Insights & Strategies

PRIVATE CLIENT SOLUTIONS

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Minority Report

In most regards the 43rd federal election can be viewed as a win for almost every party. The Liberals managed to cling to power with a strong minority despite ethics breaches, the SNC scandal and controversial images of their leader unearthed from nearly two decades ago. For their part, the Conservatives picked up 26 seats and won the popular vote with 34.4%. The NDP, while losing seats, are in the enviable position to be able to prop up the Liberals and are likely to see many of their policies shape future legislation. The Bloc made significant gains in Quebec by adding 22 seats primarily at the expense of the NDP and Liberals, the Green party won one additional seat by gaining its first member of parliament outside of British Columbia (a third seat in New Brunswick) and Canadians resoundingly rejected the People's Party of Canada's right-wing populist message.

Past Canadian Minority Governments

Year(s)	Rank (term length)	Prime Minister	Party	Duration
1873–1874	12	A. Mackenzie	Liberal	56 days
1921–1925	1	W. L. Mackenzie King	Liberal	3 years, 233 days
1925–1926	8	W. L. Mackenzie King	Liberal	204 days
1926	13	Arthur Meighen	PC	3 days
1957–1958	11	John Diefenbaker	PC	177 days
1962–1963	9	John Diefenbaker	PC	203 days
1963–1965	5	Lester B. Pearson	Liberal	2 years, 123 days
1965–1968	4	Lester B. Pearson	Liberal	2 years, 135 days
1972–1974	6	Pierre Trudeau	Liberal	1 year, 170 days
1979–1980	10	Joe Clark	PC	186 days
2004–2006	7	Paul Martin	Liberal	1 year, 133 days
2006–2008	2	Stephen Harper	PC	2 years, 207 days
2008–2011	3	Stephen Harper	PC	2 years, 142 days
2019–present	14	Justin Trudeau	Liberal	TBD

Now for the hard part. Minority governments must govern in a way that ensures it holds the confidence of parliament. If it does not, Canadians will be heading back to the polls. The last three Canadian minority governments lasted on average two years; however, the current government may exceed this given policy similarities between the Liberals and NDP and the unwillingness of the cash-strapped NDP to force another election. Another characteristic of a minority government is that they tend to be unproductive, but that is not always the case. One of the most successful minority governments, led by Lester B. Pearson, was certainly the exception. Leading two back-to-back minority Liberal governments (1963-1968), Pearson delivered many of the social programs we enjoy today, including the expansion of universal health care, establishment of the Canadian Pension Plan and the signing of the Canada-US Automotive Products Agreement, commonly known as the auto pact (or APTA). The agreement significantly increased Canada's production of automobiles and auto parts, created many high-paying jobs and increased economic ties with the US, which ultimately lead to the signing of NAFTA.

Please read domestic and foreign disclosure/risk information beginning on page 8.

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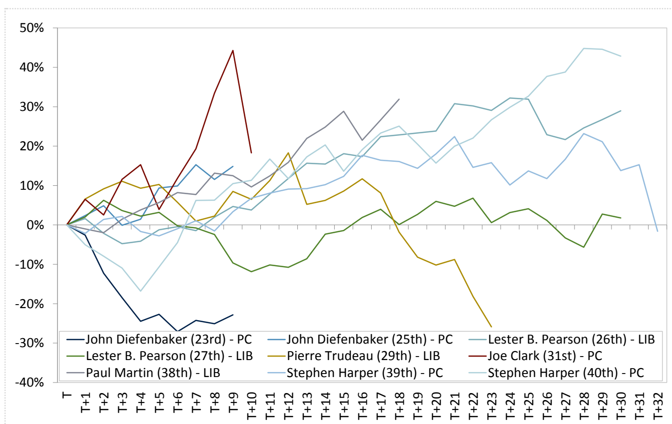
As the Liberals and NDP see eye-to-eye on many initiatives, this minority government may be uncharacteristically productive similar to the Pearson era. Both parties have common ground on such initiatives as: universal pharmacare plan, investments in affordable housing, support for post-secondary education, significant action on climate change, higher taxes for the wealthy and a price cap on mobile phone bills (more on this later). One of the challenges for the Liberals will be to pass energy-related legislation. The Liberals are committed to building the TransMountain expansion pipeline even though the NDP, Green and Bloc oppose it. However, to defeat the anti-pipeline movement, the Liberals can turn to the pro-TransMountain Conservatives for help. Another tricky subject will be taxation. Both the Liberals and NDP pledged to raise taxes on wealthy Canadians, though they disagreed on how to implement the tax. The Conservative and Liberal parties also agree on cutting taxes (or raising the basic personal tax-free amount) on the lower income bracket, but the Liberals wish to have an offsetting tax on higher income earners.

