Insights & Strategies

PRIVATE CLIENT SOLUTIONS

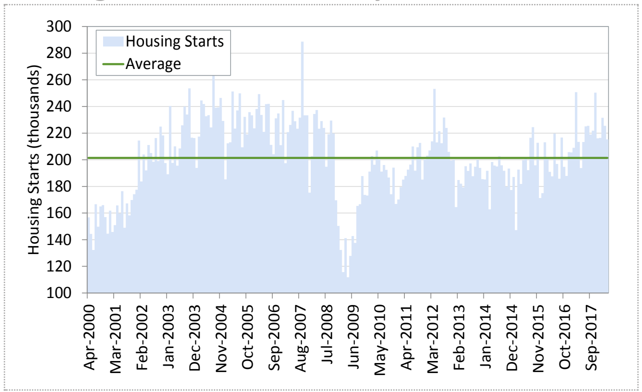
June 1, 2018

Inside this Issue

Canadian Housing

Canadian real estate has been a good asset class to own for well over a decade. The Canadian national average home price has advanced 65% over the last 10 years which is quite impressive when compared to the S&P/TSX's 27% gain over the same period. But recent measures to tighten lending standards and an uptick in interest rates have led to a slowdown in the housing market. Evidence of this slowdown affecting banks can be seen in mortgage originations stalling in the recent quarter. A more direct approach would be to look at housing starts. During the first quarter, starts were down 8.4% on an annualized basis compared to the prior quarter, and Q2 preliminary numbers point to a 16.8% drop. While starts have slowed, they are coming off of very elevated levels and the current level of household formation remains above historical levels. Given the slowdown, housing prices have also started to show some signs of fatigue. The national average home price has slipped ~11% from a year ago to $495,100, but again, the average price has retraced from elevated levels.

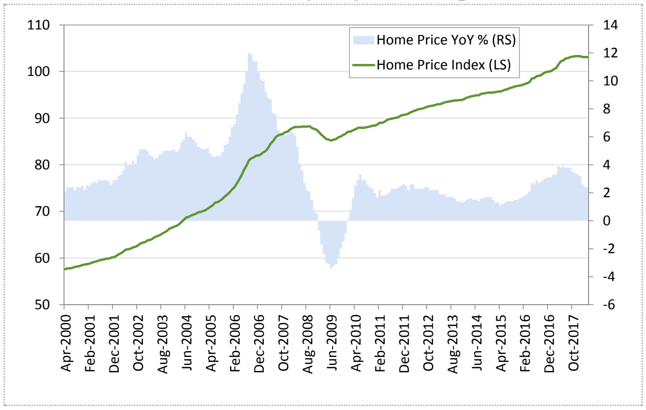
Housing Starts Remain Healthy



Source: Bloomberg, Raymond James Ltd.

As the housing market begins to slow, it raises the perennial question: Is the Canadian housing market about to bust? For it to bust, the market would need to be in a bubble but there is no clear-cut answer to that question as it depends on who you ask and what lens you look through.

MLS® Home Price Index (HPI) Leveling Off



Source: CREA, Raymond James Ltd.

Raymond James Ltd. 5300-40 King St W. | Toronto ON Canada M5H 3Y2.
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In Bubble Territory

Looking at common housing valuation metrics, such as housing prices-to-income would suggest our housing market is overvalued from a historical perspective. The median household income in Canada was around $70k in 2015, while the national house price average (as of April 2018) was $439,100. This leads to a price-to-income multiple around 7x versus the standard 3.0x multiple rule of thumb. However, if we exclude Ontario and BC (Toronto and Vancouver, in particular), the national average is also around 5.0x, which given the current level of interest rates is not an unreasonable multiple.

Price to Income By Province

Province	Average Home Price (April '18)	Median Household Income (2015)	Price-to-income
BC	$730,333	$69,995	10.4x
Alberta	$386,939	$93,835	4.1x
Saskatchewan	$288,017	$75,412	3.8x
Manitoba	$295,839	$68,147	4.3x
Ontario	$578,072	$74,287	7.8x
Quebec	$296,968	$59,822	5.0x
New Brunswick	$178,206	$59,347	3.0x
Nova Scotia	$248,672	$60,764	4.1x
PEI	$229,650	$61,163	3.8x
Nfld & Labrador	$245,697	$67,272	3.7x
Yukon	$380,551	$84,521	4.5x
Northwest Territories	$378,114	$117,688	3.2x

