Insights & Strategies

PRIVATE CLIENT SOLUTIONS

June 6, 2019

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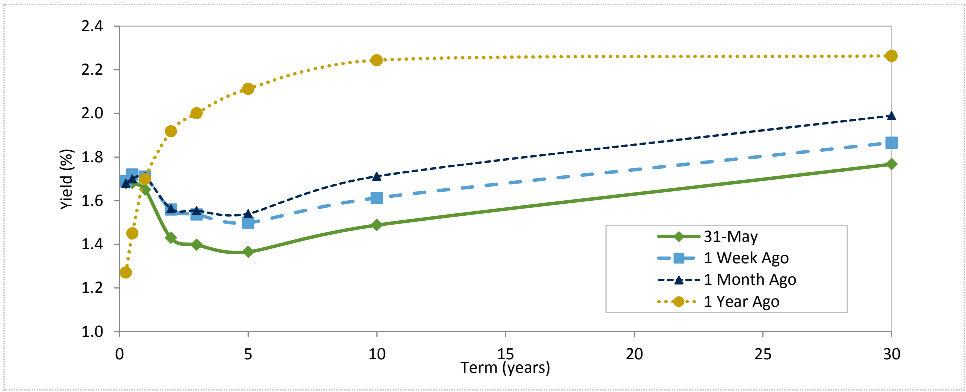
Cheers or Jeers for Cheap Rates

As the Canadian housing spring-selling season draws to a close, it's time to take the pulse of the housing market. One of our concerns this time last year was the impact rising interest rates would have on housing and consumption:

> *"… as central banks continue on their path of normalizing monetary policy, the advance in asset prices including housing will moderate, which is what we are seeing today… As the headwinds of tighter lending standards, modestly higher interest rates and elevated consumer debt levels counter the tailwind of strong employment and immigration trends, we see the housing market experience more modest growth. However, we fail to see a reason for a sharp correction assuming there is no outside exogenous shock to the Canadian economy."*

Our view remains unchanged; housing prices will moderate but one key headwind is alleviated temporarily. The interest rate outlook in Canada has dramatically shifted from a tightening bias to the expectation that the Bank of Canada's (BoC) next move maybe to cut interest rates. At a minimum, the BoC rate is on hold for the near future, which should allow millions of Canadian homeowners to continue to enjoy near rock bottom mortgage rates. The lowest national 5-year closed mortgage rate is now 2.67% for a default-insured mortgage, a level seen in 2017, according to ratespy.com. Even uninsured mortgages for applicants with a good credit history can be found for under 3%. Interestingly, due to long-term rates falling faster than short-term rates, many variable rate mortgages are offered above long-term fixed rates. This is an indication investors anticipate rates will stay the same or head lower in the coming months. Cheaper financing appears to help stabilize the housing market as national prices were up 3.8% in April and housing starts experienced a significant 23% jump following a rather poor start to the year.

Canadian Yield Curve



Source: Bloomberg, Raymond James Ltd. May 31, 2019

Please read domestic and foreign disclosure/risk information beginning on page 9.

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RAYMOND JAMES

However, regionally the picture is mixed, with prices falling outright in some cities. According to the Real Estate Board of Greater Vancouver (REBGV), the benchmark price of a detached home in April slipped 11% yoy and 0.8% from the month earlier. Condominium prices also fell, with the board reporting a 6.9% yoy decrease, unchanged from March 2019.

Outside of Vancouver, the housing market has shown greater resiliency supported by robust employment gains and now a slight improvement in wages as labour figures have continued to be a bright spot for the Canadian economy. A record 107,000 jobs were added in April contributing to the 222,000 additions to the labour force YTD. In fact, this year's gains have eclipsed all of 2018, in which the economy added 195,800 jobs. This is encouraging data; however, given the consumer's relatively stretched balance sheet, this strength is unlikely to translate into the same type of annual housing inflation we've experienced in the past, particularly in overextended markets like Vancouver and Toronto. However, the upside from the strong employment data is that there is underlying demand in the event of lower prices.

As this is a federal election year, politicians will be rolling out popular initiatives in a bid to buy votes, and housing is always a popular topic. Progressive Conservative leader Andrew Scheer has left the door open to alter the mortgage lending rules that were introduced last year, although he has not specified how the rules may change if his party is elected. An easing of the mortgage requirements could be significant for the housing market, although we would be concerned if housing were to become an even greater contributor to GDP as it currently sits near a record 7.5% of GDP compared to the long-term average of 5.8%.