Minority Governments & the Markets

It is often said markets dislike uncertainty and what could be more uncertain than a minority government? However, if you look at the past performance of the S&P/TSX during minority governments we find the market performs surprisingly well. In fact, if we isolate Liberal minorities the market performs broadly in line with average annualized return of the S&P/TSX since the 1950s. One reason for this may be the lack of legislation making its way through parliament, which allows the market to continue to operate on the known knowns with little likelihood of majority policy shifts.

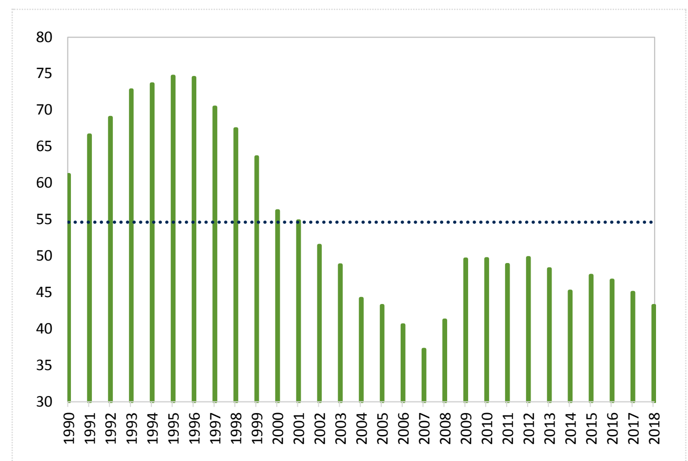
S&P/TSX Historical Returns During Minority Govt.



Source: Bloomberg

As we approach 2020 and the next federal budget, the feds are in a fiscally enviable position with federal debt levels low relative to GDP. This will allow the government to run larger deficits as they attempt to find compromise among their rival parties. Bolstering the argument for large deficits is the view that the federal government is underspending when considering historical levels of debt to GDP. As of 2018, federal debt to GDP stood at 43.2% versus a historical average of 54.6% and Canada's federal debt to GDP is among the lowest within the developed world. With the additional fiscal spending, the Canadian economy will receive a boost allowing the Bank of Canada greater leeway to buck the global trend of easing monetary conditions. Thus in the near term this should be supportive of the economic activity and a positive for the Canadian dollar.

Canadian Federal Debt/GDP



Source: Bloomberg

Jason Castelli, CFA
VP, Head of Investment Strategy

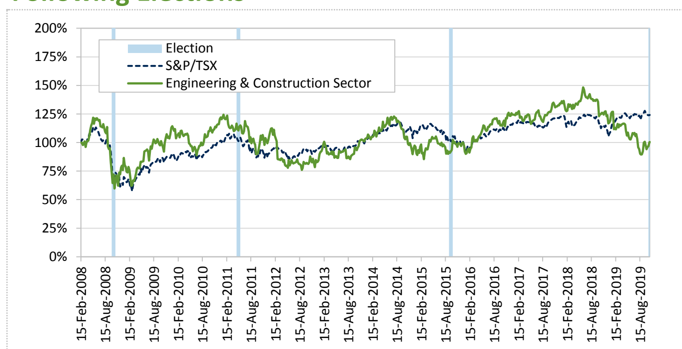
Will a Liberal Minority Government Move Markets?

