# CHARTBOOK
## Market Comment

Prepared by Ocean Front Wealth Management

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OCEANFRONT WEALTH MANAGEMENT

iA Private Wealth™

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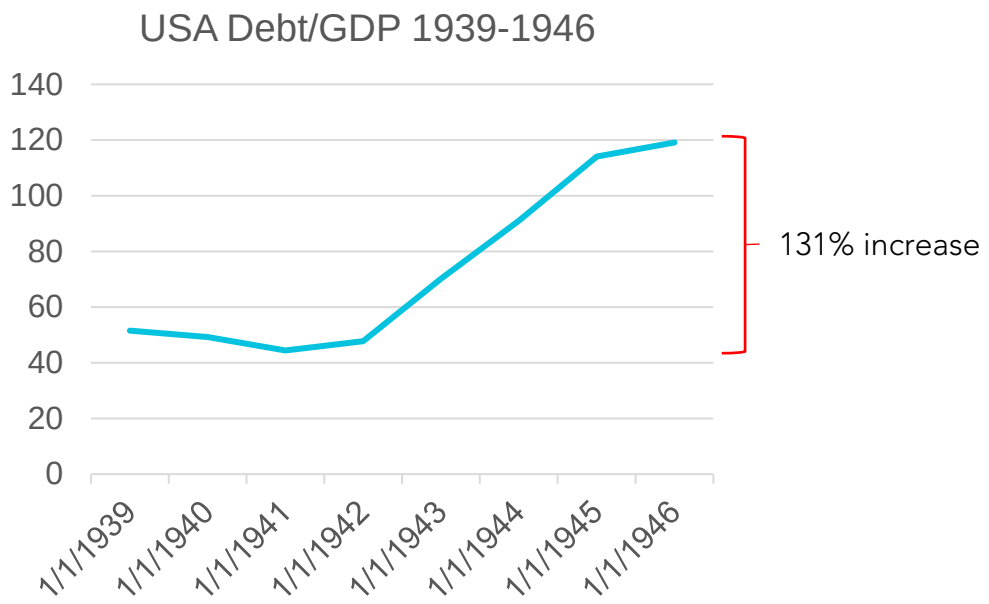
# Market Comment

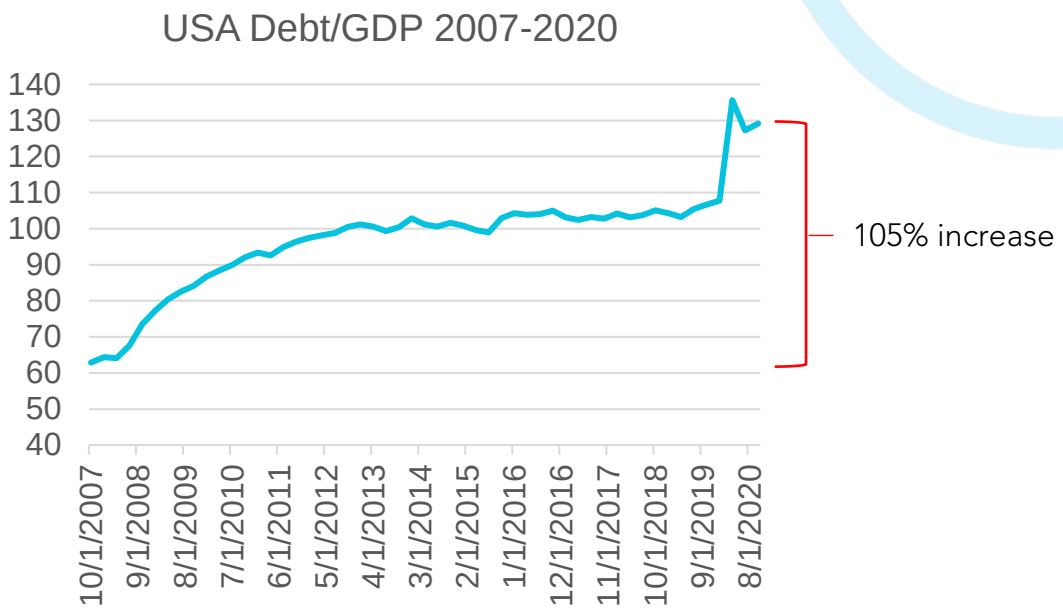
Most global stock markets rose in March, with European stocks leading the way for the most part. The Euro Stoxx 50 Index rose 7.9%, the S&P500 rose 4.4% and the TSX rose 3.9%. Under the surface of the indices there has been significant rotation among different stocks and sectors. The Nasdaq Composite Index, which was a major leader in 2020, was up just 0.5% in March as many of the large technology companies that comprise a significant weight in the index have fallen somewhat out of favour lately.

