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1. Weekly Markets Changes

[May 24, 2019]

S&P TSX	S&P 500	Dow Jones	NASDAQ	CAD/USD	Gold	WTI Crude
16,230.04 -171.71 -1.05%	2,826.06 -33.47 -1.17%	25,585.69 -178.31 -0.69%	7,637.01 -179.28 -2.29%	$0.7437 +0.12c +0.16%	$1,284.93 -1.12 -0.09%	$58.63 -4.13 -6.58%

2. Mortgage debt manageable, stress test should remain: C.D. Howe

[May 24, 2019] A new research memo from the C.D. Howe Institute finds that most Canadian households with mortgages keep their mortgage debt at a reasonable level—although some homebuyers, particularly in pricey markets, are stretched thin.

The memo, which breaks down mortgage debt relative to after-tax income for baby boomers, gen X and millennials in 2016, noted that “most households with mortgages have no real issues.”

However, a roughly equal proportion (ranging from 10.7% to 11.9%) of all three demographic groups had mortgages that were five times larger than their incomes. The most highly indebted households were in B.C. and Ontario, where, respectively, 30% and 24% had mortgages at least four times larger than their incomes.

C.D. Howe also found that, if faced with a loss of income, many Canadians had other assets to pay down mortgage debt. A “significant” share of each demographic group had $200,000 or more in flexible assets (which include deposits, RIFs, RRSPs and mutual funds), and fewer than one in five had less than $5,000 in flexible assets.

The memo noted that the overall affordability of mortgage debt serves as evidence that the tightening of mortgage rules and revisions to the stress test guidelines are working.

“Clearly such macroprudential tools are the important mechanisms for maintaining a good mortgage environment,” wrote Paul M. Jacobson, a consulting economist and author of the C.D. Howe memo. “Their apparent success suggests that such policies should be continued. Modifications, if needed, should be based on continuous monitoring of the new mortgage approvals.”
On Thursday, Evan Siddall, CEO of the Canada Mortgage and Housing Corporation, wrote a letter to the federal government’s Standing Committee on Finance defending the current mortgage stress test guidelines.

3. Best Buy cancels pre-orders for the Samsung Galaxy Fold

[May 24, 2019] The Galaxy Fold saga continues.
Best Buy is canceling preorders for Samsung's troubled foldable phone.
On Thursday, the retailer emailed customers who pre-ordered the phone a cancellation notice. The highly-anticipated device, announced in February, broke for early tech reviewers, forcing Samsung to delay the April launch. Samsung hasn't yet said when the nearly $2,000 phone will now ship.
"While Samsung continues to make progress in enhancing the Galaxy Fold, a new release date has not yet been announced," Best Buy confirmed it wrote in the email. "Because of this, we want to let you know that we are canceling all current preorders for the Galaxy Fold."
Best Buy also included a $100 savings code for future purchases.
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"We are working closely with Samsung to deliver the Galaxy Fold to customers as quickly as possible, and we value your continued loyalty to Best Buy," the company added.
In a statement addressing the problem from last month, Samsung acknowledged the phone "needs further improvements that could ensure the best possible user experience."
Some reviewers experienced issues with the 4.6 inch-smartphone, which opens up into a 7.3-inch tablet, included defective hinges and broken screens after the Fold's protective film was removed.
To fix the various issues, Samsung previously said it would strengthen the display protection and "enhance the guidance on care and use of the display including the protective layer so that our customers get the most out of their Galaxy Fold."
The Galaxy Fold problems are another debacle for Samsung. The South Korean company has worked hard for the past two and a half years to win

back consumer trust following its Galaxy Note 7 debacle. Millions of those devices had to be recalled due to reports of exploding batteries.

4. Oil gets clobbered as trade war fears mount

[May 23, 2019] A deepening trade war between the world's two largest economies is bad news for the oil business.

US oil prices plummeted nearly 6% to a 10-week low of $57.91 a barrel on Thursday as fears about the US-China trade standoff intensify in global financial markets.

Crude, which started the day above $61, suffered its worst day since the Christmas Eve meltdown on Wall Street. Oil has now plunged 13% since closing at $66.30 a barrel a month ago, delivering a fresh reminder of the boom-to-bust nature of the oil market.

