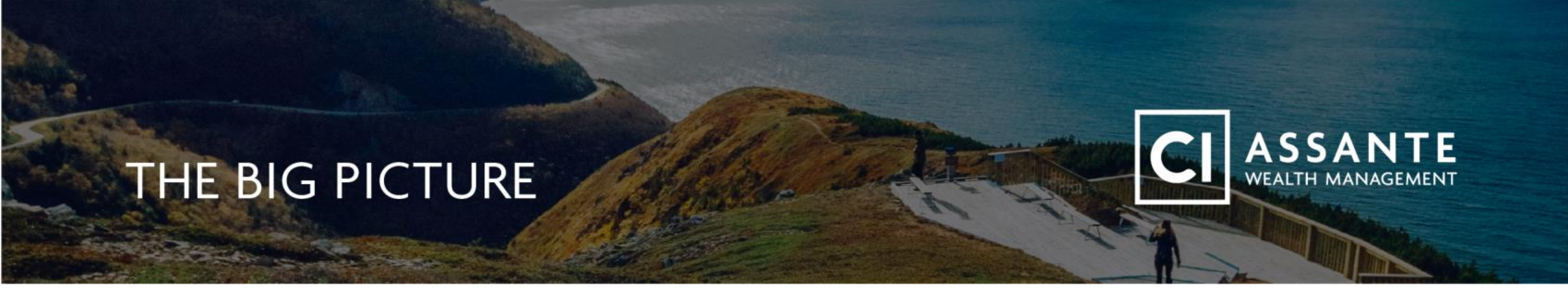

Debt represents risks for Canada

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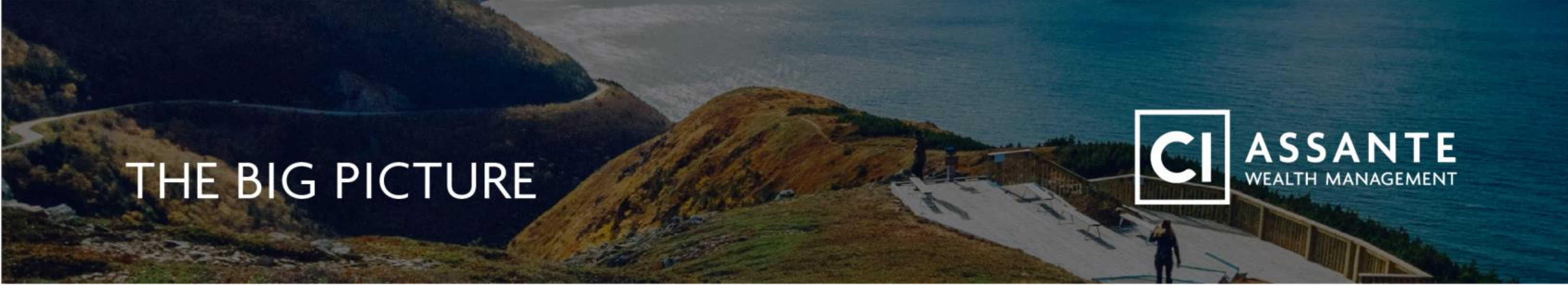
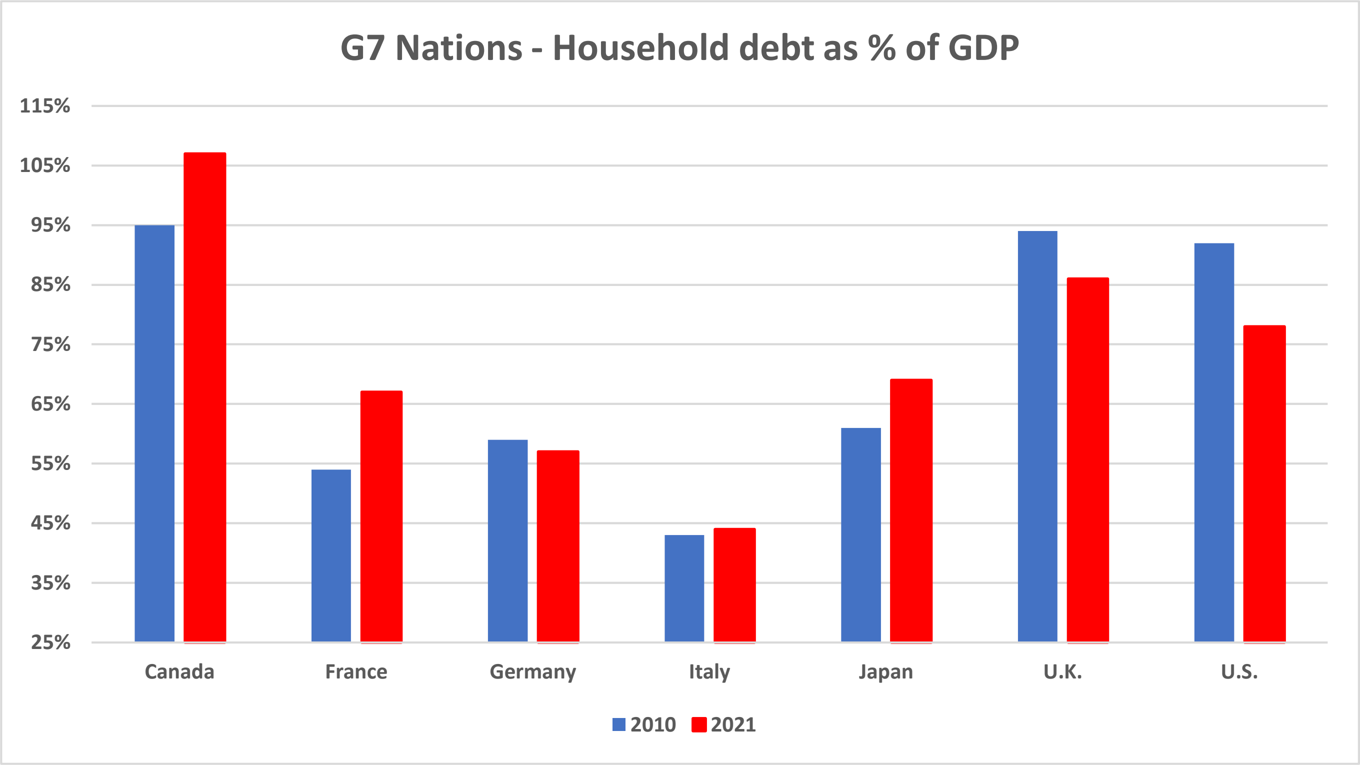
World economies have been operating under duress for several years. The uncertainty fuelled by the spread of COVID-19 led to the shuttering of vast swaths of the global economy in 2020. Subsequently, uneven reopening caused supply chain disruptions in many sectors and across borders. Over the past four years, unparalleled monetary stimulus has given rise to inflationary pressures, surging from near-zero to multi-decade highs. As a result, efforts to cool these inflationary fires have seen interest rates spike higher to similar multi-decade highs. Even though the issue of higher interest rates had retreated into the background for an extended period, the economic and market risks associated with them are now being recognized once again, especially here at home. The markets' perception of these risks for individuals, businesses and governments will dictate prices and returns, as they always have. Currently, Canada might not seem much different from other industrialized nations. However, the governments and individuals who refrain from increasing their debt also minimize their risk. Long-term investors likely have a different level of comfort with debt as it can be an advantageous investing tool. At the same time, one of the key advantages of professional advice is the opportunity for open discussion around its risks and benefits. This ensures investors have a far better awareness and understanding of their own balance sheets.



