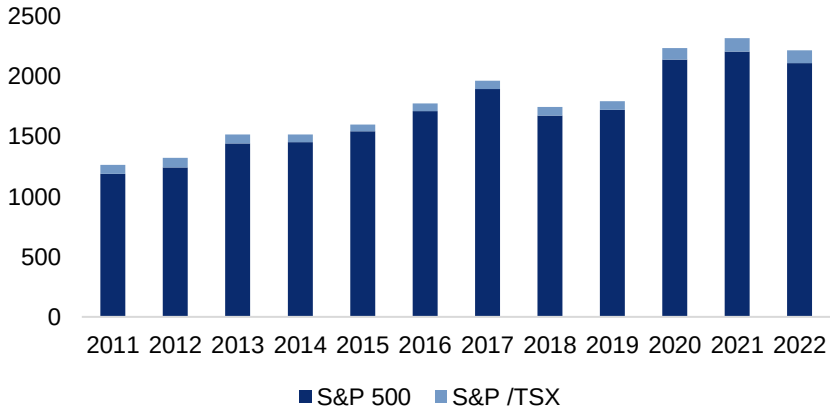


Average # years to maturity (US HY)



- Case for HY #2: risk of default arises when firms are not able to raise capital when they need it
- **Less than 20%** of the HY market comes to maturity over the next 3 years

S&P500 and S&P/TSX Agg Cash & ST Investments Balance



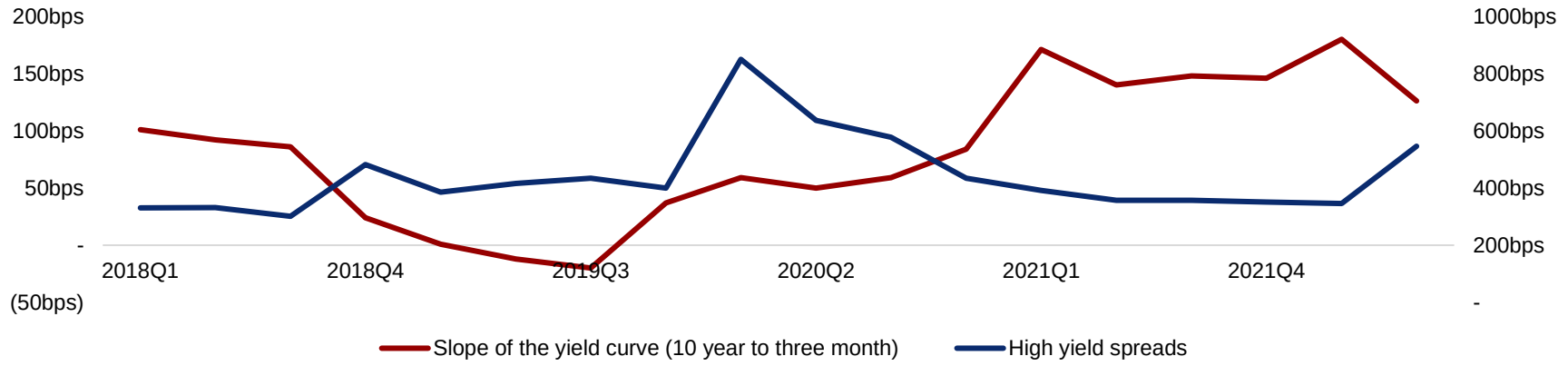
Spread expansions overestimate the probabilities of default in high-yield, measured by capital availability and leverage

Source: Bloomberg, S&P Global

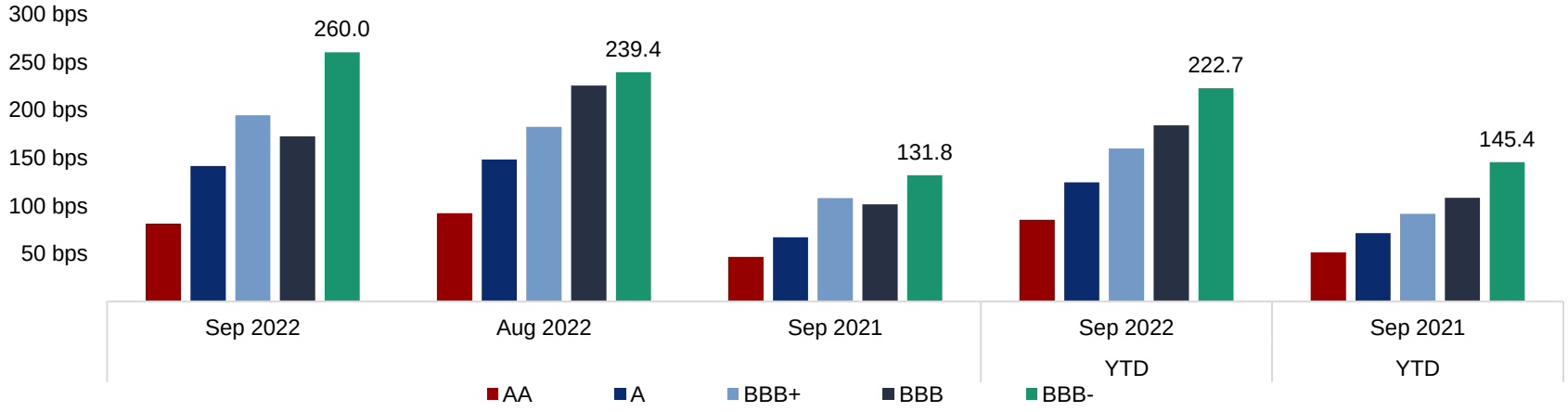
Primary vs Secondary Market Sentiment

Credit market signals through yield pricing and spreads

Yield curve inversion & quick positive turnaround in bond market sentiment pointed to expectations of a shallow recession



Negative sentiment in the primary markets reflected in new issuance spreads



Favorable trends in the secondary markets take much longer to carry over to the primary markets

Source: S&P Global, Bloomberg

Desautels Capital Management

Honours in Investment Management

Sector Fundamentals

SECTION VI

DESAUTELS Capital Management
Gestion de capitaux

McGill

Strategy Formation

Continuing to assess levers of performance

Duration
- A measurement of a bond/portfolio's sensitivity to changes in interest rate
- Expecting a fall in interest rate → lengthen the duration to get the maximum benefit
- Expecting an increase in interest rate → shorten the duration to minimize the negative effect

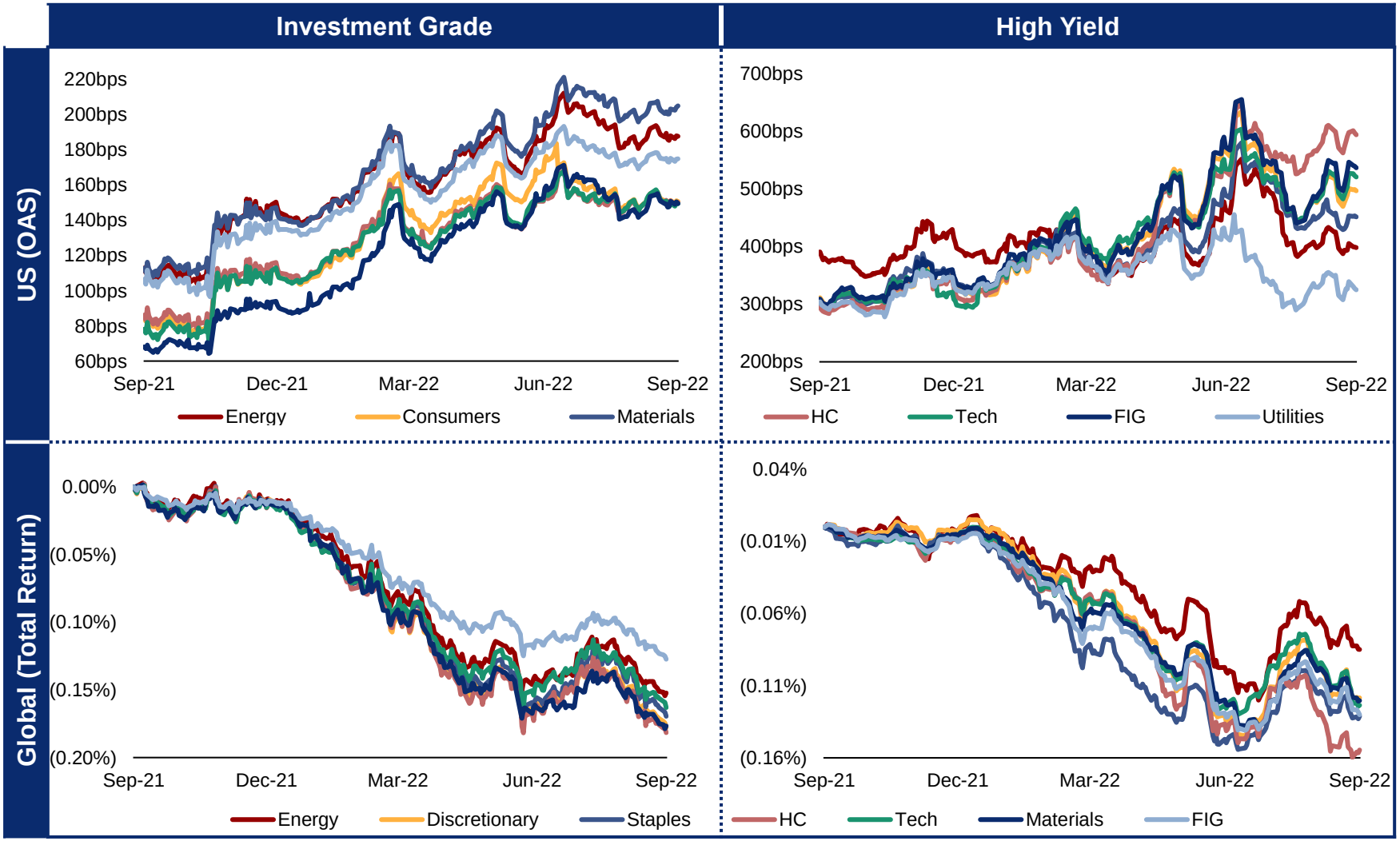
Currency
- Look at relative central bank policies to forecast exchange rate
- Use interest rate and inflation differential as a predictor
- Contemplate the influence of oil and base metals on the loonie

Credit Exposure / Quality
- Looking for spreads that justify risk-adjusted returns
- Shift to cash / sovereign bonds → reduce principal risk, but lower yield
- Overweight corporate bonds → opportunity for income, but greater risk