Source: Stats Canada, CREA

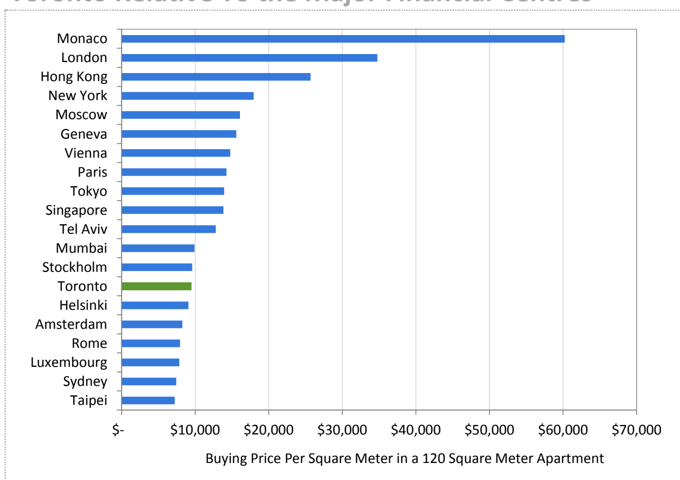
The idea that our housing market is overvalued shares many parallels to the argument market pundits make about the stock market. Based on a number of valuation metrics, it can be argued the market is overvalued. However, just because a market is overvalued doesn't mean a correction is lurking around the corner. All markets, at some point in time, can be either overvalued or undervalued. This qualification can persist for days, months or even years. For example, the S&P/TSX traded below its historical long-term average between 2011 and 2013, while for most of 2014 to 2017, it traded above the average.

The Counter Argument

Part of the reason valuation metrics appear stretched is because the average Canadian has not achieved income growth over the past decade. Average hourly earnings have grown at an annual pace of 2.2%, barely above the rate of inflation. However, recent data has been encouraging. Average wages have advanced at an annual pace of 3.6% thanks to the Canadian economy creating more full-time employment which tends to be higher paying compare to part-time employment. Over the past 12 months, total employment creation has been a healthy average of 23,000 per month with over half that tally coming from the private sector. Employment is an obvious fundamental driver for house purchases.

Another significant driver has been immigration. Immigration accounts for a large portion of population growth in Canada, roughly two-thirds. Half of these newcomers settle in either Ontario (ON) or BC, so it is understandable why the GTA and GVA housing markets have experienced a more rapid price advance relative to the rest of the country. While Canada's immigration policies are helping to offset some of our own demographic headwinds, they are also fueling housing demand, particularly in ON and BC. From a foreigner's perspective, Canadian housing does not appear stretched at all. For example, to compare relative value, we can look at apartment prices per square metre amongst major financial centres to more accurately pin point how Toronto compares to its larger city peers. It seems that we are far from being the most expensive: Monaco, London, Hong Kong, New York and Moscow occupy the top positions, and when you factor in our weaker currency and stable political backdrop, Canada looks like good relative value.

Toronto Relative To the Major Financial Centres



Source: Bloomberg, Raymond James Ltd.

Cheap Money

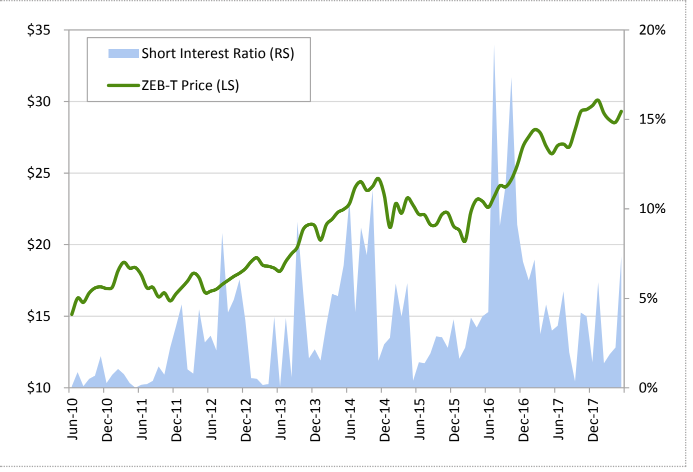
While the factors discussed above contribute to housing demand, by far the largest factor driving housing in Canada, and around the world, has been the downward trend in interest rates. In fact, we'd go so far as to say ultra-low interest rates have supported most major asset classes around the world. When money is cheap, asset prices rise. It's a simple equation that central banks have used time and time again. But 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. There are clearly pockets of the market that remain "overvalued" for the vast majority of Canadians, yet appear "undervalued" to foreign investors. These hot markets skew the national average. As the headwinds of tighter lending standards, moderately 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.

Jason Castelli, CFA
VP, Portfolio Manager

Canadian Banks: Exercising Caution

Since the 2008 recession, betting against the Canadian banks has been a losing wager. Over the past decade, we have seen a number of waves of bearish sentiment where investors (especially foreign ones) have advocated selling or shorting Canadian bank stocks as a proxy for a flagging Canadian economy and/or an overvalued housing market. Using the BMO Equal Weight Banks ETF (ZEB-T) as a proxy for the Canadian banks, we can see that short interest (investors betting against the banks) has spiked on four occasions over the 2010's and each time, the banks' share prices have continued to grind upward.

Canadian Banks (ZEB-T) Performance vs. Short Interest



Source: Bloomberg, Raymond James Ltd.

Short interest in the "Big 6" banks (Royal, TD, Nova Scotia, Montreal, CIBC and National) has been rising once again in 2018 and many investors are wondering whether this time the bears will win. We will show that the outlook for the banks is more than just about housing and make some suggestions on how to invest in Canadian banks.

