TD Wealth

Private Investment Advice

The Charter Group Monthly Letter

Mark Jasayko, MBA, CFA
Portfolio Manager & Investment Advisor
TD Wealth Private Investment Advice
The Charter Group, Langley, BC

Economic & Market Update

Canadian Real Estate: The Great Attractor of Capital

Just like gravity attracts mass, there are factors in the economy that attract investor capital.

Astrophysics tells us that there is a massive gravitational anomaly in our neighbourhood of the universe. About forty years ago, researchers were able to observe the relative movement of nearby galaxies and discovered that they were generally being pulled in the same direction. With that information, they calculated the relative position of the gravitational anomaly, estimated that it has a mass that is tens of thousands of times greater than the Milky Way, and named it "The Great Attractor."[1] However, this oddity is still mostly a mystery since we can't observe it directly. The problem is that the Milky

[1] https://en.wikipedia.org/wiki/Great_Attractor

Way galaxy completely obscures it.[2] Calculations place the Great Attractor directly opposite our relative position in our own galaxy and with current technology we can't see through the concentrated matter (stars, planets, gases, dust, etc.) found near the galactic core.

Similar to astrophysicists observing the movement of galaxies, economists and policymakers in Canada attempt to observe the movement of capital in the economy. And, like gravitational anomalies in the universe, there are a number of "attractors" of capital. These attractors might include industries with higher growth rates, securities with higher income yields, newly-introduced tax incentives, or seductive speculative opportunities.

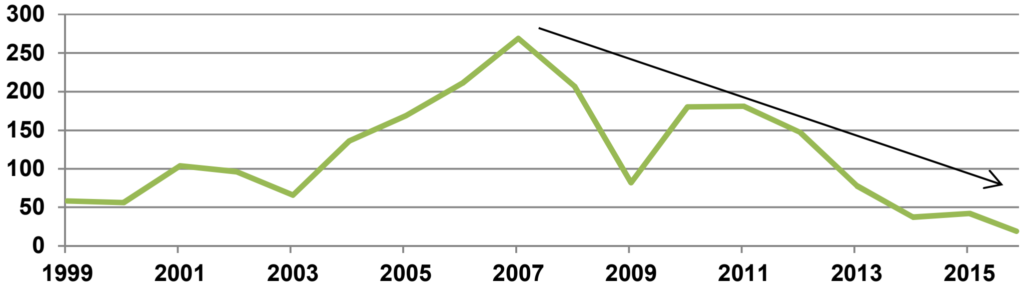
Attractors of capital include the prospect of higher growth rates, higher yields, tax incentives, and speculative opportunities.

Something that has perplexed those economists and policymakers has been the unexpected low levels of corporate capital formation (**Chart 1**) and capital spending (**Chart 2**). Capital formation involves raising money which companies then attempt to put to productive use. It may be in the form of debt from the issuance of bonds or from a bank loan. It can also be in the form of equity, including publicly-traded shares or a private equity deal.

Sometimes, a new area that attracts capital can catch economists off guard until capital flows are better understood.

So why has the formation and spending of capital slowed in Canada? One answer might be the contraction of Canada's energy sector with the decline in oil prices. As mentioned above, a growing industry can attract capital. However, the opposite can also be true. Because of the significant size of the energy sector, the investor outflow has impacted the overall national level of capital formation and spending.

Chart 1:
Capital Formation - Initial Public Offerings in Canada

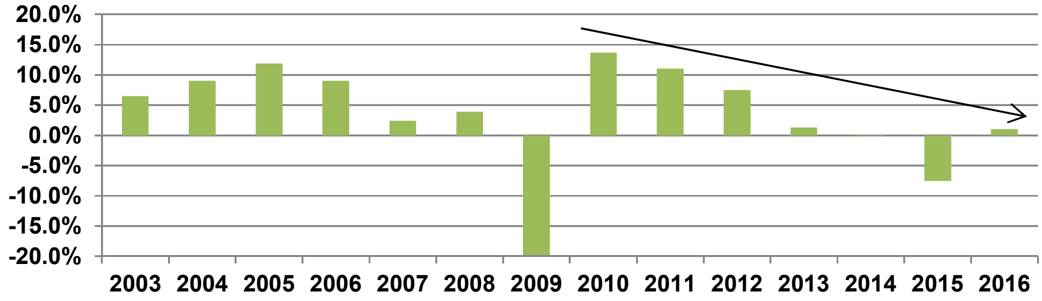


Source: Bloomberg Finance L.P. as of 5/5/2017

[2] About 20% of the observable universe is blocked by the matter we see when looking towards the centre of our own galaxy.

Chart 2:

Capital Spending - Non Residential Structures & Machinery (% YoY)



Source: Statistics Canada and The Conference Board of Canada

However, that doesn't fully explain the overall declines. Much like the Great Attractor beyond our galaxy, something not normally considered by analysts is pulling capital in a different direction.