Analysts blamed the sharp selloff on both the trade war jitters that sent the Dow tumbling more than 400 points on Thursday and evidence that excess oil barrels are starting to pile up.

"The recent stock builds coupled with fears of a global economic slowdown has the market in risk-off mode at the moment," said Ryan Fitzmaurice, energy strategist at Rabobank.

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Soaring stockpiles

The oil selloff began on Wednesday after the US government revealed a surprise surge in crude inventories. Oil stockpiles have soared by 37 million barrels over the past nine weeks to the highest level since July 2017, according to ClipperData.

That raised the possibility of another supply glut forming in the oil market, like the one that sent crude crashing into a bear market late last year.

"Traders and analysts are getting antsy," Fitzmaurice said.

Investors rushed to dump shares of oil drillers, with Hess and Devon Energy plunging more than 7% apiece. Even larger oil companies like ExxonMobil and Chevron fell sharply.

Just a few weeks ago, oil prices were on the upswing, supported by solid economic growth, easing trade tensions, US sanctions Venezuela and Iran and rising tensions in the Middle East.

However, much like the stock market, investors are coming to grips with the idea that the US-China trade war might get worse before it gets better. That would slow economic growth, hurting demand for the crude oil that powers the global business.

"Crude oil demand fears are a function of global economic growth concerns associated with tough tariff rhetoric," said Ben Cook, portfolio manager at BP Capital Advisors.

Bracing for more tariffs

Nomura warned in a report on Thursday that there is a 65% chance that the Trump administration carries through on its threat to impose tariffs on all remaining US imports from China.

"President Trump appears to have concluded that maintaining a hard line against China is preferable to striking a quick, narrow, deal," Nomura chief US economist Lewis Alexander wrote in a note to clients.

Lewis added that there is a "rising risk" tariffs will remain in effect through the end of 2020.

Even before new tariffs get imposed, the existing ones have already dinged economic growth.

Business activity "slowed sharply" in May due to trade war worries, IHS Markit said in a report on Thursday. The firm's US business activity index dropped to a three-year low and new orders for manufacturing declined for the first time since August 2009.

Of course, oil prices could rapidly rebound if US-China trade tensions ease and the two sides move closer toward an agreement.

US sanctions on Iran and Venezuela have sidelined a significant amount of OPEC supply. That's on top of deep output cuts already implemented by OPEC and its allies. The producers have signaled they're in no rush to increase supply — and the latest selloff will only bolster that position.

On the other hand, the energy market could come under further pressure if the trade war continues to escalate.

Morgan Stanley warned that investors may be "underestimating" the fallout from trade tensions.

"We see the global economy headed towards recession" if the US imposes a 25% tariff on all US imports from China, Morgan Stanley chief economist Chetan Ahya warned in a report published on Monday.

The specter of a global recession would lay the seeds for a much deeper plunge in oil prices.

5. The trade war comes to Walmart, Target and Macy's

[May 23, 2019] America's top stores and consumer brands have avoided serious damage from the prolonged US-China trade clash. But tariffs are starting to bite the retail sector.

Earlier this month, the Trump administration hiked tariffs to 25% on $200 billion worth of Chinese goods. The tariffs applied to consumer products such as luggage, mattresses, handbags, bicycles, vacuum cleaners and air conditioners. Additionally, the Trump administration has threatened to expand tariffs on Chinese imports to an additional $325 billion in goods — including toys, clothes, shoes and consumer electronics.

Although major retailers have developed strategies to blunt the impact of tariffs so far, they warned that the trade war is impacting business. Shoppers will bear many of those costs.

Walmart, Target, Home Depot, Kohl's, Macy's and others said over the past week that the tariffs have forced them to either alter their financial outlooks, remodel carefully-crafted supply chains or consider raising price tags for customers.

"We're concerned about tariffs because they lead to higher prices on everyday products for American families," Target chief executive Brian Cornell told analysts on Wednesday.

Home Depot said new 25% tariffs will add $1 billion to its costs. Kohl's, which imports about 20% of its merchandise from China, lowered its guidance for this year in part due to higher costs from tariffs.

