Third Quarter Commentary

October | 2017

Canada – In for a good time, not a long time

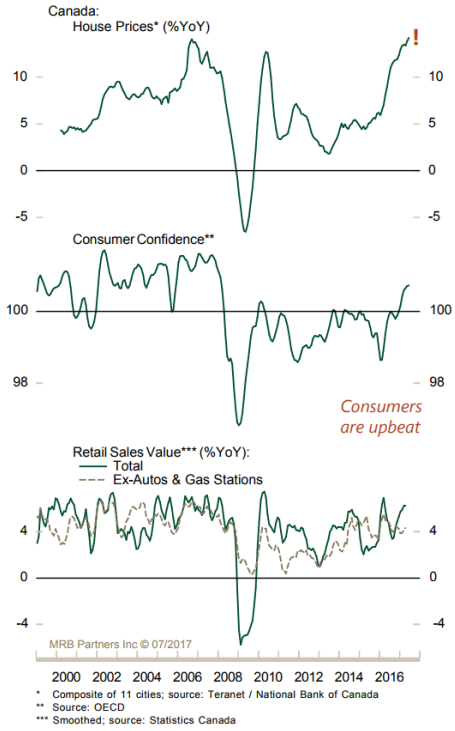
"The Bank of Canada (BoC) was the exception to the rule this week, and again hiked rates. The revival of the housing bubble in parts of the country highlighted that macroprudential policy steps alone have not been enough, prompting the BoC to pursue old-school rate hikes in an attempt to slow the stampede. The reward for hiking rates was a further spike in the currency, which is increasingly out-of-sync with the country's terms-of-trade, and has been reflected in the poor relative equity market performance. There has been a significant tightening in overall monetary conditions in Canada, and the negative economic consequences will show up down the road. It was dangerous to let the household debt/housing bubble develop, and now it will be very challenging to try letting the air out of the balloon in a controlled fashion." – MRB Partners, September 8, 2017

"From an investment standpoint, our conclusions imply that investors should pursue a "two-staged" approach when allocating to Canadian assets. Over the coming 6-12 months, a cyclical improvement in the economy means that Canadian risky assets and government bond yields are likely to rise, and we believe this stage is worth playing. But over the secular horizon, the reverse is likely to unfold, meaning that a rally in Canadian assets over the coming year will create excellent "selling conditions" for investor looking to position for a bearish structural view." – BCA Research, July 14, 2017

These comments from our favoured strategic analysts, MRB and BCA, form the basis of our allocation plan to favour Canada for the coming period.

There's no denying the facts. Canada's economy is firing on all cylinders. In the second quarter, GDP growth came in at an annual rate of 4.5%, led by strong household spending and exports. Solid job growth and low interest rates continue to boost consumer spending. Exports were led by both the energy sector and shipments of industrial equipment. On the heels of this release, the BoC promptly raised its overnight lending rate by 25 basis points, to 1.00%, leading to a subsequent surge in the Canadian dollar, which hit its highest level since June 2015. Canadian bond yields rose across the board, pulling up mortgage rates. Inflation meanwhile remained benign, with the year over year inflation rate of 1.2% well within the BoC's targeted range of 1-3%. The rate hike however, had little to do with controlling inflation. As in the case of the U.S. Federal Reserve, this rate hike was about taking advantage of strong economic data to justify rate increases to unwind rate cuts used to stimulate the economy after the 2008 financial crisis caused by the subprime mortgage bust. This move to higher rates from extraordinarily low levels will be important in

Chart 1: Canada's strong economic momentum…



source: MRB Partners

advance of the next recession. The ability to lower rates from a higher level in order to stimulate economic growth during a recession is a crucial tool for Central Banks.

From a cyclical perspective, we believe Canadian assets should perform relatively well in the coming year. Our positive bias stems from Canadian stock valuations which are priced at discount to U.S. stocks, and we anticipate a narrowing of this differential. Year to date, the TSX total return index is up 4.44%, paling in comparison to the S&P 500 total return of 14.24%. The S&P 500 return in Canadian Dollar terms however is lower, at 6.03% year to date due to the depreciation of the U.S. currency. Although we believe the risk of a further drag for foreign assets from the strengthening of our Loonie is diminished, we like the near term outlook for Canadian equities. The recent positive economic momentum in Canada is fairly broad, and coupled with the discounted valuation bodes well for near term Canadian market returns. In particular, we see the strength in our economy leading to higher bond yields, and subsequently a wider interest margin environment for Canadian banks, benefiting their bottom line. Strong jobs creation is likely to keep encouraging Canadian consumers to spend. This is a key component of economic activity.