While higher financing costs are one less near-term concern for the housing market, the reason why rates have begun to move lower has introduced a new worry. The weaker global growth outlook has been the primary reason rates have fallen around the world, including Canada. Much of the economic data released this year has painted a mixed outlook with some data pointing to a further slowdown, while other data suggests a firming in economic activity. The escalation in US/Chinese trade tensions has not helped the situation and reintroduces uncertainty at a time when the global economy is attempting to find a firmer footing.

Specifically related to US/Canadian trade relations, there has been progress towards ratification of the US-Mexico-Canada Agreement (USMCA) thanks to the lifting of Canadian and Mexican steel and aluminum tariffs. However, the largest hurdle remains. The White House will not submit the legislation for Congressional approval until the Democrats give it the green light. The Democrats have expressed concerns over the enforcement of the revised trade agreement and the Democrat-controlled House of Representatives could block the bill. Thus, USMCA remains in limbo for now, and Trump's most recent threat to impose a 5% tariff on all Mexican goods if Mexico does not step up its immigration enforcement actions increases the uncertainty surrounding USMCA ratification.

Tensions between Canada and China also remain as our country was caught in the crossfire over Huawei, the Chinese telecom giant that the US has banned for security reasons. In retaliation for the detention of Huawei Chief Financial Officer Meng Wanzhou for possible extradition to the US, China has taken aim at our agriculture exports, blocking certain Canadian canola. An expansion of this import ban would be significant to Canada as China is our second-largest export market for agricultural goods including: canola products, pulses, pork, beef, wheat and barley.

Given the mixed external backdrop, we believe the uncertainty both at home and abroad will keep the BoC on the sideline with a bias to cutting interest rates by year end. As we can see from the BoC's forecast, the central bank anticipates housing to be a net drag on the overall economy. This is indicative of moderation and/or softening in the housing market, but does not suggest a hard landing is in the cards assuming "*there is no outside exogenous shock to the Canadian economy*".

BoC Contributions to Average Annual Real GDP Growth

	Prior Est.	Cur. Est.	Chg
Consumption	1.0%	0.9%	-0.1%
Housing	-0.3%	-0.3%	0.0%
Government	0.2%	0.2%	0.0%
Business fixed investment	0.2%	-0.2%	-0.4%
Final domestic demand	***1.3%***	***0.6%***	***-0.7%***
Exports	1.0%	0.3%	-0.7%
Imports	-0.5%	0.1%	0.6%
Net exports	***0.5%***	***0.4%***	***-0.1%***
Inventories	***-0.1%***	***0.2%***	***0.3%***
GDP	**1.7%**	**1.2%**	**-0.5%**

