Weekly Updates Issue # 689

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1. Weekly Markets Changes

[November 9, 2018]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
15,274.44 +155.2 +1.03%	2,781.01 +57.95 +2.13%	25,989.30 +718.47 +2.84%	7,406.90 +49.90 +0.68%	$0.7572 -0.59c -0.77%	$1,209.65 -23.24 -1.86%	$60.19 -2.95 -4.67%

2. CPP Fund reports Q2 net return of 0.6%

[November 9, 2018] The Canada Pension Plan Fund reported a net return of 0.6% for the second quarter of its fiscal year.

The fund's net assets of $368.3 billion on Sept. 30 marked a rise of $1.7 billion from the previous quarter.

"While returns were relatively flat in the second quarter, our teams performed well against our underlying investment strategy," said Mark Machin, president and CEO at Canada Pension Plan Investment Board, in a release. "Foreign currency exchange-rate declines relative to the Canadian dollar were the fund's main headwind during the quarter, offsetting strong local currency performance."

CPP's portfolio had a net return of 2.5% for the first six months of the fiscal year. The CPP Fund has increased by $12.2 billion so far this fiscal year—from $8.9 billion in net income and $3.3 billion in net CPP cash inflows.

The fund's annualized net nominal return was 12.1% over five years and 9.1% over 10 years, the CPPIB said.

3. Supreme Court says national securities regulator plan is constitutional

[November 9, 2018] The Supreme Court of Canada says the Constitution allows Ottawa and the provinces to set up a national securities regulator.

In its unanimous ruling today, the high court also finds federal draft legislation for countrywide oversight of stocks, bonds and other investments falls within Parliament's powers on trade and commerce.

The decision could help advance plans for a national regulator of capital markets, an idea under discussion since at least the 1930s.

Supporters of the concept say it would eliminate duplication, reduce red tape and ensure more consistent enforcement and investor protection.

But the division of constitutional powers has made Canada an anomaly—a leading industrialized country with a patchwork of provincial and territorial regulators instead of a national one.

In an earlier ruling, the Supreme Court said in 2011 that a draft bill to create a national regulator strayed beyond federal jurisdiction, as the provinces and territories have constitutional authority over most elements of securities regulation.

However, the court said it was open to Ottawa and the provinces to exercise their respective powers over securities harmoniously, in the spirit of co-operative federalism.

With that in mind, British Columbia, Saskatchewan, Ontario, New Brunswick, Prince Edward Island, Yukon and the federal government signed a memorandum of agreement to create a new regulatory system.

The plan includes a common regulator, a council of ministers to play a supervisory role, a model law that provinces and territories could pass, and federal legislation to manage systemic risk, allow for data collection and address criminal matters.

In July 2015, the Quebec government asked the province's Court of Appeal to consider the proposal's constitutional validity.

The Quebec appeal court said last year the Constitution does not authorize creation of a pan-Canadian securities regulator under a single body as envisioned in the memorandum of agreement. It also flagged concerns with aspects of the draft federal legislation on the proposed role and powers of the council of ministers.

The federal government appealed to the Supreme Court on both matters.

In its decision today, the high court says the proposed co-operative system "does not improperly fetter" the sovereignty of legislatures. In addition, the draft federal legislation falls within Parliament's trade and commerce powers under the Constitution, the court concludes.

4. Fed maintains target rate, indicates more hikes ahead

[November 8, 2018] The Federal Reserve has left its key policy rate unchanged but signalled that it plans to keep responding to the strong U.S. economy with more interest rate hikes. The next rate increase is expected in December.

The Fed kept its benchmark rate in a range of 2% to 2.25%. A statement it issued Thursday after its latest policy meeting portrayed the economy as robust, with healthy job growth, low unemployment, solid consumer spending and inflation near the Fed's 2% target.

Despite a U.S. trade war with key nations, weaker corporate investment and a sluggish housing market, the Fed is showing confidence in the economy's resilience. To help control inflation, it has projected three rate increases in 2019 after an expected fourth hike of the year next month.

Analysts saw the central bank's decision to highlight the economy's strength and to make few changes in its policy statement as a sign that it remains on track to raise rates next month.

"The Fed's economic assessment remains very upbeat, noting declining unemployment and continued strong growth," said Greg McBride, Bankrate.com's chief financial analyst. "All signs point to a rate hike at the December meeting."

The Fed's decision Thursday was approved 9-0 by its voting policymakers. Its brief statement was nearly identical to the one the Fed issued in September. It said the job market has continued to strengthen and noted that economic activity has been rising "at a strong rate."

In one of its few changes, the Fed downgraded its assessment of business investment spending, observing that it had slowed from its pace earlier in the year.

