FARM STUDENT ASSOCIATION

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Fall 2019 Cheif Editor: Michael Li

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Brexit: A Never Ending Saga and Its Impact on the U.K.

By Muhammad Abdullah Saif, Market Research Analyst

What Exactly is Brexit?

When Britain held a referendum on June 23, 2016 to decide whether to Remain or Stay on the bloc, 52 percent of Britons voted to leave which led to the process of Brexit starting. The fact that Europe is Britain's most important export market along with being its biggest source of foreign investment makes the decision of immense importance for Britain's economy. The British government itself predicted that the economy would shrink by 4 to 9 percent under Brexit [1].

Undoing 46 years of economic integration and dependency was never going to be easy. Britain's main parties, the Conservatives who are currently in power and the Labour opposition are both divided over what to do. This has left the British parliament factionalized creating uncertainty. The struggle has already cost one prime minster namely, Theresa May, her job. The current Prime Minister, Boris Johnson is leading Britain's efforts to finalize a deal of leaving the European Union.

What Happened with Brexit in October?

After almost two months becoming the prime minister, Boris Johnson sent his revised U.K. exit plan to the EU commissioner on October 2 which proposed an overhaul of the controversial backstop guarantee for the Irish border. The Labour leader calls the plan a "rehashed version" of previously rejected proposals. Johnson insists that he will not request for another delay whereas government papers submitted to a Scottish court on October 4 say the prime minister will ask the EU for another Brexit extension if a parliamentary deadline for approving the new deal is missed. By October 10, the deal had started to fall out after a day of amid a day of acrimony as Johnson's office gives a negative account of a conversation with German Chancellor Angela Merkel. European Council President Donald Tusk tweets accusing Johnson of playing a "stupid blame game". Even though Mr. Johnson managed to get a draft agreement on October 17 with European Union negotiators he was forced to seek an extension. The European leaders agreed to extend the deadline by three months, to January 31, 2020. He also called for a general election to be held on December 12 [2].

The Effects on the British Economy:

As a result of the prolonged period of uncertainty, the U.K.'s sovereign credit rating was placed on negative outlook by Moody's Investor Service. They stated that Britain's ability to set policy has weakened in the Brexit era along with its commitment to fiscal discipline [3]. The decision has been announced at a time when the U.K. is in the midst of an election campaign. "The decline in institutional strength appears to Moody's to be structural in nature and likely to survive Brexit given the deep divisions within society and the country's political landscape" Moody's said in a statement.

The pound has become one of the world's most volatile currencies ever since the fall in values after 2016's vote to leave the European Union. Making it less stable than the Russian ruble or Mexican Peso. Ever since the referendum the pound is down 13%, which has pushed up the cost of energy and imported goods whilst eroding the value of savings and paralyzing investors [4].

According to report from GfK, consumer confidence in the U.K. has slumped to a six-year low. The uncertainty that prevails over Brexit has weighed on consumers and big-ticket purchases such as cars are suffering [5]. As firms ramped up stock building last month in light of the October 31 Brexit deadline the U.K. manufacturing almost returned to growth. Firms reported a weaker influx of new business. Job cuts were linked to softer client confidence, non-replacement of leavers, lower demand and staff redundancies. In addition, some firms reported that the Brexit uncertainty had resulted in hiring freezes across firms. IHS Markit's Purchasing Managers Index unexpectedly rose to 49.6 in October [6], indicating a sharp slowing in the pace of contraction as indicated in the Figure 1 below.

Figure 1: IHS Markit's Purchasing Managers Index

The U.K. is entering the December 12 election with one of the worst growth backdrops in years. Before the referendum the growth rate was 2%-plus which is predicted to drop to 1.2% this year. For the first time since 2012 the economy shrank in the second quarter this year, partly as a result of companies unwinding stockpiling which they had implemented ahead of the original Brexit deadline in March. A rebound in summer means that U.K. dodged a second quarter of contraction that would leave it in recession. As per the International Monetary Fund the U.K. has one of the gloomiest outlooks in the world for the next year. That's against a backdrop of overall global growth slowing down and the US-China trade war threatening to worsen things.

As the uncertainty looms as a result of Brexit, investment has dried up making it impossible for firms to make plans. Hence leaving consumers as the major driver of the economic growth. Even the consumers are uncertain as the confidence slumped to the lowest in six years according to GfK. Over the past few years one definite bright spot for consumers is the labor market. U.K.'s unemployment rate is close to its lowest level since 1970 whereas the wage growth is running well ahead of inflation as well. However, the pay growth has been so low over the past decade that the real earnings are still below their pre-crisis levels. Employment also fell over the second quarter for the first time in two years. Given the upcoming elections and the fact that both the Conservative and Labour party representatives plan on putting an end to the age of austerity through their policies means that Britain now has almost no chance of meeting fiscal rules requiring the structural budget deficit to be below 2% of GDP in 2020-21 [7].

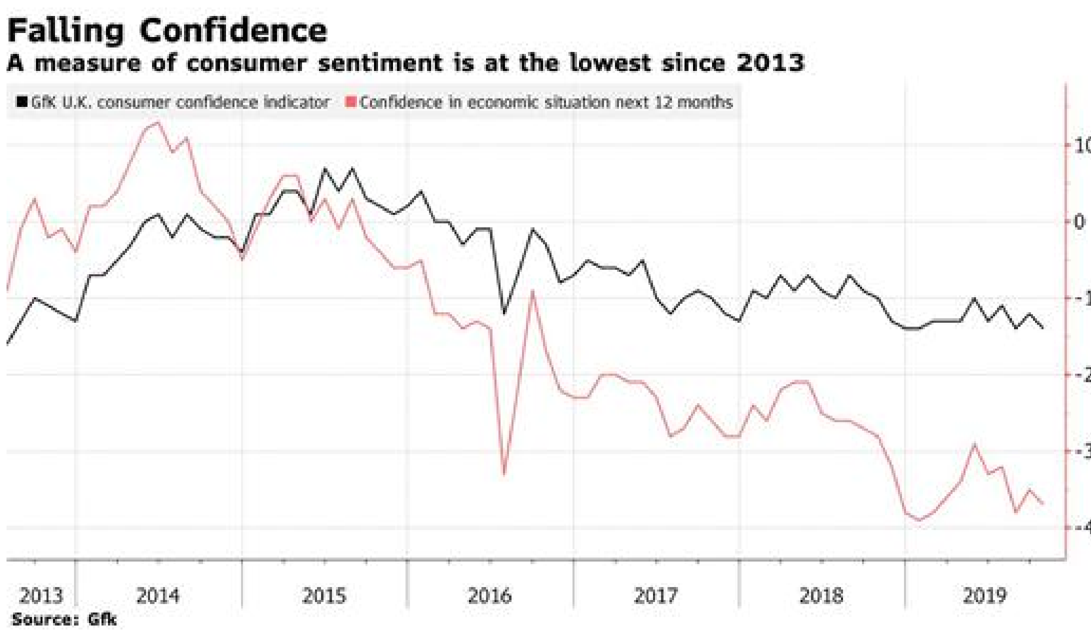

Figure 2: Consumer confidence indicator

What it Means Going Forward:

U.K.'s main political parties are heading towards a third general election in five years on December 12 promising the most radical shakeup in the nation's economy. The Conservatives want to implement a Brexit deal that the economists believe could leave the economy 3.5% smaller in the long run [8]. Whereas the Labour leader Jeremy Corbyn has pledged to borrow to fund a 250 billion-pound investment program putting an end to the age of austerity.