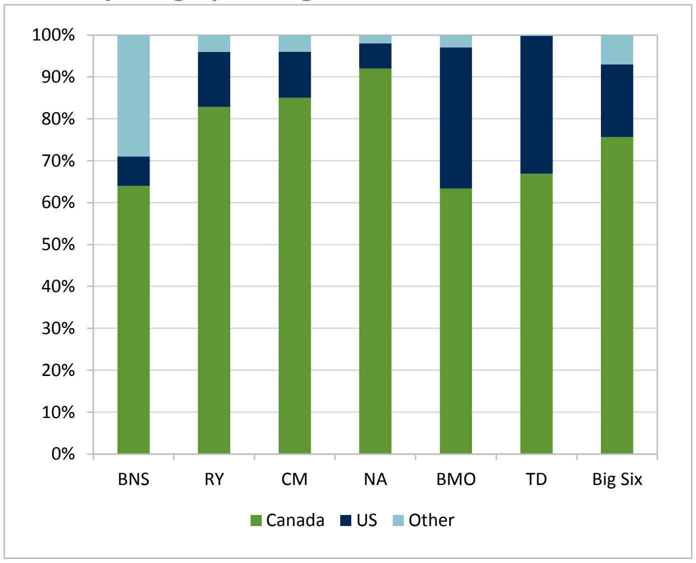
Source: Bank of Canada April MPR

Jason Castelli, CFA
VP, Head of Investment Strategy

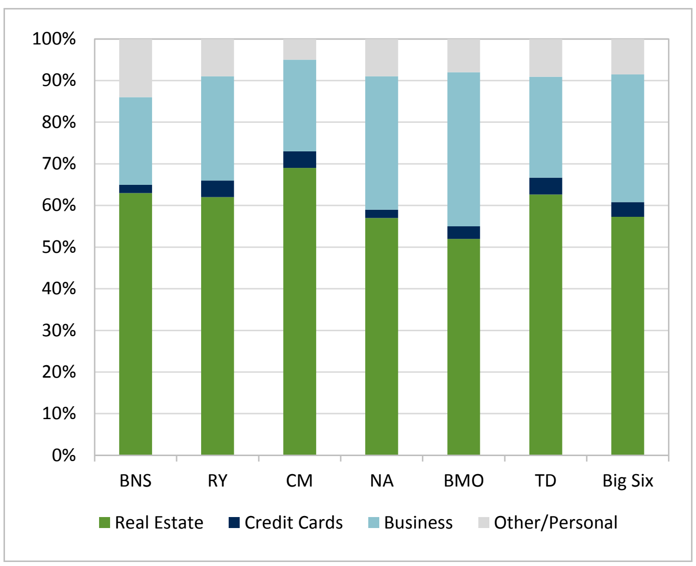
Big Six Exposures

Any conversations about housing must include the Big Six especially given their significant exposures to the Canadian real estate sector and large weighting in our index (over a fifth of the S&P/TSX Composite). Delving into Canadian bank loan exposures, we find that the majority continue to be dominated by domestic originations. A large portion of those loans are exposed to the real estate sector, something that investors have been taking note of especially given that domestic mortgage growth has been decelerating.

Loans By Geographic Region



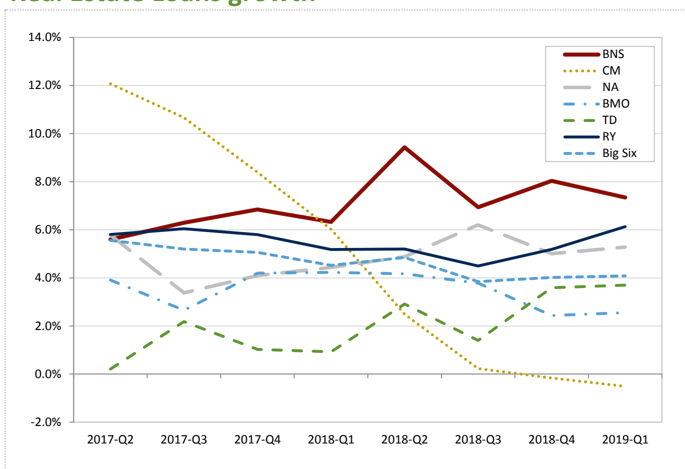
Canadian Loan Breakdown



Source: Company reports, Bloomberg, Raymond James Ltd.

As we have previously mentioned, while Big Six real estate exposure may be elevated, we believe the Canadian banks have a solid buffer against any potential credit losses especially when looking at their loan-to-value (LTV) ratios (total mortgage amount over the purchase price of the home). LTVs range from the low 50% level to the high 60s, meaning there is a healthy level of collateral backing the loans. Those with higher LTVs are CMHC-insured, meaning the federal government is protecting the banks against mortgage default risk. And while mortgage growth has been decelerating, the banks are trying to combat this with lower mortgage rates.

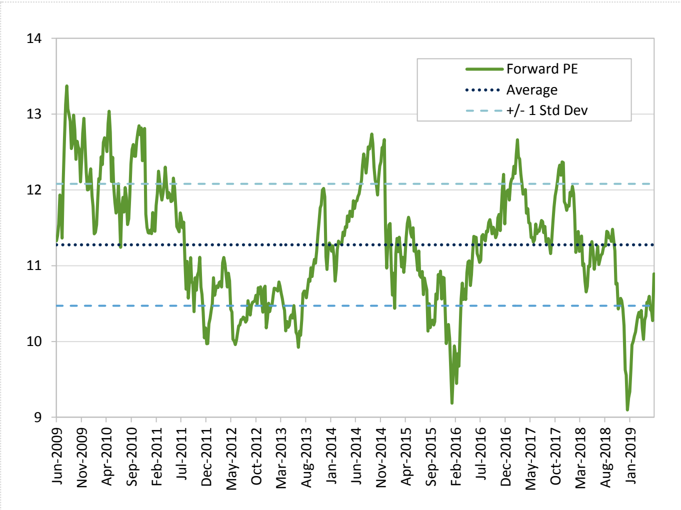
Real Estate Loans growth



Source: Company reports, Bloomberg, Raymond James Ltd.