Sector Overview
- Overview of credit fundamentals across sectors
- Select sector analyses from a fixed income investing point of view

Sector Overview – Credit Fundamentals

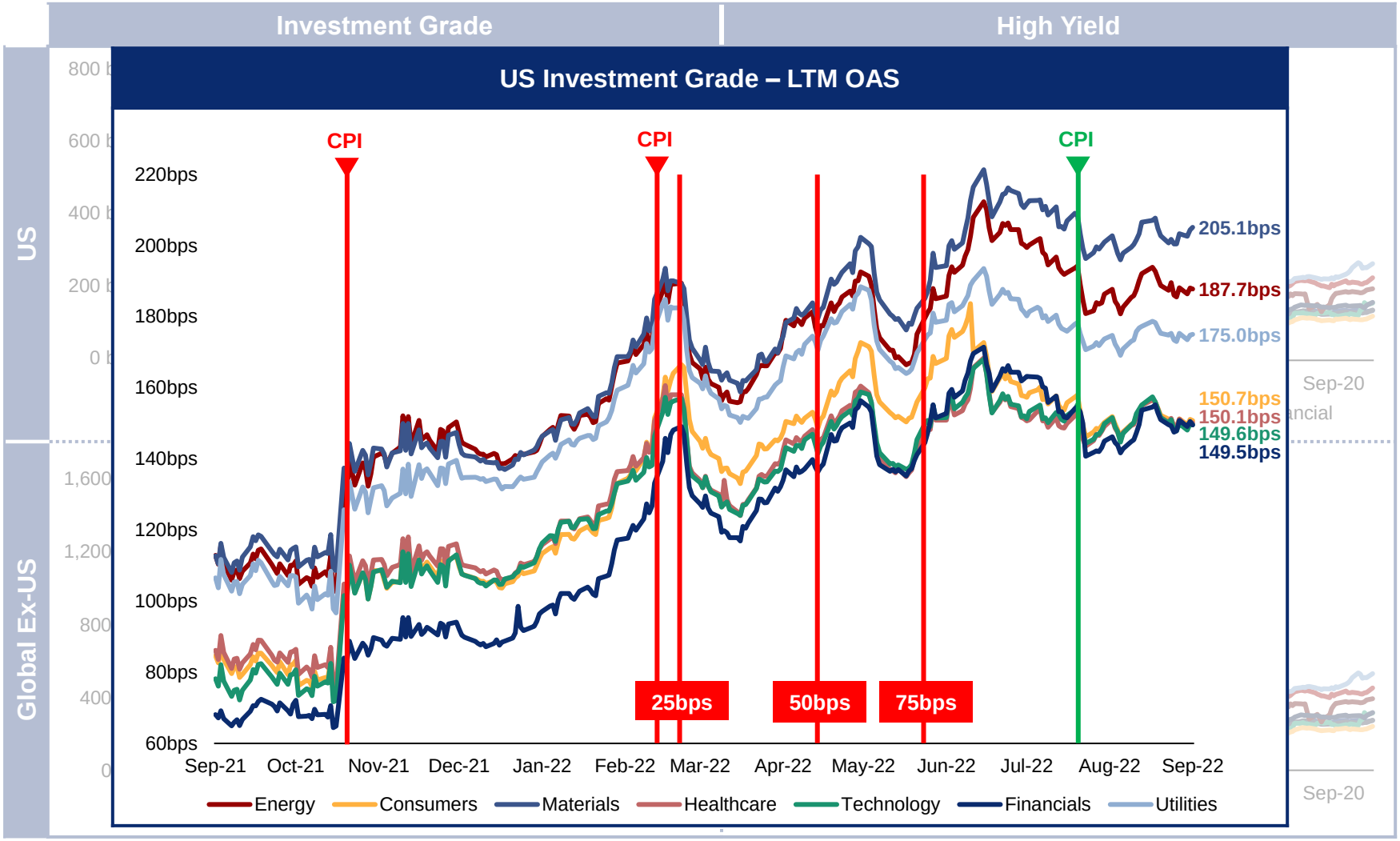
Spreads continue to widen amidst tightening macroeconomic conditions and global recessionary concerns



Consumer staples and Information Technology resiliency to the pandemic offers reasonably attractive yields for the stability they offer

Source: Standard & Poor's Index.

Spreads continue to widen amidst tightening macroeconomic conditions and global recessionary concerns



Consumer staples and Information Technology resiliency to the pandemic offers reasonably attractive yields for the stability they offer

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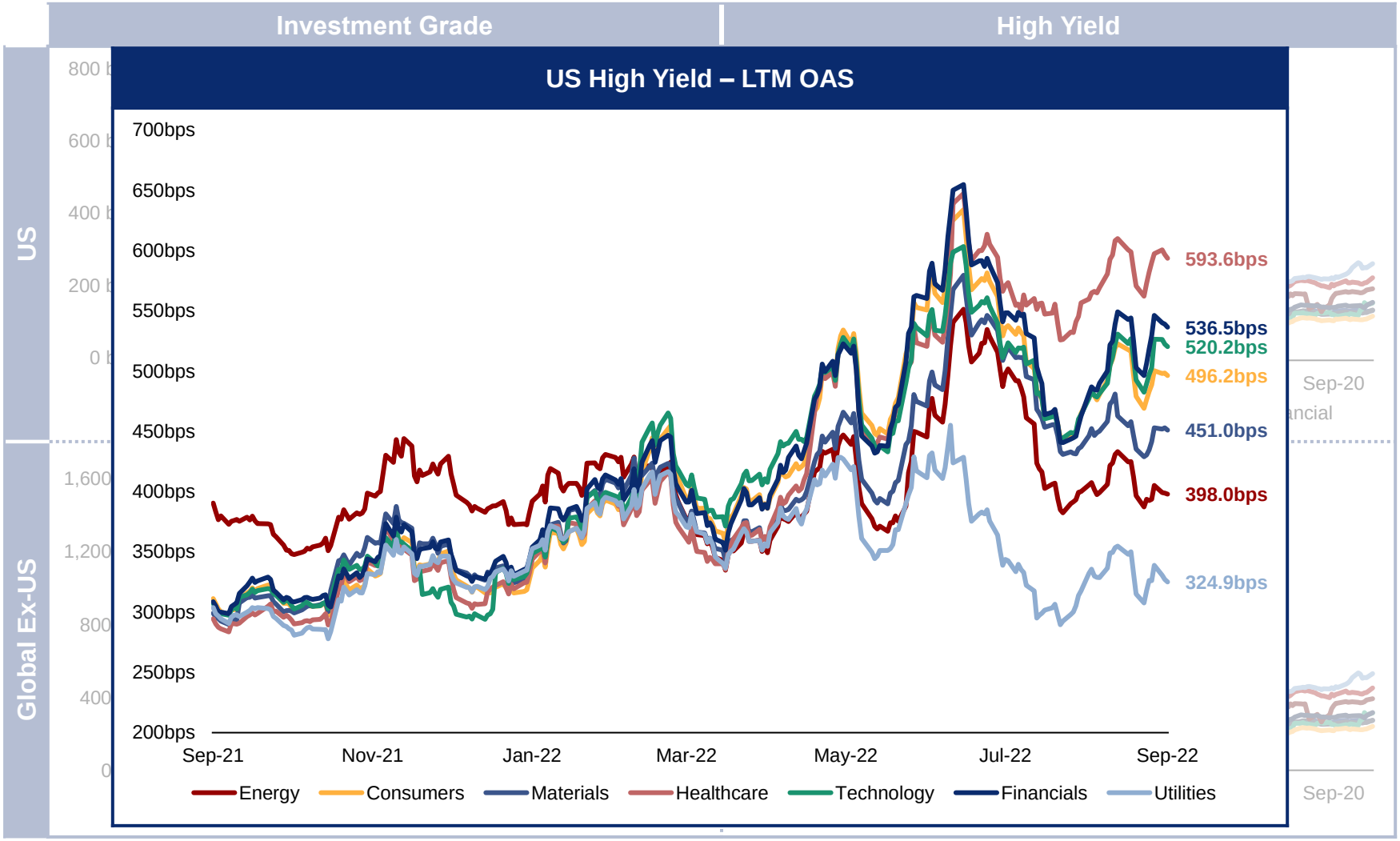
Sector Overview – Credit Fundamentals

Spreads continue to widen amidst tightening macroeconomic conditions and global recessionary concerns

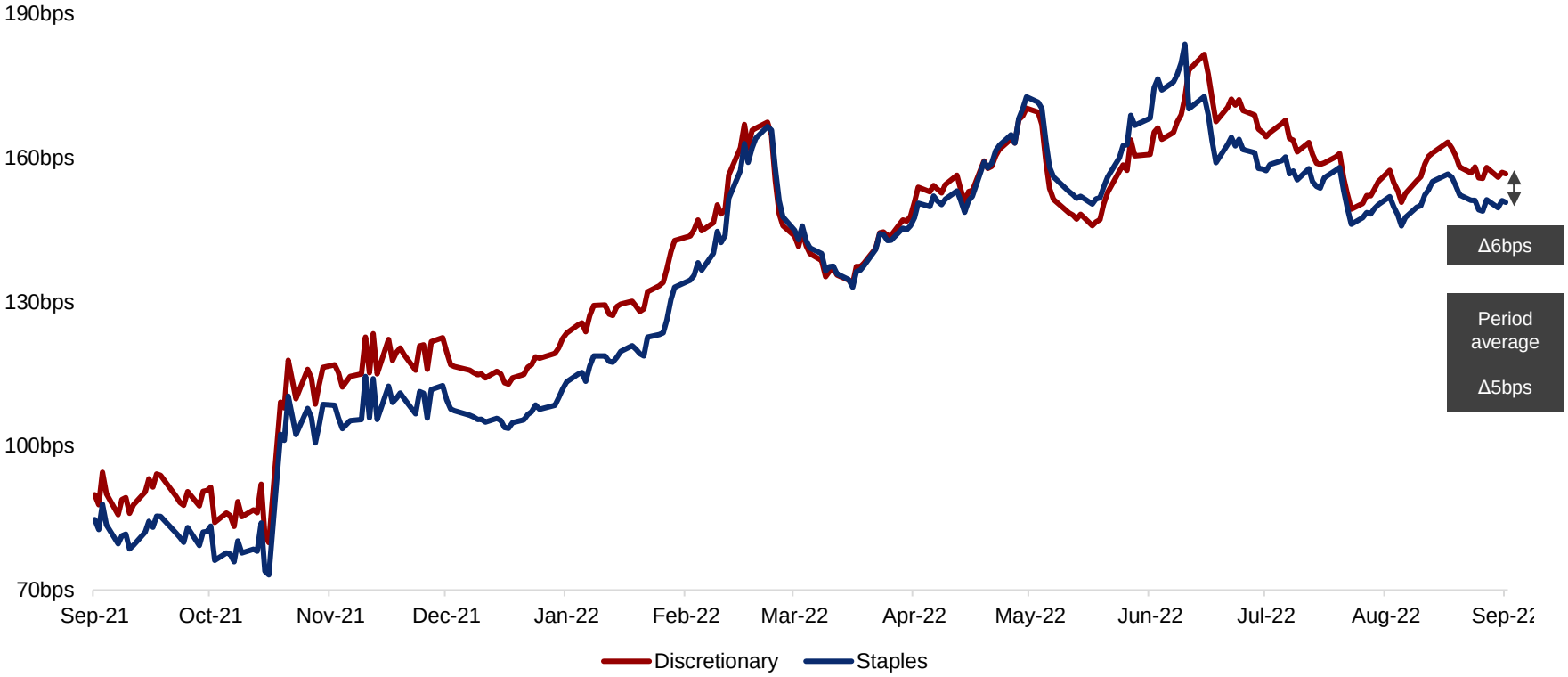


Consumer staples and Information Technology resiliency to the pandemic offers reasonably attractive yields for the stability they offer

Source: Bloomberg, Standard & Poor's Index.