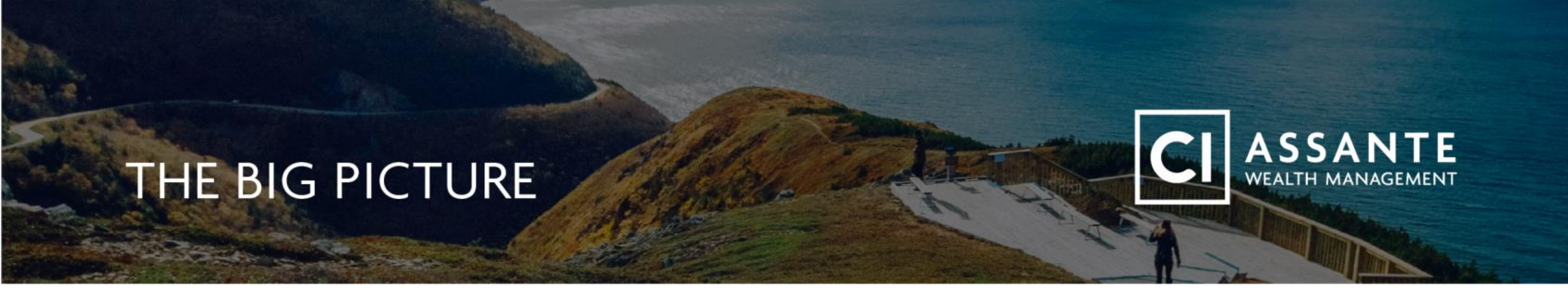


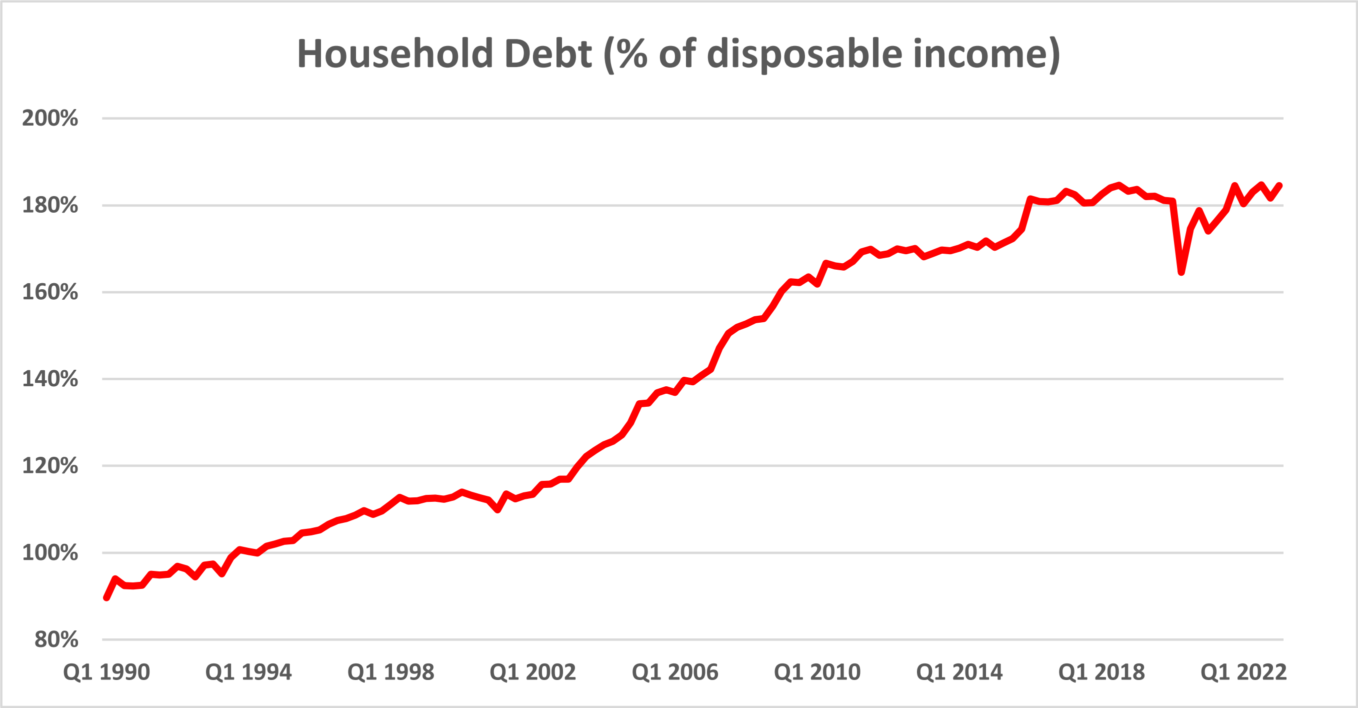
Source: International Monetary Fund

Households

The press release that accompanied an article, recently published by the Canada Mortgage and Housing Corporation revealed that Canada has the highest household debt/GDP level of all G7 nations[1]. As can be seen in the accompanying graph, Canadian households increased their borrowing between the end of the financial crisis in 2010 and the beginning of the post-pandemic recovery in 2021. While France, Italy and Japan saw a similar upward move, their starting points were well below that of Canada. In contrast, Germany, the U.K. and the U.S. all *reduced* their debt ratios over this stretch. The most recent data from Statistics Canada shows that total household debt rose an additional 6.4% between the fourth quarter of 2021 to the first quarter of 2023.

[1] *Housing Market Outlook.* Canada Mortgage and Housing Corporation (CMHC). April 27, 2023. Retrieved July 5, 2023, from https://www.cmhc-schl.gc.ca/professionals/housing-markets-data-and-research/market-reports/housing-market/housing-market-outlook

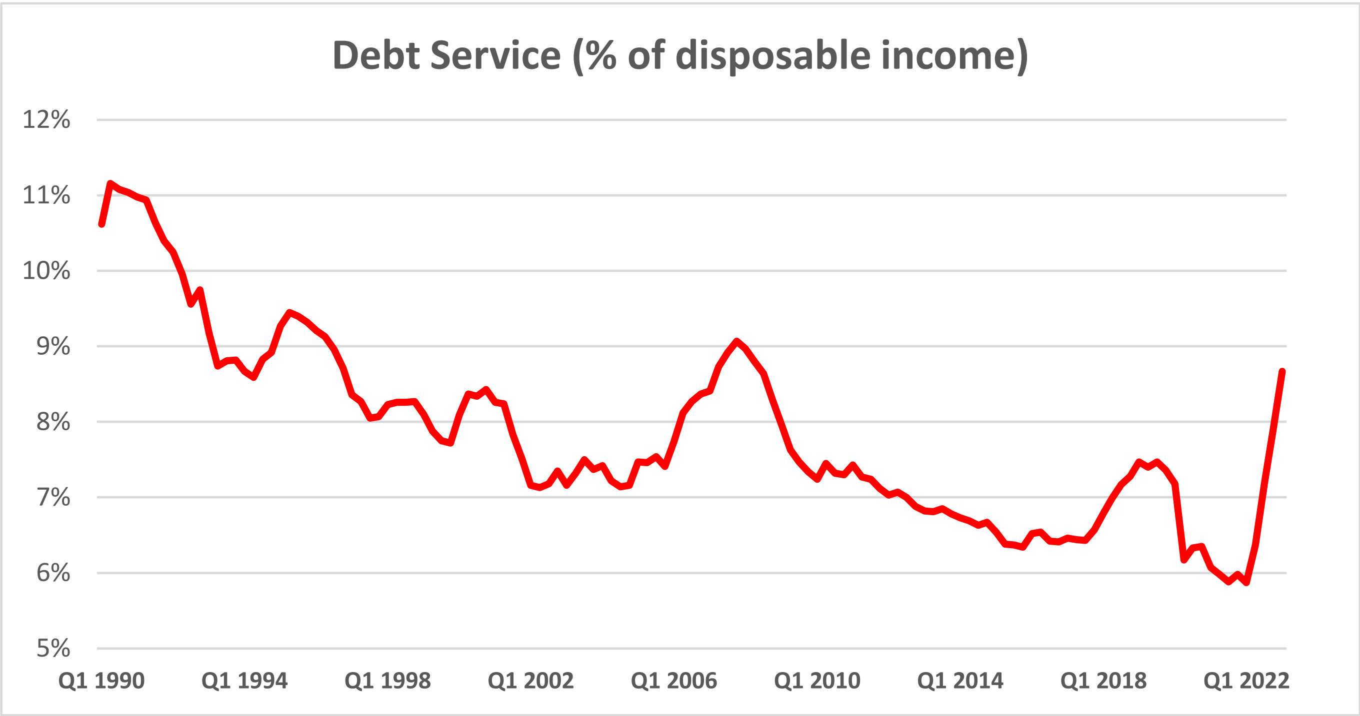




Source: Statistics Canada.

As can be seen in the above chart, it is evident that, aside from a brief period during the initial response to the pandemic, household debt relative to disposable income has also been on an upward trajectory for an extended period. The sustainability of this trend went largely unquestioned when interest rates stood at historic lows. However, that is no longer true. On March 2, 2022, the Bank of Canada initiated the current policy cycle by raising interest rates for the first time in more than three years. Since then, a substantial increase in interest rates has appeared. Given the considerable growth in borrowing when interest rates were low, that monetary "tightening" is now impacting debt servicing. As can be seen in the following graph, servicing the interest payments alone on household debt has risen from 5.9% of disposable income from the fourth quarter of 2021 to 8.7% in the first quarter of 2023. It seems that Canadians did not listen to the Prime Minister's words when he stated, "we (the federal government) took on debt so Canadians wouldn't have to."[2]

[2] Prime Minister Trudeau, press conference - July 8, 2020.