President Biden signed a new $1.9 trillion stimulus package into law which provides direct payments to Americans, unemployment insurance relief and funds for vaccine distribution, among other measures. Since then, Biden has announced a plan to raise corporate taxes in order to help fund this package and other spending.

With the Canadian government's budget being presented on April 19, we will be watching to see what Trudeau's plan is to fund its pandemic relief spending.

# Debt Accumulation



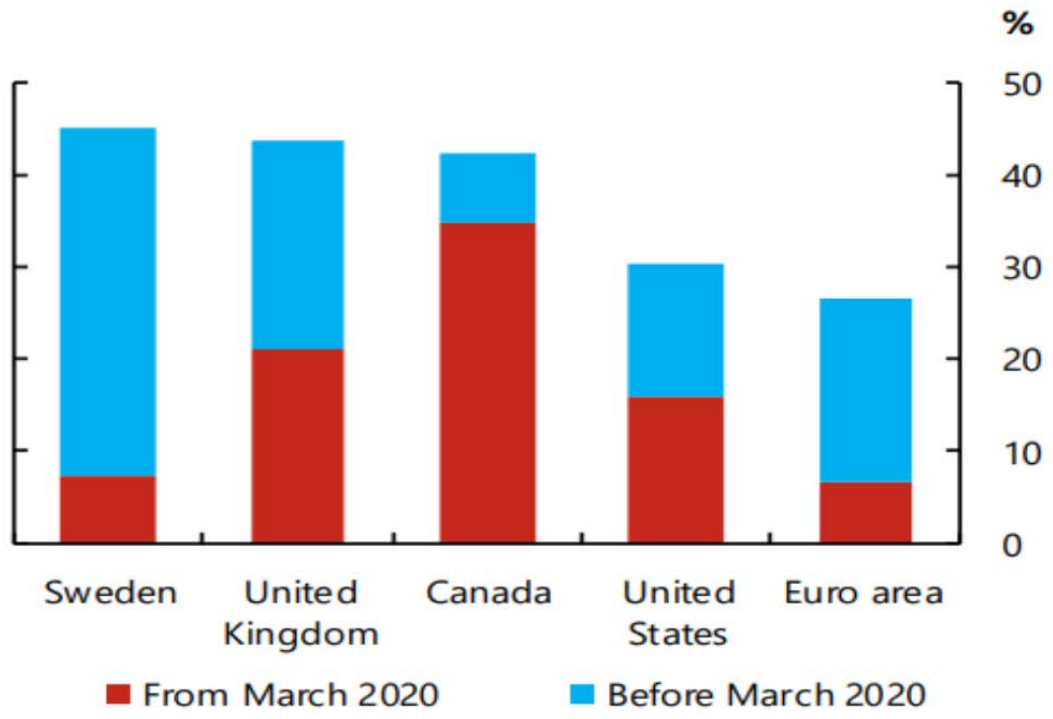




Government debt has increased significantly since the Global Financial Crisis, and debt growth has accelerated dramatically during the pandemic. The increase is comparable to the debt issued to fund spending during World War II.



