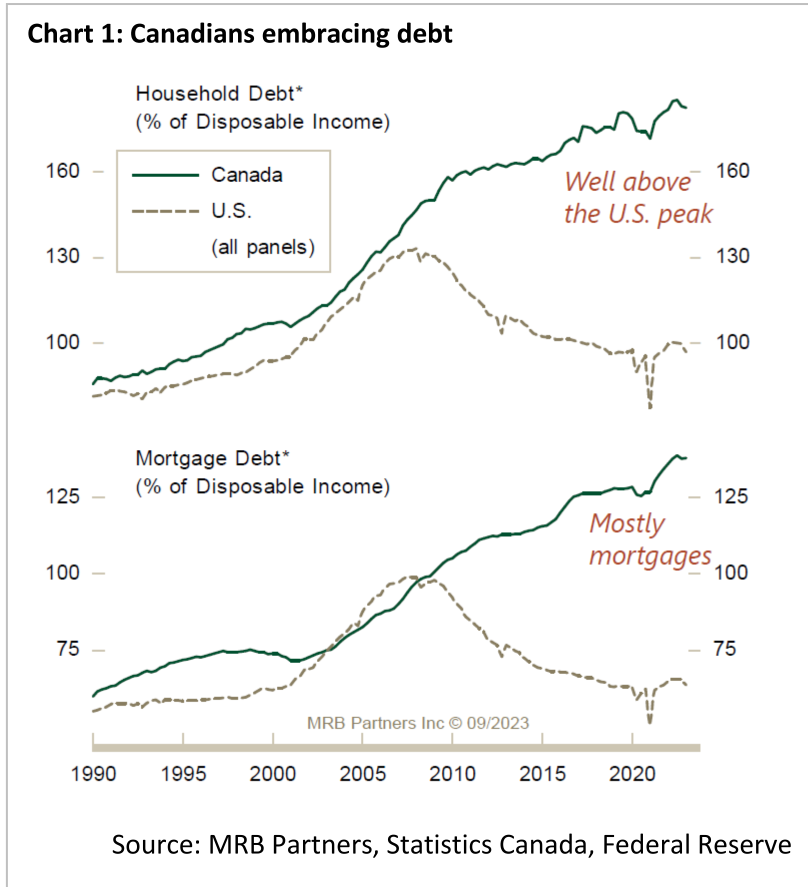
Uh Oh Canada

One of the most topical discussions in Canada recently has been about how unaffordable real estate has become. This is largely due to a combination of high real estate prices and a rapid rise in mortgage rates. The dream of home ownership, which had already been a challenge for many Canadians, has now become unattainable. An even bigger concern is the current predicament of borrowers. Recent homebuyers, who took on large mortgages made possible by low mortgage rates, are now dealing with higher mortgage payments that they did not budget for. While we are not going to discuss the outlook for the Canadian real estate market, we will focus on the ramifications for our domestic stock and bond markets.

Chart 1: Canadians embracing debt



Source: MRB Partners, Statistics Canada, Federal Reserve

The recent disclosure from three of Canada's big banks revealed that about 20 percent of all outstanding mortgages now have negative amortization, which is alarming. Negative amortization means that a homeowner's mortgage payments no longer cover the interest portion of the payments. The banks, not wanting to make the situation even worse, have relaxed payment terms by extending the amortization period for these mortgages, at least on a temporary basis, to avoid defaults. The same three banks reported that there has been a 20 percent increase in the number of outstanding mortgages that now have an amortization period of greater than 25 years, something that was unheard of in Canada a mere 18 months ago. Whereas U.S. home buyers may lock in very long-term fixed rate mortgages, Canadians don't have that option. Aside from variable rate mortgages, many Canadians opt for the five-year fixed rate mortgage. The Bank of Canada's Financial System Review estimates that about 40 percent of mortgages have already been reset higher, with the remainder to be reset within the next three years.