The opportunity for change is something that unites those on either side of the spectrum. Patrick Minford, a Pro-Brexit economist, says that a Conservative majority and a "proper Brexit" would "bury austerity" and usher in tax cuts and extra public spending. Whereas Labour supporters such as Grace Blakeley, the New Statesman's economics commentator, urge the voters to look beyond Brexit, arguing that climate change and global economic trends require a "rupture with the economic orthodoxy of the last 40 years" [9].

The Bank of England which is expected to unveil its revamped monetary policy report on November 7 is expected to cut predictions for growth in 2020 and 2021. Meanwhile the forecast for unemployment is expected to be raised for those two years and the outlook for the inflation cut [10].

[1] https://www.cnbc.com/2019/09/14/saudi-arabia-is-shutting-down-half-of-its-oil-production-after-drone-attack-wsj-says.html
[2] https://www.bloomberg.com/news/articles/2019-09-20/trump-says-u-s-sanctioned-iran-s-national-bank-for-attack
[3] https://www.bloomberg.com/news/articles/2019-09-16/oil-jolt-may-have-short-term-impact-for-markets-elsewhere
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[5] https://www.bloomberg.com/news/articles/2019-09-18/saudi-oil-attack-damages-kingdom-s-role-as-guardian-of-market
[6] https://www.bloomberg.com/news/articles/2019-09-30/saudi-arabia-rating-cut-at-fitch-on-gulf-geopolitical-risks
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[2] https://www.euronews.com/2019/10/31/from-deal-to-delay-what-happened-with-brexit-in-october
[3] https://www.bloomberg.com/news/articles/2019-11-08/u-k-outlook-cut-to-negative-by-moody-s-on-policy-paralysis
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[5] https://www.bloomberg.com/news/articles/2019-11-01/u-k-car-seller-plummets-most-since-1990-as-brexit-bites-hard
[6] https://www.bloomberg.com/news/articles/2019-11-01/u-k-manufacturing-contraction-slows-amid-brexit-stockpiling
[7] https://www.bloomberg.com/news/articles/2019-11-01/u-k-gears-up-for-election-promising-radical-economic-changes
[8] https://www.bloomberg.com/news/articles/2019-11-01/u-k-gears-up-for-election-promising-radical-economic-changes
[9] https://www.bloomberg.com/news/articles/2019-11-01/brexit-bulletin-radical-times-ahead
[10] https://www.bloomberg.com/news/articles/2019-11-01/boe-poised-to-unveil-gloomier-forecasts-amid-brexit-uncertainty

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Tesla's Surprise Third Quarter Earnings

By Michael Zheng, Market Research Analyst

A Brief Overview of Tesla

Tesla Inc. is an automotive and energy company based in Palo Alto, California. They were founded in 2003 by 5 people, the one most notably being Elon Musk. Tesla is most well known for their (Model) line of electric vehicles, including budget vehicles such as the Model 3, as well as more luxurious cars like the Roadster. Their main goal is to bring sustainable transportation as a competitive and viable option in the automotive industry [1].

Figure 1: The Roadster 2008, first car that Tesla released
Source: SportsCarMarket

What Happened in the Past Year ?

For the first time ever, Tesla showed signs of promise with two straight quarters of profits at the end of 2018. This was also the first time they revealed a profit since September 2016. Unfortunately, delays in production as well as tensions rising from the international war showed a similar trend to the previous year, suffering one of their biggest losses in the first quarter of 2019. In the middle of the first and second quarter, Tesla revealed that their Model X was involved in a fatal car crash due while their Autopilot system was active. As well, they announced a voluntary recall of 123,000 Model S's due to an issue in the power steering component [3]. This led to their stock dropping more than 22.4% between March and April and brought it to a record low for the year. Their second quarter was also abysmal, missing the consensus analysts' predictions once again. Like the first quarter, the share price had relatively little movement due to Tesla executives in Q1 telling investors to expect a loss. This time, the executives were confident for a profitable third quarter and explicitly stated this in their second quarter report.

Data for this Date Range

Sept. 30, 2019	143.00M	March 31, 2014	-49.80M
June 30, 2019	-408.33M	Dec. 31, 2013	-16.26M
March 31, 2019	-702.14M	Sept. 30, 2013	-38.50M
Dec. 31, 2018	139.91M	June 30, 2013	-30.50M
Sept. 30, 2018	311.00M	March 31, 2013	11.25M
June 30, 2018	-717.54M	Dec. 31, 2012	-89.93M
March 31, 2018	-709.55M	Sept. 30, 2012	-110.80M
Dec. 31, 2017	-675.35M	June 30, 2012	-105.60M
Sept. 30, 2017	-619.38M	March 31, 2012	-89.87M
June 30, 2017	-336.40M	Dec. 31, 2011	-81.49M
March 31, 2017	-330.28M	Sept. 30, 2011	-65.08M
Dec. 31, 2016	-121.34M	June 30, 2011	-58.90M
Sept. 30, 2016	21.88M	March 31, 2011	-48.94M
June 30, 2016	-293.19M	Dec. 31, 2010	-51.36M
March 31, 2016	-282.27M	Sept. 30, 2010	-34.94M
Dec. 31, 2015	-320.40M	June 30, 2010	-38.52M
Sept. 30, 2015	-229.86M	March 31, 2010	-29.52M
June 30, 2015	-184.23M	Dec. 31, 2009	-24.24M
March 31, 2015	-154.18M	Sept. 30, 2009	-4.615M
Dec. 31, 2014	-107.63M	June 30, 2009	-10.87M
Sept. 30, 2014	-74.71M	March 31, 2009	-16.02M
June 30, 2014	-61.90M	Dec. 31, 2008	-25.50M

Figure 2: Tesla's quarterly profits since their IPO
Source: YCharts

Between the second and third quarter, Chinese electric vehicle companies like NIO and BYD Company were suffering greatly from the U.S.-China trade war, with their share prices dropping over 75% and 25% in value respectively. Tesla share prices rose to around $250 during the decline in their competitors. This is due to several of their vehicles being exempt from China's notorious purchase tax, as well as increased production in their current main factory, located in Fremont.

