Weekly Updates Issue # 682

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1. Weekly Markets Changes

[September 21, 2018]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
16,224.13 +210.64 +1.32%	2,929.67 +24.7 +0.85%	26,743.50 +588.83 +2.25%	7,986.96 -23.08 -0.29%	$0.7742 +0.69c +0.90%	$1,200.04 +5.19 +0.43%	$70.78 +1.79 +2.59%

2. Ontario finance minister projects $15B deficit

[September 21, 2018] Ontario’s finance minister said the province will have to make sacrifices as it grapples with a newly revised $15-billion deficit, a message critics predicted would pave the way for significant cuts to government services.

In a speech to the Economic Club in Toronto on Friday, Vic Fedeli said **the province had chosen to adopt the accounting practices used by the auditor general in reviewing the recently defeated Liberal government’s budget and projections, and found greater deficits than had been reported.**

“The hole is deep and it will require everyone to make sacrifices without exception,” Fedeli said in the speech, his first major address since taking on the finance portfolio. “It will require a unity of purpose, a clear vision and a lot of hard work.”

As a result of the new Progressive Conservative government’s adjusted take on the province’s books, an independent commission tasked with examining Ontario’s finances concluded the Liberals ran a $3.7-billion deficit in the last fiscal year rather than balancing the budget as claimed, Fedeli said.

The commission also found the Liberals had overestimated their revenues for this fiscal year, reduced a reserve fund by $300 million and claimed $1.4 billion in cost-cutting measures that weren’t spelled out.

Once those were factored in, the projected deficit for 2018-19 rose to $15 billion from the $11.7 billion predicted by the auditor general, the government said.
Fedeli would not give a timeline for getting the province back in the black, though the Progressive Conservatives promised during the election campaign that they would return to balance by the end of their mandate.
“We will return to a balanced budget on a timetable that is reasonable, modest and pragmatic—but we will return to balance in Ontario,” he said.
Critics warned the commission and its findings would be used to justify sweeping cuts, noting Premier Doug Ford has vowed to find billions in so-called “efficiencies.”
The Liberals accused the government of using inflated numbers for political gain, saying the figures cited by the commission were known long before the election.
“It’s a context for cuts,” Interim leader John Fraser said. “They’re going to be deep.”
NDP finance critic Sandy Shaw called Fedeli’s speech an “act of political theatre,” and noted the Liberals behaved similarly when they took over from the Progressive Conservatives in 2003.
“They aren’t going to deliver relief. They’re going to cut and privatize,” she said.
Green Party leader Mike Schreiner said that while the commission paints a bleak picture of Ontario’s finances, that should not be used to bring in sweeping austerity measures.
“Finding efficiencies on the backs of our most vulnerable citizens is wrong. And it will only lead to more costs down the road,” he said in a statement.
Some labour groups also expressed alarm at Friday’s announcement, saying Ontario residents would suffer if services are cut or privatized.
Asked whether there would be service cuts or job losses, Fedeli said the premier had been clear about targeting only efficiencies.
Treasury Board President Peter Bethlenfalvy said the government would work with the broader public service to find ways to move forward without threatening the jobs of frontline workers.
“This is not about cuts,” he said. “It’s about transforming the way government runs its businesses, about modernizing the government services.”
Paul LeBane, vice president of public finance with the independent credit ratings agency DBRS, said that while the additional deficit beyond the auditor general’s tally was a little surprising, “from a credit perspective, not much has changed.”

“It doesn’t really change the province’s borrowing requirements, it doesn’t really change their cash position all that much, maybe they’ll borrow a little bit more to have a little bit more in contingency, in reserve,” he said.

What’s more, the deficit projection for 2018-19 appears based on the budget presented by the Liberals and doesn’t seem to factor in the new government’s policies or priorities, LeBane said. “That $15 billion will have to change as the year progresses,” he said.

The Progressive Conservative government announced the independent commission in July and tasked it with probing the Liberal regime’s accounting methods surrounding a pair of teacher pension plans and the province’s Fair Hydro Plan.