One name investors should pay close attention to is CIBC. The bank not only has the second highest exposure to the domestic market, but is also the most exposed to Canadian real estate. CIBC has seen a deceleration in real estate lending relative to its peers partly due to its exposure to Toronto and Vancouver, the two largest markets that have recently seen a slowdown in activity. During its most recent quarterly results, the bank showed continued loan growth deceleration with real estate lending balances declining by ~60 bps from last quarter. However, with the bank trading at 8.2x forward PE, or a 22% discount to its long term average and at the lowest level since 2009, we believe these concerns are priced in. That said, so long as the Canadian lending business remains weak, we expect this valuation level to persist.

Big Six Average Forward P/E



Source: Company reports, FactSet, Raymond James Ltd.

In terms of valuation, the Canadian banks trade at the lower end of their 10-year forward PE multiple. In an environment where the Big Six continue to trade at a discount relative to their long-term average, we view current levels as an attractive entry point for investors with a long time horizon. Our top picks among the Big Six are Bank of Nova Scotia (BNS-T), Royal Bank of Canada (RY-T) and Toronto-Dominion Bank (TD-T).

Larbi Moumni, CFA
Senior Equity Specialist

Not All Bonds Are Created Equal

In the aftermath of the global financial crisis, a plethora of new rules and regulations were born designed to bolster the strength of the world's major financial firms, particularly banks. These new tools that government bodies armed themselves with were to prevent taxpayers from being called upon to save these institutions in the form of bail-outs. One such rule that is beginning to have an impact on the Canadian corporate bond space is the "bail-in" regime. Many other jurisdictions have incorporated the bail-in regime, or something similar, into their respective financial systems. In this article, we'll discuss the important nuances of the bail-in regime and how it will impact investors in the Canadian corporate bond space. First, it is important to acknowledge that this new bail-in regime applies only to the big six Canadian banks as the Government of Canada has deemed them systemically important.

Bail-in Debt 101

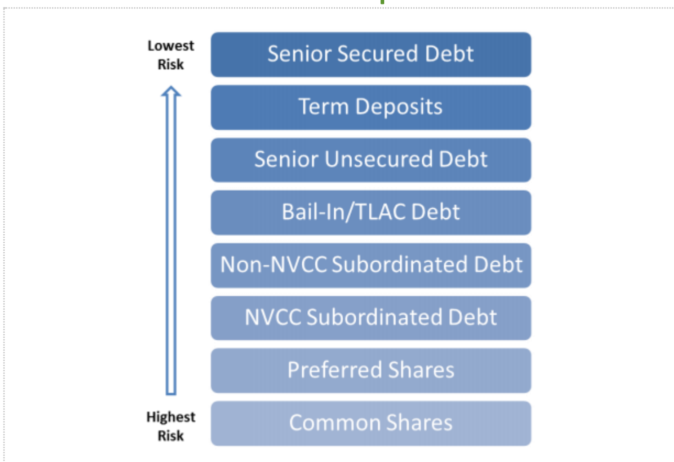
The banking system is a vital part of any economy but in Canada the importance is magnified when we consider how concentrated it is (only six major banks). During the financial crisis, many banks, mostly in the US and Europe, received bail-out packages that effectively injected taxpayer-funded capital into them. With the new bail-in regime, instead of taxpayers being forced to come to the rescue the onus will fall to the bank's creditors and shareholders to recapitalize the banks. To be precise, the bail-in regime allows the Canadian Deposit Insurance Company (CDIC) to convert the failing bank's bail-in debt into common shares, which would serve to restore the bank's viability. It is important to note that the bail-in regime only applies to new senior unsecured debt that has an original term to maturity of more than 400 days.

In the event that a bank is deemed to be failing, CDIC has the flexibility to determine how much of the company's bail-in debt should be converted, when the conversion should happen, and whether this will happen in one shot or over time. Furthermore, if CDIC were to force part of a bank's bail-in debt to be converted rather than all of it, it would apply on a pro-rata basis to all of the company's debt that is designated as bail-in.

