MFA Pooled Investment Fund Quarterly Market Update

Q3 2021

Municipal Finance Authority of BC

MFA Pooled Investment Fund Quarterly Market Update

As of September 30, 2021

Interest Rates

The global economic recovery continued in the third quarter, albeit at a slower pace than what was witnessed in the first half of this year. Price pressures continued throughout the quarter as the global supply chains for many goods remain constrained. Accordingly, we saw elevated inflation data in Canada and the U.S. Both the Bank of Canada (BoC) and the U.S. Federal Reserve (Fed) continue to view these elevated readings as a temporary phenomenon and market implied inflation expectations have remained mostly consistent with that view over the quarter. With respect to yields, Government of Canada (GoC) bond yields declined for most of the quarter, before reversing course in late September after the Fed signalled that it would begin tapering its quantitative easing (QE) program later this year. This signal from the Fed along with additional details on the expected timeline for ending its QE program gave insight to the market on the possible timing of a normalization of policy rates. This resulted in a meaningful move higher for U.S. Treasury (UST) yields to finish the quarter. Although the BoC had already begun tapering its bond purchases and continued to reduce its purchase amounts over the quarter, GoC bond yields also rose sharply following the announcement and ended the quarter slightly higher than where they began the quarter as there is generally a high correlation between GoC yields and UST yields. This correlation is largely due to the similarities in investor motivations and strong trade relationships between the two economies.

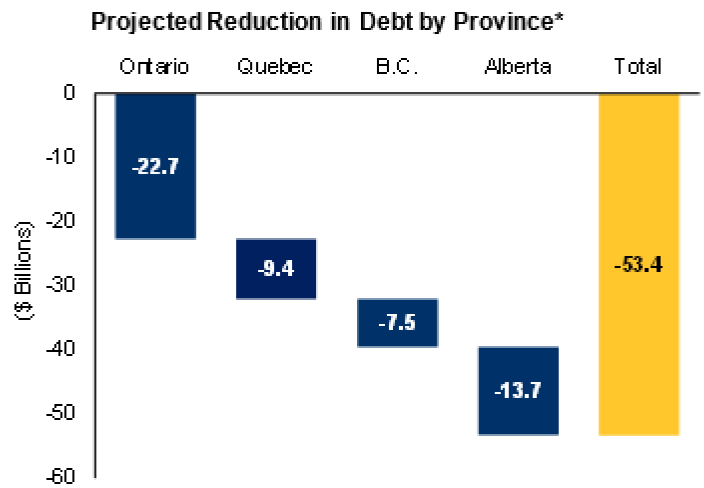
Looking forward, the bond market expects short-term yields to rise to a greater degree than long-term yields over the next year. This expectation reflects the possibility that the BoC will begin to gradually normalize policy rates from current ultra-accommodative levels as the economic outlook continues to improve. We believe yields may increase by more than what is currently priced in by the bond market, and that yields will likely exhibit modest volatility in the near term as a multitude of factors will influence the direction and magnitude of yield changes, particularly central bank monetary policy and the future path of the economic recovery. 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 at 4.1% in August, the fastest yearly pace since a brief spike in 2003 – exceeding the BoC's inflation range of 1–3% for the fifth consecutive month. This compares to eight consecutive months of inflation printing below 1% from March 2020 to October 2020. The BoC continues to view the higher inflation print to be mostly temporary due in large part to the confluence of several transitory factors. Market consensus is for above average inflation to persist over the short term driven by a combination of surging demand and supply chain disruptions. Despite headline CPI hovering above the BoC's 1–3% inflation range, the central bank will tolerate the higher inflation print for a period of time to offset the very low inflation levels experienced in 2020. In effect, this will allow the BoC to achieve an average inflation rate that is within its target range.

The bond market's expectations for long-term inflation (estimated as the difference in yield between a nominal and a real return bond) remained unchanged quarter over quarter at 1.7%, resulting in a neutral contribution from the portfolio's out-of-benchmark position in real return bonds. Market-implied long-term inflation expectations remain below the BoC's 2% midpoint target range. We believe inflation expectations are likely to move higher over the medium term.