Sector Overview – Credit Fundamentals

Consumer Discretionary vs Consumer Staples Relative LTM Spread Performance – Investment Grade



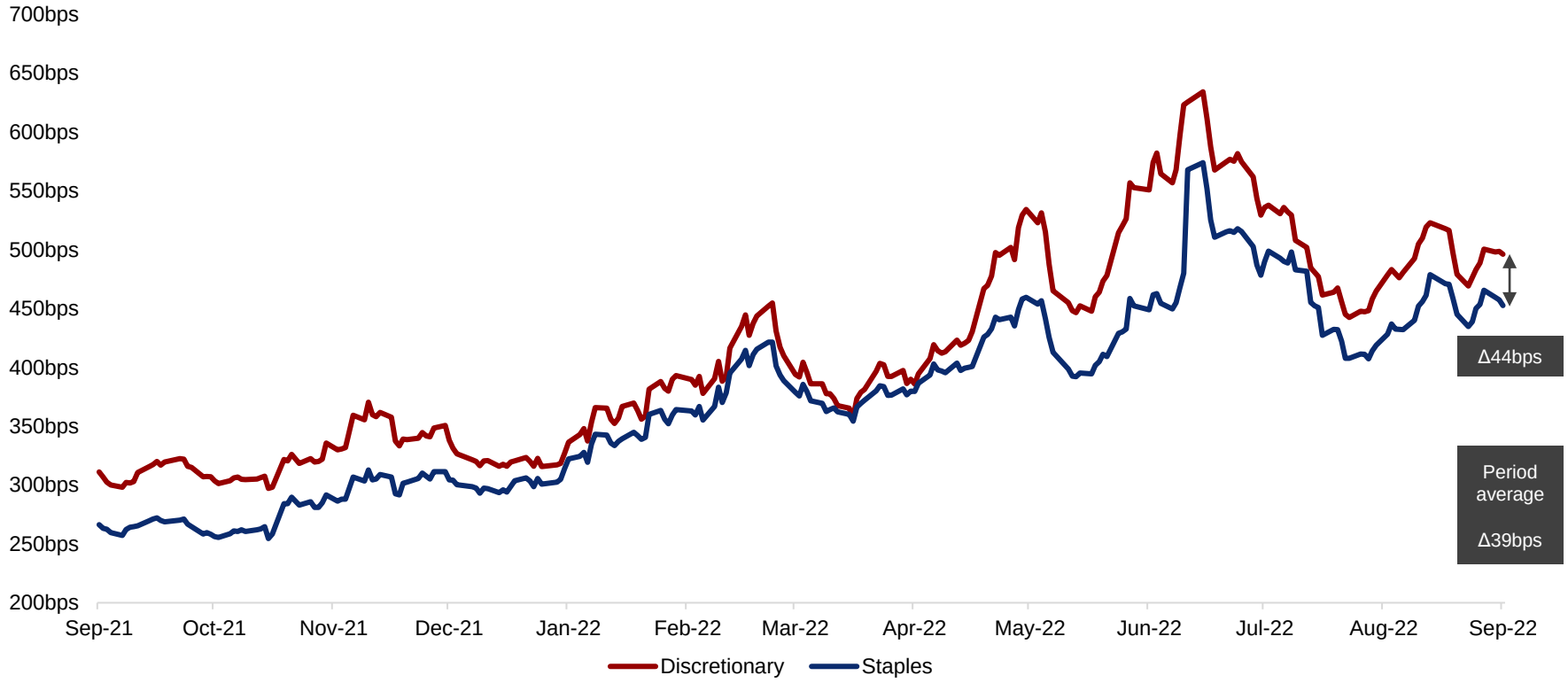
Driving Factors

1. Pandemic savings have disproportionally benefited high-income brackets, who claim an outsized portion of non-discretionary purchases
2. Dwindling savings rate and highly levered households points to an incoming trade-down in consumer demand
3. Management teams are increasingly wary of persistent inflation, which is reflected in shifts in price positioning for CPGs

Source(s): Bloomberg, Broker Reports

Sector Overview – Credit Fundamentals

Consumer Discretionary vs Consumer Staples Relative LTM Spread Performance – High Yield



Driving Factors	
4.	Latest slowdown in spending driven by a pivot away from goods and towards services
5.	The hospitality and tourism industry has yet to recover to same-period pre-pandemic projections
6.	Higher production costs that firms selling discretionary products may not necessarily pass through

Source(s): Bloomberg, Broker Reports

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Honours in Investment Management

Appendix

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Gestion de capitaux

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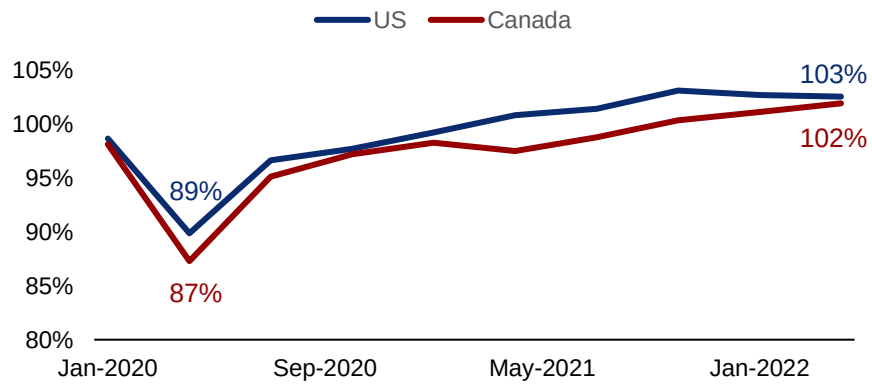
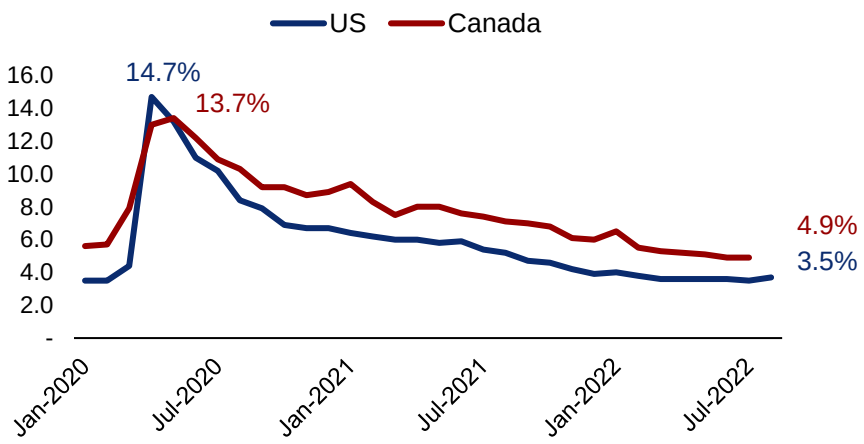
Economic Reality – Relative Growth

Despite Stronger Growth and Employment Recovery, US' Participation Rate Has Stalled

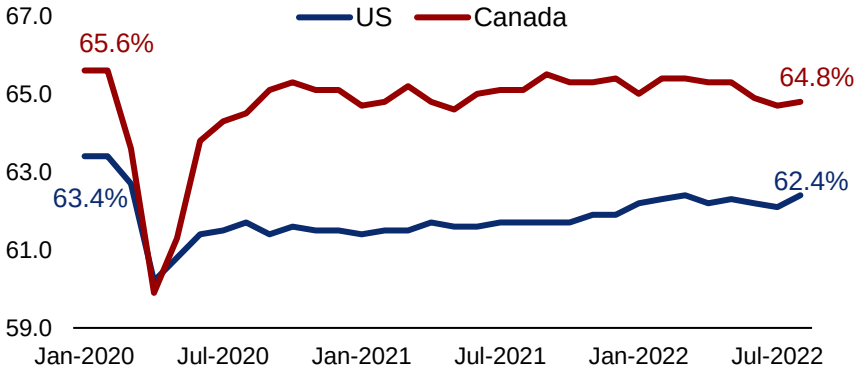
GDP – US and Canada Both Recovered to Pre-Pandemic Growth Levels in Mid'21



Unemployment Rate in US Has Recovered Faster than in Canada



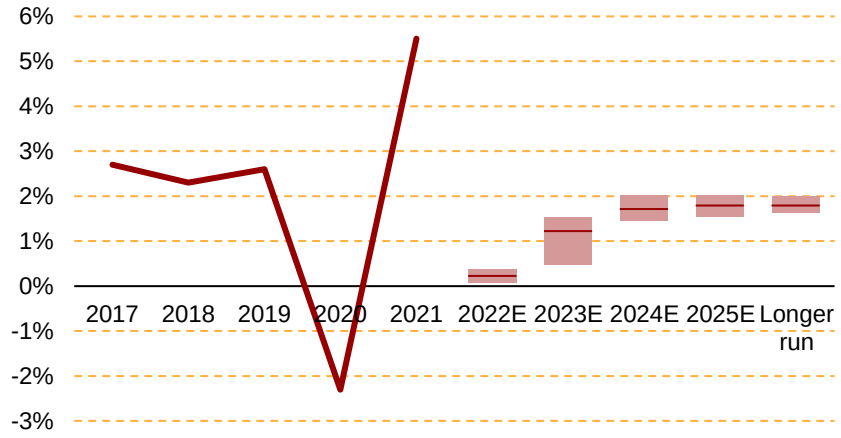
But Labor Force Participation Rate Reveals a Slightly Different Story (Skewed Unemployment Rate Calculation; US Still Lower)