- **Where does bail-in debt fit in a bank's capital structure?**

When thinking about rights upon liquidation, holders of bail-in bonds rank on par with holders of similar non bail-in bonds. However, we believe that there is heightened risk in holding a bond with the bail-in feature versus an identical one without the bail-in feature. However, these liquidation rights should be considered with a grain of salt. In our view, if a bank was close to liquidation, the bail-in feature would have already been triggered, which would mean that all or some of your bail-in debt would be converted to common shares. These issues do have a large buffer before CDIC would consider triggering the bail-in conversion. The below chart shows bail-in debt is still fairly senior on capital structure ranking. The bail-in feature is captured in the debt rating of bail-in issues, which may be rated by DBRS, Standard and Poor's (S&P), Moody's and Fitch. The ratings on these issues will be one notch lower than a comparable issue that does not have the bail-in feature.

Risk Scale of Canadian Bank Capital Structure



Source: Raymond James Ltd.

- **How is bail-in debt being priced?**

The introduction of bail-in debt is especially important in the Canadian bond market given that the big six Canadian banks represent nearly one-third of the market cap of the Bloomberg Barclays Canada Aggregate Bond Index. Royal Bank of Canada (RY-T) was the first bank to issue bail-in debt shortly after the bail-in regime came into place in September 2018. According to Bloomberg, since that first bail-in issue, we have seen six bail-in issues greater than $100mln in size hit the Canadian bond market. On average, these new bail-in bonds are currently trading at a spread of 0bps to 25bps over legacy non bail-in bonds. While there is a discount attached to the new bail-in debt, the slim spreads it trades at prove that the market is not apprehensive over this new feature.

When the times are relatively good, bail-in bonds will be valued in the same manner as non bail-in bonds. To compensate for the differences in structure, most bond traders would simply add a few basis points over non bail-in debt to provide an estimate of fair value. Convertible debt is fairly easy to value given that the conversion of the convertible debt to common shares typically comes at a fixed multiplier. Meanwhile, when the bail-in conversion is triggered, it is at the sole discretion of CDIC. This makes the picture murky when trying to analyze what your bail-in debt could morph into, (i.e., number of common shares), should the issuer be failing. That said, when it appears that CDIC may trigger the bail-in feature, the valuation would likely be closer to $0 (the theoretical price of the common shares in this event).

- **Bail-in debt = the new norm**

While any investor should abide by the saying 'never say never', we ultimately believe that a scenario whereby CDIC would trigger the bail-in feature is highly unlikely in the foreseeable future. As we mentioned earlier, if the bail-in feature had been around during the global financial crisis, the CDIC would not have triggered it upon any of the six banks to which it applies. The Canadian banks are well capitalized compared to their global peers, and additional capital requirement regulations instituted since the financial crisis has only served to bolster them. Nonetheless, when purchasing any Canadian bank bond, it is important to be aware of these features. The last of the non bail-in debt matures in early 2028, so after this date all senior unsecured bank debt is considered bail-in. With nearly $72bln in fixed rate Canadian denominated debt issued by the banks expected to mature in the next three years, look for bail-in to be a term heard more often as new capital is raised.

Chris Antony, CFA
Foreign Exchange & Fixed Income

Tax Advantaged & Liquid Real Estate, Too Good to be True?

A diverse portfolio wouldn't be complete without considering real estate. Many Canadian investors may already have a significant allocation to real estate in their family home, condo, or vacation property, but housing is tricky because it's a dual consumption good. That means, you are getting the financial benefit of owning the asset, but you are also deriving significant personal utility from that same asset. With that in mind, would you be willing to sell your family home when it's the right time in the market cycle to realize your gains and put that money to work elsewhere? For most, it's fair to say, the answer would be no. Similarly, for those planning to fund a part of their retirement with the proceeds of selling their existing house, they need to be comfortable with selling that home when the time comes. This illustrates the illiquid nature of real estate and the premium that comes with it.

Real property is a great asset class because, in a Canadian context, it typically has a lower correlation to equities, is relatively stable in value, and has exhibited consistent growth over the past several decades. However, it does come with its own challenges which include the difficulty to readily buy and sell (low liquidity), and high capital requirements. Luckily, both of these constraints can be overcome within the world of managed money and Real Estate Investment Trusts (REITs).