Looking Beyond Housing to Positive Fundamentals

In the previous section we set the backdrop that housing could be a drag on bank earnings going forward, as sales and mortgage originations are down and are starting to lap very strong quarters from 2017. However, the Canadian banks are much more than just mortgage lenders. Moreover, the negative impact of rising rates hurts certain parts of the banks' business but aids in others. Looking beyond housing, when we analyze banks from a bottom-up basis, there are a number of key industry fundamentals that we focus on to define revenue growth and profitability going forward: net interest margin (NIM), credit quality, capital markets activity, FX and non-interest expenses (NIX). Looking at these components, the Canadian banks present a relatively healthy picture. NIM is a key profitability measure, which expresses the spread between the interest a bank pays on deposits and what it receives from loans. NIM tends to widen when rates are rising and therefore, a key metric that has been in decline since 2010 should turn into a tailwind in 2018/19.

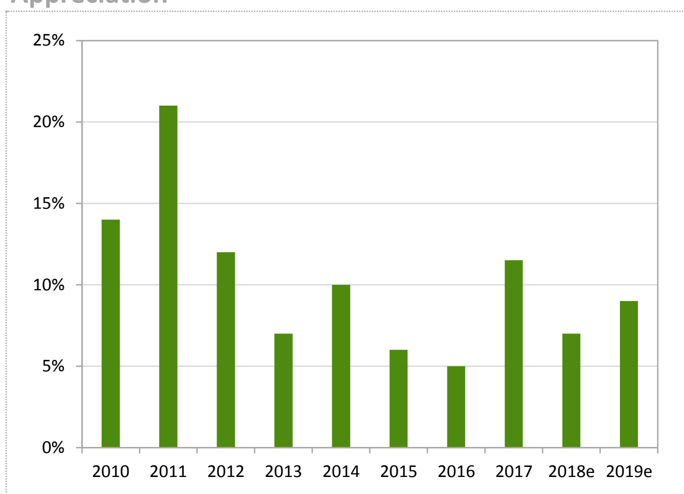
Credit quality is another attribute and highly dependent on the overall health of the economy. Canadian GDP growth is slowing but is still forecast to remain in positive territory for 2018/19 and should support the health of outstanding loans. Capital markets revenues have been net positive contributors but volatile ones. This is likely to continue. FX has been a tailwind of late and we expect those banks with higher US exposure, in particular, will likely see better results for the rest of the year as the greenback continues to show strength against the Loonie. Finally, NIX continues to be held in check as most banks show strong discipline on costs as well as benefiting from earlier restructurings and downsizings that occurred during the 2015-2016 period. In sum, many of the key non-housing metrics that we are watching remain positive for the banks.

Obviously much of the above could be undone by a crash in the housing market but we feel a controlled and moderate slowing of the Vancouver and Toronto housing markets is more likely and outside those hot-spots, the average Canadian housing market is much more fairly valued. That said, we are keeping a keen eye on inflation. Core inflation in Canada and the US remains benign; however, it could pose a risk in the future as higher than expected inflation could cause the BoC to act more aggressively on rates to the detriment of housing.

Earnings Comps Getting Tougher

So if there is no need to panic and dump all of our bank holdings, what is the appropriate exposure? A worst case scenario is not our base case but there are also challenges for the banks going forward. The group has already reported two quarters of its 2018 fiscal year that ends in October and so far the results have been quite positive. However, investors and share prices are forward looking and despite strong Q2 reporting with multiple earnings beats, we have seen share prices weaken on concerns over the rest of the year and into fiscal 2019. The outlook is for continued growth in revenue and earnings but at lower rates than we have seen over the past two years. Comparable year-over-year earnings will get more difficult in the latter half of 2018 as the industry laps unsustainably strong Canadian housing and GDP growth rates from 2017. This tells us that our expectations for price appreciation should be tempered going forward and those investors with overweight positions should consider adjusting their exposure.

"Big 6" Core Earnings Growth % Share Price Appreciation



Source: Bloomberg, Raymond James Ltd.