Quasi-Government Bonds

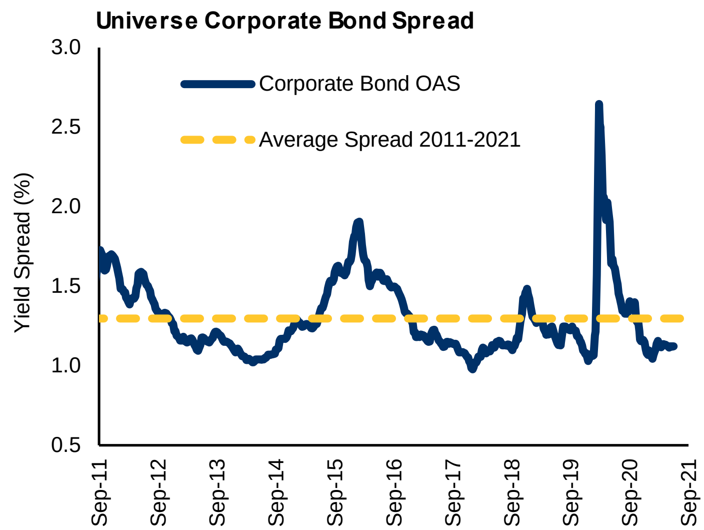


Source: National Bank
* Includes 2020-2021 and 2021-2022 fiscal revisions

The outlook for the provinces continued to improve as restrictions eased and economies reopened, which provided support and positive sentiment for the provincial bond market. As a result of the swifter-than- anticipated recovery, the largest provinces all revised their fiscal projections, erasing over $53 billion of forecasted debt from their budgets. The improved fiscal position has been driven by stronger-than-expected revenues, and lower-than-anticipated outlays. The full magnitude of these adjustments won't be known until updated budget revisions are released later this year, but the implication is that provincial bond issuance will likely slow in the fall and winter as borrowing needs decline, which will ultimately be supportive for provincial bond spreads. Against this backdrop, new issuance slowed in the third quarter to $21 billion, approximately half of the issuance size witnessed the prior quarter. The market easily digested the new supply, and provincial spreads remained broadly unchanged over the quarter.

Investment Grade Corporate Bonds

Corporate earnings remain robust alongside continued progression on the economic recovery front. During the third quarter, corporate issuers remained active in the primary market, bringing approximately $27 billion of new supply to market. Although this figure is below the $41 billion of new issuance witnessed last quarter, it is still well ahead of last year's Q3 pace as well as the long-term average. All deals remained well subscribed, as the new supply was met with healthy demand. While the primary market continued to be very active, the secondary market saw lower seasonal trading volume, which helped keep volatility at bay. Overall, investment grade corporate bond spreads were broadly unchanged over the quarter and remain at levels tighter than their long-term average.

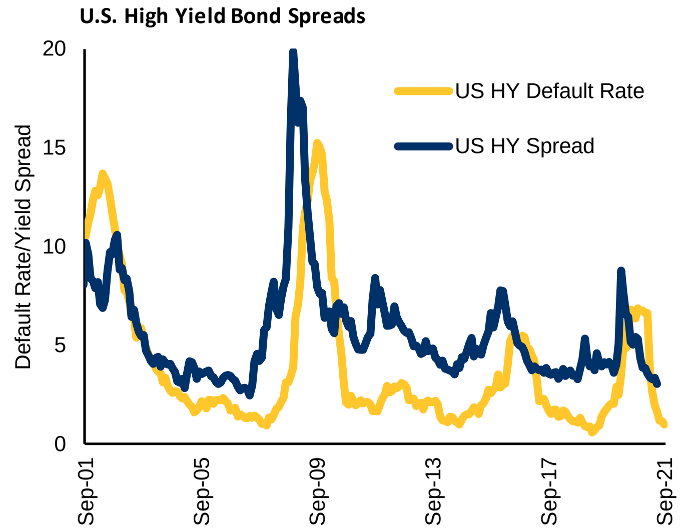


Source: FTSE Global Debt Capital Markets Inc.

From a fundamental standpoint, increasing debt levels in the Canadian economy among consumers and corporations remain a key concern. Canadian households' borrowing rate is far outpacing their income growth. Household debt-to-disposable-income reached 173% in Q2 2021 – up 0.3% from the previous quarter and 8.6% from the same quarter last year. However, consumers are still flush with cash and represent potential for both investment and re-opening spending sprees, a tailwind for risk assets. On the corporate side, the biggest potential headwind remains the elevated merger and acquisition activity funded by debt as ambitious businesses pursue growth.

High Yield Corporate Bonds

High yield bonds performed well in the third quarter in light of rising bond yields, outperforming both government bonds and investment grade credit. They once again contributed to portfolio performance, a trend that extends six consecutive quarters to the early days of the pandemic. Overall, high yield spreads traded in a very narrow range over the quarter and ended the quarter at 315 basis points, which is a similar level to where they began.



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

New issuance remains ahead of last year's record pace year-to-date as corporations continue to lock in historically low financing rates while they still can as the Fed approaches the beginning of its stimulus unwind this winter. The record issuance continues to be comfortably absorbed by yield-hungry investors, who have thus far kept the supply-demand balance in equilibrium. However, any easing of the pace of issuance could lead to further modest spread compression. New issuance proceeds continue to be used predominantly for refinancing higher-cost existing debt and general purposes, but more aggressive uses such as dividend payments and mergers and acquisitions, which were on pause much of last year, have continued to pick up over the last two quarters.

