



# FOYSTON FOR THOUGHT

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# Government "interference" = short-term noise

We regularly advise many of our clients to ignore short-term noise in the markets and focus on the long term. This week, we have two concrete examples proving our point: the Canadian government made one partial U-turn and one complete U-turn just months after announcing two controversial proposals.

#### Exhibit A: Dividend taxation for financial institutions

In March, the federal government released its annual budget which included measures targeted at the financial industry. This news negatively affected the Canadian fixed income market in subsequent months.

The budget proposed changes to the taxation of dividends received on certain shares owned by financial institutions. The proposal would deny financial institutions the ability to claim a tax deduction on the dividends they receive. This announcement was followed by notable selling pressure on preferred shares by retail investors and modest selling pressure from institutional investors. Additionally, the proposed change lowered overall demand for preferred shares as insurance companies, which had been strong supporters of the asset class, decreased their participation in the market as they awaited further clarity from the government. We believe the selling pressure and reduction in demand have been major factors in the performance of preferred shares so far this year.

Moving forward to Tuesday's fall economic statement, the federal government changed course by providing an exception to financial institutions in relation to taxable preferred shares. This development is clearly beneficial for preferred share demand. The market turned very positive as a result, a trend that we expect will continue.

## Exhibit B: Issuance of Canada Mortgage Bonds (CMBs)

March's federal budget also proposed consolidating Canada Mortgage Bonds (CMBs) into the government's regular borrowing program, claiming cost savings. While this proposal would have implications for the mortgage market (access to mortgage financing, insurance costs, etc.), we are only going to address the material impact on the fixed income market.

This budget proposal led to differing opinions on what the change would ultimately mean for the outstanding CMBs in the Canadian market. The initial market reaction was tighter credit spreads on the outstanding bonds given the potential of direct government intervention.

However, as the market digested the budget proposal, the narrative surrounding CMBs changed. Most observers concluded that market liquidity would likely decrease on a permanent basis as CMBs would simply be phased out. This viewpoint resulted in credit spreads retracing their initial move and even widening out past where they had been trading prior to the announcement. Investors who had bought CMBs at the tighter levels likely faced mark-to-market losses. After this consolidation decision, the government received negative feedback from market participants.

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Likely as a result of this feedback from investors, the federal government announced a reversal of the consolidation program in Tuesday's fall economic statement. Furthermore, the government also decided to expand the CMB program while also planning to start purchasing CMBs for itself (for investment purposes). Consequently, spreads on CMBs have, so far, tightened because of these announcements.

#### Conclusion

These two developments highlight how short-term noise may impact fixed income markets. They were surprise announcements that drove gains and losses in the short term.

Announcements and policy changes that appear to be negative can easily be reversed. It is important not to over-react to short-term situations, but rather, to maintain a long-term perspective, understanding fundamental value, and to position investment portfolios in consideration of various outcomes in order to deliver strong risk-adjusted returns.

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