Weekly Updates Issue # 629

1. Weekly Markets Changes

[September 1, 2017]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
15,191.6 +135.6 +0.90%	2,443.05 +33.50 +1.37%	21,813.67 +173.9 +0.80%	6,216.53 +218.80 +3.52%	$0.80646 +0.54c +0.67%	$1,283.94 +41.29 +3.22%	$47.87 -0.58 -1.89%

2. Biggest challenges for insurance industries are…

[September 1, 2017] Canada’s property and casualty and life insurance sectors are stable, despite potential market pressures brought on by the increase in weather and fire catastrophes, and by the persistently low interest rate environment, says a new A.M. Best special report.
Still, A.M. Best suggests monitoring factors such as potential seismic events, economic volatility and regulatory changes.
Take the Canadian life insurance segment, which is struggling with low interest rates, regulatory changes and limited domestic growth opportunities. Yet, the industry remains well-capitalized, given the build-up in its equity.
A.M. Best finds most life companies maintained pricing discipline in their markets and stayed focused on growing their core lines of businesses. The companies benefited from “solid underwriting fundamentals, increased sales, less volatile investment performance and interest rate and equity market movements,” says A.M. Best.
As for competitive pressure, “Canada’s life insurance industry remains […] dominated by the top three life insurance groups, which maintain a 63% market share as measured by net premiums written as of year-end 2016,” said Ed Kohlberg, associate director for A.M. Best. “Product pricing — while competitive — remains rational […].”

P&C pressures

In its release, A.M. Best says the pre-tax operating income of property and casualty insurers declined 26.5% in 2016.

It finds the significant decline in underwriting profits resulting from catastrophic events was partially offset by additional investment income, but that realized capital gains dropped approximately 55% from the prior year, while net income was down approximately 30%.

An September 1 announcement by Insurance Bureau of Canada links climate change to increased weather events. IBC says in a release, "Climate change is causing severe weather events, especially storms involving floods, to happen more frequently and with greater intensity. While the insured damage from the spring floods is significant, the total cost to homeowners and government is not yet known," said Craig Stewart, vice-president, federal affairs, at IBC."

The release discusses two spring 2017 storm and flooding events that occurred in Eastern Ontario and Western Quebec; one took place between April 5 and 7 while the other occurred between May 5 and 7. Combined, those events resulted in approximately $223 million in insured damage.

3. Expect political upheaval in emerging markets

[August 31, 2017] Before investing in emerging markets, think about how you'll handle short-term political volatility. After all, it's a common hurdle in that space, says Michael Reynal, chief investment officer and portfolio manager at Des Moines, Iowa-based Sophus Capital, which sub-advises the Renaissance Emerging Markets Fund.

Think about the reaction by the White House to the potential for North Korea to get nuclear weapons, and its subsequent move to pressure China to help prevent the proliferation of such weapons. While "this is a long-standing story," Reynal explains – the U.S. has been pressuring China to help with North Korea for several decades – "what [President Donald Trump] has done is accelerate that pressure," and that has weighed on global markets.

Despite being pushed by the U.S. China has continued to stand back regarding North Korea. As Business Insider reports, one possible result is further deterioration of U.S.-China relations going into the fall.

Reynal isn't convinced the White House's plan will pan out, so he's sticking to monitoring the situation and how it unfolds. "I'm not sure [Trump's plan] will work […] He is saying we have always been putting pressure on China and asked for help, and, under [former presidents] Obama, Bush and Clinton, we have not seen a significant reaction. Trump's [hope] is this that by putting more pressure and raising the rhetoric, we might get a more rapid response [from China], but time will tell whether or not that works."

So what's the lesson learned here? "First, political crises in emerging markets occur regularly," says Reynal, who suggests approaching geopolitical events cautiously. "We generally never know ahead of time how quickly a situation can escalate," he adds. "But more often than not, cooler heads tend to prevail. With this nuclear issue, I suspect things will settle down and pressure will be applied yet again on North Korea, and hopefully with better results."

Religious and cultural pressures

Reynal points to other long-term global issues that have caused short-term market pain, such as Russia's involvement with Crimea and the Ukraine in 2014. That, too, was a difficult period for global markets, he says, "but calmer heads prevailed, sanctions were put in place, [and] the reality of Crimea remaining under Russian control was established."

When it comes to Ukraine these days, he adds, "Russia's very clear that they will not be controlling the Ukraine in the long term," but the struggle is ongoing. As reported by CNBC on August 29, German Chancellor Angela Merkel says the sanctions placed on Russia won't be lifted until Moscow ceases its "imposition on Ukraine." The U.S., European Union and several other countries imposed sanctions in 2014.

