Canada's federal election through a macro lens

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Highlights

- Barring major new policy announcements, we don't expect the federal election to have a major impact on the Canadian dollar, long-term interest rates or the local stock market.
- Fiscal orthodoxy appears to be out of fashion as none of the leading parties are providing concrete plans to balance the budget. The focus remains squarely on supporting the recovery.
- A more credible fiscal plan that outlines a gradual and growth-friendly reduction in the budget deficit is needed to rebuild Canada's strong fiscal position.

While the campaign remains in its early innings, the electoral race looks more unsettled than just a few weeks ago. The possibility of a Liberal majority government, which looked likely earlier this summer is now looking less certain: betting markets currently give the Liberals only a 6% chance of crossing the 170-seat majority line on September 20.[1] A Liberal-led minority government now appears as the most likely scenario, although the outcome remains highly uncertain with the Conservatives gaining momentum in polls. In this monthly edition, we evaluate the impact of the federal election on the Canadian economy and financial markets.

From a macro lens, proposed policy platforms would impact the economy through three broad channels: (1) changes in future budget deficits and debt transmit to growth and inflation; (2) new tax and spending policies could impact income, distribution, and efficiency; and (3) structural reforms tackle long-term policy challenges, such as population aging and low productivity. All three channels are important. But as the economy recovers from its sharpest ever recession, the first channel takes on special importance. With the ongoing transition from stimulus-driven to private sector-led growth, the next government will need to balance the withdrawal of deficit-financed spending to support the economy in the short term with reducing debt to restore Canada's strong fiscal position in the long term.

The leading parties have prioritized sustaining the recovery and creating jobs over balancing the budget and reducing debt. While the recovery from the pandemic recession is incomplete and still requires support, providing excessive stimulus could run the risk of generating excess inflation. The "employment gap" is now only 270k jobs to return to the pre-pandemic employment rate (Figure 1). Whichever party ends up forming the government, it will be walking a tightrope between too much and not enough fiscal support, a challenge we described in our August commentary.

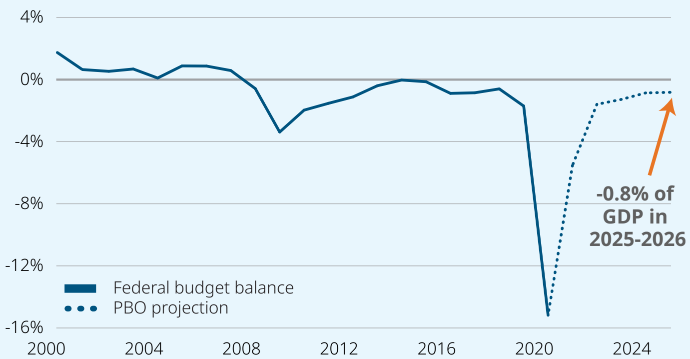
Despite the upcoming balancing act, none of the three leading political parties' electoral platforms have pledged to balance the budget within their first mandate. The Parliamentary Budget Office (PBO), the parliament's independent source of fiscal analysis, estimates that the federal deficit under current policies will persist to the end of its 5-year projection horizon (Figure 1). But the baseline deficit is small at only 0.9% of GDP in 2025-2026. Given this projection, one of the parties could have easily promised

1 PredictIt, https://www.predictit.org/markets/detail/7443/How-many-seats-will-the-Liberals-win-in-Canada's-next-election, as of August 30.

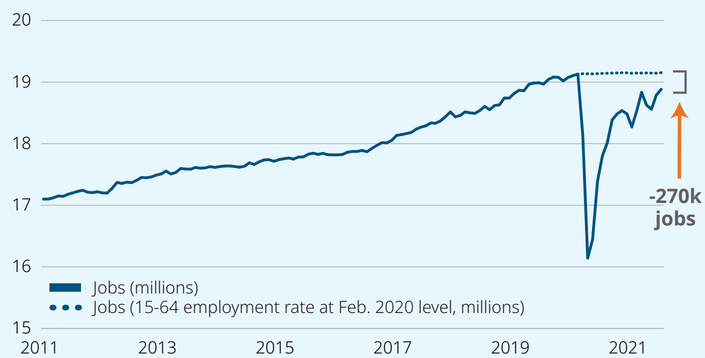
a balanced budget; the fact that none did could be a testament to the decreasing popularity of fiscal orthodoxy in Canada and globally. For Canada, reducing debt to pre-pandemic levels over time would provide fiscal space for both future economic crises and long-term fiscal challenges, such as rising healthcare costs due to population aging.