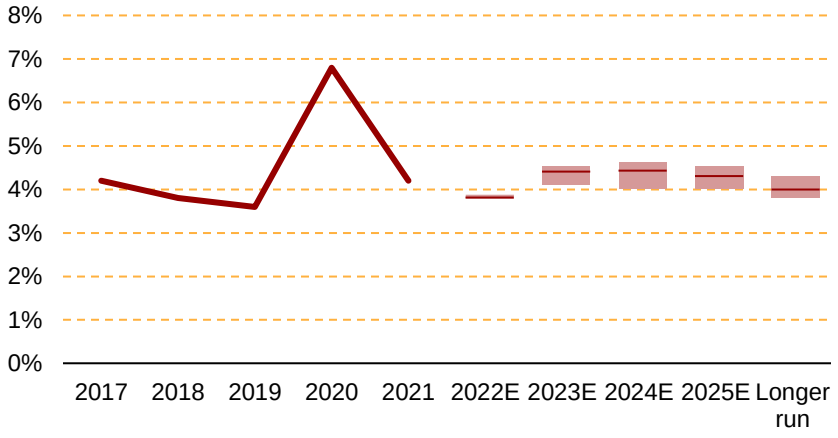
Source: JPM Research, St. Louis Fred, Bureau of Labor Statistics, Statistics Canada