Those accounting practices had led to a two-year fight with Ontario’s auditor general, who said in April that the Liberals understated their deficits by billions.

Bonnie Lysyk suggested that the $6.7-billion deficit projected by the Liberals for 2018-2019 would be $11.7 billion instead, and the projected $6.5 billion for 2020-2021 would actually be $12.5 billion.

The Conservatives have also ordered a line-by-line audit of government spending, which is expected to be finished in the coming weeks.

3. Case for interest rate hike builds as underlying inflation measures rise

[September 21, 2018] The country showed signs of growing price pressures last month with inflation staying strong and its underlying pace grinding higher—both of which propped up expectations that higher interest rates are on the way.

The annual inflation rate for August receded somewhat to 2.8%, easing from July’s 3% pace that marked Canada’s highest reading in seven years. Last month’s step back was largely due to more-moderate expansion in gasoline prices, Statistics Canada said Friday as it released its latest consumer price index.

The resilience of the August headline number kept it above the mid-point—and close to the top end—of the Bank of Canada’s target range of 1% to 3%. The inflation-targeting central bank uses interest-rate hikes as a tool to help prevent price growth from rising too high.

Ahead of its rate decisions, the Bank of Canada also keeps close watch on the three measures of underlying inflation, which strip out more-volatile items like gas prices.

Statistics Canada’s figures show that each measure crept upwards once again in August, with the average of the three moving up to 2.1%, compared with 2% in July and 1.96% in June.
BMO chief economist Douglas Porter said that, combined, the core measures are matching some of the highest underlying inflation readings Canada has seen since 2009. Porter believes the inflation figures are “a touch uncomfortably high for the Bank of Canada.”
With a tightened labour market and robust growth, bank governor Stephen Poloz is widely expected to raise the benchmark interest rate at the Oct. 24 rate announcement.
“I think that this just really is another feather in the cap and turns up the odds by a notch or two,” Porter said of Friday’s inflation report.
“Nothing to get overly concerned about, but I think the big story is inflation has moved away from years of relatively low readings to a little bit above what the Bank of Canada targets.”
However, clouding the interest-rate picture is a significant wild card: the fate of the North American Free Trade Agreement.
Without more clarity on the deal’s renegotiation, Porter said it’s tough to know precisely what Poloz will do.
The Bank of Canada, which has stressed it will stick to a gradual rate-hiking approach, **has made a point of saying it’s closely watching the NAFTA talks and other trade policy developments, which could have negative impacts on the economy.**
After the release of Friday’s inflation report, other analysts said Poloz is in line to raise the rate next month.
“While the headline inflation has eased off somewhat, the Bank of Canada core measures continued to move forward,” TD economist Ksenia Bushmeneva wrote in a research note.
“Continued progress on the inflation front alongside a well-performing economy and a range of indicators pointing to limited excess capacity suggest that maintaining stable inflation will require further rate hikes by the central bank, with another one likely coming next month.”
Following last month’s policy meeting, the Bank of Canada described the recent rise in headline inflation as temporary. It predicted inflation to fall back towards 2% in early 2019 once the effects of past increases in gas prices fade away.
The Statistics Canada report Friday showed year-over-year pump prices rose 19.9% in August, compared with a 25.4% increase in July. Excluding gas prices, the inflation rate was 2.2% last month.

A closer look at August's inflation numbers shows prices of passenger vehicles rose 2.3%, up from 2% in July. Statistics Canada said this was mostly due to increased availability of following-year models compared with a year ago.
The prices of booze and tobacco were up 4.6% last month, while food costs increased 1.6%.
In a separate report Friday, Statistics Canada said retail trade expanded 0.3% in July in large part because of sales boosts at food and beverage stores and gas stations.
The July increase, which brought sales to $50.9 billion, followed a June contraction of 0.1% and a May expansion of 2.2%.