Figure 1 | Walking a macro-fiscal tightrope

The Parliamentary Budget Office (PBO) projects continuing fiscal deficits as a % of GDP over next 5 years



The recovery is solid though incomplete, and too much stimulus could lead to overheating



Notes: Right chart: Statistics Canada. Left chart: Budget balance (% of GDP) calculated from the PBO's 2021 baseline projections.

We expect financial markets will largely shrug off the Canadian election outcome. Historically, elections have not driven strong volatility in key asset classes, including the Canadian dollar, bond yields and the stock market. As a small open economy, Canada's economy is dependent on a resurgence in international trade, especially with the US. In this context, the major drivers of the Canadian dollar include changes in world commodity prices and global demand that are independent of Canadian fiscal policy. Changes in long-term interest rates are also correlated to US Treasury yields. Compared to the US, public finances in Canada remain relatively solid given the sizable US budget deficit projected at 3.7% of GDP in 2025, high debt, and greater inflationary pressures. This suggests no immediate danger of a confidence problem for Canadian government debt simply because of the election.

Specific policies in the parties' electoral platforms have the potential to impact certain sectors in local equity and credit markets. For instance, the Liberal and Conservative economic platforms share common priorities – supporting the recovery, making housing more affordable, and reducing childcare costs – although they may aim to reach these goals through differing tax and spending policies.

- **Energy**: The three top parties support a carbon tax. The Conservatives' carbon scheme would have a lower tax rate than the Liberal and NDP plans ($20 vs. $50/tonne in 2021). But a tax on carbon seems here to stay.

- **Real estate**: The main parties' solutions to the national housing shortage are centered on constraining foreign buyers to reduce demand. The Liberal's main proposal – banning foreign buyers for two years – goes the furthest, but we expect all parties' demand-side policies to have relatively benign effects on real estate activity and prices. Low affordability is primarily a supply-side problem in Canada. Both contending parties have proposals to expand the stock of housing. The Liberals plan to grant close to $4 billion in funding for municipalities' building efforts, while the Conservatives pledge to convert 15% of federal buildings into housing and mandate denser construction around federally funded transit projects. These are good starts, but likely not enough to shift current real estate dynamics.

- **Financials**: As a boost to homebuyers, the Liberals also suggest (1) decreasing the premium for CMHC mortgage insurance and (2) encouraging tax-free savings for homebuyers. Both measures should allow for higher mortgage borrowing, marginally benefitting Canadian banks. On the other hand, the Liberals' proposed corporate tax increase for big banks and insurance companies will ding profits.

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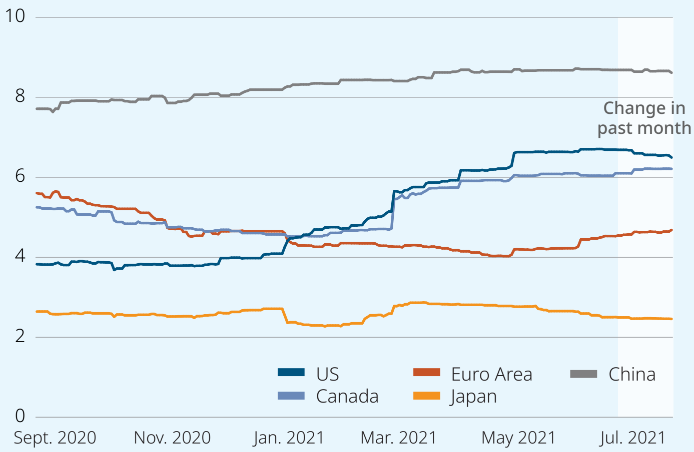
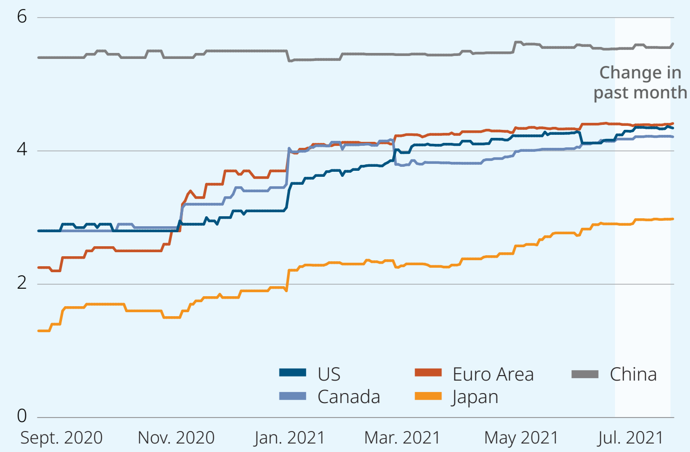
Global macro update