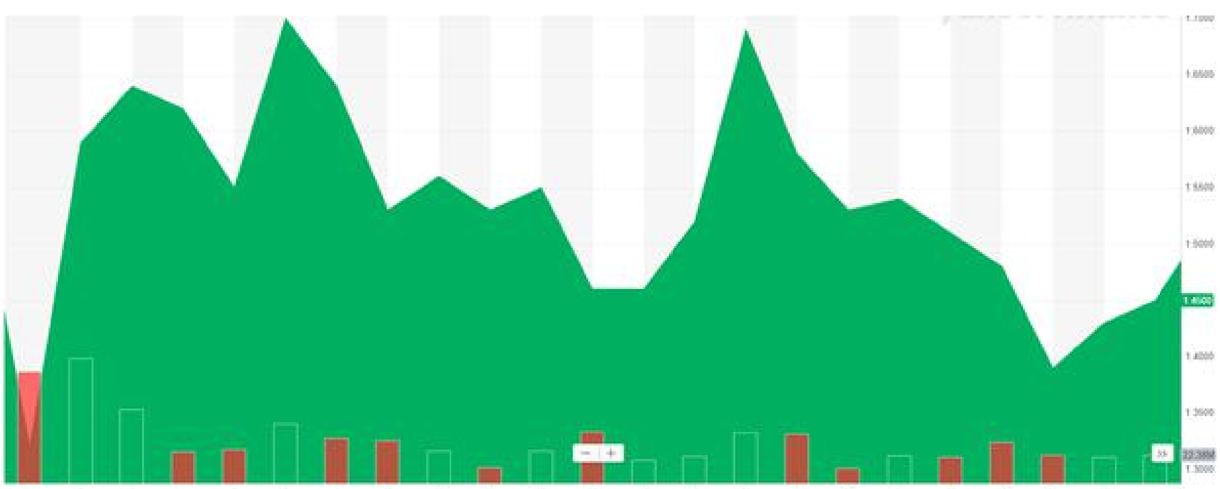


Figure 3: NIO October share prices
Source: Yahoo Finance

Figure 4: BYD Company share prices in the last 6 months
Source: Yahoo Finance

Once again, Tesla executives stayed true to their word, showing a small, but positive profit of 143 million dollars in their third quarter, surprising most people in the world. Investors were prepared for another loss, due to many political and trade barriers affecting financial markets in the summer. Elon Musk announced on Twitter that their Shanghai gigafactory and Model Y was ahead of schedule [4]. As well, their free cash flow crushed the consensus analyst estimate, with $371 million compared to $32 million [5]. Shares immediately shot up, going from around $250 to as high as $340 a share. Trades soared as high as 19% in after-hours trading [6]. Earlier in the year, Tesla said it expected to deliver between 360,000 to 400,000 vehicles by the end of the year, representing 45% to 65% growth from 2018. Many investors had doubts about these investors, but the company announced with just 2 months left in the year that they were on track to exceed 360,000 deliveries.

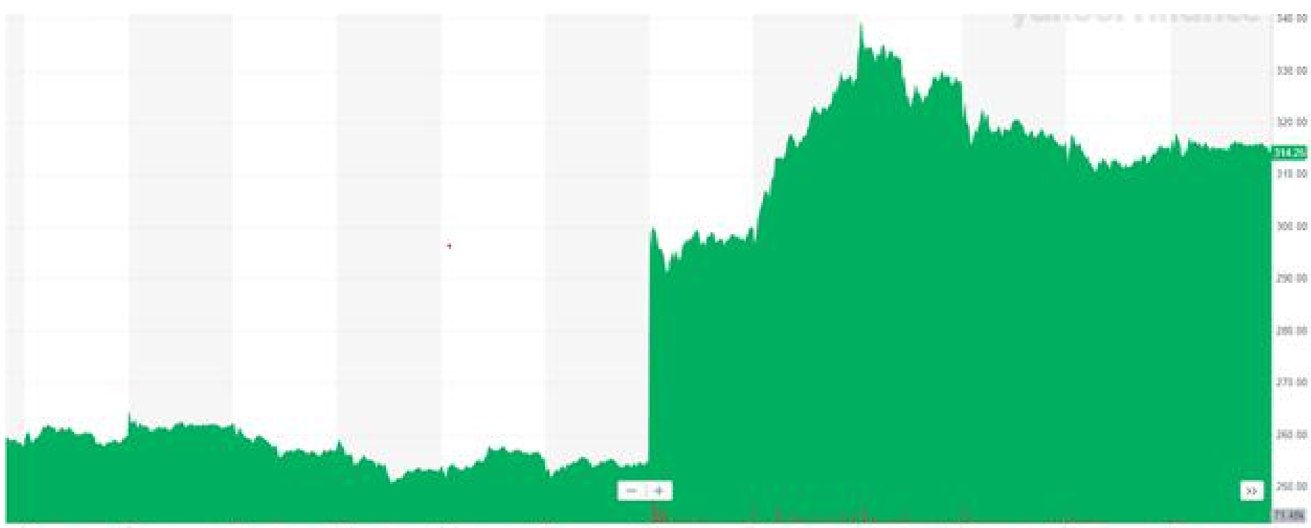


Figure 5: Tesla's October share prices
Source: Yahoo Finance

Before Tesla's official report, analysts were fearing for the worst. Analysts from various well-known organizations were agreeing on another underperformance rating. Analysts from JPMorgan announced to their clients: "We remain cautious on shares of underweight-rated TSLA on lofty valuation coupled with high investor expectations, high execution risk, and the potential for a pending cut to full-year delivery guidance at the time of 3Q earnings." JPMorgan stated the price to drop to $200, a 20% decrease. Only one recognized investment banking company predicted Tesla's changes, namely Macquarie Group. Their analysts stated: "With some seasonal tailwinds, we believe achieving the lower end of its 360-400k for the year as feasible." As well, they added: "We will look for an update on the feasibility of Mr. Musk's 2,000 unit/week production target for 2019 year-end. In addition, we will watch for any indication of a potential pull forward of Model Y launch in 2020." [7] If those two requirements are met, then Macquarie believed that the price could reach as high as $400 between the third and fourth quarter.

Currently, this seems to follow a trend from their 2018 quarterly reports. Tesla started off with record losses in the first and second quarter, only to show small signs of life in the third and fourth quarters. In 2018, Tesla also backed their forecast for profitable in the third and fourth quarters, which were made to be true. There is the possibility for the exact same result to happen in 2019, with Tesla delivering true to their promise in the third quarter, as well as forecasting a profitable fourth quarter and their estimated vehicle production.

Finally, their increased presence in China has caused NIO and BYD Company scrambling for solutions to compete with Tesla. Currently, Tesla's biggest market is the US, with China following closely behind, then Norway and the Netherlands. With the Shanghai factory going from permits to being hooked with electricity in just 168 days, Musk estimates that by the end of the year that the factory will produce as many as 1000 vehicles a week. [8] This is a worrying concern for Chinese electric automotive companies, as Tesla now has the possibility of producing locally, avoiding import duties and reducing freight expenses.

Figure 6: Shanghai gigafactory in the preliminary stages
Source: Electrek

Generally speaking, the external impact has contributed to the list of events happened to WeWork in the past weeks. Apart from WeWork's flawed business model and unhealthy financial, the unfavorable market conditions rushed WeWork a blow harshly.

The Future for Tesla

Tesla has shown repeatedly that they have what it takes to be the future in not only the electric car industry, but the automotive industry. Unfortunately, they do not have the track record of proving this, constantly reporting quarterly net losses, leading to investors pulling out due to the unsustainable direction that the company's financials are taking. Can this change in the future?

The world is pushing to be greener, with climate change strikes happening every day around the world and individuals recognizing that something needs to be done for the Earth to be sustainable. With the recent trends domestically and internationally, Tesla is proving to be doing everything right, expanding in the country with the most electric car sales (1.2 million in 2018), as well as continuing to increase production in Europe and North America. On the other side, the energy sector in Tesla has also been increasing production and sales, with Musk announcing that their solar panel sales were up 48% from the second quarter. This is Tesla's best chance of capitalizing on their upward momentum and start to show investors that they can have yearly profits instead of yearly losses every year.