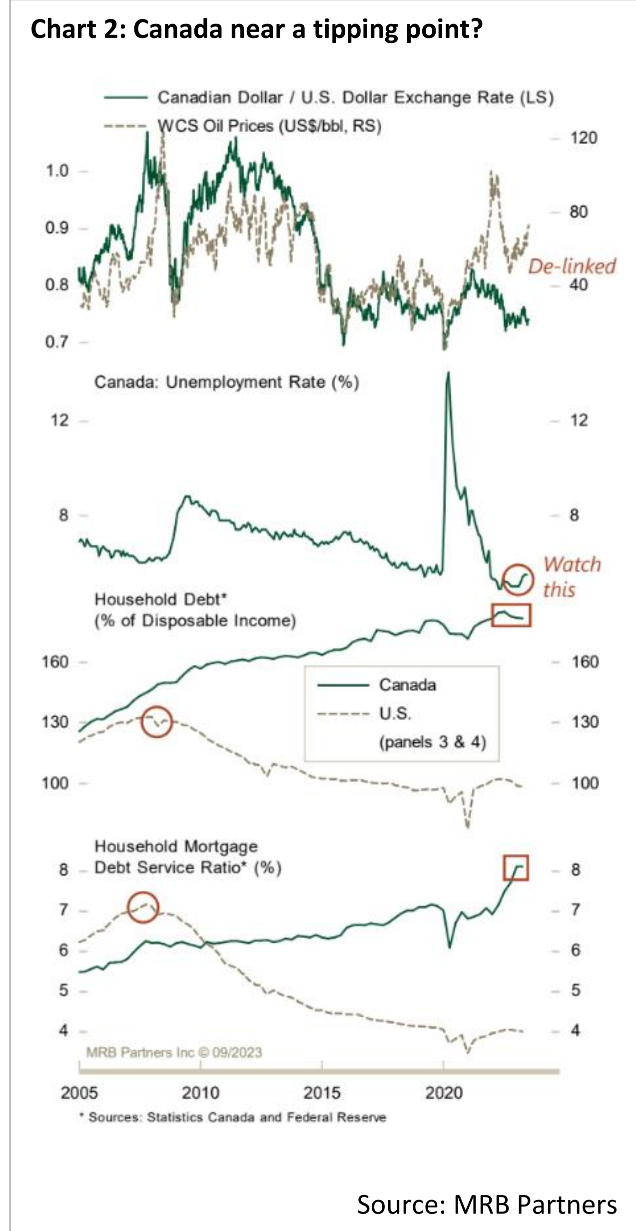
How did we get to this point? In the last two decades, low inflation and low interest rates have prompted homebuyers to assume larger and larger mortgages as home prices rose. The banks and other lenders assumed that the low interest rate environment would remain as such indefinitely, leading to aggressive competition amongst lenders making them ill-prepared for the "unexpected" rise in borrowing rates that has since occurred. This has led to alarming debt levels;

mortgage debt is now near 140 percent of disposable income and total debt has risen to 180 percent, compared to 130 percent total debt to disposable income for the U.S., just prior to the Great Financial Crisis of 2008 (Chart 1). While many people say similar past warnings were nothing more than fear mongering that didn't stop the housing boom nor have an impact on our economy, we haven't encountered this environment of high real estate prices along with surging mortgage rates in the past couple of decades. We believe we are at the potential "tipping point".

The Canadian dollar has long been linked to the direction of Western Canadian Select (WCS) oil prices (Chart 2, top panel) but there has clearly been a breakdown in this dynamic in recent years. The Loonie has fallen despite rising oil prices. The currency market has obviously been paying more attention to the key risks to the Canadian economy (Chart 2, panels 2, 3 and 4).