- **US growth** for the final months of 2021 is under threat by rising Delta variant cases, especially in the least vaccinated states. New daily cases are higher than during last winter's Covid wave in 13 states, and cases are on a rising trend (week-to-week) in all but four states. Given infections seem to be peaking in some of the worst hit states, vaccination numbers have been on an upward trend since last July and services consumption was very strong in July amid the rise in cases, we don't expect the recovery to be derailed by the virus. But growth this Fall will likely be slightly slower than previously expected.
- **China growth** forecasts for 2021 slid in the month of July. The Chinese economy is facing macro headwinds, as a withdrawal of fiscal and monetary stimulus in the first half of the year pulled the chair under a recovery driven primarily by public and residential investment. The government hoped the household sector would pick up the slack. It did to some extent, with the household savings rate declining from 33% to 30% in 2021Q, but credit growth slowed significantly in the past three months. The government has since partly reversed course, trying to stimulate bank lending, partly through a reduction in the reserve requirement ratio (RRR), and has signaled further RRR cuts to help cushion the economy as it slows. With this added stimulus China should easily reach its 6% growth target for 2021, but could also add to the private sector's leverage, which is particularly worrisome in the construction sector.

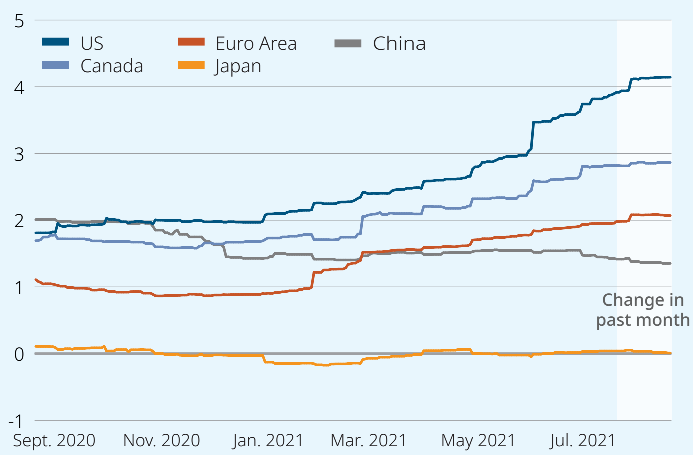
2021 real GDP growth forecast (%, consensus)



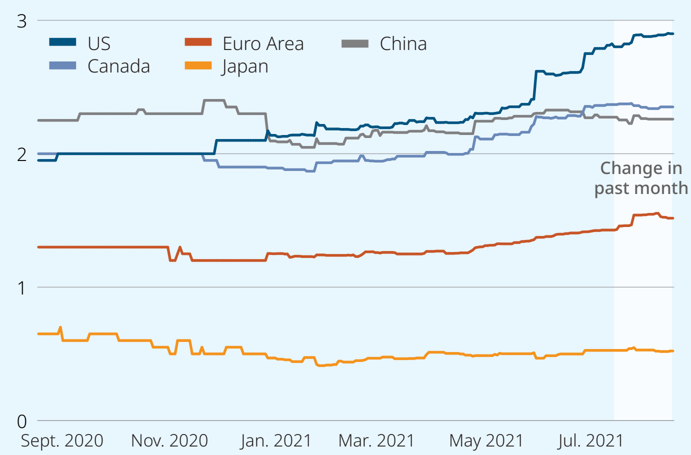
2022 real GDP growth forecast (%, consensus)



2021 inflation forecast (%, consensus)



2022 inflation forecast (%, consensus)



Notes: Forecast surveys from Consensus Economics as of August 31, 2021.