[1]: https://www.investopedia.com/articles/active-trading/072115/what-makes-teslas-business-model-different.asp
[2]: https://seekingalpha.com/news/3508772-tesla-eps-beats-2_14-misses-revenue
[3]: https://www.cnbc.com/2018/04/02/tesla-stocks-plunge-for-two-reasons-ubs-analyst.html
[4]: https://twitter.com/elonmusk/status/1187113794234793984?ref_src=twsrc%5Etfw%7Ctwcamp%5Etweetembed%7Ctwterm%5E1187113794234793984&ref_url=https%3A%2F%2Fwww.bloomberg.com%2Fnews%2Farticles%2F2019-10-23%2Ftesla-surges-as-musk-s-cost-cuts-pay-off-with-surprise-profit
[5]: https://www.fool.com/investing/2019/10/23/teslas-q3-earnings-shares-soar-as-profit-blows-pas.aspx
[6]: https://www.bloomberg.com/news/articles/2019-10-23/tesla-surges-as-musk-s-cost-cuts-pay-off-with-surprise-profit
[7]: https://www.businessinsider.my/tesla-q3-earnings-preview-wall-street-analysts-focus-on-profitability-2019-10/
[8]: https://www.bloomberg.com/news/articles/2019-10-23/elon-musk-opened-tesla-s-shanghai-gigafactory-in-just-168-days

OCTOBER 2019

Canadian Election

By Ethan Chan & Stephanie Ho, Market Research Analysts

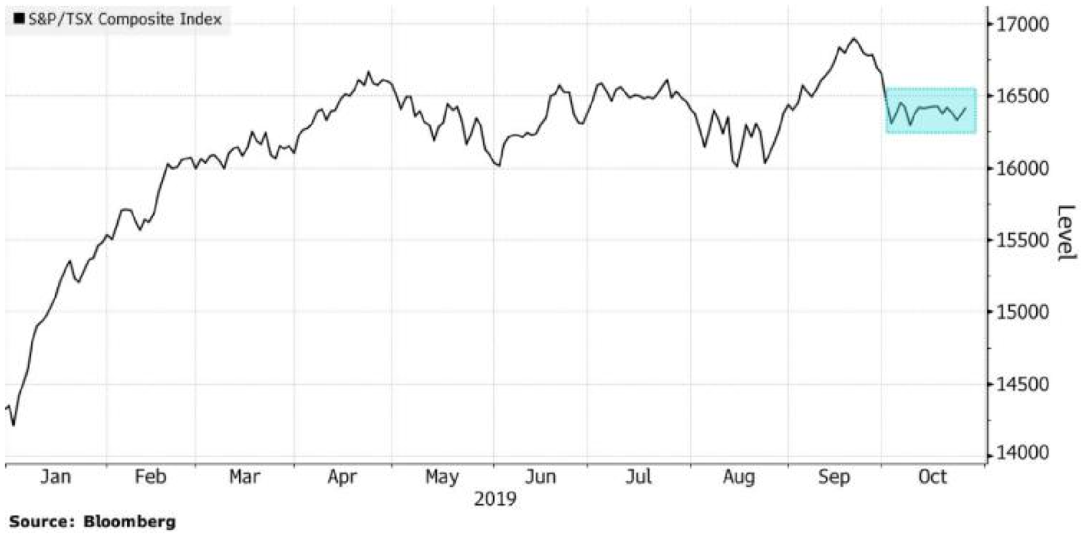
Overview of Election Result

The Liberal Party, led by Justin Trudeau, won the 43rd Canadian general election on October 21st. This year the Liberal Party collected 157 seats against Conservatives' 121 while securing only a minority government by falling 13 seats short of a majority. The popular vote was won by the Conservatives with 34.4% whiled the Liberals trailed by 1.3% at 33.1%. Trudeau will lead a minority government without a governing coalition and instead seek support from other parties on a case-by-case basis.

The government is facing a set of challenges in terms of deficits, housing problem, NAFTA, tax-cut, gun control and so on. The balance between developing Alberta's energy and fulfilling promises on climate change is one of the biggest dilemmas.

Market Reaction

The stock market seems to have ignored the election results. According to Bloomberg, "with 18 trading sessions out of the way in October, the S&P/TSX Composite Index has barely moved from the end of September with nine up and nine down days. [1]" Macroeconomic events such as the ratification of the North American Free Trade Agreement and ongoing U.S.-China trade talks are having a more significant impact on the market.



The S&P/TSX Capped Energy Index dropped 9.62% in October. Encana Corporation, one of the top 10 constituents by Market Cap, its shares fell as much as 9.3% in Toronto on October 31st after the company announced to move its headquarters from Canada to the U.S. early next year [2]. After Trudeau election won, the Canadian dollar traded at 76.36 cents US nearing three-month highs. Concerns are held that a Liberal Minority government could negatively affect the Canadian dollar due to reduced capacity to pass legislation and potential "to push for more regulation and rules on capital inflows into Canada. [3]"

The S&P/TSX Capped Industrials Index gained 1.09% in October. In particular, SNC-Lavalin shares surged nearly 14% on October 21st as "investor hopes that the Liberal election win left open the possibility of a plea deal on fraud and corruption charges against the engineering firm. [4]"

The S&P/TSX Capped Communication Services Index decreased 1.12% in October. Rogers Communications Inc. shares fell the most in almost four years from C$66.39 to C$61 on October 22nd due to loss of overages fees from customer switching to unlimited plans. In addition to vigorous competition among Canadian telecom companies, the telecom sector also faces political pressure to lower prices. The Liberals pledged to cut the average cellphone bills by 25% and would allow more competition from smaller operators [5]. The campaign was expected to be supported by other parties.

Future of a Minority Government

Canada's is currently being ruled by a Minority Government, which is the 14th time in Canadian History [6]. However, they typically last less than two years and in 1979, Joe Clark's Conservative government lasted only six months [7]. The governing party is defeated and collapsed through losing a vote in motion or a confidence vote in the House of Commons [7]. Nevertheless, keeping Trudeau as prime minister provides him with a second chance to showcase his seriousness and political instinct to the people of Canada [6]. Moreover, silence the critics about his leadership abilities through exhibiting a substantive and competent government. Knowing that, opposition parties won't give him any room to breath or allow him to regain his stride by leveraging their own positions. Trudeau's first priorities after returning as the head of the government, is too initiate tax cuts and see through the TMX from Edmonton to Burnaby to completion [8].

However, they face a strong provincial opposition “gang of six” right-wing governments consisting of Alberta, Manitoba, Saskatchewan, Manitoba, Ontario, Quebec, and New Brunswick, positioned to create problems when it comes to carbon taxation, environmental protection, transfer payments, and immigration policies [8]. In the parliamentary committees, the Trudeau government will be slightly outnumbered by the opposition parties, which provides the leverage for climate activists from outside of Parliament. Who will then be able to link with the Bloc and the NDP for space to make themselves heard in Parliament and generate a wider attention for their concerns. Nevertheless, how Trudeau decides to deal with the climate emergency will be a major test of leadership and will be viewed upon scrutiny by the Canadian voters.

