TD Wealth

Private Investment Advice

The Charter Group Monthly Letter

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Economic & Market Update

The Massive Vancouver Real Estate Bubble[1]

In 1981 I sent a letter to Vancouver-based Daon Development Corporation requesting a copy of their annual report. At the time Daon was the second-largest real estate development company in North America and was the toast of the town. As such, I certainly wasn't the only one asking for the company's annual report that year.

Vancouver's real estate market has experienced bubbles in the past. That is a lesson for current property holders as well as investors in general.

I remember when the report arrived in the mail. Thumbing through its glossy pages with photos of glass towers and well-dressed executives, it was hard not to be captivated.

[1] Circa 1981.

A few months earlier, our next-door neighbours in West Vancouver sold their home for about $400,000, an eye-popping sum at the time.

A few months later, I accompanied some friends of our family who were looking to buy a condo in the newly-completed Whistler Village and wanted to test-drive it first by staying over for a night to see what it was like. The price of the condo was close to the price of that West Vancouver home.

Our friends didn't buy the condo because of a noisy elevator that kept waking us up during the night.

Good thing, because the price of the condo collapsed shortly thereafter.

So did the price on the West Vancouver house next door.

Neither property saw their 1981 prices again until 1989.

Daon didn't survive the decade.[2]

Bubbleology

The purpose of the story above is not to provide insight into the current state of the Vancouver housing market. Instead, it was told to shed some light on nature of asset price bubbles in general which have been a recurring feature since the dawn of free-market economies.

It is hard to identify bubbles while they are growing.

We only know in retrospect if it was a bubble or not.

From an investment market perspective, we are always concerned about the general valuation of securities relative to their long-term historical average. When valuations become extreme, concerns of a bubble begin to grow. But what is a bubble? How do we really know if we are in the midst of one? What is the potential fallout when a bubble bursts?

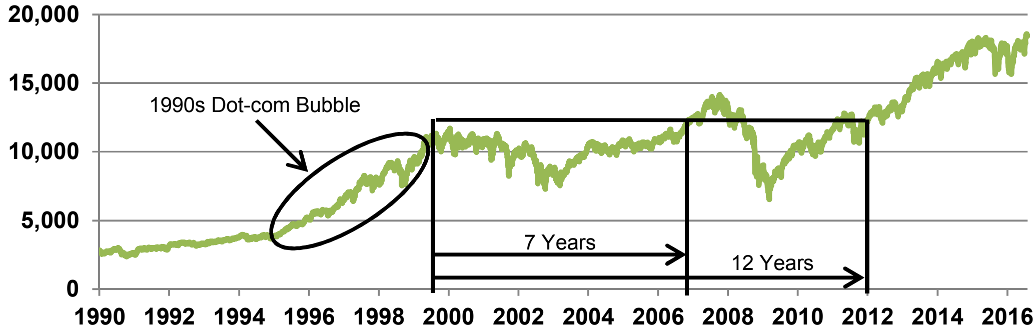
Unfortunately, bubbles are like earthquakes: we can monitor the building stress, but we can't forecast exactly when the fault will slip. Until the quake finally occurs, we don't

[2] It should be noted that Daon's demise was partly the result of being heavily exposed to real estate in Southern California in addition to its activities in the Canadian condo and office building market.

know if it will be the "big one" that relieves the built up stress. We can only determine in retrospect once the event has occurred.

Chart 1:

Dow Jones Industrial Average Index



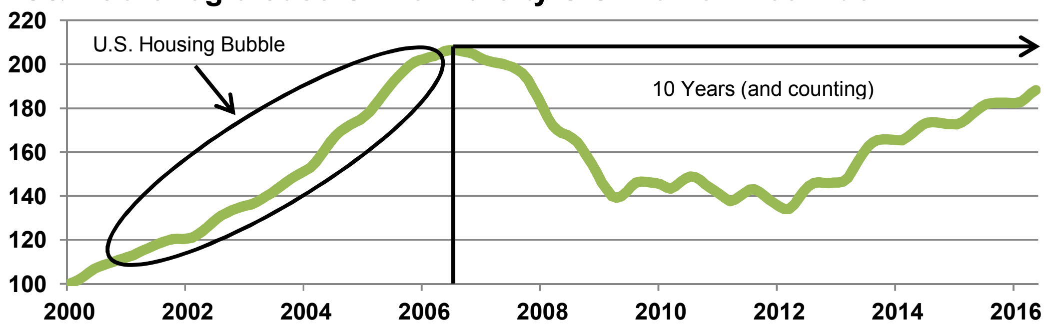
Source: Bloomberg Finance L.P. as of 8/1/2016

In the 35 years that I have studied investment market history and historic asset bubbles (including stocks, bonds, commodities, real estate, art, wine), there is one rule of thumb that has emerged: bubbles are followed by a period of at least seven years where the high-water mark of prices at the peak of the bubble are finally reached again (this would be the equivalent of the "big one" in financial markets as opposed to earthquakes). That's how long it took the Dow Jones Industrials Average to regain its March 2000 high (**Chart 1**) (plus it took another five years to pass that level permanently). In the case of U.S. housing we have just passed the 10-year mark and prices at the national level are still about 9% below where they were in mid-2006 (**Chart 2**).

