MFA Pooled Investment Fund Quarterly Market Update

Q4 2020

Municipal Finance Authority of BC

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As of December 31, 2020

Interest Rates

Global economies continued to recover stronger and faster than anticipated from the unprecedented economic shutdown experienced earlier this year. The economic recovery has been buoyed by positive vaccine developments, which have instilled hope that life might return to normal in 2021. That said, the magnitude and timing of a full economic recovery remains uncertain. In light of this, central banks continued their quantitative easing measures to ensure the bond market remains liquid and well supported, and they have committed to maintaining accommodative monetary policies until a recovery is well underway. Of note over the quarter, the Bank of Canada (BoC) announced it would reduce its Government of Canada bond purchase program to $4 billion a week, down from $5 billion a week, and pledged to extend purchases to longer-term securities. The reduction in weekly purchases coupled with a focus on longer-term securities is expected to offer the same amount of stimulus as prior to the program adjustment, however, the BoC will have a more direct influence on the borrowing rates that are most applicable to households and businesses. The BoC continues to buy provincial and corporate bonds as well, although at a relatively restrained pace. With the strong support of central banks, coupled with positive vaccine developments, investors exhibited a healthy appetite for risk over the fourth quarter. Against this backdrop, Government of Canada bond yields increased modestly over the quarter, and the yield curve steepened.

Looking ahead, the majority of bond market participants expect yields to remain low over the near term as a result of very accommodative monetary policy. Our view is generally in line with what is priced into the bond market; however, yields may exhibit some short-term volatility as a multitude of uncertainties continue to weigh on the global economy.

Real Return Bonds

The market's expectations for long-term inflation (estimated as the difference in yield between a nominal and real return bond) moved 0.2% higher to end the fourth quarter at 1.5%. The rise in market-implied inflation expectations from its lows earlier in the year can be largely attributed to an improvement in liquidity conditions primarily as a result of the BoC's continued support via its asset purchase program.

Actual inflation, as measured by the Consumer Price Index (CPI), has somewhat stabilized, though it remains below pre-pandemic levels. Looking ahead, we believe that the BoC, in addition to fiscal stimulus, has the tools required to meet its inflation target, and that market-implied, long-term inflation expectations are likely to continue moving higher – and closer to our view of fair value – over the medium term.

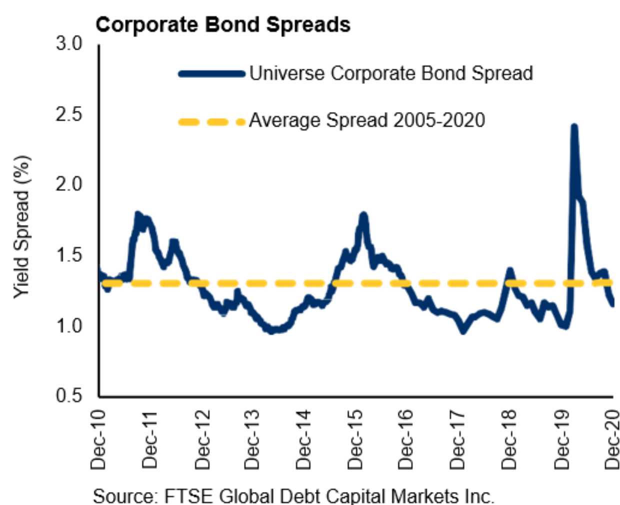
Quasi-Government Bonds

Despite promising vaccine developments that have raised the prospect for a swift return to normalcy in 2021, near-term challenges for the Canadian economy remain as we battle a second wave of virus infections. As such, the provinces sustained a strong pace of issuance to stay well-funded should the economic recovery falter as COVID-19 case counts and fatalities rise. The market easily absorbed the strong supply of approximately $25

billion during the quarter, thanks in large part to the accommodative monetary policy that continues to drive demand for credit. There was also a significant $11.5 billion of maturity and coupon payments made to bondholders in December. The subsequent need to reinvest this cash also boosted demand, driving spreads tighter across provincial, federal agency, and municipal bonds. Overall, provincial bond spreads tightened by approximately 10 basis points over the quarter, with the smaller, less liquid provincial issuers, such as Alberta, outperforming the larger and more liquid issuers like Ontario and Quebec.

Investment Grade Corporate Bonds

Corporate bonds benefitted from continued positive investor risk sentiment, which resulted in Canadian investment grade corporate bond spreads tightening by 25 basis points during the quarter. Corporate bond spreads have experienced a significant recovery since the peak of the pandemic, with spreads ending the quarter close to pre-pandemic levels. One factor that has contributed to the recovery was the introduction of the Corporate Bond Purchase Program (CBPP) by the BoC in late May. Since the introduction of the program, the BoC has completed 65 purchases for a total of only $182 million par value out of a program size of $10 billion.



Source: FTSE Global Debt Capital Markets Inc.

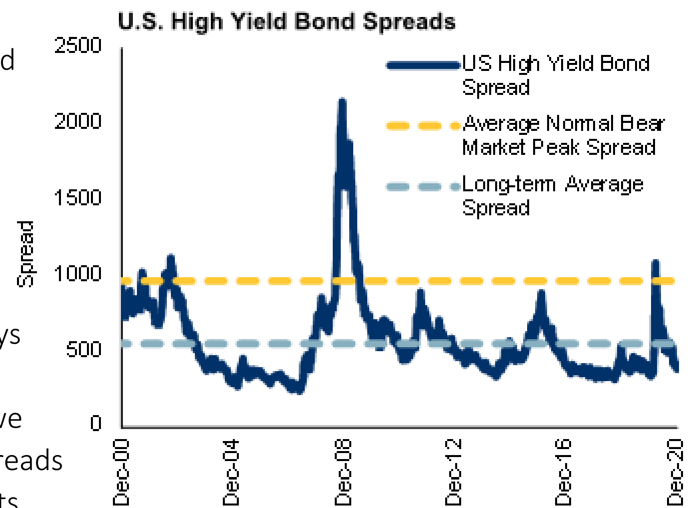
Although few purchases have been made by the BoC, the corporate bond market has been able to thrive on its own, supported by the confidence of knowing that the BoC is there to function as a backstop if ever needed. In addition, corporate bond supply was met with robust investor demand as investors continued to reach for yield, with approximately $22 billion in new supply coming to market during the quarter. The 2020 calendar year total has now reached a record $116 billion, which is roughly 5% ahead of last year's pace.