"Big 6" Net Interest Margin (NIM) Forecast

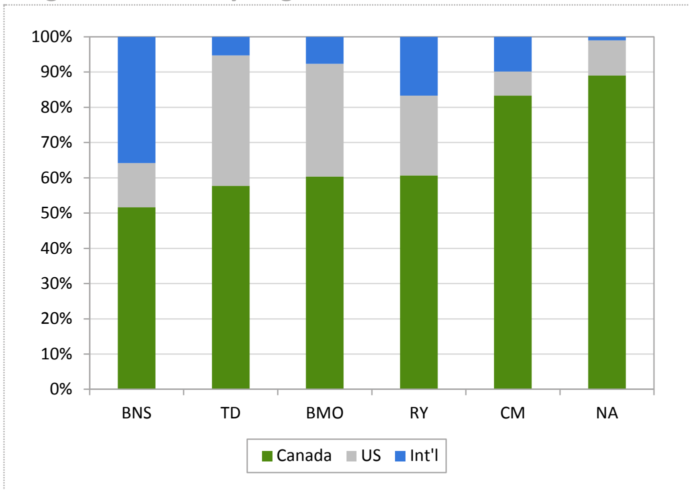
Bank	Symbol	2010	2011	2012	2013	2014	2015	2016	2017	2018e	2019e
Bank of Nova Scotia	BNS	1.9%	1.8%	1.8%	1.8%	1.7%	1.7%	1.8%	1.8%	-	-
Bank of Montreal	BMO	2.1%	2.1%	2.1%	2.0%	1.8%	1.7%	1.8%	1.7%	-	-
CIBC	CM	2.1%	2.3%	2.2%	2.2%	2.2%	2.1%	2.1%	2.0%	-	-
National Bank of Canada	NA	1.6%	1.7%	1.6%	1.5%	1.5%	1.5%	1.6%	1.6%	-	-
Toronto Dominion Bank	TD	2.4%	2.4%	2.3%	2.2%	2.2%	2.1%	2.0%	1.9%	-	-
Royal Bank	RY	2.3%	2.1%	2.0%	1.9%	1.9%	1.8%	1.9%	1.8%	-	-
Average		***2.1%***	***2.1%***	***2.0%***	***1.9%***	***1.9%***	***1.8%***	***1.9%***	***1.8%***	***1.9%***	***2.1%***

Company reports, Bloomberg, Raymond James

Reducing Risk/Raising Returns through International Exposure

One way to mitigate exposure to Canadian housing and the economy but still participate in the long term growth and yield from the Canadian banking sector is to own banks with geographic diversification.

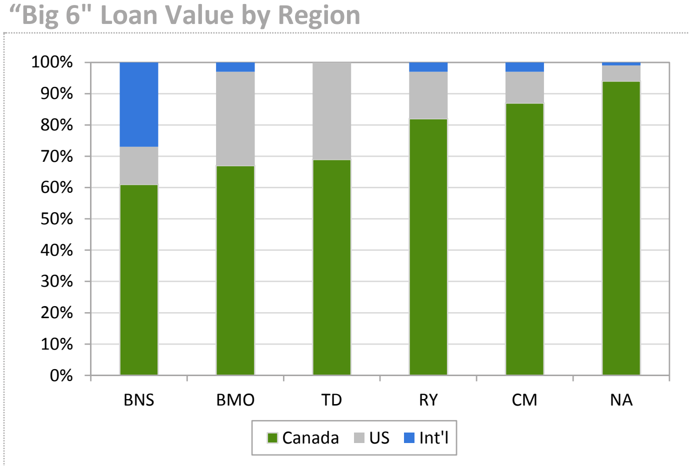
"Big 6" Revenue by Region



Source: Company reports, Bloomberg

All of the Big 6 derive 50% or more of their revenue domestically, but as the chart shows, owning TD and BMO can give an investor considerable exposure to the US economy and BNS's international diversification gives access to Central and South America. RY also offers solid US exposure with revenue in its international segment coming primarily from the Caribbean and Europe. At the far right of the scale, CM and NA have very high concentrations to the Canadian market.

"Big 6" Loan Value by Region



Source: Company reports, Bloomberg

This chart looks at geographic exposure through the loan book. Here we see fairly similar rankings in terms of diversification, although it shows a higher percentage of overall exposure to the Canadian market. The main point we want to illustrate is that the banks are not all built the same and investors can differentiate their exposure to different markets by making targeted investments in certain names.

Exercising Caution

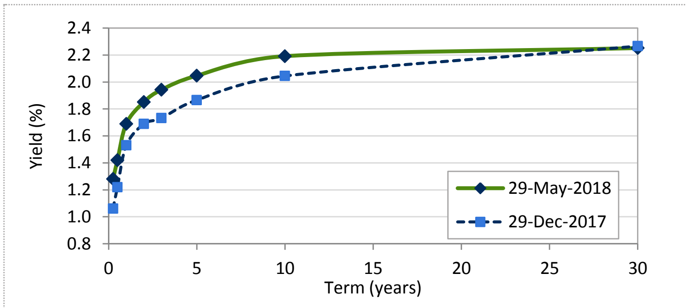
In the decade following the Great Recession of 2008, it has not been wise to bet against the Canadian banks. We have seen a number of waves of negative sentiment in the 2010's but the banks' share prices and dividends have persevered. However, at this time we do think there is reason for investors to exercise more caution than in prior years. The markets in Toronto and Vancouver are not emblematic of the overall Canadian housing market and the excesses can be managed with prudent policy from the BoC and government but risks to Canadian housing are certainly higher in 2018 than they have been in recent years. Prudent allocation to the sector and thoughtful stock selection within the group will help manage some of the risks of holding Canadian banks while maintaining exposure to one of the most consistent and best performing sectors in the S&P/TSX.

Robert Mark, CFA
Portfolio Manager

Wait and See

Canadian fixed income securities have fallen in price over the last few months. This has increased absolute yields to more attractive levels, especially in the shorter end of the curve. Case in point, a 2-year Government of Canada (GoC) bond is now yielding over 2.00%; whereas, on December 31, 2017, the yield was a mere 1.685%.

Canadian Yield Curve Has Flattened



Source: Bloomberg, Raymond James Ltd.