The growth in the real estate sector has become so prominent that it is now attracting capital away from Canadian businesses.

Although there hasn't been much empirical research on the subject yet, it appears, anecdotally, that Canadian real estate is the culprit. As I have written previously in *The Charter Group Monthly Letter*, the growth in the real estate sector and related sub-sectors have more than offset the contraction in the energy sector.

Price gains are at the heart of that growth. As prices continued to increase, it required homebuyers to parlay more capital to buy property, often combining a bigger chunk of personal savings with a bigger mortgage. Even though this does not constitute "corporate" capital formation, it is capital formation nonetheless.

The problem for the Canadian economy is that capital that is invested in real estate is less productive than capital invested in businesses.

The problem for a developed economy like Canada's is that over the short- to medium-term, the amount of capital is relatively fixed (over the longer term, it can change dramatically due to real growth or central bank policies). As a result, Canadian companies are losing a capital tug-o-war as consumers choose to pump more capital into their homes instead.

The choice to direct more capital into housing has accelerated over the last couple of years. It has gotten to the point where prominent Canadian economists are now using the word "bubble" (even though it is difficult to get the Governor of the Bank of Canada or federal and provincial leaders to utter the "B word," their recent comments and policies imply that we might be in a bubble).

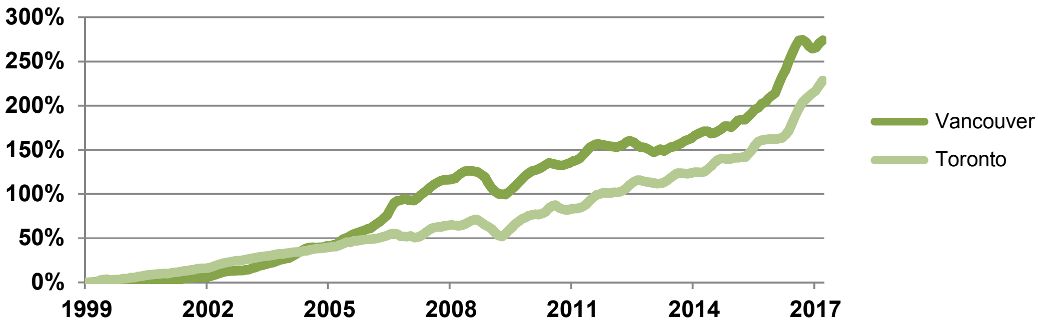
As mentioned above, one the attractors of capital is seductive speculative opportunities, and housing may be fitting that definition. Canadians may think that they are being true to their cautious sensibilities by investing more in assets that they can touch and feel. However, this tends to mask potentially unmanageable future risks involving the direction of housing prices, interest rates, and job stability if homes are purchased during periods of historically high prices.

The problem for the Canadian economy is that personal real estate is significantly less productive than other industries. The return on investment comes primarily from top-line price growth. Even though prices had risen about 250% times since 1999 (**Chart 3**), income that can be generated from rent has only risen 99%.[3] If a house is lived in by the owner and not rented out, then the return has to be measured by the "utility" the home provides. This includes things like enjoyment and proximity to work or social opportunities. How many homeowners are enjoying their homes twice as much as they were in 1999?

Industries with a large innovation component, in contrast to real estate, provide the fuel for long-term real economic growth as outside capital and internally-generated surplus capital is invested back into equipment, operations, and research. Basic common sense tells us that we can't take on the world if our economy is mostly about rising real estate prices.

Chart 3:

House Prices - Percentage Gain since 1999



Source: Bloomberg Finance L.P., Taranet, and National Bank of Canada as of 5/5/2017

If capital continues to accelerate towards real estate and away from more productive uses, political and corporate leaders will have some difficult and potentially unpopular decisions to make.

The onus will be on political leaders and policymakers to counter the previously unseen but growing attractor of Canadian capital that is the real estate industry. Perhaps more tax incentives aimed at innovation (usually a good idea) or more deregulation that would make it easier for the investment industry to raise capital (usually doesn't end well), or something else. Unfortunately there aren't easy solutions to this dilemma.

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[3] Source: Bloomberg Finance L.P. – Total Rental Income of Canadian Households

Model Portfolio Update[4]

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

	Target Allocation %	Change
Equities:		
Canadian Equities	15.0	None
U.S. Equities	35.7	None
International Equities	9.3	None
Fixed Income:		
Canadian Bonds	25.5	None
U.S. Bonds	2.5	None
Alternative Investments:		
Gold	7.5	None
Commodities & Agriculture	2.5	None
Cash	2	None

No changes were made to the individual investments or the overall asset allocation in The Charter Group Balanced Portfolio during April.

No changes were made to the Balance dPortfolio during April.

By far, the biggest contributor to performance was the decline in the Canadian dollar. Since the portfolio is historically overweight with respect to U.S. dollar-denominated investments, the returns on those investments are enhanced for Canadians as the U.S. dollar strengthens.

The decline in the Canadian dollar contributed to performance.