4. Despite likelihood of NAFTA deal, BMO head worried about trade

[September 20, 2018] The chief executive of the Bank of Montreal says that while the Canadian economy is showing positive growth in almost every province, one economic headwind worries him the most: trade.
But as Canada's negotiating team in Washington continues to try and bridge a divide that's keeping the country out of a North American free trade pact, Darryl White says he believes a deal will eventually come to fruition.
"I fundamentally think it will come together," White said in an interview. "But underlying that, it's hard to predict some random events. And there are some random events."
White's comments on the broader economy come as the Toronto-based bank announces a new initiative aimed at tackling economic disparity among neighbourhoods at home in partnership with the United Way Greater Toronto.
When asked about boosting economic growth across the country more broadly, White said Canada should be "leaning in" on encouraging investment, including potentially examining regulations and "the ability to complete projects as planned."
His counterpart at the Canadian Imperial Bank of Commerce, Victor Dodig, recently called for Canada to boost its global competitiveness in various ways, including offering clearer foreign investment rules and matching a U.S. policy that allows companies to immediately write off the full cost of capital investments. The CIBC chief executive also pointed to the debate and delay surrounding the Trans Mountain pipeline expansion project as an example of difficulties getting business done in Canada.
Finance Minister Bill Morneau is looking at targeted measures to enhance the country's competitiveness rather than broad-based tax cuts, sources have told

The Canadian Press. Morneau intends to announce plans in his fall economic update to bolster Canada's competitiveness.
White said he didn't have one specific ask for Morneau, noting that the government is being "very careful and very thoughtful" about the issue. But the evaluation of a Canadian investment opportunity would take into account many factors, including affordable housing, taxes, depreciation and regulations.
"It's hard to particularize exactly where we ought to be leaning in on encouraging investment, but to me that's the goal," said White.
"How can we encourage continued investment into Canada by Canadians and by non-Canadians [...] It's a basket of features, not any one particular feature."

5. Where rates are headed—and how fast

[September 19, 2018] Investors looking for insight on long-term interest rates can take their cue from ongoing central bank commentary.
The Bank of Canada offers "good insight" on where it aims to take its interest rate over the long run, says Patrick O'Toole, vice-president of global fixed income at CIBC Asset Management and co-manager of the Renaissance Canadian Bond Fund, an underlying fund in the Renaissance Optimal Income Portfolios.
In the central bank's last monetary policy report, published in July, it said the neutral policy rate was estimated to be between 2.5% and 3.5%.
"The Bank is saying that should the economy continue to grow at trend, and should inflation continue to meet its target of about 2%, it expects to eventually take its interest rate to at least 2.5%," O'Toole said in a late-August interview.
But keep in mind, he added, that the 2.5%-to-3.5% range is a long-run target, which "has been coming down for years, and we think it may still be a little bit high."
The Bank of Canada's rate should be roughly the same as its inflation target, O'Toole said. The inflation rate has been 2% on average for a decade, he added.
"If you get a bank rate above 2%, you're actually paying investors a real rate of return," he said.
"You shouldn't get paid a premium when you're not taking a risk on it."
O'Toole estimates the neutral rate to be closer to 2% than the 2.5% to 3.5% the bank is estimating. The central bank's guidance is "always subject to change," he said.

At the annual economic policy symposium hosted by the Federal Reserve Bank of Kansas City in Jackson Hole last month, BoC Governor Stephen Poloz said the economic uncertainty resulting from digital disruption “means following a more gradual approach to normalizing interest rates than traditional models would advocate.”

O’Toole said the governor’s comments indicate “a stark realization that the main models [the BoC] uses to gauge the pace of the economy and the potential for inflation to accelerate beyond the bank’s target aren’t really calibrated for the new economy.”

That shouldn’t come as a surprise, O’Toole said. “Models are generally based on historical events, gauging how one variable has acted to impact another variable.” And with the digital revolution, which he called a “new variable thrown into the mix,” economic modelling is becoming difficult.

Overall, the governor’s statements indicate “the target is fluid,” said O’Toole.

6. ‘Zombie’ firms dragging down productivity: Deloitte

[September 18, 2018] There is a concerning number of so-called zombie firms that are plaguing Canadian productivity, according to a new report from Deloitte.

About 16% of Canadian public companies fall into the category of zombie firms established by the OECD—more than 10 years old but unable to earn enough to cover interest payments on debt.

