The 2021 Canadian Federal Election

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The upcoming Canadian election has had its share of surprises, starting with the surge in Erin O'Toole's popularity with the electorate, making this race too close to call at this point. Current polls suggest the most likely outcome is either a Liberal or Conservative minority government.

That being said, we do not expect the election to have a material long-lasting impact on interest rates, the Loonie or the stock market, especially given the fact that the likelihood of another minority government is very high. The fundamental reason for this is that the economic cycle is the real driver for all financial markets rather than which party happens to be in power. At the margin though, a Conservative victory would be a slight positive for the Energy sector (positive comments on pipeline investments, etc.) and the market, since they are not proposing any substantial tax increases. A Liberal win would be positive for the "Green Economy," but a negative to the Financials given proposed higher taxes on banks in particular. The worst-case scenario – from a market perspective – would be an NDP win given proposed tax increases, especially the higher capital gains rate. While an outright NDP victory is highly unlikely, should the party win enough seats and strike another minority government alliance with Justin Trudeau, they could have more leverage in enacting some of the more populist elements of their platform. The bottom line is that we remain bullish on the Canadian stock market (we estimate a fair value of 24,000 representing over 15% upside) and the Canadian dollar, but not because of politics.

Macro Matters

Canada is an export and commodity driven economy, and as such is far more impacted by international growth than the U.S. This is especially true of the S&P/TSX which is heavily weighted toward Materials and Energy (25% of the Index vs. 5% for the S&P 500 in the U.S.), along with Financials (31%) and Industrials (12%). All these big sectors are leveraged to the economy while "defensive sectors" like Consumer Staples, Telecom, Utilities and Health Care represent a very modest 15% of the Canadian stock market (see Figure 1 and Figure 2).

Figure 1: Canadian Sector Weights (%)

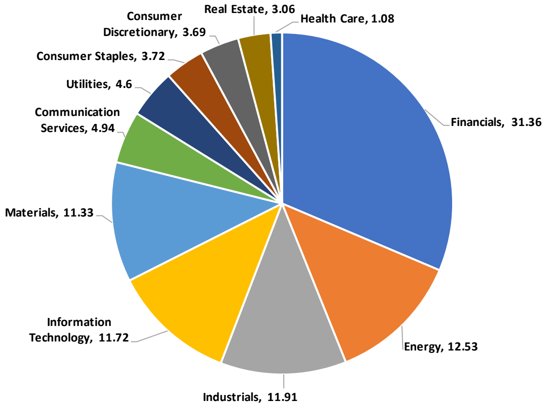
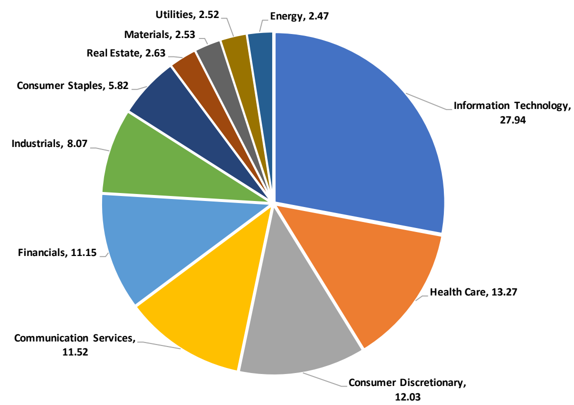


Figure 2: U.S. Sector Weights (%)



Source: Bloomberg, BMO Nesbitt Burns

The silver lining from that perspective is that global growth continues to be quite robust. Corporate profitability in the U.S. and Canada is also extremely strong despite supply chain issues to meet the pent up demand from consumers and companies. Since the U.S. is by far our largest trading partner, the strong sales and earnings momentum there is a great omen for Canada. For Q3 2021, the estimated earnings growth rate for the S&P 500 is +28%, close to a record; while in Q2, 87% of S&P 500 companies reported positive EPS and sales surprises. These are the highest percentages since FactSet began tracking this metric in 2008.

Another symptom of global economic momentum is the rally in commodities, such as copper and oil, which we are witnessing. They have historically been among the most important drivers for the S&P/TSX and the Canadian dollar as shown by Figure 3 and Figure 4.

