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Little reaction to Canada's credit rating downgrade by Fitch

On June 24, Fitch Ratings cut Canada's AAA credit rating[1] by one notch to AA+, saying the downgrade reflected "the deterioration of Canada's public finances in 2020 resulting from the coronavirus pandemic." Is this the harbinger of more rating cuts, and what impact will this downgrade have on your finances?

In a nutshell, Fitch's justification for the rating cut was that Canada will have a greatly expanded government deficit in 2020 and will emerge from recession with significantly higher public debt ratios (the Fitch press release can be found here). The growing deficit is largely driven by public spending to offset the output plunge after much of the Canadian economy was shut down to control the spread of the virus.

Fitch forecasts a severe recession in Canada, with GDP contracting by 7.1% this year, due to pandemic lockdown measures and depressed global oil demand. It expects Canadian GDP to recover by 3.9% in 2021, as global trade, commerce and domestic labor market conditions gradually improve.

Market reaction to the downgrade was a collective yawn, although the Canadian dollar weakened briefly before rebounding. This muted reaction could be due to a combination of factors.

First, Canada may be the first nation to be downgraded by Fitch, but the global pandemic has had a negative impact on the finances of numerous other nations, many of which are arguably in worse shape. Secondly, there's too much going on globally – such as the pandemic still raging around the world, the turmoil in the U.S. and its worsening relations with China, and Brexit – for market participants to pay much attention to the rating cut. Finally, Fitch is the smallest of the three major ratings agencies. Both S&P Global Ratings and Moody's Investors Service give Canada their highest country rating (AAA or equivalent).

As well, because Canada is a relatively small player in the global economy, the rating cut hardly caused a ripple in global markets. In contrast, when S&P unexpectedly lowered the U.S. AAA rating on August 5, 2011, the S&P 500 plunged 6.7% the next business day while the MSCI World Index fell 5%. But after that knee-jerk reaction, U.S. and global markets recovered in short order as they commenced their historic multi-year bull run.

Fitch Ratings also assigned a "Stable Outlook" to Canada's rating, reflecting its expectation that government debt/GDP will stabilize in the medium term and the economy will gradually recover. It also noted that Canada's AA+ rating is underpinned by its structural strengths, such as an advanced and well-diversified economy, political stability and macro policy framework.

On a positive note, a couple of data points released this week offer proof that Canada's prompt and efficient monetary and fiscal policy response to the coronavirus is indeed paying off. The Bloomberg Nanos Canadian confidence index, a weekly composite measure of Canadians' financial health and economic expectations, last week recorded its eighth straight weekly gain and its biggest increase since 2013 (Figure 1). Consumer spending also rebounded sharply in the first half of June, according to data analysis by Royal Bank of Canada.

In addition, Canada's cautious approach with regard to re-opening its economy looks like it may have been the right approach, especially compared with the U.S., where coronavirus cases are surging in some states that may have opened up too quickly.

From a longer-term perspective, the latest immigration restrictions south of the border could benefit Canada in two ways – talented overseas professionals may prefer Canada to the U.S. as an immigration destination, and the brain drain that sees thousands of Canadian workers in technology and other areas head to the U.S. each year may also be stemmed. This may accelerate the long-overdue diversification of the Canadian economy, towards the fast-growing technology and knowledge industries and away from its traditional strongholds of energy and resources.

The Fitch rating cut should be a wake-up call in two areas of one's personal finances – excessive leverage, and the risks of your investment portfolios being overly concentrated in Canada. Canadian household indebtedness is at near-record levels and is among the highest of the developed economies, so improve your personal balance sheet while you can. Canada also accounts for less than 2.5% of the global economy, so having an investment portfolio that is well-diversified by geography will provide access to investment opportunities that are in short supply locally.

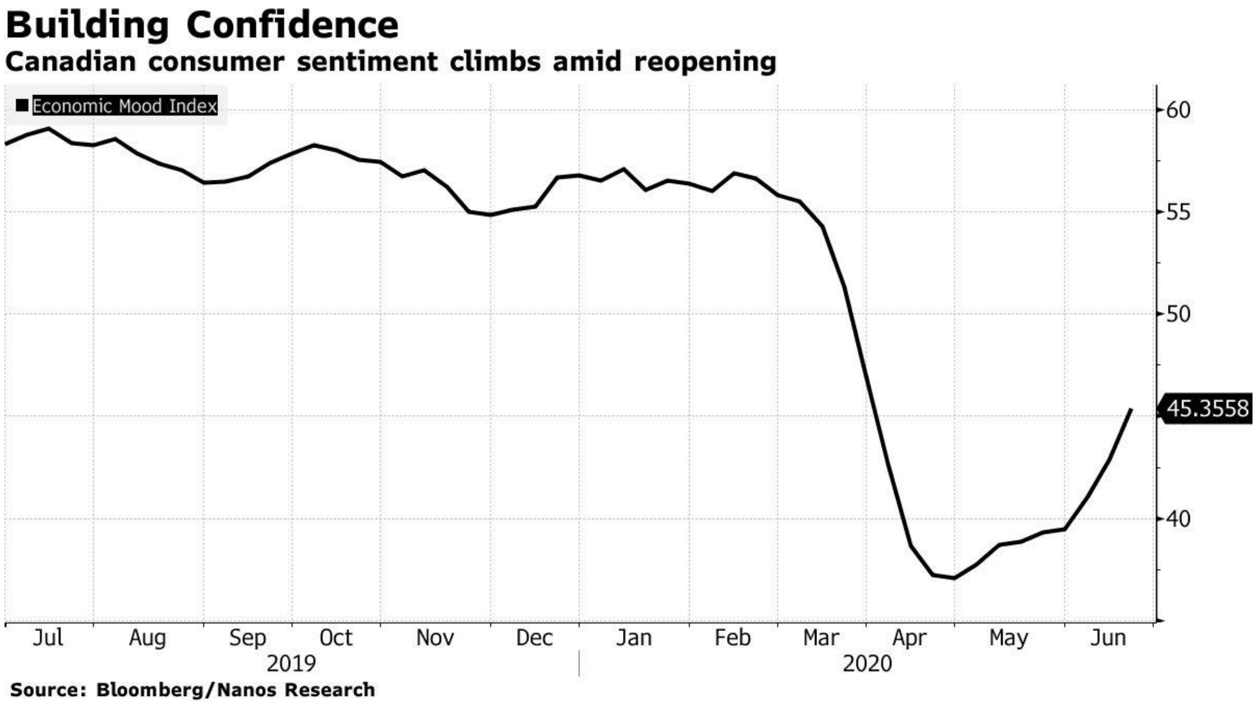
It remains to be seen whether S&P and Moody's also cut Canada's rating, in line with Fitch. If they do, it is possible that these downgrades may not be met with the same investor indifference, especially if the dreaded second wave of the coronavirus hits Canada hard. For the moment, though, our view is that Canada is better positioned than many other nations to cope with the pandemic and its aftermath, the Fitch downgrade notwithstanding.

[1] https://www.fitchratings.com/research/sovereigns/fitch-downgrades-canada-ratings-to-aa-outlook-stable-24-06-2020

Quote of the Week

"A billion here, a billion there, and pretty soon you're talking real money."
– Everett McKinley Dirksen (former U.S. Senate leader)

Figure 1: Canadian consumer confidence climbing



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