Any time a new government comes to power, strategists look for ways to tweak their portfolios to benefit from campaign policies and equity markets can make material adjustments for or against sectors of the economy that are perceived to be most affected. This time around, we expected market reaction to the Liberal's minority government to be fairly muted as much of what is driving Canadian stocks is out of the hands of the government; most significantly interest rates, US/China trade, the global economy and oil prices. So far, our expectation has been met. With minority governments, it is always a bit harder to forecast market impacts as all platforms, policies and the government itself are subject to constant review. That said, the Liberals' natural partner in the coming months will be the NDP, and based on their platform we can see two areas of agreement that could be perceived to impact public markets: infrastructure spending and cell phone bills. We also expect one area of contention: pipeline construction. However, as we cut through the rhetoric and study historical precedent, our base case continues to lean towards the status quo.

Infrastructure – More Money but Questionable Gains

Infrastructure spending has been a constant theme for any new government of the past decade (majority or minority), and we see little to distinguish this one. Federal dollars will continue to flow to public infrastructure and perhaps even housing in the new Trudeau mandate but as we have seen in the past, the overall impact to public companies is rarely enough to move the needle.

Engineering & Construction Sector Performance Following Elections



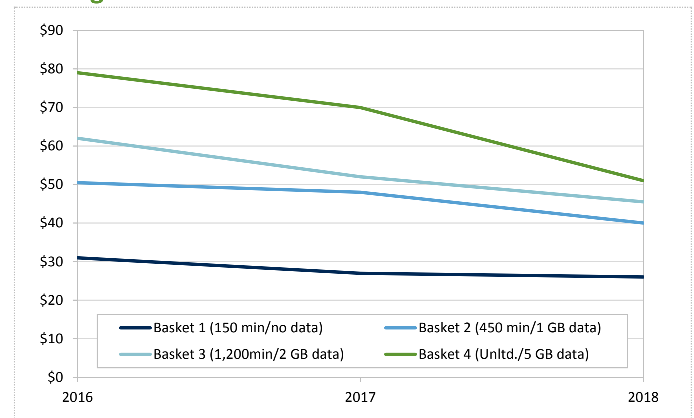
Source: Bloomberg, Raymond James Ltd.

The post credit-crisis governments of Stephen Harper in 2008 (minority) and 2011 (majority), as well as the first Trudeau government in 2015 all promised and delivered significant infrastructure spending but the impact on key beneficiaries, engineering and construction firms, was fairly indistinguishable against the overall direction of the S&P/TSX. We think this time around will be no different.

Cell Phone Bills – Discount Please!

On the subject of cell phone bills, both the Liberals and NDP ran on policies to reduce the cost to consumers. Like the multi-party crusade against bank fees in the 2000s, pledges to reduce the costs of cell phones are an easy way to curry favour with voters (Who doesn't own a cell phone? Who doesn't think they pay too much?), but are much more difficult to implement in practice. Under Prime Minister Harper, the Conservatives pledged to bring in a fourth national carrier to increase competition (they specifically courted US telecom giant, Verizon Inc. (VZ-US) in 2013) but to no avail. This time around, the Liberals and NDP committed to going straight to the source and pledged to mandate a reduction in cell phone bills. Without getting into the legal and regulatory hurdles of superseding the CRTC, the best argument we can make against the "Big 3" Canadian telecom companies (BCE (BCE-T), Rogers (RCI.B-T) and TELUS (T-T)) taking a major hit in the Trudeau minority government is that market forces are already at work to accomplish the goal. Government data shows that through different methods (increased domestic competition, unlimited data plans, handset payment options, etc.) the industry has demonstrated a decent track record of lowering the monthly outlays for its cell phone customers. The CRTC's data shows that over the 2016-2018 period, the average Canadian cell phone bill dropped 28% to $51.05. The drop at the high end (unlimited talk minutes, 5GB of data) was even more, down 35% (source: CRTC - Communications Monitoring Report 2019).

