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Private Investment Advice

The Charter Group Monthly Letter

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Economic & Market Update

Canada's Increasing Reliance on Real Estate as a Growth Engine

Soothing government rhetoric is doing its job. Canadians and British Columbians are fairly confident about the economy in general judging by the level of recent consumer spending. Promises of infrastructure spending, megaprojects on the horizon, and federal government chatter about exporting technology as well as the expertise of "architects and accountants"[1] has got us in a pretty good mood. All of this has contributed to elevated share prices, rising property prices, and a bounce-back in the Canadian dollar from lows in January.

Up until now, Canadians have been in a spending mood as governments are optimistic and as real estate continues to rise.

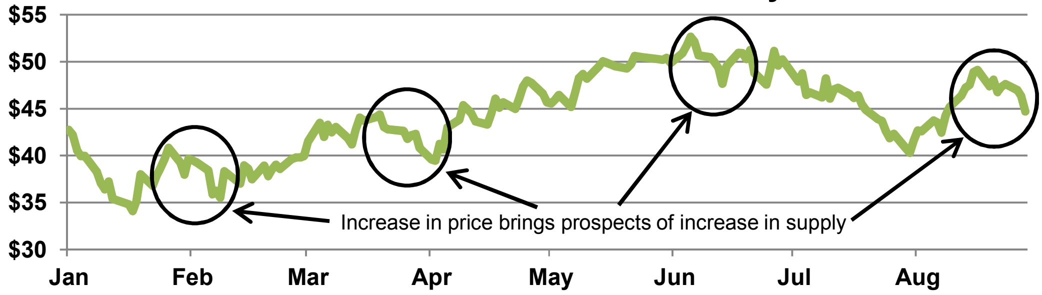
[1] T. Argitis and D. Bochove. "Trudeau's Cure for Canada's Slump? Architects and Accountants." Bloomberg News, August 22, 2016. http://www.bloomberg.com/news/features/2016-08-22/trudeau-s-cure-for-canada-s-slump-architects-and-accountants

It has also been helpful that negative economic headlines regarding Canada's export markets, notably China and the U.S., have abated somewhat since the beginning of the year (the problems have not gone away, but the focus of the news cycle has shifted towards the U.S. presidential election and lingering debate surrounding the Brexit).

The economic impact of declining energy and raw material prices has been offset by real estate.

Unfortunately, this glosses over the share of the Canadian economy that has disappeared due to low oil prices. Going forward, it increasingly looks as though oil prices will remain lower for longer than anyone had anticipated. For a while now, any increase in the price of oil is met with the possibility of increased supply from U.S. shale producers, OPEC producers, or Russia (**Chart 1**).

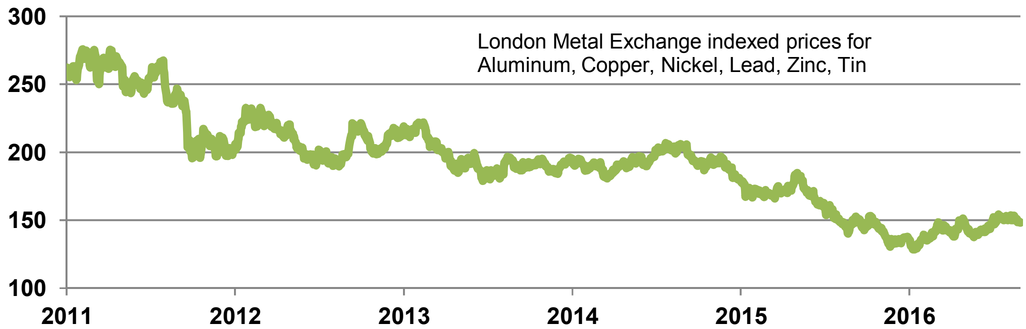
Chart 1:
Oil - West Texas Intermediate in USD since January 1



Source: Bloomberg Finance L.P. as of 9/1/2016

Canada has also suffered declining base metal prices, another important export. With inventories rising and demand falling because of slowing economies in China and other developing countries, base metal prices are about half of what they were five years ago (**Chart 2**).

Chart 2:
Bloomberg Base Metals Spot Price Index since January 1, 2011



Source: Bloomberg Finance L.P. as of 9/1/2016

In the meantime, the Bank of Canada had expected non-resource exports to ramp up because of the lower Canadian dollar. But this hasn't happened, leaving us with a shortfall in overall exports.

Despite all this, Canada has avoided a notable economic recession (although the first half of 2015 was technically a recession defined as two successive quarters of economic contraction, it was so slight that it was hardly felt by the consumer). The overwhelming reason for this: real estate.