AutoZone and Nike

Retailers argue higher costs from tariffs will force them to make a tough decision: Take up prices for consumers or eat the costs and take a profit hit. Most say they'll raise prices, although it's unclear when consumers might see higher costs on the shelves or by how much.

"We can assure you that any increase in the cost of importing shoes has a direct impact on the American footwear consumer," Nike, Adidas, Foot Locker and DSW parent Designer Brands wrote in a letter to the administration on Monday. Proposed tariffs on shoes coming from China would be "catastrophic" for consumers and the footwear industry.

AutoZone CEO William Rhodes said his company would raise prices for consumers if tariffs increased the costs of buying auto parts.

"If we do, in fact, experience higher costs, it will be our intention to pass those higher costs on to our customers," Rhodes told analysts Tuesday.

Walmart also said it will raise prices on some products as a result of the Trump administration's tariffs on Chinese goods.

"We're going to continue to do everything we can to keep prices low. That's who we are. However, increased tariffs will lead to increased prices, we believe, for our customers," Walmart financial chief Brett Biggs told reporters on a call after the company's earnings last week.

Tariffs were a major focus during retailers' latest batch of earnings. Twenty-nine retailers on the S&P 500 mentioned "tariffs" on analyst calls over the past three months, compared with just seven during the same period last year, according to a FactSet analysis.

However, the Trump administration dismissed the effects of tariffs on shoppers.

Treasury Secretary Steven Mnuchin said Wednesday at a House committee hearing that he doesn't expect there will be "significant costs" for consumers.

"I don't necessarily agree with that," said Mnuchin when pressed by Democrat Rep. Cindy Axne of Iowa on whether prices of consumer goods would be higher.

With global supply teams and enormous scale, Walmart, Target and other big-box retailers are in better positions than most companies to handle tariffs.

Cornell, Target's CEO, said that the retailer's wide range of merchandise was a "competitive advantage" and allowed it to balance the impact of tariffs "in ways not available to a single-category retailer."

Still, an additional 25% tariff on all merchandise coming from China would wipe out all retail earnings growth over the next 12 months, according to Greg Melich, analyst at Evercore ISI.

Key link in the supply chain

Retailers have bought most of their merchandise for the coming months, according to analysts. But uncertainty around trade makes it difficult for them to plan their inventory for the winter holidays, said Simeon Siegel, analyst at Nomura Instinet.

Companies are "living on the edge of a tweet trying to plan for the long term," he said. Tariffs come at a bad time for retailers already facing online disruption and rising labor and transportation costs.

Chinese labor and factories are crucial links in top US retailers' supply chains and companies say there are obstacles to quickly adjusting their intricate supplier networks.

Walmart imports 26% of its merchandise from China, UBS' Lasser estimated, while Target imports 34% of its products from China. Other companies, including sporting goods, auto parts and furniture sellers, have even greater exposure to China. Dick's Sporting Goods, for example, imports 51% of its merchandise from China, while Bed Bath & Beyond imports 53% of its goods from China, according to Lasser.

Shoe companies are closely tied to China. The country accounted for 72% of all footwear imported into the United States in 2017, according to data from retail industry trade groups.

China is a "important sourcing country and consumer market for us," Nike said in its annual securities filing.
"Footwear is a very capital-intensive industry, with years of planning required to make sourcing decisions, and companies cannot simply move factories to adjust to these changes," shoe companies wrote in their letter to the administration.

6. Debt levels hit record highs at end of last year: CMHC

[May 22, 2019] Canadian household debt reached a record high at the end of last year even as mortgage activity slowed, the Canada Mortgage and Housing Corp. said in a report out Wednesday.
The debt to income ratio of Canadians hit a record high of 178.5% in the fourth quarter last year as mortgage holders continued to take on non-mortgage debt.
The ratio increased as average monthly required payments rose 4.5% compared with a year earlier, while disposable income rose only 2.5%, the agency said.
Debt levels rose as average balances for credit cards and lines of credit grew at a faster pace than in 2017, especially in Vancouver, Edmonton and Toronto, it said.
Delinquency rates, however, remain low and stable, said CMHC senior market analyst Genevieve Lapointe in the report.
“Despite high debt levels, delinquency rates remain low and the number of highly indebted and more vulnerable consumers has decreased.”
The mortgage delinquency rate came in at 0.3%, up 0.01 of a percentage point, while the share of mortgages held by those with credit scores below 600 continued to trend lower.
The total number of new mortgages issued in the quarter came in at 223,000, down 4.8% from a year earlier.
The slower volume came as the market slowed and average prices fell on slightly higher interest rates, slower economic growth and stricter mortgage regulations.
The new mortgage regulations, which set higher stress-tests for would-be borrowers in an effort to slow the market, have come under criticism in some corners for making real estate less accessible.
The International Monetary Fund said Tuesday that Canada should maintain the regulations because household debt remains high, and a gradual slowdown in the housing market is desirable.