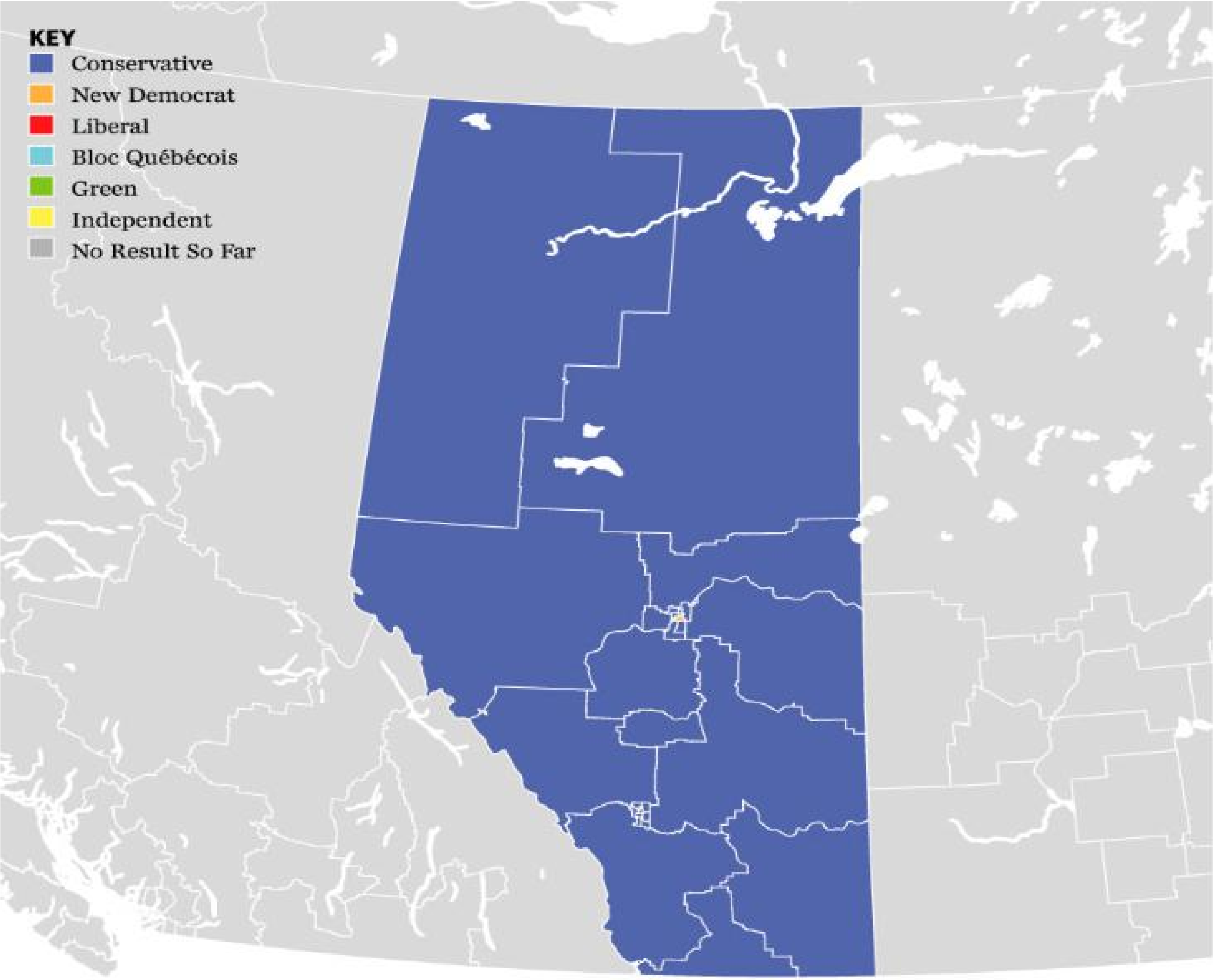
Trudeau and Alberta

The energy sector has the second largest weighting on the S&P/TSX Composite Index at 16.41% and is currently the third worst performing sector this year [1]. The negative sentiment in this sector is partially enforced by doubt on the Liberal Minority government’s ability to continue the Trans Mountain expansion project and other pipeline projects. Both the NDP and the Green party has expressed strongly opposing views because of climate concerns. Carbon tax is also expected to affect the energy sector. The Liberals set a minimum carbon price of $20 per tonne this April on New Brunswick, Ontario, Manitoba and Saskatchewan and planned to add Alberta to the list in 2020 [9].

The pipeline projects also have a strong correlation with CAD/US exchange rates. Canadian crude exports currently account for a large portion of U.S. currency earned by Canada. When oil prices are high, more U.S. dollars flow into Canada relative to the supply of Canadian dollars resulting in an increased value of the Canadian dollar [10]. Another big influence is led by Canada’s monetary policy. The Canadian dollar became the biggest loser among G-10 currencies this week following the Bank of Canada’s decision to keep its benchmark interest rate on hold at 1.75% [11]. The Bank of Canada is expecting Canada’s growth rate to further slow in the second half of the year due to uncertainty of trade conflicts and the previously mentioned problems within the energy sector [12].

A win for the Liberal Government could mean something devastating to the already slowing Alberta Economy. With the polls already tallied, Alberta voted for overwhelmingly Conservative, in fact, there was not a single Liberal seat, and only 1 NDP seat resides in the province of Alberta, which would otherwise be a sea of blue chairs.

However, they face a strong provincial opposition “gang of six” right-wing governments consisting of Alberta, Manitoba, Saskatchewan, Manitoba, Ontario, Quebec, and New Brunswick, positioned to create problems when it comes to carbon taxation, environmental protection, transfer payments, and immigration policies [8]. In the parliamentary committees, the Trudeau government will be slightly outnumbered by the opposition parties, which provides the leverage for climate activists from outside of Parliament. Who will then be able to link with the Bloc and the NDP for space to make themselves heard in Parliament and generate a wider attention for their concerns. Nevertheless, how Trudeau decides to deal with the climate emergency will be a major test of leadership and will be viewed upon scrutiny by the Canadian voters.



Maps of the Seats for which the party holds in Alberta (Source: Nationalpost)

This begs the question, how would the continued Liberal government, albeit being a minority one affect Alberta? First off, we need to understand if Trudeau did wreck Alberta's economy or was it all just Conservative propaganda. One could point to Alberta still being the Highest GDP per capita across all provinces, but that still does not address the underlying issues which Alberta is currently going through. The issue at stake is the C-69, which is a new, untested, and complex environmental process causing massive uncertainty in many of Alberta's biggest industries. Moreover, The CAPP president Tim McMillan stated the passage of C-69 that said it would create "ambiguity and uncertainty around future nation-building projects which will drive investment out of Canada and prevent provinces from prospering through the development of their valuable natural resources." [13].

Let's trace back a few steps and understand how C-69 works, it essentially puts the final say in every decision in the hands of the energy minister, and hence, the PMO. Before the C-69 came to fruition, the National Energy Board held power to approve projects, and its role was to serve as an independent regulator with no political sway. The reason being is that once politicians start meddling with things that aren't politics, they only seek for approving and declining projects that would maximize their popularity and votes. Nevertheless, one may argue that it was the Harper government that dismantled the NEB's ability to approve projects and handed it over to the politicians [13]. This is true to some degree, but Trudeau had all the support he could need in Alberta to fix the wrongs that Harper caused. With this in mind, the reason why Harper decided to put down NEB was that they were approving unpopular pipeline projects. Ostensibly, they were supporting such projects to restore public confidence in the regulatory system, but it caused the complete opposite, ruining it. The NEB is still running but now without the ease of approving projects in a short period, instead it takes years to evaluate projects, suggests improvements and provides their recommendations to Ottawa. Fundamentally Alberta and to a certain extent, Canada now runs their billion-dollar infrastructure project by not what's best for the public by skilled analysts instead of mob opinion.

One instance of the system in place is the TMX, otherwise known as the Trans Mountain Pipeline, it has already had 4.5 billion dollars in sunk costs [14]. The reason behind such approval by Trudeau is the absurd amount of money they spent and the mild criticism that he is facing about it [15]. Now to stop beating around the bush, was Trudeau the mastermind behind destroying Alberta's economy? The short answer is no. Still, the thing is he failed on many levels to understand what Alberta's going through and address the pressing problems with Canada's regulatory system, which has worsened Alberta's issues and will continue to affect the entire country for more than just its pipelines.

Now, fast-forward to present-day post-election, the frustration of what has been aforementioned, the pipeline construction, along with the Federal Oil and Gas Policies erased all the gains Liberals made in Alberta in 2015 [16]. Alberta's Premier Jason Kenney, drew up a list of expectations for Trudeau to address to halt Alberta's considerable fall. Some points include withholding from doing deals with NDP, Bloc Quebecois, and Green Party, a resource corridor across the country, fundamental change to the equalization payment program, and fixing the ever so controversial C-69 bill [17].

