MFA Pooled Investment Fund Quarterly Market Update

Q1 2022

Municipal Finance Authority of BC

MFA Pooled Investment Fund Quarterly Market Update

As of March 31, 2022

Interest Rates

The strong economic recovery continued over the quarter with the pandemic-induced economic slack now fully absorbed. Given the surge in cases caused by the Omicron variant and the accompanying public health related restrictions largely behind us, the growth outlook has also improved. Inflation over the quarter remained elevated, as supply chain constraints have proved to be more persistent than previously expected by central banks while also feeding through to a broader range of goods and services. Additionally, the increase in commodity prices as a result of the Russian invasion of Ukraine has further contributed to inflationary pressures. With the above in mind, the Bank of Canada (BoC) continued its shift toward a less accommodative stance over the quarter. They began increasing the policy rate in March and communicated that further increases will be needed moving forward to battle inflationary pressures. These rate increases will be accompanied by an end to the bank's government bond purchase program. This is expected to be passive in nature, allowing the BoC's balance sheet to shrink as bonds mature. Bond yields did not change much on this announcement, but we expect that over time this will increase the amount of government debt the market will have to absorb, which will put upward pressure on GoC bond yields. Against this backdrop, GoC bond yields rose sharply over the quarter alongside heightened volatility. Short-term yields rose to a greater extent than long-term yields, as they have a higher sensitivity to future BoC policy rate hike expectations. Overall, the result is a meaningful flattening of the GoC yield curve.

Looking forward, the bond market expects short-term yields to rise to a greater degree than long-term yields over the next year. This is driven largely by market expectations that the BoC will continue to increase policy rates from current accommodative levels. We believe that yields will continue to exhibit heightened volatility in the near term, as a multitude of factors influences the direction and magnitude of yield changes, particularly central bank monetary policy and the outcome of the Russia/Ukraine conflict. This volatility will provide opportunities for value added through active management.

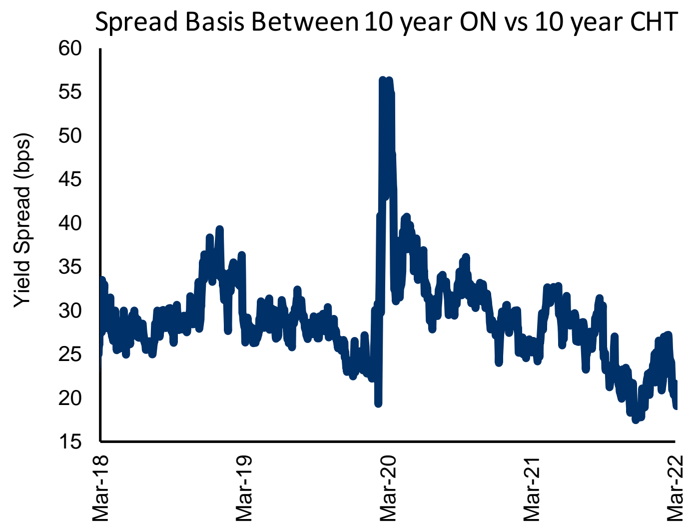
Real Return Bonds

The annual inflation rate, as measured by headline Consumer Price Index (CPI), accelerated to 5.7% in February, which is the highest level since August 1991. The Russian invasion of Ukraine is deeply troubling, injecting new uncertainties and putting upward pressure on commodity prices. This comes atop continued uncertainty about the evolution of COVID-19, even as the world makes its way out of the Omicron variant. Supply chain disruptions persist, distorting the price and availability of many goods. As a result, market consensus is for above-average inflation to continue over the short term.

During the quarter, the bond market's expectations for long-term inflation (estimated as the difference in yield between a nominal and a real return bond) increased before ending the quarter back where they began. Over the medium term, we believe inflation expectations are likely to continue moving higher, as they remain below the BoC's 2% midpoint target range, and therefore, the portfolio continues to have a small real return bond allocation.