Average Prices for Cell Service – Canada 2016-2018



Source: CRTC

Another way to track the risk of government policy for the Big 3 is to compare and contrast each one of the companies' exposure to its cell phone (wireless) business. Breaking down the revenue sources of each player it shows a fairly large discrepancy between the Big 3, with BCE having the smallest exposure to wireless revenues, while Rogers has the most. On an EBITDA basis, T and RCI.B both have roughly 70% higher exposure compared to BCE. Therefore, BCE would have the best insulation against government interference in cell phone rates but due to its concentration in wireline, it is also the slowest growing of the three.

"Big 3" Exposure to Wireless Business

	Revenue			EBITDA			Wireless
	Wire-line	Wire-less	Other	Wire-line	Wire-less	Other	EBITDA Margin
BCE	50.5%	35.8%	13.8%	52.4%	37.8%	9.8%	44.8%
RCI.B	26.2%	61.1%	12.7%	28.2%	64.4%	7.4%	49.0%
T	45.7%	54.3%	0.0%	33.6%	66.4%	0.0%	46.4%

Source: Bloomberg, Raymond James Ltd.

Pipelines – Friend or Foe?

Finally, the building of pipelines and energy infrastructure has also become a major part of the Canadian political discussion in recent years as it is perceived to be part of the broader topic of Canada's commitment to reducing greenhouse gas emissions. Although the Trudeau government has been a lukewarm supporter (at best) of pipelines, we do think that the PM's comments on the TransMountain expansion, the day after the election, were constructive. Not only did he say that he wanted to move forward on the project "as quickly possible" he also took pains to point out that profits from the project (estimated at $500 million/year starting in 2023) would be used exclusively for investment in green technology. We see this as more than just a sop to Alberta as $500 million per year in green energy spending is a message targeted much more precisely to the government's base in urban Ontario and Quebec. In regard to pipeline construction, like most investors (Canadian and foreign), we will "believe when we see it" but if current rhetoric is worth anything, the government appears serious about getting this key piece of infrastructure built. Whether this is enough to lift the significant discount placed on the Canadian energy sector by foreign investors is debatable but it does appear that in terms of optics, the worst may be behind the industry even if energy investment and employment continues to plumb new depths.

Conclusion – Meet the New Boss, Same as the Old Boss

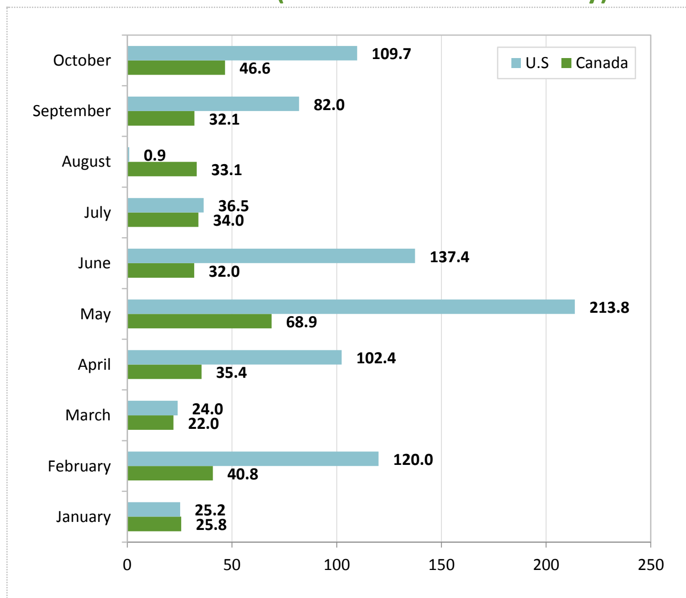
Investors often look to new governments as a potential source of change for their portfolios but history shows that major changes to market trends are either hard to come by or are experienced over a protracted period of time. We believe that in a minority government situation and a macroeconomic backdrop more dependent on external vs. internal factors, major changes are even less likely. In general, our view for Canadian equity investors is to stay the course and avoid making any knee-jerk reactions to their portfolios based on the recent outcome of the Canadian election.