Speaking of which the turmoil in Alberta has led to Encana Corp, one of the marquee companies in Canada's beleaguered energy sector moving headquarters to the US and dropping its association with Canada [2]. This intensifies the already gloomy Canadian Energy Industry, with the lack of pipeline space choking off prospects for growth, and ultimately leading to companies abandoning 30 billion of assets in Canada in the past three years [2]. The ball is in Trudeau's court now, and he, along with his cabinet, will determine the future prosperity of the Province of Alberta.

Middle Class and Affordability

Trudeau has campaigned hard on a promise to improve the lives of the middle class families. It is one of the main election campaigns for the Liberals. The Canadian middle class make up 58% of the population and are the backbone of the economy. Having policies directed towards improving the daily life of this class will have the strongest benefit on society. For this cause, Trudeaus has made promises regarding taxes, housing, child care, and education.

In terms of taxes, Liberal will raise the basic personal income tax deduction to $15,000 over the next four years from $12,069 while raising taxes on luxury vehicles and tech giants. “Firms like Amazon, Google, Netflix, Apple and Facebook would pay a 3% tax on revenue generated through sales of online advertising and user data. [18]” This tax cut will increase personal income, which means it will put more money into the pockets of Canadians while raising the standard of living for impoverished workers. This also allows for consumers to spend more, resulting in a stimulation on businesses growth and a positive impact on the economy.

For education, the government is promising to increase maximum Canada Student Grants for full-time students to $4,200. In 2018, Liberals wrote off more than $200 million in outstanding student loan payments and student debt contributed to more than 17.6% insolvencies in Ontario [19]. Liberals will make student loans interest-free for two years after graduation and graduates will not have to start repaying their loans until they make at least $35,000, increasing from current threshold $25,000.

For students with children, Liberals allow them to pause loan payments with no interest until their youngest kid turns five [20]. These promises aim to ease the debt burden on young graduates and to make it easier for governments to collect payments. This also has a positive effect on entrepreneurship because there is a strong negative correlation between rising student loan debt and the decreasing small-business creation [21].

Trudeau also promised to boost the Canada Child Benefit (CCB) by 15% for low and middle-income families with kids under one, which means eligible families will receive a tax-free monthly payment. Bank of Canada Governor Stephen Poloz suggested that CCB increased the overall economy and Statistics Canada reported that the child poverty rate declined 2% from 2016 to 2017 [22]. Critiques of the CCB argues that it discourages increased labor force participation. Since the Child Benefit is reduced with increased family income, many families have no incentive to increase household income as the CCB is reduced by additional family income. However, for the most impoverished families, this will assist them in being able to support their family and increase the amount of money they can spend annually [22].

Housing markets across Canada make up almost 8% of GDP between 2010 and 2017 [23]. With housing prices soaring sky high in major canadian cities, many people are having trouble affording new real estate, leading to a slowdown in the housing market. Based on Trudeau's promises, first-time homeowners can take advantage of the new CMHC First-Time Home Buyer Incentive, which offers them subsidies of 10% on new home purchases and 5% on resales with restrictions on down payment and income [24]. This will lower the barrier for first-time homebuyers to enter the housing market and help demand for housing. On the supply side, Trudeau wants to build 100,000 affordable homes over a decade [24]. However, these policies have the potential to push home prices higher and to encourage people to take on more debt. A 1% annual tax on residential properties is also introduced for non-resident and non-Canadian homeowners.

Deficits

In the past 2015 campaign, the Liberals failed their election promise of balancing the budget in 2019 and actually did the opposite, increasing the deficit. In the 2019 campaign, Trudeau government's election platform includes $9.3 billion in new spending with the deficit rising to $27.4 billion for the 2020-2021 year, declining to $21 billion in 2023-2024. This deficit results in a federal debt-to-GDP ratio of 30.9% in 2020-2021 and dropping to 30.2% in 2023-2024 [25]. A balanced budget is not projected until at least 2040. Surprisingly, the federal debt-to-GDP ratio is the lowest among the G7 countries pointing to a more stable economy in comparison to our peers [26].

Certain sectors will benefit from increased deficit in the short run because the government has engaged in extra spending projects, like creating up to 250,000 new child care spaces for before and after school and building 100,000 affordable homes over a decade. However, all deficits need to be financed through selling government securities, imposing higher taxes, borrowing from the private sector, etc. Therefore, in the long term deficits distort interest rate which can possibly crowd out private borrowing and eventually weaken the economy.

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Negative Interest Rates and Europe

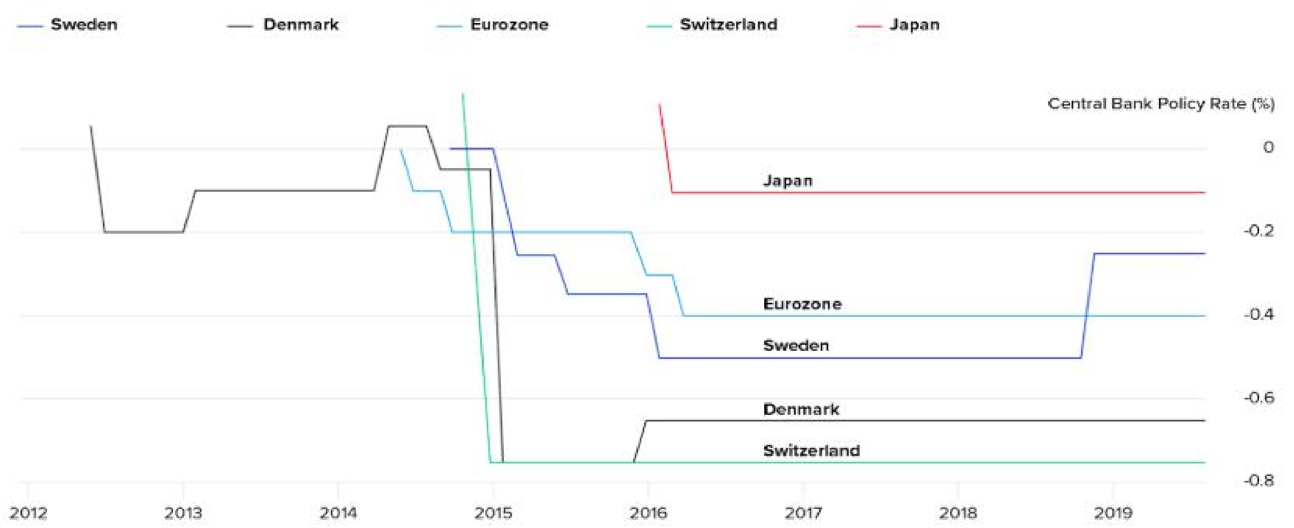
By Alex Tutu, Market Research Analyst

Since the Great Recession, Europe has not been able to recover after the devastating housing market crisis. It has seen a downward spiral in economic productivity, resulting in weaker Gross Domestic Product (GDP) growth across many countries within the union. To combat this, the European Central Bank looked to unconventional and desperate alternatives to get back on track, with Sweden being the first country in the union to introduce a negative interest rate of -0.25% at their central bank on July 2009 [1]…. But what on Earth does a negative interest rate mean? And what does this mean for Europe and its seemingly unending economic turmoil?

Negative Interest Rates? What and how do they work?