Quasi-Government Bonds

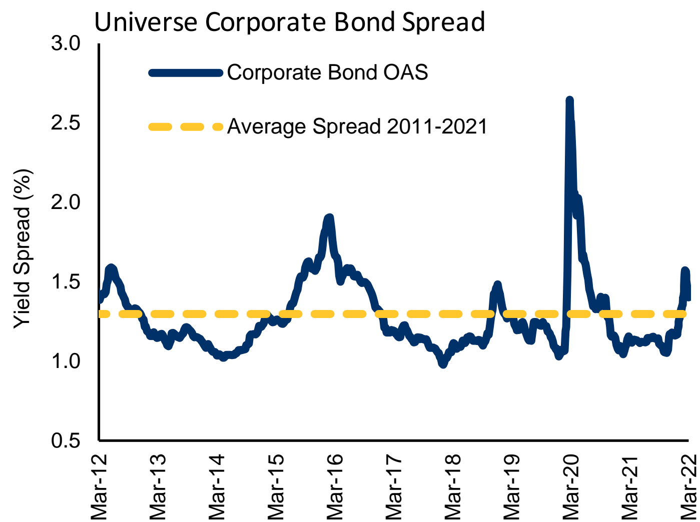
Alongside broader credit assets, provincial bonds weakened modestly on the back of waning investor risk appetite. Spreads widened across all provinces and terms, although to varying degrees. Unsurprisingly, commodity-sensitive provinces, such as Alberta, Saskatchewan, and Newfoundland, were the most resilient over the quarter, as they benefited from higher oil prices. New issuance slowed in the second half of Q1, as many provinces were hesitant to issue in an uneasy and volatile market environment. Additionally, provincial funding needs have declined as a result of stronger-than-expected revenues and lower-than-anticipated outlays throughout the pandemic, further reducing the need for significant new issuance. Looking forward, we expect the improved fiscal trajectory, coupled with a reduction in borrowing needs, to be supportive for provincial spreads.



Source: BMO Sapphire

Investment Grade Corporate Bonds

The corporate credit market was volatile during the first quarter, as concerns over the impact that soaring inflation and tighter monetary policy could have on economic growth remained fixtures of the market narrative. Russia's invasion of Ukraine in the last week of February exacerbated investors' uneasiness as commodity prices surged, sanctions were implemented and Russia threatened to default on its debt, which sent investors fleeing from risk assets. Despite the volatile rate and geopolitical backdrop, investment grade corporate bond issuance was still robust in the first quarter with approximately $46 billion of new supply coming to market, up 43% from the same period in 2021 as businesses continued to take advantage of still-accommodative financing conditions. However, the market's ability to absorb the new supply waned as a result of the increased uncertainty, which pushed broad Canadian corporate bond spreads approximately 25bps wider over the quarter, with higher-quality credit faring better than lower-quality credit.



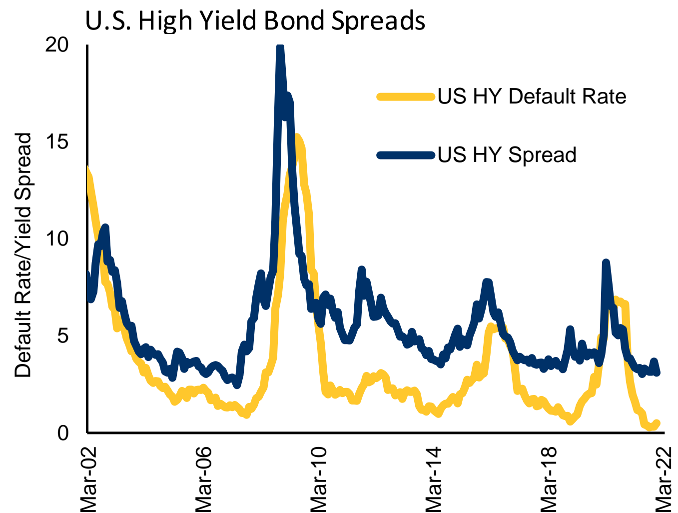
Source: FTSE Global Debt Capital Markets Inc.