If you are looking to invest money in the fixed income market at this point, there are a couple of things to consider. Firstly, economists are still calling for a rate hike in Canada over the next six months. This means a more advisable strategy would be to invest in a shorter term fixed income investment until rates increase. Secondly, you still want to be fairly compensated if you are going to take this wait-and-see approach and stay invested in the short end; if rates further out seem to provide good value, then extending the term could be worth it.

After looking at the data, we have found that extending term by a year or so may not be worth it. This is because the yield curve is quite flat, with the movement over the past three months having proven to accentuate that shape. Considering that, you have a few options. An investor could stay in the short end of the curve and buy a 1 year locked in GIC, currently yielding around 2.35% annually, or buy a more liquid 1 year banker's acceptance which is yielding approximately 2.00%. These are good alternatives because with 2 year rates only yielding slightly higher, we don't necessarily see value in extending term at this time. To compare, the annual yield of a 2 year GIC is currently around 2.55%, and a 2 year investment grade corporate bond is yielding about 2.65%. You can see then that you aren't giving up that much in yield to wait and see if rates do head higher in the near future.

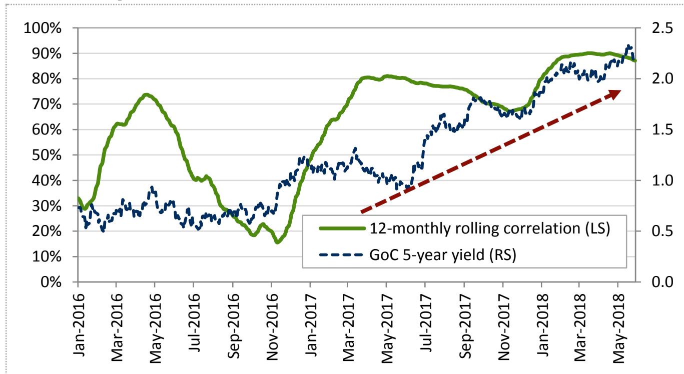
As always if you want to take all the guessing out of the equation, then buy a shorter term ladder, with the longest maturity under 5 years. That way, you are following a disciplined process, each year re-investing that year's maturity proceeds in the current 5 year bond and, if rates go up or down, you are investing in the current market at that time.

Harvey Libby
Fixed Income & Foreign Exchange

Fixed-Reset Preferred Shares

If you are looking for a fixed income product to take advantage of rising rates, fixed-reset preferred shares are a good investment choice. The fixed-reset dividend is benchmarked to the Government of Canada (GoC) 5-year yield. Every 5 years, the issuer has the option to either call in the fixed-reset pref or reset the dividend by calculating the new yield (reset spread + GoC 5-year yield). So as yields go higher, so does the dividend. For this reason, fixed-reset preferred shares can have a strong positive correlation to yields, especially in a rising rate environment.

Positively Correlated



Source: Bloomberg, Raymond James Ltd.

Below are several preferred shares that we expect will be reset to a higher dividend in the next 12 months. These preferreds will not only have their dividend go higher, but have a decent chance of capital appreciation if spreads continue to tighten, which is typical when rates rise.

Symbol	DBRS Rating	Issue Yield	Price	Reset Date	Reset Spread	New Yield *
BCE.PR.Q	Pfd-3	4.25%	$24.80	30-Sep-2018	2.64%	4.74%
ENB.PR.N	Pfd-3H	4.00%	$20.70	01-Dec-2018	2.65%	4.75%
MFC.PR.K	Pfd-2	3.80%	$22.52	19-Sep-2018	2.22%	4.32%
PWF.PR.T	Pfd-2H	4.20%	$24.47	31-Jan-2019	2.37%	4.47%
RY.PR.Z	Pfd-2	4.00%	$23.55	24-May-2019	2.21%	4.31%

Source: Bloomberg, Raymond James Ltd. As at May 29, 2018. * New yield using a GoC 5-year yield of 2.1%.

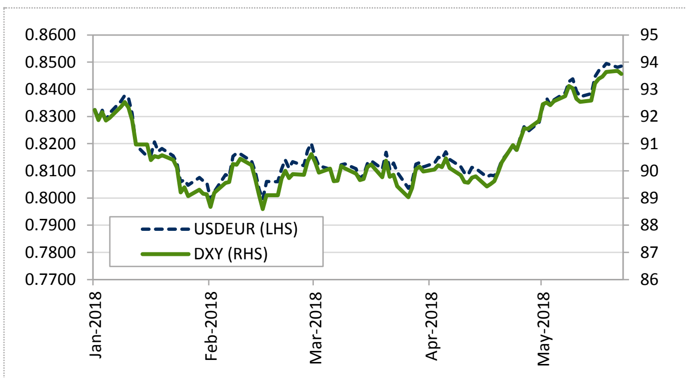
Phil Kwon
Fixed Income Specialist

Does the USD Rally Still Have Legs?