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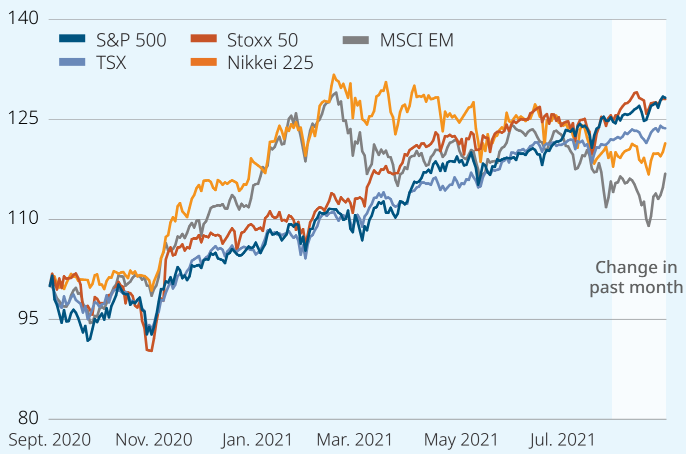
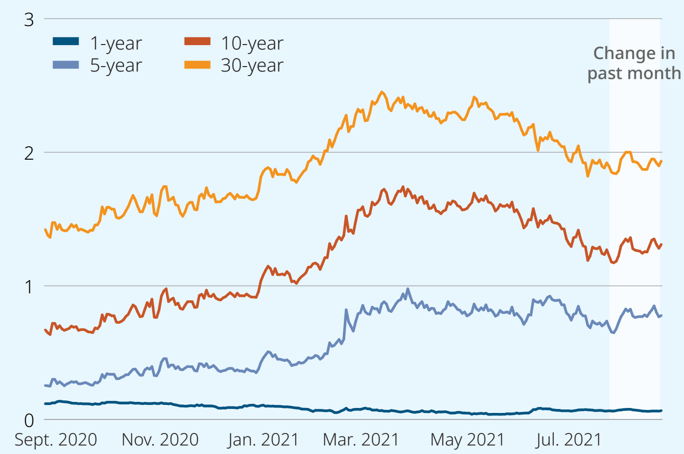
Capital markets update

- After four months of rallying, 10-year **US bonds** sold off slightly during the month of August. The initial jump in yields in early August came with the release of July payrolls showing the strongest employment gains since August 2020 (+943k jobs). The unemployment rate fell from 5.9% to 5.4%, but the labour force participation rate was little changed from its low level. For job gains to continue without generating inflation, the workers that stopped looking for jobs since the start of the pandemic will need to return to the job market. The US economy is still around 8 million jobs short of its pre-pandemic employment rate.
- **Emerging market equities** underperformed in August, dragged down in part by Chinese policymakers' pushback on foreign stock ownership and private education companies. They recovered some of the losses towards the end of the month, as Chinese authorities softened their tone and a global bid for risk assets benefitted high-beta EM stocks.
- The **US dollar index** climbed around 0.5% in the month of August, propped up by solid US payrolls numbers in the first week of the month and a global equity sell-off in mid-August. We expect the overvalued USD to depreciate as other global economies catch up to its recovery lead, attracting capital flows in the process.

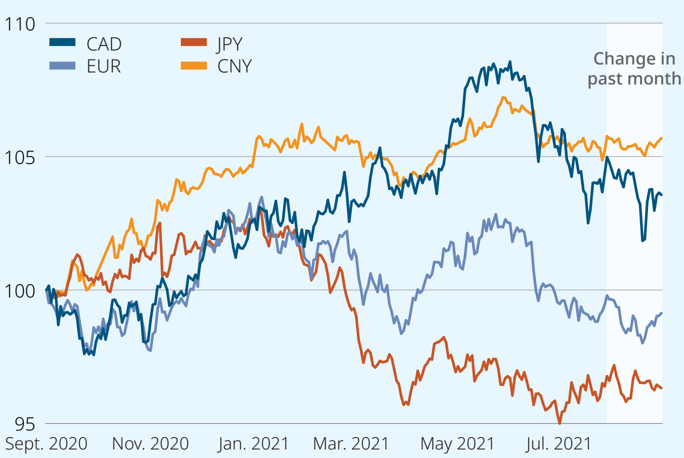
Equity indices (one year ago=100)



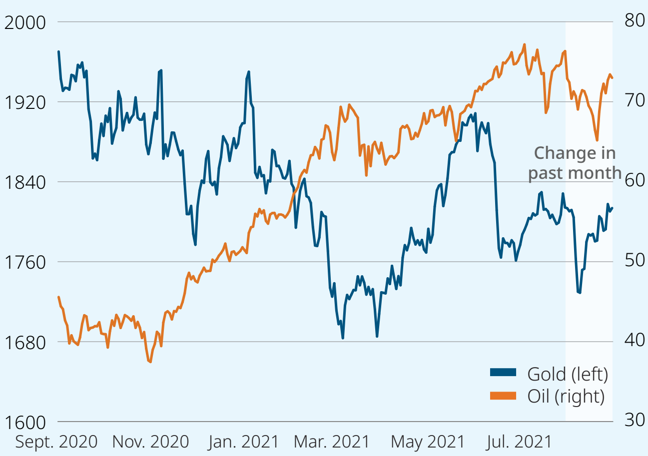
US Treasury yields (%)



Currencies (relative to USD, one year ago=100)



Commodity prices (in USD)



Notes: Financial data from Bloomberg as of August 31, 2021.