Commonly in North America, interest rates that are charged on top of borrowed assets have usually been positive as they theoretically by definition, have a lower bound of 0% [2]. However, across the ocean, our neighbor Europe has been seeing negative interest rates since they were introduced to Sweden's central bank in July 2009, when the bank dropped its cash deposit rate to -0.25%. Following this in June of 2014, the European Central Bank (ECB) lowered its cash deposit rate to -0.1% [3].

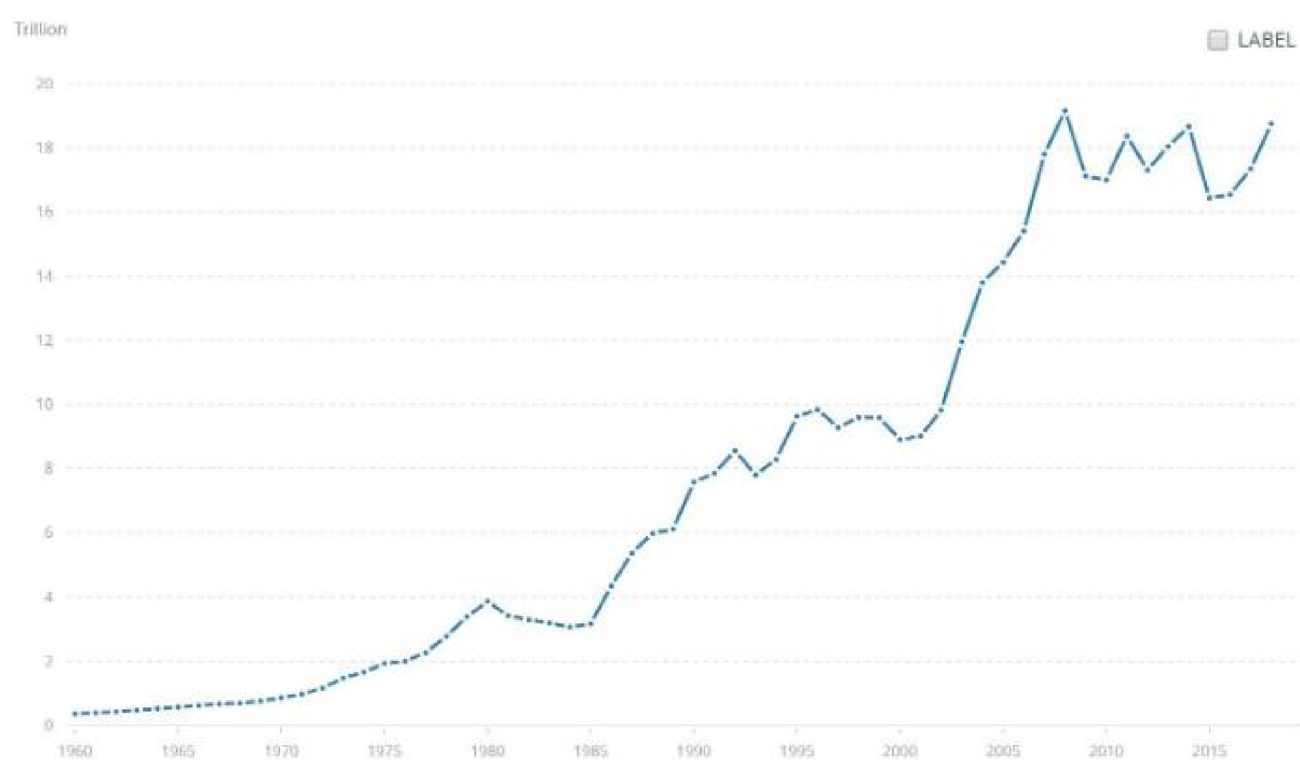
Contrastingly to the normal behavior of positive interest rates, when there is a negative interest rate, this leads to a scenario in which cash deposits incur a charge for storage at a bank, rather than receiving interest on that deposit. Instead of receiving money from the bank, customers must pay the bank to keep their money in their account. This is what Europe calls a "Negative Interest Rate Policy" (NIRP) [4]. This graph shows the interest rates of several national central banks [5].



Source: Refinitiv

Why is the NIRP needed?

In a healthy economy, consumers need to have a moderate amount of consumption to satisfy the supply of finished goods and services by companies and fuel the economy. This leads to a healthy inflation percentage and progressive GDP growth, with generally targeted levels of 2% inflation each year [6]. However, in Europe, since the financial crisis of 2008, there has been slow economic growth because of low inflation and low GDP growth [7]. As we can see in the chart, the European Union has been struggling to increase its GDP since 2008, with a current GDP of $18.756 trillion and the GDP reaching a maximum threshold of €19.164 trillion in 2008 [8].

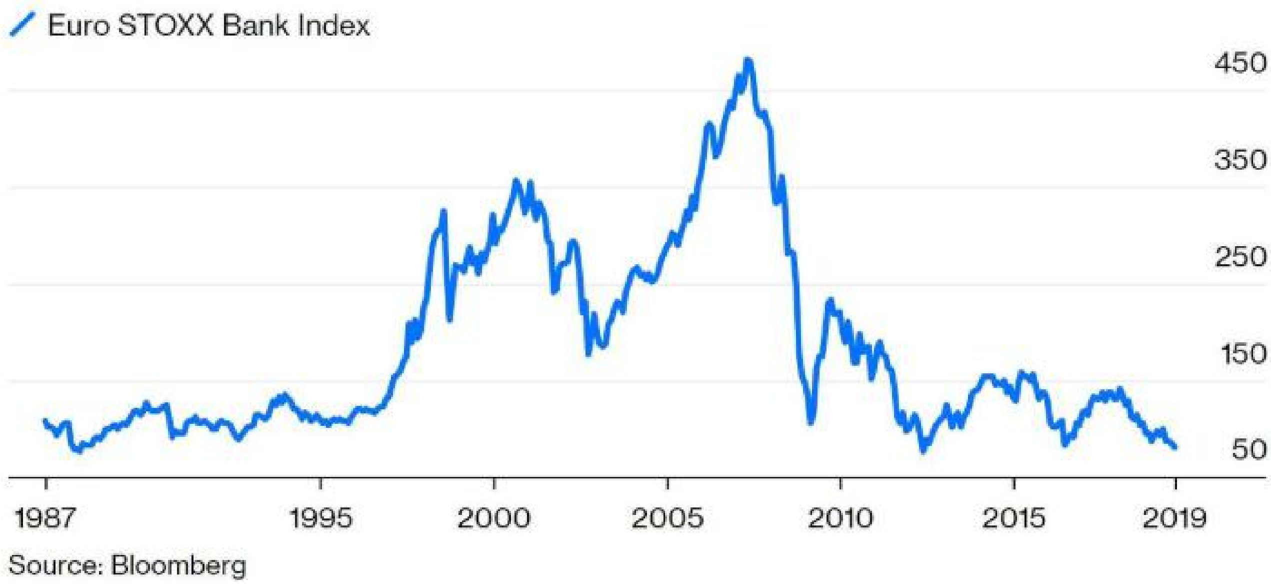


In the next chart, evidently, Europe has not had consistent inflation rates, showcasing that from the beginning of 2014 until 2017 and from the middle of 2019 until our current date, the inflation rate was below the optimal 2%. The current inflation rate is 1.2% [9].

Consequently, Europe imposed the NIRP to pressure consumers to avoid paying to keep their money in the bank and to incentivize them to spend more on products [10]. In terms of banks, the NIRP forces European banks to avoid holding their cash reserves in the ECB, encouraging banks to lend more money to their customers [11]. By lending out money and pushing consumers to spend, this, in theory, will raise inflation levels and stimulate healthy GDP growth.