Corporate earnings in the third quarter were strong as economic activity continued along its recovery, although a late summer uptick in COVID cases had caused some concerns about the resilience of the recovery as we enter the winter months. Defaults among high yield issuers were once again almost negligible this quarter, resulting in the annual default rate falling to 1.1% in August. This is the lowest rate since 2007 and is the result of a combination of fiscal support, low interest rates, a recovering economy, and importantly, a default rate that peaked at 6.8% last fall and took out the weakest players. With oil prices now above $70/barrel and the remaining energy companies mostly out of trouble (the energy sector had been the largest contributor to defaults over the past year), it is possible that default rates remain at ultra-low levels into next year, so long as there isn't a meaningful surge in COVID cases.

Mortgages

Overall, the commercial mortgage lending environment remains competitive, as lenders continue to work through capital backlogs built up during the pandemic. Typically, increased investment activity in the commercial real estate market translates into more mortgage opportunities for lenders. Investment activity has built over the first half of 2021 and Canada broke its all-time record in the second quarter with non-M&A real estate investment volumes totalling $14 billion, an increase of 149.2% over 2020. This trend is driven by real estate owners with capital backlogs and favourable investment conditions, including very low interest rates. From a lending perspective, high-quality multi-residential and industrial opportunities continue to generate the most competition among lenders, leading to tighter spreads. As health restrictions continue to ease across most of Canada alongside the introduction of vaccine passport policies, expectations for returning to work and heightened retail spending are giving lenders more confidence to seek opportunities in these segments of the market. In this environment, mortgage spreads tightened 10 bps over the quarter.

As expected, industrial and multi-residential assets continued to perform well across the country, as the macroeconomic factors remain positive. The pandemic-induced supply chain disruptions and growth of e-commerce has resulted in record demand for distribution and logistics warehouses. At a national level, vacancy within the industrial market remains very low at 2% and rental growth has been exceptionally strong, rising 34.5% over the past 3 years1. In this environment, tenant quality and their ability to sustain higher rents on lease renewal become more important when considering new opportunities.

Multi-residential has been favoured by both lenders and real estate investors. Spreads on new multi-residential mortgages have been consistently pricing 5–10bps tighter than other core sectors and properties are attracting high valuations with capitalization rates below 3% for apartment buildings in Toronto and Vancouver[1]. Market fundamentals for the sector have shown signs of recovery with rents in Canada rising year-to-date and investment sales in the sector on pace to challenge 2020's record year despite rent freezes and rising vacancy experienced during the pandemic. We vacancy rates to compress as in-person work and learning resumes, and the Federal government's heightened immigration targets take effect. We also expect the tapering of incentives such as free rent periods to improve rental growth in the market. Taken together, we believe the sector is well-positioned and we remain optimistic on the long-term outlook for multi-residential apartment housing.

While uncertainty remains, the outlook for the commercial office sector has improved as vaccination campaigns have accelerated and lockdown restrictions have been lifted across much of the country. In prior quarters, lenders were focused on more resilient sectors of the real estate and commercial mortgage markets as uncertainty about the long-term impact of the COVID-19 pandemic remained the dominant theme. While lockdown measures have been rolled back and in-person shopping has resumed, we believe there are challenges ahead, and the removal of stimulus could pose a challenge to the sector's recovery.

Investing in mortgages should be viewed over a longer investment horizon given the inherent illiquidity of private markets. A majority of commercial real estate value is derived from the long-term income generated by these assets. While competition in the commercial mortgage lending market has put downward pressure on spreads, we continue to see attractive opportunities on a risk-adjusted basis. We remain focused on opportunities within the multi-residential and industrial sectors but are open to all opportunities where reward-for-risk remains attractive.

Bond Market Outlook

Despite a slowdown in global economic growth relative to the breakneck pace of the past 16 months, economies continued to recover in the most recent period, and looking ahead, growth is forecasted at nearly 4% in many developed countries. In addition, concerns surrounding elevated inflation continue to be top of mind for bond investors, as inflation in both Canada and the U.S. is at its highest levels in over a decade. While we don't expect the underlying pressures to vanish overnight, the majority of the inflationary pressures and economic growth have largely been priced into the bond market, so there is little impetus for yields to rise significantly from here. As such, over the next 12 months the bond market expects yields to rise modestly; we also agree that yields will move higher and likely at a moderate and gradual pace.

[1] CBRE Office and Industrial Quarter Stats Q3 2021