The Fed did not specify any risks to the economy it perceives. Analysts will be studying the minutes of this week's meeting, to be released in three weeks, for any insight into economic threats Fed policymakers may see, such as the trade war between the United States and China.

In deciding how fast or slowly to keep raising rates, the Fed will be monitoring the pace of growth, the job market's strength and gauges of inflation for clues to how the economy may evolve in the coming months. The brisk pace of economic growth—a 3.5% annual rate in the July-September quarter, after a 4.2% rate in the previous quarter—has raised the risk that inflation could begin accelerating.

Some economists foresee only two Fed rate hikes next year. Others expect that economic growth will remain solid and the job market strong and that the

Fed will decide that four rate increases will be justified next year to guard against high inflation. At 3.7%, the unemployment rate is already at its lowest level since 1969.

Last week, the government reported that the economy added a sizable 250,000 jobs in October and that average pay rose 3.1% over the previous 12 months—the sharpest year-over-year gain in nearly a decade. That's welcome news for workers. But it's a trend that may raise concern that accelerating wages will help fuel undesirably high inflation.

Chairman Jerome Powell has stressed that the Fed is determined to follow a middle-of-the-road approach: Keep gradually nudging up rates to control inflation but avoid tightening too aggressively and perhaps triggering a recession.

Even after three increases this year, the Fed's benchmark rate is still low by historical standards. The central bank's policymakers have stressed, and most economists agree, that these small quarter-point increases amount to a gradual pace of credit tightening.

Still, the Fed's benchmark rate affects many consumer and business loans, including mortgages and credit cards, and when it raises it, borrowing can become more expensive for many. Savers, though, typically earn more on their cash deposits as interest rates rise.

Since the stock market started tumbling last month, President Donald Trump has attacked the Fed's rate hikes as well as Powell's leadership. Trump's public criticism has aroused concern that he is intruding on the central bank's long-respected political independence and its need to operate free of outside pressure.

At the same time, the nervousness among stock investors reflects the reality that the Fed's steady march toward higher rates is removing a key factor that has underpinned the bull market in stocks: The richer returns that investors could achieve in stocks than in bonds or savings accounts.

Fed critics had charged that the central bank was creating a bubble in stocks that would eventually pop with disastrous results. Trump, who has often invoked high stock prices as evidence that his economic policies are succeeding, has made clear his disagreement. He has called the Fed, with its string of rate increases, "my biggest threat."

Powell, who was Trump's hand-picked choice to lead the Fed, has avoided responding directly. The chairman has instead expressed determination to pursue the Fed's mandate of maximizing employment and stabilizing prices without regard to political considerations.

The Fed is edging closer to what it sees as the “neutral” level. This is the point at which the Fed’s key rate is thought to neither stimulate the economy nor restrain it.
The median assessment of Fed officials has pegged the neutral rate at 3%. One more rate increase this year and two more in 2019 would leave the Fed’s benchmark rate at a range of 2.75% to 3%.

5. The road ahead for Canadian oil producers

[November 7, 2018] As global oil prices rose this fall, Western Canadian Select moved in the opposite direction, hurting Canadian producers forced to sell at a discount.
“We’re at a level right now where differentials are extremely wide for producers,” said Brian See, vice-president of equities, energy, at CIBC Asset Management, during a late - October interview.
While Brent crude and West Texas Intermediate (WTI) hit 2018 highs of approximately US$86 and US$76, respectively, in early October, Western Canadian Select (WCS) dropped from around US$40 in September to below US$30.
That $40 to $50 differential “is so wide that the realized price is making it extremely difficult to earn an acceptable rate of return for [energy] projects,” See said. The result has been a headache for Canadian producers, which produce about four million barrels per day of oil—approximately 60% of which is heavy oil exposed to the WCS-to-WTI differential, he said.
Analysts say the steep oil price discounts and excess production were costing Alberta producers and the provincial government millions of dollars each day, due to lack of pipeline space and little storage capacity for excess oil that couldn’t be moved.
In the past there, was “ample capacity” to deal with excess production, See said. “If supply exceeded demand, you could put it into storage and therefore buffer price movements.”
Now, a lack of storage space is bringing the price of WCS down, he said. As of Nov. 6, Brent crude was trading around US$73, WTI around US$63 and WCS around US$15.
How did this happen? Oil production in Canada has grown at a pace that’s exceeded the capacity to move it by pipeline or rail, See said. Pipelines that would move Canadian oil to the coast for shipping, such as the Trans Mountain pipeline, are facing regulatory delay.
Until those issues are solved, producers are looking at other transportation means. Crude-by-rail exports increased to 229,544 barrels per day in August,

from 119,936 barrels a year earlier, according to the latest monthly data from the National Energy Board.

Another challenge, See said, is that downstream participants, including U.S. refineries, actually benefit from wide price differentials. They can take "a lower feedstock cost to process gasoline and distillates in their refineries," he said.