There were a couple of factors driving the Canadian dollar lower. One was oil which fell 3.4% during April. Rising energy prices once attracted foreign investors to Canada. As oil prices remain low, those foreign investors are cashing out and exchanging their Canadian dollars for other currencies as they depart. The most significant of these departures in April involved ConocoPhillips selling their stake in the oils sands to Cenovus Energy for almost $18 billion.

The Canadian dollar was hurt because of falling oil prices.

[4] The asset allocation represents the current *target* asset allocation of the Balanced Model Portfolio as of 5/5/2017. 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 five portfolios ranging from conservative to aggressive: Conservative, Balanced Income, Balanced, Balanced Growth, and Growth.

Another factor hurting the Canadian dollar was the chaos surrounding the alternative mortgage lenders, with specific focus on Home Capital Group. Naturally, there was a lot of press coverage in Canada. However, the international press coverage was also intense. Numerous financial journalists in the U.S. ruminated on a potential contagion effect spreading to other areas of real estate finance. This was likely a major reason as to why the stocks of the Canadian chartered banks sold off during April.

The Canadian dollar was also impacted by increased concern over the health of alternative mortgage lenders.

The other notable source of positive performance came from gold which climbed as tensions between North Korea and the U.S. ratcheted higher.

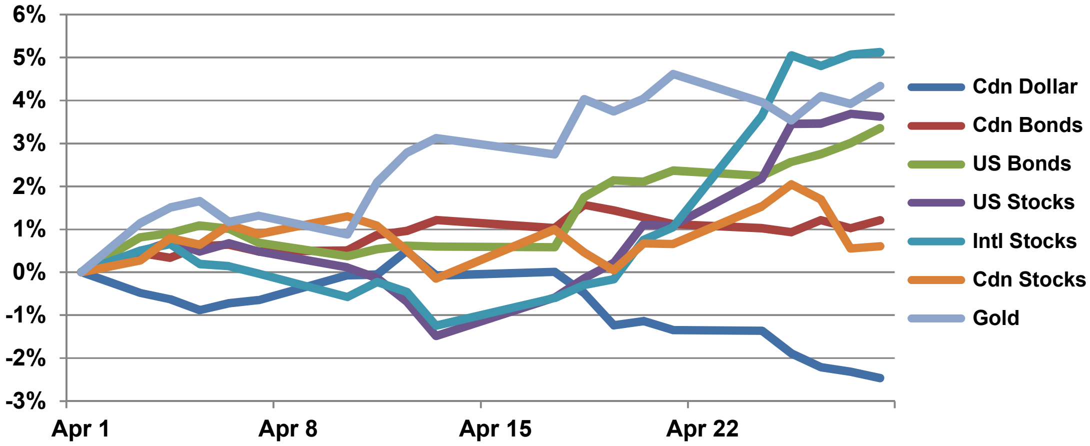
Going forward, we are entering a seasonally weaker time of year for North American stocks. Fortunately, over the near-term, there aren't many fundamental threats to the markets as investors appear to be content with current levels of economic growth and employment. However, this does necessarily diminish the potential that stocks could selloff due to investor psychology. Late spring/early summer can typically see increased volatility often followed by a summer rally.

Without many overly-concerning economic fundamentals, the market may only be subjected to psychologically-driven volatility.

Below is the April performance of the asset classes that we use in the construction of The Charter Group Balanced Portfolio (**Chart 4**).[5]

Chart 4:

April 2017 Performance of the Asset Classes (in Canadian dollars)



Source: Bloomberg Finance L.P. as of 5/3/2017

[5] 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; Canadian bonds are represented by the iShares Canadian Universe Bond Index (XBB); U.S. bonds are represented by the iShares Core U.S. Aggregate Bond Index (AGG); U.S. stocks are represented by the iShares Core 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 60 Index (XIU); Gold is represented by the iShares Gold Trust (IAU).

Top Investment Issues[6]

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

[6] 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.

TD Wealth

The Charter Group

Mark Jasayko, MBA, CFA | Portfolio Manager & Investment Advisor
Mike Elliott, BA, CIM, FCSI ® | Portfolio Manager & Investment Advisor
Laura O'Connell, CFP ®, FMA | Associate Investment Advisor

TD Wealth Private Investment Advice

604 513 6218
8621 201 Street, Suite 500
Langley, British Columbia   V2Y 0G9

The Charter Group at TD Wealth Private Investment Advice 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, B.C. 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 May 5, 2017.

The information contained herein has been provided by Mark Jasayko, Portfolio Manager and Investment Advisor and is for information purposes only. The information has been drawn from sources believed to be reliable. Where statements are based in whole or in part on information provided by third parties, they are not guaranteed to be accurate or complete. Graphs and charts are used for illustrative purposes only and do not reflect future values or future performance of any investment. The information does not provide financial, legal, tax or investment advice. Particular investment, tax, or trading strategies should be evaluated relative to each individual's objectives and risk tolerance.

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