The Canadian firms, numbering at least 350 from Deloitte’s findings, divert resources away from more productive and dynamic enterprises and diminish opportunities for growth, said Duncan Sinclair, chair of Deloitte Canada and Chile.

“That’s tied up $130 billion in capital—and even more importantly tied up people—that might otherwise be deployed into organizations that have more momentum, more growth, more capacity to assert themselves as global leaders.”

The issue is especially concerning in Canada, where the number of such companies stands 60% higher than the global average of 10%, and shows Canadian firms are vulnerable to economic shocks and technological disruption.

The consultancy did not specify which sectors were most affected, though Sinclair said more capital intensive businesses run a higher risk of falling into the situation over time.

The issue comes as part of a wider challenge of aging businesses in Canada as the global economy requires nimble enterprises to respond to changing

market dynamics. **More than 40% of Canadian businesses are 15 years or older, up from just over 30% a decade ago, said Deloitte.**

"We do have an issue of, relative to other major countries in the world, a larger percentage of our companies that are sort of lagging," Sinclair said.

While many older businesses thrive, a significant number show issues of profitability. **Deloitte found 44% of firms aged 10 years or older had stagnant or negative three-year revenue growth rates between 2009 and 2016.**

Deloitte lays out five key criteria companies need to pursue to remain successful, such as disrupting with resilience and pursing tough decisions.

The firm found Canadian businesses most lagged in the need for asserting global leadership through exports and exploring opportunities abroad. It found just 13 of the 700 Canadian firms surveyed as embodying the ethos.

Companies need to see that competition is going global and they need to respond, said Sinclair.

7. Canadians' net worth rising but so are debt levels

[September 18, 2018] Data showing that interest rates are rising faster than income provide a wake-up call to Canadian consumers who are taking on unsustainable amounts of debt.

Soaring home valuations are inflating the average Canadian's net worth, especially in the hot real estate markets of Toronto and Vancouver, but interest rate cost increases are expected to force spending restraint going forward, warned Environics Analytics in a report Monday.

"The overarching story this year is that Canadians have never been richer but, at the same time, they've never felt poorer," said Peter Miron, Environics Analytics' senior vice-president of research and development and architect of the WealthScapes 2018 analysis.

"Real estate's way up, liquid assets are up decently, their pensions are up, everything on their balance sheet looks great but, all of a sudden, when you look at these rising interest rates, that's going to start pinching their cash flow and is going to leave them with less money left over at the end of the year."

The situation isn't dire at the moment but it **could easily worsen to crisis levels—when consumers are forced to sell assets or even declare bankruptcy—within the next four years if interest rates rise as expected**, Miron said.

Canadians overall paid about $9 billion more in interest charges in 2017 than they did in 2016, according to Environics Analytics statistics.

That's about $544 more for the average Canadian household last year compared with 2016.
The average Canadian's net worth rose by 8.5% to almost $808,000 in 2017, but much of that wealth was tied up in assets that are difficult to cash in, such as real estate.
Meanwhile, average household debt climbed by 4.5% in 2017 while the average interest-expense-to-income ratio rose 40 basis points to 6.4%, the first increase in a decade, the report says.
Household debt has been identified as a key vulnerability for the financial system by the Bank of Canada, which has raised its trend-setting interest rate four times since mid-2017.
Interest rates are far lower now than in the early 1980s, when mortgage rates peaked at more than 20%, but the danger is just as real because houses are worth much more now, said Scott Hannah, president of the Credit Counselling Society.
"If you had a mortgage of $150,000 and the rates went up a quarter percent, you'd barely blink," he said in an interview.
"But when your mortgage is half a million dollars or higher, it has meaning, especially when (the rates) are projected to go higher over the long term."
Because wages aren't rising as fast as interest rates, consumers are augmenting their income with more debt, he said, which leaves them vulnerable if interest rates rise or their income falls.
The Environics Analytics report found that Vancouver's 17.2 % rise in real estate prices in 2017 led to it posting the highest growth in household net worth in Canada, up 12.7%.
But Vancouver also experienced debt growth of 8.5%, more than double the national average.
Toronto's average household net worth grew by 9.5% as real estate values rose 11.1% in 2017. The report notes that higher debt caused average interest expenses to rise by $932 per household in 2017.