The real estate industry, which is Canada's largest single economic sector accounting for over 13% of the economy, is about 75% larger than mining, oil, and gas all put together.[2] In addition, if housing prices are increasing and more housing is being built, the real estate sector contributes significantly to other industries such as retail, finance, and construction. When real estate's contribution to these other industries is added in, about 20% of Canada's economic output is attributable to housing, compared to about 17% a decade ago.[3]

Real estate is Canada's largest single economic sector.

Real estate and its related impact on other sectors accounts for 20% of Canada's economy and 17% of all government revenue.

Real estate sector plus all the other related businesses in other sectors now account for about 17%, or $120 billion per year, of all government tax revenues in Canada, including atthe federal, provincial, and municipal levels.[4] Clearly, the growth in housing has been crucial for government budgets.

If housing prices and construction continue their torrid pace into perpetuity, then we have nothing to worry about (**Chart 3**). However, if the real estate industry does begin to falter, there is no current credible Plan B for Canada to avoid an economic contraction at this stage regardless of the happy talk of promoting high tech, green tech and exporting Canadian know-how to the rest of the world.

If real estate prices and new home construction continue upwards forever, then there is no problem. But, if they merely flatten out, then the economy will have challenges.

Let's assume that housing prices and the pace of construction merely flatten out over the next year. Canada's annual economic growth is about 1.5% and about one-third of this growth is coming from real estate activities. Without housing sector growth, Canada would lose 0.5% of economic growth (**Chart 4**). Remember, this assumes things go flat.

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[2] Statistics Canada, Gross Domestic Product by Industry, June 2016. http://www.statcan.gc.ca/tables-tableaux/sum-som/l01/cst01/gdps04a-eng.htm

[3] E. Alini. "How the housing market is pumping up our GDP numbers." *Maclean's*, May 1, 2012.

[4] M. Onoszko and K. Dmitrieva. "Canada Most Reliant on Housing Just as It Orchestrates Slowdown." Bloomberg News: The Bloomberg Professional Service, September 1, 2016.

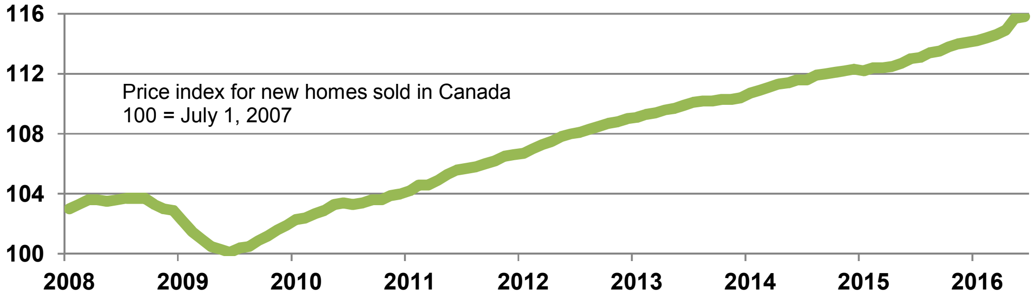
It does not begin to consider the impact if housing prices actually fall or if construction slows down.

Because of the growing dependency on an expanding housing market, the risks of contraction in the Canadian economy have increased. For Canadian investors, this raises concerns with respect to Canadian dollar exposure and being overly invested in Canadian stocks that have a high-correlation to economic growth.

If real estate does begin to flatten out, investors' concerns could focus on the Canadian dollar as well as economically-sensitive stocks.

Chart 3:

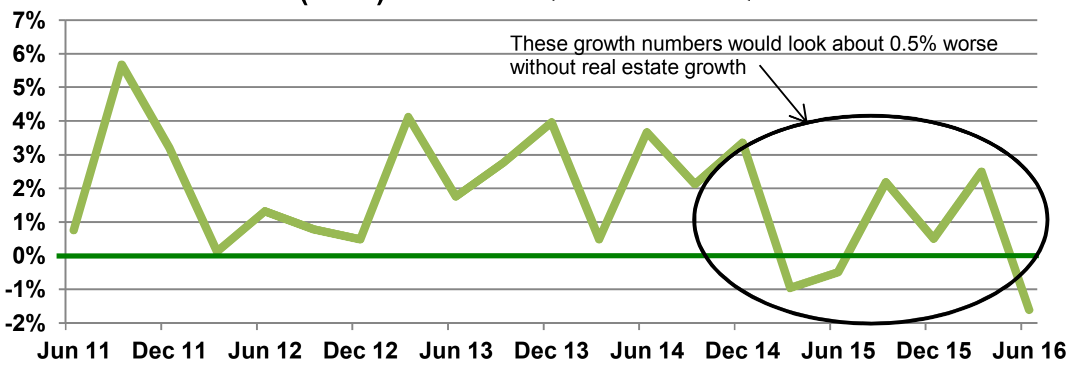
Statscan New Housing Price Index - Canada