Chart 2: …has not translated meaningful gains for Canadian Stocks (S&P/TSX Composite Year to Date)

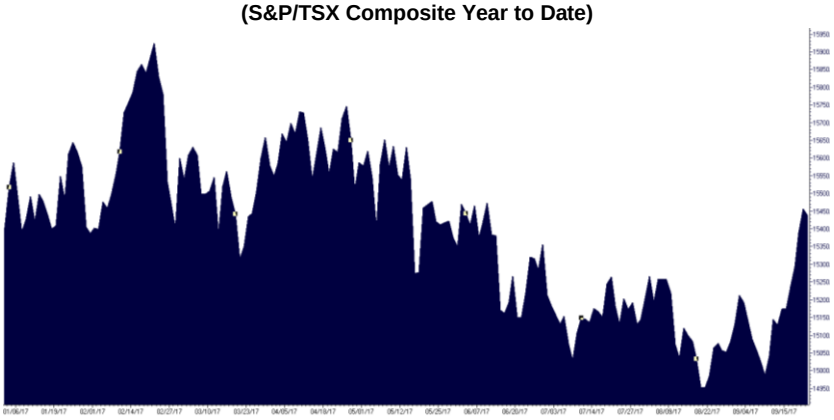
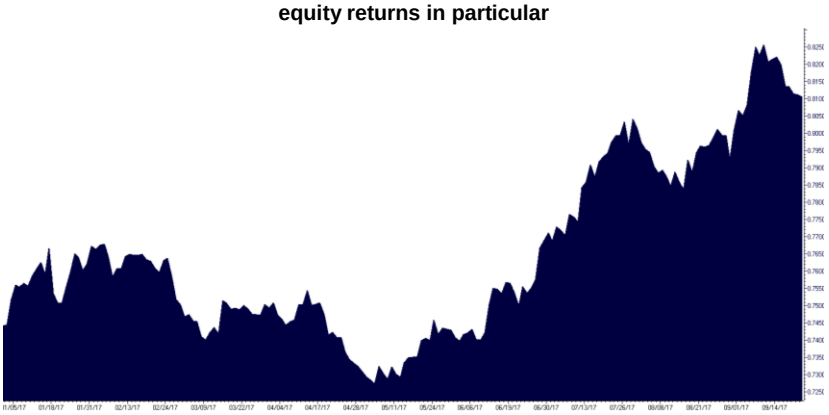


Chart 3: The rise of the Canadian Dollar in 2017 has been a negative drag on U.S. equity returns in particular



source: Thomson

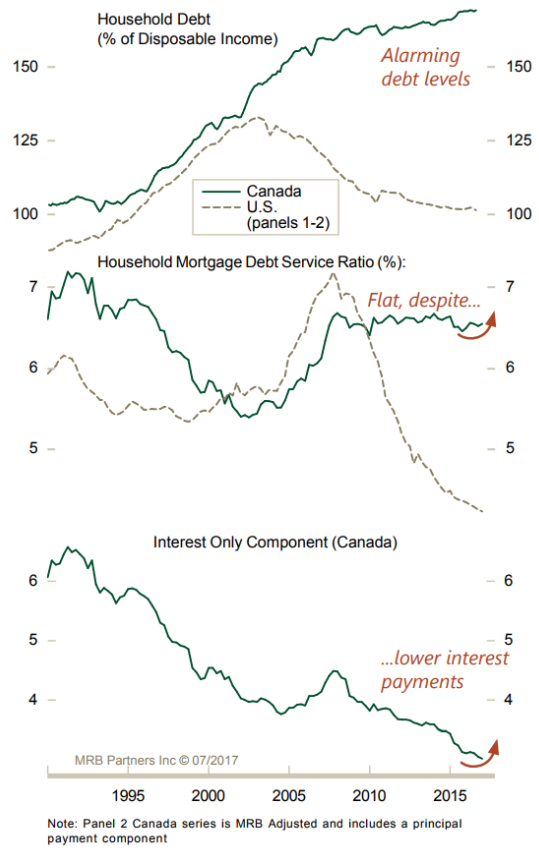
Our current positive perspective on Canada however gives way to a much different outlook beyond the next twelve months. The near term cyclical positives are unlikely to overcome the numerous long term structural negatives. Higher interest rates will impact the average Canadian family. Canadian households carry enormous amounts of debt ($1.68 debt for every $1.00 of disposable income), higher than the peak levels reached in the U.S. in 2007, and significantly higher than U.S. households today. Lower borrowing rates have enabled Canadian households to increase their indebtedness without increasing their actual debt payments. Although Bank of Canada's rate hikes have not yet hampered the demand for credit, further increases in the cost of credit will have a negative impact on our already overly leveraged consumers.