While we continue to see the USDCAD pair trading in a relatively narrow range in 2018, it is important to revisit a few topics which have developed since the turn of the year. For starters, the USD has enjoyed a nearly five-month rally on the back of political uncertainty emanating out of Italy, rising US yields and an aggressive Fed. In addition, oil has also been trading at fresh multi-year highs as renewed Iranian sanctions and a disputed presidential election in Venezuela add some concerns over reduced global oil supply. On the trade front, NAFTA negotiations continue to keep the market on the edge of its seat, highly sensitive to headlines as trade representatives try ironing out a deal preferably before the July 1st Mexican presidential elections.

The DXY, which is an index of the value of the USD relative to a basket of six foreign currencies, has increased over 5% since February of this year. Given that the EUR holds a 57.6% weight in the DXY, it is not surprising to note that the EUR's recent headwinds, due to concerns over the political uncertainties in Italy, have further influenced the DXY's strong performance.

USDEUR vs. DXY - YTD

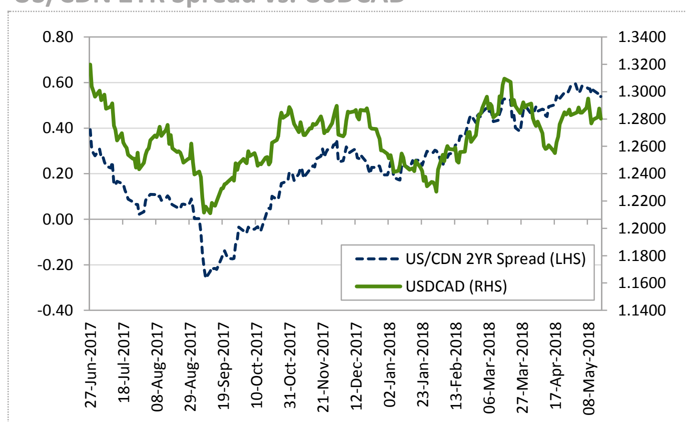


Source: Bloomberg, Raymond James Ltd.

Recently, Italy's two populist euroskeptic parties, the anti-establishment 5-Star Movement and far-right League, have proposed to elect Giuseppe Conte, a former law professor, as Prime Minister to lead their coalition government. However, both parties have advocated cutting taxes and increasing government spending and, given Italy's already high debt-to-GDP ratio, these changes will surely not be positive for the currency going forward. The other key risk event looming over the EUR is the timing of when the ECB plans to end its asset-purchasing program and lift interest rates. However, the recent string of disappointing economic data out of the Eurozone is surely keeping a lid on the EUR's performance. Nonetheless, the market continues to look for additional clarity on the ECB's monetary policy guidance going forward and whether Italy's two populist parties can sustain their political alliance after the country's president, Sergio Mattarella, gave his blessing for the creation of a new populist government in Rome to be led by Mr. Conte.

The US 10-year yield hit its highest level since 2011 when it reached 3.126% on May 17, largely driven by concerns over the growing supply of government debt, accelerating inflation as energy commodity prices climb higher, and a US Fed that appears intent on raising rates further. Interesting to note, if you consider the following graph of the US/CDN 2-year spread relative to the USDCAD pair, you can see that the interest rate differential makes the case for the pair to trade in the 1.30 level. Seeing that the pair was trading below the fair value implied by this differential for the past two months, we have finally seen another run at 1.30 just in the past week.

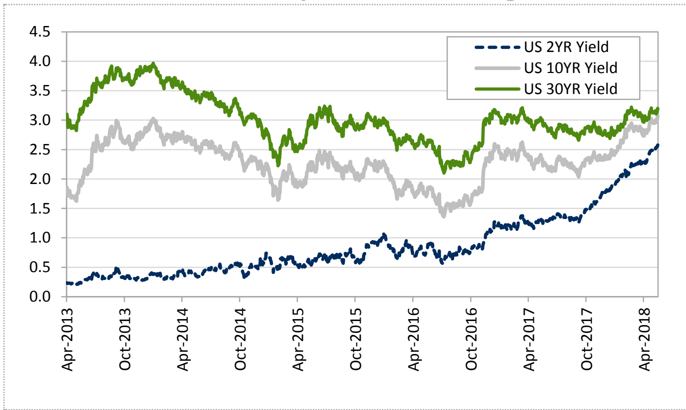
US/CDN 2YR Spread vs. USDCAD



Source: Bloomberg, Raymond James Ltd.

It also appears that the US yield curve is back in flattening mode after a slew of stronger-than-expected economic data supported the expectation that the Fed plans to keep tightening monetary policy. As a result, shorter-term interest rates have been pushed higher and some believe that the economy is gearing to let off the gas. With US GDP above 2% and inflation on the rise as the core PCE index climbed to 2.5%, a pace not seen since 2011, the market is pricing in more than two additional rate hikes by the end of this year. In regards to inflationary pressures, the key takeaway from the Fed's FOMC minutes from its May meeting show that a modest inflation overshoot above 2% "could be helpful" in anchoring long-term inflation expectations. In addition, most Fed officials see the next rate hike coming "soon," implying that a rate hike in June can be expected.

US 2/10/30YR Yields – Spreads Narrowing



Source: Bloomberg, Raymond James Ltd.