The average value of new loans in the quarter was 3.8% lower than a year ago at $264,000 as house prices remain historically elevated, while the average value of all mortgages rose 3.1% to $209,570 in the quarter, said the CMHC. The agency said debt issues are increasing for older consumers as the share of mortgage holders 55 and older continues to grow. It said mortgage delinquency rates in the 65-and-above age group have been rising and have been the highest of all age grounds since late 2015, while still relatively low.

7. Why Corporate America's mountain of debt matters

[May 21, 2019] The next recession, whenever it arrives, could be deepened by Corporate America's debt-riddled balance sheet.

Encouraged by insanely low interest rates, US businesses have taken on record amounts of debt that funded hiring, acquisitions and generous rewards to shareholders. That borrowing doesn't seem to matter much now because the economy is strong, and companies are minting more than enough money to pay down debt.

But the next recession will expose Corporate America's debt problem, revealing that many businesses binged on too much debt. Those companies will need to rapidly deleverage by slashing jobs, shutting facilities and selling assets. Some will even go out of business.

"The problem with high debt is it limits Corporate America's ability to maintain spending in a growth shock," said Troy Gayeski, co-chief investment officer at SkyBridge Capital.

That may make the next recession worse than it otherwise would be.

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"A highly leveraged business sector could amplify any economic downturn as companies are forced to lay off workers and cut back on investments," Federal Reserve Chairman Jerome Powell warned in a speech on Monday night.

Those laid-off workers would then cut their own spending, creating a cascading effect through the rest of the economy.

And investors that enabled the business borrowing will retrench, making it harder for other companies to get financing.

"The pain that investors are going to feel will be quite enormous," said Gayeski.

Debt levels should give everyone 'pause'

By some measures, Corporate America has never borrowed as much as today. The ratio of nonfinancial corporate debt to GDP is the highest since records began in 1947, according to the Office of Financial Research, a Treasury Department bureau created after the 2008 financial crisis.

Of course, the rise in business debt makes a lot of sense given how cheap it is to borrow. By keeping interest rates near zero for many years, the Fed was encouraging borrowing as a way to stimulate growth.

"To be fair to Corporate America, when the Fed is handing out free money, you probably want to take advantage of it," Gayeski said.

But now the Fed is urging companies to exercise caution.

"Business debt has clearly reached a level that should give businesses and investors reason to pause and reflect," Powell said.

With the stock market near record highs and US GDP growth accelerating during the first quarter to 3.2%, many companies are unlikely to heed that warning just yet.

Record corporate profits, juiced in part by business tax cuts, give Corporate America more than enough firepower to pay down debt.

Just 1.7% of high-yield bonds defaulted during the past year, according to Fitch Ratings.

Kraft Heinz, Tesla and GE

However, there are some cracks emerging.

Nearly $10 billion of high yield bonds have already defaulted during the second quarter, according to Fitch. That doubles the total amount of defaults from the first quarter and led Fitch to increase its default forecast for 2019.

And some major companies have come under fire for their excessive borrowing.

Kraft Heinz, which is sitting on nearly $30 billion of long-term debt, has seen its stock price plunge 26% so far this year due to its deteriorating business. The Warren Buffett-backed food giant is racing to fix its bloated balance sheet by slashing its dividend and selling off brands.

Debt is a key ingredient in the problems facing Tesla as well. Shares of Tesla have plummeted nearly 40% this year as investors fear rising competition and trouble in China will spark a cash crunch at Elon Musk's electric car maker.

General Electric's own debt woes have forced the iconic conglomerate to slash its dividend to a penny, cut jobs and dismantle its empire.