In the meantime, the problems within Ukraine remain unaddressed. As Reynal understands it, "a little-known fact is the problem within the Ukraine is primarily religious and cultural, and it's not purely about the Russian land grab."

What does this mean? Says Reynal: "Eastern Ukraine is primarily orthodox and Western Ukraine is primarily Catholic. [What's more, while] central Ukraine is also orthodox, it's primarily Ukraine orthodox versus Eastern Ukraine's Russian orthodox. The point here is there is a cultural identification issue going on, and the Russians are using that, in part, to influence what's taking place."

As a result, finding a solution isn't easy, Reynal notes, and tensions are likely to persist. As an investor in emerging markets, he will keep studying "geopolitical events and where they come from." Some global events and issues are resolved quickly but, "in most cases, issues will tick along and require monitoring."

4. Drop tax proposals aimed at business, urges coalition

[August 31, 2017] Across the country, 35 organizations have united to form the Coalition for Small Business Tax Fairness, which opposes the federal government's tax proposals that could potentially affect all Canadian-controlled private corporations.

Participating groups in the coalition include Advocis, the Canadian Institute of Financial Planners, the Conference for Advanced Life Underwriting, Independent Financial Brokers of Canada and the National Exempt Market Association.

Concerned Canadians can comment on the proposals at fin.consultation.fin@canada.ca, but they have only until October 2.

"In 10 years at the Canadian Chamber, I've never seen an issue that has generated greater concern among our members," says coalition member Perrin Beatty, president and CEO of the Canadian Chamber of Commerce, in a release. "To make matters worse, allotting only 75 days for comment in the midst of the summer holidays is not a consultation. It's a stealth attack on farmers and family businesses."

He says most of the chamber's 200,000 members are small and medium-sized enterprises, and they'll be contacting their MPs to say the proposals must be scrapped.

The coalition has presented a letter to Finance Minister Bill Morneau asking the government to take the proposals off the table and instead meet with the business community to address any shortcomings in tax policy affecting private corporations.

5. GDP strength could lead to BoC September hike

[August 31, 2017] The economy surged past second-quarter expectations with growth at an annual rate of 4.5%, giving the country its best start to a calendar year since 2002, Statistics Canada said Thursday.

Household spending and exports, particularly in the form of energy products, drove the increase in real gross domestic product, the agency said.

In an economic news report, National Bank senior economist Krishen Rangasamy says the economy grew a stunning 4% annualized in the first half of the year. "One has to go back to the second half of 2011 to see such a strong semester of growth," he writes.

There's also more growth potential, he adds, with the savings rate having "jumped three ticks to 4.6%." He finds, "The 6.6% annualized increase in real disposable incomes, the biggest increase in seven years, explains the consumption and savings surge."

Based on Thursday’s data, Rangasamy says, National Bank has upgraded its Canadian GDP growth forecast for 2017 to 3%.

The sturdy GDP data provides the latest evidence the 2017 momentum has continued to build and arrives with the Bank of Canada widely expected to once again hike its benchmark rate in the coming weeks.

In July, the central bank cited the strengthening economy when raised its rate to 0.75% from 0.5%; that was its first rate hike in seven years. The BoC’s final three rate announcements are scheduled for September 6, October 25 and December 6.

An economic flash from CIBC Economics says a September hike may be in the cards. “The market seems convinced that the Bank of Canada will wait until October, but the September meeting is now more likely,” says CIBC. “Still, after a hike, with the [loonie] at lofty levels, the Bank will sit back and wait for the Fed to resume its own rate hike path, rather than fly solo and allow the currency to overshoot.”

In terms of Q3 growth, CIBC still calls for expansion of closer to 2%, “with export and inventories among the categories likely to weigh on that quarter’s pace, and housing turnover remaining slower than it had been earlier in this cycle.” Yet, the bank’s bullish for the loonie and bearish for fixed income, and supportive of equities linked to domestic demand.

GDP details

Thursday’s GDP data shows exports expanded 2.3% from April to June, up from 0.4% in the first three months of the year. Exports in goods and services rose 2.3%, while the export of energy products increased 9.2%.

Households spent 1.9% more on goods in the second quarter — the strongest gain since 2007.

Overall, the quarterly increase came even though housing investments contracted 1.2% during a period that saw the introduction of a new Ontario tax on foreign buyers in April. In comparison, residential real estate expanded 2.9% in the first quarter.