This puts the Bank of Canada in a difficult position. The latest August inflation reading of 4.0 percent is still well above their target of 2.0 percent, despite having already hiked rates 475 basis points (4.75 percent) since April 2022. The yield on the five-year Canada bond, which is the main driver of five-year fixed mortgage rates, has risen from 0.29 percent in July 2020 to 4.32 percent. As such, we believe it would be extremely difficult for the Bank of Canada to raise rates again, given what even higher mortgage rates would mean for Canadian homeowners. More rate hikes would push even more mortgages into negative amortization. While softening house prices would likely be welcomed by the government, an outright collapse in the housing market would do more political and economic damage than good. Construction employment makes up eight percent of total employment in Canada. It is increasingly difficult to see a scenario where Canada can get through this without a recession in the coming year. GDP growth in Canada has essentially flat lined, no growth in July, and 0.1 percent growth in August.

Chart 2: Canada near a tipping point?



Source: MRB Partners

Outlook for Canadian bonds

Bonds have been one of the poorest performing asset classes over the last three years. The Canadian Universe Bond Index has had one of its worst three-year stretches in its history, with an average annualized rate of return of -5.10 percent over that period. After declining -11.69 percent in 2022, it is down another -1.50 percent so far in 2023. However, we are now turning constructive on bonds, given that we believe we are at or close to the peak in interest rates in Canada. It is increasingly difficult to envision a scenario where Canada avoids a recession in the coming 12-18 months, given the state of Canadian household balance sheets, and more rate hikes would lead to an even deeper recession and more economic pain. Also, the current yields in the bond market make it easier to make money in bonds than to lose money. This is a point of opportunity. We use the 10-year government of Canada benchmark bond (current yield 4.04 percent) in the

following table to illustrate this. A decline in yield of one per cent would produce an eye-popping 12.98 percent return over a one-year period.

Government of Canada 10-year benchmark bond – illustration only (as of Sep 30, 2023)

Increase / Decrease in Yield in the next 12 months	Total Return in 1 year
+1.00%	-2.31%
+0.50%	+1.26%
-0.50%	+8.90%
-1.00%	+12.98%

Source: Raymond James

What about Canadian stocks?

Although slowing economic growth and the aforementioned challenges facing Canada are clearly not positives for the Canadian stock market as a whole, there's reason to be more optimistic on certain Canadian stocks and sectors. Bond proxies, such as higher dividend yielding stocks primarily in utilities, consumer staples, and telecommunications sectors, have had a difficult time this year as bond yields have increased. These companies usually have little earnings growth; however, the stability of their earnings allows them to pay higher dividends, which are oftentimes competitive with fixed income investments. Within these sectors, we favour companies that have a larger percentage of their revenues from non-Canadian (mostly U.S.) sources. The likelihood that U.S. interest rates will stay higher for longer than in Canada sets up a scenario of a possible Canadian dollar decline into the next recession, and a foreign exchange benefit for Canadian companies earning U.S. dollar revenues. We will continue to underweight Canadian sectors that are most exposed to the Canadian housing market and the over-leveraged borrower, namely Canadian banks and lending institutions, and real estate investment trusts that are exposed to residential housing. While the high dividend yields offered by the Canadian banks certainly appear enticing and valuations are inexpensive, bank earnings are likely to continue to face pressure in the near term from increasing loan loss provisions, reserves that are set aside for bad loans. This prudent action by the banks could be a long term positive. Should loan defaults end up being lower than the amounts they have set aside, the reserves flow back into earnings. For now, we remain cautious on the group, and prefer what we see as a better operating environment (fewer headwinds) for larger U.S. and European banks.

The Canadian equity market has already discounted some of these concerns. The TSX Composite has had a total return of 3.38 percent year to date, trailing the 12.41 percent rise of the S&P 500 in 2023. There's value in the TSX index, priced at 13x next year's earnings, versus a still rich 19x next year's earnings for the S&P 500. We remain constructive towards individual Canadian stocks but stress the importance of stock selection and appropriate sector exposure.

Stronger economic growth in the U.S. should provide some support to counter the weakness in Canada. But ultimately, much hinges on the state of the Canadian housing and jobs market, and where interest rates are headed. Unless mortgage rates fall substantially in short order, there's likely a new flood of homeowners who will not be able to meet their mortgage obligations, adding to Canada's economic woes.

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