Figure 3: Historical Crude Oil Prices vs. C$

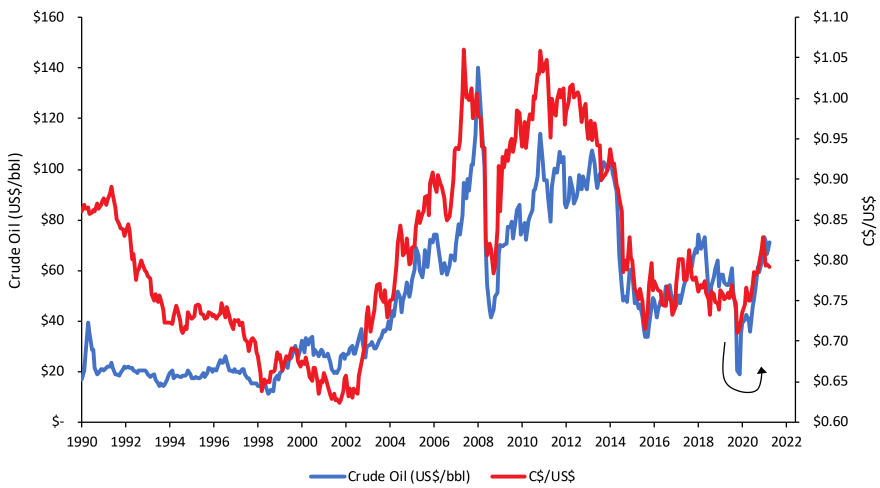
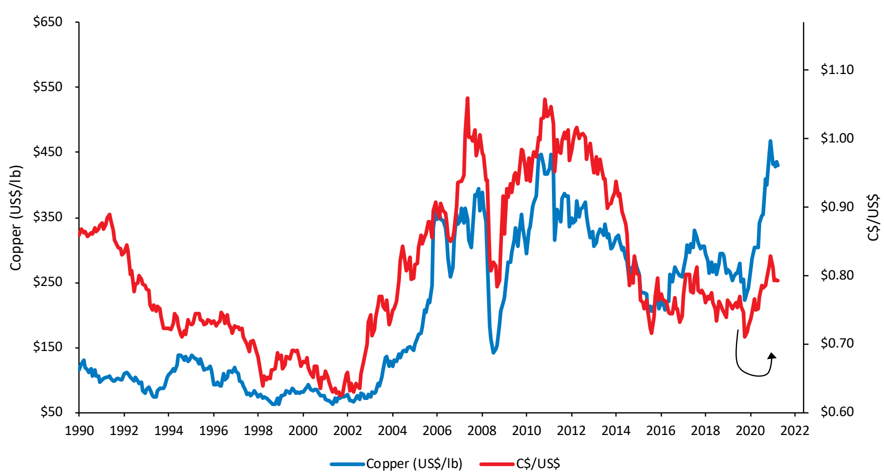


Figure 4: Historical Copper Prices vs. C$



Source: Bloomberg, BMO Nesbitt Burns

BMO's currency strategist Greg Anderson is bullish on the Canadian dollar and expects it to appreciate to $1.21 per U.S. dollar on a one-year horizon. Notably, he believes: 1) the Loonie is cheap relative to the price of oil; 2) The Bank of Canada is 60% through the tapering process (slowing down bond purchases) while the Fed has yet to begin; and 3) Canada has been a current account deficit economy for most of this century, but it ran surpluses in both Q1 and Q2. BMO's economists project a surplus for the whole year of 2021. This pushes the Canadian dollar even further toward safe haven territory in his view.

As for interest rates, domestically and globally the economy continues to benefit from very low rates, a condition not expected to be impacted by the election results. Budget deficits and debt management could ultimately lead to further credit deterioration for the government of Canada (Fitch downgraded Canada's debt to AA+ in November 2020), and pressuring long-term rates higher. However, with program costing not yet available for all parties, the short-term impact is difficult to assess.