Source: US Federal Reserve Bank of St. Louis, Ocean Front Wealth Management

# Who is Buying the Debt?




Governments issue treasury securities *(t-bills, bonds, etc.)* when they need to borrow money. Common buyers include retail investors, institutional investors like pension funds and mutual funds, and foreign governments. Governments can also buy their own debt, which is most often done using newly printed dollars by the country's central bank (Bank of Canada, US Federal Reserve, etc.). In other words, the government is essentially printing money to fund its budget.

As you can see in the chart to the left, the Canadian government owned about 10% of its total debt outstanding prior to March 2020, which ballooned to about 35% following increased spending during the pandemic.

Governments buying their own debt is also a way to keep interest rates low by keeping bond prices high. If governments were not buying, we would likely see bond prices fall and rates and yields rise, which in turn would increase the interest burden of the debt.

Source: Bloomberg, Ocean Front Wealth Management

# How Will the Debt be Paid?

Governments generally have 4 options to choose from to reduce debt burdens:

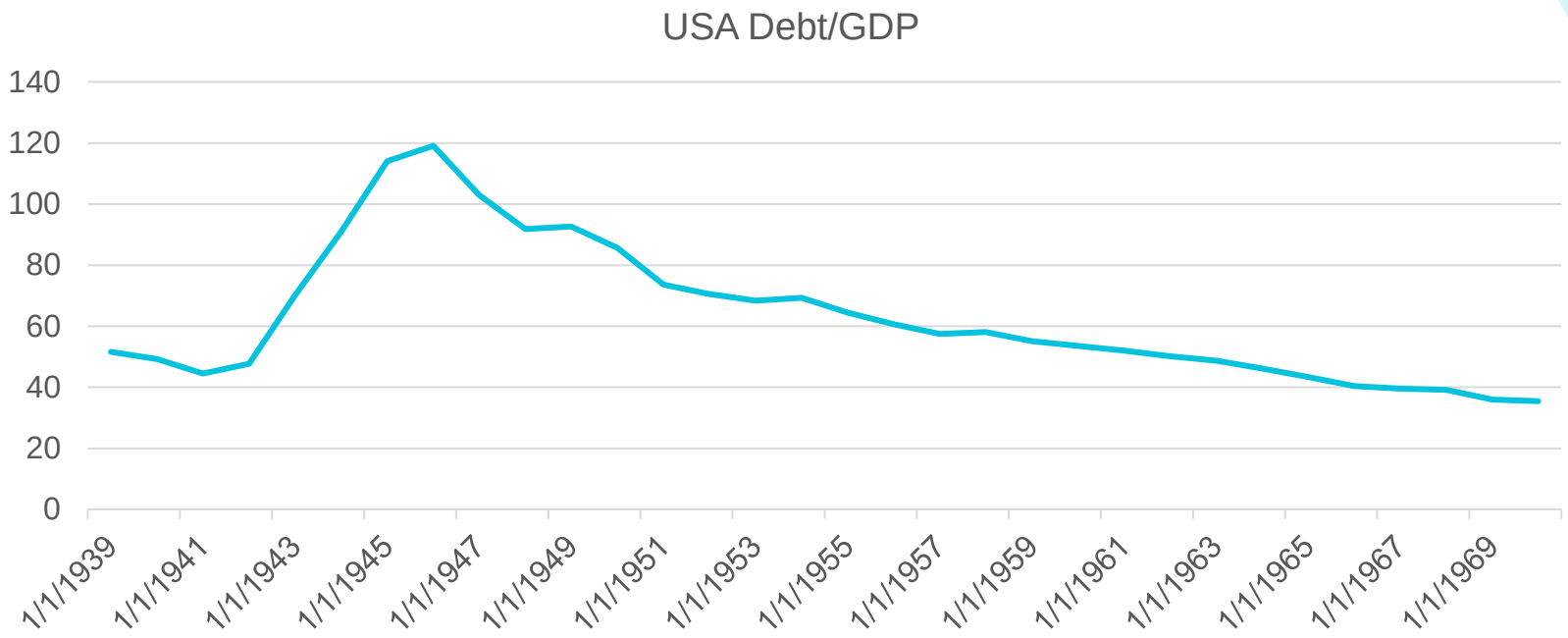
1. **Austerity**: cut spending to develop a budget surplus
2. **Increase revenue**: taxes are increased in some manner like income tax hikes, capital gains tax increases, or new taxes are introduced (such as eliminating or reducing the capital gains tax exemption on principal residences)
3. **Defaults/restructurings**: for a government whose debt is denominated in its own currency, it can print money to pay its debt, making this option unlikely
4. **Money printing**: this approach is similar to what's called "inflating the debt away". Adding to the money supply makes all pre-existing money worth less than it was before, which devalues the debt in relative terms and makes it more manageable