Fed Economic Projections

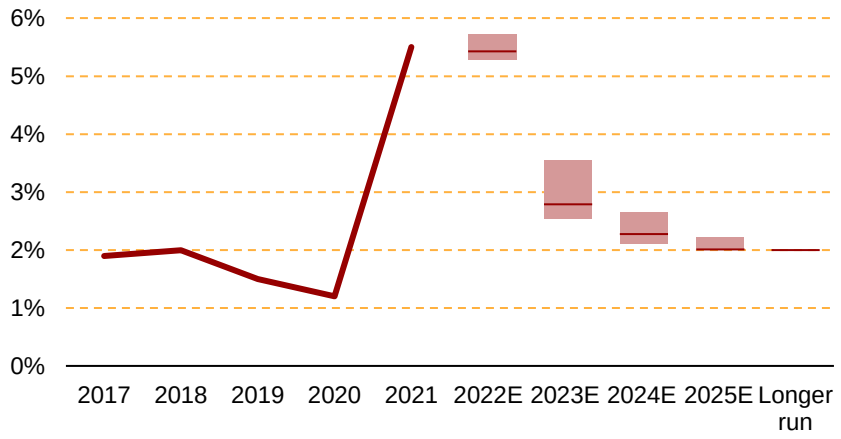
GDP



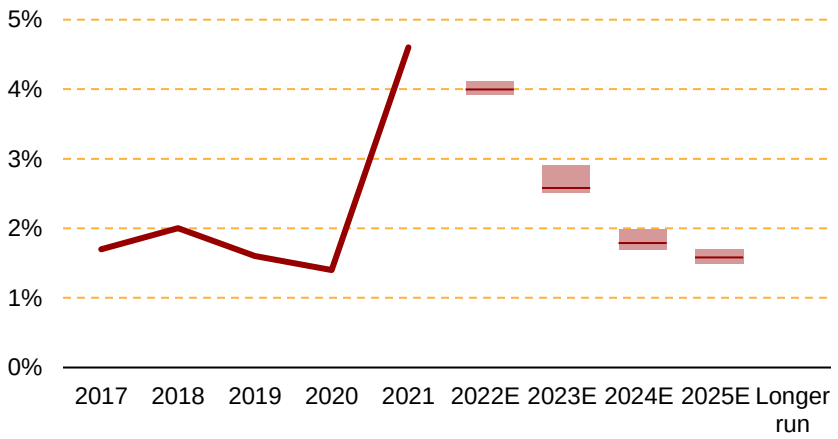
Unemployment



PCE

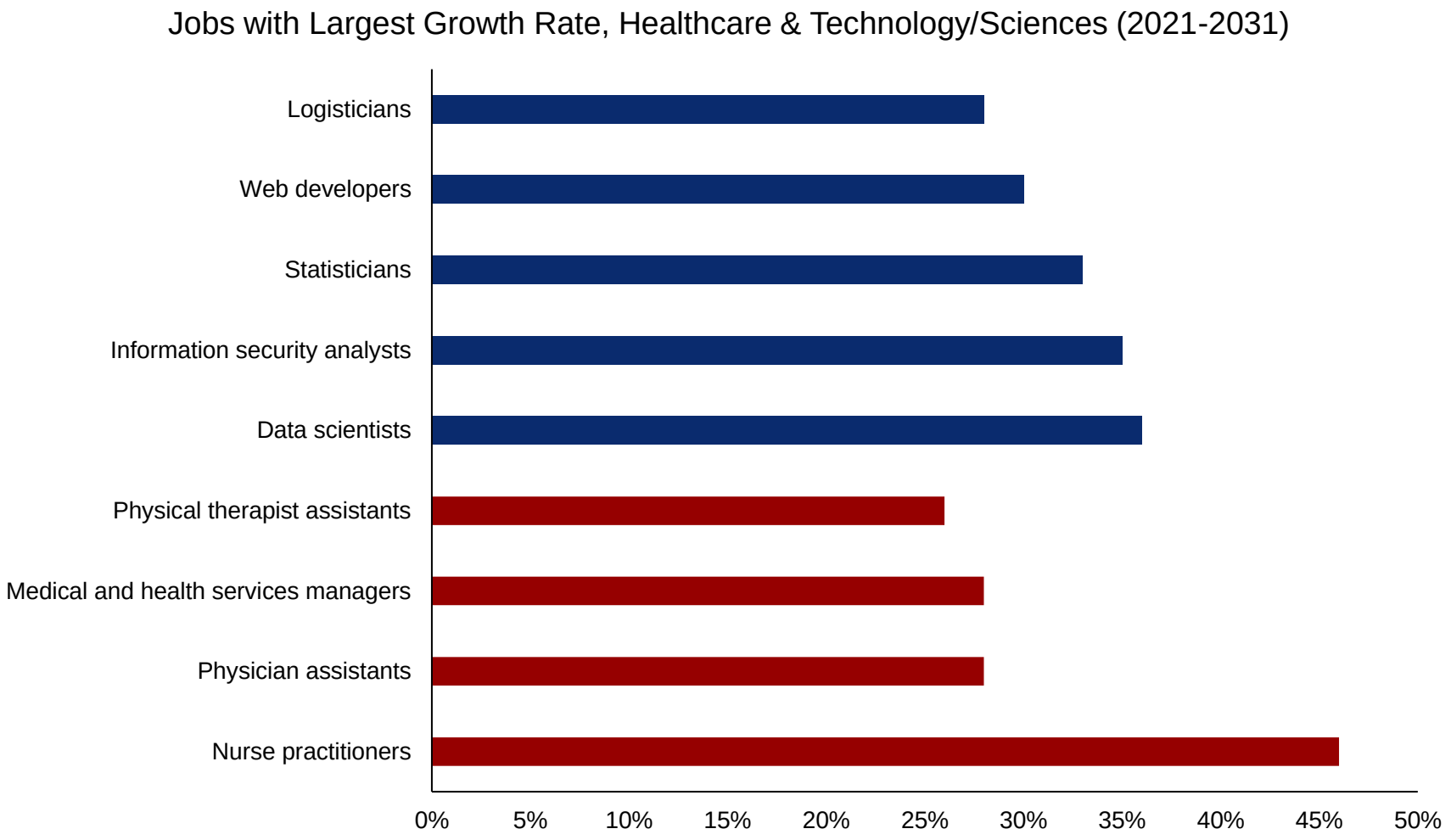


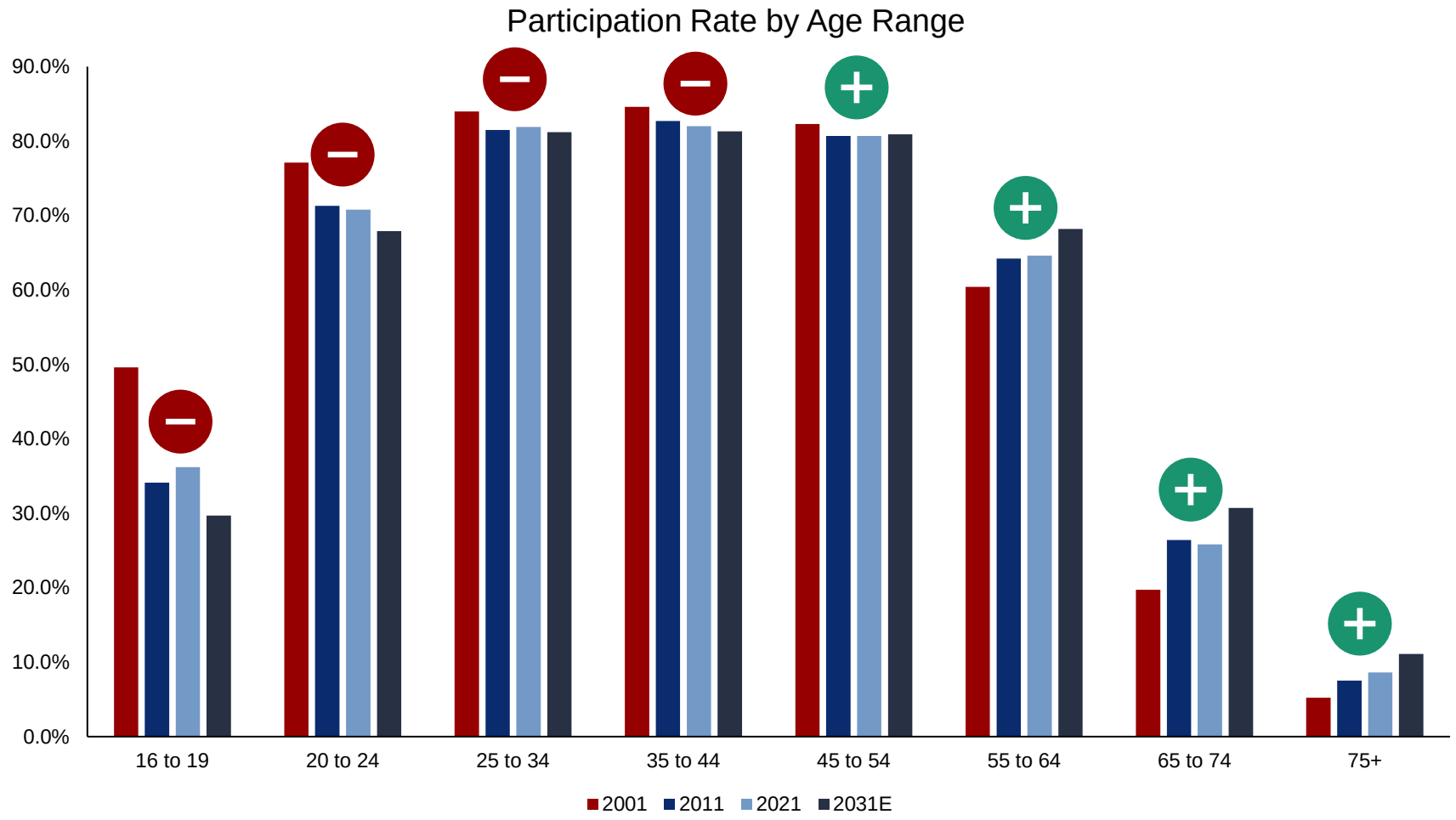
Core PCE

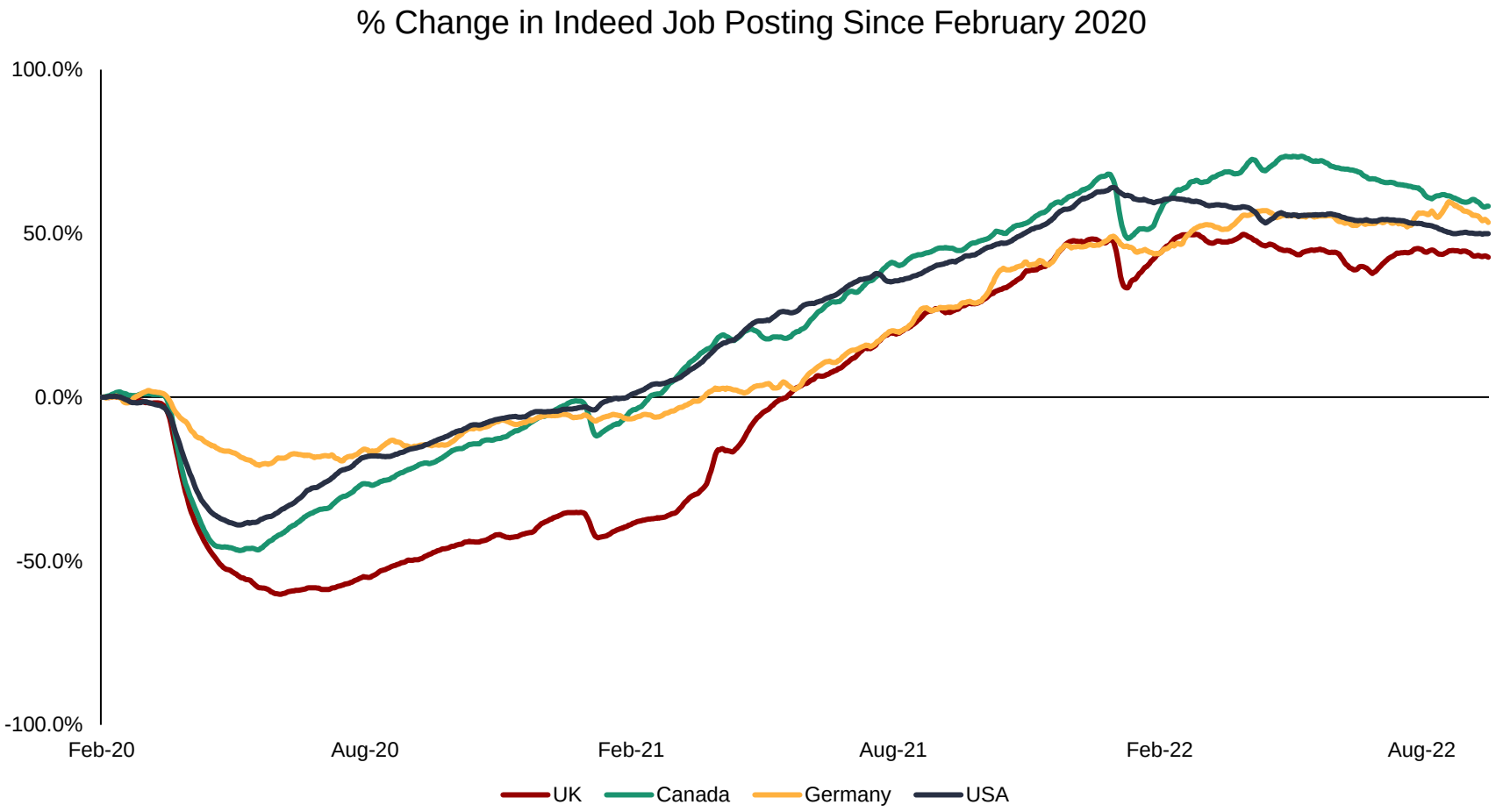


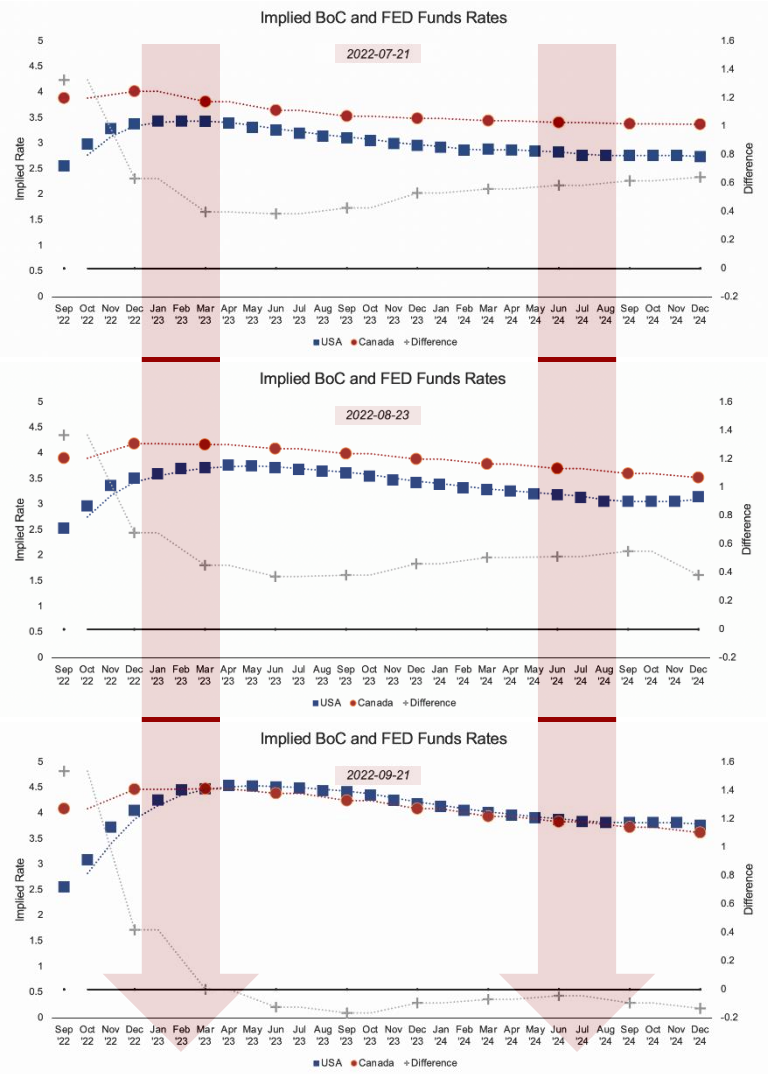
Labour Force Overview

The largest growing industries will be tech/sciences & healthcare




Participation Rate by Age Range
90.0%
80.0%
70.0%
60.0%
50.0%
40.0%
30.0%
20.0%
10.0%
0.0%
16 to 19
20 to 24
25 to 34
35 to 44
45 to 54
55 to 64
65 to 74
75+
2001
2011
2021
2031E