8. Portfolio effects of changing monetary policy

[September 18, 2018] A decade after the financial crisis, one result of governments' unprecedented stimulus programs is the buildup of debt across the globe, says Peter Hardy, vice-president and client portfolio manager at American Century Investments.
Following the 2008 bankruptcy of Lehman Brothers, various central banks lowered interest rates and pumped money into the economy to combat the crisis.

Since 2007, global worldwide debt has increased from around US$142 trillion to over $240 trillion, Hardy said in a late-August interview. "This buildup of debt will lead to volatility and to potential reduced returns in assets."

Another consequence will be slower economic growth, as people's money is used to pay off mounting debt rather than for investments, he said.

Further, investors could see lower returns. "Part of the good returns we've seen in stocks and bonds, and real estate, has been by virtue of central bank policy," he said, with the Fed, the European Central Bank and the Bank of Japan increasing their balance sheets from roughly US$3 trillion to US$15 trillion through their asset purchases.

"These purchases are a wall of liquidity that puts a bid on assets, and as that liquidity goes away you'll see asset price returns revert to a lower level."

Last week, for example, the ECB confirmed that it would cut the size of its monthly bond purchases in half after September. Those purchases will be reduced to 15 billion euros from 30 billion euros before they stop altogether at the end of the year.

The ECB isn't expected to start raising rates until the second half of 2019, but the U.S. Federal Reserve hiked three times last year and twice so far in 2018, with two more expected before year-end.

The "wall of liquidity" from central banks has impacted another element of investing, said Hardy, whose firm manages the Renaissance U.S. Equity Income Fund. Aggressive monetary policy and asset purchases have contributed to historically low volatility.

"As this accommodative policy discontinues, you're likely to see a higher level of volatility," he said.

So how can investors prepare as accommodative policy retreats?

"Investors need to account for this by maintaining a diversified portfolio of assets," Hardy said. Also, where investors have seen good appreciation in certain asset classes, taking some money off the table and returning to a target asset allocation may make sense, he added.

9. Canadian home sales rise nearly 1% in August: CREA

[September 17, 2018] Statistics released Monday by the Canadian Real Estate Association (CREA) show a small increase in national home sales in August, but the housing market continues to slow relative to its hot pace in recent years.

National home sales rose 0.9% in August, the fourth consecutive monthly gain, said CREA in a release. “However, sales activity is still running below levels in most other months going back to early 2014,” it said.
In the release, Gregory Klump, CREA’s chief economist, said that improving national home sales activity obscures “significant” differences in regional trends for home sales and prices. “Moreover, recent monthly sales increases are diminishing, which suggests that the recent rebound may be starting to lose steam,” he said.
The monthly gain in sales was led by the Greater Toronto Area (GTA), followed by Montreal and Edmonton.
Actual (not seasonally adjusted) activity was down 3.8% year over year, due mainly to declines in B.C.’s major urban centres.
“The new stress-test on mortgage applicants implemented earlier this year continues to weigh on national home sales,” said CREA president Barb Sukkau in the release. “The degree to which the stress-test continues to sideline homebuyers varies depending on location, housing type and price range.
The number of newly listed homes was unchanged from July to August, as new-supply gains in the Greater Vancouver Area and Montreal offset declines in the GTA and Winnipeg, said CREA.
Based on a comparison of the sales-to-new listings ratio with the long-term average, about two-thirds of all local markets were in balanced market territory in August, it said.
The MLS home price index was up 2.5% year over year in August, and the national average sale price was up 1% year over year, at $475,500.
Price trends vary widely among housing markets tracked by the index.
For example, home price gains are decreasing year over year—some in the double digits—in the Lower Mainland of B.C., while prices in Victoria were up 8.5% year over year in August.
For the same period, home prices rose 7.1% in Ottawa, about 6% in Greater Montreal and almost 5% in Greater Moncton.
GTA prices were up 1.4%.

Have a nice and fruitful week!

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