Options 1 and 2 are usually very unpopular with voters making them difficult to enact politically. We expect we will see some combination of option 2 and 4 come to fruition. The Government of Canada has announced that its new budget will be presented on April 19, 2021. It will be interesting to see if changes to taxes are included.



Source: Big Debt Crises by Ray Dalio, Government of Canada, Ocean Front Wealth Management

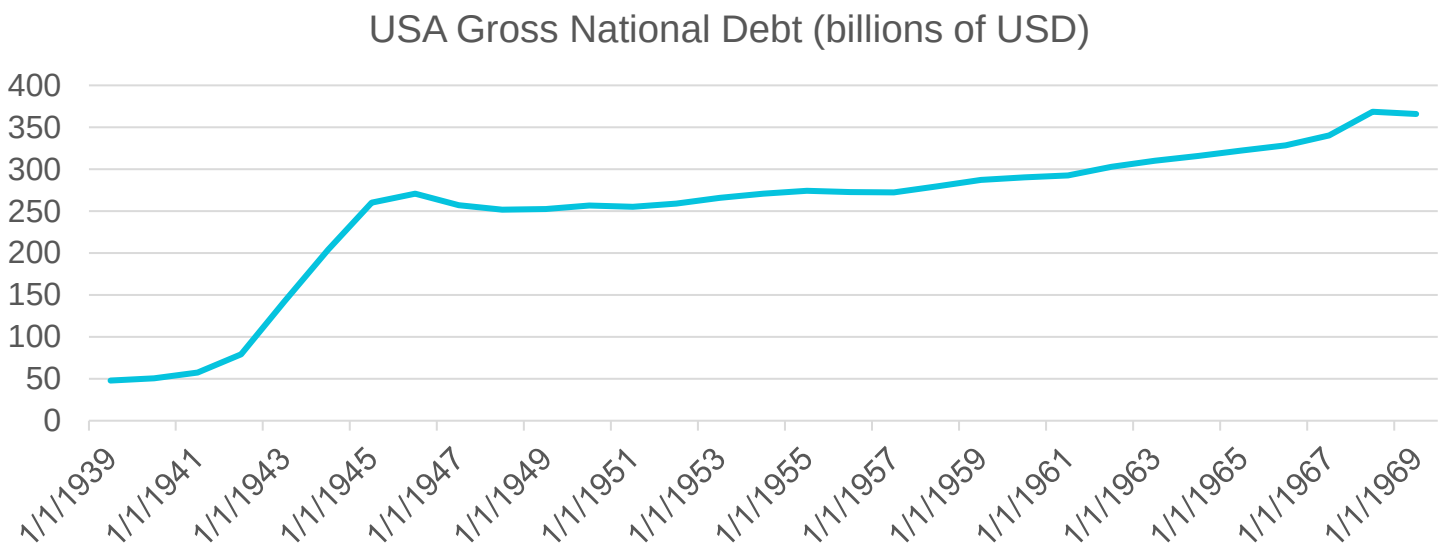
# World War II Debt




You can see in the chart that by 1970, the USA national debt (measured as a percent of GDP) had returned to pre-war levels. How was it paid down? We will examine the components of this debt/GDP ratio.

