MFA Pooled Investment Fund Quarterly Market Update

Q4 2021

Municipal Finance Authority of BC

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As of December 31, 2021

Interest Rates

The global economic recovery continued over the fourth quarter, though some headwinds have begun to develop that may adversely impact the economic outlook. The emergence of the new COVID-19 variant, Omicron, has led to greater uncertainty surrounding growth, although the economic impact will depend largely on the actions taken by governments to battle rising case rates. Further, we continued to see high inflation data over the quarter as supply chain constraints remained a factor for many goods. In response to these price pressures and the continued strong economic performance, we saw a shift in central bank communications globally, signalling that a less accommodative monetary policy stance is closer than previously expected. As such, Government of Canada (GoC) bond yields experienced heightened volatility over the quarter, with short-term yields rising meaningfully following a shift in forward guidance from the Bank of Canada (BoC) in late October. This accelerated market expectations for when the BoC would begin to increase its policy rate, as well as the pace of policy rate increases thereafter. Long-term yields were fairly stable for most of the quarter until the emergence of Omicron, which led to a risk-off tone and resulted in a modest decrease in long-term yields to end the quarter.

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 largely driven by market expectations that the BoC will begin to normalize policy rates from current ultra-accommodative levels as early as the second quarter of 2022. 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 future path of the economic recovery. This volatility will provide opportunities for value added through active management.

Real Return Bonds

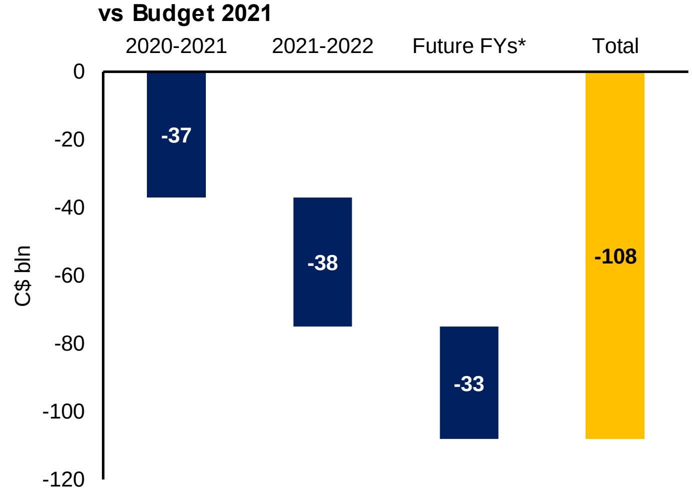
The annual inflation rate, as measured by headline Consumer Price Index (CPI), accelerated to 4.7% in November, marking its highest level since a brief spike in 2003 and exceeding the BoC's upper inflation range of 1–3% for the eighth consecutive month. Market consensus is for above average inflation 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 upper inflation range, the central bank thus far has tolerated the higher inflation print in an effort to offset the very low inflation levels experienced in 2020. In effect, this will allow the BoC to achieve an average inflation rate within its target range.

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) rose to levels not seen since 2015. Subsequently, inflation expectations reversed course, but managed to end the quarter 0.1% higher than 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.

Quasi-Government Bonds

Canada's largest provinces benefitted from a reduction to their fiscal debt projections, driven by stronger-than-expected revenues and lower-than-anticipated outlays, erasing over $38 billion of forecasted debt from their fiscal budgets. On the back of declining funding needs, provincial new issuance slowed in the fourth quarter to $14 billion compared to an average of $30 billion in the first three quarters of the year. The market easily digested the modest amount of new supply, and provincial spreads remained broadly unchanged over the quarter. Looking forward, the improved fiscal trajectory, coupled with a reduction in borrowing needs, should remain supportive for provincial spreads.