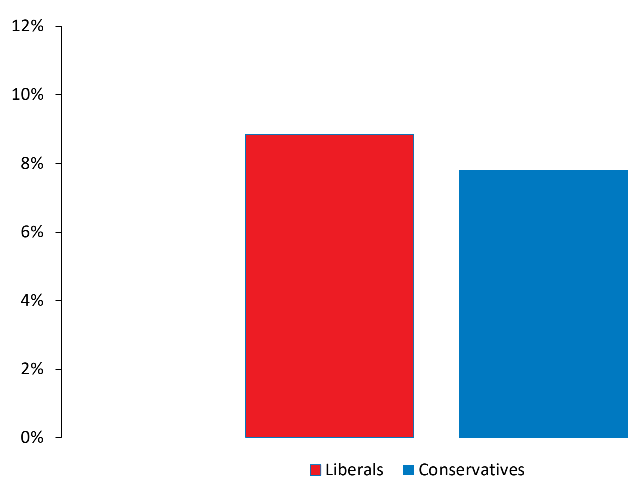
In the short term, lower consumer prices (compared to the U.S.), and growth coming back to more normal levels should reduce the need for the Bank of Canada to tighten policy at least until the second half of 2022. In addition, the Bank of Canada's expected reinvestment of its maturing bond holdings at a pace of $1 billion a week next year should remain supportive for interest rates and the economy.

Historical Performance

Based on our numbers, the market performance has been very similar for Liberal and Conservative governments. This supports our long-held view that the economic cycle is far more important than politics in determining the performance of financial markets. It also makes intuitive sense since policy differences between the parties are not that great relative to other countries (they tend to hug the center of the political spectrum).

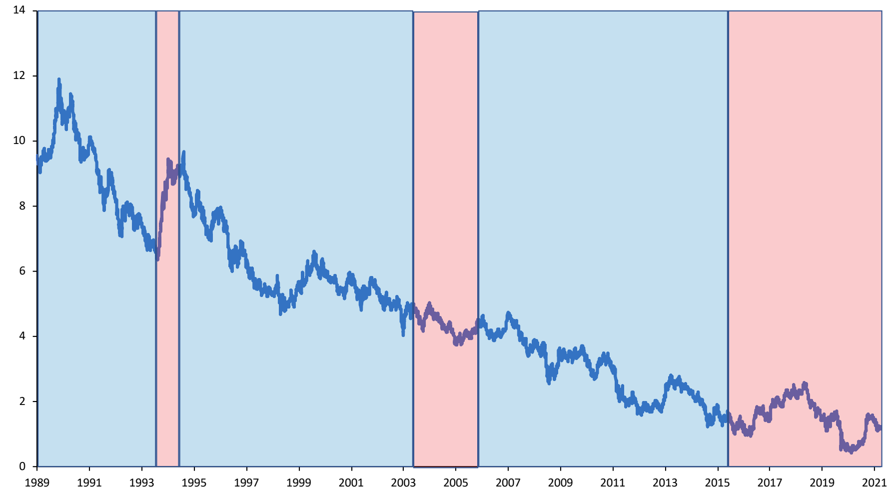
Figure 5: Party in Power and Annual Average Returns (1979-2021)

Party in Power	Conservative	Liberal	Conservative	Liberal	Liberal	Conservative	Liberal	Liberal	Conservative	Liberal	Liberal	Conservative	Conservative	Liberal	Liberal	Conservative	Liberal
Leader	Arthur Meighen	William Lyon Mackenzie King	R.B. Bennett	William Lyon Mackenzie King	Louis St. Laurent	John Diefenbaker	Lester B. Pearson	Pierre Trudeau	Joe Clark	Pierre Trudeau	John Turner	Brian Mulroney	Kim Campbell	Jean Chrétien	Paul Martin	Stephen Harper	Justin Trudeau
	1926	1930	1935	1948	1957	1963	1968	1979	1980	1984	1984	1993	1993	2003	2006	2015	now



Source: Bloomberg, BMO Nesbitt Burns

Figure 6: 10-Year Canadian Yield – Conservatives in Power (blue area) vs. Liberals in Power (red area)



Source: Bloomberg, BMO Nesbitt Burns

Sector Impact

From a sector perspective, Energy and Financials are the most impacted areas in our view.