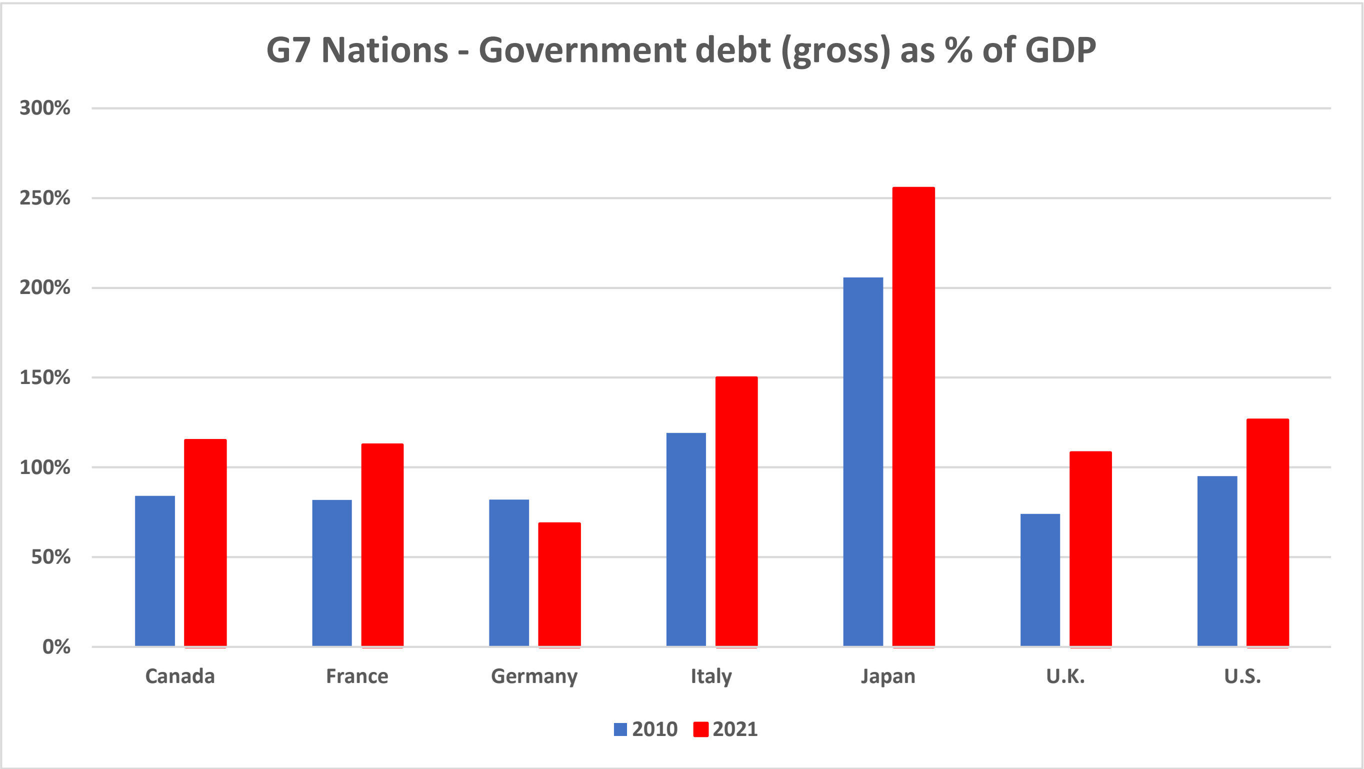


Source: Statistics Canada.

Government

Whether or not Canadians were listening, the federal government proceeded to dramatically increase its borrowing activity. By March 2023, total interest-bearing federal debt stood at $1.614 trillion, an increase of 61.5% over a five-year period. Canada's Finance Minister has often touted the country's debt-to-GDP ratio, even going so far to refer to it as "our fiscal anchor – a line we shall not cross."[3] Unlike many other nations, Canada's provinces have their own substantial borrowing programs. And, if push came to shove, few would doubt that the federal government would step in if it appeared that a province would become insolvent. Nonetheless, the graph below shows the latest update from the International Monetary Fund, which reveals that Canada's debt-to-GDP ratio (gross) was lower than Japan, higher than Germany, and yet largely the same as the other G7 nations.

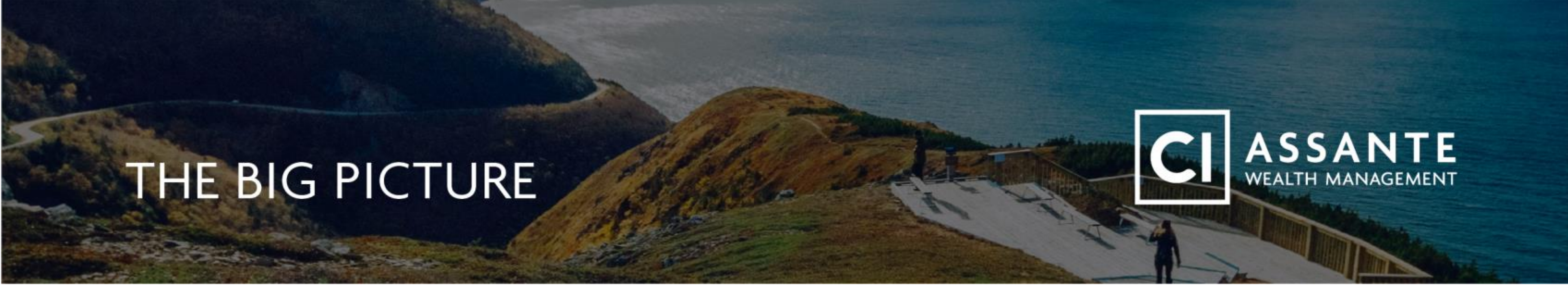
[3] Finance Minister Freeland, budget speech – April 7, 2022.