Bubbles tend to be followed by a period of at least seven years until prices recover back to the previous peak level.

Chart 2:

S&P CoreLogic Case-Shiller 20-City U.S. Home Price Index

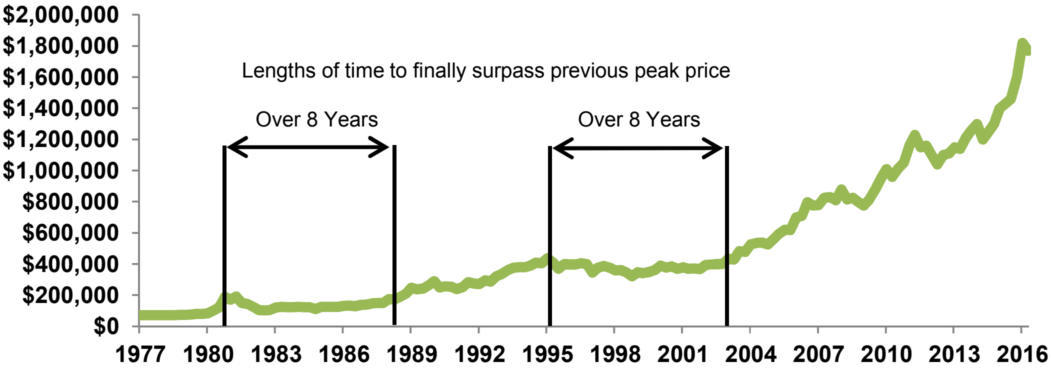


Source: Bloomberg Finance L.P. as of 8/1/2016

In the case of Vancouver real estate, the market that I described at the beginning of this letter involved a span of over eight years until the 1981 bubble prices were achieved again (**Chart 3**). Vancouver experienced another bubble which peaked in 1995 and which also saw a span of over eight years until prices fully recovered (the run-up in prices was less dramatic, so this particular bubble is not referenced as much as the 1981 bubble, despite a similar period of recovery).

Chart 3:

Greater Vancouver Single Detatched Housing - Average Sale Price



Source: Real Estate Board of Greater Vancouver as of 8/1/2016

When an investor, in real estate, financial investments or other types of assets, is forced to assess the probability of a price bubble, the main concern is the ability to weather the period of time required to see a full recovery in prices. If the investor decides to hold on, there is the burden of "opportunity cost." Until there is a recovery, that money can't be used for other investment opportunities in the meantime.

"Opportunity cost" is one painful outcome after a bubble pops if one is reluctant to liquidate.

Another burden is the "cost of carry." In the case of stocks and bonds, there is a cost of safekeeping, but this is done electronically nowadays, so the cost is minimal. However, in real estate, "cost of carry" becomes a major issue when prices level off or decrease. These costs include landscaping, repair, insurance, and property taxes. When house prices rise, the property owner justifies the "cost of carry" as the cost of holding onto an appreciating asset. When prices are flat or declining for a sustained period, the "cost of carry" becomes noticeably more painful.

"Cost of carry" which is accepted while prices are rising can be emotionally difficult after years of flat or declining asset prices.

So, is Vancouver in a real estate bubble? Are stocks and bonds in bubble territory? We should know in about seven years from now. Who will be the most impacted? That will depend upon one's debt burden, access to cash, and ability to manage risks by keeping options open.

Model Portfolio Update[3]

The Charter Group Balanced Portfolio
(A Pension-Style Portfolio)

	Target Allocation %	Change
Equities:		
Canadian Equities	15	unch
U.S. Equities	34	unch
International Equities	11	unch
Fixed Income:		
Bonds	28	unch
Alternative Investments:		
Gold	7.5	unch
Commodities & Agriculture	2.5	unch
Cash	2	unch

No changes were made to The Charter Group Balanced Portfolio's target asset allocation or the specific investment holdings during July.

Most major markets have surpassed pre-Brexit levels.

The Balanced Portfolio is still on a conservative footing. However, it was helped by the fact that almost all asset categories did well once the anxieties surrounding the Brexit vote faded. Brexit is still a serious issue for the U.K. economically and for the value of the pound sterling, but the consensus is that the overall impact on global economic growth will be very minimal.

U.S. markets powered higher mostly on the promise of further monetary easing in order to combat any of the uncertainties cause by Brexit, emerging market economic growth, or the U.S. presidential election this fall. With an overweight position in U.S. stocks, the Balanced Portfolio took advantage of the rebound.