A consensus of economists had predicted Canada to deliver a second-straight growth reading of 3.7%, according to Thomson Reuters. The Bank of Canada had predicted second-quarter real GDP to expand by 3% in its latest forecast, released in July.

Combined with the 3.7% expansion over the first three months of 2017, Statistics Canada said the country saw its strongest six-month start to a calendar year in 15 years. The data also shows the last time quarterly growth climbed as high as 4.5% was in the third quarter of 2011 when it hit 5.7%.

The second-quarter acceleration was fuelled by an eighth-consecutive monthly increase in June that included a two% expansion in the construction sector — its largest gain in four years. The report said 14 of 20 industrial sectors saw growth in June.

6. Trump previews ‘biggest-ever’ tax cut

[August 30, 2017] President Donald Trump launched his fall push to overhaul the nation’s tax system by pledging Wednesday that the details-to-come plan would “bring back Main Street” by reducing the crushing tax burden on middle-class Americans, making a populist appeal for a proposal expected to heavily benefit corporate America.

Trump said his vision for re-writing the tax system, a key campaign pledge, would unlock stronger economic growth and benefit companies and workers alike. He promised it would be “pro-growth, pro-jobs, pro-worker and pro-American.”

True to form for the president, Trump dangled the prospect of the “biggest ever” tax cut and warned that without it, “jobs in our country cannot take off the way they should. And it could be much worse than that.”

Trump, who rarely travels to promote his policy agenda, chose to debut his tax overhaul pitch before employees at a manufacturing plant in Springfield, Missouri, a community known as the birthplace of Route 66, one of the nation’s original highways, and one known as America’s Main Street.

“This is where America’s Main Street will begin its big, beautiful comeback,” the president declared.

After eight months without any major legislative victories and after a significant defeat on health care, Trump and Republican congressional leaders face mounting pressure to notch some significant achievements before next year’s midterm elections. But the tax overhaul effort already is facing political headwinds.

The White House and Republican lawmakers have not finalized details of the plan, and the push comes as Congress returns to face an intense September workload filled with must-do items such as raising the debt limit, funding the government and providing assistance for the Harvey recovery effort.

While the White House has been designing a tax plan aimed at appealing to Republicans, Trump sought to cast the effort in bipartisan terms. He called on members of both parties to work with him on a “once-in-a-generation opportunity to deliver real tax reform for everyday hard-working Americans.”

“I am fully committed to working with Congress to get this job done — and I don’t want to be disappointed by Congress, do you understand?” Trump said. “Do you understand? Congress. I think Congress is going to make a comeback.”

The president used the official White House event to inject an overtly political message aimed at Missouri Democratic Sen. Claire McCaskill, a top Republican target in next year’s midterm elections.

“We must lower our taxes, and your senator, Claire McCaskill, she must do this for you. And if she doesn’t do it for you, you have got to vote her out of office,” Trump said, drawing out each of the last five words for emphasis.

Even before Trump took the stage, Democrats eagerly laid down their own markers for what the tax plan should look like.

Senate Minority Leader Chuck Schumer outlined a series of conditions, telling reporters the tax cuts should not go to the wealthiest 1% of Americans. He added that the plan should not increase the budget deficit and should be written by both parties — not just Republicans like the GOP’s failed health care effort.

“If the president wants to use populism to sell his tax plan, he ought to consider actually putting his money where his mouth is” and cut taxes for the middle class, not the richest Americans, Schumer said.

The Trump administration released a one-page set of goals in April for its tax overhaul, followed by a joint statement in July with congressional leaders.

In an interview with the Financial Times last week, Gary Cohn, a top Trump economic adviser, said the White House and Republican leaders had agreed on a “good skeleton” for the plan, and said the tax-writing committee in the House would be drafting legislation while the White House tries to sell it.

Cohn, who recently publicly denounced the president’s response to the racial violence in Charlottesville, Virginia, travelled to Missouri with the president and was standing to the side of the stage. But he was not among a number of administration officials whom Trump publicly thanked in his opening remarks.

The White House played down the omission, saying White House staff members typically aren’t recognized in prepared remarks, only Cabinet members.

Trump said he would like to see the top corporate tax rate drop from 35% to 15%. But it’s not clear that the top rate will go that low in the plan or what kind of tax break a typical taxpayer would see.

With his promises to the middle class, Trump is essentially betting that the benefits of tax cuts for businesses will flow directly to workers, rather than ending up in the pockets of top executives and wealthy investors.

His administration has asserted that high corporate tax rates primarily hurt workers, since companies can stash their money overseas in countries with lower tax rates.