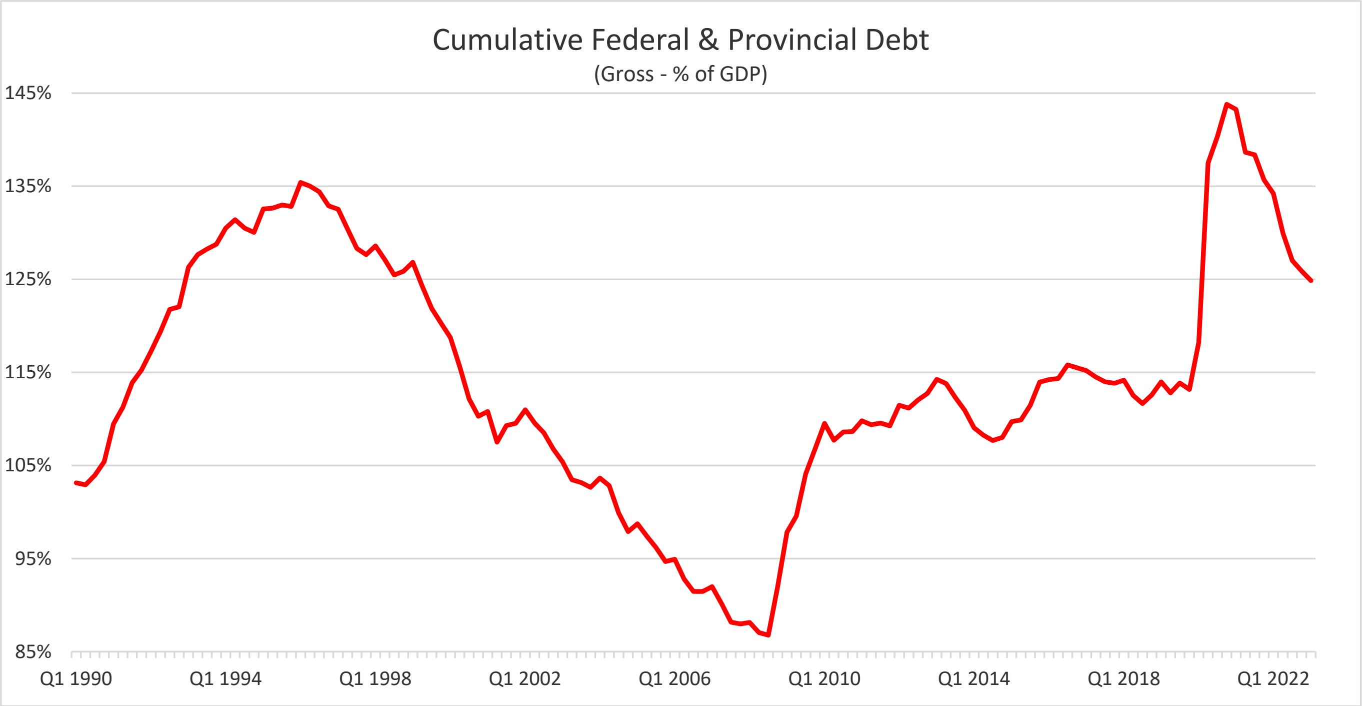


Source: International Monetary Fund

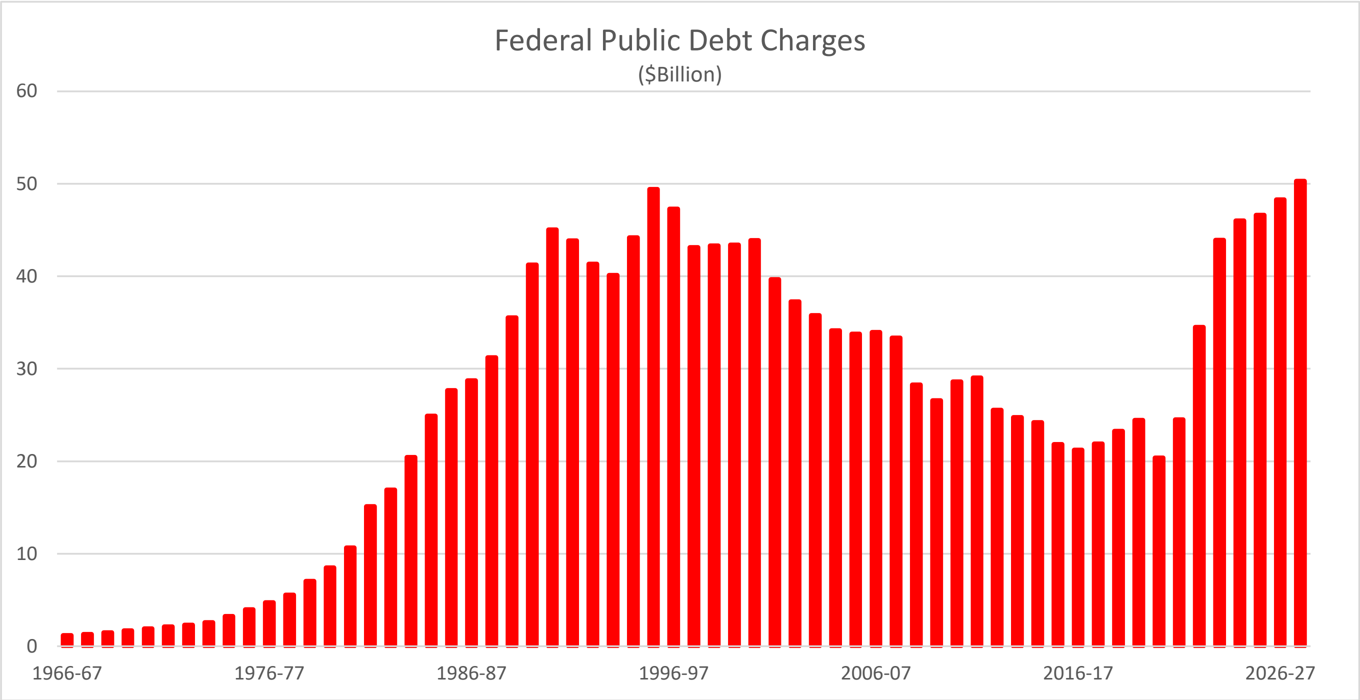
In January 1995, a biting Wall Street Journal article titled "Bankrupt Canada?"[4] labelled Canada as "an honorary member of the Third World in the unmanageability of its debt problem." As stinging as this indictment was at the time, it preceded – and some would argue triggered – a secular decline in Canada's debt-to-GDP ratio. As can be seen in the chart below, it bottomed out at 86.8% in the third quarter of 2008. The onset of the financial crisis saw heavy government borrowing and the ratio backed up. However, it did stabilize and eventually declined to 108.0% by the final quarter of 2014.