From a fundamental standpoint, the elevated levels of debt in the Canadian economy among consumers and corporations remain a key concern. The Canadian household debt-to-income ratio made a substantial jump in the past quarter. The ratio reached 171% in Q3, up 5% from the previous quarter as the effects of various government aid programs dissipated. In addition, we recognize the decoupling of corporate credit fundamentals and valuations due to the unprecedented support of central banks. With spreads approaching their post-financial crisis tights, the potential downside risk is higher should investor sentiment turn.

High Yield Corporate Bonds

The recovery in high yield bonds continued into December, with the broad high yield market returning 6.5% in the fourth quarter. This strong finish capped off a year-to-date return of 6.2% for 2020, which is a remarkable turnaround for an asset class that was down over 20% at its lowest point in March. Meaningful government support, both fiscal and monetary, since the early days of the pandemic has been crucial to both the economic recovery as well as the restoration of investor confidence in financial markets. This support allowed corporations to issue record amounts of bonds on reasonable terms in the early stages of the pandemic to help shore up their finances in an otherwise challenging environment, and has resulted in fewer liquidity challenges and bankruptcies than initially feared. The expected continuation of government support, along with the resolution of the U.S. election and the beginning of the roll-out of COVID vaccines have all been helpful to the economic backdrop. Investors have now shifted their focus from near-term infection rates to what a post-COVID return to “normalcy” might look like. Although much uncertainty remains, the shift has been generally

supportive for higher yielding assets in light of a low rate environment extending into the foreseeable future. Demand for high yield bonds reached record levels in 2020.



Source: Bloomberg, RBC GAM. US high yield daily bond spreads represents the ICE/BofA US High Yield Bond Index as at Dec 31, 2020. Normal bear market excludes the great financial crisis

The rate of high yield defaults slowed in Q4 and should end the year at approximately 7%; for the second year in a row, defaults were dominated by energy companies. While above the long-term average default rate of 3-4%, this result is not nearly as bad as feared during the early days of the pandemic. Furthermore, failing a dramatic negative turn of events in infection rates or vaccine developments, we suspect that the peak in defaults is behind us. High yield spreads have largely reflected this and have fallen to 400 basis points from a peak of 1,100 basis points in March.

Mortgages

Conventional mortgage spreads compressed over the fourth quarter by approximately 25 basis points. As of quarter-end, the mortgages held in the MFA Mortgage Fund had a yield of approximately 215 basis points over similar-term Government of Canada bonds.

The mortgages held in the MFA Mortgage Fund continued to perform well in an environment filled with many challenges related to the COVID-19 pandemic. We currently do not have any missed payments or defaults in the portfolio. Earlier in the year we did provide relief to 58 mortgages where rental income was negatively impacted due to the pandemic. These borrowers were granted a maximum three-month interest-only period, allowing some flexibility for income to stabilize. Nearly all of these mortgages have seen income collections improve dramatically, which has allowed regular payments to resume. Of the 58 mortgages, 28 have returned all deferred principal, and the remaining 30 are in the recovery phase, which is scheduled to complete mid-2021. The outstanding deferred principal payments represent less than 0.20% of the portfolio.

New mortgage origination activities picked up meaningfully in the fourth quarter. We are currently reviewing numerous attractive new mortgage opportunities; these are currently in the due diligence stage of our process, with funding anticipated in Q1 2021. We recently expanded our mortgage origination capabilities beyond just CMLS to include RBC, First National Financial, and Portage Capital. These groups should provide a meaningful level of additional origination capacity to our program. These additional sources, combined with improved market conditions, should provide more attractive origination results for our program in 2021. We currently have a strong liquidity position in the MFA Mortgage Fund, with 12.95% held in cash instruments and short-term investments.

Commercial real estate conditions continued to provide mixed results depending on location and asset class. Retail continued to face challenges given operating restrictions imposed on many segments of the market. However, we saw many retailers and landlord embrace innovation and adapt to improve operations to the best of their ability. Retailers able to survive this environment should be rewarded with pent-up consumer demand and high savings rates. Industrial and multi-family assets across Canada have exhibited exceptional results with strong rental collections, income growth, and very low vacancy levels. We continue to focus our origination efforts on the highest quality segments of the market backed by strong, stable assets, and borrowers with the experience and wherewithal to operate successfully in the current environment. The MFA Mortgage Fund

remains conservatively positioned with a cash flow coverage ratio of 1.6X and a loan-to-value of 56%, providing a significant margin of safety to mitigate market weakness.

Bond Market Outlook

Risk-on sentiment continued to permeate financial markets during the quarter as positive developments on the vaccine front, improving economic data and better-than-expected third quarter earnings helped boost investor confidence. Combined with ongoing fiscal support from federal governments, it would be a fair notion for fixed income investors to expect bond yields to rise from current levels within this environment. However, considering that central banks have expressed a commitment to keeping interest rates low to stimulate economies and maintain liquidity in financial markets, our sense is that bond yields will remain near their current low levels in the near term and that any move higher from here will likely span many years.