Source: Bloomberg Finance L.P. as of 9/1/2016

Chart 4:

Canada Economic (GDP) Growth - Quarter over Quarter - Five Years



Source: Bloomberg Finance L.P. as of 9/1/2016

Until there is a further decline in the value of the Canadian dollar vs the U.S. dollar, The Charter Group prefers an underweight position in Canadian companies that have a large export component. Also, we would be less inclined to invest in Canadian companies that sell products that are considered discretionary (non-essential) as Canadian consumers looking to rein in spending until there is more certainty in the labour market and with respect to real estate prices. Darkening economic clouds are not very conducive to the prospect of Joe Average purchasing that 70 inch 4K Ultra HD flat screen.

Model Portfolio Update[5]

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 August.

No changes were made to the Balanced Portfolio during August.

As mentioned in previous issues, the Balanced Portfolio continues to have a conservative stance. Equity indices are percolating around record levels in the U.S. The S&P/TSX Composite Index (Canadian stocks) is still down 5.5% from its record peak in September 2014 but has had a pretty good run this year. Share prices have been driven by factors other than growth in earnings, so we want to be a little cautious here.

The remarkable feature of the markets in August was the surprising lack of volatility. Occasionally there will be a month with a particular index or commodity goes to sleep. However, this August, it was as though everything went into hibernation. Other than gold

The lack of volatility across a broad swath of various markets was surprising.

[5] 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.

bullion, which was down about 3% in Canadian dollar terms, all the other asset classes represented in the Balanced Portfolio moved less than 1% (**Chart 4**).[6]

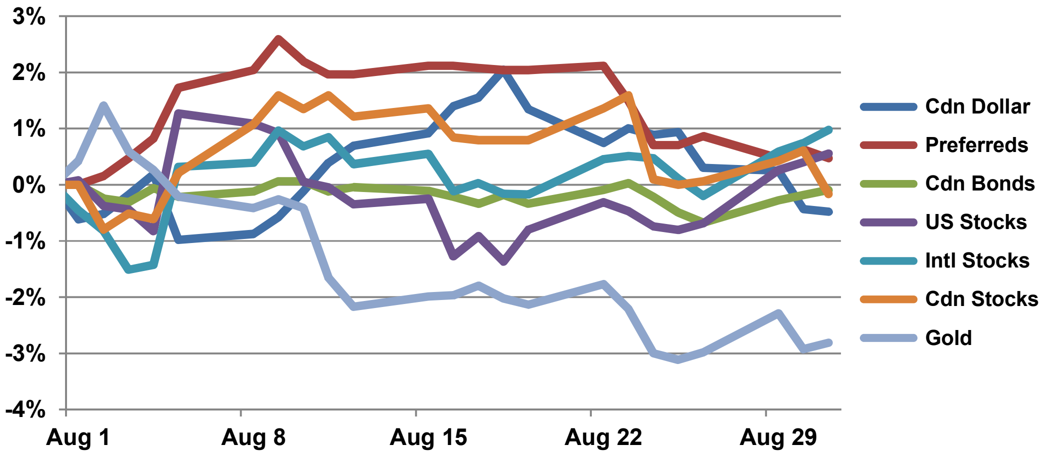
Historically, September has been the worst month for stocks, especially those in the U.S. (October is known for its dramatic selloffs, but it doesn't match September for consistency on the downward side). Seasonal tendencies are hardly a guarantee with respect to how markets will perform during the autumn this year, but there are a few hurdles that the market will have to navigate.

Perhaps August's lack of volatility is just the "calm before the storm" as investors will be faced with some tests in September and October.

The U.S. Federal Reserve (the "Fed") will decide on September 21 whether or not to increase its base lending rate. Labour market conditions suggest that it will stand pat, but there are some strategies suggesting that the Fed will surprise the market. In any case, there is no perceivable upside from this meeting (unless the Fed launches a European Central Bank-style easy-money diatribe contained in the post meeting notes).

The other source of uncertainty is the U.S. presidential election with two candidates that are able to "shock and awe" on a moment's notice. More on that subject in the next issue of the *Monthly Letter*.

Chart 5:
August 2016 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 9/1/2016

[6] 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[7]

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. Negative Rates - Europe & Japan	Medium	Negative
7. Japan's Money Printing	Moderate	Positive
8. Europe's Money Printing	Medium	Positive
9. Massive Stimulus in China	Light	Positive
10. Middle East Geopolitics	Light	Negative

[7] 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 September 1, 2016.

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