Source: US Federal Reserve Bank of St. Louis, Ocean Front Wealth Management

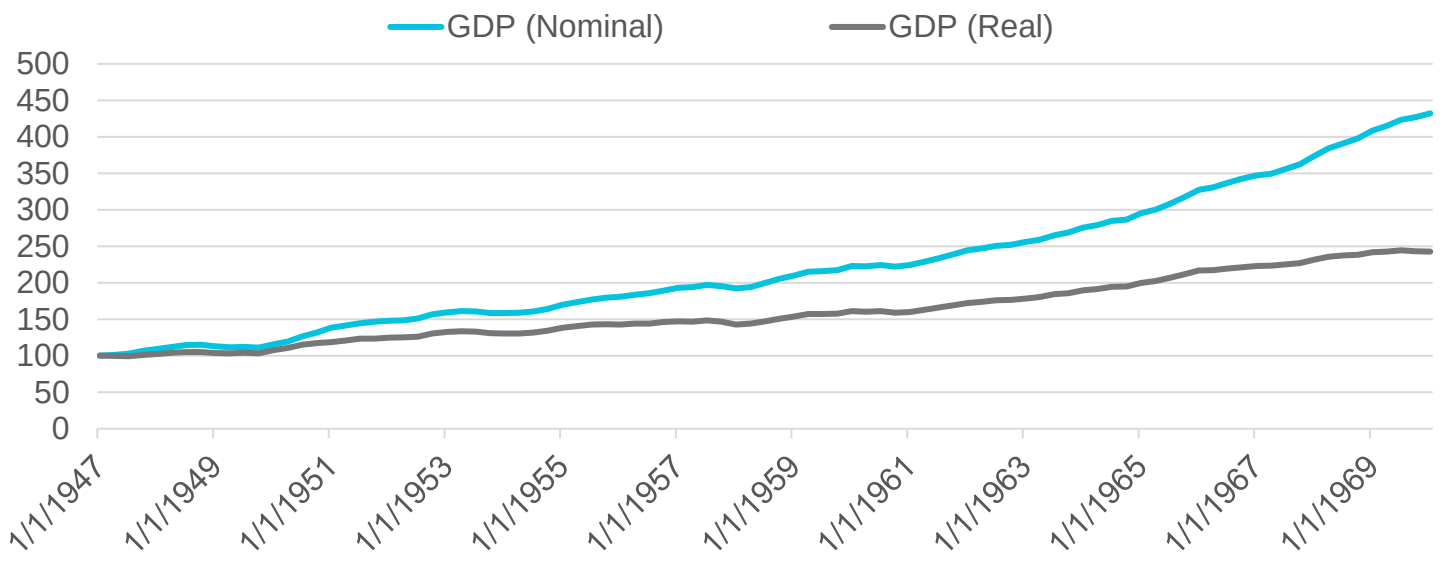
# World War II Debt (continued)




On an absolute basis (ignoring GDP), the debt consistently grew over this same period. National debt is usually shown as a percent of GDP, as in the previous slide, because making debt relative to income (GDP in this case) is a measure of how manageable the debt is for the debtor. A $500,000 mortgage is much more manageable for someone with a $200,000 income than someone with an income of $50,000. We can see that the actual value of the national debt was not paid down in this case, rather income grew and made the debt far less of a burden.