Robert Mark, CFA
Portfolio Manager

Fixed Income, FX & Canadian Elections

The question on everyone's mind is: how did the Canadian elections impact fixed income and currencies? The short answer is they did not. Though the Liberals were only able to secure 157 seats, down 20 from the previous parliament and thus losing their majority status, the market is much more concerned with broader global themes, including Brexit, US-China trade tensions and a looming 2020 US presidential election process that grows increasingly chaotic. As a result, the CAD traded in a subdued fashion on election night and FX traders focusing more on the retail spending numbers released the morning after. The 10-year Government of Canada (GoC) bond yield was effectively unchanged as well, hovering around 1.515%. Although there was no immediate observable impact on currency and yields, it is important to note that the election results may eventually, albeit gradually, reveal their economic impact over the long term. Assuming a pact between the NDP and the Liberals, both of whom look to aggressively tackle increasingly expensive housing through the federal balance sheet, there will be a widening budget deficit in the coming years. This may ultimately result in increased issuances in sovereign debt to finance these projects. Given the prevailing low interest rate environment and accommodative monetary policy decisions, as the federal balance sheet numbers evolve, yields and the CAD may come under pressure.

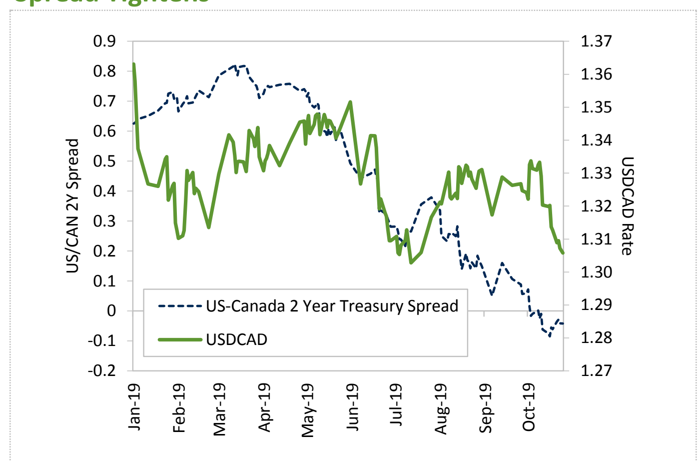
YTD New Debt Issues (Billions of Home Currency)



Source: Bloomberg, Raymond James Ltd.

Looking beyond the election, after an extended period of decline, Canadian yields steadily climbed higher throughout October on hints of optimism that pressing global growth concerns may alleviate. However, the trend eventually reversed, dipping sharply after the Bank of Canada (BoC) announcement on October 30th, where the overnight rate was left unchanged at 1 ¾ percent. Although the BoC did not rule out a rate cut early next year, the bank felt that its current monetary policy stance is accommodative given the data currently available. Further, the BoC made an upward revision to the current year GDP forecast, while revising down the following two years, citing potential future headwinds to exports given the Loonie's recent appreciation against various currencies. Month over month, the 2-year GoC yield was up 1.5 basis points, the 10-year up 10bps and the 30-year up 11bps, bringing traces of normalization to a still inverted but flat yield curve. It is worth noting that as domestic investors grow increasingly complacent in an environment where fixed income continues to offer lower and lower rates of returns, many foreign bond investors are rushing to the Canadian fixed income market. This comes as developed market countries, specifically in Europe, see their markets slip to negative sovereign yields. For example, Greece, a country that was under significant financial duress just a few years ago, issued its first negative yielding short-term debt on October 9, as the European Central Bank looks to take appropriate measures to stimulate growth in the European Union. In comparison, Canada's prominence as a developed nation that offers an attractive risk-return profile continues to grow internationally. This afforded the Canadian banks room to issue debt in foreign markets to cater to this demand.