[4] **"Bankrupt Canada?" Wall Street Journal, 12 January 1995, p. A14.**



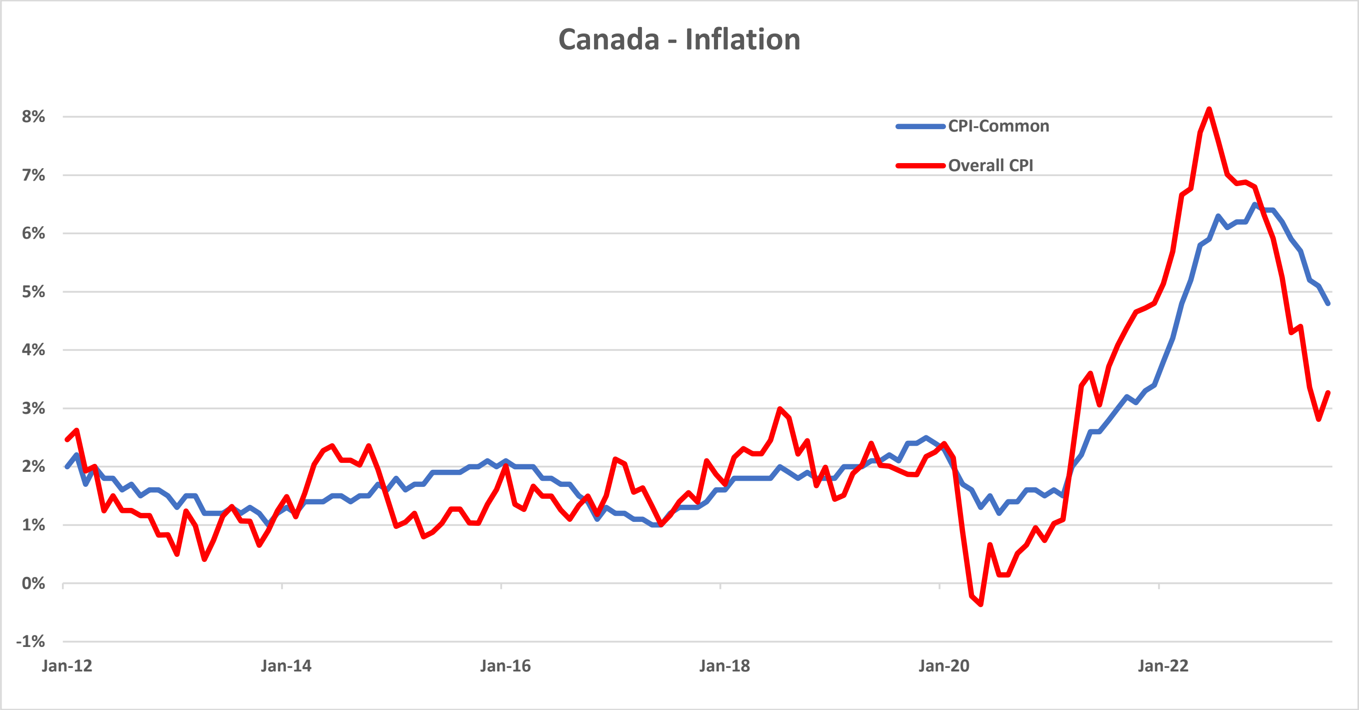


Source: Statistics Canada



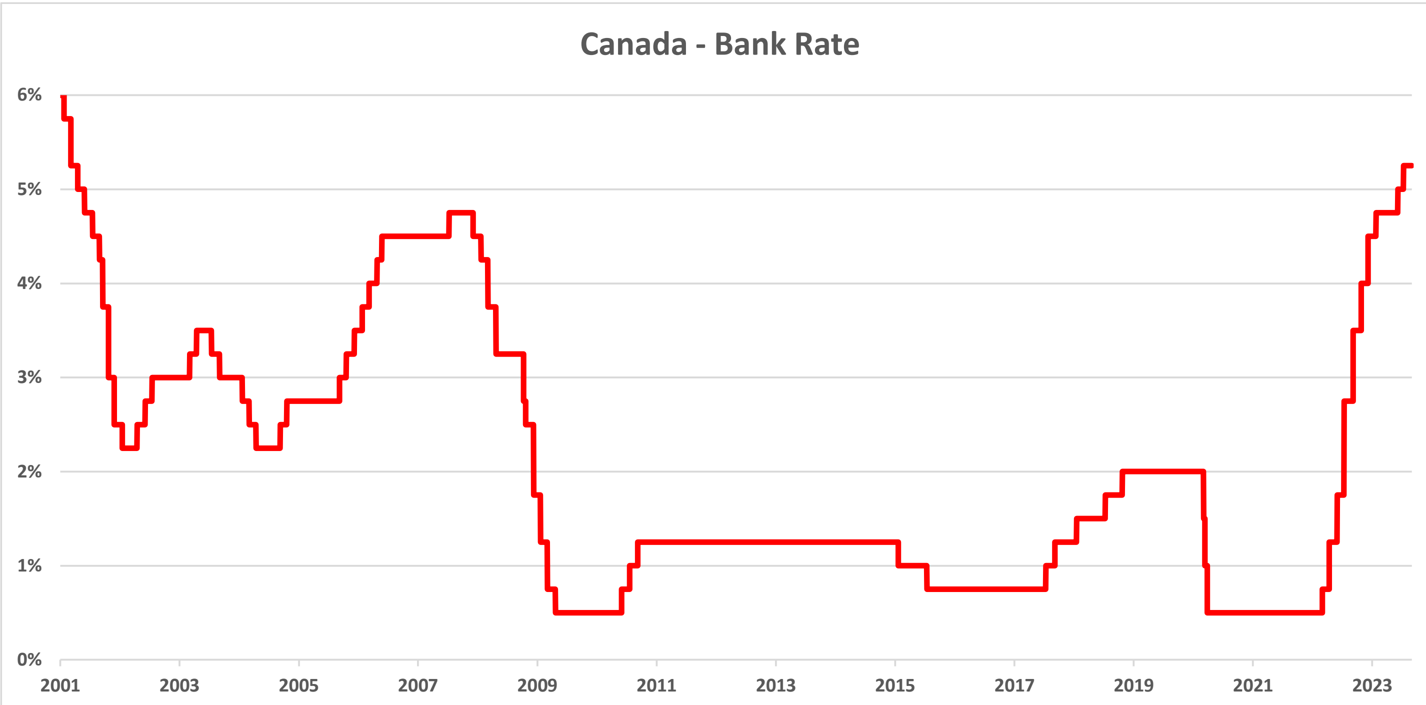
Source: Canada Fiscal Reference Tables and Budget 2023, Department of Finance.

Despite the period of economic growth that followed both the financial crisis and the pandemic, deficit financing has remained prevalent. Unfortunately, the debt-to-GDP ratio is projected to rise even more under the current federal budget (2022-23) and servicing that debt will have a significant and increasing impact. As can be seen in the chart above, public debt charges are expected to rise from $24.5 billion in fiscal 2021-22 to $50.3 billion in fiscal 2027-28, surpassing the previous record of $49.4 billion in fiscal 1995-96. The overall effect on servicing that debt will likely be magnified further as there are no plans to balance the federal budget. What's potentially more concerning is that this budget forecast was originally based on a mere 1.0% increase in interest rates.



Source: Statistics Canada

The latest figures from Statistics Canada shows should read the Consumer Price Index (CPI) rose 0.6% (seasonally adjusted) in July. On a year-over-year basis, the CPI was up 3.3%. This was above the reading of 2.8% in May but lower than the 8.1% peak recorded in June 2022, which marked the fastest growth since January 1983 (8.2%). However, as can be seen in the accompanying graph, the Bank of Canada's primary core inflation measure has not kept