QV UPDATE

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Only Time Will Tell

The political and economic tides have most decidedly turned in Canada over the past twelve months. Our once G7 leading economy is now teetering on recession, and within that context, two long serving governments touting austerity are no longer in power.

In May, the New Democratic Party of Alberta won the provincial election to the surprise of many. Their economic platform focused on running deficits to 2019 in order to maintain spending in healthcare and education, and to invest in new infrastructure projects. Six months later, the Liberals won the majority of seats in our recent federal election, promising to invest more in our economy.

Both parties promised to increase taxes for the “rich”, and to spend more to invigorate growth, create jobs, and diversify our economy. A winning strategy for their election campaigns; time will tell if it is a winning strategy for the economy.

The new Alberta government recruited former Bank of Canada Governor David Dodge to provide guidance on their five year capital plan. Based on his recommendations, there will be a 15% increase in spending on reparations to roads, schools and hospitals. From Mr. Dodge’s perspective, Alberta should take advantage of the low interest rates, their AAA credit rating, and declining labour costs to invest in infrastructure. Dodge argues that it is appropriate for the government to “*be spending more than they are taking in when there is slack in the economy, to support the economy as it's a very good time to get things done. When conditions are more buoyant, governments should be running big surpluses, leaning against that inflationary wind*." Dodge prefers investment in long-life projects, with future revenue streams to offset costs, and to provide needed economic stimulus. Debt issuance can be supported, he argues, if it enhances the productive capacity of our economy.

Based on the new Alberta government’s ambitious spending plans, the provincial budget deficit is expected to be $6 billion for 2015-2016, representing approximately 1.8% of the province’s gross domestic product (GDP). Cumulative deficits over the next three years are expected to total $15.8 billion, increasing the province’s total debt to GDP from 3% to 7%. As a comparison, Ontario’s debt to GDP is at 39.5%. The US is at 101.3%. Alberta’s debt is still low, but it is rising quickly in comparison.

The Liberal Party of Canada also heeded David Dodge’s advice with a plan to double the current infrastructure investment over the next 10 years. A higher tax rate for Canadians earning $200,000 or more, and a cut in taxes for lower income earners is expected to be included in their first budget to be tabled in December. Their election platform planned for a $10 billion deficit in each of the next two fiscal years, and they expected to return to a budget surplus in five years.

It is difficult to predict if these policies will be successful in stimulating economic growth. The public sector does not have the best track record in making profitable spending decisions. Plans for balanced budgets are also often delayed given overly ambitious revenue targets, and/or a lack of spending restraint. Further, the tax cut for middle income earners may not be enough to offset the deflationary impact of the tax increase on the highest income earners. We also risk our AAA credit rating if deficits grow larger than expected.

This shift back to budget deficits will increase the supply of Canadian sovereign debt. We expect this will put upward pressure on bond yields. This extra spending may also have an inflationary impact, which would not be unwelcomed by our central bankers. The Bank of Canada continues to focus on the widening output gap (the difference between potential economic output and actual output) in citing the need to keep overnight rates near zero. Will increased government investment help to narrow this gap, potentially putting upward pressure on prices? Only time will tell. In the meantime, we view this extra stimulus as potentially inflationary. Given this view, we will maintain our short average term bond strategy to preserve capital. We await more details about each government’s capital spending plans to learn if any of the businesses in our portfolios may benefit.