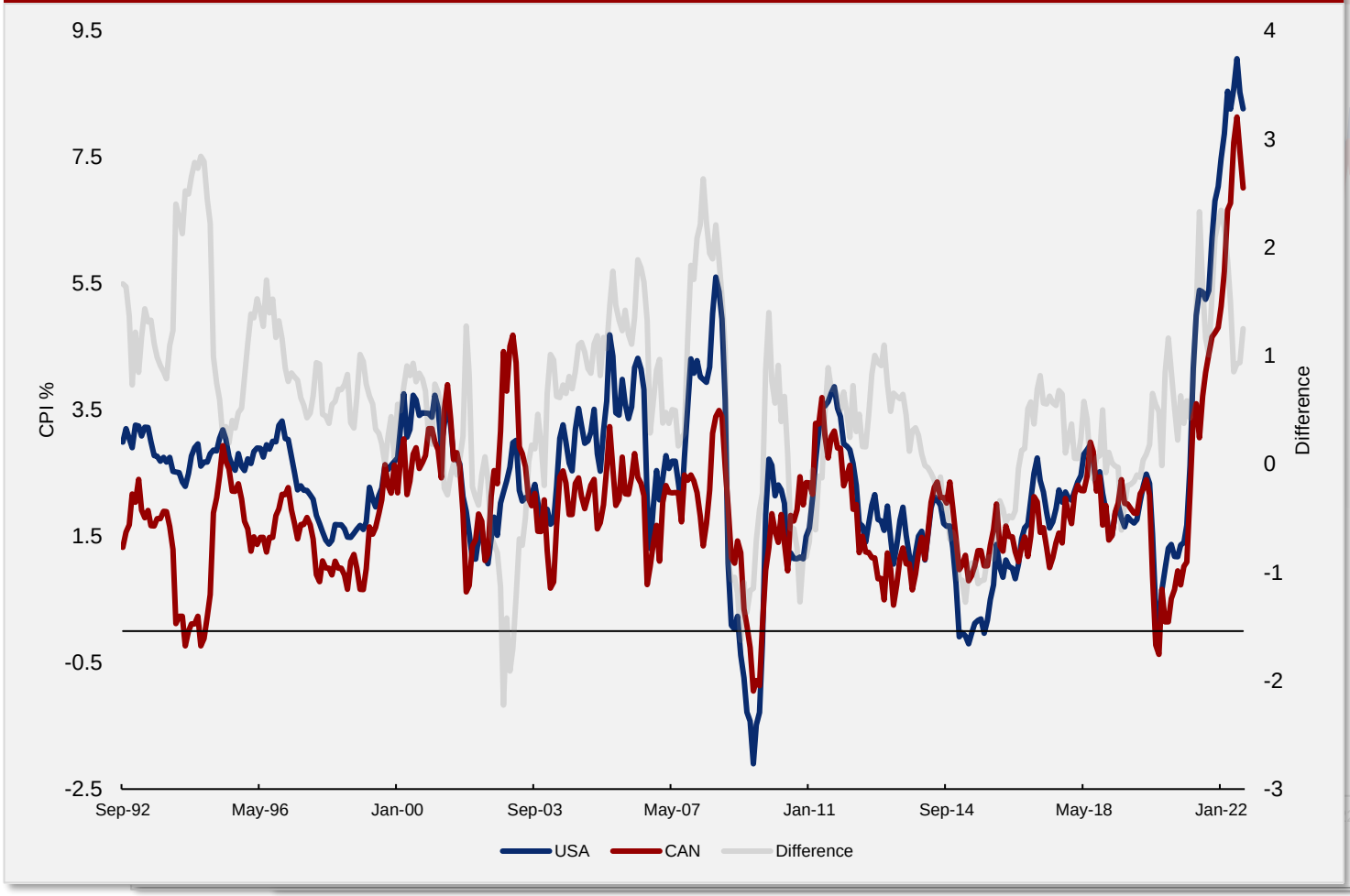

% Change in Indeed Job Posting Since February 2020
100.0%
50.0%
0.0%
-50.0%
-100.0%
Feb-20
Aug-20
Feb-21
Aug-21
Feb-22
Aug-22
UK
Canada
Germany
USA



Market expectations of the FED have continued climbing and they are now expected to have higher rates in the medium term.