CAD Strengthens Against USD as 2-Year Treasury Spread Tightens

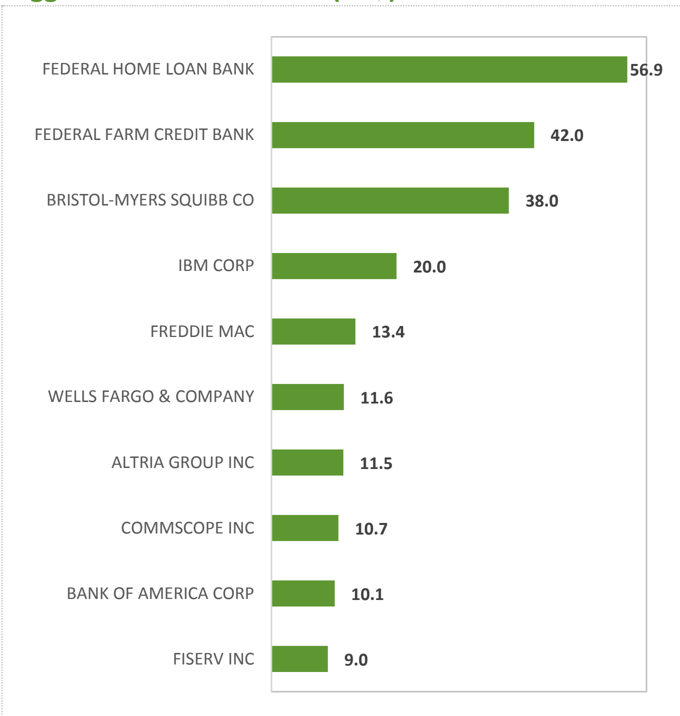


Source: Bloomberg, Raymond James Ltd.

The US stepped into October with a continuation of weak manufacturing, employment and global growth data, which

started in August. With investors rushing into safe haven assets, yields plummeted to historical lows. The 10-year r Treasury note traded at a low of 1.503% on October 6, just above the all-time low of 1.470 reached in June 2016. The low interest environment has created an ideal environment for giants like Wells Fargo, Apple, J.P. Morgan and Walt Disney to add billions in new debt to their balance sheets at a low cost. As 2019 comes to an end, new debt issuances have reached modern day highs. Although the US Treasury curve remains very flat, October saw short-term rates decline while mid to long term rates rose. In particular, 1-month to 1-year Treasury yields declined by 19 – 27bps, while 10-year were up 11bps and the 30-year was up 15bps, removing the inversion that sent some investors into panic earlier this year. October 30 saw the Federal Reserve cutting the federal funds rate by 25bps, bringing its target range to 1.50% to 1.75%, mentioning that major deterioration will be required to justify another cut going forward. A case can be made that the swift dovish turn in the Fed's interest rate policy has had its intended impact in alleviating yield curve concerns, as the Fed has effectively insured the domestic markets against anticipated challenges.

Biggest Bond Issuers in US (US$)



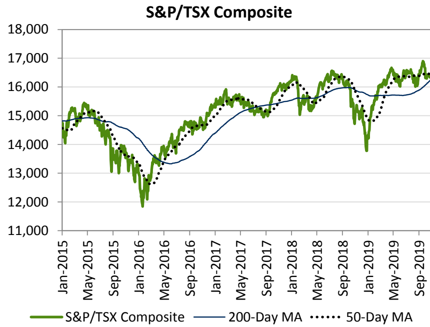
Source: Bloomberg, Raymond James Ltd.

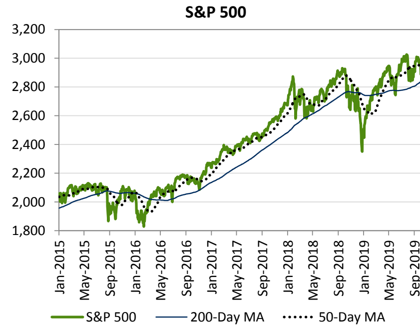
It must be pointed out that two broader concerns remain in the US debt market. Firstly, investors are concerned that after the consecutive months of rallying in bond prices, how much lower can they fall and if this will this impact asset allocation in portfolios. Investors are stuck between increasing allocation towards riskier assets with higher returns and keeping their debt holdings in case of a worse than expected global slowdown. Secondly, both financial institutions as well as the Fed have acknowledged funding concerns, which were blatantly evident after a liquidity shortage in mid-September caused the overnight lending rate to spike as high as 10%. To counter this abnormal move, the Fed ramped up its overnight repo operations in the second half of October, recently engaging in a 14-day program and raising minimum offerings from US$75bln to US$120bln. This was done in an effort to expand liquidity in the short-term markets, which have recently become volatile amidst a dovish interest rate policy. This is just a series of policy-making decisions by the Powell-led Fed, which has demonstrated that it is not willing to take any chances with the backdrop of mounting global risks.