Source: US Federal Reserve Bank of St. Louis, Ocean Front Wealth Management

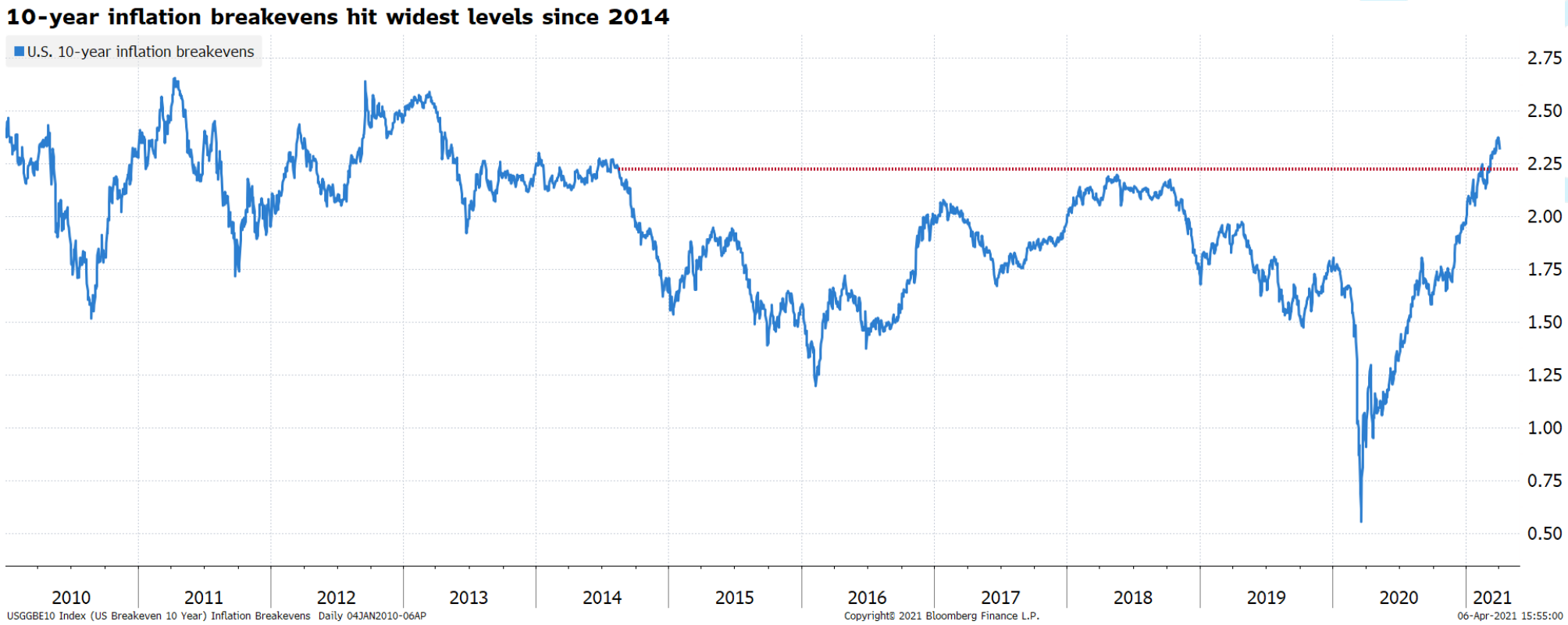
# Nominal GDP vs. Inflation-Adjusted (Real) GDP




USA GDP grew by almost 350% from 1947 to 1970. Adjusting for inflation, "real" GDP grew by 150%. Since debt does not grow with inflation, inflation can be beneficial for debtors if it increases their income. In this chart, inflation for the period is approximately the difference between nominal and real GDP, which by 1970 was massive due to the compounding effect. This is likely what governments and central banks will want to see happen this time as well, and they will likely attempt to accomplish it through policies of low rates, money printing and spending.

Source: US Federal Reserve Bank of St. Louis, Ocean Front Wealth Management

# Inflation Expectations Rising




Indeed we are seeing higher expectations for inflation, as measured by the "10-year breakeven inflation rate", the difference in yield between a US 10-year treasury bond and a US 10-year inflation protected bond. When inflation expectations increase, we tend to see yields on bonds rise as well, as investors demand a higher yield to compensate them for higher inflation.