pace. CPI common, which the central bank says is most closely correlated with the nation's output gap, stood at 4.8% in the June report. It seems that lessons from the high inflation era of the late 1970s and early 1980s that were once forgotten, are now being remembered, and a period of accelerated interest rate hikes has emerged once again.



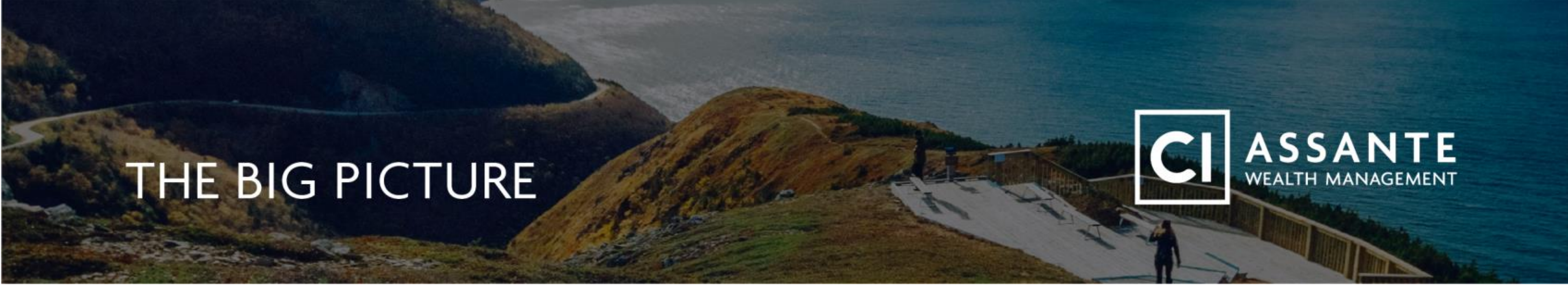
Source: Bank of Canada

As can be seen in the above graph, at its July policy window, the Bank of Canada announced that it was raising administered interest rates by another 25 basis points (a basis point is 1/100th of one per cent). The range for overnight borrowing was set at 5.00% to 5.25%, with the official Bank Rate at 5.25%. This decision came after a June interest rate hike (also 25 basis points) and two prior "on hold" policy announcements. The cumulative tightening of 475 basis points, which began in March 2022, represents the largest set of interest rate increases since November 1987 to May 1990. During that period, the Bank Rate shifted from 8.09% to 14.05% (596 basis points). The last time the Bank Rate stood at 5.25% was April 16, 2001. Notably, the statement that accompanied the announcement included text regarding the Bank's latest forecast, stating, "CPI inflation is forecast to hover around 3% for the next year before gradually declining to 2% in the middle of 2025. This is a slower return to target than was forecast in the January and April projections." The next policy announcement is scheduled for September 6, 2023.