The first constraint of real estate investing is liquidity. Selling real property is time consuming and expensive. That is where we can take advantage of REITs. REITs are a special investment vehicle that own, operate, and develop income-producing real estate properties. REITs have many benefits that we will discuss in turn, including active property management, a diverse portfolio of assets and tax efficiencies. But, first and foremost, REITs get investors over the liquidity hurdle because they trade on the exchange allowing for a single trust unit to be bought.

The next major benefit of REITs is lower capital requirements. While an individual might have enough money for a down payment on a home somewhere in Canada, few will have enough capital to buy a diversified portfolio of manufacturing plants, hospitals, office or apartment buildings. REITs allow investors to buy an ownership stake in these organizations. Given the complex operational nature of these properties, REITs are professionally managed, which provides necessary active oversight of both the properties, and in turn, your investment. This management includes day-to-day building operations, leasing, capital repairs, etc.

The last major benefit we will discuss for REITs is their significant tax considerations. REITs provide a tax efficient ownership structure of real estate assets because as long as the majority of their income is distributed to unit holders, it is not taxed at the corporate level. This effectively removes the double taxation of dividend income present in most corporate structures.

So how do REITs fit into a well-diversified portfolio? Like many securities, you can buy a basket of them or purchase them individually to gain targeted exposure to a specific manager of capital. Regardless of which vehicle you use to purchase REITs (e.g., through a fund, ETF or individually), the diversification benefits are realized by owning even just one REIT. That's because REITs are composed of a diversified basket of underlying properties with targeted economic exposure. Within a portfolio context, most view REITs as either a bond proxy in more risky portfolios or as a complement to income producing equities given their reoccurring cash flows and stable underlying base of assets. For example, our guided equity portfolios own apartments, office and healthcare REITs. REITs provide an excellent source of stable income and can typically be less correlated to traditional equities. However, given that REITs trade on the exchange, they will have higher volatility than the underlying asset class typically exerts.

Managed money products can take this one step further, in that you can purchase a diversified basket of REITs with varying underlying exposures. Given that REITs can be thought of as a collection of assets, like a fund or ETF, it is not surprising that the majority of ETFs in the space are simply an index of all the different REIT types available. Index REIT products differentiate themselves on features such as equal weight vs cap weighting, and Canadian vs global exposure. There are also a number of actively managed products that are trying to provide added value by looking for underlying price dislocation and targeted exposure to the asset class. One of the key valuation metrics active managers look at when trading REITs is the net asset value per share (NAVPS). In broad terms, this is a measurement of the underlying asset values (the value of the real estate) on a per share basis. REITs can trade at a premium or discount to NAVPS and, given this possible dislocation, we prefer an active touch in this space.

The table below highlights the top funds and ETFs available in the Canadian market place. We have run them through our proprietary quantitative ranking system looking at 5 year return data, with greater emphasis on longer-term performance. Our quantitative analysis looks at risk metrics and downside protection and does not place any emphasis directly on returns. Results of this quantitative analysis tend to favour actively managed REITs Funds/ETFs which, in our opinion, makes sense. Managers have the ability to not only identify dislocations in the price of underlying assets versus the unit price the REITs are trading at, but also make more strategic decisions on which real estate segments are poised to outperform at given times in the market cycle.

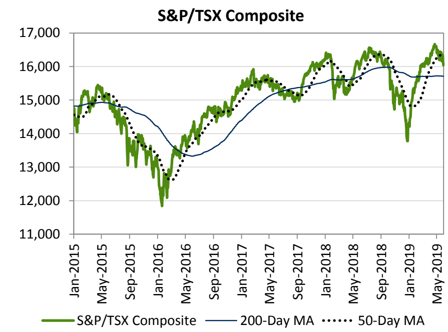
Fund Name	Rank	Total Return Annualized 1 yr	3 yr	5 yr	10 yr
CI First Asset Canadian REIT ETF	1	16%	12%	12%	16%
First Asset REIT Income Fund	2	14%	11%	12%	
Dynamic Global Real Estate Fund	3	16%	9%	12%	14%
United Real Estate Investment Pool	4	14%	10%	12%	14%
Real Estate Investment Corporate Class	5	14%	9%	12%	14%
Fidelity Global Real Estate Fund	6	15%	10%	12%	15%
BMO Equal Weight REITs ETF	7	15%	12%	9%	
Middlefield Real Estate Class	8	11%	10%	10%	

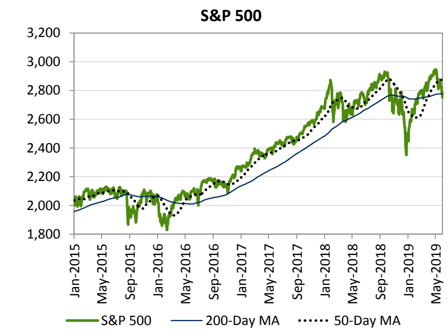
Source: Morningstar. As at April 30, 2019.