The state of the Canadian housing market continues to be a topic of much debate. Proponents of the sustainability of the rise in prices point to the fact the skeptics have long called for a meaningful correction in the prices, and time and time again have been wrong. We argue that this has no bearing on what could happen in the future. For the domestic buyer, we have likely entered into a period of increasing mortgage rates. It will be the magnitude of the rise in rates that will largely dictate the behaviour of domestic buyers and sellers. This is the biggest risk to house prices. Although the higher mortgage rates will likely have a more immediate impact on new buyers, the fact that almost 70% of all outstanding mortgages were at fixed rates at the end of last year means that changes in the mortgage debt servicing costs for the majority will probably be deferred for some

time (until these fixed rate mortgages come up for renewal). Furthermore, households with mortgages coming up for renewal this year won't see much change in their borrowing costs, given that their fixed rate terms from five years ago probably will be renewed at a rate that's likely at, or even lower than, their prior five year term. We anticipate a bigger impact on borrowers later in 2018.

Another consideration is the impact of foreign buyers on pricing (particularly in Vancouver and Toronto). Data regarding foreign ownership is spotty at best. However, the high correlation of the following factors is undeniable; the number of visitors to Canada specifically from China and Hong Kong, Canadian bank loans to non-residents as a percentage of overall bank loans, the average single family home prices in Vancouver and Toronto. The steepening climb of all three factors from 2010 onwards supports the theory that foreign capital inflows have played a role in pushing housing prices higher. Changes to the levels of foreign capital inflow due to for example a clampdown by the Chinese government, or a weakening of the economy abroad could have a significant dampening effect on demand. The state of the housing market is important to Canada, as inflated home prices have the effect of inflating household net worth, which is shown to be an influencing factor on the propensity to spend. The health of the real estate market affects spending on housing related expenditures. Residential construction, home maintenance, repair and renovations, transfer costs, spending on furniture and appliances, and other housing related spending now amounts to about 23% of our GDP.

Chart 4: Canada's low interest rate induced credit bubble



source: MRB Partners

In the short term, the sources of strength in our economy have been very broad, including stronger exports in recent months, enabling the Bank of Canada to raise rates. The rally in the Canadian dollar however, may pose a problem for domestic businesses which sell to the U.S. market. In fact, in 2016, U.S consumption of Canadian goods and services totaled more than $300 billion. Acknowledging this risk, Deputy Governor Timothy Lane has indicated the BoC will be "paying close attention to how the economy responds to both higher interest rates and the stronger Canadian dollar." In Lane's address, there was specific reference to how a stronger Loonie had hurt export industries over the past decade, and he mentioned the need for stronger manufacturing and service industries. On international trade, he also noted the risks associated with rising global protectionism, and indicated that the North American Free Trade Agreement (Nafta) negotiations is one of the main sources of economic uncertainty for Canada.

A low Canadian Dollar, low interest rates, Federal Government fiscal stimulus, and lower energy prices have all provided a boost to Canadian consumers, manufacturers and our economy. As many of these trends begin to reverse, the impact on the economy will undoubtedly be less positive. Although the unwinding of these conditions will moderate growth, Canada's economy should continue to perform well in the immediate future given its strong momentum. This will be positive for Canadian assets over the short term horizon. Outside of a negative outcome from Nafta negotiations, the already discounted valuation of the Canadian equity market should enable our stock market to close the valuation gap with that of the U.S. The real challenge for Canada is further down the road, when the confluence of these negative factors begins to take a real toll on our economy.

Our asset allocation decisions will show favour to Canada in the coming 6 – 12 months. Better valuations and near term economic momentum leads us to be positive towards Canadian stocks over the coming period. The expected concurrent rise in bond yields supports our positive bias towards the cyclical growth and cyclical yield opportunities, specifically the financials, and industrials. We strongly believe this is no more than a cyclical story. The long term secular problems of overleveraged households, overvalued housing markets, fiscal policies that become a challenge for economic growth, along with too strong a currency that puts Canadians firms at a competitive disadvantage will be too much to overcome, and will eventually lead to a period of economic slowdown and Canadian stock market underperformance.

Worth Allaye-Chan Investment Counsel | www.worthallayechan.com | worthallayechan@raymondjames.ca
Suite 2100-925 West Georgia Street, Vancouver, B.C., Canada V6C 3L2 | T: 604.659.8066 TF: 1.855.659.8066 F: 604.659.8449

WORTH ALLAYE-CHAN
INVESTMENT COUNSEL

RAYMOND JAMES®