BP plc has seen the upside in its refining division, reporting an adjusted profit of US$2.11 billion in its third quarter downstream operations, up from US$1.46 billion in the second quarter, attributing most of the increase to higher North American heavy crude oil discounts.

Outlook for price differential

The heavy oil differential will likely narrow heading into 2019, said See, who forecasts a WSC-to-WTI price gap of between US$30 and US$35 by the end of this year or early next.

One reason is several midwestern U.S. oil refineries that are undergoing maintenance are expected to restart operations, he said. "There's a million barrels of oil offline currently, and that's expected to ramp up over the next month."

Another is oilsands production continues to grow. "Even with the wide differentials today, there are still some projects that are offline and [they're] going to be coming back on," he said.

See also expects crude-by-rail shipments to increase, which will further narrow the differential by late 2019 or early 2020 to under US$30, he said.

Further, with the introduction of Enbridge's Line 3 pipeline to Minnesota, which could start operating in Q4 2019, approximately 400,000 barrels per day of extra capacity will be added, See said.

Oil opportunities

Though his outlook on differentials is improving, it's still wider than the market expectation, said See, who co-manages the CIBC Energy Fund. Still, he's constructive on oil producers and thinks it's a good time to buy quality companies.

"What we see is a structural improvement on a go-forward basis, particularly as we get into 2019 and 2020," he said.

One company he likes is Calgary-based Cenovus, mainly due to its asset sales and its improving balance sheet.

The company is looking to expand how much crude it moves by rail, Reuters reported at the end of October, signing contracts with Canadian National Railway Co. and Canadian Pacific Railway to ship approximately 100,000 barrels of oil per day from northern Alberta to the U.S. Gulf Coast beginning in the fourth quarter.

See is also watching Canadian Natural Resources (CNR), a Calgary-based heavy oil producer that reported a profit of $1.8 billion in the third quarter, up from $684 million a year ago. CNR said at that time that it plans to reduce its oil output by up to 55,000 barrels per day in November and December due to wide price differentials—after already cutting its output by 10,000-to-15,000 barrels per day in October.

Despite its focus on heavy oil, See said CNR also produces light oil, which helps buffer the big heavy oil discounts. "This is a company that continues to grow free cash flow and deliver [its] balance sheet," he said.

6. Most actively managed funds failed to beat benchmarks: report

[November 7, 2018] Most actively managed Canadian mutual funds failed to beat their benchmarks over a one-year period, the mid-year scorecard from S&P Dow Jones Indices says.

The scorecard shows how actively managed Canadian mutual funds performed in comparison with the S&P Dow Jones Indices in their respective categories for the one-year period ending June 30, 2018.

The S&P/TSX Composite and S&P/TSX 60 both rose during the one-year period, by 10.41% and 11.45%, respectively.

Six out of seven fund categories underperformed against their benchmarks, the report says. The exception was Canadian dividend and income equity funds. In that category, 67.57% of the funds outperformed the S&P/TSX Canadian Dividend Aristocrats index.

"As the Bank of Canada raised interest rates, yield-focused active equity strategies continued to offer the best relative performance of any category over a one-year horizon," the scorecard says.

Canadian-focused equity funds showed the worst relative performance, with 94.44% of funds lagging the blended benchmark of the S&P/TSX Composite (50%), the S&P 500 (25%), and the S&P EPAC LargeMidCap (25%).

International equity funds also underperformed the index, with almost 90% of the category's funds lagging the S&P EPAC LargeMidCap, compared with 73.08% in the year-end 2017 scorecard. Reasons for the underperformance could have included trade tensions and concerns about a slowdown in global economic growth, the scorecard says.

Among funds investing in U.S. equities, only 27.59% outperformed the S&P 500 (CAD), compared with 30.59% in the previous scorecard.

Most Canadian small/mid-cap equity funds (90.91%) also failed to outperform the S&P/TSX Completion index.

7. Canadian housing prices to moderate over next two years: CMHC

[November 7, 2018] Canada Mortgage and Housing Corp. says the country's real estate market is expected to moderate over the next two years as the growth in housing prices is expected to slow to more in line with economic fundamentals.

In its 2018 housing market outlook released today, the national housing agency projects housing starts and sales are both expected to decline in 2019 and 2020.

It predicts housing starts for single and multi-unit starts will fall to between 193,700 and 204,500 in 2019, while sales are anticipated to be between 478,400 and 497,400 units. Prices are anticipated to range between $501,400 and $521,600.

CMHC says it expects economic indicators like income and employment to continue to help support demand for housing starts, but these fundamentals are anticipated to slow down to a more sustainable pace.

Rising mortgage rates are also expected to affect housing demand and the resale market.

