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Don't Rely on the Punch Bowl

A plaque sits outside the walls of the St. Louis Federal Reserve building describing Chairman William McChesney Martin Jr., who was born and raised in St. Louis. He was the longest serving Federal Reserve Chairman from 1951 to 1970 and served under five presidents, from Harry Truman to Richard Nixon. The plaque reads, "On controlling inflation, he said that the Federal Reserve's role was 'to take away the punch bowl when the party gets going.'" With the Bank of Canada and the U.S. Federal Reserve well underway in their hiking cycles, we wonder how many days are left until the punch bowl is taken away.

North American economic indicators continue to show signs of vigor: near full employment in the labour markets, healthy economic momentum, and inflation is now finally back at the target rate of 2.0%. While both banks are comfortably in hiking mode, interest rates still remain near their historically low levels. From a borrower's perspective the cost of debt remains alluring. Many issuers have taken advantage of these low rates to finance transformative acquisitions in recent years. We are highly aware of this trend as many of our businesses and issuers have leveraged their balance sheets to finance these purchases. Our assessment of a business's ability and willingness to deleverage within a reasonable timeframe is an important consideration in our investment thesis and our strategy teams are managing this credit risk.

Perhaps equally concerning is the transition we are witnessing from reliance on monetary policy to expansion of fiscal policy as governments pass budgets with structural deficits to support continued growth. In the U.S., the Congressional Budget Office estimates a federal deficit of $800 billion this year and $1 trillion in 2020. These deficits will be debt financed through the issuance of U.S. treasuries, as rates remain attractive for this record amount of borrowing.

On the domestic front, Alberta and most recently Ontario (which account for ~55% of the national economy combined) are also posting large budget deficits. Oil-levered Alberta is expected to post an $8.8B operating deficit this year and $7.9B next year with no sight of reaching a balanced budget until 2023. Perhaps in efforts to win voters, Ontario completely reversed its fiscal trend and tabled a budget with serial deficits of $6B-$7B over the next three years. Canada's most populous province managed to eke out a balanced budget last year but now will not see any shades of black ink until 2024. We highlight that the back-weighted nature of these provincial deficit reduction plans does not exude a strong willingness to maintain fiscal strength today. Our bond and balanced strategies own short to mid maturity bonds from these provinces as their yield and liquidity benefit the portfolio. But these fiscal trends do warrant concern and we will manage their exposure within the overall strategy.

We are cautious of the complacency we see in the marketplace. Beware of leverage-friendly management teams that do not respect the inevitability of market cycles. Revenues and cash flow do not always rise in a straight line and debt eventually requires repayment.

Bond yields won't stay at these low rates forever. Fundamentally, increasing capacity pressures and strong labour markets could lead to higher inflation and wage growth that we have not seen for a while. Further, and as mentioned, a large supply of U.S. treasuries will soon be coming online to finance trillion-dollar deficits at the same time the Fed is reducing its balance sheet. As bond supply increases and monetary policy evolves, higher interest rates could meaningfully impact earnings, potentially hindering growth and repricing valuations.

As interest rates normalize from their record low levels, we should expect market volatility to continue. As active managers we advise our clients to be prepared. Be prepared for changes in market environments - long periods of positive momentum tend to foster a sense of security. Our strategies are positioned defensively and are ready to buy at much more generous rates of return than what is currently offered. We believe we will be better off in the long term if we prepare ourselves for the day when the punch bowl is no longer there.