CIBC Asset Management

Market Insight

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Budget Boon to Bond Market

Last Monday's federal budget will be good for the Canadian economy, good for the Canadian dollar, and good for Canadian bonds, according to experts at CIBC Asset Management.

Jeffrey Waldman, first vice-president and head of global fixed income at CIBC Asset Management, says he expects the budget's spending increases and tax reductions to stimulate domestic demand and keep the Bank of Canada (BoC) watching for signals of upward pressure on inflation.

With the Canadian economy already operating at full capacity, and with commodity prices expected to rise thanks to a strong worldwide economy, the BoC may delay easing interest rates, says Luc de la Durantaye, first vice-president and head of CIBC Asset Management's global asset allocation and quantitative products team.

This possible delay in reducing interest rates would be supportive for the Canadian dollar, says Maxime Tessier, vice-president of currency management at CIBC Asset Management. "Right now, we have a stimulative fiscal policy and a restrictive monetary policy, conditions which bode well for the Canadian dollar in the coming months," says Mr. Tessier.

The federal government expects to pay down $9.2 billion of debt in the fiscal year ending March 31, 2007. With more debt reduction expected over the next two years, the federal government's balance sheet will stand out among other countries, resulting in lower borrowing costs for the federal government and lower Government of Canada bond yields for investors, says Mr. Waldman.

Enhanced transfers to provincial governments from the federal government will have a positive impact on the provinces' balance sheets. This could result in lower borrowing costs for the provinces, says Mr. Waldman, which could translate into lower provincial bond yields for investors.

Other budget measures may also increase demand for Canadian bonds:

- The federal government expects to eliminate withholding taxes on foreign interest payments once it reaches an agreement with the U.S. on the Canada - U.S. Tax Treaty. This development could attract foreign investors to Canadian bonds and conversely attract Canadian investors to U.S. bonds, says Mr. Waldman.

- Maple bonds, which are Canadian-dollar bonds issued by foreign corporations, are to be included in Registered Retirement Savings Plans (RRSPs) and other registered plans. This change could create additional demand for maple bonds, says Mr. Waldman.

- Three federal crown corporations will no longer issue their own bonds, instead borrowing money from the federal government which will issue additional bonds to cover this extra borrowing. These changes will result in slightly more issuance of Real Return Bonds (RRBs) – slightly over $2 billion annually, compared with about $1.6 billion last year.

"Consolidating crown corporation bonds with those of the federal government will help make the Canadian bond market more liquid and therefore more attractive to foreign investors," says Mr. Tessier.

Gaelen Morphet, first vice-president of Canadian equities at CIBC Asset Management, says that the budget highlights the strength of the Canadian economy over the last few years. "The government's decision to redistribute higher-than-expected revenues back to the consumer via tax credits for families is positive for the Canadian economy," says Ms. Morphet, the head of the firm's equity value and income trust team.

But she doesn't expect her investment portfolios to be affected by the budget. "The budget will have no material impact on Canadian equity investors."