By 2020, CMHC anticipates demand will continue to shift towards relatively less expensive housing options like apartment condominiums versus higher-end single-detached homes.

"Over our forecast horizon, housing starts are projected to decline from elevated levels recorded recently. Resales should also moderate while house prices are expected to reach levels that are more in line with the fundamentals," said Bob Dugan, chief economist at the CMHC, in a statement.

8. How much time Canadians spend worrying about finances

[November 5, 2018] Canadians are spending a lot—but it's not the type of spending that shows up on their credit card statements. Rather, it's the type that shows up as lines on their faces.

On average, Canadians spend seven hours a week worrying about finances, or about 365 hours per year, finds a survey by Credit Canada and Capital One.

Survey respondents who cite financial stress as their largest day-to-day worry spend on average 16 hours a week worrying.

Many recognize the associated negative consequences, with more than four in ten Canadians (44%) saying their financial situations negatively impact their

mental health. Almost one-third (30%) say financial stress is a larger worry than their overall health.

The survey also finds that some Canadians will do most anything to avoid reviewing their personal finances.

For example, some would rather go to dinner with an ex-friend or ex-partner (11%) or get stung by a bee (7%) than review their finances. Overall, 21% report going to relatively extreme lengths to avoid a financial review. Younger Canadians are more likely than the national average to endure such indignities, at 29%.

For many, avoidance makes a bad situation worse. More than three-quarters of survey respondents (76%) say they've missed out on special experiences because of finances, including forgoing vacations (53%), expensive dinners (44%) and personal grooming (36%).

More than half (56%) are willing to make drastic sacrifices to become debt free, including never travelling or vacationing (23%), not eating out (21%) and embracing a no-spend diet (20%).

On a positive note, the survey finds that 60% of respondents have taken steps to alleviate financial stress. While 33% said they reviewed financial statements and 17% said they discussed finances with family and friends, only 13% said they sought financial advice.

9. GTA home prices rise 3.5% in October year over year

[November 5, 2018] Home prices increased in the Greater Toronto Area (GTA) in the month of October, driven in part by condo sales.

The average sale price for the month was up 3.5% year over year, reaching $807,340, reports the Toronto Real Estate Board (TREB).

Along with condo sales, price growth was driven by sales in "higher-density low-rise market segments," says TREB in a release.

It adds that the MLS Home Price Index Composite Benchmark was up 2.6% compared to October 2017.

The GTA also saw a 6% increase in home sales in October compared to the same month last year.

While mortgage stress tests introduced at the beginning of the year, along with higher borrowing costs, have kept sales below 2016's record pace, a strong economy and steady population growth are expected to support housing demand into 2019, says Garry Bhaura, TREB president, in the release.

Further, new sales listings were down 2.7% year over year in October, suggesting a tighter housing market going forward. In fact, annual sales growth has outstripped annual growth in new listings for the last five months.

To address supply concerns, “all levels of government need to concentrate on policies that could remove impediments to a better-supplied housing market, including facilitating the development of a broader array of medium-density housing choices,” says Jason Mercer, TREB’s director of market analysis, in the release.

Variable versus fixed-rate mortgages

In addition to rising home prices, rising mortgage rates will affect clients looking to buy homes.

“With interest rates on the rise and debt-laden households sensitive to higher borrowing costs, homeowners have even more reason to ensure they make the right choice,” says BMO senior economist Sal Guatieri in a report.

Guatieri sheds light on whether clients should opt for variable or fixed-rate mortgages in light of further rate hikes by the Bank of Canada. In October the central bank raised its key rate for the fifth time in just over a year, affecting banks’ prime rates.

Two years ago, the five-year fixed mortgage rate was about 2.75% or less, notes Guatieri, while it’s closer to 3.75% now. (On a $500,000 home financed with 5% down and a 25-year amortization period, the higher rate means an extra $250 in monthly mortgage payments or $3,000 per year, he says.)

Assuming a variable rate moves one-for-one with forecasted BoC policy rates, Guatieri says 3.0% is the variable rate that would leave a client no better or worse off than if they locked in for five years at 3.75%.

Why? Guatieri’s tip is based on BMO’s forecast for central bank rate hikes through March 2021.

“Assuming the Bank of Canada does what we expect it to do, 75 basis points would appear to be the magic number when deciding between a floating and fixed-rate mortgage for five years,” says Guatieri in the report. “If you can’t get a variable rate that much lower than the fixed rate, it might make sense to lock in.”

He adds, however, that borrowers have more options than fixed versus variable.

“Locking in for a shorter duration of two or three years instead of five could pay off if the economy hits a rough patch in 2021 in response to past rate increase,” he says. “The borrower could then take advantage of subsequent lower interest rates to refinance.”

Have a nice and fruitful week!

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