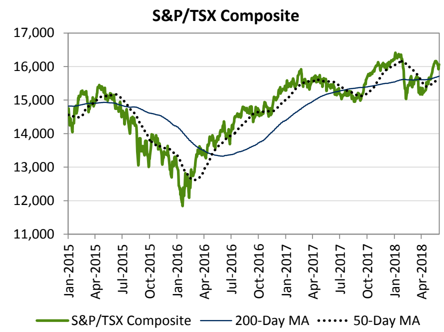
While NAFTA uncertainties continue to be a significant headwind for the domestic economy, the recent oil rally has lent some support to the Loonie. Some analysts believe that higher oil prices would fuel both export growth and a potentially more hawkish BoC amid quickening inflation. Despite the obvious domestic benefits from the pick-up in oil prices, we believe it won't be enough to offset the BoC's concerns; namely, ongoing NAFTA negotiations and the historically large levels of household debt.

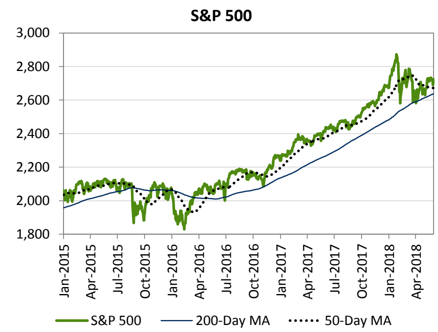
What does all this mean for USDCAD? The immediate political catalysts at play are ongoing NAFTA and US-China trade negotiations. On the NAFTA front, while it appears that all three parties remain far apart on a deal being made, some form of an agreement is expected to be reached sooner than later. The Trump administration gave both Canada and Mexico another 30-day exemption on steel and aluminum tariffs up to June 1st; however, Canada has requested a permanent exemption from these tariffs. It appears the US will be using these tariffs as a bargaining chip and potentially forcing Canada to give up more concessions in a NAFTA deal. With the Fed well-positioned to lift rates in June while the BoC takes a more cautious approach, we believe the USDCAD pair will make another run at 1.30, ultimately ending H1 near the high-end of our expected range of 1.27-1.30. Looking at the back-end of the year, we continue to believe that the market will look for opportunities to fade long USD positions once the 1.30 handle is hit. And with the BoC expected to lift rates at least once more, coupled with a potential NAFTA deal being reached, we remain firm in our H2 call for the pair to end the year back in the 1.24-1.27 range.

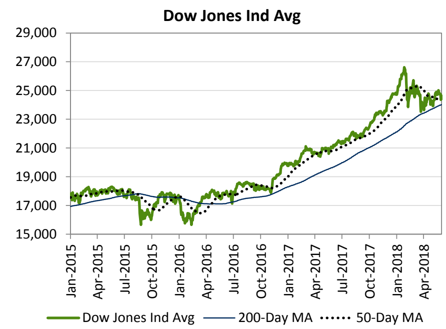
Ajay Virk & Chris Antony, CFA
Foreign Exchange