Net Improvement in Provincial Budget Balances vs Budget 2021

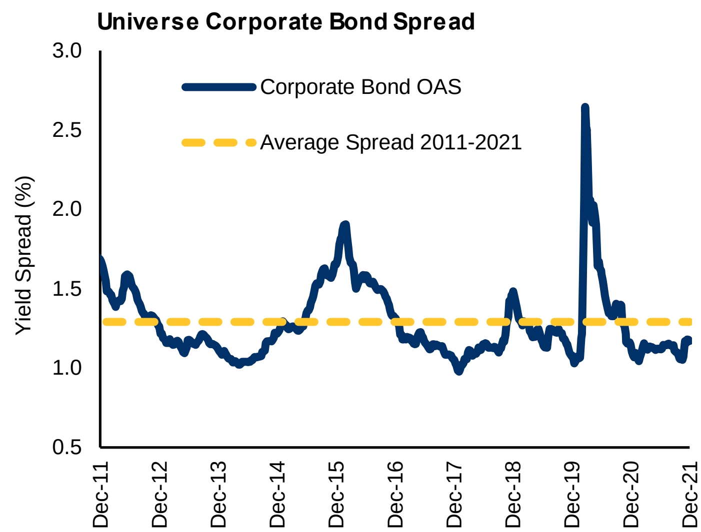


Source: NBF Economics and Strategy

* Future FYs refer only to Ontario, Quebec, and Alberta

Investment Grade Corporate Bonds

Corporate earnings remained robust alongside continued progress on the economic recovery front. Issuance remained strong in the fourth quarter with approximately $33 billion of new supply coming to market as businesses continued to take advantage of accommodative financing conditions. This wraps up a record-setting year during which we saw $133 billion of new supply in the primary market, comfortably ahead of the 10-year average of $107 billion. Along with the elevated issuance, demand for credit remained healthy, supporting valuations. Combined with the news surrounding the emerging Omicron variant and a more hawkish stance from central banks, spread levels widened only slightly during the quarter. That said, spreads remain tighter than their long-term average but reasonable given the supportive technical backdrop.

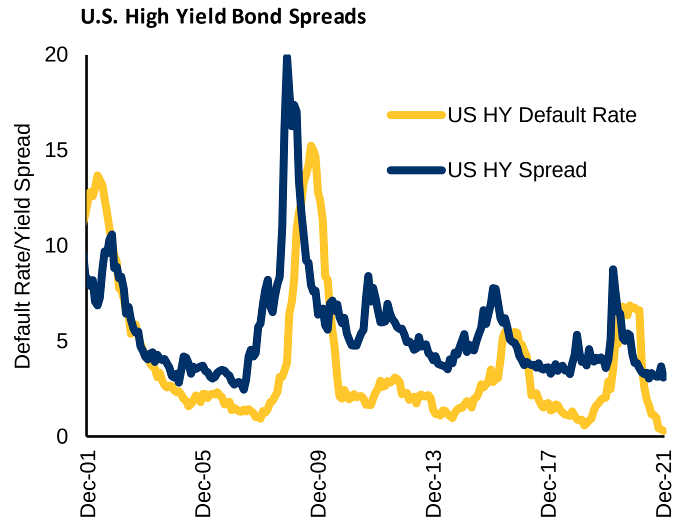


Source: FTSE Global Debt Capital Markets Inc.

From a fundamental standpoint, we remain concerned about increasing debt levels in the Canadian economy among consumers and corporations. The amount that Canadian households owe relative to how much they earn rose in the third quarter, pushed higher by growing mortgage debt. The household debt-to-disposable-income ratio reached 177% in Q3 2021 – up 0.5% from the previous quarter. However, consumers are still flush with cash, which represents potential for both investment and re-opening spending, 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

Despite a volatile fourth quarter, high yield bonds performed reasonably well and once again contributed positively to portfolio performance. High yield spreads broke their steady-state of the last few quarters by widening in November on concerns over Omicron and a hawkish pivot from the Fed, before rallying in December. Ultimately, spreads ended the quarter at approximately 310 basis points, which is slightly below where they started the quarter and meaningfully below where they began the year.



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 was robust early in the quarter before risk-off sentiment softened demand and increased funding costs. However, this late pause did not stop issuance from handily surpassing last year's record level, largely due to the frantic pace of the first three quarters as corporations raced to raise capital ahead of accelerated tapering and anticipated interest rate hikes from the Fed. The fact that high yield spreads were able to remain at low levels in the face of record issuance speaks to strong investor appetite for yield.

Despite ongoing supply chain bottlenecks, corporate earnings were generally strong across high yield issuers, with more surprising to the upside than the downside. Companies expressed concerns about cost inflation and global supply chain hiccups, which are expected to continue into 2022. These issues appear manageable barring a policy mistake by a more hawkish Fed or a meaningful increase of serious COVID cases. With oil prices having stabilized above $70/barrel, high yield defaults continue to be negligible, with only a single U.S. high yield bond default in the fourth quarter. The annual default rate declined to 0.3%, its lowest level since 2007.