From a fundamental standpoint, we remain concerned about increasing debt levels in the Canadian economy among consumers and corporations. Canadian household debt levels are at record levels, largely due to the hot housing market, which has driven more mortgage borrowing. Mortgage debt rose another $44 billion in Q4/2021 and is up over $300 billion from pre-pandemic levels. This, along with a lowering of disposable incomes as government pandemic supports continued to ease, pushed the debt-to-disposable-income ratio to a

new record of 186% in Q4 – up 6% from the previous quarter. On the corporate side, a meaningful concern remains the elevated merger and acquisition activity funded by debt as ambitious businesses pursue growth.

High Yield Corporate Bonds

Like most asset classes over the quarter, high yield bonds posted negative returns in the face of rising interest rates and a deterioration in risk appetite. Rising rates had the largest impact, but its effect was more meaningful on government and investment grade corporate bonds due to their longer durations, while the shorter-duration nature of high yield bonds helped soften this impact. High yield spreads began widening from the beginning of the quarter on concerns of increasingly aggressive monetary policy to counteract inflationary pressures, and then widened further upon the Russian invasion of Ukraine. Spreads ended the quarter higher than where they began but below their February peak.



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

High yield issuance started at a healthy level this year but then quickly dried up as risk-off sentiment began to dominate. Investor demand waned in light of increasingly hawkish commentary from the U.S. Federal Reserve (Fed) and other central banks as well as the escalating conflict in Ukraine. Issuers grew concerned that deals would not be well received amid the uncertainty.

Corporations nonetheless continued to perform well over the quarter, with earnings mostly hitting or surpassing targets and management teams mostly optimistic in their outlooks despite valid and growing concerns about inflation levels. Oil prices of above $100/barrel are a double-edged sword for high yield markets – beneficial for oil and gas companies (historically one of the most susceptible sectors); but if oil prices rise too much, the inflationary and economic consequences can become detrimental. For now, high yield defaults are sparse and expected to remain at negligible levels over the remainder of 2022.

Mortgages

Commercial real estate investment activity continued its strong upward trajectory at the end of 2021 with full-year investment volumes reaching $59 billion nationally, a 67.7% increase from the prior year and an all-time high[1]. Notably, Q1 was the first quarter since the onset of the pandemic when all major sectors of the market experienced investment volume growth that exceeded their trailing 3-year quarterly averages[2]. This increased activity level was consistent with the experience in the commercial mortgage market, where 2021 was a record year for new mortgage origination as the demand to purchase new properties flowed through to demand for new mortgages. However, despite the high volume of new opportunities, the commercial mortgage landscape remained competitive. As a result of the sharp rise in government bond yields, the all-in coupons on new lending opportunities is expected to be higher in the coming quarters than what was witnessed through 2021. This will lead to greater yield accrual and is helpful to investors who are looking for assets to protect against the

---

[1] CBRE Investment Overview March 2022
[2] CBRE Investment Overview March 2022

current elevated inflation levels. In this environment, mortgage spreads ended the first quarter largely unchanged, but widened by 18 bps in the first week of April.

At this time, many large tenants are still evaluating their return-to-office policies and determining how their workforce will operate going forward before making long-term leasing decisions on their office space requirements. For now, it remains unclear how this will drive demand for physical office space as companies continue to experiment with hybrid work models. Sublet availability rates and direct vacancy rates, which had been increasing throughout the pandemic, appear to have stabilized, at least for the time being. Sublet availability decreased for the third consecutive quarter, while direct vacancy increased by only 0.1% to 12.7% nationally, with half of tracked markets either experiencing a quarter-over-quarter flattening or a decline in their vacancy rate[3]. Supporting the sector has been strong employment growth in Canada. Notably, a key growth driver for Canadian office leasing activity has been the technology and creative (gaming, visual effects, and media) sectors, which jointly accounted for 38.1% of all new leasing in 2021 – representing nearly as much as the next five industries combined[4].