One challenge the Bank currently faces during this tightening cycle is its previous decision to employ Quantitative Easing (QE) as a response to the pandemic. The Bank defines QE as a process where "a central bank buys government bonds. Buying government bonds raises their price and lowers their return— the rate of interest they pay to bondholders. This rate of return is also known as the bond's yield."[5] The Bank did *not* engage in QE during the 2008/09 financial crisis. This easing must now be *reversed* by Quantitative Tightening (QT), which means selling these government bonds into the market at a time when the government itself is tapping those same markets to borrow more money by issuing new bonds. This crowding of the markets is expected to put additional upward pressure on interest rates. Further, this process forces the Bank to sell its assets at a loss – selling low after buying high. For the first time in its 88-year history, it reported a loss in the third quarter of 2022.[6] This

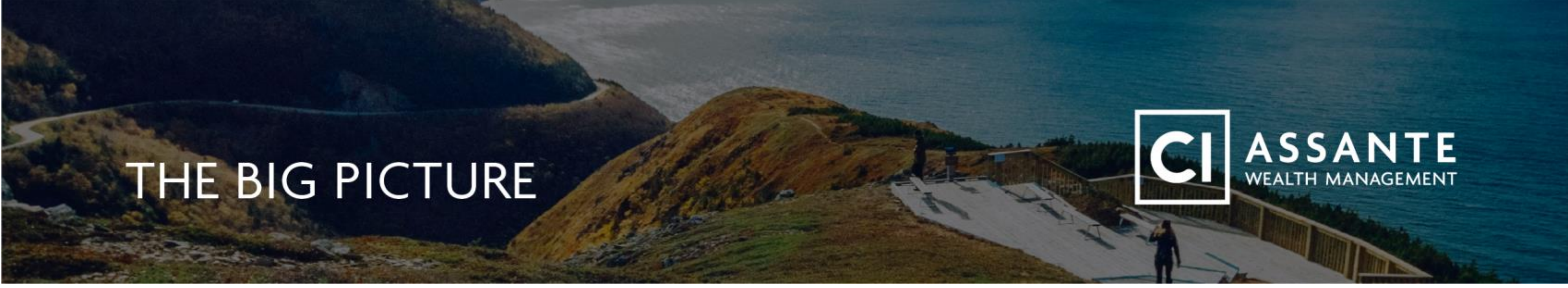
[5] *Understanding Quantitative Easing.* The Bank of Canada. June 6, 2022. Retrieved August 10, 2023, from https://www.bankofcanada.ca/2022/06/understanding-quantitative-easing/

[6] Bank of Canada reports $522-million third-quarter loss, losing money for the first time. The Globe & Mail. November 29, 2022. Retrieved August 10, 2023, from https://www.theglobeandmail.com/business/article-bank-of-canada-reports-522-million-third-quarter-loss-losing-money-for/



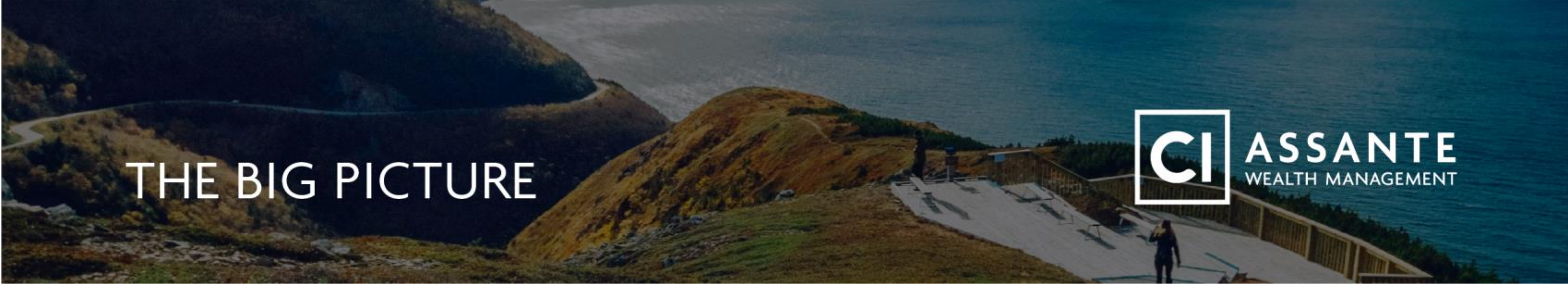
unanticipated loss had to be covered by the federal government. Other headlines highlighting the surge in sovereign defaults[7] act as a reminder that government borrowing comes with risks. In the end, both households and governments need to review their respective debt positions and understand the consequences of a prolonged period of higher interest rates. Given the concerns, having a professional advisor and a full understanding of the use of borrowing within a well-diversified investment portfolio can help insulate investors from these concerns.

[7] Sovereign debt defaults soar as governments feel pinch of higher rates, data show. The Financial Post. August 2, 2023. Retrieved August 10, 2023, from https://www.msn.com/en-ca/money/topstories/sovereign-debt-defaults-soar-as-governments-feel-pinch-of-higher-rates-data-show/ar-AA1eBeiE?ocid=entnewsntp&pc=U531&cvid=61990f9bd784495b89b4fb50a808c4ec&ei=21



CONCLUSIONS

- Unlike the preceding period of “lower for longer,” the scale of borrowing seen over the pandemic period and the plans for continued deficit financing suggest that interest rates will now be “higher for longer”
- The borrowers that continue to ignore the lessons of the past will have the greatest difficulty moving forward. Those issuers who re-establish a stronger base for servicing their debts will be rewarded by the markets with lower interest rates and higher valuations
- Investors who have the advantage of professional financial advice are typically far more aware of their own debt situation and are better positioned than those who do not. Having a greater awareness typically allows for easier adjustments



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