Trump's Treasury Department cited a 2006 Congressional Budget Office study to back the claim that workers mostly bear the brunt from corporate taxes, as well as research by Kevin Hassett, the economist picked to lead the White House Council of Economic Advisers.

But Treasury officials concluded in a separate 2012 analysis that only 18% of corporate taxes' costs fell on labour. This would suggest that Trump's plan is more likely to bolster stock prices and CEO pay than trickle down to worker's salaries.

7. New ODSP limits better, but not good enough

[August 30, 2017] Starting September 1, Ontarians with disabilities will have more — but perhaps not enough — flexibility when it comes to their finances. Previously, single recipients of the Ontario Disability Support Program could only receive $6,000 in gifts in any 12-month period. Ontario has increased the amount to $10,000, which some advisors say is still insufficient.

"You painted the house but you haven't renovated anything," says Ron Malis, a Toronto advisor who specializes in clients with disabilities. He calls even the new limit "a significant barrier," and notes that ODSP recipients in expensive cities like Toronto often can't get by on the government benefit alone, especially since their expenses can be much higher than those of non-disabled people. "You may have [additional income] sources, but [the limit] means you can open the tap on those sources only so much."

Also new: gifts of any amount will not count toward the $10,000 limit if the ODSP recipient uses the gifted funds to buy a home or a car, or pay first and last month's rent.

For some people, this can make a huge difference.

"I'm dealing with a case right now — a mother who lives with her disabled adult child," says Jason Pereira, a senior financial consultant at Woodgate & IPC Securities Corp. in Toronto. The mother wants to downsize from a house to two units in the same condo building, and thanks to the new rules, she can now put one of the units in her son's name instead of in a trust or keeping both in her name. "I think this lowers the bar of complexity," he says.

ODSP changes as of Sept. 1

- Asset limits will increase from $5,000 ($7,500 for couples) to $40,000 ($50,000 for couples). The Ontario budget originally indicated the change would take effect "by January 2018."
- The exemption for cash gifts will increase from $6,000 to $10,000 a year.

But owning a home doesn't mean a disabled client can pay for its upkeep. "If you think about it, you get $12,000 to $14,000 a year in ODSP benefits, plus now an extra $10,000 in gifts," says Geoffrey Zaldin, president at Special Needs Financial Inc. in Toronto. "So $24,000. If you get a $400,000 condo, even if there's not a mortgage, between taxes, hydro and condo fees potentially, you could be at almost half of what you're allowed to have from ODSP benefits and gifts, minimum. And if you throw in a mortgage, it could be 100% of your allowed income. In which case, you're allowed to have the exempt asset — you just can't afford to maintain it."

Zaldin says the cap on gift income should be sufficient to allow the person to pay a mortgage on a basic condo, along with condo fees, utilities and living expenses — which in many places will be higher than $10,000. To that end, he also suggests the cap be adjusted geographically (or allow more exemptions), as real estate in Toronto costs significantly more than in Thunder Bay, for example.

There's good news on that front. Also starting Sept. 1, ODSP recipients' asset limit will increase from $5,000 ($7,500 for couples) to $40,000 ($50,000 for couples). (Note that if an inheritance or any other gift or payment is kept, it is treated as an asset the month after it's received, and ODSP asset rules apply.)

"You can't underestimate the dignity aspect of it," Pereira says. Under the new rules, clients will be able to keep more cash in their bank accounts, build emergency funds and simply have more control over their lives.

ODSP recipients whose assets exceed the limit will lose their ODSP unless they spend the excess funds or use them to purchase exempt assets, such as segregated funds or investments within an RDSP.

"The problem with an RDSP is that you can't get at the money without suffering some significant government penalties," says Malis. Because RDSPs are meant to encourage long-term savings, and because the government contributes up to $90,000 to each account, it "will take as much as $3 for every $1 that you take out [prematurely] as a penalty." RDSPs also have a lifetime contribution limit of $200,000.

Losing ODSP benefits means losing more than just monthly cheques.

“The biggest government assistance would be the ODSP drug and dental program, because somebody could be on $100,000-a-year drugs,” Zaldin says.

Parents or any relatives who wish to bequeath or give ODSP recipients amounts above the limits can avoid threshold issues by putting the money in a Henson Trust, but Zaldin notes this must be done before a parent’s death; executors can’t set up such a trust when reviewing the will. Furthermore, money in a Henson Trust can only be spent on medically necessary goods and services (e.g., nursing) to be exempt from asset limit rules.

“So, you may have a Henson Trust of $1 million that your parents left you, but you’re going to be very limited in what you can use that isn’t absolutely medically required and allowed by ODSP,” Zaldin says.