Charts of Interest

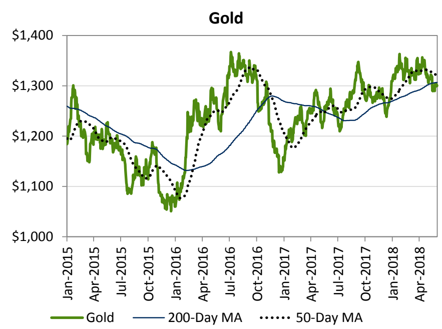
Markets

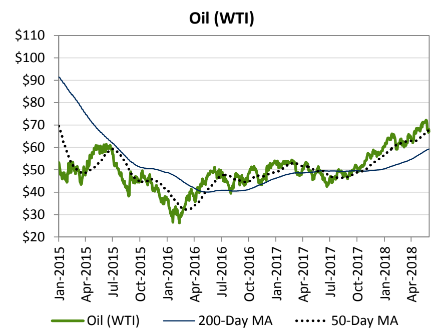


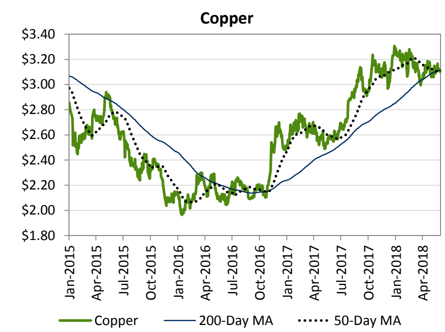




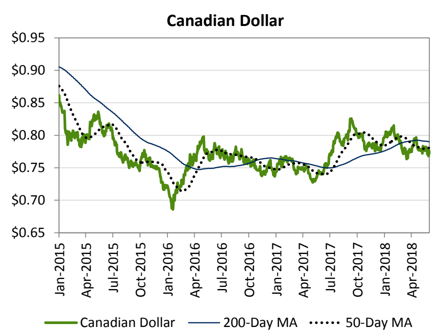
Commodities

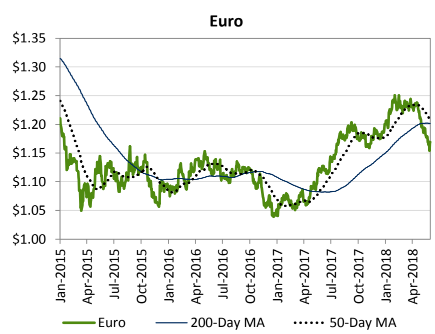


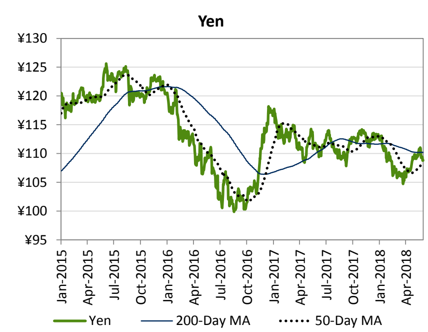




Currencies



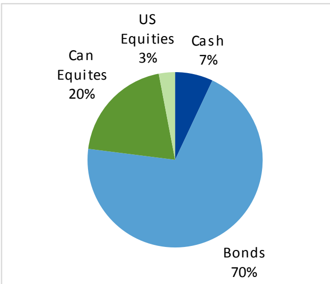


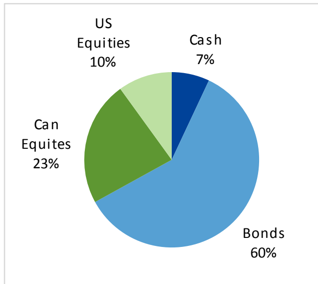


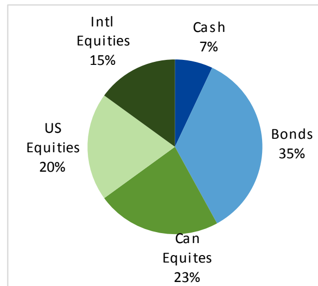
Source: Bloomberg, Raymond James Ltd. Performance as at May 31, 2018.

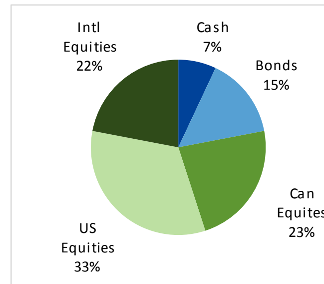
Investor Profiles and Asset Class Weightings

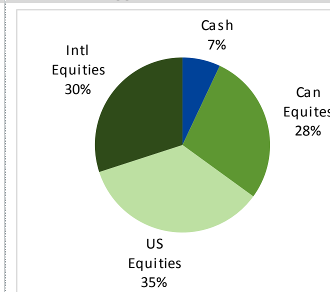
Recommended Asset Allocation











	Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
Cash	7%	7%	7%	7%	7%
Bonds	70%	60%	35%	15%	0%
Can Equities	20%	23%	23%	23%	28%
US Equities	3%	10%	20%	33%	35%
Intl Equities	0%	0%	15%	22%	30%
Tactical Asset Mix (Bonds include cash)					
Bonds | Equities	77 | 23	67 | 33	42 | 58	22 | 78	7 | 93
Strategic Asset Mix (Bonds include cash)					
Bonds | Equities	80 | 20	70 | 30	50 | 50	30 | 70	10 | 90
Asset Ranges					
Cash	0-20	0-20	0-20	0-20	0-20
Bonds	60-100	50-90	20-70	10-50	0-30
Equities	0-30	10-50	30-75	50-90	70-100

Description

Capital Preservation	Conservative	Moderate	Growth	Aggressive Growth
May be appropriate for investors with long-term income distribution needs who are sensitive to short-term losses. The equity portion of this portfolio generates capital appreciation, which is appropriate for investors who are sensitive to the effects of market fluctuation but need to sustain purchasing power. This portfolio, which invests primarily in fixed-income securities, seeks to keep investors ahead of the effects of inflation with an eye toward maintaining principal stability.	May be appropriate for investors with intermediate-term time horizons who are sensitive to short-term losses yet want to participate in the long-term growth of financial markets. The portfolio, which fixed-income securities tend to make up the largest proportion of holdings, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. The portfolio has characteristics that may deliver returns lower than that of the broader market with lower levels of risk and volatility.	May be appropriate for investors seeking a balance between capital preservation and capital growth. This portfolio, which is a split between fixed-income securities and equities, seeks to keep investors well ahead of the effects of inflation with an eye toward maintaining principal stability. With roughly half of the portfolio invested in a diversified mix of Canadian and international equities, investors should be comfortable with moderate fluctuations in the portfolios.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which has a higher weighting in equities, seeks to keep investors well ahead of the effects of inflation with principal stability as a secondary consideration.	May be appropriate for investors with long-term time horizons who are not sensitive to short-term losses and want to participate in the long-term growth of the financial markets. This portfolio, which is primarily invested in equities, seeks to keep investors well ahead of the effects of inflation with little regard for maintaining principal stability. The portfolio may deliver returns comparable to those of the broader equity market with similar levels of risk and volatility.

Important Investor Disclosures

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