Mortgages

The commercial real estate market entered 2021 with significant demand from both borrowers and lenders to put cash to work. As such, investment activity proved very strong through the first three quarters of 2021 (fourth quarter data is not yet available), reaching an all-time record of $15.8 billion in non-M&A real estate investment volumes in Q3 2021, an increase of 146% over the same period in 2020. [1] The most active areas of the market have been multi-residential and industrial, with investment volumes 52% and 60% in excess of their three-year trailing averages, respectively.[2] The high commercial real estate investment volumes are a positive for lenders, as more activity creates increased lending options. The increased universe of lending opportunities was important, as strong demand from lenders translated into a very competitive commercial mortgage lending market, an environment we expect to continue into 2022. In this environment, mortgage spreads tightened by 9 bps and 57 bps over the quarter and year, respectively.

The COVID-19 pandemic caused an abrupt, widespread shift to remote working arrangements for a large portion of office-based businesses as Canadians did their best to stay home and practice physical distancing. While increased foot traffic has been observed in 2021 for most urban cores, office towers have yet to

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[1] CBRE Investment Marketview Q3 2021
[2] CBRE Investment Marketview Q3 2021

experience the same resurgence. According to a recent Colliers survey, only 51% of businesses currently have their employees back in the office in some capacity.[3] However, the same survey also found that 85% of the companies expect to have their workers return to office in 2022, at least part of the time. While encouraging, leasing activity reports suggest most office tenants remain in wait-and-see mode, focusing on back-to-work programs while deferring leasing decisions until it is time for a lease renewal. This has contributed to stable office rents in most markets across the country.

Retail businesses struggled in 2020 as a result of the pandemic; however, consumers have generated substantial growth for the sector in 2021. Retail sales year-to-date as of October 2021 are 12.7% higher than the prior-year period, and preliminary data for November is encouraging.[4] Growth of the retail sector is expected to be challenged by continued global supply chain issues and labour shortages within service-oriented retail in 2022. Delays and increased prices for key materials are already limiting what Canadian manufacturers can produce and hence what retailers are able to sell. However, despite these pressures, the medium- and long-term fundamentals for the sector have improved

Industrial real estate has continued to perform very well in 2021, as increased adoption of online shopping has necessitated an increase in the square footage for storage and distribution facilities, fueling demand for industrial warehouses. This has contributed to the national availability rate hitting an all-time low and average asking rent increasing 6.3% year-to-date.[5] While developers have remained bullish with 34.1 million square feet of industrial currently under construction across the country, the entire development pipeline would increase existing inventory by less than 2%, and projects under construction that are scheduled to be delivered in 2022 are already 63% pre-leased.[6] Taken together, the low vacancies and significant rental growth appreciation experienced in most markets have created an environment for stable and growing cash flows to support mortgage debt payments.

As the Canadian economy has taken off in 2021, so has the multi-residential sector, experiencing both rental price growth and falling vacancy as labour market conditions have improved and immigration has rebounded to pre-pandemic levels. Although the recent emergence of Omicron may cause a short-term setback to the sector's strong performance, mid- and long-term fundamentals are positive. Rental housing demand is expected to continue to be fueled by the Canadian government's increased immigration target levels for 2022 and 2023, and affordability issues continue to make renting the preferred option for many would-be first-time home buyers. Also supporting the sector's outlook has been the struggles of developers to deliver new supply to the market. Taken together, we view this supply-demand imbalance as a strong indicator that there is room for further rental growth, which will strengthen the debt service abilities of multi-residential borrowers.

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.

[3] Colliers Canada "Canadian companies experiment with finding return-to-office 'middle ground'"
[4] Statistics Canada
[5] CBRE "Canada Quarterly Statistics Q3 2021"
[6] CBRE "Canada Quarterly Statistics Q3 2021"

Bond Market Outlook

Global economic growth continues to progress, and while leading indicators of growth are off their highs, they are still at levels consistent with a robust and above-average expansion over the next 12 months. As such, the need for extraordinary monetary stimulus by central banks is becoming less evident, especially when taking into account persistently elevated inflation levels. Policymakers are beginning to dial back accommodation and/or communicate their intention to raise interest rates, although the path to normalization will likely be uneven. Over the next 12 months the bond market expects yields to rise from current levels; we likewise expect yields to move higher, and likely at a moderate and gradual pace.