Source: Bloomberg Professional, Ocean Front Wealth Management

# Interest Rates Rising


Rates on bonds have risen recently along with inflation expectations. The yields in this chart are "nominal" yields, they are not adjusted for inflation. If we adjust for inflation using the expected inflation rate from the previous slide, we get a "real" rate of interest of 1.6508% - 2.3% = -0.65% on the 10-year US Treasury, a negative real rate of interest. This is another way to think about how inflation can have the effect of reducing debt, if there is a negative rate of interest on debt it will decrease without even being paid down, as is the case with the real rate of interest in this example.



Source: Bloomberg Professional, Ocean Front Wealth Management

# Implications for Investors


If an inflationary environment is beneficial for debtors such as governments, it would have to be detrimental to their lenders. And who are the lenders? The bondholders. There are a lot of investors with their retirement dollars invested in bonds who could see negative real rates of return on those holdings if this scenario plays out. When rates/yields rise, the prices of bonds fall. As you can see in the chart, the price return of the 10-year US Treasury is -5% YTD.

Source: Stockcharts.com, Ocean Front Wealth Management

# Implications for Investors (continued)

| Class | Index | 6 month Returns(%) |
|---|---|---|
| Cryptocurrency | Bitcoin | 450.7 |
| Cyptocurrency | Ethereum | 443.7 |
| Materials | Lumber | 64.8 |
| Energy | RBOB Gasoline | 62.7 |
| Agriculture | Soybean Oil | 58.6 |
| Industrial Metals | LME Tin | 57.7 |
| Energy | Crude Oil - Brent | 55.2 |
| Energy | ICE Gasoil | 53.3 |
| Agriculture | Corn | 48.9 |
| Energy | Crude Oil - WTI | 47.1 |
| Agriculture | Canola | 45.5 |
| Agriculture | Soybeans | 40.4 |
| Livestock | Lean Hogs | 38.8 |
| Industrial Metals | LME Aluminium Alloy | 36.2 |
| Precious Metals | Platinum | 31.9 |
| Industrial Metals | Copper | 31.8 |
| Industrial Metals | LME Copper | 31.7 |
| Industrial Metals | LME Primary Aluminium | 26.1 |
| Materials | Cotton | 25.4 |
| Agriculture | Soybean Meal | 24.6 |
| Industrial Metals | LME Zinc | 17.4 |
| Agriculture | Sugar | 13.0 |
| Precious Metals | Palladium | 12.4 |
| Livestock | Live Cattle | 11.5 |
| Agriculture | Coffee | 11.3 |
| Industrial Metals | LME Nickel | 10.7 |
| Industrial Metals | LME Lead | 8.3 |
| Agriculture | Wheat | 6.9 |
| Agriculture | Rough Rice | 5.7 |
| Precious Metals | Silver | 4.4 |
| Energy | Natural Gas | 3.2 |
| Agriculture | Orange Juice | -2.7 |
| Agriculture | Cocoa | -7.8 |
| Precious Metals | Gold | -9.2 |

Select Commodity and Cryptocurrency
6 Month Returns ending March 31st, 2021

How can investors protect themselves in an environment where fixed income returns may be negative for several years? In an inflationary environment, goods and assets whose supply is relatively limited should see their prices increase or at least keep pace with inflation.

These assets can include commodities like agricultural products, metals and oil, and may also include certain cryptocurrencies which are intended to have a relatively fixed supply, like bitcoin. In certain groups of our model portfolios, we have recently added commodities exposure via a broad-based commodities ETF, as well as bitcoin exposure via a bitcoin ETF.

Source: Bloomberg Professional, Ocean Front Wealth Management

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Source: Ocean Front Wealth Management

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Source: Ocean Front Wealth Management

## Disclaimer

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