[3] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 6/1/2016. The asset allocations of individual clients invested in this Portfolio will differ because of the relative performance of the asset classes since the last rebalancing and because of differences in the timing of deposits and withdrawals. The Balanced Model Portfolio is part of a sequence of seven portfolios ranging from conservative to aggressive: Very Conservative, Conservative, Balanced Income, Balanced, Balanced Growth, Growth, and Aggressive Growth.

There were also positive contributions from international stocks, and gold. In addition, the weakness in the Canadian dollar over the month accentuated these positives.

Finally, there were also solid gains in Canadian stocks during July.

Looking forward, the next couple of months are historically the most volatile seasonal stretch for stocks. Although October gets the reputation as being the month when biggest market collapses have occurred, August and September are worse on average. We have had a better than average summer rally this year, pushing U.S. stocks back up to record levels. As a result, the flow of news regarding economic numbers and corporate earnings will be critical over this stretch. Perhaps the Balanced Portfolio's current conservative bias will be put to the test if we do see volatility.

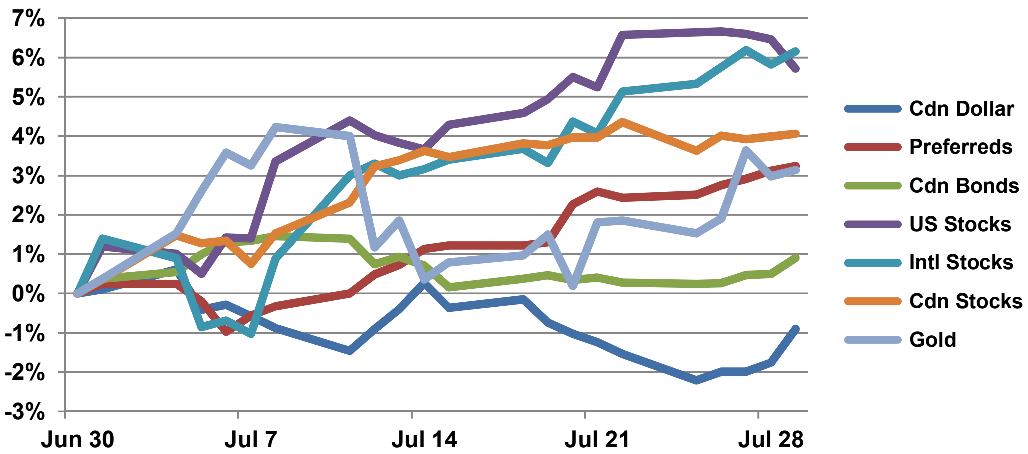
The months of August and September are historically the most difficult for stocks.

This is one reason why the Balanced Portfolio continues to have a conservative stance.

Below is the July 2016 performance of the asset classes that have the most significant impact on our model portfolios, including the Balanced Portfolio (**Chart 4**).[4]

Chart 4:

July 2016 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 6/1/2016

[4] Source: Bloomberg Finance L.P. – The Canadian dollar rate is the CAD/USD cross rate which is the amount of Canadian dollars per one U.S. dollar; Preferred shares are represented by the iShares S&P/TSX Canadian Preferred Share Index (CPD); Canadian bonds are represented by the iShares DEX Universe (Canada) Bond Index (XBB); U.S. stocks are represented by the iShares S&P 500 Index (IVV); International stocks are represented by the iShares MSCI EAFE Index (EFA); Canadian stocks are represented by the iShares S&P/TSX Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[5]

Issue	Importance	Potential Impact
1. China's Economic Growth	Significant	Negative
2. Short-term U.S. Interest Rates	Significant	Positive
3. Canada's Economic Growth (Oil)	Moderate	Negative
4. Canadian Dollar Decline	Moderate	Positive
5. Long-term U.S. Interest Rates	Moderate	Negative
6. Japan's Money Printing	Moderate	Positive
7. Europe's Money Printing	Medium	Positive
8. Negative Rates – Europe & Japan	Medium	Negative
9. Massive Stimulus in China	Light	Positive
10. Middle East Geopolitics	Light	Negative

[5] This is a list of the issues that we currently deem to be the ten most important with respect to the potential impact on our model portfolios over the next 12 months. This is only a ranking of importance and potential impact and *not* an explicit forecast. The list is to illustrate where our attention is focused at the present time. If you would like an in-depth discussion as to the potential magnitude and direction of the issues potentially affecting the model portfolios, we encourage you to email mark.jasayko@td.com and set up a time to talk face-to-face or by phone.

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The Charter Group at TD Wealth is a wealth management team that specializes in discretionary investment management. For an annual fee, we manage model portfolios for private clients and institutions. All investment and asset allocation decisions for our model portfolios are made in our Langley, BC office. We do not outsource any of the decision-making for our model portfolios – there are no outside actively-managed products or funds. We strive to bring the best practices and the calibre of investment management normally seen in global financial centres directly to the Fraser Valley and are accountable for the results.

Accountability is further enhanced by the fact that we commit our own investable wealth to the same model portfolios in which our clients are invested.

The information contained herein is current as of August 1, 2016.

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