The next subprime? Probably not

SkyBridge Capital is betting against corporate debt, as a hedge against the next recession. The firm's biggest short positions are linked to junk bonds.

"Whatever the cause may be, the acute point of pain will be in corporate credit," said SkyBridge's Gayeski, predicting "explosive upside" for the bets in a recession.

The good news is that, unlike the subprime crisis, this business debt is unlikely to be the cause of the next meltdown.

"The parallels to the mortgage boom that led to the Global Financial Crisis are not fully convincing," Powell said.
He noted that the increases in business borrowing are not "outsized" and haven't been fueled by a "dramatic asset bubble." Powell also pointed out that the financial system today "appears strong enough to handle" business-sector losses. Banks have been forced to bulk up on capital to prevent a repeat of 2008.
And there are signs that growth in business debt has moderated over the past year. That's likely a reflection of rising concern about how much longer the economic expansion can last. Investors have pressured companies to clean up their balance sheets — even in the notoriously undisciplined oil industry.
Still, Powell warned Corporate America against taking on even more leverage.
"Another sharp increase in debt, unless supported by strong fundamentals, could increase vulnerabilities appreciably," he said.

8. IMF advises against measures to boost Canadian housing market

[May 21, 2019] Measures to boost Canada’s housing market amid high household debt would be “ill-advised,” a new report from the International Monetary Fund (IMF) says.
“The government is under pressure to ease macroprudential policy or introduce new initiatives that buttress housing activity,” the IMF report said. “This would be ill-advised, as household debt remains high and a gradual slowdown in the housing market is desirable to reduce vulnerabilities.”
The international body noted that low interest rates have contributed to a booming Canadian housing market. Policy including a mortgage stress test that came into effect at the start of 2018 contributed to slowing the rise of household debt, it said.
Real estate groups and others have lobbied government to overturn the mortgage rule changes. In their pre-election budget, the federal Liberals introduced a first-time homebuyer incentive that allows clients who have the minimum down payment for an insured mortgage to apply to finance a portion of their home purchase through a shared equity mortgage with the Canada Mortgage and Housing Corporation (CMHC).
Last week, Conservative leader Andrew Scheer said a Conservative government would rework the mortgage stress test to make homes more affordable.

In its latest financial system review, the Bank of Canada said vulnerabilities linked to housing and high household debt have "declined modestly but remain significant." It attributed improvements to slower credit growth since 2017 that coincided with interest rate hikes and stricter mortgage rules.
"With [macroprudential] measures working well, their effectiveness should not be diluted by home buyer initiatives that inadvertently increase household debt," the IMF report said.
Instead, governments at the federal, provincial and municipal level should work together on a strategy to increase housing supply.
The Organization for Economic Co-operation and Development (OECD) made a similar recommendation for housing supply in a separate report on Tuesday. The OECD noted slowing household credit growth and said "no further tightening in macroprudential policy is called for at this time."
A sharp housing market correction is a key risk, the IMF said. Its Financial Sector Assessment Program stress test examined what would happen in the event of a severe recession occurring alongside significant financial market stress, exchange rate depreciation and a housing market correction. Banks would be OK in such a scenario, but household mortgage defaults would rise significantly and the CMHC and private insurers would need a $15- to $23-billion capital injection, the report said.
While monetary tightening will be needed eventually, the IMF said this should occur gradually given economic risks and uncertainty around the neutral rate. The Bank of Canada should also be prepared to cut rates if the outlook deteriorates, it said.

Slower growth projected

The IMF projected the Canadian economy to grow by 1.5% in 2019 after a slow first quarter, down from a January projection for 1.7% growth. "Over the medium term, low productivity growth and population aging will limit potential growth to around 1.7%," the report said.
The OECD downgraded its projection for Canadian economic growth to 1.3% this year and 2% in 2020. It projected global growth of 3.2% this year and 3.4% in 2020.
"The global economy is expected to achieve moderate but fragile growth over the coming two years," the OECD said. "Vulnerabilities stem from trade tensions, high policy uncertainty, risks in financial markets and a slowdown in China, all of which could further curb strong and sustainable medium-term growth worldwide."

Have a nice and fruitful week!

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