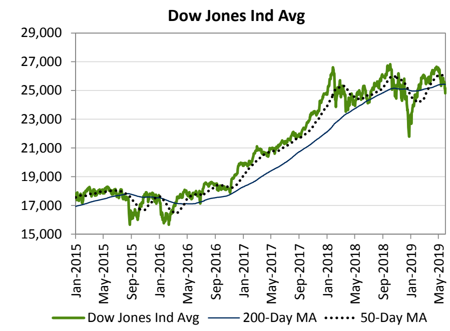
Spencer Barnes, MSc., CIM
AVP, Mutual Fund & ETFs

Charts of Interest

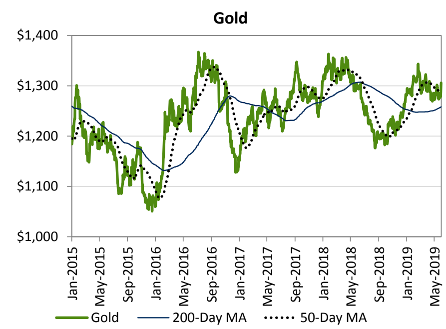
Markets

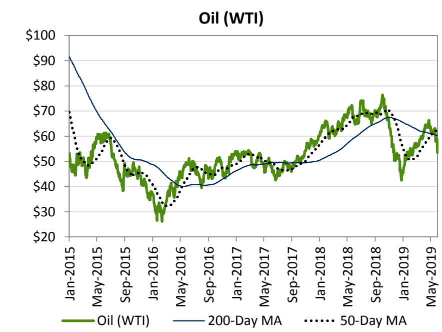


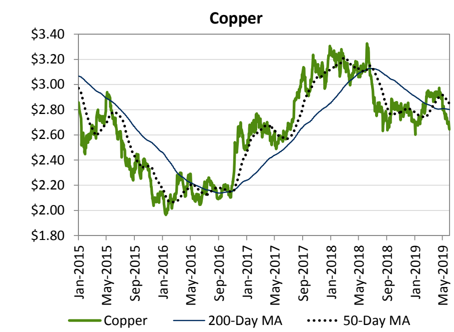




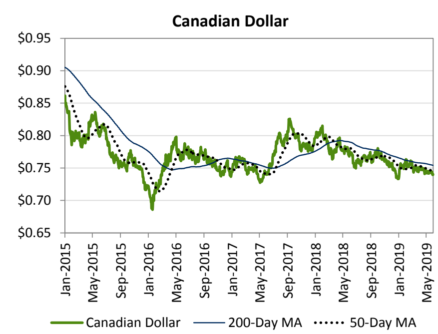
Commodities

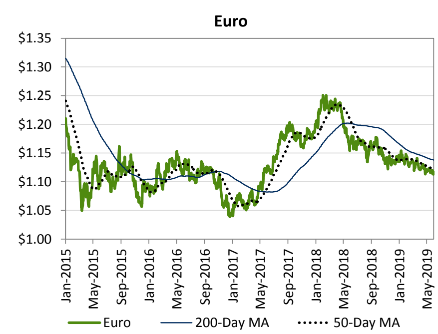


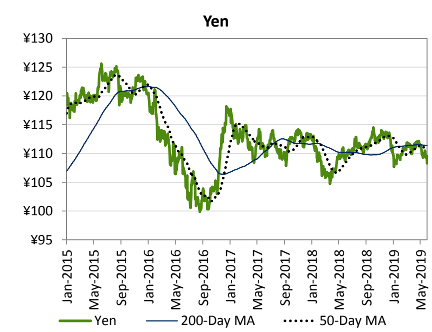




Currencies







Source: Bloomberg, Raymond James Ltd. Performance as at May 31, 2019.

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