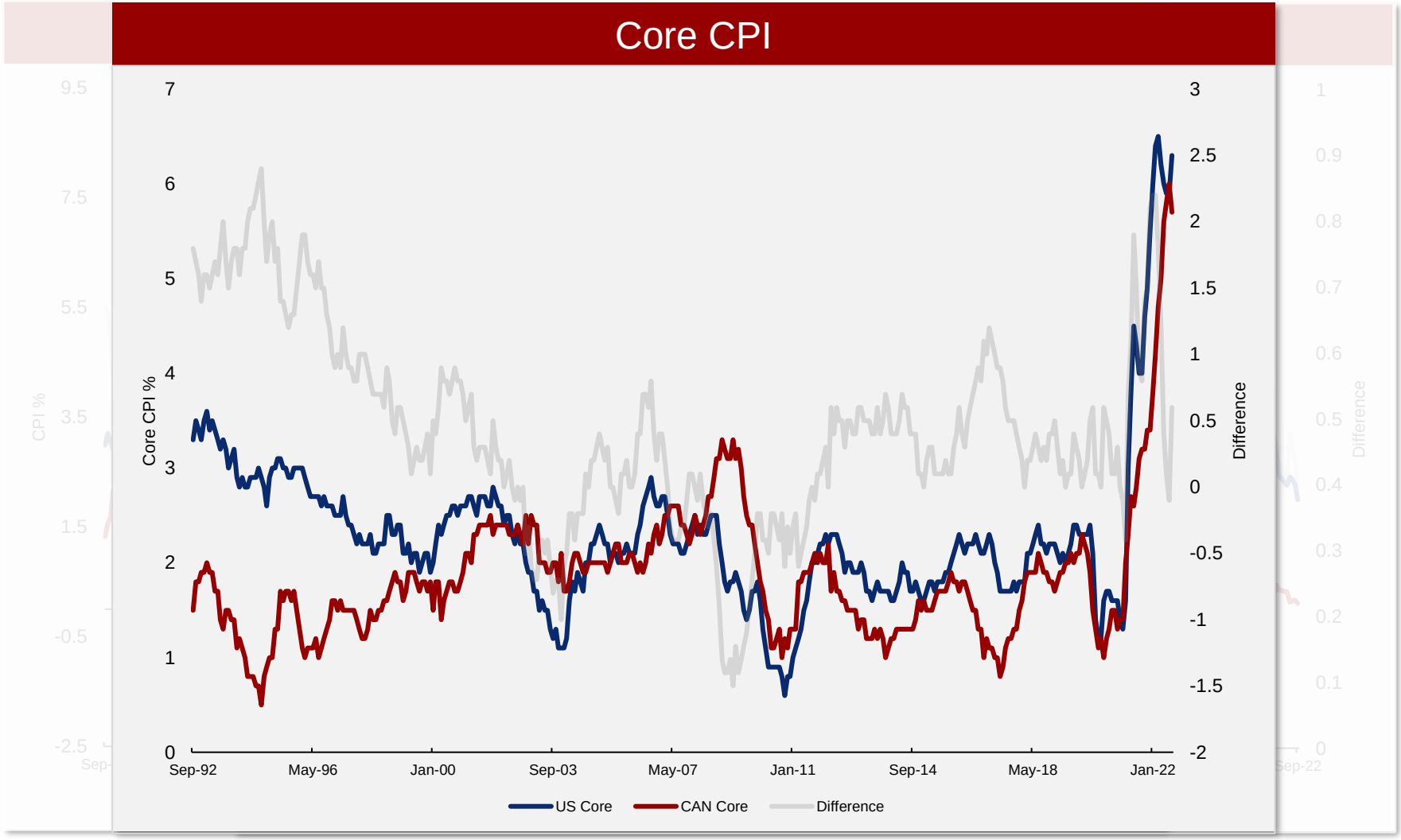
Bloomberg

CPI



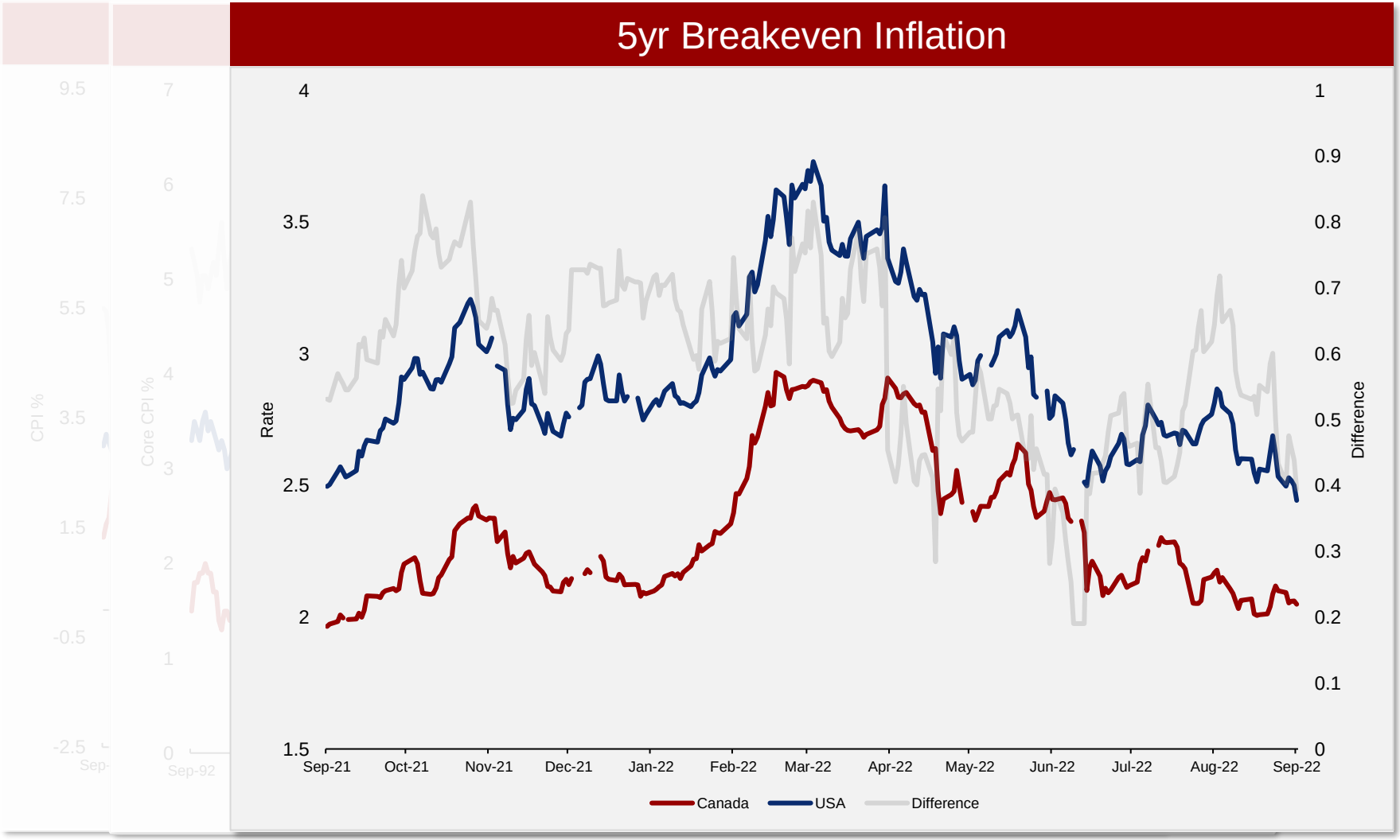
Bloomberg

Core CPI



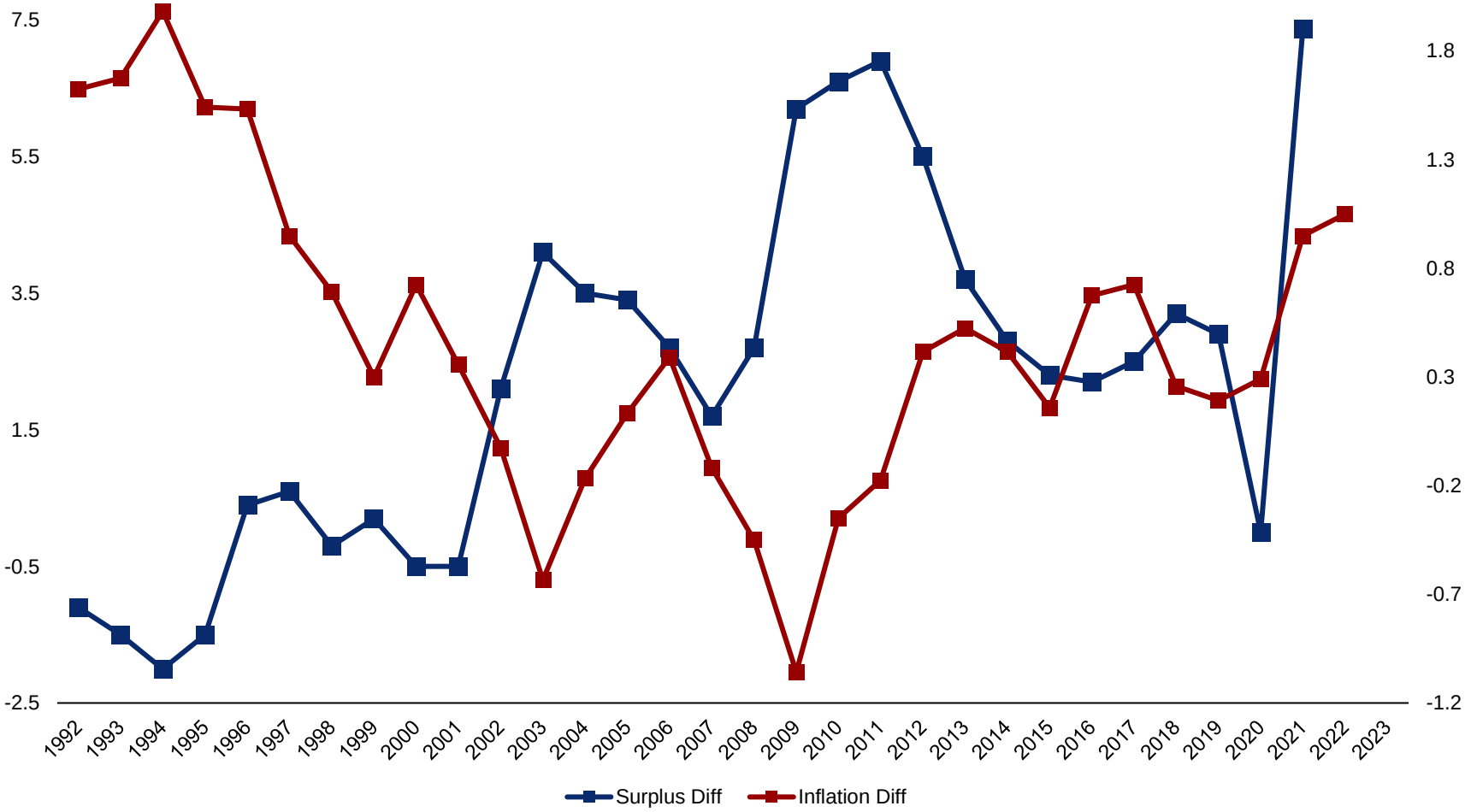
Bloomberg

5yr Breakeven Inflation



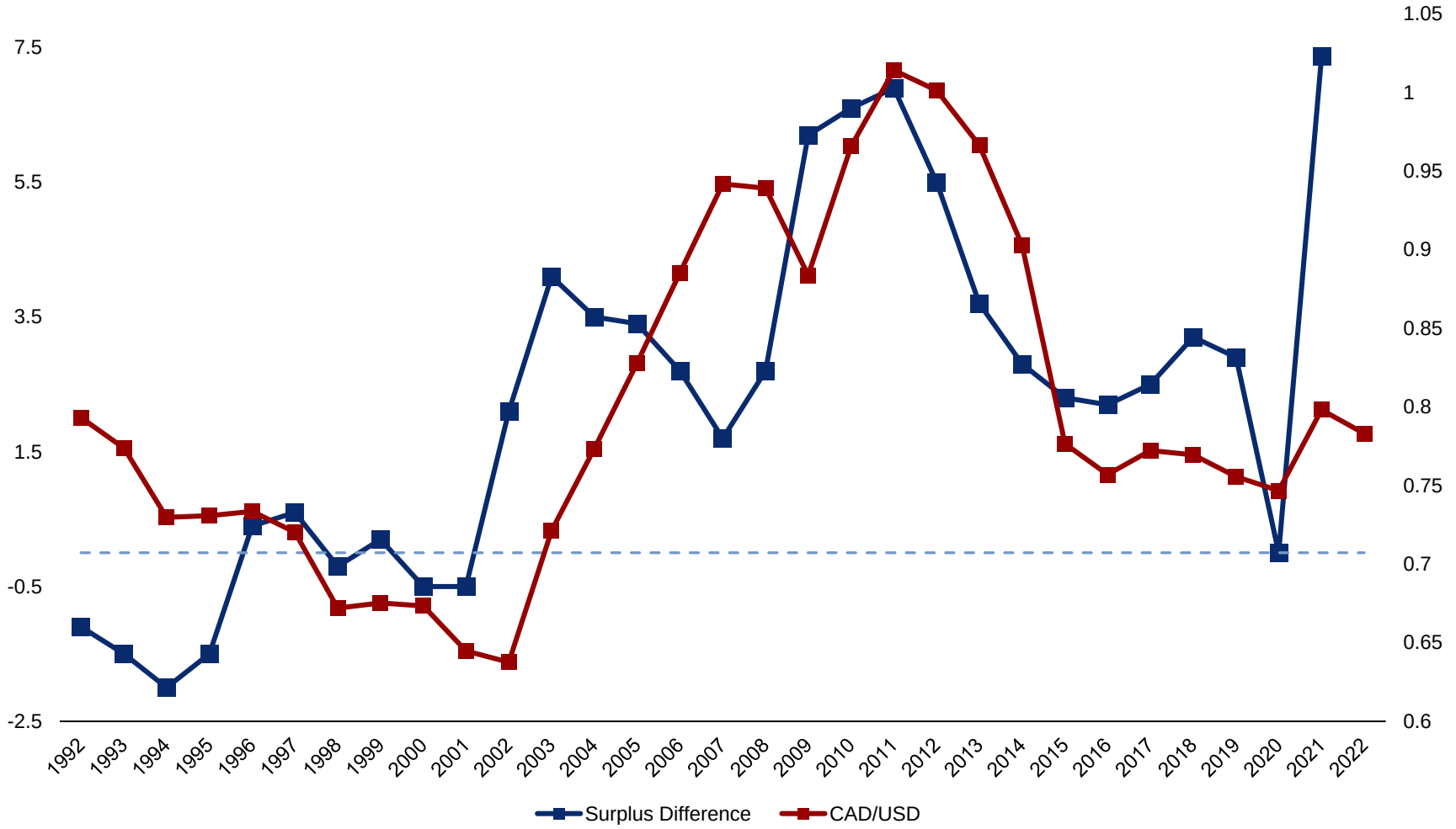
Bloomberg

CAN/USA Surplus Differential vs Inflation Differential



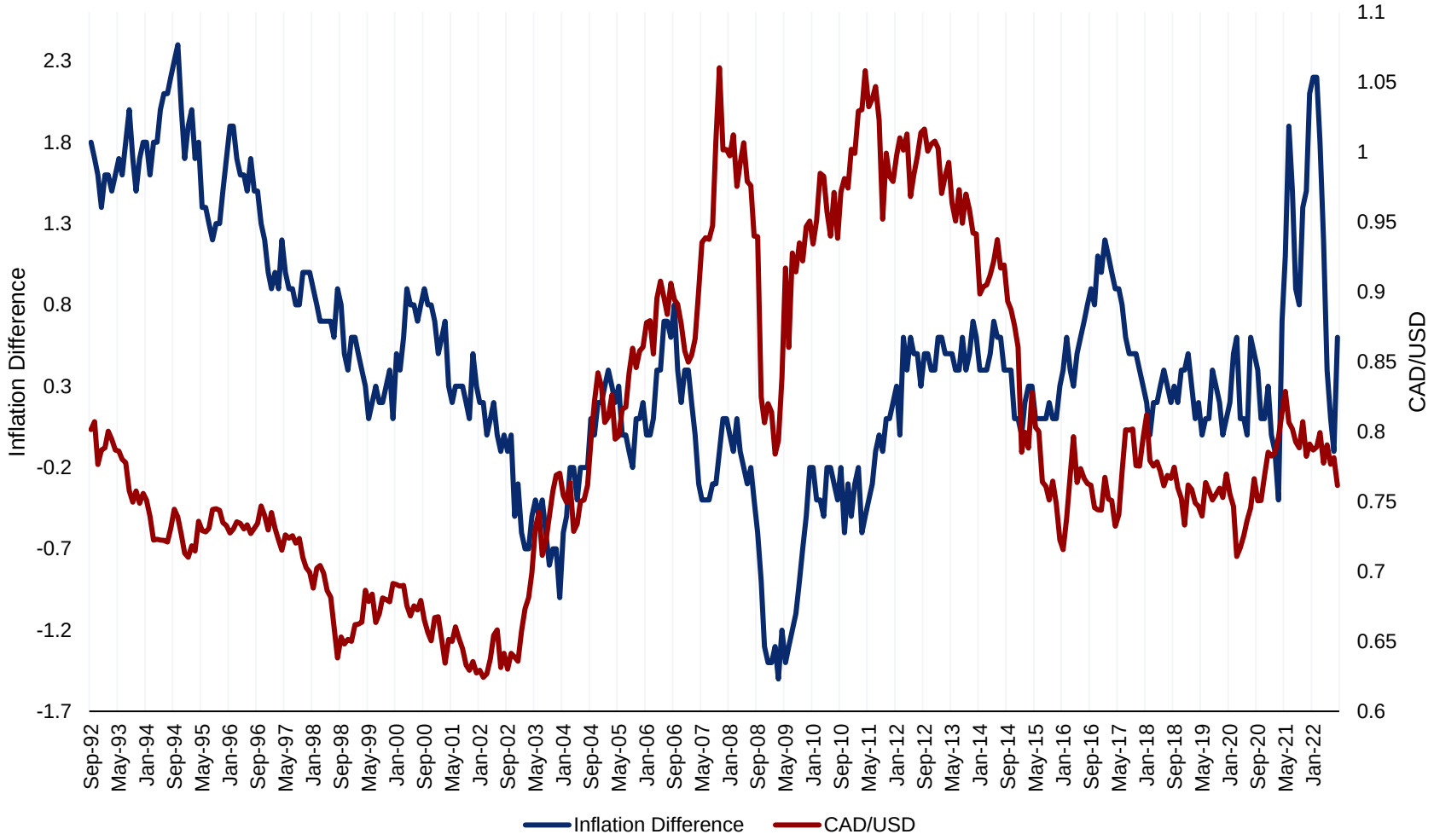
American Presidency Project, The Fiscal Monitor, Bloomberg