BMO Energy Infrastructure and Utilities analyst Ben Pham recommends owning utilities/renewables over pipelines under a status quo Liberal government, and owning pipelines – on improved sentiment – in the case of a Conservative win.

He highlights the following key points:

1) Carbon taxes/CCUS (Carbon Capture, Usage and Storage) are expected to go to $170/tonne by 2030 from $50 in 2022E under Liberals, while Conservatives could maintain it at $50. Both parties are aligned with providing subsidies to facilitate CCUS.

2) Renewables/electric grids. Liberals are proposing net zero emitting electricity system by 2035 and additional renewable tax credits. This could increase renewable energy penetration and electric grids. Renewable growth can still occur under Conservative rule, but likely at a slower pace.

3) Pipeline support. The Liberals are currently supportive of building out pipeline egress, such as the TMX expansion project. That said, the Conservatives will have a louder drumbeat in supporting pipeline infrastructure (to the extent the market needs it) such as a revision of Bill C-69 (Impact Assessment Act), and repeal of Bill C-48 (oil tanker ban) bringing some life back to Enbridge's Northern Gateway project.

For Financials, the Liberals are proposing a 3% surtax on profits over C$1B, so the large banks would be most impacted but not enough to warrant a change in our bullish view. National Bank, Royal Bank and CIBC generate the highest proportion of earnings from Canada among the Big 6 banks, at 77%, 68% and 67%, respectively. Royal Bank has the highest profitability over $1 billion and could therefore be disproportionally impacted relative to peers.

Our analyst team believes that the impact is generally immaterial (a few pennies per share) to Life Insurers since Canada can only tax Canadian lifecos on earnings from their Canadian segment (Canada accounts for 20%-25% of bottom line for MFC, 34% for SLF, and 37% for GWO). Intact Financial gets 66% of its operating earnings from Canada, and thus about $1.3B in earnings from Canada, so a 3% tax on $300mm is $9mm or about $0.05, or less than 1% of operating EPS.

As it relates to mortgage lending, both the Liberals and Conservatives are proposing changes to mortgage insurance rules (i.e., increasing the $1MM limit on the value of a house for insured mortgages). This could prove to marginally support housing affordability. Separately, the Conservatives want to remove the requirement to conduct a stress test when a homeowner renews a mortgage with another lender. Mortgage profitability is typically higher upon renewal given brokers are paid commissions only for the initial term, so this proposal is likely to increase competition for that business.

Party Platforms: Major Economic Issues – From BMO Economics

Budget deficit: The Liberals' 2021 budget pegged the deficit at $154.7 billion, or a still-hefty 6.4% of GDP, followed by deficits north of $50 billion in the following two years. While fiscal upside is likely built-in thanks to a firmer-than-projected economy (especially in nominal terms), election promises may eat into much of it. The Conservatives and NDP have not costed their proposals, but are not shy about spending.

Health care: Understandably, health care is top of mind for many voters right now. All three parties have targeted faster vaccine access, with the Conservatives and NDP calling for additional investments into domestic production. The Conservatives are promising to boost annual growth of the Canada Health Transfer (to the provinces) to at least 6%, while the NDP continues to push national pharma care.

Child care: Both the Liberals and NDP are targeting a $10/day subsidized child care program. The Conservatives are instead proposing to cover up to 75% of child care costs by converting the Child Care Expense deduction into a refundable tax credit.

Housing: All three parties address affordability with both demand- and supply-side policies. In particular, they all target non-resident owners and promise additional (new or repaired) housing units.

Taxes: The 2021 budget didn't include any major tax changes. The Conservative platform includes many incentives to boost the recovery, largely targeted at near-term investment and hiring, in addition to some populist measures aimed at vacation and retail spending. The NDP's proposals target higher-income earners and corporations.

Environment: Climate remains a key plank in each platform. The Liberals and NDP are largely sticking with the current carbon tax system, while the Conservatives have proposed that the money from carbon pricing goes into personal savings accounts.

While Canadians await the results of the September 20 election, as always, investors are encouraged to remain focused on their long-term objectives. Please speak with your BMO Private Wealth professional if you would like to discuss your portfolio.

