QV UPDATE
Weekly Commentary | March 31, 2017
Vanessa McNabb, BComm | Ian Cooke, CFA

QV Investors Inc.

Much Ado About Nothing

Who would have thought the title of this Shakespearean comedy, turned Hollywood "romcom" movie, would aptly describe Canada's 2017 Federal Budget? In the story, the fates of two romantic relationships are at the mercy of a series of staged dramatic events, hearsay and accidental overhearing. Just as in the story, rumours ran amok leading up to last week's budget release, which on most accounts failed to amuse. Not surprisingly, Canada has decided to tread lightly in the face of a potentially more competitive US economic backdrop.

One of the hotly debated topics leading up to the release was the potential increase to the capital gains inclusion rate, which refers to the percentage of realized capital gains brought into taxable income. Many in the investment community were preparing for the inclusion rate to increase from 50% to 66%, or even as high as 75%. Some investors went as far as to crystalize their gains, preferring to pay tax now at the lower inclusion rate rather than deferring tax to the future at a potentially higher rate. To many investors' surprise, Canada's Minister of Finance, Bill Morneau, suggested that an increase to the capital gains inclusion rate was not even a key area of focus for this budget.

Was all that fuss "much ado about nothing"? For investors who knew that in the near-term they would need to sell securities in order to accomplish an overriding objective, such as restructuring investment portfolios, transferring from one financial institution to another, or provisioning for a withdrawal, one might argue they are no worse off. After all, Morneau did not explicitly state that such tax reform was off the table for future budgets. However, for long-term investors, realizing gains earlier than necessary could mean forfeiting future capital growth that would otherwise be earned through compounding the amount paid in tax. Though we understand the importance tax strategy plays in financial planning, we place investment strategy first, keeping with the old adage, "the tax tail should not wag the investment dog."

The Federal Budget does highlight a growing concern relating to deficit spending and Canada's ability to navigate through more challenging times ahead. We are pleased to see Canada's willingness to maintain their AAA rating, holding its net debt to GDP ratio near flat at 31.6%, still the lowest of the G7 nations. What is concerning is the seemingly unapologetic willingness to defer the achievement of a balanced budget. This complacency towards Canada's fiscal position leaves little room for Canada to address challenges that could arise from US economic policy reform. Better fiscal positioning would provide us with more confidence in Canada's commitment to remain competitive.

A similar story was being told out West as Finance Minister, Joe Ceci, delivered Alberta's third consecutive deficit budget two weeks ago. The NDP government is forecasting a $10.3 billion deficit for 2017, with debt expected to increase to $71 billion by 2020. Despite the province's ever increasing debt, it still leads the nation with the lowest net debt to GDP ratio at 6.1%. Concerning to us is that much of Alberta's budget is predicated on a significant recovery in the oil and gas sector. In the event of a less than rosy recovery in the oil patch, the province still has policy levers it could pull to help reduce much of the deficit, such as a sales tax or increasing income tax, albeit both unappealing to tax payers.

Alberta's low debt ratios and potential tax levers help us find comfort in our existing Alberta bond holdings, which are short in duration, maturing within seven years. Even in a weak economic environment, we do not foresee substantial credit risk. Nevertheless, Alberta's deteriorating balance sheet will cause us to assess whether there are better opportunities to invest in the bonds of other provinces offering comparable or better yields, but with an improving economic outlook and a focus on debt reduction.

With interest rates near record lows and credit widely available, increasing reliance on debt is concerning. For these reasons, we maintain defensive credit positioning in our bond and equity portfolios. *Much Ado About Nothing* is generally considered one of Shakespeare's finest comedies. For long-term investors, tax payers, and lenders, current borrowing trends are no laughing matter.

Copyright © 2017 QV Investors Inc. Readers may forward electronic versions of this Update. All views and projections are the expressed opinion of QV Investors Inc. and are subject to change without notice. This Update is provided for informational purposes only. QV Investors takes no legal responsibility from any losses resulting from investment decisions based on the content of this Update.