Since the onset of Canada's mass vaccination program, a recovery in retail has been underway with pent-up consumer demand driving sales for retail businesses. As the existence and severity of government-imposed restrictions have abated, retail foot traffic and store-based retail sales numbers have both rebounded to pre-pandemic levels[5]. Retail fundamentals have also improved. Rental rates increased across all Canadian markets in 2021, while Canada's retail vacancy rate declined 1% year-over-year to 7.7% as of December 31, 2021, supported by strong leasing in open-air centres[6]. However, retailers are contending with supply chain difficulties, with many manufacturers facing long delays and rising costs for materials, and the current inflationary environment. Despite these headwinds, rent delinquencies remain low for both open air centres (1%) and enclosed malls (2%), with few retailers remaining on rent deferral programs across the market[7].

Increased immigration targets, the return of international students, the high costs of home ownership, and the undersupply of housing continue to provide support for the performance of purpose-built rental housing. In February, the Federal government announced the increased and successively higher immigration targets (permanent residents) for the next three years, which are the highest ever targeted in Canadian immigration history. Also released in February was CMHC's annual rental survey, which highlighted the affordability challenges facing Canadian tenants. The findings from the survey showed that national average apartment rents increased by 3% year-over-year to $1,167 last year from $1,128 in 2020 and $1,080 in 2019. Unsurprisingly, multi-residential lending opportunities continue to generate strong competition.

Canada's industrial sector continues to exhibit strong fundamentals, with national vacancy rates falling to a record low of 1.3% in the first quarter[8]. Availability challenges have been particularly acute in the warehouse space, where demand for fulfilment centres has outstripped supply in both primary and secondary markets. On a per-square foot basis, pricing for industrial assets now sits 20% higher than a year ago, effectively doubling in price at the national level since 2016[9]. A lot of investor capital has been focused on the industrial sector with investment volumes in 2021 representing a 35% increase over 2018, the next highest year on record[10]. Core markets like the GTA and Vancouver, have been witnessing transactions at capitalization rates below 4%. Given that we are in an inflationary environment, this implies that market participants are pricing in significant rental

---

[3] Colliers "National Market Snapshot 2022 Q1"
[4] CBRE "Canadian Real Estate Market Outlook 2022"
[5] CBRE "Canadian Real Estate Market Outlook 2022"
[6] Colliers "2022 Retail Outlook Report"
[7] Realpac Q4 2021 survey
[8] Colliers "National Market Snapshot 2022 Q1"
[9] JLL "Canada Investment Outlook – Year-end 2021"
[10] JLL "Canada Investment Outlook – Year-end 2021"

growth appreciation, which is supportive of greater net operating income for borrowers to make their mortgage payments.

We are encouraged by the strengthening cash flow stability of tenants following the recovery from the depths of the pandemic. While we continue to favour the stability and quality of the industrial and multi-residential sectors, we are actively pursuing opportunities in high-quality office and retail properties with strong fundamentals and returns commensurate with the risk.

Bond Market Outlook

All major fixed-income indices experienced losses in the latest quarter on account of bond yields increasing in all key markets as central banks begin to shift toward a less accommodative monetary policy to combat rising inflationary pressures. In addition, punitive sanctions on Russia have led to a rise in commodity prices, which will push inflation even higher and weigh on consumer confidence. From a geopolitical standpoint, there is a good chance that Russia's recent actions will cause long-lasting changes to the post-1989 world order. Financial markets are adjusting to reflect these heightened risks. Over the next 12 months the bond market expects yields to rise from current levels and prices already reflect these anticipated increases; we likewise expect yields to move moderately higher, but they will likely continue to exhibit some volatility in the near term.