What we'll be watching in September

September 17: University of Michigan Consumer Sentiment Index release

- The UMich Index, an important barometer of US consumer sentiment, nosedived in August as inflation persisted and Covid cases rose across the US. The US recovery has relied heavily on household consumption. Plus, future growth depends on consumers continuing to spend their pandemic savings, especially in the service sector. Further deterioration in consumer confidence could threaten the recovery's momentum.

September 22: US Federal Open Market Committee (FOMC) rate decision

- The FOMC's September meeting could give us more details about the timeline to taper asset purchases, which we expect will begin around end of 2021 and be completed around end-2022.
- Powell's speech at the Jackson Hole retreat on August 27 attempted to decouple tapering expectations from rate hike expectations, but in our view it is very unlikely the Fed would raise rates *before* tapering is completed.

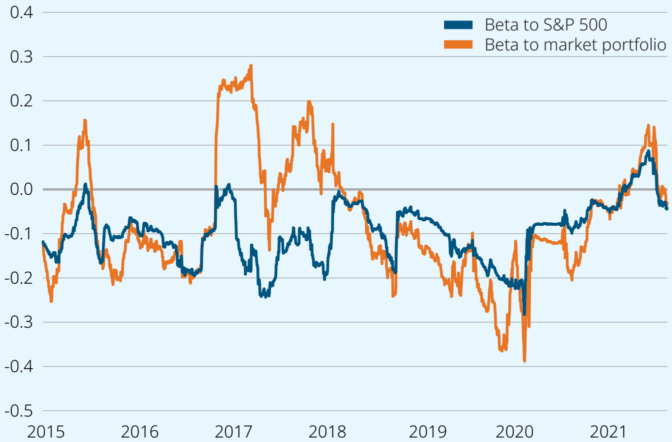
September 22: Bank of Brazil rate decision

- The Bank of Brazil has raised rates more than any other major central banks in 2021, hiking four times since March. With inflation still surging (+9% year-on-year in July), the Bank of Brazil is extremely likely to hike again in September.
- The central bank's hawkish stance should contribute to the appreciation of the undervalued Brazilian real. Brazil's current account balance turned positive in Q1 amid continued strength in commodity prices, which have still not been matched by an equivalent BRL appreciation.

Emerging theme

- **The short-term beta of US Treasuries** has recently reverted to 0 after a few months of unusually positive correlations, both relative to the S&P 500 and a proxy of the global market portfolio.
- **As inflationary pressures slowly ease in the coming year**, we expect correlations between sovereign bonds and equities to revert to their historical averages. Over the last ten years, G7 sovereign bonds all boast negative betas (between –0.2 and 0) to their local equity markets, save for shaky Italy.
- With a low and negative long-term correlation to equities, a long sovereign bond exposure is an **efficient diversification tool and offers downside protection in the face of demand shocks**. The bond rallies in the 2008 financial crisis and March 2020 showed this well. But supply-side shocks, including inflationary run-ups, can decrease sovereign bonds' protective quality. As long as central banks target stable inflation and maintain credibility, inflation spirals that would sustainably flip the bond-equity correlation, as they did in the 1970s, are unlikely.

90-day rolling beta of US Treasuries has fallen back below 0



Notes: Calculated with data via Bloomberg. Market portfolio proxy is 60% MSCI World, 40% aggregate global bonds.