8. Proxy firm ISS to Home Capital: Enough with Buffett, already

[August 30, 2017] Shareholders of Home Capital Group are being advised by leading proxy advisory firm Institutional Shareholder Services (ISS) to vote against a deal that would see Warren Buffett’s Berkshire Hathaway increase its stake in the Toronto-based company.

Home Capital shares and prospects have improved since the American billionaire’s conglomerate announced in June that it would support the embattled alternative lender through an investment of $153 million, acquiring a 19.99% stake in the company, and by providing it with a $2-billion line of credit.

The financial lifeline provided much needed funding and helped restore investor confidence in Home Capital after the company faced a run on deposits by customers in April following allegations by regulators that it misled investors.

Berkshire Hathaway also agreed in June to invest a further $246.7 million, at $10.30 per share, which would increase its indirect stake in Home Capital to 38.4%, pending shareholders’ approval in a vote on Sept. 12.

ISS said in a report Tuesday that at the time it was announced, the second round of equity investment from Berkshire seemed the best available alternative for stabilizing Home Capital.

But since then, ISS added, the company has made substantial progress, such as board and management renewal, Ontario Securities Commission and class action settlements, asset sale, dividend suspension, repayment of Berkshire’s line of credit and restoration of deposit inflows to historical averages.

“On a cost-benefit analysis, the proposed Berkshire second tranche appears to offer nominal additional reputational and strategic benefits to those already established under the Berkshire first tranche, while dilution cost of the discounted second tranche is substantial,” the firm said.

“On balance, a vote against the proposed second tranche of the Berkshire equity investment is warranted.”

Despite ISS’s warning that the proposed second tranche will do little to enhance the already-improved stability of the company, Home Capital says the larger investment will lead to a stronger commitment from Berkshire to the long-term success of the lender.

“This creates strong sponsorship to withstand regulatory, policy and economic changes,” Home Capital said in a statement.

“Berkshire’s involvement has received favourable press coverage and has generally been well received by our stakeholders, including depositors and borrowers.”

Last week, another proxy adviser firm, Glass Lewis, endorsed the proposed Berkshire second tranche.

“We believe the additional capital provided by the private placement will provide the company with sufficient flexibility to pursue its strategy, which we believe is in the best interests of shareholders,” Glass Lewis wrote in a report to clients.

On Tuesday, Home Capital also announced it was continuing to rebuild its executive ranks with the hiring of a new chief financial officer who has extensive experience in Canada’s financial services industry. The company said Brad Kotush, a former CFO at Canaccord Genuity Group Inc., will join the lender as of Sept. 1.

9. Trade gap reveals potential for volatile loonie

[August 30, 2017] Reuters reports that Canada’s current account deficit widened in Q2, as the country’s international trade gap grew because imports rose, as revealed by Statistics Canada data. The seasonally adjusted current account deficit stood at $16.3 billion in the second quarter; however, that’s short of economists’ forecasts of a $17.4-billion gap.

The current account is Canada’s broadest measure of trade, explains National Bank senior economist Krishen Rangasamy in an economics report. The current account deficit of $16.3 billion equals about 3.6% of GDP, he says.

Andrew Grantham, senior economist at CIBC, says in a note that the Q2 current account deficit isn’t surprising, given lower oil prices.

Further, he says the figure was lower than consensus expected largely because of a better starting point, as the Q1 deficit was revised to $12.9 billion from $14 billion. That's because the goods deficits was a bit narrower in Q1 than expected.

Still, a growing current account deficit could be cause for concern.

Domestic savings vs foreign investment

"The persistence of red ink on the external balance for 35 consecutive quarters suggests there's more to the deficit than cyclical factors," says Rangasamy.

One root cause is arguably the lack of domestic savings.

"Dissaving by both government and households tends to bid up imports not just of goods and services, but also of capital to finance investment," he says.

Regardless, running a current account deficit means Canada borrows from abroad to pay for expenditures. That's not so bad if foreign capital inflows are long term, stable and raise the country's potential growth, says Rangasamy.

But that's not the case.

"Unfortunately for Canada, the main source of financing is short-term capital," he says. "The external deficit in Q2 was entirely financed by portfolio and other short-term capital inflows for the seventh consecutive quarter."

That leaves Canada vulnerable to shifts in investor sentiment, thereby potentially making the Canadian dollar more volatile, he concludes.

Says Grantham: "Although it wasn't as bad as expected, the widening in the current account deficit during Q2, and only modest help going forward from crude prices, highlight a headwind to further C$ appreciation from here."

Have a nice and fruitful week!