Appendix

Federal Election 2021: Major Economic Issues

Liberals	Conservatives	NDP
Businesses		
Extend the recovery hiring program to March 31, 2022	Paying up to 50% of salary for net new hires for six months after CEWS ends	Continue existing small business wage and rent subsidies
Extend the wage and rent subsidies to Sept 25, 2021; phase-out began in July	Loans of up to $200k for SMEs in hospitality, retail, and tourism; up to 25% forgiven	Long-term hiring bonus to pay the employer portion of EI and CPP for new or rehired staff
Temporary wage and rent support of up to 75% for tourism industry		
Taxes		
3% digital services tax to start in 2022	5% investment tax credit for capital investments made in 2022 and 2023	Increase the capital gains inclusion rate to 75%
Luxury goods tax		Raise the top marginal tax rate 2 ppts to 35%
Raise taxes on banks and insurance companies that earn more than $1 bln/year	25% tax credit on investments up to $100k in small businesses over the next two years	1% wealth tax for >$10 mln in wealth
		Raise corporate income tax rate 3 ppts
Minimum 15% tax on people who qualify for top marginal tax bracket	15% tax credit for vacation expenses of up to $1k/Canadian for trips in Canada in 2022	Taxes on multinational internet companies
	Sales tax and 3% digital services tax on companies that don't pay tax in Canada	Temporary 15% tax on excess profits by large corporations who received the wage subsidy during the pandemic
	1-month GST exemption and 50% dine-in rebate	
Fiscal		
FY22/23 deficit $62.7 bln (PBO)	FY22/23 deficit $57.3 bln (PBO)	$48 bln of net new spending over the next 5 yrs
No plan to balance the budget	Balanced budget still a long-term priority	No target to balance the budget
Health Care		
Funding for virtual care; strengthen federal powers under the Canada Health Act	Boost annual growth rate of the Canada Health Transfer to at least 6%	National pharmacare starting in 2022
		Universal dental care
Domestic vaccine production in Quebec; free vaccine boosters	Prioritize COVID booster shots and accelerate homegrown production of vaccines and PPE	Establish a crown corporation responsible for domestic production of vaccines
Environment		
Reduce corporate income tax by 50% for manufacture of zero-emission technologies	Personal Low Carbon Savings Account and a Small Business Low Carbon Savings Account	Reduce emissions by at least 50% from 2005 levels by 2030; maintain carbon tax
Interest-free loans of up to $40k for home energy retrofits	Remove the carbon tax backstop system; cap carbon tax at $50/tonne	Goal of 100% non-emitting electricity by 2040
		Retrofit all buildings by 2050
Child Care		
Cut child care fees by 50% by the end of 2022	Create refundable child care tax credit; cover up to 75% of child care costs (income tested)	Universal $10/day child care
Universal $10/day child care within five years		Expanded access to EI for parents
Expanded Canada Caregiver Credit	Expand Canada Child Benefit and EI benefit	
Housing		
1% annual vacancy tax on non-resident owners	Encourage 1 million homes in the next 3 years	Build 500k+ units of affordable housing in the next ten years; half within five years
Eliminate blind bidding; open price transparency	Ban on homebuying by non-residents with a review in two years	20% tax on non-resident foreign buyers
Flipping tax (12-mo.) and foreign-buyer ban	Encourage 7-to-10-year mortgages	Double Home Buyers Tax Credit to $1,500
Phased cut on GST for first-time buyers of properties from $300k to $450k	Amend the mortgage stress test to improve access for non-permanent employees	Re-introduce 30-year terms to CMHC-insured mortgages for first-time homebuyers
Tax-free First Home Savings Account up to $40k		
Other		
Expanded EI and worker benefit	Double the Canada Workers Benefit up to a maximum of $2.8k/person or $5k/family	Targeted student debt forgiveness up to $20k; double Canada Student Grants
Double Canada Student Grant for two years		
Federal minimum wage of $15/hr	Connect all Canadians to high-speed internet by 2025	Cap cell phone and internet prices
Permanently eliminate interest on Canada Student Loans		Expand sickness benefits from 15 to 50 weeks
		Guaranteed basic income
		Federal minimum wage starting at $15/hr

Sources: BMO Economics, Federal Budget, party statements ** new promise after Budget 2021*

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