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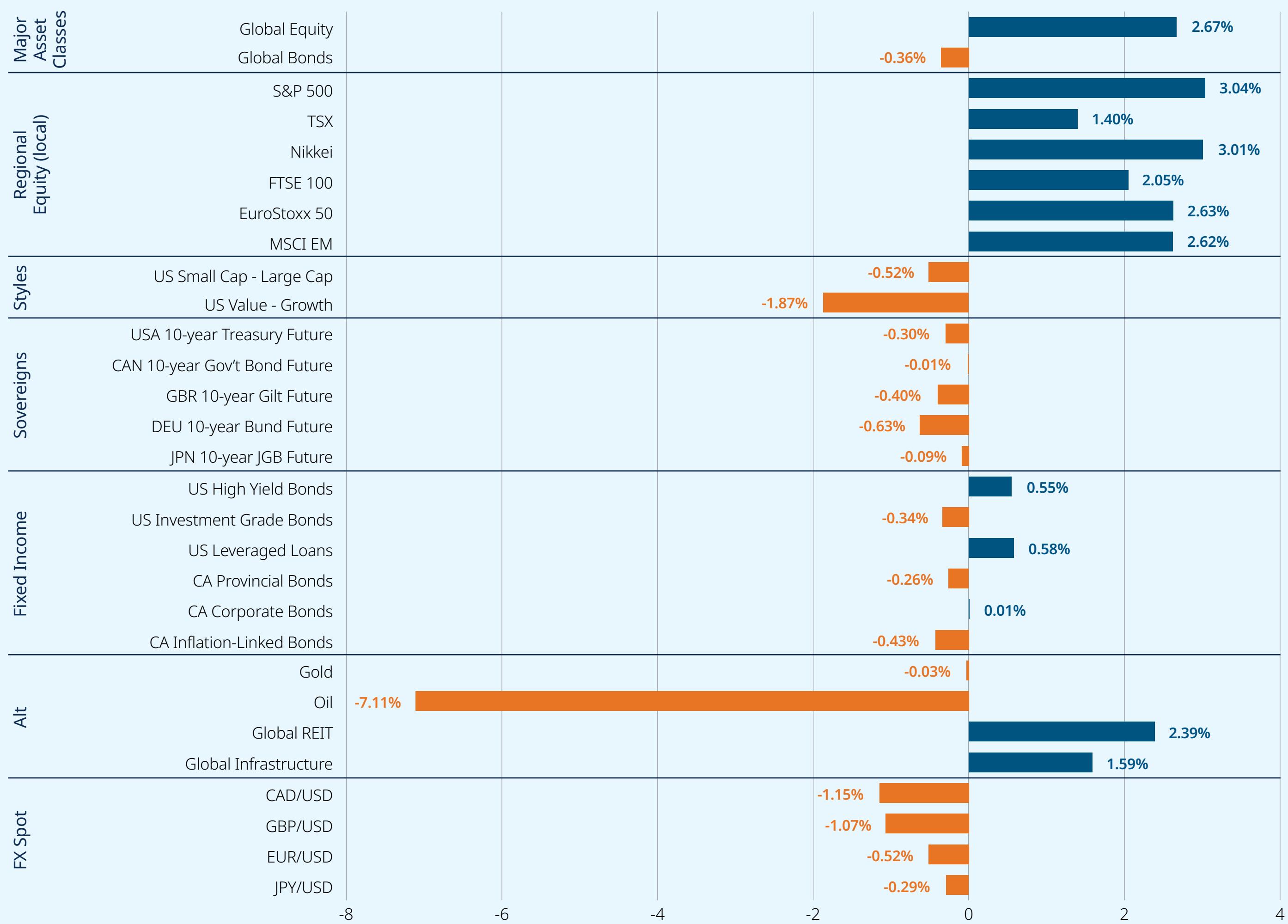
Appendix:
Capital market returns in August



Notes: Market data from Bloomberg as of August 31. Index returns are for the period: 2021-08-01 to 2021-08-31. In order, the indices are: MSCI World (lcl), BBG Barclays Multiverse, S&P 500 (USD), TSX Composite (CAD), Nikkei 225 (JPY), FTSE 100 (GBP), EuroStoxx 50 (EUR), MSCI EM (lcl), Russell 2000 - Russell 1000, Russell 1000 Value - Russell 1000 Growth, USA 10-year Treasury Future, CAN 10-year Gov't Bond Future, GBR 10-year Gilt Future, DEU 10-year Bund Future, JPN 10-year JGB Future, BAML HY Master II, iBoxx US Liquid IG, Leveraged Loans BBG (USD), Provincial Bonds (FTSE/TMX Universe), BAML Canada Corp, BAML Canada IL, BBG Gold, BBG WTI, REIT (MSCI Local), Infrastructure (MSCI Local), BBG CADUSD, BBG GBPUSD, BBG EURUSD, BBG JPYUSD.

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