Surplus Differences vs CAD/USD



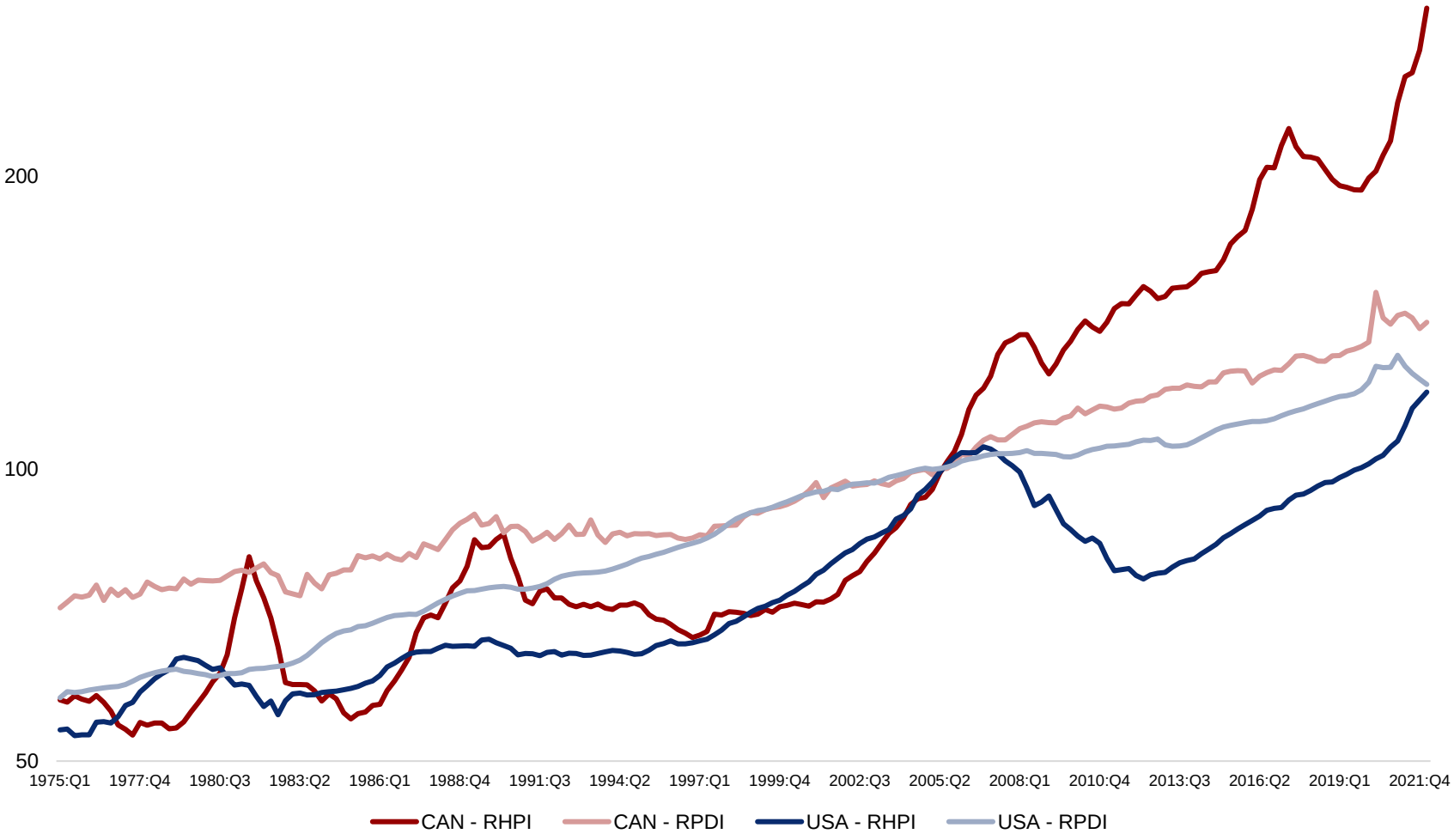
American Presidency Project, The Fiscal Monitor, Bloomberg

CAN/USA Core Inflation Difference Compared to CAD/USD



Bloomberg

Real Housing Prices vs Real Disposable Income in USA and Canada



Dallas FED

BBB / Inflation Reduction Act

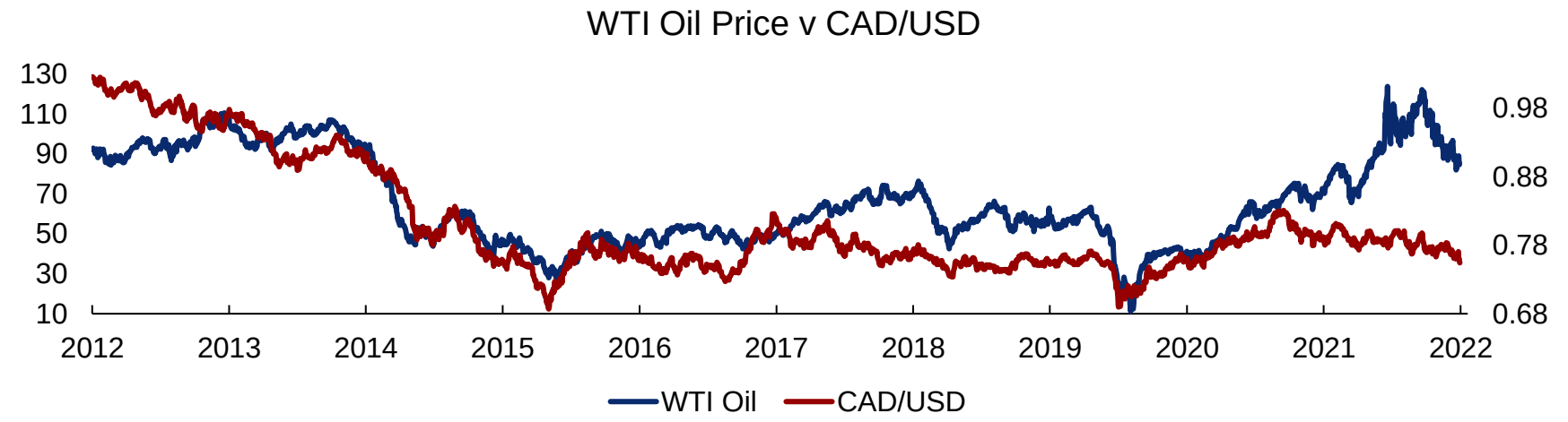
Aside:
Infrastructure Investment and Jobs Act
-> $550B on infrastructure spending
•$110 billion for roads, bridges, and major projects.
•$66 billion for passenger and freight rail.
•$11 billion for transportation safety.
•$39 billion for public transit.
•$17 billion for ports and waterways.
•$25 billion for airports.
•$7.5 billion for clean school buses and ferries.
•$7.5 billion for electric vehicle charging.
•$1 billion to reconnect communities, including funds for projects that remove barriers to opportunity caused by legacy infrastructure.

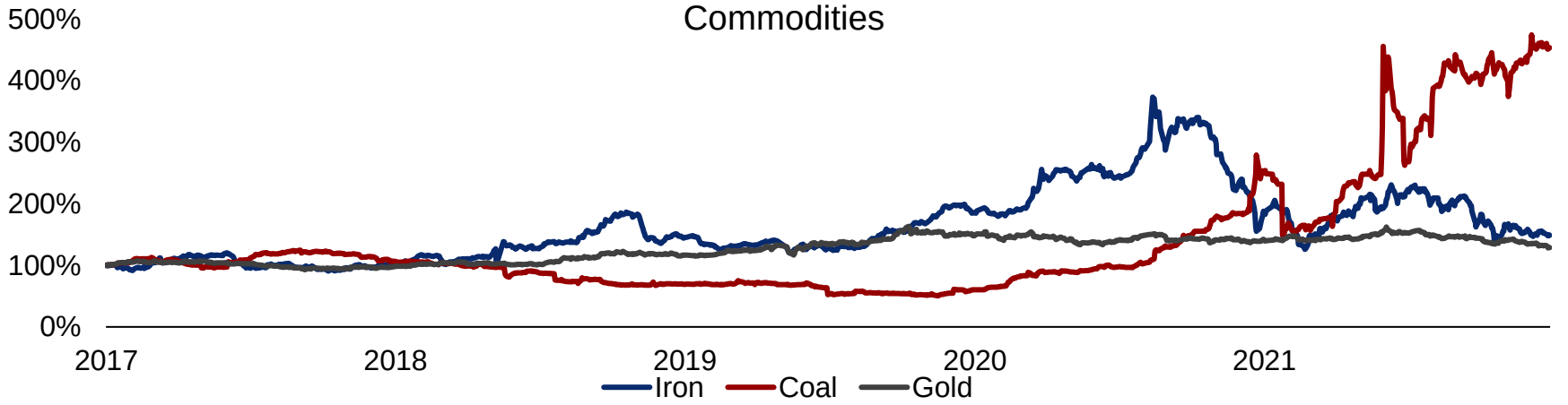
•$23.4 billion for Clean Water State Revolving Fund (SRF) and the Safe Drinking Water SRF programs
•$15 billion for lead service line replacement.
•$10 billion to address Per- and Polyfluoroalkyl Substances (PFAS).
•$3.5 billion to support water infrastructure in Tribal communities.

Expectation:
Raise $737B
Spend $437B
Save deficit $300B

Amount	Source
	REVENUE
$222 billion	15% corporate minimum tax *
$265 billion	Prescription drug pricing reform **
$124 billion	Enhanced IRS tax enforcement **
$74 billion	1% stock buyback fee *
$52 billion	Loss limitation extension *
$737 billion	**Total revenue raised**
	INVESTMENTS
$369 billion	Energy security and climate change investment ***
$64 billion	Affordable Care Act extension **
$4 billion	Western drought resiliency ***
$437 billion	**Total investments**
$300+ BILLION	**TOTAL DEFICIT REDUCTION**

Penn Wharton Budget Model suggests inflation reduction will be indistinguishable from 0


WTI Oil Price v CAD/USD
130
110
90
70
50
30
10
0.98
0.88
0.78
0.68
2012
2013
2014
2015
2016
2017
2018
2019
2020
2021
2022
WTI Oil
CAD/USD


Commodities
500%
400%
300%
200%
100%
0%
2017
2018
2019
2020
2021
Iron
Coal
Gold

Bloomberg