Why is the NIRP needed?

Addressing Europe as a whole, the Eurozone banks are trading at the lowest levels in 30 years, with the current level of 80.8, indicating the lack of inflow of cash into financial instruments like stocks and bonds [12]. This imposes a problem as less cash in these markets restrict companies and the government to finance their operations.



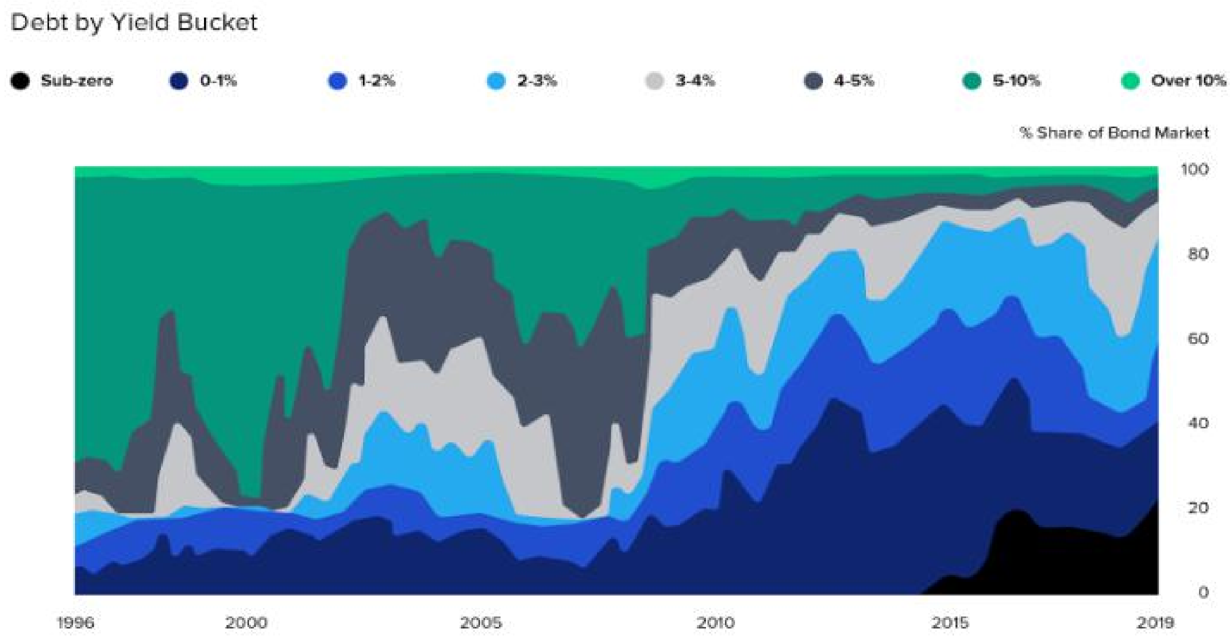
In total, since the beginning of the NIRP, banks have paid over €20 billion in negative interest rate fees, providing a tangible view of the paralyzing fees [13]. Each country of the Eurozone is nuanced: member populations range from 500,000 to 83 million people and Gross National Income per capita from €13,400 to €68,000 [14]. Europe has had difficulty in trying to compromise each region accordingly under one common policy rate. Contrastingly, a few countries within the union have flourished because of the NIRP.

For example, Sweden wanted to naturally depreciate its currency, the krona, against the Euro, deterring foreign investors from weakening the krona [15], and meeting its targeted export demand. Since 2015, the krona depreciated by 15% against the Euro. Sweden now has one of the most robust economies due to the NIRP and its influence on optimizing exports.

Next, Switzerland decreased its interest rates to -0.75% to dampen the foreign demand for its currency, the Swiss franc [16]. This day, known as “Frankenschock”, prompted the most significant currency market swing since the 1970s, as the franc strengthened by 30% against the Euro in one day [17]. Since then, Switzerland has seen relatively positive effects of negative interest rates on its economic performance. Personal savers have been protected, and banks have only passed on negative rates to corporate customers. Banks have recovered cash by pricing up mortgages, which has helped to prevent property bubbles from emerging [18]. Aside, from these two countries, many other countries in the union have been struggling with this new policy.

In Denmark, although its interest rate is currently at -0.65%, Denmark initially cut its interest rate to -0.75%, to achieve a similar goal like Sweden and lower its currency against the euro, the krone [19]. The consequences of negative interest rates for Denmark have been prominent; since 2012, Danish inflation hasn’t moved above 1%. In 2019, Danish house prices reached their highest ever levels, growing by 4.2% on the year, with a 1,500 sq foot abode in Copenhagen now costing on average $745,000, revealing extremely fast-rising asset prices.

Changing to Germany, the country’s finance agency 10-year government bonds are at -0.24% interest rate. The negative yields enjoyed by nations such as Germany now constitute over 20% of the global bond market. The shift in the bond market over the past 20 years has been tectonic, with the allocation of negative interest rates on bonds greatly increasing beginning in 2014 [20].



Source: ICE BofAML Global Fixed Income Markets Index

Therefore, although some countries in Europe have benefited from the NIRP, it is clear to see from GDP data and specific data that not all the countries in Europe have turned to an upside. Consequently, the inference that needs to be made is that the amount of decrease in interest rates is still not enough to make a significant positive impact on Europe's economy.

Future Impact of NIRP on Europe

Aside from Switzerland and Sweden, who have seen desired growth since the NIRP, the rest of Europe is still biting the dust. Cutting down the interest rates between -1% and 0% still has no prolific effect on economic growth. It seems that if Europe wants to see significant growth, it is a great possibility that interest rates will continue to be cut and result in lower and lower interest rates over the course of the next few years. Although the application of negative interest rates should work, it turns the economic theory behind it upside down. In terms of human behavior, it is rather absurd for a lender to expect to pay the borrower money when the borrower is already receiving money from the lender. The introduction of negative interest rates is a head-turning and eyebrow lifting bewilderment that can be used in short and brief durations to stimulate an economic growth impulse in times of downpour. Caution beware, however, that tampering with natural human behavior will have serious effects under prolonged exposure, as it can lead to serious issues like credit debt, asset bubbles and currency fluctuations that will explode and hamper any progress done by the NIRP over the years. Therefore, negative interest rates is an interesting and potential short term resolution, but needs to be as optimal as fast as possible to avoid long-term consequences regarding fatal economic exposures.

What is means for the investor

It is rather difficult to find a motivation to buy a bond if you end up losing money once the bond matures because you need to pay to keep the bond due to the negative interest rate. The only way to make money off of a negative interest rate bond is to sell the bond before it matures, as typically a negative interest rate bond rises in price quickly, therefore profit can be made as long as this action is done before maturity [21].

Considering North America's stable economy in comparison to Europe and the availability of fairly great bond rates in Canada, the risk of owning a negative interest rate bond exceed its benefits, resulting in a disadvantage for investors particularly in North America. The only incentive is if the investor lives in the areas where there are actual negative interest rates, and profit can be made through the secondary bond market, because central banks will keep purchasing bonds to stimulate the economy [22].

Therefore unfortunately the hassle, risks and the national lack of previous experience of negative interest rates outweigh the benefits for the average North American investor and it is difficult to stir up an incentive for an NIRP bond when there are better ways to earn profit in Canada. However, if an investor is really keen on diving into negative interest rate territory, as long as there is a demand for Central Banks to buy NIRP bonds, there is profit to be made but keep in mind that there is a serious risk of losing money.

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