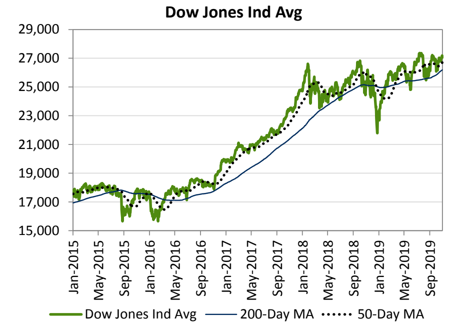
Ahmed Husain
Fixed Income

Charts of Interest

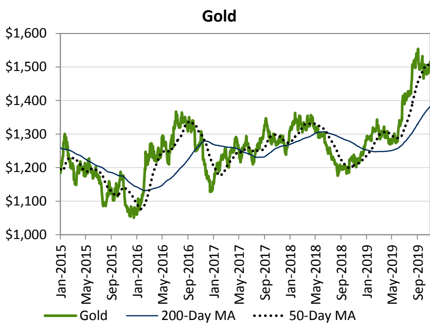
Markets

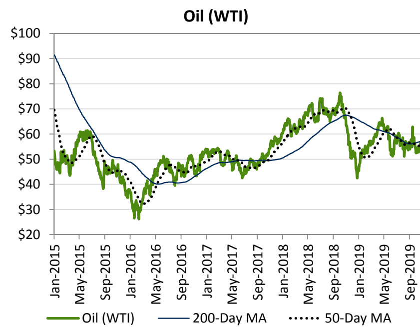


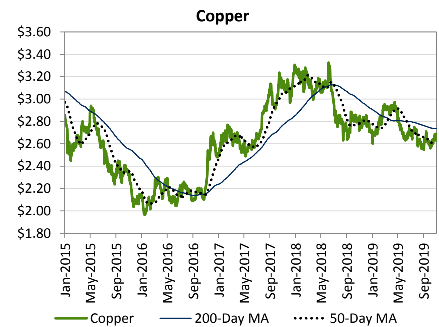




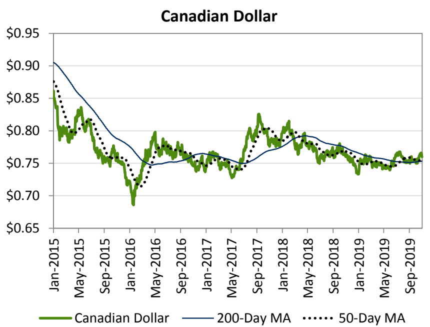
Commodities

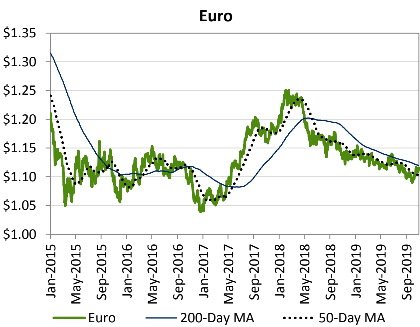


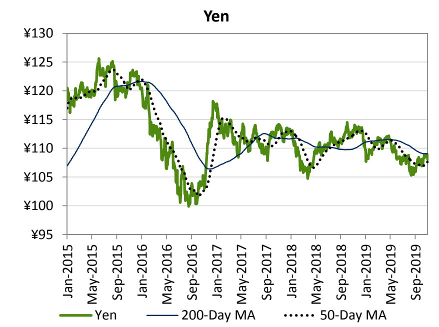




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at October 31, 2019.

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